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Issues in Life Insurance Consolidations

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Summary: This session discusses financial, strategic, and regulatory issues that arise from the combination of life insurance businesses through merger, acquisition, or reinsurance, with a special focus on the needs of mutual companies.

Mr. Harris N. Bak: We're going to talk about issues in consolidations as opposed to recounting specific deals. We have a very experienced panel with us. We have Henry Siegel, Fellow of the Society of Actuaries (FSA), who is a vice president of mergers and acquisitions for New York Life. We also have a guest speaker, Ira Friedman. Ira is a vice president and associate general counsel at Metropolitan Life. He heads up the general corporate law group and he's responsible for mergers and acquisitions (M&A), and international and corporate law. Ira was the lead lawyer for Met Life in the recent New England merger as well as for the purchase of the Traveler's group and disability business, the formation of Metra Health, and the subsequent sale to United HealthCare.

Ira also headed the legal work on Met Life surplus notes and he was the principal draftsman of the capital note law that New York enacted earlier this year. He graduated from New York University Law School and has been with Met Life for almost 25 years. We're going to start with Henry and Ira will follow. I'll make some closing remarks.

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†Mr. Friedman, not a member of the Society, is Vice President of Metropolitan Life Insurance Company in New York, NY.

Mr. Henry W. Siegel: First of all, a statement requested by my public relations department; anything I say is my opinion and my opinion only. None of it represents the view of New York Life and if you deduce anything from it concerning New York Life's future actions, you're probably going to be wrong. Second, I should mention that some of my comments are intended to provoke controversy and questions.

WHY DO COMPANIES MERGE?

My basic premise is that industry consolidation is the residue of failure. You don't get consolidation because somebody is out there with a lot of money going around buying up companies. You get consolidation because companies fail and are therefore available to be bought.

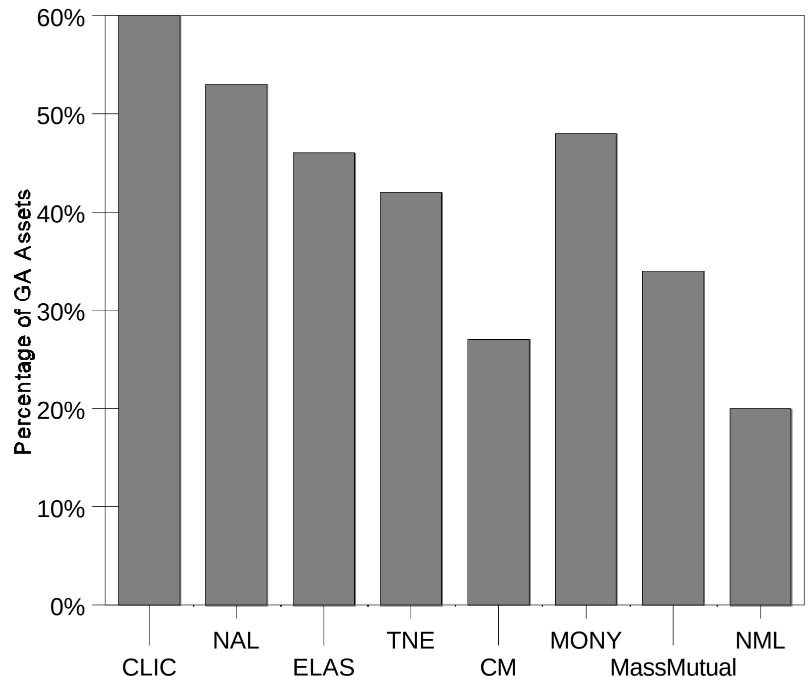
Companies fail for a variety of reasons. They fail because of losses on assets. They fail because of bad underwriting. They fail because their focus or scale is wrong. Finally, to some extent, and I think this is a growing reason, companies fail because their distribution system doesn't work.

We can all think of examples of asset failures. The collapse of the real estate market led to the loss of independence of a number of companies. The collapse of the junk bond markets also had its fall out; we are all familiar with the Executive Life failure. Asset failures have been the driving force behind most of the major consolidations of major companies in the past few years and, to some extent, they may be in the future. The interesting thing is, it could have all been predicted. Chart 1 shows companies' assets as of December 31, 1989 and the percentage of the assets in the general account of these companies invested in real estate and mortgages as a percentage of the total.

The companies on the left of the chart are companies that have lost their independence. You can see that they all had a very significant percentage of their assets in real estate and mortgages. The smallest one on the left side of the chart is Connecticut Mutual; it's relatively small percentage of real estate assets suggests that the company must have done more than one thing wrong in order to reach the position it is in.

On the right side are companies that have survived. One could deduce from this chart, that Mutual of New York has done something right. By all indications it should have been on the left side, but it remained solvent. It must have done something to be able to stay on the right side.

CHART 1
PERCENT OF ASSETS IN REAL ESTATE AND MORTGAGES
AS OF 12/31/89



Next, let's look at underwriting failure. The disability insurance (DI) consolidation that has gone on is largely a result of underwriting failure. Companies underwrote DI very aggressively in the 1980s. In the 1990s, when they suffered the losses, they suddenly decided that maybe they didn't have the facility to underwrite DI after all. Many company have gotten out of the business. As a result, after the recent merger with Paul Revere, Provident Life & Accident has the vast majority of this business. If you look at Table 1, which is based on data from Life Insurance Market Research Association (LIMRA) of 1995 sales, you see that between Paul Revere and Provident, sales were about $150 million. Almost half of the business of these 11 companies are from Paul Revere and Provident. Also, four of the companies on this chart are now doing all their marketing through Paul Revere, including New York Life. If you look at 1996 numbers when they come out, it will be even clearer how big the difference is between Paul Revere combined with Provident and the rest of the industry. They are in a true position of dominance in this business. The consolidation of the DI business has, therefore, already taken place.

The prime examples of failure from inadequate scale or focus are in the health care business. There have been many mergers of health care companies brought on essentially because one company or both companies decided they were too small to compete and they had to do something about it.

TABLE 1
DI SALES BY COMPANY—1995

Company	1995 Sales
Paul Revere	106,939
NML	43,581
Provident	42,034
UNUM	26,412
Guardian	20,392
Mass Mutual	16,282
Great-West	13,730
NYL	12,549
TNE	12,461
Conn Mut	11,657
Equitable	10,055
Total Top 11 Companies	316,092

At the same time, companies have failed because of a lack of focus (or a change in focus). In the 1970s and 1980s, many insurance companies were purchased by noninsurance companies and nonlife insurance companies because those companies thought with all the great cash flow generated by the life business they could do things. Some have since discovered that if you don't know what you're doing in life insurance, you can get burned. Others decided that the rest of their basic business wasn't doing so well and they had to concentrate on it. As a result, companies like AON and AMEX got out of the business, Alexander Hamilton was also sold by its noninsurance parent as was Paul Revere for that matter.

If you look around, you will notice other companies who are going through the same kind of process at the moment. I believe there will continue to be life insurance companies becoming available for this reason.

WHO IS BUYING?

In order to consolidate you need to have buyers who are buying. Many of the transactions have been mutuals merging with other mutuals. Obviously, mutual mergers can only be done between mutual companies.

Also, there are two prominent consolidators in the industry. One is GE Capital, and the other is Conseco. GE Capital has basically gotten into every line of business except traditional life insurance.

It's a leader when it enters. That's one of the goals that Jack Welch has set; anytime GE gets into anything it has to be a leader. It is now one of the leaders in term insurance, annuities, universal life, structured settlements and long-term care.

Conseco is another company who is active in acquisitions. They tend to focus on products to meet the retirement needs of seniors the same way GE Capital does. This focus on annuities and products designed to sell to seniors is a theme which is going to grow in the industry as the baby boom, of which I am unfortunately on the leading edge, becomes older and we start to look for retirement vehicles.

WHY ISN'T THERE MORE CONSOLIDATION?

Anybody who has ever met with an investment banker or, even worse, a management consultant, has been asked why there isn't more consolidation in the industry. That's because there are so many players. The answers are varied, but the first one is that life insurance companies fail very slowly. Mutual companies, in particular, can survive a very long time if they have the cooperation of the regulators. Furthermore, there is an impossibility of doing a hostile takeover.

This was driven home to me when I read the Met/New England brochure. If you read that carefully and you looked at the numbers on New England, you discovered that New England had no surplus at all when the assets were restated on a New York statutory basis. In Massachusetts, they had surplus, so they could stay in business; in New York they would have been out. There are other examples of situations where regulators, because of favorable treatment on financial statements, have helped keep companies in business that probably should have been in rehabilitation or sold.

At the same time that there's not more consolidation, there are always new people coming in because there are very few barriers to entry. Twenty years ago when variable life annuities were starting, we thought that having to develop systems to administer variable products would be a barrier to entry. People wouldn't be able to afford the major systems cost and therefore there would be a general shake-out, or a limit on the number of people who would get in.

Well, it was a good theory, but what happened is that third-party administrators have come in and offered systems to people at reasonable prices where they could afford to get into the business. Furthermore, because you had to have registered distribution, stockbrokers and banks, and independent brokers have stepped up and they've allowed people to distribute products even when they didn't have captive agency forces that were licensed to sell them. The barriers to entry at this point are relatively small.

It's also very difficult for mutual companies, which still are among the largest in the industry, to raise capital to buy other companies. Every so often somebody comes to me and says, what's New York Life buying these days? And I wave my hands. And then they'll say, what are you using to pay for it? And the answer, of course, is cash. I can't pay stock for companies the way GE Capital can, and that limits how much the larger companies can buy the small ones. At the same time, trying to demutualize is costly, time consuming, and requires a change of culture, which nobody takes lightly.

The mutual holding company, in my opinion, has very limited possibilities. The capital raising potential is much more limited than under a complete demutualization. There are major conflicts of interest between the stakeholders, the policyholders and the shareholders, which have only begun to be explored. We only have one company, AMERUS, that has done this. Whether those conflicts will cause problems later on will only be discovered as people actually start doing it. In many states, of course, there is no enabling legislation, which further limits its applicability.

Finally, the last barrier to consolidation, is the regulators. Regulators are worried about jobs. They're worried about jobs in their state. For instance, consider a very old example, the Phoenix/Home merger. There were requirements that the Phoenix had to keep a certain number of jobs in New York and a certain number of jobs in Connecticut because the regulators were concerned about losing jobs in their state. Furthermore, there are some states with very few companies. If they lose those companies, the regulators may lose their jobs. Therefore, you've got regulators worrying about jobs from a number of different directions.

WHAT IS THE FUTURE?

So, what is the future of M&A? The future is, there is always going to be failure in the industry. There are too many companies for there not to be. There will be some asset failures resulting from the old type of stuff. There may still be real estate losses in Canada. Primarily, however, we're going to start seeing companies going under because of new things.

In the last couple of days, I've heard investment bankers describe derivative deals that companies are doing with regard to collateralized mortgage obligation and junk bonds that are very risky. This leads me to suspect that if too much of it goes on without proper regulation, there will inevitably be companies who will find that their assets no longer are sufficient to meet their liabilities.

Noninsurance and nonlife insurance companies will also continue to divest in order to focus on their core businesses. Among the small players, consolidation will continue for scale, although this is not of major immediate importance to the industry as a whole. As I said earlier, one of the key things that I think is going to happen in the future is that you will start to see failures caused by bad distribution. I think they're going to happen in two ways.

First of all, I think broker/dealers and bankers are going to start limiting the number of insurance companies they're willing to offer. One example is Smith Barney; their parent has indicated in various forums that they want to limit the number of insurance companies that the Smith Barney brokers offer. In particular, they want them to sell more of Travelers. If this limitation happens, there are a lot of companies out there now who are relying on stockbrokers or who are relying on banks for distribution who will find that they are squeezed out of the market.

At the same time, career agency forces, in general, are under a great deal of pressure. About two days ago I got a copy of the current *Best's Monthly,* which included a staggering statistic. In the decade ending 1993, which is the last decade they had data for, there was a 27,000 net decrease in the total career agency force in the country. That is a huge number and it is going to continue in light of increasing number of companies trying to sell the same products and competing for distribution.

At the same time, who knows what's going to happen with the Internet. There are companies trying to sell on it. It may be successful; it may not be. The failures become M&A candidates.

OVERALL CONCLUSIONS

I have, in conclusion, three parting comments. First, M&A activity will continue to be a major focus for many companies in the next decade and beyond. Second, at the same time, the industry will continue to be fragmented. The largest companies are strong. If you make up a list of the top 20 companies, you will see that there are very few companies on it that look like they're candidates for failure on any rational basis in the next decade.

Finally and most importantly, to be successful as a consolidator you need to be successful. This means that the first thing you have to do if you're going to do mergers and acquisitions is make sure that you have a strong business yourself.

Mr. Ira Friedman: A couple of years ago, I was talking to one of my friends who is in the audience, Ian Solomon, about the way that business has changed the English language. The example I gave him was that in the old days, when something terrible happened and a company had a crisis to respond to, it was called a “problem.” Then, at some later point in time, someone said, “You know, you can't see the cup as half empty; you have to see it as half full. It's not a problem, it's a challenge.” (This is what I call making a business problem into an Olympic event!) Then somebody else came along and said, “No, you shouldn’t see it as a challenge, you should see it as an opportunity.” Without missing a beat he said to me, “I suppose that means that you can now have a situation that amounts to an insurmountable opportunity."

I will begin by talking about the strategic objectives of the principal types of consolidating insurance transactions. I am going to be using three relatively recent MetLife transactions as the paradigms for my talk. We acquired the Travelers group life and related businesses in January 1995. At the same time, we also formed a joint venture with Travelers in the health care benefits business, which we called Metra health. In August, 1995, in what was probably our best-known transaction, we were fortunate to be able to merge New England Mutual into MetLife.

By the way, I should mention that nothing I say here in even the most remote sense represents any of MetLife's views. They are all my own. Before I talk about the legal aspects, let me say a few things about MetLife's strategic objectives in doing those transactions. In the case of the acquisition of Travelers' group business, Travelers' strategic objective was fairly straightforward. Sandy Weill did not want to be in the group insurance business. So it became evident early on that if he was going to do a venture in the group health business, he also wanted to shed Travelers' group life, dental, disability, and related businesses. For MetLife, the group life acquisition represented an opportunity to acquire a very large block of what we consider to be "small" group cases. Everything is relative, and I'm told by people in the industry that MetLife's small groups aren't so small. In all, we acquired roughly 42,000 cases; and of those, 40,000 were in the small group segment of the market.

The second major value that transaction had for us is we also acquired Travelers' disability business along with a corps of people who really know how to run that business and could complement the people that we already had. As for the formation of Metra health, both MetLife and Travelers shared the recognition that their respective indemnity health businesses had not met their expectations. Maybe one could call it a failure, Henry. Clearly, we hadn't achieved the kind of critical mass we needed in the managed care business. We probably had health maintenance organizations (HMOs) in markets that were already saturated and weren't strategically located. So the goal was to bring both of our businesses together, shed operations that didn't belong where they were, and create a higher, combined platform from which to compete in the markets where profit was a possibility. Things worked out much better than we expected when we created Metra health in January 1995. In October 1995, United Health Care bought the Metra health organization at a substantial profit to both of the original owners.

The merger with The New England represents a situation where the two parties had complementary interests. The New England's focus in the marketplace is on the high-end individual insurance market. One of the things you need in order to sell in that market is an excellent credit rating. Unfortunately, for some of the reasons Henry mentioned—although I wouldn't call them failures—The New England's rating had gone down. The New England saw a merger with MetLife as an opportunity to give their excellent general agency force the kind of ratings they need to sell in their market. For MetLife, it was an opportunity to take an excellent organization that works in the high-end market, bring it into MetLife and let it do the business it knows how to do best. The other benefit to MetLife, of course, was that The New England had $16 billion worth of business, and it's a good thing if you can acquire that large a block of business.

Let me now turn to the key aspects of each of these kinds of transactions and discuss how a lawyer looks at them. Obviously, acquiring a business means acquiring a business. One company is getting out of it. The other company is acquiring it. When you look at this from the lawyer's perspective, you have to deal with the steps needed to get the deal done. First, you have to analyze the interest of state regulators and the impact that the transaction will have on their regulatory power and on their state. For Travelers, getting out of the health care business presented a key issue—jobs. As Henry mentioned, states do not like losing employment. There was a hearing in Connecticut, and the most significant focus was probably jobs. Another challenge for Travelers arose from the fact that group life and health are typically run as integrated operations. Travelers (and MetLife) had to figure out how to split them off. In Travelers' case, one major chunk would go to MetLife and the other to Metra health.

The second aspect of acquiring business is that there is a transfer of assets and/or administration. Typically, on the day after a transaction like this takes place, the business that was on the selling company's administrative systems the day before is still on the selling company's administrative systems. It usually takes a period of time to migrate the business over to the buyer's systems. When you're talking about transitioning business administration, a lawyer immediately thinks of checking software licenses. These licenses may, for example, have change-of-control provisions that give the owner of the licensed software rights in the event that the licensee is sold. Also, software is typically licensed for use by the licensee or, in some cases, by the licensee and its affiliates. It would be unusual for a software license to allow unrelated third parties to use the software. In the end, these issues should not be obstacles to getting the deal done. Most licensees will readily agree to having a reputable buyer assume the license, but they may ask for additional money in the process.

A joint venture of the type we are discussing would involve reinsurance. As you all know, reinsurance involves the transfer of assets and liabilities. One issue we face is whether we transfer actual investment assets or cash. When the assets themselves are transferred, they get marked to market because the reinsurer has to receive assets with a value equal to the liabilities it is taking over. In the Travelers transaction, we had a situation that has probably come up in other transactions. They had several hundred million dollars worth of premiums and other receivables. MetLife agreed to take the receivables and count them as good assets, but only on the condition that, to the extent that they proved uncollectible, Travelers would replace them with cash.

When you're transferring administration in the kind of deals we're talking about, you're going to have issues relating to people, issues relating to facilities, and issues relating to equipment. How do you get those moved over? What do you take? What don't you take?

Regulatory approvals are needed for reinsurance transactions and, at least in New York, and I suspect in a number of other places, if you're going to have the buyer administer business of the selling company, you may need regulatory approval for the administration agreement as well.

An additional aspect of this kind of a transaction is an antitrust analysis. What will the effect of the transaction be on the market share of the acquiring company? Unless the transaction comes within certain safe harbors, you have to make what is known as a “Hart-Scott-Rodino” filing with the federal antitrust regulators, and you may have to get antitrust clearances from various state insurance regulators. Typically, these filings are a formality, and the transaction goes forward without any changes, but there are exceptions. In the United HealthCare acquisition of Metra health, it turned out that United HealthCare and Metra health each had a very significant presence in St. Louis. As a result, both the federal government and the State of Missouri required United HealthCare to agree to divest certain Missouri operations of Metra health within a short period after the acquisition.

Finally, the ultimate and frequent objective of the selling company is to move the business totally off its paper into the acquiring company. That requires “assumption reinsurance.” Assumption reinsurance effects what the lawyers call a “novation.” It creates what the law regards as a new contract. You have a new party and you can't do that without the express or implied agreement of the other party to the contract; in this case, this means the policyholders must agree. The National Association of Insurance Commissioners (NAIC) has addressed the process of getting actual or implied policyholder consent, as has New York. As a practical matter, in a very large deal, particularly if the ceding company is domiciled in New York, assumption reinsurance is likely to be a long process. A fair number of regulatory approvals may be needed, and communications with the policyholders may take a long time. So it could be some time before the business is fully transferred off the seller's paper, if ever.

To summarize, the four aspects that I talked about are: acquiring and getting out of the business itself, transferring assets and/or the administration of the business; the regulatory approvals that are needed, and the special problems that come up in conjunction with assumption reinsurance.

Let me turn now to the joint venture, represented in MetLife's case by the Metra health transaction. First and foremost, the joint venture presents the normal set of partnership questions—how to start the venture, how to run the venture and, in the event that things don't work out or if one of the two parties wants to sell out of it, how to end the venture.

In the Metra health transaction, we each contributed managed care, indemnity insurance operations and related businesses, but also cash. The amount of cash contributed was driven not only by the need to make sure we got to a 50/50 sharing of the joint venture, but also by the need to give the insurance company that was going to continue to write the indemnity business sufficient capital in order to satisfy regulatory requirements. We also considered who was going to control the partnership and what decisions would require the agreement of both partners. These issues are fairly standard and normally get worked out in the course of negotiation.

There is invariably an agreement between the two partners; if the joint venture takes the form of a stock company, it's a shareholder agreement. The agreement deals with such questions as, what happens if one of the parties wants to sell out? Does the other party have a right of first refusal, and how does that work? There are standard templates for these kinds of provisions, but as we all know, nothing ever works out quite the same as the last transaction, so a fair amount of negotiation and customization goes on.

Finally, if things really break down, you may need to have a deadlock provision, which enables the parties to split the partnership and admit that things haven't worked out the way they had hoped it would and say, "Let's be friends, but let's get divorced."

Just like the acquisition setting, a joint venture would involve reinsurance and administration issues if the partnership is going to take over a block of business and administer it. As is typical of such deals, when we formed Metra health we had to determine how to get the customers into it. Assumption reinsurance might have worked, but it was fairly complicated. So we agreed that as the customers of

MetLife or Travelers came to their renewal dates, we would each do our best to encourage them to roll over into Metra health. Another area we had to deal with was, what happens to claims that are already in dispute when the risk goes to Metra health? It's one thing for the new company to handle disputes that come up after the transaction takes place. But what about claims that are already in dispute? Perhaps the best approach is to leave them with the two partners rather than putting them into the new company.

As I mentioned earlier, what to do about facilities and people, and the equipment that goes along with facilities, are issues that need to be addressed in setting up this kind of partnership. The kind of partnership we are talking about will involve a consolidation of operations. So either the partners can decide which employees will be asked to move to the new venture or, as we did in Metra health, all the employees who were involved in the operations of each of the companies could move into the venture and the venture's senior management will decide who is the best person for various positions. The kinds of personnel questions that come up are, who is going to pay the severance for the employees who are terminated by the partnership? What employee benefit plans will the venture's employees participate in? A new company is unlikely to have employee benefit plans ready on day one, so you transition the employees out of the partners' existing plans.

By the way, in our litigious society employee terminations have produced more work for the lawyers than I would have wanted. As you know, people who get terminated tend to consult a lawyer and it's not surprising to find a fair number of lawsuits. Retaining key people, especially people who fear that they might be terminated as the venture gets going, is another challenge. The cardinal rule, as far as I'm concerned, is "tell the employees the truth." You tell people the truth as soon as you can. You communicate to them as much as possible. You structure programs to provide incentive for the good people to stay with you—say bonuses and things like that.

To summarize, the three most critical sets of issues I see in partnerships and joint ventures are: the standard set of partnership issues—creating it, running it, terminating it if necessary; reinsurance and administration arrangements, which are probably unique to partnerships involving insurance operations; and facilities, equipment and people—how do you split them up and how do you deal with all the people issues that come up in the course of this kind of a transaction?

Now I would like to turn to the transaction that I love the most—the merger. That's The New England merger in particular. The first area that a lawyer has to think about when he or she is told that a merger is in the offing is the regulatory approval process. The most important states are the domiciliary state of the company that is going to survive and the state where the company that's going to disappear is domiciled. Of the two, the state of the company that's going to disappear would be inclined to have more to think about than the state of the company that's going to survive. In the case of The New England merger, we found New York to be very thorough and very reasonable. They didn't let us avoid any issues. They made us address them carefully. At the same time, it's fair to say that Massachusetts gave us more of a run for our money than New York did because they were losing a company. Again, the one issue that seems to dominate everything (taking a backseat only to the treatment of policyholders going forward) is jobs!

Massachusetts hired outside advisors. They had one advisor for the actuarial and accounting issues. They had another advisor for legal matters and, finally, they had an investment advisor. These firms put us through months and months of detailed due diligence, and they focused on many issues. I'm glad to say, at the end of the day, they agreed with us that the merger was fair and was something that Massachusetts should approve.

When you have a merger, the question that has to be asked is—do the policyholders of both companies have to get some benefit? Is it sufficient for the policyholders of one of the two companies to get a benefit as long as the other company's policyholders don't suffer? Or is it sufficient that neither set of policyholders suffer? There's no doubt in my mind that it's much easier to do a merger if one and one equals three—if there's a benefit to both sets of policyholders. The way this worked out in The New England merger was very interesting. We agreed that $150 million of the New England surplus could be added to the New England block of policies in MetLife in order to support their dividend scales. New York asked, “How can this be fair to the MetLife policyholders—you're putting $150 million into this closed block?” We said, “That's not coming from the MetLife policyholders; it's coming from The New England’s policyholders.” And then Massachusetts turned to us and asked, “How can this merger be fair to The New England’s policyholders if you're spending $150 million of their own money?” By the end of the day we persuaded them, as was the case, that this was $150 million that could not have been spent by The New England other than with the backing of the MetLife capital.

A critical issue that this touches on is the matter of fairness to the policyholders’ dividends. That is probably the most central issue to the approval of a mutual insurance company merger. You have to show that the policyholder dividends will be determined after the merger in a fair and equitable way. In The New England merger, one issue that we faced had to do with the fact that a fair number of accounting adjustments were going to be made in order to conform accounting methods. Both The New England and MetLife had valid accounting methods. But MetLife tended to be more conservative. When the book of business was coming into MetLife, we decided to use the MetLife accounting treatment for such things as real estate assets.

Massachusetts, rightly so, wanted to make sure that the policyholders' dividends from The New England were not going to be disadvantaged because MetLife felt it should be more conservative in these accounting matters. We dealt with this issue in the dividend policy statement that we crafted. It's available to the public as part of The New England's proxy statement. There we also dealt comprehensively with how dividends were going to be determined and with the essential principles that were going to be applied while the TNE block continued to be a segment. Among other things, we said that we would keep the block as a segment for at least ten years after the merger.

People issues is the first issue. If you can't make the executives of the two companies comfortable with what's going to happen to them as a result of the merger, you can't do the merger. The only exception that I can think would be the case of a failing company, where the executives might be just as happy to be relieved. But if you're taking two companies that are fairly healthy, the executives have to be comfortable that after the transaction is over, they will be treated fairly. The second most important issue having to do with people—and facilities and everything else that is essential to operating the business—is the extent to which you're going to consolidate operations. We did what we referred to as a strategic merger. We didn't consolidate. It was very important to MetLife to have the people who knew how to run the high end of the market remain with us. So we did not face the consolidation issues that typically arise in a merger.

Unexpected liabilities are a particularly critical area of concern in the case of a merger because, unlike an acquisition, where the seller is still around, in a merger the seller disappears. So it is very important that the surviving company do very thorough due diligence on this issue before the merger takes place. If there's any liability left over, it's yours. There's no seller to sue.

I just want to clear up some other fundamental issues. A friendly merger cannot take place unless the parties trust each other. They need to share a common vision of how the post-merger operations will be conducted and what the roles of the respective parties will be after the merger. From the standpoint of the regulators, in addition to the dividend issue, they raised with us the question, what would happen if MetLife were to demutualize after the merger? How could Massachusetts be assured that the former New England policyholders would be treated fairly? We had to give Massachusetts assurance that the fairest method of determining the respective policyholders' interests would be used. In addition, we had to comfort Massachusetts that the incentive compensation arrangements for management of

The New England after the merger would be such as to create an appearance that they put their self-interests above those of their policyholders. We were able to satisfy them readily on all those points.

Again, the key elements that the lawyers look at with respect to the merger of mutual life insurance companies are: the need for domiciliary state approvals; the benefits to both sets of policyholders; policyholder dividends; people issues; unexpected liabilities; and other fundamental issues that the regulators can raise and that the parties themselves have to deal with.

Mr. Bak: We're talking about all transactions—whether it's mergers, acquisitions, joint ventures, etc. What drives these transactions? There are a number of drivers, including need for capital, desire for growth, market recognition, critical mass, and economies of scale. I think it's really none of those. What really drives all transactions is market share. We're in a mature industry and everyone is fighting for a limited amount of market share. There's no way to get it except by taking it from someone else.

If you've been following the acquisition markets lately, there have been historic multiples of both prices to earnings and prices to statutory generally accepted accounting principles (GAAP) book. I believe that recent acquisitions have been done for rates of return of under 10% after tax, which is very low. Some people attribute this to the supply of excess equity capital. There are many equity funds out there chasing the same few properties. I think it's more like a game of musical chairs. There are but a few attractive properties available, everyone wants to get them, and no one wants to be left standing when the music ends. In my opinion, that is what is driving these transactions. All the other things are ancillary.

Everyone needs capital, but what do you need capital for? If you aren't worried about selling, you could just stop, close down your agency system, and have all the capital you want. You need capital to either buy distribution, buy other companies, or to attract business. The last item is included because in certain types of business, such as accumulation business, customers are attracted to companies with stronger capital ratios.

People frequently point to a “desire for growth” as a driver. Again, a merger gives you growth, but that's just one-shot growth. However, if it gives you market recognition, it could lead to compound annual growth. Recall the Malthusian model in which arithmetic growth doesn’t amount to a hill of beans in the long run.

Another thing that perhaps doesn't get enough attention is the buy-versus-build analysis. Any company that has enough capital and wherewithal to do an acquisition or a merger could just build their own operation. You could buy the talent, you could buy the agencies, etc. The key thing is the speed of entry versus the cost of the acquisition. It costs more to pay for something that's already there, but the speed of entry is critical. If it takes you two years to enter the variable annuity market and you could do it more cheaply than buying a variable annuity company, by the time that two years is up, there's no more shelf space. Everyone has made their relationship. Henry and Ira both spoke about how there's going to be a consolidation of distribution, and if you miss your opportunity, it may no longer be available.

We've been focusing on mutual companies, and one of the problems with mutuals is limited capital. There have been many talks in this session and other sessions about all the ways mutual companies could raise capital, such as reinsurance, issuing surplus notes, etc. There hasn't been much explanation about the mutual holding company.

There is a statute in Iowa, and similar laws have been passed in several other states. There are at least two models of mutual holding company acts and the difference between the two that I've seen was the intermediate holding company. In both versions, the insurance company becomes a stock company. The policyholder still has the same policies, and gets the same dividends. The policyholder exchanges his intangible ownership in the mutual life insurance company for an intangible ownership right in a "mutual holding company," which initially owns 100% of the insurance companies. Really nothing has happened, but the newly stocked life insurance company now has the right to sell equity to other owners. The investors could be other insurance companies, private investors, etc. By selling minority shares, they raise capital, which they could use to buy other companies. The intermediate holding company also could borrow, thereby using leverage to raise funds for acquisitions or other purposes.

It has been thought of by some people as a semidemutualization. The only difference between this and demutualization is that the policyholders haven't gotten anything tangible, which is why some regulators are reluctant to approve it. They feel if you're going through this process, if you're changing a form, at least give somebody $1,000 worth of stock or cash. Here, they just trade one intangible right for another. But, of course, it's much faster to do this. The most time-consuming and extensive part of a demutualization is figuring how much to give each and every policyholder.

We're back to the main topic—another way to build market share is through joint ventures, which is what many people do in the disability income business. Some companies didn't have the know-how or risk appetite to be like a Paul Revere, so they enter into joint ventures where their agents sell Paul Revere products. Sometimes they're private label; sometimes they're co-marketing, the difference being only who has the primary liabilities. In both cases, the expert, in our example, Paul Revere, does the administration.

Just a quick summary. As I pointed out, the real motivation is growth. It could be direct growth or indirect growth through raising capital. Every type of transaction primarily gives you either growth or capital. In a mutual holding company you get both. Demutualization just raises capital, it doesn't automatically give you growth, although you can then use the capital for other purposes.

Let's talk about mergers. A mutual merger is a funny animal, particularly for actuaries. When we work on an acquisition, somebody asks, is this a good transaction for our company? We're not lawyers, and we're not accountants. We ask if it’s worthwhile financially. We look at an actuarial valuation based on discounted cash flows. If the discounted cash flows are worth more than the price of the company, it's a good deal. If they're not, it's a bad deal. While this is a slight oversimplification, that's the primary issue.

We also do a valuation on the mutual merger. It has to be a pretty bad company to come out to be worth less than zero. Of course, there is no cash paid for a mutual merger, so one way to look at it is every merger is a good deal.

Another way to look at it, which is equally valid, is to say no merger is ever a good deal. Whenever you merge companies you have a stronger company and a weaker company. Whether you measure it by a risk-based-capital ratio or by any other measure, there's always a stronger and a weaker company. When you put the two together, you get a medium company, which means the stronger company has weakened itself. If you're a policyholder of a stronger company, why would you want your company to weaken itself to support another company?

Sometimes there's magic. Expense savings, synergies, etc., sometimes work out and sometimes do not. In truth, I think the answer is somewhere in between the two extremes. You do need to do a valuation, but it sometimes is a good deal and sometimes isn't, and you have to analogize it, not to a cash acquisition but to a stock-for-stock deal. When one company trades some of its stock for 100% of the stock of a small company, it's not paying anything besides diluting its stock. Similarly, when a mutual company merges, it is diluting its corporate equity. We'll get to dilution shortly. In some ways mergers are very similar to acquisition. You have the same people issues, organization chart issues, downsizing issues, and regulatory issues as Ira mentioned.

The following are some ways that mergers differ from acquisitions. For mutual companies there's no hit to capital in a statutory merger. There could be a hit to the risk-based-capital ratio, but there's no direct hit to capital. Unfortunately, stock is not available to compensate displaced executives.

Harmonization of dividend scales is very important. We'll talk about that a little later. There has been more focus on the policyholder interest; there is focus on the policyholders both as policyholders and, very recently, policyholders as owners.

To understand dilution, we have to try to understand what a mutual policyholder is entitled to. In order of importance, a mutual policyholder, like any policyholder, is entitled first to a sense of financial security. If he feels his company is not going to survive to pay his death benefits, then everything else is irrelevant; so the first consideration is that if there's a merger, there is no material diminishing of financial strength. Without that, no one could give a fairness opinion.

The policyholder’s second right is his entitlement to receive dividends. The merger should not be expected to cut his dividends.

The third is his equity interest. This had never been an issue, to my knowledge in any merger until the Met/New England merger, when the issue was raised by the Massachusetts Insurance Department. They said that New England policyholders have an equity interest. You can't do anything with it other than vote for management, but if they were to demutualize they would be entitled to cash or stock. They wanted assurance that if the companies first merged and then MetLife demutualized, the New England policyholders wouldn't get less consideration than if New England were to demutualize on its own. That's a hard concern to answer. It's a hypothetical event that may or may not happen. Laws change; the future changes. Eventually Massachusetts was satisfied, but it took some real actuarial and legal gymnastics to get past that one.

One issue that actuaries have to deal with is dividend harmonization. The states want to be satisfied that the merger will not, ipso facto, hurt the dividends, particularly of the disappearing company. They feel that the management of the stronger company is in control. How do they know these dividends won't be cut? Massachusetts, in particular, was concerned that Met's more conservative accounting would result in weaker dividends to the New England policyholders. Met assured them that their dividends were driven by the real economic situation—the divisible surplus—not by accounting consideration. You obviously can't run a merged company on two sets of accounting principles, but accounting should not be the primary focus in driving dividends.

We talked about policyholder equity interest. Let's talk briefly about cost of capital. When I mention dilution, if a stronger company merges in a less strong company, it doesn't pay any cash, but there is dilution and one of the measures of dilution is cost of capital. Essentially it's giving up some of its risk-based-capital percentages to support the other company. In that way it's similar to how you measure cost of capital for a stock company.

Just a couple of words on dividends. If you have two companies with different dividend formulas, say one company with a three-factor formula and another company with a different formula, for a period of time, the companies each have to agree to keep the original dividend scales or dividend formula and practices for each set of policyholders. Ultimately, they have to be merged, and in order to merge them you have to understand the unique characteristics of every company's dividend formula. One issue that was raised on Mass Mutual and Connecticut Mutual was that the expense savings, by putting the companies together, would be shared fairly among both classes of policyholders. Similarly, two companies can't necessarily have the same mortality charge in their dividend formulas. The policies were underwritten differently.

In order to come to a conclusion that the merger is fair to policyholders, there are several steps. First, you must do separate company projections for each of the two merging companies. You then do combined company projections. You should be able to demonstrate that the combined company has key ratios that are not weaker than either company had previously. As you know, in the risk-based-capital formula, when you combine companies there are some savings. For example, if each company has double capital for its ten largest bonds, when you put the companies together, that capital is released. The same is true of mortality and morbidity factors. As you get one larger company, the factors are not additive.

You have to reflect expense savings and marketing synergies. You also must reflect marketing losses. If two companies have agencies across the street from each other, and you put the companies together, chances are you will have less than the sum of the two markets. You'll lose some marketing opportunities. This might be particularly true in the reinsurance area. As reinsurers consolidate, some direct companies will choose to maintain their choice of reinsurers.

A quick note about cost of capital, which is always a controversial item. When you have a merger or an acquisition, usually there's a team from the company, that consists of several experts—it consists of a chief financial officer (CFO) and treasurer, people from the controller's area, actuaries, and investment bankers, and everyone has a different idea of how to measure the cost of capital.

In finance courses, the cost of capital refers to what we call the hurdle rate, which is the interest rate you must earn for you to be interested in investing your money. The CFO would say, after we do the merger, will we be able to meet my return on equity (ROE) objectives? If we need a 10% ROE or 8% or 12%, that, in the CFO's mind, is the hurdle rate we need on the investment. A treasurer, particularly for a stock company, would look at the weighted average cost of capital. He would measure how much his debt cost him and how much he needs to return on his equity. A company like GE, which can leverage at extremely low rates, has a tremendous advantage in cost of capital over most other buyers.

As actuaries, we have been saying that the cost of capital, which is the cash-flow discount rate we've been using, is the sum of two things—it's the risk-free-debt rate, plus the risk premium. In other words, a riskier business, let's say health insurance, might have a higher discount rate than something very stable like a mature block of whole life policies. If you put those two together, that's very, very analogous to the capital-asset-pricing model that's taught in every finance course. They talk about discounting cash flows. We talk about discounting statutory earnings after reflecting capital requirements. If you take statutory earnings and subtract out the increase in required capital, you essentially have the amount that can be paid as dividends to shareholders, which is the cash flow to the investor.

The actuarial model and the finance model are exactly the same, but I suggest we have a third piece, which is a spread for surplus strain. Because our distributable amounts depend on accounting, and surplus strain reduces the amount we can pay out to investors, that must be factored in. This point is important now because some states (like New York) require you to write off goodwill. If you buy a company, the excess of the purchase price over surplus comes right out of surplus. The NAIC allows you to write it down over ten years. That means if a New York company and a non-New York company are bidding for the same property, and they have the same views, the non-New York company can pay more. It will get a higher discount rate, a higher rate of return because it has less capital tied up, so I think that should be factored in.

The investment bankers say that the cost of capital is dictated by the capital markets. If more people are bidding for a company, you have a lower hurdle rate, which is kind of circuitous, if you think about it. We use a formula to translate this into value. We multiply the required capital by the difference between the discount rate and the tax-free reinvestment yield. If you have money that could be used to earn 10% or 15% investing in things, but has to be left in surplus earning only 5% after tax, the present value of that difference is the cost of capital.

For some companies it depends on the current capital position. If your risk-based capital is extremely high, for example 300%, you might say there's no cost of capital because you have capital to burn. It depends on your leverage, your ratings, and the availability of new capital. It also depends on whether you are a company that can go back to a capital market. The capital market is driven by uses. If you have good uses for the capital, you can raise money cheaply. Therefore, if there's a good opportunity, you're not constrained by capital. If you are a company that does not have access to capital markets, like mutual companies, cost of capital is a bigger consideration.

Mr. Siegel: As we were preparing these remarks, it occurred to me that we were missing two things. First we were missing a good close. Second, all of us have been in situations where we were dealing with deals that didn't make a lot of sense and we haven't commented on those deals. I thought that it would be a good close, therefore, if I prepared, with a nod to David Letterman, my top-ten reasons why acquires overpay for life companies. You may recognize some of these reasons.

10. "Chairpeople want to visit Florida or California more often."
9. "It's small and no one will notice."
8. You've got to follow carefully. "There's a low multiple of book if you adjust for the unrecognized asset values and forget that the acquisition charges and adjustments virtually wipe out reported surplus." If you say it fast enough it's been known to work.
7. "It's only stock." (That's for my friends at GE Capital and Conseco.)
6. "With our name on the product, sales are automatically going to take off."
5. "On a marginal basis, the internal rate of return is 20%."
4. "It's strategic"—and I know we've all heard that one before.
3. "The chairpeople's salaries and asset size are highly correlated."

But lest you think from this that I think that chairpeople, actuaries, or anybody else are the prime culprit, look at the last two.

2. "The investment banker's analyst told me my stock would not decline." (That's a polite way of saying they probably told you it would double.)
1. "The investment bankers lead you to believe that there is more than one bidder."

Mr. Philip J. Bieluch: My first question is directed to you, Harris. You talked about holding companies and you said that less than 50% of the equity could be provided by a minority investor. My understanding of the law is that less than 50% of the votes could be owned by a minority investor, but that the minority investor could give two, three, or four times by having multiple classes of stock.

Mr. Bak: I believe that's true. I was referring to voting control.

Mr. Friedman: It depends on the state, on the exact reading of the law. But the general answer is "yes."

Mr. Bak: It also depends on the plans, if they approve.

Mr. Bieluch: But it's still a vote issue, not an equity issue?

Mr. Friedman: In theory.

Mr. Bieluch: That gets into other issues, such as policyholder stock. My second question is for Ira. If you're sure that the assumption reinsurance generates a brand new contract, do you think it's prudent to go for a 7702 and 7702A ruling that it's not a new contract. How do you handle that facet of it?

Mr. Friedman: By telling you that I don't know how to spell the word *tax*. I have a feeling that the objective here must be to convince the IRS so you don't have to do retesting. But I'm not an expert on the tax law, sorry.

Mr. Melville J. Young: In fact, the IRS does require that the original reserve be maintained in a reinsurance transaction.

Mr. Steve R. Daubenmier: Many of the items you brought up regarding mutual mergers seem to be for large companies. I'm wondering, as the companies get smaller and smaller (say companies with under a billion in assets) do the complexities become less as far as the regulators' willingness to approve it without so much effort?

Mr. Friedman: I have to say I haven't really thought about it, but I think some of the difficult issues—like a large employee population—seem to me to be less complex when you have a merger of smaller companies. I suspect the answer is that many of the complexities either reduce or go away.

Mr. Bak: First, let me give a plug for Mel Young, who has a session on smaller company consolidations. Second, let's extrapolate from a couple of demutualization transactions. Everyone has heard about the big ones, like the Equitable, or State Mutual. Midland Mutual demutualized and Savings Bank Life Insurance in Massachusetts effectively demutualized because of it's size; the states were much less troublesome on the dividend-fairness issues. They insist it be fair, but they didn't require the same kind of detailed analysis like the bigger ones require.

From the Floor: That's particularly true in The New England/Met deal. When you have two different dividend groups in the two companies, where do new policies fall that were sold within the smaller company after the deal went through? It seems like they should be in a limbo status, particularly if there appears to be some sort of subsidy one way or the other.

Mr. Friedman: Let me just say that in the New England deal, we emphasized the strategic nature of the deal. We weren't consolidating. So what happened was—and I assumed people knew but maybe they didn't—the existing block of business came into MetLife as part of the merger, but new business (with an exception I'll mention in a minute) was going to be written in a subsidiary. NEVLICO was the New England Variable Life Insurance Company and became a Met-sub as an asset of The New England. We renamed it New England Life and that is The New England going forward.

All the new business, with one exception, is written in the subsidiary. The exception has to do with business written right after the merger through The New England's general agency force. The New England's management and our management were concerned that this be pretty much a seamless transaction from the standpoint of the general agents. NEVLICO, or NELICO as it now is called, didn't have the broad array of products licensed in the various states. On the day of the merger they were still in the process of doing their product filings. So what were the general agents going to sell the day after the merger? We were able to get all the states to agree that while they were considering the new product filings for NELICO, the agents would be able to continue to write business on the same forms as The New England had been using the day before the merger, only now the forms would carry a MetLife endorsement. Thus, for a period of time, what we call "transition policies" are being written in MetLife. Once the transition period ends in a state, the new policies will be issued by the subsidiary.

Mr. Peter P. Wu: I can answer that question based on what Phoenix Home Life has been doing. After the merger, Phoenix Mutual's old block was one class. Home Life's old block was another class, and the Phoenix Home—meaning the new issues since the merger—became a third class. As you pointed out, the plan is going to have those classes merging within us, maybe in a ten-year period. That's the plan we filed with New York.

Mr. Friedman: Let me just add to what I said. The business that MetLife's agents produce the day after the merger is MetLife's business. So we have two blocks in MetLife. The New England policy block is a separate segment. The New England policies will be going into the subsidiary.

Mr. Bak: The states aren't that concerned by new business written by the subsidiary. What they're concerned about are the policies in-force whose holders contracted for one type of company are suddenly being thrown into another company, basically against their will. Those are the people that they feel need the most protection.

From the Floor: Ira, you were very circumspect in describing how Massachusetts was careful in their approval. You said that, in small companies, you expect less difficulty, and jobs are less important. From the investment point of view or financial point of view, the concern that is creeping out is that once you start down the road on this kind of merger of two small mutuals, it may be a certain kind of extortion being exercised against you by the state losing the company. What if you invest a great deal of money in the process only to be held up at the eleventh hour by a state that doesn't want to lose the jobs?

Mr. Friedman: I'm inclined to say that in our hearts we knew we're right, but you're right, that could be a problem. In the perfect world you sit down with a state on day one and say, “OK, we're going to do a merger. Let me know what your issues are.” Maybe that's a little easier to do in a small company merger. I'm not sure. But in the context of the MetLife/New England merger, the issues only began to emerge as the consultants did more and more due diligence. If I were being cynical, I would say they found better and better ways to run up large bills. But the fact is, I don't think any of the issues they raised were phantom issues. I think they were all real questions.

You're right. If, in a small company merger, you can get those things on the table upfront, that could make the process much easier and avoid the risk of spending a lot of effort and money. I guess it's a public relations risk as well. It would be terrible to have gone down a long road only to have the regulators say “no” at the end of the day.

Mr. Young: I’ll echo some of the things that have been said. I've been involved in a number of small company mutual alliances or mergers. I think that, generally, there's less problem with the regulators with a smaller company merger as opposed to the kinds of things that Ira was talking about because there is at least the perception that maybe somebody's in danger. The state wants to protect the policyholders, and perhaps this emerging company will be stronger. In negotiating with state insurance departments, perhaps you can provide some sort of guarantees, which are usually very important to the boards of directors; most of the small mutuals are entrenched in small communities. Job security is very important, and continuation of the entity is very important to those communities. Normally there are some guarantees that are made that the jobs will continue in that state, and in that community. The company will continue in that community in some form, and very often you're able to show that there will be more jobs because the resulting organization is going to be stronger and able to do more things.

Mr. Friedman: Let me just add something on the Massachusetts Division. Even though they put us through a great deal of pain, the fact of the matter is, at the end of the day, exactly what they were worried about did happen. There is a consumer in Massachusetts who sued to try to stop them from approving the merger. He made all kinds of claims about a number of things, including the benefits this merger would present to The New England policyholders. So at the end of the day, it proved to be helpful for both sides, as well as the regulators, that they engaged in this kind of comprehensive process, raising issues, making sure that the answers to the issues were real answers and that they were defensible.

From the Floor: What kind of arrangements and protection were made for the top executives on some of these mergers you discussed, and how far down was any protection given?

Mr. Friedman: As far as protection, we made arrangements for the top executives to have what they already had and with MetLife's program for executives with comparable jobs. For example, on the incentive compensation program, we said that the standards would have the same kind of rigor as those used for the incentive compensation program for MetLife executives. Massachusetts basically prohibited New England Mutual from paying bonuses to the top executives for having done the merger. I believe that merger bonuses were paid, but they were not paid to the top corps of executives.

From the Floor: Were there employment contracts for specific periods? Can they be laid off a year later, from that standpoint?

Mr. Friedman: There are employment contracts for the top executives. In terms of the organization in general, we did give the Massachusetts Insurance Division a letter that said that for three years we would basically try to maintain current employment levels. That's a real expectation, and if a company proves to be as successful as we hope it will, the employment may even increase. I think that's a testimony to the quality organization we acquired.

Mr. Armand M. de Palo: I'd like one of the panelists to talk about the problems of merging two boards of directors. One of the problems you have in any merger, be it an insurance company or an industrial company, is you don't want two 13-member boards becoming a 26-member board. Disengaging boards and buying out the boards may be just as much of a problem as buying out executives. I think some mergers of the mutual industry have actually put in place some sort of ten-year grade-out for the existing board members of the assumed company.

Mr. Siegel: The short answer is, yes, it's a problem. Typically you might have two boards when you're done, and the large company would dominate the parent company. You'd have a secondary board underneath like the New England board, which would pick up most of the existing board members of the second company.

Some board members, hopefully, are near retirement or can be convinced to retire and you don't have to take them up, but that's something you have to negotiate. Every deal is going to be different, depending on the content of the board, who's on it, and whether it's a merger of equals or a merger of unequals. All of that has to be done carefully. If you read the Phoenix Home proxy in particular, it was very explicit as to how they did the boards. They basically had ratios based on surplus. They applied the ratios to each board.