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MERGER AND ACQUISITION TOPICS

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Recorder: MARY GAY LAVONAS

- Valuation for purchase of health blocks of business
- Due diligence prior to acquisition
- Administrative problems to resolve
- Are rules of thumb appropriate?

MR. WILLIAM J. THOMPSON: I am a consulting actuary in the Hartford office of Milliman & Robertson, Inc. We have two panelists who will share their expertise with us. Al Riggieri is an actuary at the Paul Revere Insurance Group where he has participated in buying blocks of individual disability income (DI) business and has been responsible for valuing those blocks of business for the past three years. Prior to that, Al was responsible for Paul Revere's individual DI valuation and financial reporting functions. Steve Millar has had personal experience with mergers and acquisitions. Steve joined Central Life when his former company merged with Central Life in 1981. For the next seven years, he assisted in Central Life's acquisition of group insurance blocks of business. For the last three years, Steve was a key player in the sale of seven blocks of Central Life's group and individual business. At the beginning of the process, Steve was an officer of Central Life. Now that the sales have taken place, he is a self-employed actuary. Our recorder is Mary Gay Lavonas, an associate actuary in the Albany office of Milliman & Robertson.

According to Bob Shapiro's inventory of corporate merger activity reported in the *Actuarial Digest*, the number of life and health company mergers have averaged 14 per year during the 1988-90 period for about \$1.8 billion a year. In 1991, there were 18 such mergers for a total of \$1.4 billion. There seems to be an increase in the number of smaller company mergers and block-of-business deals that have taken place over the past couple of years. More multiline companies are evaluating their strategic directions and, as a result, have been divesting themselves of lines of business that do not mesh with those goals.

An actuarial appraisal is usually an important ingredient in the sale of a company or a block of business. The American Academy of Actuaries adopted Actuarial Standard of Practice No. 19 to set out the considerations that bear on the actuary's professional work in performing actuarial appraisals. The standard took effect in January 1992. Al will discuss many of the technical issues that an actuary needs to address when performing an actuarial appraisal and when participating in the sale or purchase of a block of business. Steve will follow with a discussion of the other important issues that go into the sale of a block of business. We will then take questions and comments from the floor.

MR. ALBERT A. RIGGIERI, JR.: There has been a lot of activity in the area of mergers and acquisitions over the last few years. It is an appropriate topic since we are probably going to see continued activity as companies focus on their core of business and the industry consolidates. I will start by giving you a few additional

details and background from Paul Revere's point of view. I have been involved in block acquisition activities for over three years. My perspective is from that of an actuary working for a company that acquires in-force blocks. We normally use coinsurance to accomplish this so my comments basically will be built around that as the form by which a company will take over risk and administration from a client. In my presentation, a selling company will be referred to as the ceding company, and a buying company will be referred to as the assuming company. Although my comments are specifically directed toward DI, I think the principles apply universally to all lines.

My company does not enter into arrangements on in-force blocks without a corresponding agreement for future new business. In-force quotes and new business proposals are normally coordinated activities. I also provide actuarial support on the new business side. The arrangements for new business going forward can vary from those with very standardized forms of agreements to very complex ones with private labeling for companies with large amounts of new business production. In our case, we supply all of the underwriting, claims, and sales support for new business going forward, and the marketing company supplies field force to get to the end consumer.

To date, we have reviewed 12 in-force blocks; three have gone to full implementation. From this, we have learned that there are a variety of reasons why each block studied will not culminate in an agreement between the two companies. One of the reasons is that a company that is looking at its options to exit may decide to stay in the business. Another reason is that the philosophy at your company and the ceding company may not line up in the areas of marketing, operations, or general business directions so you will not always get a strategic or operational fit. In addition, I keep in mind that we are in a highly competitive environment, and if we were successful on every try, I would begin to question whether or not we were doing something wrong.

There are normally several parties involved and you have to keep an eye on all of them when you are looking at blocks and new business arrangements. Some of the players in the process are management, consultants, and staff members from both companies. All of those parties are going to bring certain interests and requirements that they have into the discussion. It is very important that you maintain a good relationship with all the parties in order to get the best result.

I will now address in further detail the actuarial elements relating to in-force block valuations, interpretation of the valuation results (if a valuation is completed) and how you might view them, and important elements related to in-force block negotiations and new business arrangements.

Your overall goal in evaluating an in-force block of business is to develop a ceding commission payment which will have a series of constraints associated with it. First, it has to compensate the ceding company for the value of the business. Second, it must achieve a fair rate of return for the assuming company, while covering the benefits and expenses for the block in aggregate. So the ceding commission payment has a set of constraints upon it. I usually call the ceding commission the present value of future distributable surplus or the after-tax, aftersurplus profits to be produced by the block in the future.

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Table 1 shows a three-year projection for an in-force block. Originally, it was a 25-year projection but the first three years are shown here for illustration. The table shows the elements of pretax statutory income, the federal income tax (FIT) cost, and the cost to hold required surplus. Note in particular that the tax rate is over 50% in the early years of our projection due to tax reserve timing differences. Also, there is \$12 million in surplus tied up from day one. It takes a long time for that to come back into the flow of dividends you can pay your shareholders. You should also note that the cash benefit payments rise as a percent of premium as the block ages and the reserve growth starts to slow down. Those are all normal events in an aging block of disability business. The investment income is based upon the interest rate assumed to be earned on statutory reserves and the surplus assigned to the block.

TABLE 1
Sample In-Force Block Valuation
Statutory Earnings after Taxes and Surplus (millions)

	Year 1	Year 2	Year 3
Premiums	\$35	\$31	\$28
Inv. Inc.	11	12	13
Revenue	46	43	41
Benefits	16	17	19
Reserve Chg.	16	14	11
Commissions	3	2	2
Expenses	3	3	2
Costs	38	36	34
P-T Income	8	7	7
FIT	(2)	(4)	(4)
Surplus	(12)	0	0
Dividends	(6)	3	3

Price = PV(Dividends) = \$15M

Listed below are the nine key pricing parameters that we consider when we are evaluating an in-force block. The actuarial issues related to valuing an in-force block are similar in many ways to those involved in pricing any insurance product. Key assumptions need to be developed and a profit target is normally established. In this case, we use return on capital employed. These concepts are entirely consistent with pricing new business. While this is generally true, there are specific considerations and situations we take into account when we are valuing in-force blocks. I will go through the nine key pricing parameters now and highlight a few areas we look at fairly closely:

Key Pricing Parameters

Mix of business	Reserves and reinsurance settlement
Policy persistency	Federal income taxes
Morbidity experience	Return on investment
Expenses and field compensation	Required surplus
Investment return	

MIX OF BUSINESS

A good starting point is to study the mix of business from which you can get a feel for the business that is in force with a client company. You can identify the types of policies that have been sold and the markets in which the company has been operating. Mix of business can be studied by occupation class, occupation, elimination period, benefit period, issue state, gender, issue year, type of contract, etc.

What is important is that these studies can give you a good feel for the business and deepen your understanding of the morbidity and persistency results you are seeing as you are looking at historical experience. It is important to take a few issue years as a block and study the trends and changes in the types of products the company has been issuing. This also is a good point in time to look at the portfolio of products that have been offered over time, and how much volume has been accumulated under the different portfolios of products.

PERSISTENCY

Normally, when reviewing policy persistency, you have a good deal of information that you can base this assumption on. In reviewing the historical experience, however, you have to keep your eyes open for several items that are fairly important going forward. First is the potential for a policyholder shock lapse. Second, and closely related to this, you must consider your ability to influence the producers who sold the business to maintain persistency in the block. Third, you must consider the impact of future conservation activities. We place a high value on maintaining favorable persistency going forward, and normally try to build some type of incentive into the arrangement to reward or penalize the ceding company for persistency experience. One good approach is to spread out the ceding commission over a period of years and express it as a percent of collected premium. That in itself will keep the ceding company very interested in the results. It is important to keep the ceding company involved because it can influence the producers who wrote the business. The producer is the one who is in touch with the policyholder. This is where your real relationship is maintained.

In valuing in-force DI blocks, we keep a close eye on persistency. There are two reasons for this. One is recovery of the ceding commission. It is important to have good persisting business to recover it. Second, and more importantly, persistency affects the extent to which you will hit your morbidity targets. If persistency is off, it is probably your better risks that are lapsing their policies, and you are likely to see morbidity ratios rise in the future.

MORBIDITY

As for morbidity experience, unfortunately, historical information concerning claim incidence and recovery is normally very difficult to obtain. One of the reasons a company would be exiting the business is that it does not have sophisticated systems to track and monitor its experience closely. In order to develop some type of information related to morbidity experience, we look to the NAIC annual statement as a good starting point and review basic loss ratios. We try to get aggregate loss ratios for the block for a period of 4-5 years. Also, many times a company will have a system that can isolate segments of the business and we can then look at loss ratios among segments. When we use these results from either the NAIC statement or a loss ratio system, we are very careful to audit and tie back to individual policy and

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claim records. We want to make sure that the data on which we are basing our assumptions is accurate.

If you can obtain good loss ratio information, you can compare the block that you are pricing with a similar block and compare across blocks by segment to determine how morbidity costs have been running for the past few years. Sometimes a review of this type is helpful in determining a set of morbidity assumptions for the block. In projecting expected loss ratios for a block of business, I think it is important to use a very detailed model office with specific assumptions for persistency, incidence and recovery rates as well as ratebook premiums.

If you look at history and try to reproduce the loss ratios a company has experienced and you do not match immediately, you could probably put in a macro level morbidity adjustment to produce a match. Then, you will at least be projecting on the basis of a solid actuarial model. It is also important when you are projecting morbidity costs to project both policy and claim reserves under the statutory and tax bases since they are going to have an important impact on the timing of profits from the block.

Finally, you need to consider what type of impact your claims operation will have in the future. You are pretty much locked into the underwriting decisions that have been made and the underwriting practices that a ceding company has used, but your claims operation can have an impact on the morbidity results in the future.

EXPENSES AND FIELD COMPENSATION

For expenses, we look at the specific elements of administration that are required as well as which company will provide the services for the block. Billing and collecting, policyholder services, and claim administration are the key elements. Premium tax allowances to the ceding company are also normally included. We look at which company can provide the support to the block in the most effective manner. Normally the ceding company is looking to get out of the business so that we end up with the administration. Sometimes there is a short transition period, and the ceding company will hold on to some of the administration while our systems come up to speed. When they do, we give them an allowance, on a temporary basis, for the cost to service the block. However, if it wants more or less in allowances, we will have more or less of a ceding commission to pay it. They need to keep in mind it is a zero-sum game when allowances are changed.

Finally, we look at our costs to determine what it is going to take up front to put the deal into effect. This will normally include our staffing cost for all of the pricing and negotiation work, and, all of the systems work that has to be completed.

Concerning field compensation, it is in your interest to keep agents well compensated in the future. We normally provide an allowance to the ceding company, and it pays the agents. We think this is the best approach since the ceding company has all of the records that are maintained for the agents. In some cases, such as if you were taking over a whole company, you might consider consolidating the payment of agents, but in our case we usually give a commission allowance to the ceding company.

INVESTMENT RETURN

There are usually large sums of money changing hands between the two companies at the effective date of transaction. We look for all of the block's statutory liabilities and the assets behind them to be transferred as of the effective date net of any ceding commission. We do not run any modified coinsurance arrangements between companies. The arrangements therefore include a very large cash transfer from the ceding company to the reinsurer and the overall investment return assumed in pricing is therefore heavily influenced by current market rates. We keep in close contact with our investment area, and find out from them what type of gross rate of return we can expect related to the asset transfer. We then factor in potential defaults and investment expenses and consider what might happen with the future course of interest rates. It is important now to be very careful when setting your pricing interest rate because we have an economic environment with a potential for declining interest rates. You have to make a long-term projection and consider what type of reinvestment risk you will be exposed to. You can leave some of the risk with the ceding company, but that would probably increase the complexity of your arrangement significantly. In addition, there might be some problems in the current emerging reinsurance regulations. California's current regulations and NAIC proposed regulations require that you take over all significant risks in a reinsurance transaction.

RESERVE ADEQUACY

We look at the adequacy of reserves when we are taking over a block of business. We complete a thorough review of policy and claim reserves. Our interest is in knowing if the ceding company's reserves are adequate and if they will be equal to the ones that we will establish on our books. We look at various components of the reserves. We consider questions such as: Are all of the miscellaneous benefits appropriately valued? Is the incurred but not reported reserve (IBNR) adequate? Are the valuation data accurate? When is claim liability first recognized, and how does it coordinate with the IBNR reserve? In most cases, we do find pluses and minuses in the reserves, and we adjust for them. In the aggregate, we then consider the pricing impact of any reserve differences.

There are two areas that we look at when we are considering the impact of different reserves from the ceding company to the assuming company. They are the timing of profits going out in the future and the impact on historical loss ratio experience. If you are looking at historical loss ratios and the company has been underreserved, you want to consider whether or not its experience is appropriate to price the block in the future; in addition, what will the likely impact on the timing of profits be.

EXISTING REINSURANCE

We look to recapture any existing reinsurance in effect since we like to have any other reinsurer out of the picture. We normally ask the ceding company to approach the reinsurer to recapture the existing business. They usually have an ongoing relationship that they can capitalize on and they work out a fair settlement before we get involved. There are many other ways to handle existing reinsurance, but we find it is cleaner if we can stay out of the picture. We have no interest in continuing the reinsurance, and it will only add to our ongoing administration cost. If the reinsurance is settled, we look to have the reserves transferred to us gross of reinsurance, and we have no ongoing costs to support reinsurance.

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FEDERAL INCOME TAXES

In pricing in-force block transactions, we build in a cost for federal income taxes by projecting out taxable income for the block. This may sound obvious, but I have heard the argument that since we get a ceding commission deduction, we should be able to ignore the impact of taxes when pricing. This is not true because there are a series of timing differences between statutory and taxable income which I will briefly describe for you.

Taxable income in a DI block is normally higher than statutory income while the reserves are building. It takes a long time for those reserve timing differences to turn around. In addition, you lose some or all of your ceding commission deduction because the IRS tells you to calculate it on the basis of tax reserves rather than statutory reserves. In other words, you have a pretax loss by paying the ceding commission to the ceding company, and you do not get much of a tax offset for it. The ceding company benefits from this and receives most of the ceding commission tax free. We usually point this out to the company.

Deferred acquisition cost (DAC) taxes also have an impact on pricing in-force blocks. There is a significant tax impact as of the effective date since all of the assets transferred from the ceding company become income to us for DAC tax purposes. On an ongoing basis, the block will pick up the DAC tax at the normal rate, 7.7% of premiums. We currently have to consider the impact of DAC taxes in light of the emerging reinsurance regulations. We usually ask the ceding company whether or not it wants all of the DAC taxes covered. If so, we would have to provide an allowance and price it out so that we pay 100% of DAC tax.

The final regulation coming out this year will likely end up with a split between ceding and assuming companies. With each of these tax timing differences, it takes many years to turn around. With the impact of discounting, you get many up-front costs with taxes and not much benefit through the "turnaround" when it comes because it is so deferred. Finally, we are careful to be tax efficient because if there are differences between our tax position and the ceding company's, we take those into account.

Table 2 provides an example of how federal income taxes impact the ceding commission for a block purchase. In this example, we have a block of business worth \$50 million on the basis of pretax statutory earnings. The present value of taxable income before the DAC tax (i.e., without DAC taxes) is \$60 million. The present value of taxable income is larger than the present value of statutory earnings because of reserve timing differences. DAC tax will add an additional \$5 million of tax charges (present value basis) to be paid by the assuming company. Statutory reserves are \$15 million larger than tax reserves at the effective date of the transaction. I remove this amount from the price before I take the ceding commission deduction. For simplicity, I have assumed a tax rate of 33.33%.

We determine our price by taking all future taxes into account and removing them from the present value of statutory pretax profits. In this case, we have \$25 million taxes driven by one third of the \$60 million plus the \$5 million for DAC tax. We then take \$15 million out of the price and take a third of that amount (this is the ceding commission deduction) as a credit. By the time you work all of the algebra around

and gross up the price by the tax rate, you end up with a \$30 million price from a \$50 million pretax profit position. In this case, we had \$20 million of taxes or 40% of the pretax statutory value go to taxes. I have seen some cases where just the present value of pretax statutory profits have been presented to a ceding company as a value for a block. We then have a difficult time convincing them that there is a tax cost associated with the transaction.

TABLE 2
Federal Income Tax Example

PV (Statutory P-T Profits)	\$50 million
PV (Taxable Income)	60 million
PV (DAC Taxes)	5 million
Initial Stat - Tax Reserves	15 million
Tax Rate	33.3%
Price = \$50 million - \$25 million + 33.3% x (Price - \$15 million)	
Price = (\$50 million - \$25 million - \$5 million)/0.666 = \$30 million	

RETURN ON CAPITAL INVESTED

Return on invested capital, which is our pricing goal, is tied to the cost to obtain capital and the risks assumed in a block purchase transaction. You have to be aware also of the relationship between the risks assumed and the capital structure. Some arrangements can leave you with more or less capital or more or less risk transferred in the arrangement.

Here are a couple of examples. If we have put in persistency incentives, we are probably more comfortable on the risk end, and we can then lower the rate of return that we are looking for. This is the target that our company would like to achieve. In another case, if we spread out ceding commission payments, we have a very low capital structure in the arrangement, but we have all of the risk, so our return is usually leveraged up. We usually think hard about how much of the leveraging benefits we can pass on to the ceding company. Normally, when you set your return in a stock company, you have a corporate target that you can look at as a minimum or "hurdle rate." You can then adjust it if the risk profile and the capital structure of the arrangement is different than your core of business. That is how we look at pricing these arrangements when we get to our final pricing decisions. In the independent valuations I have seen, there have been quotes from 12-20% on rate of return. These usually give the ceding company some feel for price sensitivity given different rates of return which the assuming company might be asking for.

REQUIRED SURPLUS

An area of concern with many valuations that are produced is the lack of properly reflecting the cost to hold required surplus. It is becoming more and more important with our risk-based capital formulas to reflect this cost properly. If it is ignored, it significantly overestimates the value of a block.

Let us consider the cost to hold surplus. The cost is equal to the initial surplus that you put up minus the present value of any future surplus releases minus the future after-tax interest earned while you hold the surplus. The present value is calculated at your target rate of return and the investment return that you earn on the surplus is

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tied to your after-tax market rates. As an example, you might be in the 15% range for the target return on investment, and at a 6% rate on the after-tax interest earned on the surplus. Again, you have to gross this cost up by one minus the tax rate in order to get an equivalent amount that you would have to remove from the pretax presurplus value for a block. In many cases, I have seen that the cost to hold surplus is almost equal to the initial surplus put into the arrangement. One common component for that is the C-2 risk component, equal to 15-20% of premium. If you had a rule of thumb, you might consider 15-20% of your in-force premium as the cost to hold surplus.

SENSITIVITY TESTS

In reviewing a set of results, consider using sensitivity tests on a block of business. When a valuation is completed, we try to get a feel for what the key drivers behind a block of business are through this technique. This helps us understand the information that we are producing and explain it to our management and the management of the ceding company.

Table 3 shows some sensitivity tests. In this example, we have the pretax value as about 100% of an in-force premium (this is a commonly quoted number). After tax and after surplus, the value is 45% of premium. You lose 55% of your value to taxes and surplus. For the morbidity test, I applied a 5% fluctuation to cash benefits and claim reserve changes, and ended up with a 14% shift in price, almost a three-to-one sensitivity. For the investment return, you get a 20% shift in price, given a 1% interest rate differential earned on the assets that are equal to the statutory reserves and surplus for the block of business. For expenses, consider a 1% of premium shift in your expense rates, which, in this case, is worth 4% of premium. If your expense ratio is off by 1%, you get about a four-to-one ratio on it. DAC tax costs 9% and target return or your own return is about a 5% price shift for every 1% shift in your target return.

TABLE 3
Interpretation of Results
Sensitivity Testing

	Percentage of In-Force Premiums	
	Pretax value	After-Tax Surplus
Basic Value	100%	45%
Morbidity 5%	14	14
Investment Return 1%	20	20
Expenses 1%	4	4
DAC Tax	N/A	9
Target Return 1%	5	6

The interesting thing here is the investment return gets about 20% for 1%. This is worth much more than a 1% shift in your target return because the investment return is working on the base of statutory reserves and surplus, whereas your target return is basically working on whatever capital you have tied up, which is usually smaller than the reserve base.

We use results such as this to compare our pricing results to other valuations performed for a block. It also allows us to concentrate our attention on the most important areas when we are refining our assumptions or our estimates. Finally, we use the results to compare across various blocks that we have priced to find out why our prices are varying.

I have heard certain rules of thumb presented for valuing an in-force block such as a percent of premium or a percent of the DAC asset. I do not use these rules of thumb very often because, in every case, I find something that invalidates them. An example would be two blocks with a 2-8% commission differential; you would get quite a different value in your pricing results and general rules of thumb break down. Also, morbidity results can vary dramatically between companies so that would invalidate general rules.

As another example, your investment return might drop dramatically driven by changes in the investment environment like we had toward the end of last year. All of these things will tend to invalidate a general rule so I try to stay away from them and go more towards sensitivity analysis.

MR. STEPHEN K. MILLAR: In medical insurance, the seller and the buyer sometimes agree to share the benefit risk temporarily after purchase, usually at the insistence of the buyer. Sometimes only a portion or none of the purchase price is paid up front. Any remaining payments would be based on the loss ratio, sales volume, earned premium, or persistency. Another approach is where the seller pays the buyer for losses in excess of an aggregate cover, either a dollar amount or a loss ratio. One of the results is that it keeps the seller involved throughout the transition after the sale. It is a very effective administrative tool. Another result is that the seller will often lower the price when the buyer makes a request for risk sharing. Another approach that you often see is that carriers will say that they will not take the risk unless they can use their own underwriting on each case. This is usually done in large group business.

MR. RIGGIERI: In regard to negotiations, after we complete an initial valuation for a block, we normally get involved in a process where the companies close whatever gap exists between what each party wants in the arrangement. We usually find it is best to identify some of the key issues up front, but it is not always possible to do that. We end up with a process, which extends over a period of a few months, where the two companies will negotiate with each other to close down the gaps. The key elements we find that we are negotiating on are price, agreement features, and language.

PRICE

The ceding company usually has a perception of what the block of business is worth or a price it is aiming towards. Also impacting negotiations will be other competitors' quotes. We usually try to find some trade-offs to help close the gaps. We ask for more participation from the ceding company in order to have a higher comfort level and that sometimes improves our pricing position. Intangibles are also important in our pricing decisions. If the new business potential is good and if our companies mesh together well, in some cases, we can take into account in our pricing, that we

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probably perceive less risk on the in-force block. We identify key issues and then work through a series of steps to close down any price differentials.

AGREEMENT FEATURES

Another area of negotiation is that of agreement features. We find negotiations taking place on risk-sharing, allowance schedules, split of administration, responsibilities for administration, due diligence issues, and punitive damage responsibility. Sometimes the ceding commission features are an area for negotiations. We will decide with the client company whether a ceding commission will be paid up front or if it will be spread over a period of years to the ceding company. Many times we have an approach that we like to take on these items, and we try to explain it to the ceding company and gauge its flexibility during the negotiation process.

LANGUAGE

The final area for negotiations is treaty language. Striking a legal agreement can sometimes take as long as all of the other elements of negotiation. Worries from both sides really need to be expressed in regard to what the arrangement is all about. Contrary to what you might believe, there is really no standardized language. There are usually a lot of twists and turns to take into account. For the most part, the drafting of the legal agreement should be done in such a way that it does not change the underlying structure of the arrangement. You need to watch for small provisions that can really impact you in price.

MR. MILLAR: The key appraisal value parameters in an acquisition of block-approved medical business are persistency and morbidity. When I am an actuary for the buyer, actuarial data alone are not sufficient to allow me to build an appraisal. The agents and the brokers are capable of moving the best business. If they are unhappy, it causes morbidity and persistency deterioration. I look at the quality and future control of the distribution system, and the relationship for existing and new business. The quality of the relationships influences my expected persistency and morbidity as well as my assumptions for new sales. I have to make business judgments about the overall quality of the underwriting and the claims functions in addition to the agency functions.

As an actuary for a seller, my appraisal should reflect the seller's perspective. The seller wants to increase the price, and the seller knows that the ultimate value reflects the buyer's management plans. My appraisal should realistically model the buyer's management of the business, not the seller's. A best case appraisal may be too aggressive to influence a buyer. As an actuary, the best feedback I can get is to find out what the buyers did with my appraisals. The risks on assets and liabilities need to be adjusted out of the purchase price. Start-up costs are another adjustment.

MR. RIGGIERI: In new business arrangements, some form of marketing and manufacturing relationship is established. In that relationship, we consider ourselves as the manufacturer and our client company as the marketing company. The marketing company distributes products through its field force, and we manufacture the product for it. There are a variety of possible types of arrangements, probably as many as there are companies, but a few key issues evolve as the central ones when you are looking at establishing new business arrangements.

The first issue is the product label. Probably the most important aspect is whether or not the marketing company requires name recognition. In most cases, it can use the manufacturer's name knowing that it can approach the end consumer with a quality product from a company that specializes in the line. While that is true in general, sometimes there are emotional aspects involved with whose label goes on the product. It is usually advantageous to both companies if you can keep it on the manufacturer's paper since there are fewer legal and regulatory constraints involved. Under a private label (where the marketing company's name is on the label), all of the necessary policy forms need to be filed with 50 state insurance departments each time you have a product change, which can happen frequently. In addition, from the marketing company's point of view, it can avoid a great deal of accounting work if the manufacturer's name is on the label. It doesn't need to establish any liabilities on its balance sheets so that simplifies the accounting process. There are additional costs in setting up private label arrangements. Sometimes you have system hookups between companies. These may only make sense if there is a very significant volume of business, so we try, as much as possible, to keep it on our paper.

In the area of field compensation, an important element in any marketing arrangement of this type is maintenance of field force integrity for the marketing company. You must provide a structure that will keep the producers under the agreement and not allow them to come directly to your company for product and service outside of the arrangement. If the commission structures under the arrangement and outside of it are not leveled (i.e., if there is no level playing field), you will defeat that purpose in the marketing arrangement. Most of the marketing companies want their field force linked to their general agency systems and agents. They want to have a solid connection to them and do not want them to escape for service outside the agreement.

There are usually things they can do to keep them under the agreement like providing conference credits and fringe benefits to encourage producer loyalty. Whenever they produce under the arrangement, they are qualifying more and more for those benefits. If the manufacturer, in this case us, is allowed to pay the producers directly under its compensation arrangements, it seems to work out well since we then have a pretty level commission playing field across companies. In some cases, however, we cannot do that. It is not possible in specific places where the marketing company wants to coordinate with other lines of business. We take that into account. We can structure an allowance under this arrangement so that the marketing company can pay its agents the best way it sees fit. That usually works out well as long as the commission structure stays level between the companies.

In terms of administration, most elements move to the manufacturing company. We bring specialized services to the arrangements in dealing with the product line and the marketing company really does not want to be heavily involved in administering the business anymore.

As for marketing allowances, the marketing companies will want a rental fee for use of its field force. They need to cover all the costs to recruit and train agents. They also provide conference credits and fringe benefits to the field force. The only way for them to recover those costs is through some sort of a marketing allowance. When you are looking at a marketing allowance, it is very important to know what

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type of services go along with it. I have seen higher and lower marketing allowances with some indication that there is more or less field service from the manufacturing company going along with it. You cannot look at just the marketing allowances alone. You need to look at the level of direct support provided.

When our company has significant control over underwriting, administration, field compensation and claims administration, there is obviously little need for risk-sharing between the two companies. That is particularly true in any cases where there is a volume of business that does not put us at substantial risk (where it is not 20%, 30% or 40% of our new business production). Once you get up to that level, you are at risk of gearing up for it and then having it removed. You then feel you are back one step in terms of control over all of the underwriting and field decisions that are made. We then try to build in some risk-sharing. In that way, we maintain what we call a community of interest in the overall business that is being produced in terms of persistency and morbidity. In terms of risk-sharing, there are many forms you could put into effect, but usually those revolve around leaving some interest in the persistency and morbidity results at the marketing company. One simple example is to have a marketing allowance tied to overall persistency results. If persistency begins to fluctuate and deteriorate, its marketing allowances will go down. Another example would be where we have an allowance structure to give the marketing company a very small profit if they hit our overall morbidity goals and a loss if they do not.

There are a few intangibles that you need to be concerned about. First is how the field force will react to doing business with the company. There is a very large field relationship that has to be worked out, and you need to know how your field will react. You should also find out if the manufacturer has local representation. You want a good local field office network that will provide your agents and producers direct field support. You should ask yourself whether or not that field force can, through their special skills, really add value to your agents and producers. One other important aspect of an intangible is the makeup of the lines of business at a company. No marketing company would want to be in direct competition with another major player in one of its major lines. I think you will see more niche players in the future in this area.

My final comments will address issues related to accounting for in-force blocks and new business produced under comarketing arrangements.

In considering the accounting practices for in-force blocks, there are a number of issues related to the transactions that take place at the effective date and those related to accounting on an ongoing basis. A few of the important items are reserves, initial transactions, and GAAP accounting.

RESERVES

We use our reserving basis and techniques to establish liabilities on our balance sheets. In those cases where the ceding company retains some portion of the liability, we encourage them to use our basis for at least claim liabilities. They sometimes continue to determine policy reserves under their approach. We look at reserving as one of the strengths we bring to the relationship and consider it a valuable service to the ceding company.

INITIAL TRANSACTIONS

On a statutory basis, we book the ceding commission as a reinsurance allowance that flows directly to our bottom line. This is the only impact of the transaction on our pretax statutory income. If we were to bring in the assets transferred from the ceding company and the initial reserve balance through income, we would end up with the same pretax cost. We feel it is better to leave our income statement undistorted by these items. Sufficient notes are made, in writing, in areas to allow users to adjust liability changes to account for the reserves transferred and balance these changes to Page 5 and Schedule H.

GAAP ACCOUNTING

We establish reserves on a GAAP basis that we feel will provide the best estimate of liabilities for benefits in the future. Given that we are dealing with an in-force block of business, we also consider that the reserve does tie into morbidity costs going back to when the policy was issued. We try to stick close to the assumptions used for our own business and modify only where appropriate. As for the cost of insurance purchased (CIP), we construct an opening balance sheet that includes a CIP balance that is equal to a purchase price determined on a GAAP basis. In other words, it is equal to the difference between assets transferred from the ceding company and our GAAP liabilities. Under this approach, our initial GAAP equity is equal to the capital invested by our stockholders as of the effective date. We then write off the CIP going forward to give us a fairly level return on GAAP equity over the long run for the block if experience does materialize as expected.

For the most part, all reserving and accounting for the new business is driven by our systems. In most cases, we do everything from billing and collecting premiums to paying claims. Therefore, we control the majority of the accounting for the transaction. The marketing company is interested in reserves only in those cases where it has its name on the label and/or it participates in the arrangement in a way that leaves it with a benefit liability. Even in those cases, we again encourage it to use all of our reserve bases and techniques. This frees up staff except for recording the transaction on a macro basis on its financials.

MR. MILLAR: Al discussed the scenario where the agents continue to sell for both selling carrier and the buying carrier. Al's comments also apply to a block of individual medical business that is leaving an individual life carrier.

In group insurance though, the relationship usually transfers to the new carrier, and the agent's relationship with the selling carrier ends. Where significant blocks of business are controlled by a TPA, an association or an agency, the buyer really may be negotiating with those people rather than the carrier. So you really should consider who controls the customer when you start your negotiation. The selling company may receive an override based on new sales where blocks of business are closed. On blocks that are closed to new business, the only relationship that continues with the new carrier is a service and commission relationship. On blocks that are open, the buyer's interest and production from the agency force depend on the distribution structure, the loyalty of the distribution system, and whether the agents are captive or not.

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The remainder of our prepared remarks will focus on the seller side with an emphasis on the management of the sale and the issues that evolve. My comments are more appropriate to the sale of a block of business than they are to the sale of a company or a division. My background is predominantly group medical.

Concerning the sales management process, we have chosen five major task areas. They are marketing, packaging and selling, completing the sale, transfer and implementation, and follow up. We will outline a process often used with blocks that have significant value, significant volume, and consequently many possible buyers. If you have a block with less value, low volume, or fewer buyers, you can streamline this process. We wanted to give you a total process that you can always cut back.

Our goal is to get you thinking about the management effort needed and the valuable roles that actuaries can play. The front end activities involve marketing. This may sound trite, but you have to define what it is that you are selling. This includes the blocks of business, the assets and liabilities, the systems, the leases, and other agreements being transferred. I have seen purchase prices adjusted as much as 20% because the seller and buyer differed in what they thought was being included in the sale. As a seller, you own the right to take the benefit risk and reinsure that risk. On business written through a trust vehicle, the settlor, the one who directs the trust, has the right to choose a carrier. If the selling carrier is not the settlor, he may not have much to sell. The seller also needs to clarify for buyers the method that will be used to decide on a buyer and the preferred method of transferring risk. Very often this will be asked up front.

The seller needs to understand the marketplace for transferring blocks. In recent years, buyers have become more focused by product and by case size. Prices paid for blocks have reduced and now include more contingency payments. Less credit is now given for anticipated new production. There are fewer buyers with noninsurance backgrounds.

Understanding the buyers means knowing who the possible buyers are, their strategies, and their approaches to acquisitions. A seller should become aware of those organizations that regularly buy blocks. In today's regulatory environment, the seller has to judge each buyer on the buyer's ability to complete the acquisition and to manage the block after the acquisition. Managing buyers means selecting the buyers, helping the buyers with the acquisition process, and gracefully eliminating unattractive buyers. Buyers and sellers often retain actuaries, strategists, and investment bankers who specialize in all of these marketing activities.

Regarding packaging and selling, I think confidentiality agreements should always be used. They should be always signed by each possible buyer before any data are released. This protects sensitive information of the seller, prohibits the buyer from using information for reasons other than evaluating the block of business, and limits the seller's warranties on data. My recommendation to any seller of any block is that it distribute a professionally packaged offering memorandum that stresses the positive aspects of the block. An offering memorandum provides summary level information about the seller's recent financial results, products, distribution channels, major functions, systems, key personnel, and plans for the future. Sellers often provide

actuarial appraisals with an offering memorandum. My preference is to provide an actuarial appraisal to buyers only when I think it will enhance the price of the block.

On any significant sale or any sale where employees transfer with the business, officers of the seller should make presentations to the buyers. At the same time, the buyer begins the initial stage of his thorough review process called due diligence. In due diligence, the seller should provide carefully packaged and prepared information about rating, reserving, experience analysis, underwriting practices, claims procedures, policy forms, sales plans and results, marketing agreements, and other tactical plans. Major systems should be demonstrated, and key employees should be made available for interviews.

The process can take several weeks with one buyer. With multiple buyers, it can take much longer. To reduce the time and expenses, the seller needs to regularly seek input from buyers. The process naturally culls unattractive buyers.

As we move to completing the sale, perspective buyers make an offer that is often called a letter of intent. A letter of intent contains the buyer's proposal for the purchase price, transfer of risk, administrative duties, and supporting agreements in addition to any risk-sharing. As a seller, I prefer a letter of intent that binds the buyer as much as possible to stick with the acquisition, outlines a path to get to definitive agreements, and moves to the next phase. On the other hand, the buyer prefers a letter of intent that is not binding, moves the process along to the next phase, and effectively eliminates the other buyers. These natural differences and approaches need to be negotiated along with all the items that are in the letter of intent. These offers should be reviewed carefully by lawyers and managers of the sale. This is when the seller must negotiate the strongest because once a buyer is selected, the seller's negotiating power decreases.

I have a few comments about building a purchase price. In my experience, seller's management has always sought an appraisal before agreeing on a price. The board of directors or top management does not always need an appraisal to decide to exit a line of business because they have been receiving projections for years. They have seen your results. They are trying to answer strategic questions and they do not need an appraisal to do that. Business unit managers seldom make the decision to exit a line of business. Another thing that happens is that managements often seek outside actuaries to do appraisals because they feel those actuaries will be more objective. The seller's product actuaries are usually not asked to build the appraisal, especially if they are transferring to the buyer with the block of business.

As actuaries for the seller, we need to remember that the management of the seller will use our appraisal as a sales tool to influence the buyer. Part of our job is to convince the managements of both buyer and seller that the block has more value under the management of the buyer. Assumptions used should reflect the management actions of perspective buyers, if the actions are known. As the sales process evolves, I like to ask the buyers what their marketing plans are, what their expense levels, claims savings techniques, and other assumptions are, and I try to build these into my appraisal. It does not always work because sometimes appraisals go out before you even get to meet the buyers but if you can meet them, you would be surprised by what they will tell you.

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As previously mentioned, group medical has net worth adjustments usually retained by the seller and excluded from the purchase price. In individual medical insurance you need to consider the active life reserves. The amount of active life reserves is either negotiated separately or is part of the total price.

Ultimately, I think the lesson that is hard for most of us as actuaries to learn, at least the first time we do one of these, is the real value may not have anything to do with what we put in that appraisal. Really, it is dependent upon what the competitive marketplace will pay for in a bidding situation.

When selecting the buyer, my recommendation to any seller of a medical block is to consider at least three criteria when selecting a medical carrier: purchase price, the buyer's ability to maintain the vitality of the block, and the ability to work with the buyer for the next 12-18 months. After offers are reviewed, a buyer is selected or the block stays with the seller.

The time frame for final due diligence will depend upon what was negotiated in the letter of intent, but usually continues until agreements are signed. The buyer performs final due diligence on systems, procedures, policy forms, agreements and other financial and nonfinancial matters.

The seller and buyer outline an administrative plan sufficient to develop the remaining agreements, but not sufficient usually to actually transfer the business. A very practical management challenge arises because the people who are negotiating and building these agreements are not the people who have to administer the transfer of business. In my experience, the implementation of a significant sale requires financial and management integration between various functions at different levels of management from top to bottom, at many conceptual levels (especially when you get into the reinsurance agreements), and from the beginning of the process to the end of the process. I would recommend to any seller that one person be responsible for that integration and be involved in all aspects of the sale from the beginning until after a transfer occurs. Many actuaries are uniquely qualified to perform this function because of the breadth of their training and experience and because of the good questions they ask. Once agreements are signed, regulatory approvals are sought.

The first financial closing usually occurs when agreements are signed. Communications on the sale could be made to some stakeholders, as will be covered later. On a major acquisition, I would say that you may be done with 40% of the tasks or maybe 50% of the tasks; on a minor sale this might be 80% of the tasks by this time. The conversion of procedures and data systems can take several months. I recently did a closing on a block of business that was purchased in 1986.

Financial closings continue well after the conversion of systems if the acquiring carrier is paying claims for the selling carrier. Audits of claims, reinsurance recoverables, premiums and other items are a vital part of the follow up, and I would recommend that an actuary be involved in reviewing the work papers even if accountants are doing the work papers because of the actuary's ability to ask questions.

RISK TRANSFER METHODS

Again, let me repeat that we are talking about a block of business as opposed to a merger of a company or acquisition of a company. The legal and regulatory complications of the risk transfer ideas are much more difficult under the acquisition of an entire company. In the past, there have been two basic methods used to transfer risk. The first one is what I call cancel and reissue; the second one is assumption reinsurance. Based on my experience and input from some investment bankers that I called, assumption is used most often but both methods can be effective depending on the blocks of business and the administration involved. Cancel and reissue is an approach where the existing carrier cancels the business and the new carrier issues a new policy. This approach has the advantage of separating each carrier's administrative and systems duties and policyholder values. This is especially useful on large case business, or when transferring ASO and experience refund coverages on an anniversary. The cancel-and-reissue approach does not usually involve state insurance department approvals.

Under assumption reinsurance, existing carrier's rights and obligations under the existing policies are transferred to the assuming carrier. The transferring carrier's obligations are extinguished if the legal work is done properly. Assumption reinsurance is a good approach when you transfer all risks and all administration on the same date. Assumption treaties must be approved by the domiciliary states of each carrier and a few other states. Assumption certificates are filed in all states where insurers reside. As a seller, I prefer an approach where assumption is followed by subsequent reissue under the policy forms of the assuming carrier. This method minimizes the residual liability of the selling carrier.

Indemnity reinsurance is usually not used as the primary method of transferring medical business. It might be very appropriate for long-term disability (LTD) business, the reason being that it is basically the direct-rating carrier that retains the direct obligation of the policyholders. Indemnity reinsurance is often used during the transition period while carriers are seeking the approval of the assumption treaties. It also is used in those states where the policyholders have the right to refuse assumption.

In recent years, regulators have become concerned because there have been some failures of assuming carriers, loss of coverages, and increased pressures on risk pools and guaranty associations. States are in the process of strengthening their laws regarding transfer of business, especially assumption reinsurance. New York allows policyholders to refuse an assumption. Minnesota will approve an assumption only if the seller agrees to also remain liable with a buyer. One state is considering special surplus requirements for assuming carriers. My feeling, talking to lawyers and people I have dealt with, is that regulators consider assumption reinsurance as an important mechanism that they would like to retain, but they are going to make it more strongly regulated.

The NAIC has been developing the Assumption Reinsurance Model Act. The most recent draft of the act specifies minimum filing and approval requirements for the domiciliary states of both carriers. Under the act, all states would require the filing and sending out of a notice to policyholders similar to today's assumption certificates but with much more detail. The Model Act allows each policyholder to reject the

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assumption by responding through the mail. That is a very important point. As is the case today in most states, payment of premium is considered implied consent to the assumption.

If the Model Act is passed as currently written, insureds who accept the assumption would move to the new carrier. Those insureds who reject the assumption would remain the risk of the selling carrier. This certainly creates some problems. I think the selling carriers in this situation would pass the risk on to the assuming carrier by using indemnity reinsurance. I think another problem that would arise is that the administering carrier would have to administer two sets of policies. So I think, if the law is passed as it is written today, carriers would just move away from assumption reinsurance and move to indemnity reinsurance; or they may move to the cancel-and-reissue approach.

ASSET AND LIABILITY TRANSFER

Let me talk about something called policyholder values. It relates to values that are the risk of the policyholder such as policy year refunds, stabilization reserves, deficits, and claim reserves. Conflict arises when planning for the date of risk transfer, the date of administrative transfer, and the accounting for policyholder values. The underwriter calculating annual values wants to transfer risk and administration for each case on the policy anniversary. This way values for a policy year all come off one system, and policy year stop-loss coverages do not have to be shared by the carriers. The administrators want to transfer risk and administration of all cases on one date. Both approaches can work, but the underwriter's approach is usually best when policyholder values are involved. As an actuary, you should make sure the lawyers do not shift the risk from the policyholders to the carriers.

Our discussion on medical claim reserves is on fully pooled reserves. There are two basic approaches. The first transfers liability and sufficient assets to the new carrier. The second approach sorts all claims between carriers after payment. Under the first approach, all benefits become the risk of the new carrier. Under the second approach, each carrier is responsible for all assigned claims.

When selling a block, the situation you are facing is far different than it is during the normal administration of a block of business. Under the normal management of pooled claims, the extension of benefit provision is applied when cases terminate. When blocks are sold, the carriers usually agree to treat each case as if it had terminated immediately prior to assumption and then sort claims between carriers as if the extension of benefits provision applied. However, because the cases have not really terminated, the claims examiners do not always ask the questions needed to administer the extension of benefits provisions. Add to this two managements, two claims systems, and differing interpretations of state laws, and you have a major management challenge. Actuaries can be very helpful in sorting through these issues if they are willing to get involved with administrative practices.

On most blocks of pooled business, I favor the sorting approach. My preferred approach assigns dates of service for each claim line item with paid claims sorted by carrier based on the date of service. The seller's claims are then loaded by a negotiated percentage to cover disabilities. This is a big negotiation. The advantage of this approach is that the conflict is all negotiated in advance rather than on a

claim-by-claim basis. Believe me, there can be conflict because there are a lot of dollars involved. If a pooled medical block is a small portion of the sale package, I prefer to negotiate and transfer pooled reserves rather than sort paid claims.

Some other items that can be considered under assets and liability transfer are active life reserves, pension plan assets, furniture and equipment, files, systems that can be sold, leases, service agreements, and trust agreements.

COMMUNICATION TO STAKEHOLDERS

When I talk about communication, I like to use the word stakeholder because it broadens my perspective. Management should be informed as a regular part of the process. We previously discussed communication required to regulators. Under group medical, key agents who control blocks of business should be interviewed during a sale. Their support is usually necessary before and after an acquisition. The biggest problem with a block of business after sale is that persistency is terrible because the agents are unhappy with the new carrier. One piece of advice I must give you is, treat the agents as if they are almost (but not quite) a part of the negotiating party.

As previously outlined, policyholder communication is required by the states. This should be supplemented by joint correspondence from both carriers and phone calls and visits to key accounts. Employees of both the seller and the buyer are key to the successful transition. They deserve to know as much as can be told, when it can be told. Stockholders and the public need to be considered also.

UNIQUE IMPLEMENTATION PROBLEMS

In a major acquisition, the seller and the buyer are partners for 12-18 months. As a seller, I think you had better understand the buyer and feel comfortable working with him or else do not pick him. Issues will arise that were not addressed in the letter of intent and the definitive agreements. In my opinion, both seller and buyer should assign a representative to address these issues. The seller will need to lend administrative support throughout the entire transition to maintain service to policyholders and agents.

The first problem to address after a buyer is selected is when and how risk and administration will be transferred. Systems conversions, timing of approvals, timing of policyholder values, employment offers, systems leases, expense reimbursement, services provided, and many other issues need to be negotiated and incorporated into agreements. The final agreements cannot possibly consider all the issues that will arise so facilitative managers need to be assigned to the implementation. Actuaries can provide unique support to the issue of expense reimbursement. Sometimes our natural inclination is to itemize costs and list all services provided. Itemized costs are appropriate for data processing services but not for administrative services. If you list each service, someone will spend the transition fighting for the services and arguing about costs. My recommendation is to study the detail thoroughly and negotiate a simple expense reimbursement formula for comprehensive administration and claims services. Percent-of-premium or percent-of-claims formulas are appropriate. If you do not do that, what you are going to find is people arguing about what services should be provided, and they will all become cost accountants as you get into the transition.

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DUE DILIGENCE ISSUES

With regard to due diligence issues, the seller's perspective conflicts with the buyer's. As a seller, I am seeking the highest price for management while considering the future of all stakeholders. I want to move quickly and influence the buyers by stressing the positive aspects of the block. The buyer is cautiously uncovering mysteries and seeking a low price.

I feel the best approach for a seller is to consider all buyers as knowledgeable. A seller should provide all information necessary to manage the business. Do not make the buyer's discovery a burden. In today's regulatory environment, if you sell to an uninformed or financially unsound buyer, the risks may be sent back to you in the future by the regulators. A seller cannot ask the management questions for a buyer, but he can help facilitate the buyer's process if this is in the seller's best interest.

Trade secrets and information about blocks and systems not being sold should be excluded. In the stage of due diligence that precedes an offer, you may have to tell a buyer that certain information will be provided only after an offer is made. In one sale, a buyer's first request from me was for the programs backing my statistical system. I told him to put his cash on the table.

Another requirement is that the same data should be provided to all buyers. The best rule of thumb is to remember that the buyers are evaluating your personal and professional integrity and the integrity of your client. The good buyers will walk away if personal trust becomes an issue.

MR. VICTOR R. PAGUIA: I have a general question as to whether some thought has been given to the impact of small group reform on the marketplace as far as buying and selling blocks of medical insurance.

MR. MILLAR: I like to look at small group reform as rates having to fit in a corridor. As soon as you impose somebody else's rates onto your rates, you have another player in that corridor. So, for some people, I think there is going to be reluctance to buy business or to assume business that is outside of the corridor. I think it will be an initial test as part of your due diligence process, and it could hinder some moving of business.

MS. CAROL J. MCCALL: It seems the NAIC may actually affect how the business is assumed, that is whether it is cancel-and-reissue or assumption-and-reissue, if you are trying to buy a block that is significantly out of compliance or underrated. Does it seem that there may be an effect on how you actually go about getting the business?

MR. MILLAR: You mean to avoid having extra classes?

MS. MCCALL: Yes, that you may not be able to have certain classes. The number of classes due to acquisition are limited to three, I believe, and you cannot keep the same. At some point you are going to have to roll.

MR. MILLAR: I do not know of anybody buying more than three classes in an acquisition, but they might. I do know that one state, Wisconsin, is going to require, if you have a block of business you have acquired, that you roll it into your regular

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blocks. You must get rid of the acquisition block as a separate class. Wisconsin law is not clear, but that is what they say they want. I do not know if it is going to change the methods. I could see if you used the cancelation-and-reissue approach, you would have to move it in with the rest of your block, but remember you are trying to keep policyholders happy. If you do not keep policyholders and agents happy, the business is going to walk away from you. You have a lot of considerations. I do not have one exact answer.

MR. LEONARD KOLOMS: To answer Ms. McCall's question, I think if a cancelation and reissue is not considered as an acquisition, the new policies issued are your policies and they fall under your rules. It is no different from issuing a contract. You could probably coinsure for a while, making all the modifications on the other company's paper before transferring over to yours. If you wanted to do some other kind of arrangement, those both would work. Benefit Trust Life has assumed 17 blocks of business including four group blocks, medical, noncancelable disability, guaranteed renewable (GR), and major medical, just about the whole facet of health business. We have seen changes taking place in the acquisition marketplace with the small employer. We understand there are a couple of companies who used to be in that marketplace who are no longer in it because of the small employer regulations. In addition, it is becoming a problem if you do not try to cancel and reissue. You need to be very concerned with your rate structure, and what is going to happen with it.

Steve's method, I think, is completely different from Al's or from ours. In our 17 acquisitions, we have worked in a completely different manner. In all of our 17, it has always been a one-on-one situation. I think it is very similar to the way Paul Revere works. There are no multiple buyers with due diligence coming in. That is more like a sale of a company. I think on the 17 acquisitions we had, both parties thought of it as a win-win situation. Maybe you could comment on that.

MR. MILLAR: I think you are right. I think there is a significant block of business with multiple buyers. I have seen it for another block that I was involved in that was sold. The kind of process that I mentioned is often one that is orchestrated by the investment bankers. It would not be typical of the one-on-one situation. It certainly was not typical of the way we worked. As far as a win-win situation is concerned, I only know if I won and not if you won. There are many ways you can reduce this. I think there should always be a package, even if it is only three, four, or five pages. One of the worst things I see is when I get loss ratios, and that is all I get – I get nothing about the block or the distribution system. You have to underwrite the business, and you have to underwrite the way the seller does business. I do not think the block we sold to you, for example, would have been sold that way if it had had a significant value, e.g., many millions of dollars.

MR. KOLOMS: As I look at the 17 acquisitions we have had, 10 of them are different. The reason why, I think, is that only four have had the same financial structure. Most of them were in a loss position before we purchased the blocks of business, and we feel we have a good arrangement out of it.

MR. RIGGIERI: We normally do have competition involved in most cases, and the process does involve information going to all of them. It is a more complicated process in DI than in group medical. I also think the DI business may involve a few

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more complications. We take a very long look at the data, the types of business that have been put on the books, and the policies and policy forms. We have a fairly long start-up period. I think that is important for any potential seller to know up front that it takes a long time to understand and analyze the block. The reason for that in noncancellable DI is that we take on very long-term risk. We need to make sure that we have all of the bases covered.

MR. KOLOMS: I agree. In the medical business, you can come up with an opinion very fast.

MR. RIGGIERI: If you are saying that it is easier in the medical business to come to a conclusion on the block, I believe that is true.

MR. KOLOMS: I mean you do not have the claim reserve question as to whether or not even the past experience is any good. In medical, you can come to an opinion very fast, which helps a lot.

MR. THOMPSON: I think one point that comes out of the discussion on this issue is that there is no one right way, no simple cookbook, that applies in all situations. You need to look at the reasons why a company is selling what it is selling. Are there a whole variety of different things there? What sort of marketplace is there? What sort of value does it feel that it is going to be able to pass on to somebody else? What it really shows is a need for a well-thought-out, well-orchestrated, and well-documented process of information, due diligence, and a lot of traditional actuarial analysis along the way.

