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Closed-Block Purchase Price Adjustment in a Sponsored Demutualization Transaction

by William Hines

A sponsored demutualization is a merger transaction whereby a stock insurance company acquires a mutual insurance company. The process is similar to a straight demutualization. During the merger process, the mutual company converts to a stock company. However, unlike a straight demutualization, no IPO is conducted. The acquiring company purchases the stock of the converted mutual company. The purchase price paid by the acquiring company is distributed to the policyholders of the former mutual company.

Merger agreements for sponsored demutualizations should include a purchase price adjustment for final funding of closed blocks. This is because the value of the closed-block business is almost always unknown at the time that the parties agree to the merger.

The value to an acquirer of the closed-block business is proportional to the excess of the closed-block liabilities over the assets allocated to the closed block (the closed block deficit).

The proportion depends on the spread between the after-tax investment income on assets backing the deficit and the discount rate used to value the company. It would be 100% if they were equal and is likely to be around 60% for a typical transaction in today's market.

The appropriate assumptions used to fund the closed block are subject to negotiation between the demutualizing company and the insurance regulator (and maybe other insurance regulators, especially if the company is licensed in NY) of their state of domicile. These negotiations are likely to reduce the amount of the deficit. A regulator has actually proposed closed-block assumptions that would have resulted in a zero deficit in a particular transaction.

The acquiring company is not a party to these negotiations which usually take place well after a merger agreement has been entered into.

As the value of the closed-block business is not known until well after the merger agreements have been signed, and it is likely that the value declines as a result of the negotiations with the insurance department, it is prudent to include a purchase price adjustment in the merger agreement to account for the difference between anticipated and actual closed-block funding.

What is a Sponsored Demutualization?

Many mutual companies have demutualized during the past five years and this process is fairly well established.

1. The mutual company converts to a stock company.
2. The stock company distributes the value of the mutual company, primarily in the form of shares of stock, to the former mutual company owners, the policyholders.
3. The stock company conducts an initial public offering (IPO).
4. The proceeds from the IPO are used to compensate policyholders who cannot receive stock, or whose distribution would be too small to warrant stock compensation, as well as general corporate purposes.

A sponsored demutualization is similar to a straight demutualization.

1. The mutual company converts to a stock company.
2. The acquiring company receives the stock of the converted mutual company in exchange for cash or stock of the acquiring company (the consideration).
3. The consideration is distributed to the policyholders of the converted mutual company. Thus, the converted mutual company becomes a stock subsidiary of the acquiring stock company.
4. There is no IPO as is common with straight demutualizations.

The sequence of events starts with the two parties agreeing to merge and drawing up a merger agreement that spells out, among other things, the purchase price and the steps that need to take place before the merger is

continued on page 8

and the discount rate. If the after-tax investment earnings rate is equal to the after-tax discount rate, then each dollar change in the size of the deficit will equate to a dollar change in value. If, as is more typical, the after-tax investment earnings rate is less than the discount rate, each dollar change in deficit will equate to less than one-dollar change in value. Using an 11% discount rate, a 4.55% after-tax (7% pre-tax) investment yield and a 7.5-year average duration of liabilities, each dollar change in closed block deficit would roughly equate to $0.60 change in value.

CLOSED-BLOCK FUNDING

The appropriate assumptions used to fund the closed block are subject to negotiation between the demutualizing company and the insurance regulator of their state of domicile and possibly other jurisdictions as well. Because the merger has not yet taken place, the acquiring company is not a party to these negotiations. The conversion process, including regulatory approval of the closed block funding, is a prerequisite to the merger. However, the negotiations usually take place well after a merger agreement has been entered into. The negotiations are often lengthy and detailed. Business practicalities preclude parties from waiting for negotiations to be completed prior to agreeing on a purchase price. Therefore, a certain level of closed-block funding must be assumed in developing the purchase price. To the extent the funding subsequently changes, the value of the business to the owner of that business also changes.

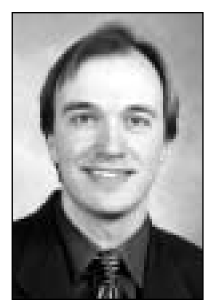
Insurance regulators are concerned with protecting policyholders by providing adequate security that insurance companies will be able to make good on their promises to pay benefits and dividends. All other things being equal, a higher level of assets (and lower deficit) in the closed block leads to a higher level of security regarding future benefit and dividends payments. Thus, closed-block funding negotiations by and large reduce the amount of the deficit and thus the value of the closed block business.

Given the size of the closed blocks of the U.S. companies that have demutualized, it is easy to see how small changes in assumptions can lead to large changes in funding. Without a provision in the merger agreement to adjust the consideration paid to acquire the mutual company, additional closed-block funding will cause the acquiring company to pay more than they would have otherwise paid for the business had they known the approved level of funding.

Assuming full disclosure and adequate due diligence was performed, the acquirer and the mutual company agree on a price using the same set of assumptions with regard to anticipated funding of the closed block. A purchase price adjustment can be structured to maintain the fairness of the original price to both parties in the event that negotiations lead to a higher level of closed-block funding. A well-structured adjustment is one that is relatively simple, can be explained to all involved (management, lawyers, investment bankers and actuaries alike), and is fair to both parties involved. A fair adjustment formula would result in a purchase price that the parties would have reasonably arrived at if they both had known the approved level of funding.

CONCLUSION

Sponsored demutualization transactions have many similarities to straight demutualizations. Unlike other merger transactions, they pose an additional risk to the acquiring company because the final funding amount of any required closed block is not usually known at the time the merger agreement is signed. Because the value to the owner of the closed-block business is proportional to the closed-block deficit (the excess of the closed-block liabilities over the closed-block assets), it is recommended that the merger agreement include a purchase price adjustment for the final funding amount. ❖



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