EMERSON, REID'S

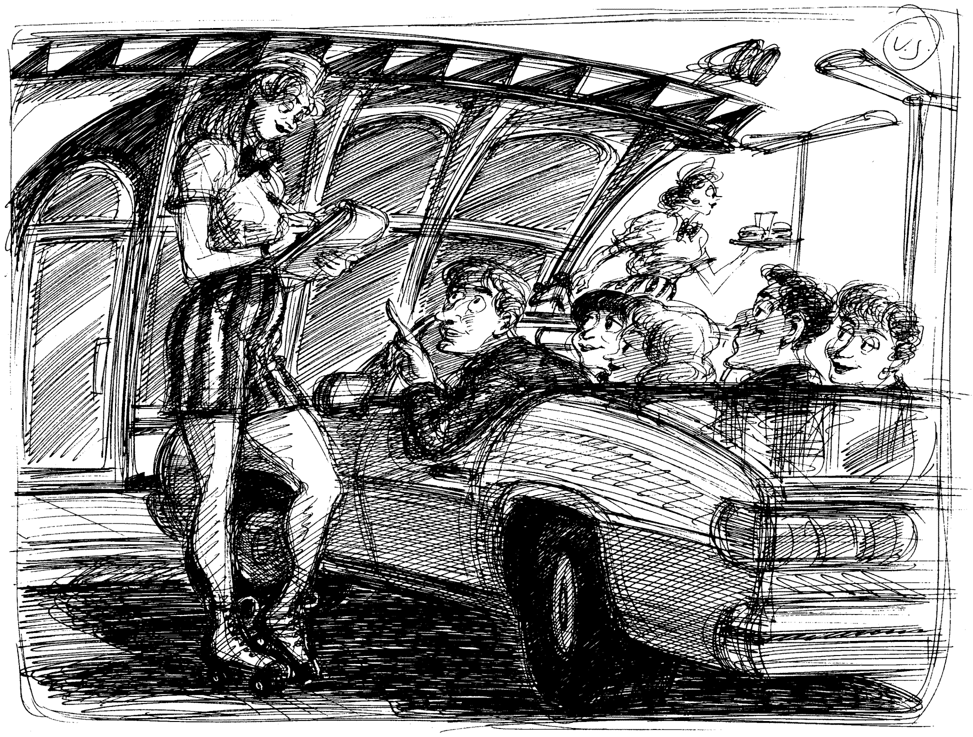
Vol. 7 • No. 2 INSURANCE OBSERVER April 1995

There's a Long Goodbye

The Home: Running on Empty

Sixteen months ago, a slew of euphoric investors made a terrible mistake: they bought $280 million of senior notes issued by Home Holdings, a heavily indebted insurance holding company that might best be described as a staggering slag heap. That Home Holdings was able to sell five- and ten-year notes at a mere 7% and 7 7/8% is a testament to the investors' greed, or at least to their willingness to believe. Even then, Home wasn't a particularly good credit. It was rated BBB– (a shade over junk), and the prospectus for its senior notes listed eleven pages of "risk factors." Investors would have done well to have paid heed to these, since Home subsequently lost $385 million and the notes are now trading at sixty-five cents on the dollar.

Considering the Home Insurance Company's precarious financial condition, that it was able to write $2 billion in premiums in 1994 is a testament to something—inertia, naïveté, greed—take your pick. Still, business was leaving in droves, and Best's November 7 downgrade to B+ only exacerbated the situation. Fourth-quarter "major casualty" premiums, for example, fell from $128 million in 1993 to $87 million in 1994.



"Two single-premium deferred annuities, one universal life, a variable annuity, and a side of term."

That the 142-year-old Home Insurance Company will go into runoff (assuming completion of the proposed Zurich deal) is an ignominious, but perhaps fitting, end for a once-great institution that's been on the skids for decades.

The Zurich-Home deal is the sort of thing that only clever lawyers and bankers could have dreamed up. Its marvelously complex, contorted structure addresses the various regulatory rigmarole and, equally important, attempts to skirt restrictions in the senior notes' indenture, especially those that might create a "change of control," which, under the terms of the indenture, would trigger an "event of default" requiring immediate repayment of the notes.

The deal has something for everyone to dislike. Big boys like AIG and Chubb are griping about the runoff structure. If there aren't enough funds to pay claims, the costs of the Home's insolvency would be picked up by state guaranty funds, which would then assess solvent insurance companies. Of course, no one can *prove* that the Home is either solvent or insolvent. The answer will only be known over time. (The bond market seems to be saying that not only does the Home have enough money to pay off its liabilities, but there's also something left over for the creditors of the parent

TABLE OF CONTENTS

company.) Being solvent, however, isn't the same thing as being sound.

Critics of the deal have complained that Zurich is cherry-picking the Home's good business while leaving the bad, and that if this is allowed, it will set a precedent in which insurance companies will be able to walk away from their liabilities.

That conclusion is incorrect. While it's true that Zurich is trying to buy the good and leave the bad, there's nothing wrong with this practice, at least in theory. If the Home's ongoing business is sold at a fair price and the remaining liabilities are run off, the company is no worse off than it would have been otherwise. (In fact it's in better shape, because given its rickety condition, it wouldn't have been able to hang onto the business.) One way to view the deal is this: the Home is having a going out of business sale and selling off what it can. It is up to the insurance regulators to ensure that the Home Insurance Company—and not Home Holdings or Trygg-Hansa—receives full value for the assets that are sold or transferred to Zurich.

The Home's producers are less than thrilled by the deal. Obviously, they're losing a market, albeit a shaky one, and their clients face uncertainty regarding the payment of their claims. But the producers have further reason to feel bamboozled: when Home signed an agreement last December with Fund American for a $400-million capital infusion (which would have shored up the company's ratings and allowed it to remain in business), the Home's CEO Lars Göran-Nilsson wrote a letter to producers that began, "I have some very good news for you." Nilsson went on to say that the proposed deal "recognizes the extraordinary value of the Home's franchise." This, of course, was nothing but jive. When push came to shove, it turned out that—surprise!—Trygg-Hansa and the Home didn't really give a hoot about their producers.

A rating agency can't be concerned about the ramifications of its actions if it wants to maintain the public's trust.

Finally, Home's noteholders, who have a senior claim on Home Holding's assets, dislike the Zurich deal, because—to put it simply—they feel they're getting screwed. On March 15 a majority of the noteholders filed a "notice of default" asserting that, among other things, Home Holding's plan to borrow $98 million from Zurich (at a thirteen-percent interest rate) to repurchase its stock from the public for $10 per share violates Delaware corporate law, because the stock redemption would impair its capital. The noteholders also asserted that the Trygg Hansa-Zurich-Home deal involves a fraudulent conveyance of Home Holding's assets—e.g., Trygg is entering into a transaction that will leave Home insolvent.

As a last-ditch gambit, the noteholders proposed a feeble good-bank/bad-bank restructuring plan along the lines of Cigna's recent restructuring. The noteholders announced that this asset shuffling should result in an A– Best's rating for the "good" insurance company, but Jack Snyder, A.M. Best's senior vice president, quickly dispelled that notion, calling the noteholders' expectation "extremely presumptuous."

Snyder's swift reaction was the correct one and is indicative of Best's rapidly evolving standards. But Best still has a ways to go. Although it is the rating agency of record by dint of its longevity, its procedures and mind-set have been flawed (see *Emerson, Reid's Insurance Observer*, October 1994 and November 1994, in which we exposed Best's covert rating agenda and explained why we expected Best to begin downgrading companies rated A–).

Best is making changes in what had been an out-of-touch organization. While we're sympathetic to its perceived dilemma—if it changes its ratings and methods too rapidly, it might discredit itself in the marketplace and roil relationships with insurers—we have little tolerance for waffling or inaccuracy. All rating agencies have a covenant with their subscribers to provide ratings that are accurate and, if necessary, brutally honest. A rating agency can't be concerned about the ramifications of its actions if it wants to maintain the public's trust.

There are a number of changes that Best could make to improve its service. For starters, it should adopt designations similar to those used by other raters (AAA, AA+, AA, AA–, A+, etc.). This would give Best ten levels of "secure" ratings as opposed to the six it has now (A++, A+, A, A–, etc.). This method would make finer distinctions between shades of financial strength.

In addition, Best must clarify its ratings definitions and rid them of puffery. For example, Best's "secure" ratings vary from "superior" to "very good," whereas the other raters' definitions range from "superior" to "adequate." Historically, Best has had kind things to say about most insurance companies, and it has not yet shed this attitude. For example, its lowest "secure" rating, B+, is defined as follows: "Has achieved a very good overall performance... [has] a good ability to meet [its] obligations to policyholders over a long period of time." Standard & Poor's, on the other hand, defines its lowest secure rating, BBB–, as follows: "Adequate financial security, but capacity to meet policyholder obligations is susceptible to adverse economic and underwriting conditions."

Finally, and most importantly, Best must state precisely what its ratings mean. Standard & Poor's, Duff & Phelps, and Moody's align their ratings with historical bond-default ratios. (A BBB bond, for example, has a 5.58% chance of defaulting over ten years.) Best has not yet done this, and until it does, or at least publishes some set of long-term standards as to failure probabilities, its ratings will lack clarity. ■

If you are a subscriber and would like a copy of Zurich's information-filled 21-page Form A filing that spells out the details of the Zurich-Home deal, kindly send us a check for $10 and we'll be pleased to forward it to you.

EMERSON, REID'S INSURANCE OBSERVER

David Schiff, Editor and Writer
Penny Kappas, Circulation Manager
Tom Smith, Graphic Design
John Cauman, Copy Editor

EMERSON, REID'S INSURANCE OBSERVER is published six times a year by Emerson, Reid & Company, Inc., 10 Columbus Circle, New York, N.Y. 10019. Telephone: (212) 765-2103. Fax: (212) 246-0876.

Subscriptions are $99 for one year and $180 for two years.

Catastrophe-Triggered Surplus Notes

Nationwide Mutual's Alternative to Reinsurance

Giant insurance companies with significant catastrophe exposures have been unable to buy enough reinsurance—there simply isn't sufficient capacity. But even if there were, at the prices currently bandied about there would be few takers.

While stock companies can avail themselves of balance-sheet-enhancing alternatives such as issuing new shares or getting capital from a corporate parent, these options are out of the question for mutual insurance companies. This creates something of a conundrum: although a mutual might be well-capitalized at present, in the event of a major catastrophe, it might not be. The question, therefore, is how can a mutual replenish its capital—on advantageous terms—in the aftermath of a major catastrophe?

Nationwide Mutual, with the help of J.P. Morgan & Company, recently came up with a clever solution to this dilemma by issuing "contingent surplus notes" that allow it access to long-term, fixed-rate capital via a ten-year option to issue $400 million of thirty-year surplus notes.

The mechanics of the deal are as follows: J.P. Morgan organized the Nationwide CSN Trust, which issued $400 million of securities, the proceeds of which were invested in ten-year Treasurys. The interest on the Treasurys will be passed along to the investors. At any time during the next ten years, Nationwide may access all or part of this $400 million by issuing a surplus note to the Trust. In exchange for this option, Nationwide will pay an $8.8 million annual fee to the Trust, which is also passed along to the investors. (If the funds are never touched, after ten years the contingent surplus notes will be called at a premium.)

The securities, which were bought by institutional investors, consist of two tranches due February 15, 2025. The first tranche, $392 million of 9⅞% "trust notes" (rated AA– by Standard & Poor's and Aa3 by Moody's), were sold at a 220-basis-point spread over thirty-year Treasurys. The second tranche, $8 million of 12.22% "trust certificates" (rated A– and A1), are junior to the trust notes and were sold at a 450-basis-point spread over thirty-year Treasurys.

According to a knowledgeable player, the deal went well and the spread "tightened on the break." It's now 198 basis points for the trust notes, a substantial pickup, but still forty-eight basis points more than the yield on Nationwide's conventional surplus notes.

Flexibility, But at a Cost
Nationwide's Surplus Notes

Type	Size ($millions)	Description	Yield to Maturity	Rating
Surplus Notes	$200	6½% of 2004	7.97%	AA–
Surplus Notes	300	7½% of 2024	8.90	AA–
Contingent Surplus Note ("Trust Notes")	392	9⅞% of 2025	9.38	AA–
Contingent Surplus Note ("Trust Certificates")	8	12.22% of 2025	—	A–

"We look at this transaction as an alternative to traditional catastrophe reinsurance," says Robert Oakley, Nationwide's chief financial officer. (The company, which writes over $7 billion in premium, also has $200 million of catastrophe reinsurance.) "It's a way of providing reinsurance-like protection at a very attractive cost. If we could buy reinsurance at a reasonable price we would, but we can't. Our perception is that traditional reinsurers act like bankers anyway. They lend you capital and expect you to pay it back."

Unlike traditional reinsurance, which is temporary capital, contingent surplus notes (which are an off-balance-sheet item) allow their issuer access to long-term capital. (Surplus notes are thought of as equity by regulators and rating agencies because their claim on insurance company assets is subordinated to policyholders.) It is the *long-term* access to capital that makes contingent surplus notes a viable alternative to reinsurance. For example, even if Nationwide could buy adequate reinsurance this year or next, it would have no guarantee that adequate reinsurance would be available in the future. That's problematic, because insurance companies generally build up their books of business on the assumption that they can lay off part of their risk. If, however, it turns out that they can't, they may not have the flexibility to reduce their exposure, because regulators, as evidenced by their behavior after Hurricane Andrew and the Northridge earthquake, are reluctant to allow insurers to cancel blocks of homeowners policies in a crisis.

There are other advantages to the contingent surplus notes. Nationwide can access the capital for any reason, not just a catastrophe. (Say the company wants to make an acquisition, or interest rates spike up.) The drawback to the notes, of course, is that Nationwide isn't actually *transferring* its catastrophe risk, it's merely spreading it over time. Although it's reasonable to assume that the company can earn enough money over the years to make up for impact of a major catastrophic loss, the notes aren't permanent capital. Ultimately they must be repaid.

But then, Nationwide has thirty years to worry about that. ■

Mid Ocean

Mid Ocean Limited, the Bermuda-based catastrophe reinsurance company formed by Marsh & McLennan and J.P. Morgan in August of 1992, has, according to its 1994 annual report, "made significant progress in implementing [its] strategy to [become] one of the leading reinsurers in the world."

Despite a $95-million hit from the Northridge earthquake and a severe bear market for bonds, the company reported decent results: premium volume was $358 million, net income was $91 million, and shareholders' equity stood at $804 million. Mid Ocean has thirty-four employees.

Please Don't Shoot the Professor

Conseco Tries to Muzzle Distinguished Accountant

Abraham J. Briloff, who is seventy-seven years old, has been a certified public accountant for fifty-three years and has taught accounting for almost as long, first as an adjunct professor and eventually the Emmanuel Saxe Distinguished Professor at Baruch College, City University of New York. "I can speak very positively about the extraordinary material and psychic benefits that come from the pursuit of a great profession," he told us in his soft-spoken, precise manner. "But when the covenants of the profession have been desecrated it arouses a certain passion in me. I just can't speak casually about something that's so important."

In Briloff's universe it isn't enough that the numbers in financial statements conform to Generally Accepted Accounting Principles (GAAP), they must conform to something even more important—the truth.

Over the years, in *Barron's*, and in his books, *Unaccountable Accounting*, *The Truth about Corporate Accounting*, and *More Debits Than Credits*, Briloff has dissected the financials of hundreds of public companies—including many in the insurance business. He, perhaps more than anyone, has exposed the creative accounting techniques used to enhance corporate appearances and obfuscate reality. "I cannot conceive of any industry that requires a higher standard of accountability than the insurance industry," says Briloff. "Hucksterism and gimmickry aren't acceptable standards."

In recent years one company, Conseco, a high-flying life-insurance holding company based in Carmel, Indiana (see *Emerson, Reid's Insurance Observer*, March 1994), has both fascinated and infuriated Briloff. Although not widely known before its attempted takeover of Kemper, Conseco has, according to its annual reports, achieved success by making highly-leveraged acquisitions of life insurance companies, cutting the fat out of their operations, and enhancing the investment returns through "active" management of their portfolios. As the 1989 offering memorandum for Conseco's first LBO fund noted, "Life insurance companies have generally not made extensive use of debt financing to support growth or acquisitions."

But Conseco is not merely a grower or acquirer: it is the quintessential wheeler-dealer, purchasing companies outright, selling off partial interests to the public, buying back shares of the sold-off subsidiaries, repurchasing its own stock, buying holding-company stock for its insurance subsidiaries, selling off companies, repurchasing spun-off companies, and managing an LBO fund that buys life insurance companies. As if this were not complex enough, sometimes Conseco's insurance subsidiaries are carried on its balance sheet on an equity basis, at other times on a consolidated basis. Says Briloff, "Conseco changes its configuration as if it were a chameleon. You can't track one periodic statement versus another. Sometimes you can fiddle with the numbers to get a sense, but that shouldn't be the standard of disclosure."

Conseco's accounting methods are aggressive and a number of transactions with the company's CEO are highly unusual, to say the least.

Needless to say, Conseco's financial results have been stunning: assets have grown from $12 million in 1983 to $10.8 billion in 1994, and net income was $150 million last year. Along the way, Stephen Hilbert, the company's flashy chairman, has become extremely rich. He wears $3,500 Bijan suits, gets around on Conseco's swanky corporate jet, and has four homes, including one of which measures 30,000 square feet.

There have, however, been nagging questions about Conseco, especially its accounting methods. In 1992 and 1993, short-sellers who had bet that Conseco's stock would decline experienced significant losses when the stock soared from a low of $20 5/8 to a high of $75 3/4.

Although Briloff is not a short-seller of Conseco (in fact, he owns a few shares so that he receives statements and filings), his criticisms and analyses, often in the pages of *Barron's*, have been of great interest to short-sellers due to his impressive credentials and his track record as an incisive commentator.

On October 26, 1994, Briloff delivered an address at Binghamton University's School of Management entitled "A Critique of Conseco, Inc.—Standards of Accounting and Accountability," which dealt with technical accounting issues. Among those issues was whether it was appropriate for Conseco to: 1) consolidate some of its partially owned subsidiaries; and 2) recognize income when a partially owned subsidiary issued stock.

Conseco always disagreed with Briloff's conclusions, and until late 1993 the company's shares continued their upward trend. But Conseco's stock has been sinking since then—it's now $38—and the failed Kemper acquisition has further hurt the company's credibility.

Perhaps that's why Conseco decided to take extraordinary methods to silence Briloff when he was scheduled to discuss Conseco at Executive Enterprises' life-insurance seminar in New York last month. In a letter dated February 16, 1995, Lawrence Inlow, Conseco's executive vice president and general counsel, wrote to the president of Executive Enterprises, suggesting that Conseco might bring legal action if Briloff were to mention the company. "We are not convinced that academic discussion is his sole motivation," wrote Inlow, adding that Briloff often chooses to scrutinize "companies with significant amounts of short-selling of their stocks."

Inlow's implication was clear—that Briloff was in cahoots with the short-sellers. This is a familiar refrain on Wall Street, where a negative article often elicits from its subject charges of market-rigging and short-selling. (In fact, a lawsuit with similar allegations was brought against David Schiff, editor of *Emerson, Reid's Insurance Observer*, as a result of an article he wrote for *Barron's* some years ago. The suit, which was groundless, was thrown out of court.)

Inlow's letter continued: "While Professor Briloff's attacks against Conseco...have...been made in *Barron's* (under the guise of freedom of the press) and...to students...(under the guise of academic discourse)...remarks made at your seminar would constitute 'commercial speech' and, therefore, would be judged under a different set of standards... We think that at the least it would be unwise, and at the most perhaps subject Executive Enterprises to potential liability, to permit Professor Briloff to engage in his campaign to defame Conseco from the dais at your seminar."

Executive Enterprises was surprised by this letter and at first backed down, requesting that Briloff refrain from making "negative, derogatory, or otherwise uncomplimentary" comments about Conseco. In the end, however, Briloff went on as planned and made a passionate, reasoned argument. Conseco was invited to speak in rebuttal, but chose not to.

One of the issues Briloff discussed was the way Conseco reported income from transactions involving Bankers Life, of which it owned fifty percent. In March 1993, Bankers had completed a public offering in which it raised $405.3 million by issuing stock at $20.79 per share, reducing Conseco's ownership to thirty-one percent. Although Conseco didn't receive any of the proceeds (they went to Bankers), it recorded a gain of $101.5 million representing its percentage of the increase in Bankers' shareholders' equity as a result of the offering. Although this was permissible under GAAP (but not required), Briloff believes it was improper. He explains:

The company's authority [for booking the increase as income] is derived from an SEC staff accounting bulletin, SAB No. 51, issued in 1983. The SEC had previously insisted that such appreciation be deemed part of capital, and not an item to be passed through the income statement. But, in 1983, the agency's staff grudgingly decided to permit inclusion of such gains in income in certain limited circumstances. Even so, the SEC stressed that its dispensation was interim guidance only: its expectation was that the Financial Accounting Standards Board would soon get its act together and conclude a long-standing project on consolidation and equity accounting that was to address this issue.

Two points are of special interest here. First, Conseco's inclusion in its income of the $101.5 million gain is *permissive—not mandated.* Second, it has been more than a decade since SAB No. 51 was promulgated, and the FASB has yet to address the issue on which the SEC staff offered "interim guidance."

With all due deference to their collective wisdom, in this context they have done violence to some very basic accounting concepts:

• One is the fundamental accounting precept that we do not recognize income unless and until it is realized. Certainly, in this instance, Conseco did not realize any increase in its spendable funds—there was only an unrealized appreciation in the value of its investment in Bankers Life.

• The underlying precept in FASB Statement 12 dealing with investments in equity securities is that unrealized appreciation is not to be reflected in the income statement.

Were that the whole story it would be bad enough, but there is another angle, one that Briloff finds especially galling. Six months after the Bankers offering, Conseco bought ICH's twenty-five percent interest (13.3 million shares) in Bankers for $287.6 million ($21.50 per share), increasing its ownership to fifty-six percent. In this transaction, Conseco's purchase price *exceeded* its proportionate share of Bankers' shareholders' equity by $160 million, but rather than account for this in a manner consistent with the earlier transaction and charge the excess against income, or at the very least offset it against the previously-booked income,

Conseco, inc.

Lawrence W. Inlow
Executive Vice President
and General Counsel

February 16, 1995

Mr. James Slabe, President
Executive Enterprises Inc.

Re: Seminar: Evaluating Life and Health Insurance Companies, March 2 and 3, 1995

Dear Mr. Slabe:

I am writing to you at the suggestion of the Chairman of Executive Enterprises, Norman Fast with whom I spoke by telephone last Friday. We are very concerned that one of the scheduled speakers at your above-referenced seminar for Friday March 3, 1995, Professor Abraham Briloff, intends to make a presentation regarding the accounting practices of our company. As we have discussed with your Program Director for this seminar, Ms. Julianne Cefalu, Professor Briloff has engaged several times over the past three years in making caustic, personal attacks on Conseco and its executive officers. While he purports to have only academic interests in making these attacks, we are not convinced that academic discussion is his sole motivation. Professor Briloff often chooses examples for his scrutiny which also just happen to be companies with significant amounts of short-selling of their stocks.

While Professor Briloff's attacks against Conseco to-date have, to our knowledge, been made in Barron's, (under the guise of freedom of the press) and in remarks made at a seminar on October 26, 1994 to students of the State University of New York at Binghampton (under the guise of academic discourse, we suppose), his appearance at your seminar would be taking these attacks one step further. Since Executive Enterprises is a for-profit organization, we believe the Professor's remarks made at your seminar would constitute "commercial speech" and, therefore, would be judged under a different set of standards than, perhaps, the remarks made in a newspaper or classroom. We think that at the least it would be unwise, and at the most perhaps subject Executive Enterprises to potential liability, to permit Professor Briloff to engage in his campaign to defame Conseco from the dais at your seminar. In short, we suggest that you either instruct Professor Briloff to delete from his presentation all references to Conseco and any material which could be directly connected to Conseco, or eliminate him from the faculty of the seminar.

We have previously forwarded to Ms. Cefalu materials in our possession from Professor Briloff's previous attacks on Conseco. We would welcome the opportunity to discuss this matter with you, and whomever else you think should be involved, at your office in New York at a mutually convenient time next week.

Sincerely yours,

Lawrence W. Inlow

Lawrence W. Inlow

P.O. Box 1911
Carmel, Indiana 46032
(317) 573-6100

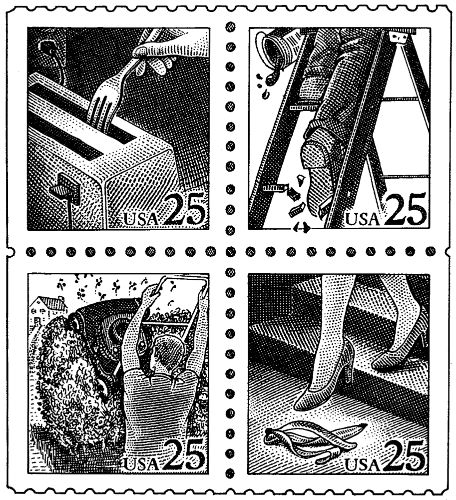
Conseco tries to silence Professor Briloff.

Conseco elected to carry it on the balance sheet as goodwill to be written off over forty years.

To recap: Conseco began 1993 owning fifty percent of Bankers Life. Early in the year Bankers issued $405.3 million of shares at $20.79, reducing Conseco's interest thirty-one percent. Later in the year Conseco paid $287.6 million, or $21.50 per share, to raise its interest in Bankers to fifty-six percent. Even though Conseco ended the year owning only a slightly higher percentage of the company than it had started with, and even though it had raised its percentage by paying *more* for its shares than what Bankers had received from issuing shares to the public, as a result of these transactions Conseco reported income of $101.5 million. In addition, through the magic of accounting, Conseco was able to transform what otherwise would have been a $302.9 million carrying value for Bankers into a $518.8 million carrying value. Notes Briloff, "Had Conseco acquired [ICH's twenty-five percent stake] on the initial public offering, it could not conceivably have been permitted to book that $101.5-million gain via the SAB–51 dispensation; even the most accommodating CPA could not have swallowed such an incestuously induced plus."

There is another twist to this story. When Conseco was planning to acquire Kemper, it announced that it would sell its stakes in Bankers Life and two other partially owned insurance companies, Western National and CCP. Conseco was unable to find a buyer for Bankers, and the Kemper deal fell through. On March 2, 1995 Conseco did an about-face and offered to acquire the public's forty-percent interest in Bankers for $464 million, or $22 per share.

Conseco has engaged in other unusual transactions as well. In February 1994 it closed Conseco Capital Partners II (CCP II). This limited partnership, which will do leveraged buyouts of insurance companies, raised $623.8 million, including $100 million from Conseco, $100 million from Conseco's partially owned subsidiaries Bankers Life, CCP, and Western National, and $36 million from nine of Conseco's officers and directors—including $15 million from Stephen Hilbert.



Product Liability Commemorative Stamps

Hilbert's investment, and that of Conseco's other officers and directors, raises a troubling question: is it appropriate for Conseco's management to separate its interests from those of Conseco's shareholders in this manner? After all, if CCP II's deals are successful, the returns to the limited partners will be far greater than the returns to Conseco's shareholders. Shouldn't Conseco have subscribed to the extra $36 million, and thus accrued that potential benefit for its shareholders?

Conseco's board is of the belief that management's interests should be aligned with those of the shareholders. Indeed, the "purpose" of Conseco's 1994 Stock and Incentive Plan was to "provide incentives to increase the personal financial identification of key personnel with the long-term growth of the company and the interests of the Company's shareholders." But, by allowing nine select executives and directors to invest directly in CCP II, Conseco fostered a situation that *separated* the "personal financial identification" of these key personnel from the interests of shareholders. In light of this, it is especially noteworthy that on February 9, 1994, one week after Hilbert, et al., invested in CCP II, Hilbert and many of the same executives disposed of $173 million of their Conseco shares. Hilbert, the largest seller, unloaded over $125 million.

According to the company's proxy statement, Conseco actually *prompted* this action by "inducing" Hilbert, et al., to exercise their options for 3.6 million shares of company stock. As part of the "inducement," Conseco granted new "reload" options to the "affected executives" so that their ownership interest in the company would remain the same. This allowed the executives to sell their shares (which they got from exercising their old options) at $59.25—eliminating their downside while still maintaining all their upside, since the strike price on the new options was set at $59.25. Hilbert received almost half of the reload options. Furthermore, as part of the executives' option exercise, Conseco "withheld" 1.8 million shares to cover federal and state taxes owed by the executives—in effect repurchasing these shares for $59.25 each.

Conseco's rationale for inducing the executives to exercise their options was that the company would realize a $200 million tax deduction, the net after-tax benefit of which would be $67.5 million. But what was the urgency for doing this in February? Conseco still had most of the year left to accumulate tax deductions. (At year end 1994 it undoubtedly had hundreds of millions of dollars of unrealized losses in its fixed-income portfolios.) It seems likely that given Conseco's lofty stock price at that time (and, as we shall see later, Hilbert's personal financial situation) the executives might have wanted to cash in their options of their own volition, in which case Conseco would have gotten the tax benefits without any inducements.

"The company parted with over $100 million in cash," reckons Briloff, "whereas the tax saving involved no more than $67.5 million in funds. Since the parent company's operations do not generate a surfeit of cash, one is led to question the wisdom of the deal as a matter of company policy."

Conseco December 31, 1994
Fancy Accounting

Assets	
Investments	$8,159
Cost of policies purchased	1,323
Goodwill	676
Other	643
Total Assets	10,801
Liabilities	
Insurance Liabilities	8,537
Notes Payable	804
Other	391
Total Liabilities	9,732
Minority Interest	321
Shareholders' Equity	747*

*Includes $283.5 million of prefered stock. ($millions)

Could it be that Hilbert, et al., wanted to cash in their shares and that the deal was structured to accommodate their objectives rather than those of the company? At least two other transactions make that worth pondering.

On February 9, 1994, one week after the executives invested $36 million in CCP II and the same day that Hilbert, et al., exercised their options, sold 2,242,769 shares at $59.25, and were granted 3,036,000 reload options at the same price, Conseco bought "as part of its ongoing stock repurchase program" 683,545 of its shares from the marital estate of Hilbert and his ex-wife. The price was set at $59.25 per share, the day's closing price, making the total purchase $40.5 million. According to Conseco, its purchase of these shares permitted the Hilberts to cash in "without adversely affecting the market for the Company's stock."

But why was Conseco so concerned about "adversely affecting the market" for its stock at that moment? If it was trying to buy shares as part of an ongoing stock repurchase program, one would assume that it would want to buy these shares as cheaply as possible. Indeed, Hilbert has said that Conseco views periods of "down volatility" as "special opportunities" to buy back stock.

Since the company's share repurchase program allows "the timing and terms of the purchases to be determined by management based upon market conditions," one can't help but wonder if it wasn't a bit more than coincidence that "management's" timing of the repurchases was so favorable to the executives (who were the same people as "management"). Since the sale of the Hilberts marital estate shares (not to mention the other 2,242,769 shares sold) might have adversely affected the market, wouldn't it have been more appropriate—*or less unseemly*—for Conseco to have purchased these shares at some discount to the closing price?

Another unusual transaction involves a New York City condominium that Hilbert bought for $6 million in November 1993. Two months later he decided that he didn't need the condo, so he sold it to Conseco for $6 million, which picked up $110,000 in real estate transfer taxes that Hilbert would normally have had to pay.

It was certainly Hilbert's good fortune that Conseco was suddenly in need of a $6-million condominium that, according to the company's proxy, will be used for "corporate receptions, business entertainment, and overnight accommodations for senior executives in connection with business purposes related to the New York office." What is particularly surprising, though, is that *Conseco* doesn't exactly have a New York office. The New York office belongs to Conseco Capital Partners II, of which Conseco is the general partner. This fact prompts one to ask: why should Conseco pay for an apartment used for CCP II? Although we aren't privy to the terms of the CCP II deal, the memorandum for Conseco's first LBO fund stated that "the Fund will bear its ongoing expenses."

One might also wonder, why does the New York office, which has only six professionals, need such a lavish apartment?

The answers to these, and to many other questions about Conseco, are blowing in the wind. ■

An Outbreak of 'Common Sense'

The Beardstown Ladies, Primerica Financial Services, Financial Strength

"These are the times that try men's souls," began *Common Sense*, Thomas Paine's forceful argument for America's independence. Speaking of the present, however, we sometimes feel that these are the times that try men's patience. Everywhere we turn someone seems to be espousing "common sense" solutions to complex problems.

The Death of Common Sense by Philip Howard has been on the best-seller list for many weeks. Subtitled "How Law is Suffocating America," Howard's book boldly comes out for individual responsibility and is dead set against red tape and bureaucracy. "Relying in ourselves," he writes, "is not a new ideology. It's common sense."

Another best seller, *The Beardstown Ladies' Common-Sense Investment Guide*, is written by a group of gray-haired, small-town-Illinois women whose investment club has racked up big returns over the last decade. The Guide offers homespun wisdom (if Wal-Mart's parking lot is full, the stock is a buy), pseudo-erudite hokum (pay attention to a stock's *beta*), black-box bunkum (pick stocks with a three-to-one Value Line "upside-down" ratio), and recipes ("Shirley's Stock Market Muffins—guaranteed to rise), but is short on anything really useful. Most investors would do better using a little common sense and putting their money in a mutual fund.

Those not wanting to take their investment cues from the Beardstown biddies can opt for Warren Buffet, the Omaha oracle. Buffet's methods are presented reverentially in *The Warren Buffet Way* by Robert Hagstrom, now in its fourth month on the best-seller list. Buffet might be said to employ a common-sense approach to investing—common-sense, that is, if you're a genius. What puzzles us is why the masses are showing such a lack of common sense by shelling out $24.95 for Hagstrom's hagiography when they could send away to Berkshire Hathaway (1440 Kiewit Plaza, Omaha, NE 68131) for a *free* copy of Buffet's collected letters to shareholders, which, along with Benjamin Graham's books, are the best stuff ever written about investing.

Then there's the proposed Common Sense Product Liability Act, favored by the business community in general and the insurance industry in particular. When it comes to common sense, however, there's room for a difference of opinion. According to Consumers Union and to Public Citizen, the act poses "a profound threat to the health and safety of all Americans."

In a *Business Insurance* article a few months ago, Gregory Hidden, American General Hospitality's director of risk and insurance services, predicted that 1995 would be characterized by "common sense." Said Mr. Hidden, "I'm hoping for an end of things like the McDonald's hot coffee episode. I just don't feel juries should be giving dumb people money, but they have been."

But wait. Aren't juries composed of ordinary people? And, if ordinary people don't possess common sense, than who does? Risk managers, implied David Katz in the *National Underwriter*. He described the field as one that requires "a predominance of common sense and experience." (What profession *doesn't* require that?)

Similarly, when Anthem Casualty Insurance Company appointed Notre Dame football coach Lou Holtz to its board recently, the coach admitted to *Business Insurance* that he knew little of insurance, but said that he would "bring some common sense to the table."

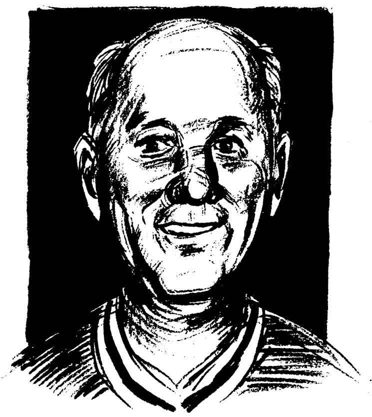
We hope that the common sense he brings won't be the *Common Sense* penned by Arthur L. Williams, the former high-school football coach who created a billion-dollar, multi-level-marketing organization now called Primerica Financial Services.

Williams was a master at using populist rhetoric ("People like us have to fight a conspiracy [big universities and big corporations] that is out to program America"), inspirational homilies ("You can change your life in thirty days"), and greed ("Become mega-wealthy. Mansions and mega-mansions...tons of money") to imbue a sales force of 200,000 part-time "entrepreneurs" with a messianic zeal based upon the slogan, "Buy term and invest the difference." The sales force was then set loose to indiscriminately replace whole-life-insurance policies with William's pricey term insurance.

Williams's *Common Sense*, like much of the material put out by his organization, was filled with inaccuracies, out-of-context quotations, and self-serving recommendations. "Never buy a life-insurance policy that pays a dividend," was just one of his simple-minded sayings. Although Williams stepped down from his organization under a cloud of trouble in 1991, not much has changed. *Common Sense*, with some minor changes, is still being shilled by Primerica Financial Services throughout most of the country.

Common sense, as opposed to uncommon wisdom, is something the insurance business has in abundance. In the aftermath of the industry's well-publicized real-estate and junk-bond problems, too many companies have taken to touting the purity of their investment portfolios in a way that at best fosters foolish per-

Can You Believe It?



ARTHUR L. WILLIAMS
A HIGH SCHOOL-FOOTBALL-COACH-TURNED-LIFE INSURANCE HUCKSTER, MADE HUNDREDS OF MILLIONS OF DOLLARS BY EXHORTING HIS HUNDREDS OF THOUSANDS OF PART-TIME SALESMEN TO "DREAM BIG" AND ADVISE CLIENTS TO "BUY TERM AND INVEST THE DIFFERENCE"

ceptions, and at worst provides misleading information. "Exceptional financial security is provided by the combination of what may be the highest-quality investment portfolio in the life insurance industry..." boasted LifeUSA a while back. "Every long-term investment in the Life USA's portfolio is rated AAA... There are no junk bonds, private placements or direct real estate investments."

What does this really mean? Not much. For starters, although LifeUSA's investments may be triple-A, the insurance company is not. Best rates it B++ and Standard & Poor's has it at Bq. Furthermore, the AAA rating refers to *credit quality*, not *interest-rate* risk. (Investors can generally increase their yield by assuming credit risk—lower-rated bonds, for example—or by taking interest-rate risk—longer-term maturities or certain classes of mortgage-backed securities.) Despite what you may read in the trade ads, there's nothing inherently wrong with credit risk. In fact, life-insurance companies have to take some sort of risk to achieve a satisfactory investment "spread." (Unfortunately, the industry has, in the words of Standard & Poor's director Mark Puccia, "a tendency to give away what it hasn't earned.")

Real estate, junk, and equities may be appropriate investments for a company depending upon the nature of its products, the duration of its liabilities, and the strength of its balance sheet. Northwestern Mutual, for example, which is one of the strongest life insurers, has 7.4% of its general-account assets in stocks. Teachers Insurance & Annuity, which also has top ratings, has a third of its assets in mortgages—reasonable considering the length of the company's liabilities.

The irony, of course, is that strong companies can afford to take risks that should lead to better returns (studies have shown that riskier investment classes tend to have higher, but more volatile, returns over the long term), but weaker companies are playing a dangerous game when they take the same risks.

There is some point at which insurance buyers will refrain from doing business with weaker carriers. The precise location of this point, however, is unknown; it's a moving target that fluctuates with the business cycle, public perception, and current headlines. But every now and then a time comes when buyers view financial strength as an important issue. In those situations, weaker companies may be unable to attract or retain good business (witness The Home after its downgrade to B+).

We think there's a decent likelihood that financial strength will become a critical issue in the primary property/casualty business, if only because it hasn't been important in the past. The marketplace's perceptions are evolving rapidly. In the large account market, ratings on the lower edge of the "secure" spectrum are already unacceptable to many. This may create a new class of risk for weaker companies; a rating below A– may actually become a black hole: as a company approaches that level, buyers begin to shun it, further weakening the company and exerting downward pressure on its ratings, causing it to be inexorably sucked into the abyss.

In the past, buyers have been willing to do business with weaker companies because their prices or terms may have been marginally better. Whether such behavior is still worth the risk remains to be seen, but one thing is certain: it's not the Warren Buffet way. ■

The Insurance Beat

How's the Weather?

ONE WOULD NOT EXPECT a group of high-powered insurance executives to travel to Washington for a meeting with the Vice President and then spend their time talking about the weather, but that's exactly what happened on February 9, when representatives from various insurance trade associations met with Vice President Gore to discuss their concerns about the effect of a changing climate on Americans and their property.

"The insurance industry has a vested interest in matters of climate and weather," Franklin Nutter, president of the Reinsurance Association of America, noted later.

One inevitable result of the meeting: the industry will undertake an analysis of the United States' exposure to long-term changes in the world's climate. Although we have no inside track on the contents of the report, we'll hazard a guess at one of its conclusions: changes in the weather may have profound implications.

Whither the Free Market?

IN RESPONSE to a recent survey conducted by *Independent Agent* magazine, agents said that the selling of insurance by banks was the most important federal issue facing the industry. Among the reasons agents gave for keeping banks out of insurance were the following: "Banks... have a superior marketing advantage over the independent insurance agent"; "We don't need more competition and splitting of the pie"; "It would cut out the insurance agency"; and our personal favorite, "When a customer can consolidate homeowners, flood, life, and disability all into the monthly mortgage payment, it's too convenient!"

Agents also cited their longtime favorite reason: banks would pressure customers to buy insurance in order to get mortgages. What they neglected to say, however, is that laws could be passed prohibiting such coercion.

While it's true that competition from banks might make it tougher for agents, competition—the free market—is good for consumers, isn't it?

The *Independent Agent* survey also revealed that the agents aren't shackled by the bonds of consistency. When queried about health-care reform—which they said was their number two federal issue—an astounding 93% of agents said that the most important facet of that issue was "finding a free-market solution."

ReliaWhat?

ON SEPTEMBER 15, 1885, the Northwestern Aid Association of Minneapolis was formed as an "assessment" company. It reincorporated in 1901 as a "stipulated premium" company and changed its name to Northwestern National Life. Five years later it reincorporated as a "legal reserve" company under the Northwestern National Mutual Life moniker, and one year later the word "Mutual" was dropped from the name. When the company demutualized in 1989, it became known as the NWNL Companies.

The United Services Life Insurance Company, which sells life insurance and annuities to military officers, was formed in 1937 and has been a subsidiary of the USLICO Corporation since 1984.

In January 1995 NWNL acquired USLICO, and the name of the combined companies became ReliaStar, which, we're told, "communicates reliability, strength and performance."

Of course.

The Corporate Closet

A NEW BOOK, *Cracking the Corporate Closet: The 200 Best (and Worst) Companies to Work for, Buy from, and Invest in If You're Gay or Lesbian—and Even If You Aren't*, by Daniel Baker, Sean O'Brien Strub, and Bill Henning, takes a dim view of the insurance industry.

The authors define the "best" and "worst" companies according to three criteria: whether the company includes sexual orientation in its anti-discrimination policy, whether it offers domestic partnership benefits, and whether it is sensitive to the gay market.

In addition, they look for evidence of a "glass ceiling—an invisible barrier of unstated prejudice that keeps certain people from reaching the top ranks of a company." (In their haste to indict the insurance industry, the authors overlook that the chairman of one of America's largest insurance companies is gay.)

Although the authors admit that the insurance industry does "quite well" as far as equal employment treatment is concerned, and that it has made a "concerted effort to be more forthright in its support for gay equality and in AIDS charitable giving," they are of the opinion that insurance companies are a "bad lot." Three of the thirteen "worst" companies in America are in the insurance business.

So what is it the industry does that's so terrible? It screens life-insurance applicants for HIV in states where such action is legal and, allegedly, "pinklines" areas with a high concentration of gay men.

"Those who most need access to health insurance are least able to get it," say the authors.

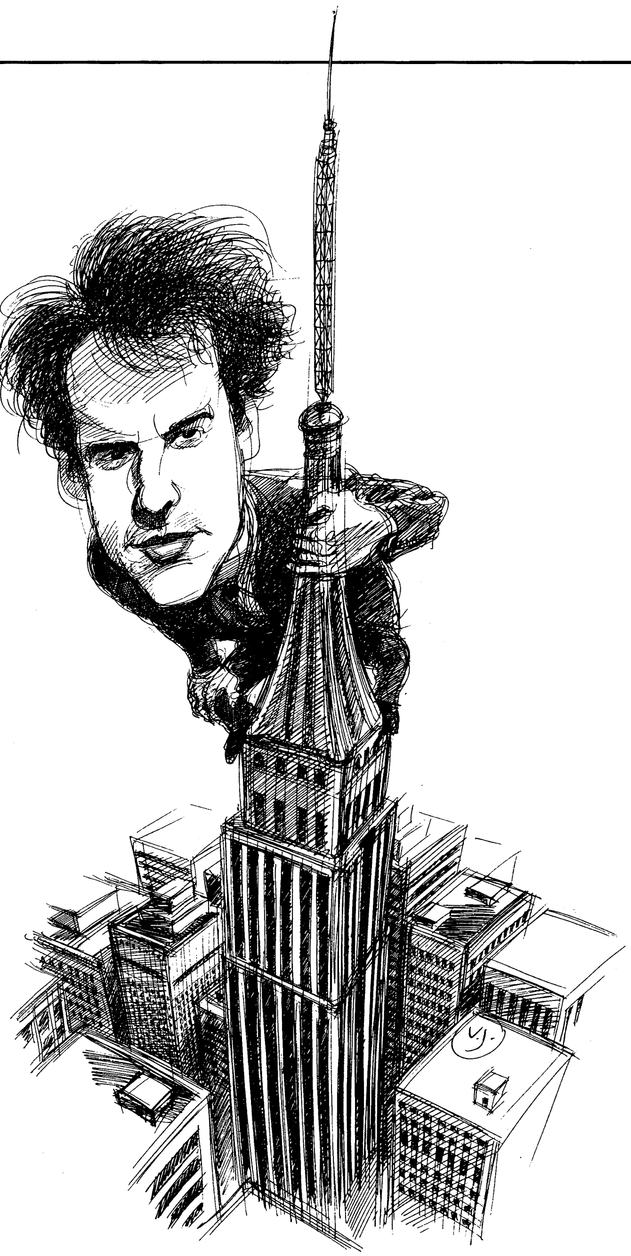
What they really mean, however, is that some of those who most need access to health *care*, can't afford insurance. That, of course, is not the industry's fault.

Kobe Beef

ALTHOUGH THE KOBE EARTHQUAKE caused considerable suffering and huge losses, it has not caused a run-up in the price of Kobe beef, an unusually rich Japanese steak that comes from beer-fed, hand-massaged steers. At the Old Homestead steak house in Manhattan's meat district, a fourteen- to sixteen-ounce Kobe beefsteak is still $115.

"It's the most refined beef in the world," declares Marc Sherry, the Old Homestead's owner. "It has ten times as much marbling as the finest prime beef in America. We sell all we can get."

Not everyone is enamored of Kobe beef, however. Sparks Steak House, for example, doesn't even carry it. "I don't think it has the flavor of American beef," says owner Pat Cetta, adding, "I think America can be proud of its beef. We have a fine product."



David Schiff, the editor and writer of "Emerson, Reid's Insurance Observer," ponders the insurance scene.

Instead of doing something productive, like selling waxed fruit, David Schiff, the curmudgeonly editor and writer of *Emerson, Reid's Insurance Observer*, has chosen to wile away his time chronicling the madness of the insurance crowd.

Why insurance, you ask? To that same question Haverhill replied (in what was to become known as "Haverhill's reply"), "Why not insurance?"

Insurance, you see, is just like any other business—only worse. It combines the tedious drudgery of banking with the mindless travail of the assembly line. If it were possible to get repetitive-stress syndrome of the cerebrum, one would, undoubtedly, get it from the insurance profession.

It is against this dismal background that Schiff, a spirited iconoclast with plenty of time on his hands, has chosen to ply his trade at a scrappy little newsletter that hopes someday to turn a profit.

Of course, *Emerson, Reid's Insurance Observer* isn't for everyone. Those who don't have the time for cutting-edge analyses, the stomach for groundbreaking exposés, the guts for hard-hitting commentary, or the sense of humor for seething irreverence, are better off not subscribing.

All others should send in their money.

☐ **Please send me six issues, a one-year subscription, for $99.**

☐ **Twelve issues, a two-year subscription, for $180.**

NAME/TITLE ______________________

FIRM ______________________

ADDRESS ______________________

CITY/STATE/ZIP ______________________

PHONE ______________________

☐ CHECK ENCLOSED ☐ AMERICAN EXPRESS ______________________

CARD # ______________________

SIGNATURE ______________________

4-95

EMERSON, REID'S
INSURANCE OBSERVER

10 Columbus Circle, New York, NY 10019
Telephone 1-800-827-2103 FAX (212) 246-0876