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**RESPONSIBILITIES OF THE MANagements AND  
BOARDS OF MUTUALS IN THE CURRENT ENVIRONMENT**

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- o Economic value of mutual companies
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- o Policyholders' rights to value
- o Implications for the management of mutuals
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MR. ARNOLD A. DICKE: Our first speaker is Bill Britton, with Tillinghast in Hartford.

MR. WILLIAM R. BRITTON, JR.: To kick off this session, I will couch my remarks in the framework of a mutual company considering a conversion. We will assume that the board and management have sound business reasons for conversion, and that they are looking to me as the actuary for advice. We will assume that we have discussed many of the conversion issues, including that the policyholders must have a continuation of their current dividend expectations. We have made sure that the convert company will be sound, and we are focusing now on value.

With this background, let us look at the economic value of a mutual in terms of values that might be achieved after a conversion and distributed to policyholders. Since we are at preconversion, we do not know what the value is. We have several ways of looking at value, including actuarial appraisal value and the GAAP book value. We know that, after the conversion, the value of the company will be defined in terms of market value.

Of primary concern to us is the amount of distribution to policyholders. The principal parties to a conversion. Include the policyholders, the shareholders, (current or new), management, the ongoing enterprise and the state. For the conversion to be successful, we will have to balance the interests of the policyholders and the new shareholders. In case of a tie or a doubt, the weight will always go towards the policyholders. How much is enough to distribute to the policyholders? First of all, we need to balance all of the parties interests. There has to be enough money to pay something out to policyholders and continue the organization as an ongoing viable economic entity. We also must satisfy whatever legal minimums might exist in our state of domicile or in any of the other states that may have jurisdiction over the transaction.

How much is enough? This is the single most important and most contentious question in any conversion. From an actuarial perspective we would like to provide a quantitative answer to this. So we might look at things like statutory surplus, GAAP surplus, and actuarial appraisal value. It would seem that, at a minimum, you must distribute statutory surplus. Most mutuals

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contemplating conversion would have gone through the process of calculating GAAP financial values. We also might want to do an actuarial appraisal where we would treat policyholder dividends as a benefit to be paid out in the future. Each of these amounts have some theoretical justification as the basis for distribution to policyholders. In the final analysis, however, the amount of distribution will involve an actuarial point of view as well as legal, accounting and investment banking points of view. The final determination of the value to be paid to policyholders will be a political decision made by the state regulatory authority.

Perhaps we can look at some of the recent conversions to get some idea as to what the payout might be. There have been three major life insurance company conversions recently: UNUM, (formerly Union Mutual), Northwestern National (NWNL), and Maccabees. There are a number of similarities among these companies. They are well managed, diverse, financially healthy companies. They are located in jurisdictions that have no statutory prescriptions for the payout. I think the statutes in each instance were enabling and not terribly restrictive or onerous. Finally, each of these conversions was done in a manner where forces drove the ultimate price. The differences among them are many, but let me focus on two: timing and form. With UNUM, the form was an initial public offering, with capital raised from existing policyholders, employees, and other new shareholders. The conversion was accomplished in September 1986. Northwestern National was, a kind of a cleanup of a hybrid form of structure where the existing shareholders bought out the ownership rights of the existing policyholders. No new capital came into the company. The conversion was completed in July 1988. With Maccabees the most recent conversion. There was a capital infusion from the new buyer. The conversion was accomplished simultaneously with the acquisition in January of this year.

Let us go back to the UNUM conversion and look at some of the numbers that were floating around in relation to some of the possible bases for distribution to policyholders. First, the amount paid to policyholders was \$652 million. The year-end 1985 statutory book value was \$347 million. The 1985 GAAP book value was \$652 million and this was the payout determined by the superintendent of insurance in Maine. At the time of conversion, the GAAP book value was \$739 million. One number that is not up there and is of interest is the original proposed payout to policyholders at UNUM. That was \$267 million, the statutory surplus at the end of 1984. When you look at these numbers, the payout was equal to the GAAP book value at the prior year-end, almost twice the statutory book value, but slightly less than the GAAP book value at the time of conversion. With Northwest National the payout was on the basis of the actual price of the stock in relation to the GAAP book value. For this purpose, Northwest National looked back at a recent period, 1984-1988, and determined that average relationship of the price of stock to the GAAP book value was .88, and that was the amount that went to policyholders. With Maccabees, the amount paid to policyholders was an initial distribution of \$100 million with \$10 million held back in a contingency fund, based on a 1987 year-end statutory book value of 38 million and a 1987 year-end GAAP book value of \$67 million. So that with Maccabees, the payout was 1.5-1.6 times GAAP book value and 2.6-2.9 times statutory book value.

For interest, I contacted the research area of a stockbroker with whom I deal and obtained some average purchase prices of stock life insurance companies in each of these years. The averages were determined in relation to GAAP book value. The range is not that great, being 1.2 in 1986, 1.3 in 1987 and 1.2 in 1988.

I also looked at the same research firm's tracking of 40 stock life insurance companies' average trading values at specified periods. They track these values weekly, so I picked off some values that were of interest. In September 1986, the average trading price of the 40 stocks in the group was 1.5 times GAAP book value.

In September 1987, the ratio was 1.4. The October 1987 value shows the effect of black Monday, as it dropped from 1.4 to .9. Then at the same time in 1988, the ratio went back up to 1.1, and currently it is about 1.2.

So all of these together let us see if we can learn anything from it. With UNUM, the payout to book ratio was 1.0 accomplished in September 1986, when the ratio of average purchase price to book of life insurance companies was 1.2 and the average trading price to book was 1.5. With Northwestern National the payout to book ratio was .9 in July of 1988, when the average purchase price to book ratio was 1.2 and trading price to book ratio was 1.1. For Maccabees, the payout to

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book ratio was 1.5, when the average purchase price to book ratio was 1.2, and the average trading price to book ratio was 1.2.

What can we conclude from this? I do not want to draw all the conclusions because that would be the subject of some more discussions, but let us take a look at a few.

First, form is important. Initially, I think many of us thought that initial public offerings would be the primary route that companies would take to conversion. But I would urge each of you who are contemplating such an action to study carefully the Maccabees model. It is quite interesting, and it may be a situation where all parties win.

Second, timing is important and investment bankers would tell you that the time you bring your conversion to the market may be everything.

Whatever the form and timing, it is clear that a conversion can create significant values for the existing policyholders. In a sense, they can have their cake and eat it too. They can get immediate payout in the form of cash or shares of a new company and they can continue to have the same policy and dividend expectations, through, in the case of the conversions so far, a financially stronger operation.

MR. DICKE: Our next speaker is Patrick Delaney. He has had extensive experience in corporate representation and in administrative and regulatory matters. He acted as the special counsel for the state of Minnesota insurance commissioner for mutual policyholders' interests in the conversion of the mutual department of the NWNL companies to a stock company. Mr. Delaney is a frequent lecturer at continuing legal education seminars on corporate law. He wants me to point out that the views he expresses are his own and not, necessarily, those of the state of Minnesota insurance commissioner.

MR. PATRICK DELANEY: My practice is essentially in corporate and regulatory law, and I have consulted with a number of mutual insurance companies about potential demutualizations. I was special counsel for the insurance commissioner of Minnesota in the NWNL deal. One thing that might be useful to talk about is the difference between the approach that actuaries take to this sort of transaction and the approach taken by some of the uninitiated such as me. The best way to illustrate this is to tell you about my classmate Kelly in law school. Kelly was the guy who had a good record in law school, seldom bought a book and seldom went to any courses, except for one admiralty law class. As those of you who went to law school know, courses typically run for one year with one test at the end. You get a blue book and somebody gives you questions and says write for four hours. In our international law course Kelly showed up the first day, did not buy a book and showed up for the test. The subject of the question was a train wreck on the German-French border. It was a complicated thing about all the different nationals who were involved and then the professor said "write about this." I am afraid that this is the same way some of us understand actuarial science.

I want to talk about a couple of things that relate particularly to mutual companies. I will start with the director's duties. There is a notion among some that the directors of mutual companies have duties different from those of the directors of other insurance companies and, indeed, other business corporations. There is no foundation for that in Minnesota or Delaware law. I cannot speak about the law of the other 48 states of the union, but I think I am right in saying there is no real difference. There are two duties. One is the duty of loyalty to the company and the other is the duty of care, both of which are called into play in the proposed demutualization or conversion transaction. Another interesting point is that those statutes that relate to the duties of directors and that relate particularly to insurance companies grant to insurance company directors the same degree of indemnification by their companies as if they were directors of industrial corporations. One thing that Bill talked about I would like to touch on is the form of these transactions. The form of the NWNL transaction was the creation of an upstream holding company and a merger into it. I think that was an essential part of that transaction and an essential advantage to a number of people.

Now, let us go to the subject that Bill addressed most specifically and that is value. In a conversion in Minnesota, the governing statute says that each policyholder is entitled to shares of stock of the company purchasable by his equitable share of the surplus. It is a wonderful formulation when you think about it. The first question that we had to address was what does the

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word equitable mean in that context. Is that a term of accounting art or is it a term of legal art or does it just mean fair? The insurance commissioner of Minnesota ruled that word meant fair in that context. In Minnesota, the conversion statute permits the payment of cash, as in other states, in lieu of capital stock. Both forms of consideration were paid in the NWNL transaction. It is useful to note the analogy between a conversion and a merger of two corporations. In a conversion, under Minnesota law and that of most other states, a dissenting policyholder has the right to payment. That is, he has the dissenter's rights as if he were a dissenting shareholder in a typical business corporation merger. In fact, in Minnesota, the way that a demutualization transaction proceeds is that evidence is produced both in the form of the application filed by the company seeking to convert and at a public hearing held for the purpose of examining the matter and permitting members of the public and other interested persons to comment. The commissioner must approve the plan if the plan, first of all, has been approved by the policyholders. That requires the distribution of a proxy statement that meets the requirements of The Securities Exchange Act of 1934. The proxy is therefore a lengthy and difficult document. Secondly, it requires that the plan not violate any other law and thirdly, the heart of the matter, the plan cannot be contrary to the best interests of the policyholders. That gets to the question of valuation. The principal question is what constitutes surplus -- is it statutory surplus? Is it GAAP book value? Is it the breakup or the aggregate market value of the company or, in the case of NWNL where you had both a mutual company and a stock company in one organization, is it the market value of the stock as traded? In the NWNL case, there were various discussions and proposals and filings. The fact is the securities commissioner, and before him, the hearing examiner found that it was fair to pay the mutual policyholders an amount, as Bill said, that constituted a ratio of the preceding few years' market value to the GAAP book value of the company.

One thing that all who are involved in this business ought to bear in mind is the principle that was laid down, and I think poorly laid down, but nonetheless it stands there, in the old Union Insurance case in Nebraska in the late 1970s. The court ruled that a ruling by an insurance regulator that a distribution to mutual policyholders is fair does not settle the matter. The directors may still be liable for an element of unfairness which someone can prove in court. Therefore, the directors have their own duty and need to undertake due diligence and to consider the matter independently of the consideration given to it by the insurance commissioner.

One other most interesting subject that I am going to leave to my fellow panelists, particularly to Arnold, is the subject of what exactly is the nature of a mutual policyholder's interest? That is a subject that has not been given a good deal of treatment or thought, by the legal profession. I think people consider the interest of a mutual policyholder to be the same as that of a stock holder. The reason they do is that when the question comes up, it is in the context of a conversion that you have to come to grips with it.

MR. DICKE: Our next speaker is Jules Pallone, who was Chairman and President of Maccabees Mutual Life Insurance Company, and now is President and CEO of Royal Financial Services, the company that was formed by the conversion of Maccabees Mutual.

MR. JULIUS L. PALLONE: Arnold asked me to talk about the process that we went through to demutualize -- how we started and some of the things that happened as we went along. One thing about which I am glad is that no one from Royal was here to hear Bill because they might have felt that they paid a little bit too much for the company.

Let me go back and give some background on Maccabees. This is the second conversion that Maccabees has had in thirty years. Maccabees started out as a fraternal society back in 1878, and it converted to a mutual company in 1961. On January 1 of this year, we converted from a mutual company to a stock company. It is interesting to compare the two conversions -- when the company went from a fraternal to a mutual, it took in excess of 2½ years to complete the transaction from the point that the board had approved the conversion; there was a tremendous amount of resulting litigation that was not expected because a fraternal and a mutual are not so far apart; and there was a complete loss of the company's sales organization. The conversion from a mutual to a stock company took less than six months from the time that the Board had approved the conversion. So it is interesting to look back to see the differences -- to see what happened to make that conversion a much easier one to complete even though it was certainly a more complicated type of conversion. Well, first I think that we spent a great deal of time preparing for the conversion, including communicating effectively with all our people -- inside people, the

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employees of the company, and our sales force. We made certain that they understood why we were looking at demutualization and what would be the results of converting from a mutual to a stock company, particularly, how it affected them. The other thing that was critical to the success of the conversion and lack of any litigation or negative reaction was the fact that the Board saw its main responsibilities as the responsibilities to the policyholders, recognizing clearly that it also had to be concerned with the interests of the employees and the sales force. Still the policyholders were, in the Board's mind, its major responsibility.

Let me go back to talk about what motivated us to consider demutualization in the first place. Maccabees had grown very rapidly in the past seven to ten years. The amount of surplus that we had was adequate, but certainly it was not sufficient for us to continue to expand at the rate at which we were expanding. It also was not sufficient to satisfy what we believed to be the abilities and the potential that the company had. We had a staff of people that were capable of doing a great deal more than we thought our surplus would allow us to do. We had agents who produced a tremendous amount of business -- some of it with us, but some of it with other companies because we could not accommodate their total needs. We could not write single premium life business, we could not write annuities and we could not do a number of other things because of our surplus constraints. We needed to look at what options we had to raise surplus. We looked at reinsurance arrangements. However, those are temporary, and long term they really do not work, at least in our case we did not think surplus relief arrangements would work. We looked at a subsidiary stock company we had formed. We thought about taking that company public and selling a piece of it and so on, but that certainly would not have produced anywhere near the kind of money that we felt we needed in order to pursue our goals and objectives. And, obviously one alternative that we had was to cut back and say well, all right, we are not going to do all of these things, we are going to be a different kind of company, but we felt that should be the last resort. That was only if we could not do something else. So demutualization, converting to a stock company, seemed to make a great deal of sense. We spent quite a bit of time discussing it and came to the conclusion that we should pursue it.

The next question was -- well, do we go public, or do we seek a parent and convert and be acquired at the same time that the conversion takes place. Our Board leaned toward going public because they felt, at that time, that the policyholders might be better off if we went public. They would get shares of stock and would benefit from longer term in the growth of the company. Management leaned toward being acquired. I think the deciding factors were 1) we looked at the size of our company and realized that we would be easily acquired at some later date by someone else, 2) the number of policyholders (we had about 150,000 policyholders) to whom we would have to distribute stock, maybe not to all of them but to many of them, and the cost associated with that stock distribution far outweighed the benefits that they would get and 3) the uncertainty of going public, the uncertainty that we would have the ability to raise money, particularly since as a mutual company, we had never done GAAP statements, and so did not have a track record to which we could point. As a result of that and after quite a bit of a discussion, we decided that the approach that made the most sense for us was to convert and be acquired by a company that could provide us with the kind of capital for which we were looking and could also give us the autonomy that we wanted to have -- quite a big order. We communicated this plan to our agents and to our employees, and we identified carefully the kind of company for which we were looking.

We started talking with companies about 3½ years ago. We talked with three companies prior to our discussions with Royal. The first two we disposed of fairly quickly, primarily because we were just getting our toes wet. We were just finding out what demutualization and being acquired was really all about. With the third company that we talked, negotiations were carried on for quite a long period, actually for about one year. We came to the point where we were just about ready to open the champagne because the deal was going to be done and then suddenly it was not done. Let me tell you a little bit about why it was not done. This company offered us everything. It was wonderful. First of all, they met our requirements. They were a strong company, highly regarded, international in scope, and they had no insurance operations in the U.S. They were looking for a U.S. company upon which they could build and expand. Also, they were far away which was nice. It makes life easy when you do not have to deal with someone across the street or in the next state. They agreed, and our Board was astounded that they did this, that our Present Board in effect, could retain control of the company for 10 years. This was an unusual agreement. They also gave management, I would say, 24K gold parachutes and a very lucrative long-term incentive plan, one that could have made quite a few people rich at Maccabees. The distribution

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to policyholders was in the neighborhood of, looking at it after the facts, 90% of GAAP surplus and that is where the problem arose. Quite frankly, management felt that was right and fair. After all, policyholders are not stockholders. Therefore, it is a bonanza for them anyway; all their other benefits remain intact, and all they give up is the right to vote, which most of them do not exercise. After we got to this point, our Board decided that they should have an investment banker look at this and give a fairness opinion. The investment banker refused to give a fairness opinion or decided not to. The Board felt that the policyholders had to be treated in the same way as stockholders would be treated. We had a great deal of discussion. We read all the available papers on the subject. If you want to read some interesting papers, there are about 10 or 12 different papers on this subject. Their points of view range all the way from the surplus of a mutual company in a conversion belongs to the state to, and I love this one -- it is called the captain theory -- it all belongs to management. But, we could not convince our Board that was the way to go. They liked the one that said it all belongs to the policyholders. As a result, the deal was not made. I think we had gone down this track with this company too far for them to change their position, and they did not like the fact that this had changed at the last minute.

We then talked with Royal sometime in early 1988. We now had a pretty good feel of what it was that the Board would approve. Very clearly, we would have to get an investment banker's fairness opinion. Very clearly, we would have to look at something other than what we had looked at up to that point, which was statutory surplus plus present value of future profits on the existing block of business. We would have to do a GAAP set of numbers and an actuarial appraisal, and see what those values presented. We did those things, and as a result, the Board and the people from Royal came to an agreement that seemed quite reasonable. We then went to the insurance department. We had not talked to the insurance department until then, and that was about June 1988. When we went to the department, they basically asked us three questions. The first was -- what is the total dollars that you are paying to your policyholders, and how does that relate to these other numbers? Obviously, from what Bill just showed you, those were very nice. The relationships were wonderful and they had no concern about those. The second question was -- how are you going to distribute those dollars among your various classes of policyholders? A great deal of work had been done in developing that distribution. Probably the major work that was done was to determine how to equitably distribute this amount of money to the different classes of policyholders, including not only our individual policyholders, but also our group policyholders. We satisfied them that what we had done in that area was done as fairly and as objectively as we could do it. The final question was -- what are management and the board getting out of this deal? In this case, we had to say nothing because that was what we were getting out of it -- at least up front. There is obviously some potential down the road, well nothing except opportunity, which is the reason that management approached demutualization in the first place. I think you recognize that we did not go into demutualization with the idea that we want to distribute money to our policyholders. We were not that altruistic. We went into demutualization with the idea that it was in the best interest of all parties, including the employees of the company, to do it, and the policyholders would come out of this certainly no worse off but most likely much better off. As it turned out, they were. Demutualization took place and once the department was satisfied with our answers, which was in June or July of last year, they were incredibly helpful in pushing this demutualization through. They worked with other insurance regulators around the country to get their approvals because we needed approval from all the states in which we are licensed, which is all except New York.

Now that it has been done, how do we feel about it? Well, from the policyholders' standpoint, they certainly have been winners. The cash distribution of \$100,000,000, and it may be something more than that, was very significant. Some of the older policyholders received an amount equal to their cash value. Certainly, that is a significant amount of money. Our newer universal life policyholders, a fairly large group of people, only receive \$135, an amount sufficient to buy out their voting rights. I believe that about 40,000 of our total policyholders were universal life policyholders. We walled off the traditional life policyholders and we put into the walled off portion assets sufficient to meet the dividend payments that our present dividend scales provided, and to meet the potential for those dividends to be increased in the future if our experience is better than expected. So they remain walled off and they will continue to participate in their own experience, as that experience develops. Certainly, we have a much stronger company. Our surplus increased from roughly \$35 million to more than \$100 million at the present time, and we have access to additional funds if we need them, e.g., if we could justify the use of those funds to profitably expand our business. It is interesting that 98% of the policyholders who voted, voted in favor of demutualization, even though a fairly high percentage of those people only got \$135. The

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total that voted was somewhere between 40-50% of all policyholders. This was a very favorable response from our policyholders.

The employees certainly benefited from the demutualization. We are now part of a much larger international organization. The interaction with that organization has been very positive. Our actuaries, for example, have traveled to England a number of times, one benefit they would not have had without this demutualization. But there are many other benefits and much more potential that result from being a part of this much larger organization. Our opportunities are much greater. We are developing new products, expanding our markets, and taking advantage of the additional capital that we have available. The opportunities of personal growth within the company are also expanded, I think, as a result of this happening. Our agents are very happy with it. That was one of the areas of concern -- would our agents accept this as a positive or would they see it as a negative? Well, they are happy because they represent a much stronger company. We have had an "A" rating from *Best's* because of our leverage ratio-surplus to adjusted insurance inforce. In fact, we met all the other requirements of an "A+" company, but we did not meet that one. Well, we still do not have the "A+" because *Best's* does not react too quickly, but hopefully that will happen and make our agents happy. Plus, again, the availability of additional products is something to which they look forward. Royal is happy. They now have a life company in the U.S. which they wanted; they already had a large property and casualty (P&C) company here. They have a large life insurance company in the U.S. which has the potential of becoming a very large life insurance company, and they are happy. How do I feel about it? I guess I feel basically that reporting to God was fine, but reporting across the ocean is not too bad. It all worked out fairly well.

MR. DICKE: Now we will change gears a little bit. We have talked so far about conversion of mutuals to a stock form. But our topic is responsibilities of the boards and managements of mutual companies and we intend to include those mutual companies that intend to continue as mutuals. Our next speaker is Jim Morton. Jim is a Fellow of the SOA and he is Chairman and CEO of the John Hancock.

MR. E. JAMES MORTON: Well, I wish I had some of those great war stories to tell as Jules and some of the others have, but we have not demutualized so I cannot do it. I would like to try to give you a very sketchy overview of how the top management of one large mutual life insurance company has responded to the environmental changes that we've all experienced recently, and the reaction of the Board of Directors to those actions.

I might start out with a sentence or two of personal history. I've been Chairman of the Board and CEO of the John Hancock for about 3 years; I was President and Chief Operations Officer for 5 years before that; and for the previous 32 years I fought it out in the trenches, including a 7-year trip as Chief Actuary of the company.

At the John Hancock we began what is today called diversification more than twenty years ago when we entered the mutual fund business and the P&C business; and at the same time started getting our feet wet internationally with the purchase of a Canadian life insurance company and the establishment of an international network for the reinsurance of employee benefits provided overseas by American multinational companies.

The motives of those moves were clear -- the mutual fund and P&C entries were designed to put more money in the hands of our agents; the international moves were essentially to enter markets that we had previously neglected. In addition, I would also say that ego-building had something to do with all of them. Making money was a subject that I never heard mentioned, either at the time or for quite a few years afterward.

As you all know, everyone in the industry received a sharp culture shock in 1979 and 1980 as a result of sharply rising interest rates, high inflation and the first stages of deregulation. Like everyone else, the John Hancock underwent severe cash flow problems and then took a fresh look.

It was in 1980 or 1981 that we came to a deliberate conclusion about our future. We wrote it down, and with very little change have been following that road ever since. What it said then in part was:

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"The mission of the John Hancock companies is to be a prominent and financially strong provider of a broad range of insurance, financial and administrative services and products to individuals and organizations."

This course was not chosen without debate, but it was certainly accepted then, and has been ever since, as the guiding statement of the corporation.

As to why we chose that path, I believe it is fair to say that we believed it was a matter of survival. It seemed that everyone was trying to get into our business -- it seemed reasonable to get into theirs. It was also clear from the emerging savings and loan (S&L) experience (and from our own asset-liability matching and disintermediation problems) what could happen when you had all your eggs in one basket. There was also the alluring opportunity, as we saw it then, for synergies such as expense reduction and cross selling. And finally there was "positioning" which meant that with a diversified group of services one could go wherever the current economic winds were blowing. Needless to say, some of those feelings about the future have proved to be more accurate than others.

Looking back now, I recall that the only real debate at top levels was not *should* we do it, but *could* we? Did we have the resources -- money, talent, and will -- to compete with Citicorp, American Express, and Sears Roebuck -- to name a few. What made our decision unanimous was that we truly felt we had no other choice.

Having made that decision, we had to convince our Board. Our Board has always been made up chiefly of prominent outsiders representing diverse disciplines and points of view. That they accepted this revolutionary change in direction was a tribute to either their perspicacity or to management's salesmanship -- perhaps equal portions of each. But they did buy into it and have continued to support it through several generations of CEOs and changing board composition. During those first years we bought a stock brokerage firm with some investment banking capability, we entered the banking business, we started a leasing company, we expanded our casualty business into commercial lines and reinsurance, we began direct insurance operations in southeast Asia, and a number of other odds and ends. I look on that phase as sort of collecting the pieces.

It rapidly became clear that making it work was a lot different from collecting the pieces. For one thing we had some organizational problems. Our approach was to collect everything together in a downstream holding company called, not surprisingly, John Hancock Subsidiaries, Inc.

The second thing we needed to do was to set some priorities, and it is at this stage that I am finally getting to the topic of this discussion.

If one believes that one must take a certain action in order to just plain *survive*, it is clear that taking that action is in the best interest of the policyholders -- at least in short run. But it was also clear to us that other actions, such as shutting down any further sales operations, would provide a much higher return to the existing policyholders than anything else.

We came to the same conclusion that I think the managements of mutual companies have come to over the centuries -- and that is that our responsibility is not only to the existing policyholders, but also to those yet to come. Staying in business is important. There is also the not unimportant question as to whether or not the existing policyholders are really entitled to all that surplus built up by past blocks of now extinct business -- but that is another subject.

In any event, our conclusion was that any new venture we entered into would be required to plan for an eventual rate of return on its investment which, on a risk-adjusted basis, would be comparable to other investments available to the company. This decision was without doubt the most important and the soundest one that we made and it had very far-reaching implications.

To restate it, our decision was that our new ventures, as well as every other business unit, had to be *profitable* -- that word which for so many years had fallen just short of being obscene in a mutual company environment.

The first thing we obviously had to do was to build an accounting system that would show whether anything was making money or not. Our statutory accounting system did not do it. The



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creation of a true GAAP system took us several years, cost several million dollars, and its development is still continuing. But a few years ago when we started getting our first quarterly reports, it provided a whole new viewpoint for management and our directors alike. Now "earnings" are such a part of our life, it's hard to believe that we ever operated without caring about them.

It was also clear that our organization was totally unsuited to the new profit-oriented environment, so we shifted to a profit-center system and decentralized most of the corporate decision-making authority to the profit-center managers. By the way, that position of "profit-center manager," although not an official title in the company, is the most sought-after job that we have.

Finally, it was necessary to change the way we compensated people. We have both long- and short-term incentive plans where the amount of money distributed is highly dependent on bottom-line results. At the upper levels of management 50% of one's annual compensation in a good year can come from incentives. I hasten to add that we have also had some bad years, in which that percentage can -- and has -- dropped to zero.

In short, this simple reordering of priorities or I should say "ordering" since we really had no priorities before has truly changed the "culture" of the company. We are actually very close to running our business like a business.

In all this, our Board has been extremely supportive, and I think in many instances because they have been subjected in their own world to even more change than we have experienced. For example, I have on my board the CEO of Gillette, who has fought off the raiders and is now dealing with the results of that battle. We have the CEO of Nynex who essentially underwent the same changes in culture we did and also has some interesting union problems. I have a banker who is heavy in Brazilian loans, a scientist on the board of Exxon, the CEO of a major manufacturer of military hardware, and the Chairman of the Board of a utility owning a piece of Seabrook. Sympathy for dealing with the forces of change is not hard to find from such a group.

But my board has in no way ignored the theory questions about policyholder value and ownership. We have had several full scale presentations to them on demutualization, including a close analysis of the union mutual case, and the implications for the John Hancock.

In all those discussions, I must tell you that the interesting question raised by Arnold Dicke has never been raised by my Board. That is, should we consider demutualization in order that the existing policyholders may realize their value in the company. On the other hand, the usual reasons put forth for demutualization have been considered carefully. As you know these are the difficulties of raising capital in a mutual company (other than by earning it -- an apparently distasteful prospect to some); the wish to change to a more entrepreneurial culture; and perhaps the difficulty of diversifying because of not being able to form an upstream holding company. In addition, I believe that my directors believe as I do, that demutualization is probably inevitable at some time -- and I wish to emphasize *at some time* -- not now, and not in the immediate future. That is because our participating policyholders are shrinking rapidly as a proportion of our total customers.

None of our banking customers, our mutual fund shareholders, our leasing customers or our P&C policyholders are *participating* policyholders of the John Hancock Mutual Life Insurance Company. For that matter, neither are people who have life insurance policies from our Canadian subsidiary or any of our own John Hancock variable life or universal life policyholders. At the moment we manage about fifty billion dollars of assets and have about six million participating policyholders. What will happen when we manage a trillion dollars and have one thousand participating policyholders? Perhaps some changed form in organization is inevitable.

I think our Board, if I may use the expression, is on board with management on these questions. If the question of distributing all the value now to the participating policyholders ever does arise, it will likely be far in the future when we have examples to follow, legislative guidelines to adhere to, and, most importantly, some other CEO than me.

MR. DICKE: Now we are going to have some questions. I also have a few that I would like to ask the panelists that were provided to them in advance of the session. The first question was already

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answered by Jim, so perhaps we can ask the other panelists what they think. The question is: "Do policyholders have a right to demand that management actively seek demutualization deals which would result in a large one time distribution to the current policyholders?" Would anyone else like to tackle that?

MR. PALLONE: I guess I would comment that I do not think policyholders have yet exerted their right to demand it. I guess I would feel that once the company has decided to do it, the policyholders have a right to get everything to which they are entitled.

MR. DELANEY: I think, Arnold, that pretty clearly they have no right to demand demutualization, but likewise clearly they have a right to have the Board consider it as an option.

MR. DICKE: Let's put this in context. Suppose you were a board member and consider the kinds of broad responsibilities that had been placed on boards in general since the early 1980s. The boards of stock companies have, of course, become more and more vulnerable to stockholder suits. Are you sure you would feel comfortable that mutual company board members have nothing to fear?

MR. BRITTON: I want to add a slightly different slant. I agree with the others that policyholders do not have a right to demand it. But, at the same time, the board has an obligation, to consider it either from a business standpoint or in the context of what you just said, maybe a potential defensive obligation to demonstrate that they have considered it. If it appears to be right that is one question, and if it appears to be wrong, they can save it for the record. I do think that the board needs to consider it because I do believe that conversion may be the best option for a number of companies in the future.

MR. DICKE: Let me make the case a little stronger. How should a mutual company board react to an unsolicited offer that the company demutualize and then be acquired? Does that change the situation at all?

MR. PALLONE: I think that, like any other legitimate question, our board is only required to react to the requests that come from policyholders and I am not ever sure that they are required to do that. Presumably, if you got an unsolicited offer from some other organization I would think that organization would try to stir up some interest among the policyholders of your company, and I think the board would have to consider that. They are supposed to act in the best interests of the policyholders.

MR. DELANEY: Arnold, I think that unsolicited offers must be considered by the board members, and, if they are not, board members could be held liable to the policyholders. The thing that ameliorates that is that policyholders of mutual companies are not terribly well organized at the moment, but I have faith in my brethren who are plaintiff's lawyers that they will figure out ways to organize those people in the future.

MR. DICKE: In light of this type of situation, does it make sense for mutual companies' managements to be pursuing anti-takeover strategies, and, if so, what sorts of things could be done?

MR. MORTON: Arnold, I think we already have one. We have six million policyholders. It is very difficult, I would think, no matter how good the lawyers are, to organize that. We have had a couple of instances in our company over the years where there has been an effort at some fringe group of policyholders' involvement. It certainly has proved not difficult for management to collect some overwhelming number of proxies on this subject. Whether or not the kind of proposal that you talk about would do it, I do not know. But our rules, our bylaws, I think the laws of Massachusetts require that any kind of change in the Board of Directors that is not initiated by the Board has to come up with 1/10 of 1% of the policyholders or something like that; 1/10 of 1% of six million is a big number.

MR. DELANEY: Well, I was just going to say to support what Jim said that I believe that part of the record of the NWNL conversion was that at one time, one of the famous corporate raiders accumulated a significant amount of that stock, forgetting that it was both a stock company and a mutual company and then came along and said he owned a good deal of stock. The CEO of

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NWNL was able to say, "Gee, that's interesting, but you know we have hundreds of thousands of mutual policyholders who actually control the vote." That killed the takeover attempts quickly.

MR. DICKE: So the conversion probably makes them, in a certain sense, more vulnerable now. They do not have that particular takeover defense.

Maybe we should ask a general question that came up in our discussions earlier. What is the nature of a policyholder's interest in a mutual company as compared, for example, with a stockholder's interest in a stock company?

MR. MORTON: You cannot sell it to somebody else.

MR. DELANEY: It terminates with the policy.

MR. BRITTON: There has been a fair amount written in the actuarial literature and in other literatures. The range of opinions seems to go, from the policyholders owning everything and having the rights to everything, to the policyholders owning nothing. As a practical matter, future conversions are likely to be assessed by the regulatory authorities in the light of the policyholders getting at least a fair share. If values are to be distributed, and all else is equal, policyholders will need to have a more, equal value than others.

I focus on the policyholder intent, and that is the appropriate focus. The contrary opinions about policyholder rights will just not fly in light of the regulators' interests, concerns and attitudes.

MR. DICKE: Let us turn to the question of diversification. I guess I have this vision -- I suppose it is like the vision of the natural man that philosophers had in the 18th century -- of the natural mutual company being organized in order to benefit its individual policyholders. Then, somehow, through time, most of the mutuals -- probably all the large mutuals -- have accumulated a great many other businesses and diversified into a number of areas. What kind of criteria should be applied to decide if a particular diversification proposal is appropriate, and what sorts of diversifications meet these criteria for a typical mutual company?

MR. MORTON: Well, Arnold, I think I did respond to that from our point of view. As far as we are concerned, any new venture has to stand on its own feet as an investment of a policyholders' money. Once you have done that, it seems to me that you are free to pursue other ventures as long as they meet those criteria. It certainly is true of most new ventures that it takes a long time before you get back your investments. That is the critical nature of it, and I believe that if you are going to diversify, you need to have the philosophy that it is an ongoing organization. You are not going to wrap it up and go away in a short period of time.

MR. BRITTON: I believe that underlying profit motive is the fundamental criterion for diversification. If you look at the 3 companies we have been studying, all were highly diversified companies. All of them, I think, ultimately would have been in danger of what I see as the policyholder implosion that Jim described a bit earlier -- once you diversify, parts of your enterprise are in a non-mutual part of the organization in substance if not in form. Sometimes you accomplish that by putting things in the downstream subsidiary. Other ways would be to have universal life policies, for example, that are technically par policies because they are written in the parent company, but with no intention ever of paying dividends. So long range, diversification is going to lead you in a direction that minimizes the historical mutual policyholder owners of the company, and you need to consider that when you go into diversification. Also, I think that diversification is going to be necessary for survival.

MR. OWEN A. REED: I will make some comments in which you might be interested. In Canada, there are some recent regulatory developments. The industry is going to be subjected to new legislation, and the regulators have been considering what to put in to protect the rights of participating policyholders. Very briefly, the latest version that they are asking for reaction to is that there should be a written policy on dividends which is approved by the board of directors. A short synopsis will be given to each participating policyholder each year. On the question of diversification, their idea is that policyholders be able to ask questions about any potential diversification and call a special meeting with regard to it.

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MR. DICKE: Thank you for filling us in on that. Going back to some of the deals that went through, what has happened to the stock price after demutualization? Have these things worked out in that regard?

MR. BRITTON: UNUM started out at 25.50, the subscription price of the offering. In the year that it demutualized, 1986, it traded slightly above that range to about 28. The following year, 1987, it traded between 15 and 31, so it got hit pretty badly. I did not trace back to see if the 15 was right after Black Monday. It is now in the 40 area, so it seems to have done quite well. I think UNUM's primary problem was managing and employing all the capital that came in with the conversion. There was more capital than could be used in the existing business. The Northwestern National conversion does not seem to have adversely affected the price of the stock. There was probably some temporary dilution as a result of the conversion, but it seems to have traded well. Jules would know more about the impact that Maccabees has had on the Royal.

MR. PALLONE: The impact it had on the Royal may be 2 or 3 pence. I am not sure if it was negative or positive, but it was minimal.

MR. DICKE: Royal is much larger than Maccabees, is that it?

MR. PALLONE: Royal is a company that has operations in 80 countries and surplus of about \$4 billion, so we are insignificant at least at this point. Hopefully in the future we will not be, but as far as the stock value is concerned, we are.

MR. PETER S. KREUTER: Mr. Pallone's comments certainly seem to indicate that the demutualization of the Maccabees was successful in terms of accomplishing the goals of providing access to additional capital. With regard to the other two demutualizations that were discussed, does management feel that those were likewise successful?

MR. DICKE: I am afraid we do not have anyone to answer that question authoritatively.

Besides demutualization, another strategy that could be undertaken to possibly benefit policyholders would be a merger of mutual companies. A number of people suggest these have been held back by the reluctance of management to be part of an organization where there are fewer management positions.

MR. MORTON: I do not know if there have been any or not. But I know there has been a lot of talk about them, and there have been a number of proposed mergers that almost got to the merger stage and then fell apart. I think the reason is the difficulty of trying to put together management teams and especially of trying to make sure that the boards of directors of both parties are accommodated. Certainly when you look at what might happen through the merger of a couple of midsize companies, you often find that the resulting balance sheet is very much improved. You certainly should get economies of scale. It is surprising that these have not been pursued more often, and I think it all boils down to the people question. I think I was telling Arnold that you need to find two mutual companies where both CEOs are about to retire and have no successors.

MR. PALLONE: I might add to that, Arnold, that we did at one time prior to pursuing demutualization consider merging. In fact, we had quite a long discussion with one company that had lots of surplus and really was not doing anything. We felt that was an ideal company with which to merge. It would have satisfied our surplus requirements, but the people problem killed the deal because the other company wanted more than we were willing to give and vice versa. Perhaps, if the two CEOs had been ready to retire, it would have been different.

MR. BRITTON: Yes, as a practical matter, that will hold for the future as long as we do not have any severely distressed situations nor any severe jolts like we saw with interest rates in the early 1980s. I think the first mergers of mutuals might occur in distressed situations or if there is an overall jolt, such as the one in interest rates. The ego problems will become less important, survival may become paramount and we will see some mergers.

MR. ISADORE JERMYN: I have a few questions. My first question is for Jules Pallone. You mentioned that the distribution of the surplus by class of policyholders was well received by the

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insurance departments. Is the method of distribution a matter of public record or do you expect it to become one? Is anyone proposing to write a society paper on this subject?

MR. BRITTON: In all 3 situations, at UNUM, the method of distribution is a matter of public record. There were actuarial opinions on both sides describing how it was done. They are available through the state insurance departments. That is true in the case of Northwestern National as well.

MR. JERMYN: The second question relates to the concept of walling off assets. In the case of Maccabees, there was talk about assets having been walled for the previously participating policyholders. Is it anticipated that future dividends to those policyholders will only result from experience on those walled off assets? Might some of the experience that is derived from the new business ventures accrue to the benefit of the previously participating policyholders, or have they effectively signed off any rights to those ventures?

MR. BRITTON: The latter is the case. The walled off assets at both UNUM and the Maccabees were determined in a manner that would, under current conditions with the current dividend scale, give reasonable assurance that dividend scale could be met. If for any reason the basic policy benefits could not be met, there is an obligation on the part of the Maccabees, Royal and UNUM to fulfill the basic policy obligations, but not the dividends. The existing policyholders that are in the walled-off block will not participate in the experience of new business ventures. If expenses are reduced because unit costs are reduced as a result of the demutualization or merger, there would be some benefit to the walled-off policyholders.

MR. JERMYN: Could it only be of a positive nature?

MR. PALLONE: Yes.

MR. JERMYN: It could not be that if unit costs for some reason deteriorated, dividends could be reduced as a result.

MR. PALLONE: No.

MR. JERMYN: One last question, perhaps purely hypothetical. In the case of the Hancock you mentioned that as you are growing, your block of participating policyholders is diminishing and is likely to diminish further in the future. Has any thought been given to making some of the universal and variable life policies participating so that the block of participating policyholders remains?

MR. MORTON: I guess a lot would depend upon not only what we see as happening but what we would like to happen. I think that question boils down to whether or not we want to remain a mutual company for a long distance in the future. I will say that on the course that we are heading, there are some interesting tontine questions that develop. We have a group looking at that and they have not yet reported their findings. I think the question you raised is one that we should consider -- what would we like the long-range future of the company to be -- as a mutual company or on a demutualization route? I think whichever of those major decisions would be made would affect the way we either franchise or disenfranchise policyholders. It would be easy to sort of close off the existing block of participating policies. I do not think that is in the cards but it is something that I think should be considered as part of the strategic plan. We have not done it yet.

MR. BRITTON: It is interesting that in both UNUM and Maccabees there were nonparticipating policyholders who received distributions as a matter of equity, rather than as a matter of law. If you look at those situations, there were groups to which it appeared to be only equitable to give them something and that is what happened.

MR. PALLONE: Yes and the reason for that is that the nonparticipating policyholders did not know they were not participating. The policyholders of the subsidiary stock company that was owned by Maccabees did not know that they were not part of Maccabees and that they were not participating policyholders.

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MR. NATHAN F. JONES: Anything I say is not an official position of the New York State Insurance Department. In the first place just for information, because the issue of merger of mutuals arose, we do have a medium-sized life insurance company upstate that has been merging right and left. However, in that case it is really a question of acquisition. The medium-sized company is acquiring one mutual after another so that they can grow larger. This is something the CEO of the medium-sized company clearly wants to do.

The other thing I wanted to say was because of what Mr. Morton had said. Mr. Morton is probably aware because I am that the CEO of the Metropolitan was very concerned about this same question of the diminution of the number of participating policyholders and the outlook for the future. As a result of that, we now have legislation in New York that says if a mutual company can get a non-par permit, they can give all those policyholders the right to vote. That was their solution to this problem. But I suppose something that has not been mentioned yet in that context is that we are all in that way at the mercy of our friends down in Washington. The reason I think for handling some of these universal life and other things the way they were was the federal income tax bill. We do not know what will happen on that in the future, even though both the Prudential and the Metropolitan have shifted their new universal life issues into the parent company. Thus, they are well set as long as the income tax is not too unfavorable for that.

MR. MORTON: I agree with the representative of the New York Insurance Department. Certainly, the reason we sell our variable and universal life policies through a stock subsidiary of the John Hancock was originally triggered solely by income tax considerations.