The world's most dangerous insurance publication℠

SCHIFF'S

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INSURANCE OBSERVER

The Revolution Was Not Televised

Staring at the Sun

The limos are lined up in front of Goldman Sachs until late at night. Investment bankers, money managers, and corporate lawyers are buying lofts in Soho and Tribeca, not far from CBGB's, the birthplace of that nihilistic form of noise and self-destruction known as punk rock, epitomized by a T-shirt worn by a member of Richard Hell's group, Television, that said simply: "Please kill me."

Insurance companies are wearing that same T-shirt today, as they compete beyond reason for business, acquisitions, and investments. Insurance has become, in the words of analyst V. J. Dowling, "a capital trap," and we're in the "cheating phase" of the cycle where companies are fudging their results. They are praying for an upturn that, alas, will only come when capital is depleted and fear abounds.

On the other hand, we haven't seen so many insurance-stock bargains since 1994. Good companies such as W.R. Berkley, EMC, NYMagic, and Risk Capital (all of which we've bought) are selling below book value, as are many others. Although we've been bearish on the industry for quite a while (and continue to be so), we are bullish on cheap stocks of good companies; they usually provide decent returns to those who are patient.

The soft market: Underwriters rush to insure a burning building.

No one, however, should get rich off a mutual insurance company. A mutual is a non-stock corporation that's supposed to be run for the benefit of its policyholders. When managed properly, a mutual can be a wonderful institution. If a mutual falls into the wrong hands—and many have—it becomes an institution that serves "special interests"—those of its officers, directors, and managers.

We began examining the mutual insurance industry closely in 1996 and were distressed by what we found. While we knew from our years in the insurance business that many mutuals didn't really "walk the walk," we were surprised to discover that many no longer even "talked the talk." Across the country a movement was spreading, and its message was an ugly one: it's okay to screw mutual policyholders because they aren't really "owners." And, because they didn't understand what they had, they wouldn't notice when it was taken away.

By mid-1997, horrified by the events at Allied Mutual and by the mutual-insurance-holding-company movement, we decided we couldn't be an "observer" any

TABLE OF CONTENTS

The Revolution Was Not Televised: Staring at the Sun • Kamen wasn't lucky.................. 1
How to Influence People and Sell Insurance: The Annals of Misleading Advertising........... 4
Allied Mutual's Ring of Fire: A Public Hearing in Iowa • Follow the Money.................. 18
What Commissioner Vaughan Didn't Say: 'Potential conflicts' of interest.................. 23
Junk Jurisprudence: Update on the Allied Mutual Lawsuit.................................... 25
It's Pronounced 'Money': Insurance Commissioner Neil Levin looks the other way......... 26
Tune In, Turn On, and Buy Auto Insurance: The Internet insurance market.......... 28
The Insurance Beat: Honest Abe • Sandy Weill stays warm • DeAlessandro • and more......... 31

longer. It was time to step into the ring. We felt that we had an opportunity to make a difference in one of the insurance industry's greatest financial issues: what would happen to the $300 billion of value in America's mutuals that belonged to the mutuals' policyholder-owners?

We didn't know that our "opportunity" would become a costly round-the-clock job that would leave us exhausted, disgusted, and exhilarated. Even if we had known that, we probably wouldn't have done anything differently.

In our first article on Allied Mutual (September 1997), we wrote the following:

> We sense a turning of the tide, a move towards reform. Not so long ago, shareholders of public companies were disenfranchised, too, but activists... demanded accountability. This simple truth is often forgotten: mutual insurance companies are not the property of their directors or employees—they belong to their policyholders.
>
> Policyholders' long period of quiescence may be coming to an end...

David Schiff announced his candidacy for Allied Mutual's board in these pages and in a $7,500 ad in *The Des Moines Register*. He wrote that by exposing Allied's unsavory dealings "to the light of day, the policyholders, the regulators, the press, and the public will demand change. The time is right, and I hope my action will serve as an inspiration for mutual policyholders, as a wake-up call for regulators and legislators..."

Words are powerful, but so is money. For every *word* published here, the big mutuals—MetLife, Principal, MassMutual, New York Life, John Hancock, Northwestern, Prudential, and others—spent thousands of dollars to forward their agenda. They advertised, sent out mailings, dispatched lawyers and teams of executives across the country, bombarded state legislatures with money and lobbyists, and lavished money on investment bankers.

In January 1998, several months after Jason Adkins (a public-interest lawyer who had a profound influence on Schiff) and Schiff had been crisscrossing the country, speaking before NAIC meetings, state legislators, industry conventions, agents and brokers, and anyone else who would listen—*Schiff's Insurance Observer* published "The Revolution Will Be Televised," an in-depth analysis of mutual-insurance history, corporate governance, and recent hearings that had been held by Assemblyman Pete Grannis of New York.

The atmosphere was becoming charged, and we envisioned a revolution culminating in reforms along the lines of those enacted after the 1905 Armstrong hearings. We wrote the following:

> A pundit once said, "nothing is illegal if 100 businessmen do it." America's mutual insurers can join together in a conspiracy; they can hire the fanciest lawyers and place lobbyists in every state capitol; but in the end, their audacious mutual-insurance-holding-company maneuvers will backfire. Before too long their affronts to decency, fairness, and mutuality itself will unleash a wave of rage and a sense of betrayal that will explode in front-page headlines, exposés, and—yes—national hearings...
>
> We envision mutual directors being grilled in Washington by a latter-day Charles Evans Hughes, the steady gaze of network cameras capturing each embarrassing moment.
>
> But before it's too late—we want to say something that Clint Eastwood's Dirty Harry might have said to Harry Kamen [MetLife's chairman]: "The Magnum .45 of fairness and public opinion is cocked and pointed at your head. The only unknown is whether there's a bullet left in the chamber. So think about it long and hard, and ponder this question: 'Do you feel lucky, Harry? Do you feel lucky?'"

As it turned out, Kamen and many other mutual CEOs *did* feel lucky; they didn't give a damn about any Magnum .45 of fairness. After all, they were packing heavy artillery: money, governors, legislators, lawyers, and investment bankers. What they didn't have, however, was The Truth.

In one respect, Kamen and his co-conspirators were right, and Schiff was wrong: the revolution would *not* be televised. What happened, instead, was a quiet revolution, one in which the well-armed giant mutuals one-by-one laid down their arms, caving in as their disgraceful behavior was attacked by guerrilla activists.

They were beaten in a brawl of words by a motley crew: Adkins, a lawyer, reformer, and man driven by fairness; Joseph Belth, a retired professor from Indiana and writer of *The Insurance Forum*; Pete Grannis, chairman of the New York State Assembly Insurance Committee and a man so out of touch with big-money politics that he refuses to take donations from the industry he oversees; and Schiff, a pissed-off insurance observer.

There were many others who played a role in the battle: 24-year-old Brendan Bridgeland, policy director of the Center for Insurance Research and a tireless worker; Theresa Amato of the Citizen Advocacy Center (in Elmhurst, Illinois), who stayed up all night with Adkins and Schiff, preparing an assault on the Illinois legislature; Annamaria Lloyd, a outspoken Principal Mutual agent from Seattle who traveled to Des Moines to join Adkins and Schiff and testify at Principal's mutual-holding-company hearing in January 1998; David Winters, a big-time money manager who flew in from New Jersey to speak out at the same hearing; James Hunt, an actuary and former insurance commissioner who is now with the Consumer Federation of America; Ralph Nader who spoke with power and eloquence at the New York State Assembly hearing; David Morrison at the Coalition for Consumer Rights; Citizen Action; New York Public Interest Research Group; a number of stock insurance companies (including Conseco, which played a key role in Indiana); the American Association of Retired Persons; and various policyholders, agents, and individuals who wrote letters or spoke out someplace.

The media were important, as well. If you're right, know what you're talking about, and spend your day speaking to reporters about events that have major financial ramifications, chances are they'll want to write about it. Adkins' and Schiff's travails were covered extensively by newspapers, insurance publications, magazines, newsletters, some radio, and a bit of television. Schiff ran for Allied Mutual's board and made bids to acquire FCCI Mutual, Provident Mutual, and Allied Mutual on behalf of policyholders. Adkins, and the

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organization he founded, The Center for Insurance Research, filed motions, brought lawsuits on behalf of policyholders, and weighed in just about everywhere. Joseph Belth went to Provident Mutual's public hearing, asked pointed questions, then sunk his teeth into the matter like a pit bull—and still hasn't let go.

The facts speak for themselves: a bunch of knowledgeable activists can bring about change—especially when they're right. The subject of mutual-insurance-holding companies and demutualizations went from being arcane to being the biggest issue in the insurance industry—particularly the life insurance industry.

The mighty Prudential, which had been plagued by scandal, was the first to throw in the towel, announcing plans for a demutualization in February. John Hancock succumbed a few months later. Then New Jersey prohibited mutual-insurance-holding-company conversions, and the New York bill, supported by Governor Pataki, Senator D'Amato, Insurance Commissioner Levin, and the Life Insurance Council of New York, disappeared in June. (In the fall, D'Amato removed a provision from H.R. 10—that he'd previously inserted—that would have allowed mutuals to redomesticate if the state in which they were domiciled didn't permit mutual-insurance-holding-company conversions.)

Then MetLife, which had miscalculated so badly, announced that it, too, would demutualize. In 1999, General American, the second mutual-insurance-holding company, gave up on the now-discredited structure and announced that it would demutualize. Last month AmerUs, the first mutual-insurance-holding company (and the only one to have issued stock publicly) announced that it was considering a full demutualization. (By this time, investors weren't particularly eager to buy stock in mutual-insurance-holding-company subsidiaries.)

Along the way, some mutuals managed to slip through the cracks. As a rule, the farther a mutual was from a media center, the greater its ability to pull the wool over its policyholders' eyes. Among those that converted to mutual-insurance-holding companies are Ameritas in Nebraska, FCCI in Sarasota, Ohio National, Principal in Iowa, and Security Benefit in Kansas.

What has now evolved is a two-tiered structure. Smaller mutuals in states far from the glare of publicity, *may* be able to convert to mutual-insurance-holding companies (even though the concept is brain-dead and waiting for someone to pull the life-support plug). In all likelihood, however, they will find themselves encumbered with lawsuits, particularly if they try to issue stock.

As for the biggest mutuals—that's a different matter. Although MassMutual could, in theory, convert (since Massachusetts has a law permitting mutuals to do so), it would have trouble explaining why it was shafting its policyholders by giving them nothing when John Hancock, Prudential, MetLife, and General American are giving out stock.

MassMutual, Northwestern, State Farm, Nationwide, or any other giant mutual would probably not want to be in that position. For these companies, the ramifications of embarking upon a mutual-insurance-holding company could be disastrous; their size guarantees that there would be plenty of media coverage, most of it unfavorable. Their size also guarantees that there would be lawsuits.

The most recent body blow to the mutual-insurance-holding company structure took place on February 11, when Judge Levin in Pennsylvania enjoined Provident Mutual from implementing its abusive conversion plan (which had been approved by the Pennsylvania Insurance Department after a farce of a hearing presided over by deputy insurance commissioner Gregory Martino.)

Judge Levin ruled that Provident's information statement to policyholders contained material omissions, including the following: 1) The plan didn't disclose that Morgan Stanley and/or PriceWaterhouseCoopers had concluded that full demutualization was better for policyholders than the mutual-insurance-holding company conversion contemplated. Such a disclosure would have provided the proper context for policyholders to evaluate whether the plan was really in their "best interests." 2) Policyholders weren't informed why Morgan Stanley wasn't asked to compare Provident's plan with other alternatives in order to determine which plan was better from a financial point of view. 3) The plan didn't adequately explain what policyholders would have received under alternatives—such as a full demutualization. Policyholders could then have evaluated the Board's conclusion that the conversion was in their best interests. 4) The plan didn't discuss the material factors that Morgan Stanley relied on in reaching its opinion.

In short, Provident got its policyholders to vote for something (a plan of conversion), without properly informing them of the ramification of their vote. Without informed consent, a vote is tainted.

Last April, at the Provident public hearing, Schiff urged the Pennsylvania Insurance Department to make Provident provide such disclosure to policyholders. [See *Schiff's Insurance Observer*, May 1998]:

> I think Provident policyholders should be told approximately how much the company could be sold for—a rough estimate. If it were twice book—and there are approximately 300,000 policies—that could be $5,000 per policyholder.
>
> Policyholders can't possibly make an informed decision unless you provide them with the proper information, which you have not done.
>
> In this brochure you sent [to policyholders], you said the plan "maximizes the value of our subsidiaries." Who does it maximize value for?

If policyholders of a mutual were given a simple choice: $5,000 (or $2,000 or $10,000) in cash or stock from a full demutualization, versus a "membership interest" that carries no expectation of profit in a mutual-insurance-holding company, virtually all would choose the money or shares. Mutual executives have known this all along, but they never explained it to policyholders this way.

As a result, many giant mutuals that wanted to raise capital (foolishly, we think) have, perhaps, missed the market. At best, their timetables have been set back by a couple of years. And their policyholders have been ill served by the executives' money grab. But for now, the worst is over.

There is a place for mutual insurance. (A mutual-insurance-holding company *does not* preserve mutual insurance, but rather destroys it, because the mutual insurer is converted into a stock insurer.) One cannot compare mutuals and stock insurers by looking at returns-on-equity or earnings growth—the goals for each organization are different. Mutuality is a good structure when used properly. Companies like Guardian, New York Life, Northwestern, and State Farm would do well to keep that in mind. (New York Life, however, should keep it in mind *after* booting out chairman and CEO, Sy Sternberg.) ■

How to Influence People and Sell Insurance

Awful Disclosure: The Annals of Misleading Advertising

Although we've long been interested in how insurance is distributed, until now we haven't written much on the subject. This article should begin to remedy that. At this moment our concern is not how insurance is sold, but how it is *mis*-sold through advertising and promotional materials.

When people in the insurance industry think of insurance fraud, they tend to think of fraud perpetrated upon insurance companies. A growing problem, we believe, is fraud perpetrated upon buyers of insurance; we define "fraud" as any "perversion of the truth in order to induce one to part with money."

Conduct that fits our definition is widespread; it encompasses property-casualty insurance as well as life and annuities. It is employed by small insurance companies as well as by many of the biggest and supposedly best. The targets are individuals, small businesses, big businesses, and other insurance companies.

Because objectionable marketing techniques are often artfully employed, they can be hard to detect, especially by the unknowing. We've all grown accustomed to these "hidden persuaders" because they work so subtly that we're generally unaware of them. But the pervasiveness of these methods of deceptive persuasion does not justify their use. Puffery and braggadocio might be tolerable in the sale of breakfast cereals and laundry detergents but are often unacceptable in the sale of insurance.

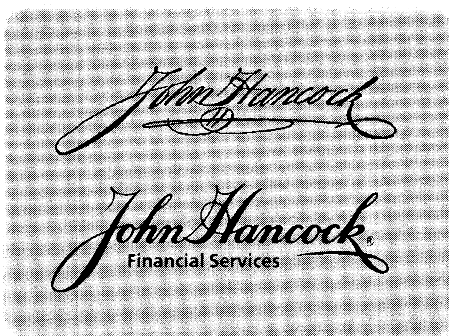
The misleading marketing practices we intend to cover do not, for the most part, involve specific misrepresentations about insurance coverage or pricing. In general, they deal with the means by which insurance companies instill a false sense of security about their financial strength.

In this age of convergence of giant financial institutions and the spread of co-branding, misleading advertising and marketing pose a threat not only to consumers, policyholders, and insurance companies, but to financial institutions including banks, investment firms, and holding companies.

✦

The insurance industry is in the business of selling security. People aren't likely to shell out good money for a piece of paper known as an insurance policy unless they believe that the issuer of that policy is prosperous, strong, and solvent.

Insurance companies sell their soundness in several ways. For starters, their names tend to convey the impression of stability and credibility. Joseph Belth's fine book, *Life Insurance: A Consumer's Guide*, notes that companies often choose names that suggest such desirable traits as "financial strength (Guaranty, Protective, Reserve, Security), financial sophistication (Bankers, Commercial, Financial, Investors), maturity (Colonial, First, Old, Pioneer), dependability (Assurance, Great, Reliable, Trust), fair treatment (Beneficial, Equitable, Golden Rule, Progressive), intimacy or friendliness (Citizens, Family, Home, Peoples), breadth of operation (Continental, National, International, Universal), and government (American, Republic, State, United States)."



The real signature and the logo.

Some companies have associated themselves with famous Americans, even when such an association is dubious. Lincoln National Life, Franklin National Life, Washington National Insurance Company, and John Alden Life were formed 50 years, 94 years, 123 years, and 281 years, respectively, after their namesakes' deaths. (There's no Benedict Arnold Insurance Company.) The award for chutzpah, however, goes to John Hancock Mutual Life, which was started 69 years after John Hancock's demise: not only did John Hancock (the insurance company) appropriate Mr. Hancock's fancy signature as its logo, it actually registered that signature as a trademark.

An insurer doesn't need to trade off the goodwill of famous Americans if it has an honest folksiness about it—the kind of good old reliability that's been around for as long as anyone can remember. Take Old Reliable Casualty Company. It's been old and reliable ever since it was formed way back in 1978.

Names are important. When Lloyd's of London—which had a reputation for transacting its affairs on a higher plane—one of "utmost good faith"—dumped its pre-1993 liabilities into a questionably capitalized run-off company, it gave that company a magnificent moniker that bespeaks fairness as it rolls off the tip of the tongue: Equitas.

Good names are merely a beginning. Insurance companies burnish their images through the use of branding and advertising, both of which have become increasingly sophisticated. It has been our observation that advertisements (which generally emphasize protection, security, and prudence), have shown a growing tendency to tout insurers' size and financial strength, as well. Many insurance companies, however, have gone far beyond selling the sizzle and are making misleading claims about their financial resources. Such practices are likely to haunt them someday.

The New York State Department of Insurance has rules governing insurance-company advertising. Regulation 34A, for example, which deals with life insurance and annuity contracts, sets forth certain commandments so eminently fair that it's hard to imagine that anyone, in any state, in any line, could disagree with them:

> Advertisements shall be truthful and not misleading in fact or in implication.
>
> The format of an advertisement...shall be sufficiently complete and clear so that it is neither

misleading nor deceptive *nor has the capacity to mislead or deceive.* [Emphasis added.]

An advertisement shall not use logos...in a context which might imply that the policy is being sponsored or endorsed by an organization, if such is not the case.

An advertisement shall not use a trade name, an insurance group designation, name of the parent company or affiliate of the insurer...service mark, slogan, symbol, or other device or reference if such use would have the tendency to mislead or deceive as to the true identity of the insurer, *or create the impression that someone other than the insurer would have any responsibility for the financial obligation under the policy.* [Emphasis added]

Condor Insurance Company, which specializes in auto liability for local trucking operators in California, recently ran an ad that creates the impression that someone other than Condor has responsibility for Condor's financial obligations under a policy. Condor has $10 million of surplus and carries a "B (Vulnerable)" rating from A. M. Best, but its full-page ad touts its affiliation with its parent company: "*We're backed by the financial strength and stability of Amwest Insurance Group* (rated A- 'Excellent' by A.M. Best)." [Emphasis added.]

Amwest is indeed rated A-, but that rating doesn't extend to Condor. If Condor fails, Amwest isn't obligated to make good on Condor's liabilities. Shirley Burch, assistant to Amwest's president, explained Condor's ad, saying, "We try to put our best foot forward."

But isn't that misleading?

John Savage, Amwest's president, said that Amwest had put money into Condor and that Condor *is* backed by Amwest.

But doesn't "backed by the financial strength and stability of Amwest" imply that Amwest is providing Condor with some sort of explicit guarantee or obligation?

Savage, expressing concern, acknowledged that Amwest provides no guarantees to Condor, nor does it have any financial obligation to the company or its policyholders. (Indeed, if Amwest were to guarantee Condor, Condor's ratings would probably rise and Amwest's would probably fall.)

Although we've singled out Condor, it is not unique. A list of other companies whose ads give the impression of greater financial resources than are actually committed includes such companies as AIG, Colonial Penn, Employers Reinsurance, MassMutual, Motors Insurance Company (a subsidiary of General Motors), PXRE Reinsurance Company, Travelers, Winterthur Swiss Insurance Group, and Zurich. These companies' ads are of concern for an obvious reason (it's wrong to mislead), and for a not-so-obvious reason (insurance companies may be exposing their parent corporations and affiliates to liability). In the event that Condor were to fail, policyholders who relied upon statements made in Condor's ad would probably discuss the matter with Amwest—in court.

At issue in such situations is the following: if a holding company's insurance-company subsidiary becomes insolvent, can an insured pierce the corporate veil and attach the assets of the holding company? (Most insurance companies are owned by holding companies or by insurance companies that are owned by holding companies, e.g., National Union is a subsidiary of American International Group, Inc., and Travelers Indemnity is a subsidiary of Travelers Property Casualty Corp., which is 82% owned by Citigroup.) Given many of the practices employed by insurance companies, piercing the corporate veil doesn't seem all that farfetched. (In Japan, where failure is in abundance, *The Nihon Keizai Shimbun* reported that companies affiliated with insolvent Japanese life insurers may have to pay some of the losses of their insolvent insurance affiliates.)

Where does promotion end and deception begin?

Owens Financial Group (represented by Anderson, Kill & Olick), sued AIG, accusing it of, among other things, false advertising. As part of a well-known advertising series, AIG had run a full-page ad with a large photograph of a mountain of old tires. The caption read: "Dump Them, You Break the Law. Recycle Improperly, You Break the Law. Meanwhile, More Tires Just Came In." The ad's text mentioned "environmental controls" and "environmental standards," and said "fortunately, AIG specializes in designing the kind of custom coverages you need..." Owens' complaint, filed in October, alleges that AIG insured a used-tire recycling facility (including some of the tires featured in the ad) under a Pollution Legal Liability Policy, then denied coverage on the grounds that tires are not "pollutants." (AIG declined to comment; its denial of coverage is based on policy terms and conditions.)

While the issues in Owens v. AIG deal with coverage rather than financial strength, the lawsuit raises a question worth some reflection: how often do insurers' advertising departments talk to their legal departments?)

Later in this article we'll delve into some of the incredible claims being made in insurance-company ads. We shall examine the dubious, review the spurious, and fathom the depths of the fallacious. Before doing that, however, we'll journey into the past—when a dollar was worth its weight in gold, financial crises were known as "panics," and Alan Greenspan was yet unborn. We'll visit an era in which inflated trusts imploded, monopoly trusts were busted, and dicey sovereign debtors did what they tend to do—default. In short, our tour will take us through times that, on the one hand, bear little resemblance to the world of today, and, on the other hand, are strikingly similar. Then, as now, financial decisions were made by Homo sapiens (who tend to react emotionally), rather than by Vulcans (who tend to act logically).

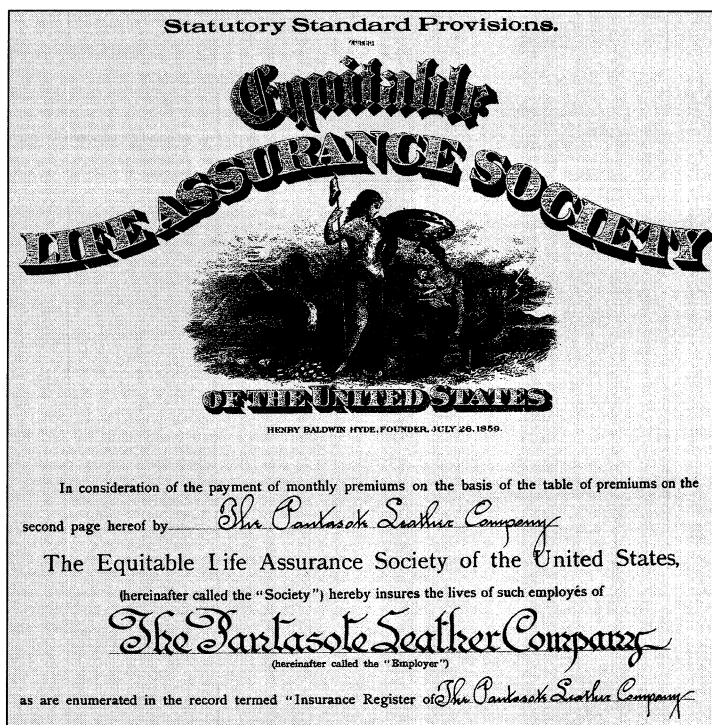
As part of our trip, we'll take a gander at a number of notable failures (insurance and otherwise) and examine some of the means that insurers have used to convey the look and feel of financial strength.

Although insurance policies now look as if they have come out of a laser printer, such wasn't always the case. In the good old days, policies often had an official appearance that included indicia, engravings, flowing longhand script, and *real* signatures.

An Equitable policy from 1911, for example, bears a greater resemblance to paper money or to a corporate security than it does to a modern policy. Equitable's name, "Equitable Life Assurance Society of the United States," is set in engraved, shaded typeface, and is placed above Equitable's corporate emblem, an allegorical neoclassical image called the Protection Group.

The Protection Group, first used in 1860, is a depiction of a bare-breasted female warrior (reminiscent of Delacroix's "Liberty") holding a shield over

a bare-breasted young mother cradling an infant. To the Protector's right is that great American symbol, the bald eagle. In the distance is an image familiar to anyone who has looked at the back of a one-dollar bill: the Great Pyramid. Adding extra drama is a jagged bolt of lightning shooting down from the heavens. (Over the years, Equitable became a tad prudish, and the risqué Protection Group image was redesigned. Now, the breasts of the Protector and the mother are cloaked.)



Statutory Standard Provisions.

Equitable
LIFE ASSURANCE SOCIETY
OF THE UNITED STATES

HENRY BALDWIN HYDE, FOUNDER, JULY 26, 1859.

In consideration of the payment of monthly premiums on the basis of the table of premiums on the second page hereof by The Pantasote Leather Company

The Equitable Life Assurance Society of the United States,

(hereinafter called the "Society") hereby insures the lives of such employés of

The Pantasote Leather Company

(hereinafter called the "Employer")

as are enumerated in the record termed "Insurance Register of The Pantasote Leather Company

A fancy-looking Equitable Life policy from 1911.

Although property and casualty policies may not have looked as currency-like as Equitable's policy, property and casualty insurance companies have long used familiar images to connote solvency and security. Failing to heed Samuel Johnson's admonition that "patriotism is the last refuge of a scoundrel," they often wrapped themselves in the flag.

A National Union Fire Insurance Company sign from the early 20th Century incorporates both the American flag and the Capitol building. (What do you expect from a company called "National Union"?) A Great American Insurance Company sign from the same era shows Uncle Sam against a backdrop of the American flag. (The FDIC wouldn't come into existence for another 15 years, and there are still no Federal guarantees for insurance policies.) Great American also advertised its surplus—$10,759,422—and declared itself to be a "Solid thoroughly American Institution," boasting "Losses Paid Since Organization over $90,000,000."

The Continental Insurance Company (founded 70 years after the end of the American Revolution), used a Revolutionary War soldier as its corporate symbol. United States Fidelity & Guaranty's insurance companies' symbol included a bald eagle holding a shield with stars and stripes. The American Fire Insurance Company of Philadelphia used a bald eagle carrying an American flag. Aetna's signs contained an American flag and a shield with stars and stripes.

While waving the American flag won't actually sell insurance, it probably reduces resistance to the sales process. Another way to reduce resistance is for insurance companies to convey the image of great financial strength, regardless of whether they are in possession of such.

On November 21, 1929—twenty-three days after the stock market crash—Hugh Hart, vice president of The Penn Mutual Life Insurance Company, spoke before the Boston Life Underwriters Association, emphasizing the "stabilizing factors" present in the U.S. economy. "We," he said, referring to American insurance companies, "are carrying a financial reserve of $100 billion of non-shrinkable, non-declinable, non-panicable life insurance." The effect of this was comparable to what might happen if Abby Joseph Cohen were to tell a meeting of The Beardstown Ladies' investment club that the Dow was going straight to 15,000—the audience broke into applause. That Hart's words were a pile of bushwa was, apparently, beside the point. Although he continued to refer to a "vast reservoir" of "$100 billion," no such reservoir existed. In actuality, the $100 billion was the *face* amount of life insurance in force. The life-insurance industry's total assets were less than $20 billion, and, contrary to Hart's assertion, these assets were shrinkable, declinable, and panicable.

By 1933, insurance-company balance sheets were laden with defaulted mortgages, non-performing loans, and illiquid bonds, and a national life-insurance moratorium (similar to the Bank Holiday) was instituted. Assets were frozen, and policyholders were prohibited from cashing in their policies or taking out policy loans. (Death benefits continued to be paid.) The life-insurance industry decided to put its best foot forward by publishing a pamphlet absolving itself of blame. "Following the suspension of banking activities, the brunt of the crisis fell heavily upon the life insurance companies," explained the pamphlet. "They became the victims of a financial situation *in which they had no part.*" [Emphasis added.]

But life-insurance companies *did* have a part in the crisis. They had been swept up in the euphoria of the 1920's, making speculative loans and recklessly concentrating their assets in real-estate mortgages. Around the time the industry's pamphlet was published, 25% of Equitable's residential mortgages were in default, and the Metropolitan Life Insurance Company was the owner of a busted mortgage on the Empire State Building and in the process of becoming the owner (through foreclosure) of 2,000,000 acres of farmland.

Fifty-eight years after the life-insurance industry had published its pamphlet, Mutual Benefit sent its agents an important letter along with a pamphlet entitled "Facts & Fiction." The letter, dated June 27, 1991—a mere 18 days before Mutual Benefit would be taken over by its regulators—stated that concerns about Mutual Benefit's financial stability were the result of "a series of rumors and misinformation." The pamphlet claimed that Mutual Benefit was in "strong financial position," was "a solid 'investment grade' company," had "limited exposure to 'high risk' investments," and "continues to be an extremely profitable insurance company."

These statements were false. An affidavit filed in the Superior Court of New Jersey subsequently revealed that two months earlier, Mutual Benefit had met with the New Jersey Insurance Commissioner "to advise him of its increasingly precarious financial condition." At that meeting, Mutual Benefit disclosed that it wouldn't make a profit in 1991 and that it had grave concerns that, as a result of anticipated asset writedowns, its ratings would be downgraded by Standard & Poor's and Moody's.

How is it that Mutual Benefit, which had been around since 1845, could tell the public that it was strong when it had told the commissioner it was weak? Part of the answer has to do with the nature of insurance regulation. Although no honest company in Mutual Benefit's financial condition could have issued securities without first disclosing its distressed condition, Mutual Benefit's products (whole life, fixed annuities) are not considered securities. Even though these products are generally considered "investments" by those who purchase them, they are exempt from SEC regulation. As a result, an insurance company isn't required to issue a prospectus and disclose material information when it sells these "investments."

The McCarran-Ferguson Act, passed in 1945, delegates the regulation of insurance to the states rather than to the federal government. Unfortunately, the states haven't always provided adequate regulation. In a "race to the bottom," state legislators have often undermined good regulations to please powerful insurance-company constituents, and have used *lack of regulation* as a means of economic development. (The theory behind this practice is that insurers will relocate to the state with the easiest regulation.)

Mutual-insurance-holding-company legislation, which, fortunately, has *not* been passed in 30 states (among them New York and New Jersey), is just one example of terrible state regulation.

What does it say about state regulation if an insurance company like Mutual Benefit—one in dangerously weak financial condition—is not required to disclose its "precarious financial condition" to prospects prior to selling them a policy? It says that regulation is often ludicrous. While there are many good people in state insurance departments, the combination of inadequate insurance-department budgets, revolving-door commissioners, and a regulatory process heavily influenced by big money tends to produce unsatisfactory results.

There is perhaps no better example of the inadequacy of state regulation than Iowa, which takes in $140 million a year in premium taxes, but spends just $6 million on regulation. Iowa's insurance industry is large, and its insurance department is woefully understaffed. Letters go unanswered, complaints are ignored or misunderstood, and complex financial shenanigans are overlooked, because there's no one there who has the time to understand them. Worst of all, the Iowa Insurance Department is run by Terri Vaughan, who doesn't seem at all perturbed by this.

Vaughan's role as commissioner has been catastrophic for policyholders: she was personally responsible for permitting three large mutuals, Allied, AmerUs, and Principal, to engage in transactions in which policyholders were skewered.

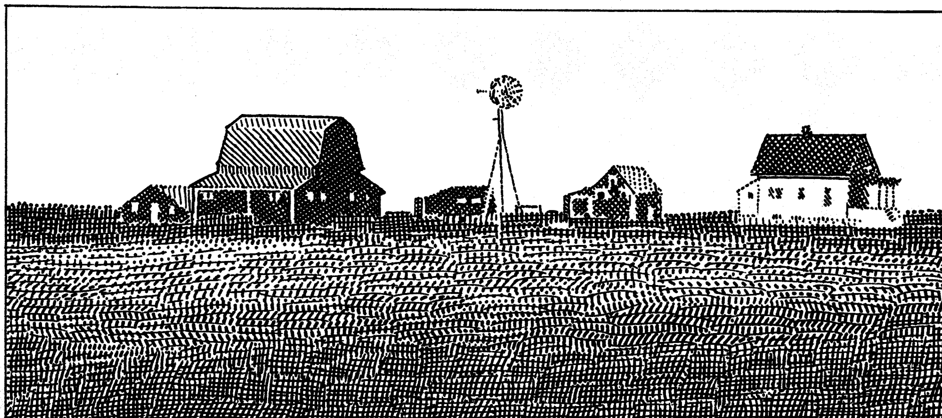
With the recent election of Tom Vilsack as governor of Iowa—the first Democrat to hold that office in 30 years—it seems likely that Vaughn will be out of her job in April, when her term expires.

Life insurers haven't cornered the market on financial instability. During the more-than-250-year history of American property insurance, failures have been common. America's first property insurer, the Friendly Society for the Mutual Insurance of House Against Fire, in Charleston, South Carolina, was wiped out in 1740, a mere four years after its formation. The Great New York Fire of 1835 bankrupted all but three of New York's insurance companies, and the Great Chicago Fire of 1871 burned up 68 insurance companies. Between 1969 and 1994, 591 property-casualty companies failed.

The Home Insurance Company, once the largest fire-insurance company in America, approached the abyss a number of times before ultimately falling in. (Its surplus was wiped out by the Chicago Fire in 1871, and had it been forced to mark its investments to market in 1932, it would have been undercapitalized.) Despite such setbacks, The Home grew larger. In 1968, during an era of great consolidation in the insurance industry, it was taken over by a conglomerate, City Investing. (Great American, The Hartford, Reliance, and many others were taken over around the same time.)

Under City Investing's management—rather, *mis*management—the seeds for The Home's eventual demise were sown. When City Investing was liquidating in 1985, it couldn't find a buyer for The Home, so it spun it off as an independent company. The Home Group, as it was now called, then did what numerous insurance companies have done in the past, are doing at the present, and will do in the future: it became a financial-services supermarket. It acquired a securities brokerage (Gruntal), a savings & loan (Carteret), and grew its assets rapidly and imprudently.

Then, in 1989, The Home Group changed its name to the patriotic sound-



Metropolitan Life Insurance Company's investment portfolio, 1935.

ing "AmBase." (An American flag adorned the front and back cover of AmBase's annual report.) A 1990 ad for The Home Insurance Company carried the tag line, "A subsidiary of AmBase Corporation." It seems that The Home was trying to improve its appearance of financial strength by showing that it was part of AmBase, and that AmBase, which was overleveraged, was trying to improve its stock price by showing that it owned The Home.)

If that was the strategy, it failed. The Home deteriorated, and AmBase's stock collapsed. Miraculously, a buyer from Stockholm, Trygg-Hansa SPP, shelled out about $800 million for The Home, apparently on the theory that nice Swedish fellows could do a better job with the company than could AmBase's chief honcho, the avaricious George T. Scharffenberger. The Swedes must have had one too many Aquavits to think such thoughts, and would soon rue their investment.

In December 1993, Lehman Brothers, Donaldson Lufkin & Jenrette, Salomon Brothers, and Gruntal—all of which, apparently, were *not* under the influence of Aquavit—underwrote public offerings in which $128 million of stock and $280 million of debt were issued by what was now called Home Holdings. That well-known Wall Street houses would underwrite the toxic securities of a nebulously capitalized insurance sinkhole isn't surprising; underwriting fees are so high that it's difficult for firms to say "no." (A note for the historical minded: Lehman was once owned by American Express, Salomon became part of Travelers Group, which, in turn, became part of Citigroup, and Donaldson Lufkin & Jenrette is a subsidiary of Equitable.)

Although the prospectuses for Home Holdings' rotten securities contained 14 "Risk Factors," one essential risk factor (that The Home was particularly vulnerable to adverse effects in the event of a rating downgrade by A. M. Best) was, incredibly, omitted. When Reliance Group had issued $650 million of debt a month *prior* to Home Holdings' offering, its prospectus included the following: "A downgrade in the Best rating below A- could adversely affect the competitive position of the Reliance Property and Casualty Companies." One would have thought that Donaldson Lufkin & *Jenrette*, a lead underwriter in both deals, might have learned from Reliance's prospectus and insisted upon a similar risk factor in the Home deal. (Richard Jenrette, who, in 1990, became CEO of DLJ's parent, Equitable Life, when it was in deep financial trouble, is a man well aware of risk.)

On November 7, 1994, after *Schiff's Insurance Observer* had published six articles criticizing Best's rating practices during the previous year (see "The Will Rogers of Insurance Rating Agencies," "An Unreasonable Risk of Insolvency," "Let's Face the Music and Dance," "Does Continental Deserve a B+ Rating Instead of an A-?", "Clear and Present Danger: How 'Managed' Ratings Inflate the Ratings of Weaker Companies," and "The Harder They Fall: Why Best's Ratings Portend a Rash of Downgradings"), A. M. Best downgraded The Home from A- to B+, hastening The Home's demise into runoff, where the ultimate payment of its liabilities remains uncertain. Amazingly, Best did not consider The Home to be "Vulnerable" until March 4, 1996, at which time it assigned it a B- rating. (At that time, B- was defined as "adequate." These days B- is defined as "fair.") On March 4, 1997, The New Hampshire Insurance Department issued an order placing The Home under formal state supervision. Six days later Best assigned The Home a rating of "E (Under Regulatory Supervision)."

While Best did not distinguish itself in the early 1990's, it has made significant strides in the last few years. Although its rating system could be improved—for example, it should use a scale similar to that used by Standard & Poor's and Moody's (AAA, AA+, AA, AA-, and so on)—its hardcover *Insurance Reports* is an indispensable source of information that we use daily. (For an excellent recap of the complex mess that is now The Home, we refer readers to the 1998 edition of *Best's Insurance Reports*, pp. 2332–2339.)

The Home is just one of many once-great insurance companies to have gone awry. Financial institutions, by their very nature, are prone to all sorts of problems, particularly during the busts that tend to follow booms. Whether one chooses to call the current U.S. economic environment a boom, bubble, bull market, or new era, it will, in all likelihood, be followed by what will be known as a bust, bear market, recession, or depression. (If Beardstown lingo is employed, it may simply be referred to as a "correction.")

Although the Internet-stock mania is a good example of a current speculative bubble, we'll cite instances of financial hysteria and speculation that are more pertinent to the insurance business. We'll show that prestigious institutions don't necessarily guarantee their subsidiaries or the products they sell, and that a respected name doesn't necessarily provide any value for policyholders or creditors.

Near the height of the mid-1998 financial frenzy, Goldman, Sachs & Company tried—but failed—to fob off its stock upon the public at a $30-billion market valuation, more than four times book value. Goldman's failure was the public's good fortune, for Goldman and its rapacious partners don't knowingly sell anything—including so-called "fairness opinions"—at bargain prices.

Those versed in financial history may recall Goldman Sachs Trading Corporation, a giant investment trust formed by Goldman, Sachs in 1928. Investment trusts were the rage back then, and Goldman Sachs Trading, essentially a blind pool, raised hundreds of millions of dollars very quickly. Using a leveraged pyramid structure, it acquired other investment trusts which had, in turn, previously acquired other investment trusts. (Through a merger with Financial and Industrial Corporation, Goldman Sachs Trading ended up with control of the Manufacturers Trust Company, later known as Manufacturers Hanover.) These financial machinations propelled Goldman Sachs Trading's stock from $50 to over $113, far above the underlying value of its inflated assets. Investors undoubtedly assumed that Goldman, Sachs, by sponsoring Goldman Sachs Trading and providing it with several directors, was, in some way, guaranteeing Trading's success. Such was not the case. Goldman Sachs Trading soon turned into a debacle, and

by 1932, when its shares were priced at $3^{1}/_{2}$, the concept of investment trusts had been in disrepute for a couple of years.

"Economic, like alcoholic, excess has its inescapable aftermath," wrote John Kenneth Galbraith in the introduction to the 1988 edition of his book *The Great Crash, 1929*.

Another example of a financial mania partially sponsored by a reputable company was the debacle in Latin American bonds. National City Bank, the forerunner to First National City Bank (which subsequently became Citibank, now part of Citigroup), was a major underwriter of Peruvian bonds in the 1920's, when the City Bank imprimatur was viewed as a seal of approval; that seal ultimately meant nothing. Peruvian government bonds, issued at par in the 1920's, traded down to $3 in 1932, as Peru, like virtually all South American countries except Argentina, defaulted on its U.S. debts. (The phrase "Peruvian bond" subsequently became a pejorative term, a synonym for a worthless debt.) In 1933, the Glass-Steagall Act separated commercial banking and securities underwriting.

Financial institutions are like candles: they can give off light right up to the moment that they suddenly flicker out. Kidder Peabody, which cost General Electric dearly as a result of a 1994 bond-trading scandal, had a history of being solvent most of the time; 1930, however, was not one of those times. Kidder had to be bailed out by J. P. Morgan and Chase National Bank. (Chase was the Rockefeller bank, and John D. Rockefeller was its largest shareholder.)

In 1955 Chase merged with the Bank of Manhattan to form Chase Manhattan Corporation. In 1970, when David Rockefeller became chairman and CEO, Chase Manhattan created and sponsored Chase Manhattan Mortgage & Realty Trust. (Much as the 1920's had seen a boom in leveraged investment trusts, the early 1970's was the heyday of a new type of leveraged trust, the Real Estate Investment Trust (REIT). Between 1970 and mid-1974, REITs grew from $2.5 billion in assets and $1.6 billion in equity to $21 billion in assets and $6.6 billion in equity.) The illustrious Chase Manhattan name—not to mention the Rockefeller connection—made Chase's "trust" all the more appealing to investors. Indeed, many believed that Chase Manhattan wouldn't let Chase Manhattan Mortgage & Realty fail, thereby sullying the illustrious Chase Manhattan moniker; they were dead wrong.

Although Chase Manhattan served as Chase Manhattan Mortgage & Realty's management advisor, it didn't guarantee or assume financial responsibility for Chase Manhattan Mortgage & Realty's obligations. After several rounds of restructuring beginning in the mid-1970's, Chase Manhattan Mortgage & Realty filed for bankruptcy in February 1979. (Many other REITs collapsed, as well.)

Six years later, the failure of Chase Manhattan Mortgage & Realty was ancient history. The stock market had turned, and New York was on the upswing. Thus in 1985 the Rockefeller family was able to cash out of Rockefeller Center through a mortgage REIT, Rockefeller Center Properties.

The original $44.9-million mortgage on Rockefeller Center, made by Metropolitan Life during the Depression years 1931–1935, had carried a 5% interest rate. In bullish 1985 the Rockefellers were able to take out a $1.3-billion mortgage on Rockefeller Center. The money came from a public offering of shares underwritten by Goldman, Sachs and Shearson Lehman. The shares in Rockefeller Center Properties, priced at $20, were not an *equity* interest in Rockefeller Center; rather, they were an equity interest in the *mortgage* on the property. The Rockefellers did not provide any guarantees, although many shareholders were undoubtedly drawn to the deal by the luminous Rockefeller name. (Surely the Rockefellers wouldn't let Rockefeller Center fail!) Another attraction: the prospectus for Rockefeller Center Properties implied that shareholders could earn a 13% annual return (rents were supposed to keep rising). Investors would have been wise to ask, "If the Rockefellers are borrowing from me, what do they know that I don't?"

In 1989, in a splendid stroke of timing, the Rockefellers sold 80% of their *equity* in Rockefeller Center to Mitsubishi for $1.4 billion. Soon after, rental rates in Manhattan started to fall, and vacancy rates soared. In May 1995, Rockefeller Center's owner filed for Chapter 11 bankruptcy protection. Shareholders of Rockefeller Center Properties ultimately received $8 per share—a loss of 60% on their investment.

We mention some of these long-ago events because, in the age of consolidation, convergence, co-branding, global marketing, financial-services supermarkets, and Citigroup, it's worth remembering that a good name does not connote solvency, and that risk, without the commensurate potential for reward, is not worth taking—either for an insurer or an insured.

Many insurance companies would have people believe that because they're part of larger organizations, people should have greater confidence in doing business with them. While that *might* be the case, it also might not. Many large companies don't provide guarantees that enhance the financial strength of their insurance subsidiaries. "Multi-line writers may establish an affiliate to write casualty lines of coverage *in order to isolate the parent from the potential loss exposure* of these more volatile lines," notes A. M. Best. [Emphasis added.]

Writes Moody's: "Because rated companies can issue very long-dated contracts it is important to determine the parent's long-term support and ownership commitment towards its subsidiaries."

Rating agencies, like everyone else, can only make informed guesses about what's going to happen over the long term. While their opinions are worth paying attention to, one must recognize their limitations; most of the major insurance-company failures caught the rating agencies by surprise. Furthermore, insurance companies—like everything else in the world—are often up for grabs if the price is right. Thus, while Colonial Penn might now fly the General Electric flag, there's no guarantee that it won't be sold in the future. Similarly, there's no guarantee that Travelers Property Casualty won't be set adrift by Travelers Group.

In a moment we'll examine a variety of ads that are misleading in some form

or other. Before we do that, however, let's review two recent examples of insurance-company debacles that illustrate our point—that an insurer's good name and prestigious parent company may be of little use to an insured when the chips are down.

Example one: from 1980 until 1987, First Capital Life was called E.F. Hutton Life Insurance Company. Policyholders probably felt a sense of comfort knowing that they were with an insurance company bearing such a distinguished name—that E.F. Hutton wouldn't let anything bad happen to its insurance company because that would besmirch the name made famous by the advertising campaign, "When E.F. Hutton talks, people listen." In 1987, E.F. Hutton was taken over by Shearson Lehman, a subsidiary of American Express, and E.F. Hutton Insurance Group, which included E.F. Hutton Life, was sold to First Capital Holdings. When First Capital Life (aka E.F. Hutton Life) failed in 1991, E.F. Hutton didn't step in to pick up the pieces or make good on the liabilities, even though Shearson Lehman Hutton Holdings was still the largest shareholder in First Capital Holdings. Policyholders of E.F. Hutton Life learned the hard way that E.F. Hutton's talk was cheap.

Example two: in 1992, Prudential Property and Casualty Insurance Company (PRUPAC) was wiped out by Hurricane Andrew. (PRUPAC's capital was subsequently replenished by its parent, Prudential Insurance Company.) In 1993, when the Florida Insurance Department wouldn't permit PRUPAC to non-renew policies in areas where it had a high catastrophe exposure, PRUPAC brought suit, claiming that it faced "an unreasonable risk of insolvency" as a result of the Insurance Department's actions. So that there were no doubts that the "risks" were faced by PRUPAC (as opposed to Prudential Insurance Company), Prudential said that it would not necessarily bail out PRUPAC if it became insolvent again, and emphasized that it was providing "no guarantees" to PRUPAC.

That was then; this is now. "In 1996, we launched a corporate-wide initiative called 'One Prudential,'" writes Prudential's chairman and CEO, Art Ryan, in the company's most recent annual report (available on Prudential's website). "In simple terms, One Prudential means...Prudential will look and act like one company...By coordinating our marketing efforts, we're bringing a wider, more accessible menu of services to our retail clients...[and] by unifying our communication and graphic standards across all of our businesses, we're helping to strengthen our brand."

A homeowner who isn't knowledgeable about insurance, corporate law, finance, insurance regulation, and Prudential might accept at face value what Ryan says in the annual report: "Prudential is a trusted name in quality insurance products. As a top issuer of life, personal lines, property & casualty insurance, as well as annuities, we have distinguished ourselves as an industry leader. *Our strength lies in our commitment to our customers.*" [Emphasis added.]

That "commitment" doesn't extend to guaranteeing PRUPAC's policyholders in the event that PRUPAC should fail.

To win a prize for being misleading, an insurance company's ad, brochure, or letter should do the following: make a ludicrous, beguiling statement; imply things that aren't true; use a well-known name and logo to lull the reader into complacency; create the impression that the owner of that name and logo is guaranteeing its insurance company's obligations to policyholders (even though it really isn't); and, finally, prey on someone who won't understand any of the above.

By these criteria, Colonial Penn is a prize-winning insurance company.

A New York State resident, John Q. Public (not his real name), recently received a nine-by-twelve-inch manila envelope that carries a provocative question in bold type: "Want to save $337 a year on your auto insurance?" The envelope's large white label reveals that it was mailed from the "Executive Offices" of "Colonial Penn Insurance, *A GE Financial Assurance Company*." The label prominently displays the General Electric logo.

Inside the envelope are four pages, printed front and back. The first page is a letter on stationery which displays the General Electric logo and, like the mailing label, is from the "Executive Offices" of "Colonial Penn Insurance, *A GE Financial Assurance Company*." (The letter also includes the slogan, "We bring good things to life.")

Attached to the letter is a yellow Post-it® note with the GE logo and the Colonial Penn and GE names. Although the letter is addressed formally, ("Dear Mr. Public"), the Post-it®, which was printed to look handwritten, reads, "John, Call now for a free price comparison. See how much you may save. – Chris."

The letter and the three following pages are all part of Colonial Penn's clever—but misleading—marketing effort to sell personal auto insurance directly. Although the insurance being pitched is from Colonial Penn, the words "General Electric" or "GE" appear 13 times, General Electric's logo appears eight times, and the slogan "We bring good things to life" appears three times. (The Colonial Penn name appears many times, too.)

What the mailing *does not include*, however, is anything making it clear that General Electric is not responsible for Colonial Penn's policyholder obligations. Indeed, the use of General Electric's name, logo, and slogan seems *designed* to make Mr. Public believe that General Electric is responsible for Colonial Penn's policyholder obligations. (The closest the mailer comes to having a disclaimer is some small print on the back of the enclosed application, which reads: "Colonial Penn's automobile policies are issued by either Colonial Penn Insurance Company, Colonial Penn Franklin Insurance Company, or Colonial Penn Madison Insurance Company of Valley Forge, PA.")

One page of Colonial Penn's mailer extols six "ABSOLUTE GUARANTEES" in big, bold capital letters. Underneath is an official guarantee entitled "GUARANTEE OF BETTER SERVICE & BENEFITS." This guarantee raises an obvious question: how can Colonial Penn (and General Electric) "guarantee" better service and benefits unless they know what service and benefits Mr. Public is already receiving?

Some of the "benefits" in the guarantee appear particularly attractive. For example: "*We guarantee* you will never be 'dropped' because of an accident...

When you qualify for our guaranteed policy renewal you'll never lose your coverage because of your age or driving record."

That sounded great, so we called Colonial Penn and asked a customer-service representative what it meant. "After one year," she replied, "as long as you've had no accidents or tickets, you're put into our 'guaranteed' program."

When we pressed for more information, it became clear that Colonial Penn was providing a guarantee that meant little, if anything. Yes, the company guarantees that it will *renew* your policy, but it doesn't guarantee the rate it will charge you. The customer-service rep admitted that if you had a bad driving record, Colonial Penn—which tends to write insurance for preferred risks—might charge rates as high as those in the assigned-risk pool.

Another one of Colonial Penn's "guarantees" turned out to be illusory: "*We guarantee* responsive customer service 24 hours a day! Call us anytime of the day or night, seven days a week. You shouldn't have to schedule your day around your insurance company's hours. Our friendly customer service representatives are always willing to answer any questions you have."

We took Colonial Penn (or was it General Electric?) up on its offer, and called its customer-service line one Sunday after midnight and said we wanted to ask some questions about a policy's terms and conditions. We were informed that for questions of this sort we'd have to call back between 7:00 a.m. and 11:00 p.m.

On the last page of its mailer, Colonial Penn makes misleading statements about its financial strength and ratings:

RATED "EXCELLENT (A-)"

You can feel secure knowing that you are dealing with a company rated "Excellent (A-)" by the A.M. Best Company. This rating, from the most respected rating company in the insurance industry, attests to Colonial Penn's financial stability, soundness and operating performance. Colonial Penn is a member of the General Electric family of companies dedicated to the highest quality products and services. GE tied for the #1 ranking in 1995 and 1996 in the Forbes Super 100, which measures sales, profits, assets and market value.

We will now examine, and respond to, Colonial Penn's words:

COLONIAL PENN: "You can feel secure knowing that you are dealing with a company rated 'Excellent (A-)' by the A.M. Best Company."

RESPONSE: Notice how Colonial Penn has inverted its Best rating: Best always shows its ratings as a *letter* followed by a *description*, e.g. "A- (Excellent)." By inverting the order—"Excellent (A-)"—Colonial Penn has put its best foot forward and altered the meaning of the rating, since "Excellent" sounds better than "A-."

Furthermore, although an A- rating is in Best's "secure" category, it's debatable just how secure you can feel about a company with an A- rating. (A "B+"rating is also "secure.") Fifty-two percent of the property-casualty "rating units" that have a letter rating are rated "A-" or higher, and 36% are rated "A" or higher. "A-" is Best's fourth highest rating category; it is three notches above the "Vulnerable" category.

When we called the Colonial Penn toll-free hotline and asked a representative to explain the significance of Best's "A-" rating, we got the following response: "That means we take care of our customers and we take care of our claims." That is erroneous. Best's ratings refer to an insurer's financial strength, not to its customer service.

COLONIAL PENN: "This rating, from the most respected rating company in the insurance industry, attests to Colonial Penn's financial stability, soundness and operating performance."

RESPONSE: A.M. Best's ratings don't "attest" to anything. (Webster's defines *attest* as "to affirm to be true or genuine" and "to authenticate officially.") Best says its ratings "reflect our independent opinion of the financial strength, operating performance and market profile of an insurer relative to standards established by the A.M. Best Company. Best's ratings are not a warranty..."

COLONIAL PENN: "Colonial Penn is a member of the General Electric family of companies dedicated to the highest quality products and services."

RESPONSE: Although Mr. Public might have been reassured by this and by the repeated use of the GE logo, Colonial Penn's policyholder obligations aren't guaranteed by General Electric.

COLONIAL PENN: "GE tied for the #1 ranking in 1995 and 1996 in the Forbes Super 100, which measures sales, profits, assets and market value."

RESPONSE: A red herring. While it's wonderful that GE is so successful and large, size doesn't guarantee financial strength, and GE doesn't guarantee Colonial Penn's obligations. Amica Mutual, Cincinnati Insurance, Erie Insurance, and USAA, to name several companies that are minuscule compared to GE, all carry A++ ratings.

General Electric doesn't just tout itself to unsophisticated folks looking to save a few bucks. Employers Reinsurance Corporation (aka ERC), which is owned by GE, has been running a series of full-page ads in insurance publications. You've probably seen them: they contain a catchy quote (e.g., "'It's not whether you get knocked down. It's whether you get up again.' –Vince Lombardi"), in white lettering on a red background. The ads contain a few lines of text ending with the slogan, "It's a world of risks. Be prepared." Underneath the text, the famous GE logo is featured as prominently as "ERC."

And what is it that GE—we mean ERC—is telling readers? Here's a sampling from several ads (we've added the italics for emphasis): "At ERC our risk experts have over a century of reinsurance expertise behind them. *Not to mention the vast resources of GE.*" "With reinsurance experts in more than 40 countries *and GE capital reserves*, we can help manage all kinds of risk." "ERC's customized Casualty Facultative programs...*backed by the interminable* [sic] *resources of GE.*" "Put the *combined strength of GE & ERC* to work for you." "*...backed by the prodigious resources of our parent company, GE.*"

So, the vast—rather, interminable—resources and capital reserves of GE are supposedly backing ERC, and this combined strength will work for you. But does that mean what it sounds like it means—that GE provides guarantees or sets up reserves for the benefit of ERC policyholders?

We phoned ERC and were told to call Neil McGarity of GE Capital, who's in charge of answering pesky questions from people who believe that words mean something.

"Does General Electric explicitly guarantee ERC?" we asked McGarity.

"It's simply saying that if you want

security…" his voice trailed off.

We asked about the "backed by" claims and expressed the opinion that the ads were misleading.

McGarity didn't seem to share our concerns: "'Backed by' means that they are a member of the GE family and we stand behind them."

What does *that* mean? Is GE guaranteeing ERC's obligations?

McGarity characterized our comments as "overblown speculation," and said he didn't want to talk further.

We weren't surprised. After all, what was he to say? That ERC's ads are misleading hokum? That GE *isn't* guaranteeing anything when it put its logo on ERC's ads?

Other ERC ads are misleading in a different way: "Pad yourself with ERC's innovative Casualty Treaty services. Backed by a network of deep GE capital reserves, *it's the highest rated service in the industry*."

We'll skip a discussion about whether GE—or rather, ERC—offers fine Casualty Treaty services. But is it really the "highest rated service"? (A footnote in the ad explains that by "service" ERC is referring to its ratings of A++ from Best's, Aaa from Moody's, and AAA from S&P.)

Is it proper for ERC to say that it is the "highest rated [insurance company] in the industry"? Doesn't that mean that no other insurance company is rated as highly (which, of course, isn't true)? Interestingly, in a press release to the investment community, GE and ERC are more careful about what they say: "ERC holds *top* financial strength ratings from Standard & Poor's…"

Another five-star General whose advertisements have caught our eye is General Motors. MIC Re, rated A+ by Best, is a subsidiary of Motors Insurance Company, a subsidiary of GMAC Insurance Group, which is owned by General Motors. MIC Re's two-page ad features a Chevrolet truck above the following: "As a member of the General Motors family, MIC Re engages significant resources to ensure the success of our Treaty and Facultative customers…" The ad features a big "GM" logo at the bottom right. General Motors, of course, is not responsible for MIC Re's liabilities.

For that matter, Citigroup isn't going to be on the hook (absent a lawsuit) if Gulf Insurance Group runs into trouble, even though Gulf's ads display the Travelers' umbrella and say that Gulf is "a member of Citigroup." (Gulf is owned by Travelers Property Casualty Corp., which is 82% owned by Travelers Group, a subsidiary of Citigroup.) Unless financial regulations are changed in the next five years, Gulf will no longer be a "member" of Citigroup.

Frontier Insurance Company isn't located on the frontier—unless one considers the Catskills to be the frontier. Yet the company's logo is a Davy-Crocketesque figure in a coonskin cap with a rifle—an ironic touch, considering that Frontier has shot itself in the foot by growing too rapidly. One of its recent ads was, mostly, typical trade-publication fare in which a company uses a silly sports metaphor to link an image with words. Frontier pictures a high jumper bent backwards as he clears the bar, with the caption, "Frontier's market flexibility gets you over the top when you compete for excess workers comp business."

The ad goes on to say that Frontier Insurance Company is "a member of Frontier Insurance Group (NYSE: FTR)—which is nearing Two Billion Dollars in assets." Frontier's use of its New York Stock Exchange listing is, we suppose, meant to impress people, implying that the company is strong. (Frontier Insurance *Company*, by the way, does not have Two Billion Dollars in assets; it has $1 billion, and is not listed on the NYSE.)

Frontier is one of the few companies that advertises its Demotech ratings. (We pay no attention to Demotech's ridiculous ratings and don't think anyone else should, either.) Frontier, for example, is rated A- by Best, A+ by S&P and—get this—"A Prime (Unsurpassed Financial Stability)" by Demotech. If Frontier's financial stability is "unsurpassed," then we're all in trouble. (For a good article on Demotech's ratings, see the January 1998 edition of *The Insurance Forum*, [812] 876-6502.)

United Capitol Insurance Company, which writes environmental liability and is owned by the folks who "get you over the top," has been running an ad that demonstrates how creative typography can be used to give an impression of greater financial strength than actually exists: "A member of the Frontier Insurance Group, Inc. (NYSE-FTR), United Capitol combines the flexibility of a surplus lines carrier with the strength and stability of an *A-rated* parent company." [The italics are ours.] Since the words "A" and "rated" are being used as an adjective that modifies "parent company," it is proper to insert a hyphen between "A" and "rated," producing the phrase "A-rated parent company." Here's the problem: United Capitol is rated "A-". By eliminating the space between "A-" and "rated," United Capitol boosts its rating a notch and misleads readers. United Capitol's ad should read, "an 'A-' rated parent company."

Unionamerica Insurance Company runs an ad that says in big letters, "Meet the 'A Team,'" then goes on to say, in smaller lettering, "With the 'A Team' you get more than just ratings." We suppose the "more" refers to the five Unionamerica executives pictured in the ad. What you don't get from the "A Team," however, is an "A" rating from Best. (The ad notes that Unionamerica is rated "A-" by Best and "A" by Standard & Poor's.) The ad continues: "The 'A Team' also scores straight 'A's in flexibility, innovation, and service." Not to mention an A+ for creative advertising.

More insidious is Winterthur Swiss Insurance Group, which knows how to make beautiful music with its misleading advertising. One ad shows a photograph of hands playing a piano keyboard, along with the header, "We write insurance in concert with you." The ad includes a chart of "key figures"—$72.4 billion in assets, $19.4 billion in premiums, and 27,797 employees—and lists the name and address of six Winterthur insurance-company groups. The text says that each company in the Winterthur network in North America is "independent…Yet we are part of a well-orchestrated, worldwide effort to provide our policyholders the strength, stability, and security of one of the world's largest, most successful insurance groups."

Winterthur's $72.4 billion in assets

are not allocated to pay the claims of each insurance group or company; these assets are held in numerous entities. Also, as we have noted before, size does not equate with financial strength.

Although Winterthur's ad doesn't show ratings, its insurance companies have varying degrees of financial strength. Blue Ridge and Republic Underwriters both are rated "A-"; Southern Guaranty and Unigard are rated "A"; and General Casualty is rated A++.

In a recent ad, PXRE Insurance Company, which underwrites catastrophe reinsurance, declares that it provides "continuity of coverage for the next time all hell breaks loose." (We wonder about PXRE's continuity; with its stock trading below book value, it's a dirt-cheap asset play. We'll bet that it's taken over within five years. Who knows, it could be taken over between the time we go to press and you receive this issue.)

What intrigues us about PXRE's ad is the following statement: "We write business worldwide, supported by over $475 million of our own surplus, *and almost $4 billion in capital made available to us by trading partners* who share our underwriting philosophy." [Emphasis added.]

What is this "$4 billion in capital" and why doesn't it show up on PXRE's balance sheet? And what are "trading partners'?

PXRE didn't return our calls (maybe all hell had broken loose that day). But we assume that the "$4 billion in capital" from "trading partners" is just a highfalutin way of describing the company's retrocessions (the ceding of some of the risk that it has assumed through reinsurance). If our assumption is wrong and PXRE has, say, a $4-billion line of credit that it can call upon to pay insurance claims, we'll be glad to provide a free subscription to every PXRE employee.

While PXRE is proud to lay claim to its trading partners' capital, MassMutual, "The Blue Chip Company," proudly lays claim to money that it manages for others, advertising the following: "For more than 145 years, people across America have relied on us to insure their lives and financial future. With over $160 billion under management and excellent ratings, MassMutual and its subsidiaries have the financial strength to help families and businesses keep their promises."

According to A.M. Best, about $100 billion of MassMutual's $160 billion are assets *managed* by MassMutual's subsidiaries: Oppenheimer Funds, David L. Babson & Company, and Cornerstone Real Estate Advisors. These assets no more belong to MassMutual than the assets in Smith Barney's money-market funds belong to Sandy Weill. Furthermore, MassMutual's $100 billion in noninsurance assets are not what give the company the financial strength to keep its promises (nor are its $60 billion of insurance assets on its balance sheet). MassMutual is a well-capitalized insurer with top ratings, and it shouldn't have to resort to the use of misleading statistics to imply that it is strong.

One of the great ironies of the insurance industry in recent years is that supposedly high-quality mutual life insurers like MassMutual—companies allegedly run for the benefit of their policyholders—have been staunch proponents of the Mutual Insurance Holding Company concept, a neutron-bomb form of corporate organization that levels policyholders but leaves mutual-insurance-company executives standing.

AIG is a fine organization filled with innovative folks. Surely it doesn't need to mislead the public about its financial strength. And yet, it is not above artful guile. The following is from the folder that AIG uses to deliver personal auto-insurance quotes *directly* to prospects. (In personal lines, AIG is a direct writer, eschewing brokers and agents.)

> AIG—WORLD LEADERS IN INSURANCE AND FINANCIAL SERVICES
>
> In reviewing your rate quotation, please keep in mind that this automobile insurance is offered by member companies of American International Group, Inc. (AIG), one of the largest and most respected insurance organizations in the world.
>
> In April 1998, Fortune Magazine *ranked AIG #1 in the insurance industry among publicly-traded Property & Casualty stock companies based on revenue.* And in its March 30, 1998 issue, Business Week reported that *AIG has the highest profitability and highest market value* among companies rated in the nonbank financial category. *That puts it above such industry giants as Travelers, Allstate, Fannie Mae and Morgan Stanley.* [Emphasis added.]

While AIG's statements may be true, they are irrelevant, and it's hard to see how they could do anything other than confuse an AIG Auto Insurance Program prospect.

So what if AIG is the largest publicly traded property-casualty insurance company based upon revenue? In personal auto (the coverage in question), AIG's insurance companies are relatively small—about 5% the size of State Farm.

And so what if AIG has a higher "market value" than Travelers, Allstate, Fannie Mae, and Morgan Stanley? Travelers and Allstate write much more personal auto than AIG. (AIG writes much more personal auto than Fannie Mae and Morgan Stanley, but then, these two aren't in the insurance business.)

Why would AIG compare itself to Fannie Mae and Morgan Stanley in a direct-mail piece to consumers? Has it gone daft?

We called the toll-free number provided by AIG and asked the fellow who picked up the phone if he could tell us what AIG was talking about in the folder it sends to prospects. His response was that it meant that AIG was a well-run company that would be around, and that it had the revenues behind it to pay any claims.

We professed confusion. Is there some significance to AIG's having the highest profitability and highest market value?

Well, explained our man, "We make money for our stockholders—we're just telling you that we're solid." He also told us that AIG's stock had gone way up in the past year.

But we're interested in buying a policy, we said, not stock. Our man then told us that all of this stuff had something to do with AIG paying its claims in a timely manner.

AIG's profitability and market value have nothing to do with paying its personal-lines claims in a timely manner. We know this, and Hank Greenberg knows this—but individuals who buy insurance directly from AIG may not know this.

Given that Mr. Greenberg's temper is reputed to be a tad combustible, we hope that he doesn't get mad at the customer-service man who spoke with us—after all, the poor fellow didn't write the twaddle in AIG's direct-mail piece.

In our February 1998 issue, we wrote about Reliance*Direct*, the direct-selling auto insurance subsidiary of Reliance

Insurance Company, whose marketing pitch boasted that it would reduce policyholders' premiums by "eliminat[ing] the middleman so your rates are never inflated by agents' commissions and sales fees." Reliance's agents and brokers, not surprisingly, didn't take kindly to eliminating middlemen, and Reliance*Direct* changed its name to Insure*Direct*. "We're saying 'good-bye' to middlemen and high overhead," said its website.

Insure*Direct* didn't catch on, and the company went back to its old appellation, Reliance*Direct*. "Only our name has changed—we're still the best choice for auto insurance!" exclaims its website. "We still offer the same great coverage, low rates, attentive customer service, and responsive claims handling. So why the change? We've decided to return to the proud heritage of our parent company—Reliance Insurance Company. Reliance's roots go back to 1817."

Reliance*Direct* has been around since mid-1997; last year it wrote about $5 million in premium. It's rated A- by Best. "We like to consider our company the very bright child (if we do say so ourselves) of a well-established parent," says the website. "You see, we're a part of Reliance Group Holdings, a company with over $11.3 billion in assets, as well as a long, colorful history of its own."

Moody's gives Reliance Group Holdings' senior debt a "junk" rating—Ba1. "Bonds which are rated ['Ba1'] are judged to have speculative elements," says Moody's. "Their future cannot be considered well assured." The rating of Reliance Group Holdings' senior debt is far more relevant to Reliance*Direct's* policyholders or prospects than is the fact that Reliance Group Holdings has $11.3 billion in assets.

Reliance*Direct* is nothing if not brash. "Something is definitely wrong with car insurance today. You pay and you pay and you pay. And when something unfortunate happens—when you finally need them to hold up their end of the bargain—it's as if they don't know you anymore. For this, middlemen pocket roughly $11 billion a year in commissions. And insurance companies wind up with lots of extra profits. Something's gotta give."

Reliance*Direct's* website doesn't actually *name* any of the insurance companies that are violating the law by not "hold[ing] up their end of the bargain" and thereby making "lots of extra profits." (By the way, Reliance, was once a big writer of personal lines—until it pulled out of the market earlier in the decade.)

The website also claims that "some other low-priced insurers are giving 'direct' a bad name." Really? When we think of "direct," GEICO Direct's name comes to mind. While we're aware that it can be difficult to get through to the company at times, its website is remarkably understated: no mention of billions in assets; no wild claims. While the Berkshire Hathaway connection is mentioned, it is done so in the middle of text: "GEICO Direct is a wholly owned independent subsidiary of Berkshire Hathaway."

Reliance*Direct* has more to say: "We cut out literally [sic] tons of overhead. You don't pay for agent commissions, huge corporate travel accounts or layers upon layers of bureaucracy. But the insurance you get is just as complete as any of the companies who hide those expenses in your final costs."

Last year Reliance*Direct* sent out a junk-mail solicitation in which it claimed: "We...provide you with excellent service and promptly paid claims. Which is why A.M. Best rates us 'A- (Excellent)' for paying claims." Reliance's "A-" rating is not a measurement of service and promptly paid claims, it is a measurement of financial strength.

Reliance*Direct* doesn't give "direct" a bad name. It merely gives "Reliance" and "insurance" a bad name.

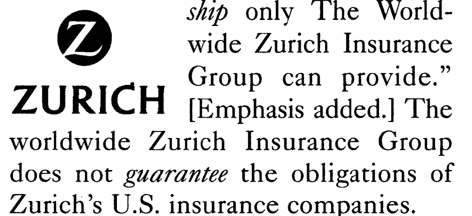
Like many other mutuals, Mutual of Omaha is pondering some form of demutualization. Last year it asked Nebraska's insurance department whether it could keep its well-known name if it demutualized and became a stock company. Commissioner Timothy Hall told Mutual of Omaha that it could continue to use "Mutual" in its name—provided that it included some sort of disclaimer that it wasn't a mutual.

The word "mutual" has positive connotations, particularly in insurance. The applicable definition in Webster's is the following: "of or relating to a plan whereby the members of an organization share in the profits and expenses; specifically: an insurance method in which the policyholders constitute the members of the insurance company." It is no more appropriate for a stock insurance company to use "mutual" in its name than it would be for Colonial Penn to tell policyholders it's a charitable organization.

In January, we called Commissioner Hall to ask about his decision. So far, neither he nor his office has returned our call. On February 19, we wrote the following letter:

> Dear Commissioner Hall:
>
> We are giving consideration to forming a Nebraska-domiciled insurance company called Mutual of Nebraska Insurance Company. Although it will not be a mutual, we believe that using "mutual" in the company's name will help us sell insurance, as many prospects are likely to mistake the company for a mutual and think that it will be run for their benefit rather than for ours.
>
> We are not averse to using some sort of disclaimer to the effect that Mutual of Nebraska is not a mutual. Perhaps the company's logo will carry the following tagline in small print: "a stock company."
>
> We trust that you will approve the name proposed above (or some variation of it, if the name is already taken). We would appreciate it if you would provide guidelines for using the word "Mutual" in a stock company.
>
> We look forward to your response.

The Zurich organization, a financial-services conglomerate, engages in promotion that is as full of holes as Swiss cheese. For example, a 1995 Zurich-American Insurance Group ad in *Business Insurance* said, "We're willing to take risks other companies won't. And we'll service our policies in a way other companies can't. *Because we're backed by the financial strength, stability and the power of partnership* only The Worldwide Zurich Insurance Group can provide." [Emphasis added.] The worldwide Zurich Insurance Group does not *guarantee* the obligations of Zurich's U.S. insurance companies.



Zurich also hits individuals directly. A New York resident recently received a mailing from Zurich advising him of the "opportunity to invest in one of the highest yielding general money-market funds in America"—the Zurich YieldWise Money Fund. The mailing, which included a letter, brochure and other material, cited three reasons why Zurich could offer such attractive

yields. The first reason: the fund is "100% No Load—so every investment dollar works hard for you." That claim is meaningless: to our knowledge, *all* money-market funds are no-load. (Zurich also explained that its yields were high because its expenses were low and that you pay only for the services you use.) After a little salesmanship, the letter launched into familiar language: "And behind your investment stand the resources of a global financial leader with more than $200 billion in assets under management."

The amount of money that Zurich manages worldwide, is irrelevant to the yield and safety of the Zurich YieldWise Money Market Fund, and telling prospects about the "$200 billion" seems calculated to instill in them a false confidence. Neither the Zurich YieldWise Money Market Fund nor the worldwide Zurich organization guarantees the yield investors will receive or the return of their principal.

Zurich's letter states that its fund is not guaranteed by the FDIC and that "it is possible to lose money by investing in this and all money-market funds." That essential fact could easily be overlooked amidst the attractive brochures.

The expense rate for Zurich's money market fund is low—0.44%—but not so low as that of Vanguard Prime Money Market Portfolio, which is 0.32%.

What makes Zurich's solicitation ironic, however, is that last November, Zurich-American Insurance Group unveiled a new type of coverage—a Money Market Net Asset Value Protection policy, which "protects investors when the assets that underlie money market funds default and jeopardize the $1.00 Net Asset Value of the fund." Notes Zurich's press release: "We think this will help the average person who invests in money-market funds feel more comfortable when they turn to these important savings vehicles." (The policy is sold to *managers* of money-market funds.) The press release also notes that the policy is issued by member companies of the Zurich Financial Services Group, which has "gross premiums of more than $44 billion" and "$375 billion of pro-forma assets under management."

We wondered whether Zurich YieldWise Money Market Fund bought the new Money Market Net Asset Value Protection policy, which Zurich-American says is "beneficial to both money market shareholders and investment advisors." When we called Zurich YieldWise Money Market Fund's toll-free hotline and asked about the insurance policy, the man who answered the phone said yes, the fund carries the insurance.

We were surprised, and suspected that his answer was wrong, so we asked again, in greater detail. "We're backing our funds with $367 billion in assets," he responded, spouting some irrelevant information that we suspect he'd been told to say.

When we asked once more whether the Zurich YieldWise Money Market Fund actually had the Zurich insurance policy, we got a different answer: "No."

Perhaps the most egregious recent example of a parent company's involvement in its insurance subsidiary is the case of Florida Progress, a large public company that owns Florida Power Corporation, an electric utility, and Mid-Continent Life Insurance Company, the oldest insurance company in Oklahoma.

In 1986 Florida Progress purchased Mid-Continent as part of a diversification effort. Mid-Continent's primary business was the sale of a two-part policy called "Extra-Life," consisting of a small amount of participating whole life and a large decreasing term-insurance rider. The policy was sold as a "level-premium" policy with a guaranteed death benefit. (The concept behind the policy was that dividends on the whole-life portion would be used to pay the premium on the decreasing term-insurance portion.)

Mid-Continent isn't a large company. According to Best, which gave it an A+ rating for many years, at year-end 1996 it had $281 million in assets and $64 million of surplus.

Mid-Continent became a debacle—an actuarial nightmare that led to its own ruin, financial problems for policyholders, and significant potential liabilities for Florida Progress. Unlike most failed life-insurance companies (which ran into trouble as a result of investments that went sour), Mid-Continent ran into trouble as a consequence of inaccurate actuarial assumptions.

Our December 1991 issue included a piece on Peter Hutchings, executive vice president and chief financial officer of Guardian Life Insurance Company, and an actuary by training. In the wake of the Executive Life and Mutual Benefit fiascoes, Hutchings surmised that in the future the industry might well see *liability-side* problems (as opposed to asset problems) due to actuaries' aggressive behavior. (Insurance companies' liabilities are primarily *reserves*; these liabilities are offset, in theory, by assets.)

Mid-Continent's complicated "level-premium" policy was mispriced, apparently due to at least two mistakes: 1) Assumptions about lapse rates were wrong; lapse rates turned out to be much *lower* than expected. That was a problem because the policy was constructed so that it would be very profitable in its early years, but not in its later years. This is reminiscent of a "tontine," a financial arrangement in which the surviving participants profit at the expense of participants who drop out or don't survive. 2) Assumptions about future investment yields were overly optimistic.

As a result, Mid-Continent's reserves were understated. Once the company became aware of this, it was faced with several alternatives, including the following: it could try to raise the premium on its "level-premium" policies, which could provoke outrage and lawsuits; it could successfully raise the premium on its "level-premium" policies (but still suffer from adverse selection); or premiums could be kept level and, to maintain solvency, Florida Progress could pump in plenty of new capital, or find someone who would.

Mid-Continent decided to raise the premiums on its "level-premium" policies.

In "The Disaster at Mid-Continent Life" (*The Insurance Forum*, August 1997), Joseph Belth quotes liberally from the Extra-Life sales literature. Here is just a small sample: "Guaranteed Level Protection at the Lowest Level Premium Outlay"; "Guaranteed Death Benefit… Level Premium!"; "Both your premium and your coverage are designed to remain level"; "The premium starts at $641 per year. In the 21st year it's still $641. Ditto in the 31st year and every year"; "*Frog Insurance* is life insurance

that jumps up in price every year...At Mid-Continent we sell *People Insurance*...The scheduled premium does not jump."

Belth writes that a *footnote* in a sales illustration for a Mid-Continent policy says that "dividends and insurance premiums based on the current scale are not guaranteed." Belth also quotes obfuscatory policy language that apparently says something to similar effect, although, as Belth notes, this is contradictory to the impression created by the sales literature. (Belth has graciously provided us with copies of certain court documents he obtained regarding *State of Oklahoma v. Mid-Continent Life*. The opinions expressed here, however, are our own.)

The premium increases on Mid-Continent's "level-premium" policies led to complaints, ultimately leading to the company's seizure by Oklahoma regulators on April 14, 1997, on the grounds that it was massively underreserved. Since then, the regulators have been involved in a legal battle with Florida Progress, seeking $300 million to bolster Mid-Continent's reserves. At year-end 1997, Mid-Continent's assets totaled $314 million, but its surplus was *negative* $348 million.

Florida Progress doesn't see eye-to-eye with Oklahoma's regulators. It denies that it owes $300 million, and it denies that it guaranteed that the premiums on its "level-premium" policies would actually remain level.

For now, the issue of whether Mid-Continent can raise the premiums on policies it hawked as being "level premium," is murky. In 1997, an Oklahoma judge ruled that Mid-Continent *could* raise premiums, but at the same time the judge appointed the Oklahoma Commissioner as Mid-Continent's receiver and directed him to submit a plan of rehabilitation. The matter has not yet been settled.

What distinguishes the Mid-Continent mess is the role that Florida Progress played. Of the 150,000 Extra-Life policies sold, "more than 100 were sold to current and former employees of Florida Progress itself," writes Ameet Sachdev in *Knight-Ridder Tribune Business News*. "They had been assured by no lesser figure than the chairman of Florida Progress that the rates would stay the same 'as long as you keep the policy.'"

Over the years, Mid-Continent and Florida Progress played up the link between the two companies. At a Florida Progress meeting for financial analysts on October 16, 1987, in a presentation by a Mid-Continent executive, the following statement was made: "Agents...like the Florida Progress ownership, and they know that it adds financial clout to their own sales presentations." The full text of the presentation was sent to Mid-Continent's "Associates."

On October 4, 1991, Riley Simon (chairman and CEO of Mid-Continent until March 1995) sent the following letter to Mid-Continent's regional directors:

> The enclosed September 1991 Report to Shareholders of Florida Progress is an outstanding sales piece. Many of our Regional Offices have received calls from stockholders wanting to buy from Mid-Continent Life as a result of this piece.
>
> These reports will be put in the November 5th commission statements and each Regional Office will be receiving 200 of them.
>
> I highly recommend you put one of them in each of your broker kits; it shows the strong relationship between Florida Progress and Mid-Continent Life, and their commitment to us.

On November 8, 1994, Mid-Continent and Florida Progress met with A.M. Best. A formal presentation from that day, entitled "Corporate Overview," is printed over Florida Progress's name and logo. Among the points that Florida Progress made to Best in that presentation is the following: "We are here today to express our commitment to Mid-Continent and to support our plan to maintain the A+ (Superior) rating."

To what extent Best relied on Florida Progress's assurances remains proprietary, but the record shows that Best maintained Mid-Continent's A+ rating for two more years, at which time it downgraded the company to "A." It did not downgrade its rating further until after its seizure by Oklahoma regulators.

This incident with Best only serves to highlight the problems that can arise from rating agencies' reliance on an insurer's parent-company support—whether that support is explicit, implicit, or assumed—as a justification for providing a higher rating to an individual insurance company.

Another piece of material apparently distributed by Mid-Continent shows the company's name and logo, and, in smaller letters: "A Florida Progress Company." Beneath that are the words, "$5 Billion. Rated A+ (Superior) by A.M. Best Company." The $5 billion, presumably, refers to *Florida Progress's assets*.

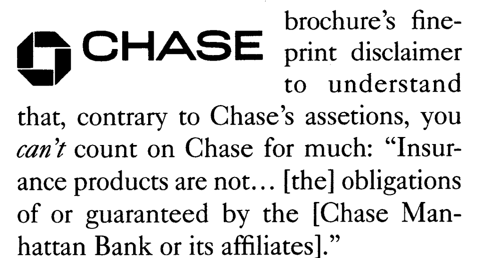
About 40% of Mid-Continent's Extra-Life policies were sold in Texas. In April 1998 Paul Hendrix, a Texas insurance agent, wrote to John Crawford, Oklahoma's insurance commissioner:

> In formal training sessions and in individual meetings with District Managers of Mid-Continent, agents were assured many times that Mid-Continent Life had always made dividends since its founding in 1909, would continue to do so, and if needed, the parent company, Florida Progress Corp., was there to back up any losses.
>
> So agents sold policies with the confidence that these terms would be met because they had the history, the knowledge, and the backing of Florida Progress to make sure policyholders were taken care of...

Florida Progress's "commitment" to Mid-Continent—which was expressed to the company's sales force, to policyholders, and to Best—only applied during good times; in hard times it meant nothing. That's worth remembering.

Chase Manhattan is in the insurance business, and it has been engaging in curious behavior. A brochure for Chase Insurance Agency, which we picked up at a Chase bank, displays the Chase logo and states, "Remember, when you need to find the right insurance, YOU'VE GOT CHASE." The brochure tells readers that they "can count on Chase," and urges them to call "1-800-CHASE24."

Reading this brochure you could easily think that Chase Manhattan Bank is the insurer, or that it's guaranteeing the insurer. You would have to read the brochure's fine-print disclaimer to understand that, contrary to Chase's assetions, you *can't* count on Chase for much: "Insurance products are not... [the] obligations of or guaranteed by the [Chase Manhattan Bank or its affiliates]."



But perhaps the disclaimer is wrong. Maybe Chase Manhattan Bank *does* guarantee—albeit inadvertently—the insurance sold by its insurance agency. Perhaps the fine print won't be enough to overcome lawsuits, should they arise. After all, can Chase use its name and logo to tell customers (in large print)

that they can "count on Chase," while disclaiming responsibility in small print?

We recently examined a 120-page life-insurance proposal from Chase Manhattan Bank—or was it from Chase Insurance Agency? It's hard to tell. The proposal, made last year, was bound in a dark, heavy-duty cover on which Chase's logo and "The Chase Manhattan Private Bank" were embossed in gold. (Inside, a plain sheet of paper stated that the contents were "presented by" Chase Insurance Agency.) Chase Manhattan Private Bank is not an insurance agency, nor is it licensed to sell insurance. The proposal did not carry a disclaimer that the insurance being proposed was not an obligation of or guaranteed by Chase Manhattan Private Bank.

That's the *good news* about Chase's proposal.

A New York insurance regulation (53, Section 3.2b, number 8), prohibits an insurer, its producers, and other authorized representatives from using the words "vanish," "vanishing premium," or similar terms when using an illustration in the sale of a life-insurance policy. This regulation was enacted January 1, 1998, in response to the scandals and lawsuits caused by vanishing-premium sales illustrations. Unfortunately, the proposal in the Chase Manhattan Private Bank binder, which included a sales illustration from MassMutual, ignored the regulations. It said:

> Although plan premiums are contractually payable for life, it is possible to "*vanish*" them through the use of dividends. Under a *premium vanish plan*, both past and current dividends are used to offset your annual premium." [Emphasis added.]

Chase had no formal response to our questions about these documents, but that's not surprising. We'd hardly expect it to admit violating New York State regulations, engaging in misleading and deceptive behavior, and selling insurance through a bank rather than through an insurance agency. (We have sent a copy of this article to the New York Insurance Department and look forward to its response.)

MassMutual didn't have much to say, either. On January 15, 1999, we wrote to the company asking whether it considered any of Chase's material misleading or in violation of insurance regulations.

Callow readers may find this hard to believe, but MassMutual—a certified

PRODUCT DESIGN

This product offers a flexible design concept that allows you to add term insurance to a base whole life policy. The amount of the term can be varied on a discretionary basis to fit your premium and risk constraints.

Base Policy

Although plan premiums are contractually payable for life, it is possible to "vanish" them through the use of dividends. Under a premium vanish plan...

Paid-Up Additions

Paid-Up Additions provide additional death coverage and are purchased internally by excess policy dividends on a no load basis. Because these additions provide permanent paid-up insurance, they offset the amount of term insurance needed to maintain the initial specified face amount. Like the base policy, this portion of the coverage has a guaranteed cash value and a guaranteed death benefit. Eventually, under current dividend projections, the paid-up additions will replace all the term element of the policy. At that point the policy death benefit will begin to rise above the initial specified amount.

Chase Manhattan's life-insurance illustration

member of the Insurance Marketplace Standards Association (IMSA), which is dedicated to ethical market conduct in the advertising, sale, and service of individual life insurance and annuities—did not respond to our letter. MassMutual, whose website proudly bears the IMSA logo and carries the solemn pledge to uphold IMSA's "Principles and Code" and meet its "rigorous standards," apparently sees no incongruity with the rules of ethical conduct in ignoring valid questions about its conduct and that of its representatives.

MassMutual's failure to respond doesn't exactly surprise us: the company has been a vocal omnipresence in the national debate about mutual-insurance-holding companies, using its political and financial muscle to influence and eventually help pass anti-policyholder mutual-insurance-holding-company legislation in Massachusetts.

We have written to the Massachusetts Insurance Department and to IMSA about MassMutual's advertising and its relationship with Chase. (Our bet is that we'll never get a satisfactory response from the Massachusetts Insurance Department, and that after receiving a letter from IMSA saying that it takes such matters seriously, we'll never hear from it again.)

Today the distinctions between a bank, insurer, mutual fund, money manager, securities firm, investment bank, and other financial services have blurred. Unless economic cycles have been repealed—and in the future, financial-services conglomerates can sidestep problems they haven't been able to sidestep in the past—harsh failures are not to be ruled out.

At the dawn of this decade, the "Citicorp" name had little value. Yes, Citibank was "too big to fail," but Citicorp's bonds traded at levels that implied insolvency, and an auction for the company's resettable auction-rate preferred stock *failed*—a blow to the perceived integrity of the rest of the organization. In 1973, for reasons that have more to do with psychology than securities analysis, Citicorp's stock traded at four times the company's book value of $7.45 per share. In 1991, it sold for about one-third of its *reported* book value of $21.22 per share. (The common dividend was omitted that year and wasn't resumed until the second quarter of 1994.)

Today Citigroup is back in favor. Through Primerica it hawks overpriced term insurance to underpaid patsies. Through Travelers it sells life insurance, annuities, and property-casualty insurance. Through Salomon Smith Barney it transacts securities, investment banking, and asset-management businesses. Through Commercial Credit it operates a consumer-finance business. Through Citibank it runs a commercial and consumer banking business.

Citigroup is on the cutting edge of convergence. *Bank Investment Marketing* reported that the cross-marketing arrangements between Citigroup's subsidiaries will soon include the following: brokers at Citicorp Securities selling Travelers' annuities, salesmen at Salomon Smith Barney offering Citibank mortgages, Citibank loan officers offering Commercial Credit's appraisal services, Travelers' insurance being pitched to Citibank's credit-card customers, Commercial Credit's debt consolidation loans being offered to Citibank customers, and employees of both companies being offered *everything*. And this is just the beginning.

Citigroup is not alone in this game. Everyone wants to play. The players, larger than ever, are creating the kind of financial sprawl typically seen during extended booms. Don't be surprised to see more companies advertising their huge asset bases and claiming that they are "backed by" something or other.

Mergers and acquisitions have been justified by the theory that "size matters." While that may be true, it's wise to remember the words of that bare-knuckled master of the sweet science, John L. Sullivan, who noted: "The bigger they come, the harder they fall." ■

Allied Mutual: Ring of Fire

A Public Hearing in Iowa

As a result of an astonishing array of asset shuffles orchestrated by Allied Mutual's board between 1985 and 1994 (and exposed in these pages in September 1997), all of Allied Mutual's employees, most of its premiums, and much of its value were transferred to an affiliate, Allied Group. Although Allied Mutual once owned all of Allied Group, when the assets were finished being shuffled, it owned virtually none of Allied Group.

By July 29, 1998, when the Iowa Insurance Department held a public hearing regarding Nationwide Mutual's plan to take over Allied Mutual and Allied Group, Allied Mutual's six directors owned $50 million of Allied Group stock, much of it derived from a stock-option plan and an ESOP that they had set up.

Allied Mutual's directors controlled Allied Group; four sat on Allied Group's board, and two—John Evans and Douglas Andersen—served as chairman and CEO, respectively, of both companies. Allied Mutual's policyholders were unaware that their company's directors were Allied Group shareholders in Allied Mutual clothing. Although Allied Mutual solicited proxies from its policyholders, it hadn't told them of its directors' irreconcilable—and, to our knowledge, unprecedented—conflicts of interest. Although the directors had already profited enormously from the past asset shuffles, they would profit much more from the structure of the final asset shuffle.

ALLIED GROUP

Despite having been stripped, Allied Mutual was still worth about two-thirds of what Allied Group was worth. But under Nationwide's proposed takeover—which Allied Mutual's directors unanimously approved—Nationwide would buy Allied Group (which had $271 million of surplus and $615 million in premiums) for $1.6 billion, $600 million of which would go to Allied Group's employee-shareholders.

Unfortunately for Allied Mutual's policyholders (who owned Allied Mutual), Allied Group's bonanza would come at their expense. Allied Mutual's directors had agreed to deliver Allied Mutual, which had $242 million of surplus and $333 million in premiums, to Nationwide for *negative* $200 million. (Allied Mutual's policyholders would receive a $110-million dividend, paid out of their company's own surplus. After the dividend, Allied Mutual's surplus—adjusted for taxes and other assets—would be $200 million. Nationwide would then absorb Allied Mutual through a merger without paying any money and Allied Mutual policies would be converted into Nationwide Mutual policies.)

John Evans, chairman of Allied Mutual and Allied Group

Why would "A+" rated Allied Mutual be given away while its doppelgänger, Allied Group—with a virtually identical book of business—would be sold for $1.6 billion?

Ask Allied Mutual's directors—particularly John Evans, the architect of all that took place. (You won't get a good answer, but ask anyway.)

In January 1998, Nationwide had approached Evans with a deal: it would pay $1.55 billion ($47 per share) for Allied Group, and it would "merge" Allied Mutual into Nationwide. Evans said this was a generous offer for Allied Group and asked for, and received, reassurance that Nationwide would indemnify him and the other Allied Mutual and Allied Group directors for all claims that could be asserted against them. (Allied Mutual was under investigation by the Iowa Insurance Department, and Evans and the other directors had recently been hit with a policyholder lawsuit accusing them of breach of fiduciary duties, waste of corporate assets, transfer of more than $500 million in value, and other improper behavior.)

Nationwide and Evans didn't strike a deal, however, and talks between the two companies were called off. On May 18, Nationwide launched a hostile $47-per-share offer for Allied Group. Nationwide's proposal included a $65-million dividend for Allied Mutual's policyholders.

Evans and the interlocking Allied Mutual directors were now in a bind: Allied Group's stock had been trading below $30, and the $47 bid was a breathtaking 27 times adjusted earnings per share. (Nationwide *Mutual* could offer such a high price because, unlike a stock company, it could "merge" with Allied Mutual, thereby avoiding paying any money for it.) If Allied Group's directors didn't accept Nationwide's bid, Allied Group's share-

holders would probably sue the directors. On the other hand, the deal was a terrible one for Allied Mutual, and Allied Mutual controlled Allied Group. (Unfortunately for policyholders, Evans and the other directors controlled Allied Mutual.)

But it was more complicated than that. Allied Mutual was under pressure from: 1) Jason Adkins, the indefatigable consumer advocate who was handling the derivative- and class-action policyholder lawsuit; 2) David Schiff, who was running for Allied Mutual's board and had, in September 1997, outlined a conservative plan that would distribute at least $385 million to policyholders; 3) the local and national press, which, following the exposé in *Schiff's Insurance Observer*, had taken great interest in the Allied Mutual affair, and 4) Iowa's insurance regulators, who couldn't just stand by and ignore everything. (On second thought, maybe they could—their "investigation" had already been going on for eight months.)

Matters were further complicated by the fact that Allied Group's earnings would be under pressure in the years ahead. In 1993, Evans and his buddies had jiggered the pooling-administration agreement between Allied Mutual and Allied Group so that some of Allied Group's expenses would be charged to Allied Mutual on an ongoing basis. In 1997 alone, this expense shift boosted Allied Group's pretax earnings by $12.8 million, and cut Allied Mutual's by the same figure. (Instead of making a $6.6-million underwriting profit, Allied Mutual lost $6.2 million.) In May 1998, after Schiff's relentless criticism, the Allied directors began to unwind the expense shift. In the years ahead, Allied Group wouldn't be able to skim this easy money off the top of Allied Mutual.

Allied Mutual's directors—particularly Evans—had masterminded a situation that had made them a lot of money. But they had been exposed, and were now sailing between the Scylla of Allied Group's public shareholders (and their own financial interests) and the Charybdis of their fiduciary responsibility to Allied Mutual's policyholders.

What was particularly troublesome to the directors (we presume), was the existence of a mechanism that could prevent an unfair takeover of Allied Mutual and block any acquisition of Allied Group. This mechanism belonged to Allied Mutual.

Back in 1992, Allied Mutual's directors had overseen a weird switch-a-roo in which Allied Mutual, as usual, had been bagged. Allied Group had issued $52-million of 6¾% nonconvertible perpetual preferred stock to Allied Mutual in exchange for 6,166,875 common shares of Allied Group that were owned by Allied Mutual. The exchange of shares was structured in such a way so that Allied Group was likely to profit at Allied Mutual's expense. As Conning & Company noted in what may be the worst "fairness opinion" of all time, the preferred shares that Allied Mutual received "would have a fixed carrying value," whereas Allied Group was expected to achieve "future growth" that was "disproportionate" to Allied Mutual's. In short, Allied Group's common stock was likely to grow rapidly and its preferred stock would not appreciate at all. (Because of this stock swap, Allied Mutual would miss out on $250 million of capital appreciation; see *Schiff's Insurance Observer*: October 1997, pp. 12-13, and February 1998, pp. 5-6.)

In May 1998, the 6¾% perpetual preferred shares became very important. Although now worth one-sixth of the value of the common shares for which they had been swapped, they carried the same voting rights that the common shares had. Through this 18.2% voting right, the preferred shares "constitute[d] a block," explained a lawsuit filed by Nationwide in conjunction with its hostile offer, "that prevents [Nationwide] from obtaining [the] 85% of the voting stock of Allied Group" that Nationwide would need to avoid the restrictions of the Business Combination Statute.

Nationwide was correct. By exercising Allied Mutual's preferred voting rights, Allied Mutual's directors could block a deal that wasn't favorable to Allied Mutual. But blocking the deal proposed by Nationwide conflicted with the Allied Mutual directors' *personal* financial interests. If the directors used Allied Mutual's leverage to negotiate a decent price for Allied Mutual—say $600 million—Nationwide would presumably pay that much less for Allied Group, which would have resulted in Allied Mutual's directors and employee-shareholders receiving $20 million and $200 million less, respectively, for their Allied Group shares.

The Allied Shuffle

Toss a coin. If it's "heads," Allied Group gets all of the money. If its "tails," Allied Mutual gets none.

	Allied Mutual	Allied Group
Premiums	$333,000,000	$615,000,000
Surplus	$242,000,000	$271,000,000
Takeover Price	($200,000,000)	$1,600,000,000

So Evans played the "let's talk" gambit: after a little negotiating, Nationwide raised its bid for Allied Group to $48¼ and raised the proposed dividend for Allied Mutual's policyholders to $110 million. (This made it seem as if the Allied Mutual directors had extracted some significant value). Nationwide also agreed to give Allied Mutual's directors broad indemnification.

Sixteen days after the inception of Nationwide's hostile offer, a deal was agreed upon, and Allied Mutual's directors voted for a transaction that would enrich themselves, but provide scant value for their policyholders.

It's hard to imagine that an *independent* Allied Mutual board would have approved the transaction that was approved by John Evans, his longtime friends James Callison and James Kirkpatrick, his brother Harold Evans, and his subordinates Douglas Andersen and Fred Morgan. And it's inconceivable that Allied Mutual's policyholders would have voted for it had they been apprised that they could have received $612 million instead of $110 million.

Here's how we arrived at $612 million: 1) Nationwide agreed to pay $1.6 billion for Allied Group (and absorb Allied Mutual and its $200-million of surplus in a "merger"); 2) The combined surplus of Allied Mutual and Allied Group was $513 million.

Nationwide, therefore, was paying a total of $1.087 billion ($1.6 billion minus $513 million) for the Allied companies' business.

Allied Mutual owned 34% of the Allied pool of premiums (and had the right to extend "Intercompany Oper-

ating Agreements" until 2018). Allied Mutual's 34% share of the $1.087 billion that Nationwide was paying for the business comes to $370 million.

Adding this $370 million to Allied Mutual's $242 million in surplus results in a total value of $612 million for Allied Mutual.

Using the same formula, Allied Group was worth $988 million, about $30 per share—the approximate price of its stock prior to the announcement of Nationwide's takeover offer.

Think about this. Allied Mutual was worth about $612 million and it had the mechanism (preferred-stock voting rights) to block a takeover. Yet Allied Mutual's directors didn't make a bona fide attempt to get the highest price for Allied Mutual. (In fact, they didn't make *any* attempt to sell the company.) "We were not requested to, nor did we, solicit the interest of any other party in acquiring [Allied Mutual]," wrote Allied Mutual's investment banker, Donaldson, Lufkin & Jenrette, in its remarkable "fairness opinion." Donaldson's opinion was so limited in its scope that it didn't include an appraisal of Allied Mutual's fair value or a study showing what comparable companies had sold for. In essence, Nationwide would pay a whopping price for Allied Group and get Allied Mutual thrown in for free.

After Allied Mutual's directors approved the deal, Jason Adkins sought an injunction to prevent the deal from occurring while the policyholder derivative- and class-action lawsuit was pending. In denying the injunction, Judge Eisenhauer didn't rule on the merits of the case. Instead, he said that any harm to Allied Mutual's policyholders wasn't irreparable—that money damages would suffice.

The judge's decision is troubling. When there are allegations of serious misconduct and prima facie evidence of conflicts of interest, one wonders why a judge would simply pass matters along to the next government authority—in this case the Iowa Insurance Department, which had looked the other way for so long.

Furthermore, if the deal were consummated, it would be impossible to recover money from those who profited—the Allied Group shareholders. Because of the indemnification Nationwide granted to Allied Mutual's directors, any payments for damages would most likely be borne by Nationwide Mutual's policyholders.

Follow the Money: **Allied Mutual's Directors**

All six of Allied Mutual's directors had a disgraceful conflict of interest—they were large shareholders of Allied Group, and would receive $48.25 per share for their Allied Group stock.

Director	Number of Allied Group shares beneficially owned
John Evans	366,247
Douglas Andersen	322,433
James Callison	26,644
Harold Evans	47,994
James Kirkpatrick	92,017
C. Fred Morgan	88,125

In attendance at the July 29 public hearing were at least four lawyers for Nationwide, four lawyers for Allied Mutual, one lawyer for Allied Life, six people from the Iowa Insurance Department, and two people from the Ohio Insurance Department.

David Schiff, who owned a ten-dollar Allied Mutual policy, was also present, and planned to cross-examine witnesses and testify in the public interest. Accompanying Schiff was his stepdaughter, 23-year-old Courtney Walter, a designer, photographer, and all-around fine companion. Walter's official function was to view the hearing through the "eye of truth"—a high-resolution video camera—and to record the proceedings.

Walter's assistance notwithstanding, the hearing was a frustrating event, and there were moments when Schiff feared that some of the words spoken might shatter the expensive lens on the "eye of truth."

Nationwide's executives—Dimon McFerson, chairman and CEO; Richard Crabtree, president and COO; and Robert Oakley, executive vice president and CFO—testified about the transaction and, in so many words, said that the deal was fair to Allied Mutual. That their testimony was self-serving was no surprise; they had a fiduciary duty to Nationwide, not to Allied Mutual. But under cross-examination by Schiff, they often claimed a lack of knowledge about Allied Mutual and its complicated relationship with Allied Group.

Also appearing was Douglas Andersen, CEO and director of Allied Mutual and Allied Group, who had helped orchestrate the deal and would retain his job once it was consummated. In his role as Allied Mutual's CEO, he testified under oath that Allied Mutual's merger into Nationwide was "in the best interest of Allied Mutual's policyholders."

Schiff didn't make much headway in his cross-examination of Andersen, whose mechanical responses, vacant gaze, and professed lack of understanding, made getting an intelligible answer difficult.

What follows is an edited version of what happened when Schiff tried to question Andersen about the Nationwide Mutual "membership certificate" that Allied Mutual policyholders were to receive. (Andersen had testified that the membership certificate protected Allied Mutual policyholders and was a benefit to them. Allied Mutual's investment banker, Donaldson, Lufkin & Jenrette, had written a fairness opinion—included in the proxy statement sent to policyholders—that said that the holder of a membership certificate would participate in any "Realization Event," defined as a demutualization or extraordinary transaction involving Nationwide Mutual.) Schiff, however, didn't believe that the membership certificate was likely to benefit most Allied Mutual policyholders because, based on Allied's retention ratios, many of Allied Mutual's policyholders would no longer have policies when a realization event occurred, if one were ever to occur. (Only policyholders who had policies on the cut-off date, June 3, 1998, would receive membership certificates.)

SCHIFF: In considering the proposal to merge Allied Mutual into Nationwide, did you take into consideration—for purposes of a realization event—Allied Mutual's policy retention ratios?

ANDERSEN: I'm sorry. Retention ratios?

SCHIFF: I'm using a term that you refer to in your annual report—the percentage of policyholders that you retain each year. It's 88%, approximately.

MICHAEL THRALL (ALLIED'S LAWYER): [Lengthy objection.]

HEARING OFFICER: Overruled.

ANDERSEN: Okay. Do you want to repeat the question, please?

SCHIFF: I'm asking if you took into consideration the retention ratios—the policyholders that would be in force at future periods, who might benefit from a realization event. Did you take that factor into consideration in considering the fairness of this transaction? [Editor's note: Schiff was trying to find out if Allied Mutual had even *considered* whether policyholders might benefit from a transaction at some future point.]

THRALL: I am going to object to the question and to the use of the term "realization event" unless it is defined or given some—

SCHIFF: It is defined in the proxy statement. It's in the fairness opinion.

THRALL: Could I have the question read back?

The question was read back.

THRALL: I'm going to object to the question as compound and unintelligible. I don't know how the witness could answer that question. The Donaldson, Lufkin & Jenrette opinion is part of the record. It's part of the proxy statement. It speaks for itself.

SCHIFF: I could phrase it as four separate questions if that would make it easier to understand.

THRALL: That's one of the bases for my objections.

HEARING OFFICER: Could you simplify that question, please?

SCHIFF: (To Andersen) Are you familiar with the phrase "realization event"? Do you understand what it means?

ANDERSEN: I'm not familiar with the phrase, but it's defined in there.

SCHIFF: Do you understand that it means a demutualization or other extraordinary transaction?

ANDERSEN: Extraordinary event, okay.

SCHIFF: One of the purposes—as you testified—of the membership certificate would be to allow policyholders to retain their interest in Nationwide Mutual. Is that correct?

ANDERSEN: Yes.

SCHIFF: In the event that there was a realization event, policyholders that are in force could get a distribution of some sort. Is that correct?

ANDERSEN: Okay.

SCHIFF: In considering the fairness of this proposal [the merger of Allied Mutual into Nationwide], did you consider what percentage of policyholders might be in force at the time that a realization event occurs?

THRALL: I'm going to object as irrelevant.

HEARING OFFICER: Overruled.

THRALL: It's speculative, too. We're asking this witness to speculate.

HEARING OFFICER: I'm going to overrule the objection.

THRALL: When is this realization event supposed to occur? Is it two years down the road? What assumptions are we making? I would object further to the question as vague.

HEARING OFFICER: At this juncture the objection is overruled.

ANDERSEN: "Retention ratio" refers to how many policyholders stay with you over a period of time. Policyholders can move from company to company. Over a period of time a book of business will fluctuate as far as the number of policyholders are concerned. Given a hypothetical scenario—which this is—at some point in time a realization event takes place; nobody knows at what point in time it will take place, what the realization event will be. That's why I don't understand the question. It's something that nobody would know, and I don't know how anybody could ever arrive at it, given the period of time, unless you knew when the realization event takes place, what the lapse ratio will be of the policyholders. [Editor's note: Insurance companies are in the business of making estimates about the probabilities of future events that involve a great deal of uncertainty, i.e., how many claims will occur, when they will occur, how much they will cost, when they will be paid, and so on.]

SCHIFF: Did you make any projections along these lines under various scenarios?

ANDERSEN: It's difficult to make projections on something on a hypothetical basis, since Nationwide has publicly stated it has no plans for the realization event.

SCHIFF: Is the answer to my question "no" or "yes"?

ANDERSEN: It would be very inappropriate to try to make a projection on some unknown event at some point in time that has been put into the [proxy statement] that there's no intention for a realization event to take place.

SCHIFF: What is the benefit, then, of the

Allied Mutual Policyholders Get Useless Certificate, Allied Execs Get Money

The table to the right provides estimates about the percentage of Allied Mutual policies in force on June 3, 1998 (the "June 3 policies") that will be in force at future dates. Under the terms of Allied Mutual's merger into Nationwide, few current Allied Mutual policyholders are likely to benefit from any potential "Realization Event" (defined as a demutualization or other extraordinary transaction involving Nationwide).

The smaller the percentage of June 3 policies in force upon the occurrence of a realization event, the less consideration Nationwide will end up paying for Allied Mutual.

Using Allied Mutual's current retention rate of 88%, only 53%, 28%, and 8% of June 3 policies would be in force in 5, 10, and 20 years, respectively.

Based upon likely scenarios of retention rates (and the timing of any Nationwide demutualization*), the June 3 policyholders would have fared better had Allied Mutual been sold to the highest qualified bidder in a cash or stock transaction, rather than having been merged into Nationwide in return for membership certificates. As a result, the transaction did not meet applicable statutory provisions: that the merger of Allied Mutual into Nationwide be in the interests of Allied Mutual policyholders, and that these interests be properly protected under the merger.

*Nationwide has "no present plans" to demutualize.
–Allied Mutual Proxy, 6/29/98, page 34

	June 3 Allied Mutual Policies In Force at Future Dates at Various Retention Ratios		
End of Year	88%	94%	82%
1	88%	94%	82%
2	77%	88%	67%
3	68%	83%	55%
4	60%	78%	45%
5	53%	73%	37%
6	46%	69%	30%
7	41%	65%	25%
8	36%	61%	20%
9	32%	57%	17%
10	28%	54%	14%
11	25%	51%	11%
12	22%	48%	9%
13	19%	45%	8%
14	17%	42%	6%
15	15%	40%	5%
16	13%	37%	4%
17	11%	35%	3%
18	10%	33%	3%
19	9%	31%	2%
20	8%	29%	2%

Current retention rate is approximately 88%
Source: Allied Group's 1996 annual report, page 10

membership certificate?

ANDERSEN: The benefit of the membership certificate?

SCHIFF: Yes.

ANDERSEN: That gives an ongoing right. As long as the policyholder maintains his policy with Nationwide, he'll have all the attendant benefits that he had when he was with Allied, so it keeps the right of mutuality.

SCHIFF: You stated that a significant factor considered—and a benefit to policyholders—is the preservation of mutuality. That's Exhibit 4.

ANDERSEN: That's right.

SCHIFF: Do *Allied Mutual* policyholders, in general, pay lower premiums or higher premiums than policyholders of [Allied Group]?

THRALL: I object.

HEARING OFFICER: Sustained.

All day long, Schiff's questioning had been cut short by the hearing officer, Anuradha Vaitheswaran. This obstacle was compounded by constant objections from Allied's lawyer, Michael Thrall, who was an effective nuisance. At one point, when Schiff was trying to ascertain whether Andersen was familiar with Allied Mutual's financial statements, Thrall objected, exclaiming, "We're going to be here all night." This was ironic, considering that Nationwide had spent plenty of time running out the clock, yet Thrall hadn't objected to that. Nationwide's McFerson, for example, had gone on and on about how Nationwide donated so much blood to the Red Cross, gave so much money in matching donations to the United Way, planned to hire more people in Des Moines, encouraged high school students not to drink and drive on prom night, and so on.

One would have thought that the Iowa Insurance Department—which had done a poor job of regulating the Allied companies in the past and had made material mistakes in the companies' triennial examination reports—would have wanted to question Andersen under oath. But it didn't. Instead, the commissioner and the members of her staff sat and watched—as they had all day—even though this transaction, fraught with conflicts of interest, was by far the largest mutual merger in Iowa's history.

No questions were asked of Evans or Allied Mutual's investment banker, either—for a good reason: neither was present. A week earlier, when Schiff had learned that Allied Mutual had "made no arrangements to secure [the] presence [of Evans and Donaldson Lufkin & Jenrette's representative] at the hearing," he wrote to Iowa's insurance commissioner, Terri Vaughan, and urged that she subpoena them or postpone the hearing until their presence could be secured.

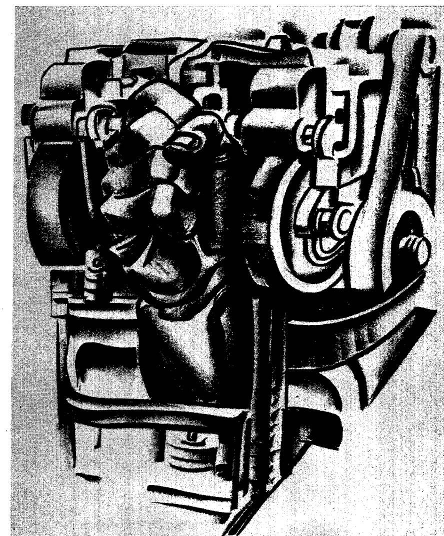
Vaughan did neither.

As for Schiff's discovery request (made in accordance with the Iowa Code), for the production of Allied documents that were relevant to the hearing, that went nowhere. (The Insurance Department could have insisted that Allied Mutual produce the documents, but didn't.)

Perhaps the farcical nature of the entire proceeding is best illustrated by the testimony of Allied Mutual's sole expert witness, Douglas Reichardt, chairman and CEO of Holmes Murphy & Associates, the largest insurance agency in Iowa.

Under oath, Reichardt testified that his firm distributed Allied Mutual's products and that he was familiar with Allied Mutual and its proposed merger into Nationwide. He said that the proposed merger was *"good for policyholders"* and (in an odd comment) *"good for insurance agents."* He also affirmed that it was *"in the interest of the policyholders."*

We assume that an "expert witness" would not voluntarily testify in a billion-dollar matter unless he has researched the subject and read the relevant materials.



Mutual policyholders, unite!

Hugo Gellert, "Machinery and Large-Scale Industry 44," Mary Ryan Gallery

Allied Mutual's proposed merger into Nationwide was particularly complex. One essential document, Allied Mutual's proxy statement to policyholders, summarized the transaction in 163 pages of dense print. Anyone who had not read that—much less the thousands of pages of documents that are referred to or summarized in it—would be in no position to testify knowledgeably about the merits of the transaction from the policyholders' point of view.

What follows is a verbatim transcript of Schiff's cross-examination of Reichardt.

SCHIFF: Hello. Have you reviewed the proxy statement sent to Allied Mutual policyholders?

REICHARDT: No.

SCHIFF: Have you read the intercompany operating agreements?

REICHARDT: No.

SCHIFF: Have you reviewed Allied Mutual's statutory financial statements?

REICHARDT: No.

SCHIFF: Have you reviewed Allied Group's SEC filings?

REICHARDT: I have not.

SCHIFF: Have you reviewed the Form A filing?

REICHARDT: No.

SCHIFF: Have you made any assessment as to what the companies are worth? Either company—Allied Group, Allied Mutual?

REICHARDT: No.

SCHIFF: Have you consulted with any advisors on this?

REICHARDT: No.

SCHIFF: I don't have any further questions.

How Reichardt could have formed his opinions without reading any of these materials or consulting with anyone remains a mystery.

Six weeks after the hearing, Commissioner Terri Vaughan concluded that the proposed transaction "protects Allied Mutual policyholders," is "fair and reasonable to the policyholders," and that "no reasonable objections exist."

She then signed an order approving Allied Mutual's merger into Nationwide Mutual. ■

What Commissioner Vaughan Didn't Say

The Allied Connection

Iowa's insurance commissioner, Terri Vaughan, has done more harm to policyholders than has any other current commissioner. Under her reign of error, she has approved three abusive mutual-insurance-holding-company conversions (AmerUs, National Chiropractic, and Principal), permitted AmerUs's mutual insurance holding company to issue stock through Goldman Sachs at a price that diluted policyholders' interests, taken no meaningful action once the sleazy asset shuffles at Allied Mutual were exposed, avoided seeking regulations that would provide for fair elections at mutual insurance companies, and approved the Allied Mutual giveaway. In short, she's the Mike Tyson of insurance commissioners: when she comes near a mutual policyholder she bites his ear off.

We've observed Vaughan's behavior closely. We've met with her on many occasions (she's personable), and have watched her in action at NAIC meetings, public hearings, and conferences. When we first made her acquaintance a couple of years ago, we thought that with her background in insurance academia, she would be a good commissioner. We were wrong.

Vaughan knows insurance: she can discuss no-fault, workers comp, and ratemaking. But she lacks one quality that no amount of knowledge can overcome—good judgment. She's a greenhorn when it comes to corporate finance and corporate governance—fields that are essential to understanding mutual insurance holding companies and "mutual-policyholder value," a concept not dissimilar from "shareholder value." As an insurance commissioner she's like a scientist who can analyze every trace element in a cigarette but doesn't know that smoking is bad for you.

Part of her problem is that she's insurance commissioner in a town where insurance is a giant business. We suspect that she's not eager to alienate the big insurance companies that she's supposed to regulate. (Former Iowa insurance commissioners have developed cozy relationships with Allied: William Timmons was on Allied Group's board, and Bruce Foudree was one of Allied Mutual's lawyers.)

Vaughan has been a vocal advocate for mutual insurance holding companies. For a while she seemed to be in the camp that argued that mutual policyholders aren't "owners." She moved to a slightly different camp, however, after a pesky insurance observer read the following statement at Principal Mutual's public hearing (over which Vaughan was presiding), regarding its plan to convert to a mutual insurance holding company: "In contrast to a stock company, a *mutual insurance company* is owned by its policyholders." Those words are from the seventh edition of *Fundamentals of Risk and Insurance*, written by Vaughan and her father.

Vaughan did not disclose relationships that could pose "potential conflicts" for her.

Vaughan's *new* argument seems to be that policyholders are "owners," but that their ownership doesn't entitle them to a hell of a lot. (Don't be surprised to see the "owner" language disappear from her textbook's eighth edition.)

Although Vaughan claims to be sensitive to the issue of conflict of interest, her actions speak otherwise. In approving the merger of Allied Mutual into Nationwide, she was able to overcome the ugly fact that every director of Allied Mutual had a material conflict of interest—his significant ownership of Allied Group stock. (This conflict made it unconscionable for Allied Mutual's board to recommend the Nationwide "merger" to Allied Mutual's policyholders; the board should have stepped down en masse and allowed independent trustees to take over.)

Vaughan's judgment is further called into question by her behavior at the July 29 Allied-Nationwide hearing. When the hearing began, she made an important disclosure: "Those of you that have been familiar with... [previous] proceedings will note that Scott Galenbeck is not here. Scott is the general counsel for the Insurance Division. He will not be participating in this hearing or in any other matters that are involved in this case. He is an Allied Mutual policyholder, and because of some concerns about potential conflict, it was determined that it would be best if he did not participate in this matter."

Galenbeck, an assistant attorney general, had disclosed his potential conflict of interest. Vaughan, however, did not disclose relationships that could pose "potential conflicts" for her: 1) Her father, insurance professor Emmett Vaughan, teaches a course for Allied. Although he is affiliated with the University of Iowa, the Allied course has nothing to do with the university. It is sponsored by Allied and is for Allied's agents. 2) Vaughan's husband is an executive at CGA Insurance Services, an insurance agency in Iowa with 30 employees. Its website says that Allied Insurance Group is its exclusive personal-lines market, and that CGA is Allied's "18th largest agency." CGA also writes commercial lines with Allied, and is the "top agent from the 350+ agent exclusive program" for Allied Life.

Terri Vaughan did not disclose her father's and husband's relationships with Allied. These relationships—whether "conflicts of interest" or "potential conflicts"—are of concern: her father earns money from Allied, and her husband's employer is a significant producer for Allied.

When we asked Vaughan why she didn't disclose these relationships, she said, "I think you're being silly. Scott [Galenbeck's] potential conflict was that he stood to profit. Neither my husband nor my father nor I stood to gain anything."

"You might stand to *lose*," we noted. "Your husband might stand to lose."

Vaughan said she assumed that her husband didn't write "much" business with Allied, and that her father "certainly doesn't need any business with Allied."

Continued

Vaughan's argument was "silly." While it was appropriate for Galenbeck to disclose that he was an Allied policyholder, it is worth noting that he didn't stand to gain "much" as a result of his Allied Mutual policy. Moreover, he would only gain if he took actions that *benefited* the policyholders. And, since a mutual insurance company is supposed to be run for the benefit of its policyholders—not its management—one could easily make an argument that his status as a policyholder, if anything, *sensitized* him to the issues.

But that isn't the point; the point is disclosure. Vaughan's "potential conflict" was that her husband and father might benefit by *not losing* relationships that they had if Vaughan were to approve the transaction that Allied's directors and executives wanted. Had she *not* approved Allied Mutual's merger into Nationwide, perhaps her father would have lost business with Allied; perhaps her husband's firm would have lost its relationship with Allied.

Terri Vaughan's role in the Allied-Nationwide merger was akin to that of a judge. To illustrate our point about conflicts of interest we'll make an analogy: imagine, for example, that your Ford Pinto's gas tank explodes, and you participate in a class-action lawsuit against Ford. The judge handling the case has several clerks, one of whom owns a Ford Pinto. The clerk discloses this fact and, to avoid any conflict of interest, withdraws from the case. The judge, on the other hand, does not reveal that her husband is an executive at one of Ford's largest dealers. Nor does she reveal that her father does some consulting for Ford.

No one is perfect. One cannot expect a commissioner—or anyone else—to be right all the time. But one does expect a regulator to disclose material information that might affect, or appears to affect, important matters. Of course, it's always possible for a person to make a mistake and not make such a disclosure.

But for Terri Vaughan—who has made so many mistakes—this is one too many.

Iowa's new governor, Tom Vilsack, should not reappoint her when her term expires at the end of March. ■

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Junk Jurisprudence

Update on Allied Mutual Lawsuit

February 9 was just another day in Des Moines. The streets were quiet, and people went about their business. At Principal Mutual's office tower, businessmen dined at the best restaurant in town, 801 Grand Steak Chop House. Not far away, at Farmers Mutual Hail Insurance Association, the Rutledge family conducted business as usual. For the Rutledges, mutuality is like a religion in which policyholders are God.

Over at 701 Fifth Avenue, Allied Group's headquarters, mutuality had once been a religion, although one in which mutual policyholders went to hell.

At the Polk County courthouse, Judge Larry J. Eisenhauer went about his business, which, apparently, is this: demonstrating that no matter how ridiculous the proposition, you can always find a proponent and a believer.

On that day, Eisenhauer dismissed Civil Action No. CE 35780, a derivative and class-action lawsuit brought against Allied Mutual and its directors by a policyholder, represented by Jason Adkins. (The gist of the lawsuit was that Allied Mutual's directors made a bundle—at Allied Mutual's expense—by breaching their fiduciary duties, wrongfully transferring corporate assets to Allied Group, and wrongfully transferring control of Allied Mutual to Allied Group.)

In dismissing the lawsuit, Eisenhauer had ruled that mutual policyholders have no right to sue directors of Iowa mutual insurance companies, even if those directors have defrauded the mutual in every manner imaginable.

In a section of his ruling entitled "statement of facts," Eisenhauer noted the following: in 1985, Allied Mutual's subsidiary, Allied Group, completed a public offering, the proceeds of which went to Allied Group rather than to Allied Mutual. "This transaction began the ultimate process whereby the assets of Allied Mutual were shifted to Allied Group, until, eventually, Allied Group controlled Allied Mutual."

Eisenhauer summarized how Allied Mutual's share of the Allied Pool's premiums had decreased from 85% to 36% between 1985 and 1993, while Allied Group's share increased from 15% to 64%. "In January of 1993 Allied Mutual gave up its control of the pool to a subsidiary of Allied Group for no consideration. All of Allied Mutual's employees also became Allied Group employees in 1989, making Allied Mutual completely dependent on Allied Group."

Eisenhauer noted that Allied Mutual had sold its interest in Allied Group, giving up "any possibility of sharing in Allied Group's growth and success." He stated that "the Director Defendants did benefit from these transactions," and that "from 1985 to 1993, Allied Mutual restructured itself to the benefit of Allied Group."

People who don't work for Allied would probably say that folks who do such things ought to be horsewhipped. A mutual insurance company, as we have endlessly noted, is supposed to be run for the benefit of its policyholders.

But Eisenhauer, who apparently does not believe in horsewhipping, dismissed the lawsuit, opining that policyholders of a mutual insurance company have no standing to bring derivative lawsuits in Iowa. Although *shareholders* may commence such proceedings on behalf of corporations, writes Eisenhauer, "there is silence with regard to whether policyholders in a mutual insurance company share that right." Thus, he makes a negative inference and concludes that this was the result of legislative intent: "The legislature," while considering derivative actions, "chose to remain silent with regard to the rights of policyholders."

If Eisenhauer is correct, then mutual-insurance-company directors can loot a mutual, sell its assets, and pocket the money—yet remain immune to policyholder lawsuits brought on behalf of the mutual. In effect, a mutual's directors do not owe a fiduciary duty to the mutual or its policyholders.

With that in mind, let's examine Allied Mutual's Amended and Restated Articles of Incorporation. Article 10 clearly states that directors shall be personally liable for the breach of their fiduciary duties and other misconduct:

> A Director of this Corporation shall not be personally liable to the Corporation or its Members for monetary damages for breach of fiduciary duty as a Director, *except* for liability (i) *for any breach of the Director's duty of loyalty* to the Corporation or its Members, (ii) for *acts or omissions not in good faith* or which involve intentional misconduct or knowing violation of the law, or (iii) for a transaction from which the *Director derived an improper personal benefit.* [Emphasis added.]

In his ruling, Eisenhauer didn't exactly say that mutual-insurance-company directors have no fiduciary responsibility to their company or to policyholders—he merely said that a policyholder of a mutual insurance company has no legal standing to seek redress for a director's breach of his fiduciary responsibility. (But since policyholders can't sue, then, in effect, directors aren't accountable for their misdeeds.) According to Eisenhauer, the *silence* of Iowa law supersedes the *actual words* in Allied Mutual's articles of incorporation.

Eisenhauer gave a variety of reasons for dismissing the class-action portion of the lawsuit. We'll mention one: "The case law…is clear that a party *entitled* to bring a derivative lawsuit cannot maintain a duplicative class action in which no unique injury is alleged." [Emphasis added.] But he had just ruled that policyholders *are not entitled* to bring a derivative lawsuit. If that was correct, how could the class action be "duplicative"?

The Hawkeye State's motto is "Our liberties we prize and our rights we will maintain." Tell that to the judge who just declared open season on mutual policyholders.

But perhaps that's not so bad as it sounds. Even if every mutual in Iowa were looted by its directors, the total value stolen would be a mere $20 billion or so—barely enough to fund the Iowa Insurance Department for the next 3,000 years.

As for Eisenhauer's ruling, Adkins believes that it contains "reversible error" and has filed an appeal.

We, too, believe that the ruling should be reversed. Policyholders should be given the courtesy of a full-blown trial when directors of an Iowa mutual loot their company. Then—and only then—should the judge rule against the policyholders. After all, in Iowa, a mutual insurance company is owned by its *directors*.

Damn the policyholders—full speed ahead! ■

It's Pronounced 'Money'

Neil Levin Looks the Other Way

In early October David Schiff received a copy of Mutual of New York's 317-page "Policyholder Information Booklet" on the company's plan to demutualize. Once Schiff had perused the document, it became obvious to him that the deal proposed by Mutual of New York (MONY) was extremely unfair to its policyholder-owners. Although its book value was $35 per share, MONY intended to do a public offering at about 70% of that—way below the price at which comparable life-insurance companies were selling. What made this plan particularly irksome, however, was that MONY did not intend to let existing policyholders buy shares at the low public-offering price.

Schiff called the folks at MONY, expressed his concerns, and asked them to alter their plan. They chose not to.

On October 19, Schiff testified at MONY's public hearing, which was presided over by Neil Levin, New York's insurance commissioner. Schiff explained why MONY's plan would dilute policyholders' interests, and urged Levin not to approve any plan that didn't provide policyholders with either subscription rights or some other mechanism to purchase shares on the offering. As Schiff spoke he watched Levin, who understood precisely what he was saying. (Levin used to work at Goldman, Sachs.)

Over the ensuing weeks, Schiff made several calls to MONY and to Levin. MONY didn't provide a satisfactory response to his calls, nor did anyone from Levin's office.

On November 2, Richard Mulroy, MONY's general counsel, wrote to Levin, claiming that it would be a hardship for MONY to let its policyholders in on the IPO that was going to take place.

Although Levin had championed the disgraceful mutual-insurance-holding-company bill that was defeated in New York, Schiff was optimistic that Levin would do something constructive this time around.

By November 9 it appeared that Schiff's optimism was misplaced: MONY's offering was only days away and Levin had taken no action to rectify matters (and a source in the insurance department informed Schiff that he was not going to, either).

The next day, November 10, David Schiff faxed the following letter to Neil Levin.

Dear Superintendent Levin:

I am writing to you in the public interest, in the interest of all MONY policyholders, and in the interest of a specific MONY policyholder, John Katzman.

I urge you not to approve MONY's present plan of demutualization on the grounds that it is not "fair and equitable" to MONY's policyholders.

MONY's public offering—the scheduling of which is imminent—is unfair to policyholders, not just because it is economically dilutive, but because it is economically dilutive *and makes no provision for policyholders to participate in the offering,* thereby avoiding dilution.

As you are well aware, the investors who stand to benefit from the steep discount to book value at which MONY's shares will be priced will be the favored clients of Goldman, Sachs and the other underwriters.

In his November 2 letter to you, Richard E. Mulroy, MONY's General Counsel, notes that in AmerUs's public offering [AmerUs was formerly a mutual insurance company], policyholders subscribed to only 20% of the shares offered. I suspect that MONY, because of its well-known name, could have attracted a higher percentage. Nonetheless, if only 20% of MONY's shares were to be purchased by policyholders, it would amount to $40-million-to-$50-million worth of stock.

More importantly, it is inherently unfair to deny MONY policyholders the right to purchase shares in their own company when such shares are being sold at a deep discount to book value and to intrinsic value.

Because of the nature of the proposed underwriting, MONY policyholders are unlikely to be able to purchase shares on the offering. (I spoke with Merrill Lynch yesterday to see if a policyholder could purchase stock in the offering and was advised that *even Merrill Lynch*—the largest securities firm—was not in the selling group.)

When I first voiced my concern to MONY at least 10 days prior to the October 19 hearing, MONY had plenty of time to provide a fair mechanism for policyholders to participate in the offering. Even as of the October 19 hearing, MONY had time to create a plan that would have enabled policyholders to purchase shares at the offering. Contrary to Mr. Mulroy's letter, subscription rights and "the distribution of 'red herring' prospectuses" were not necessary. MONY could have mailed a simple notice to policyholders that: 1) informed policyholders of the offering, 2) provided a toll-free number to call, 3) advised policyholders that, if they desired, they could receive a prospectus and purchase shares pursuant to the offering.

The cost of such a mailing would have been nominal—a fraction of the figure [$2 million] cited by Mr. Mulroy—and would have been more than recouped from the sale of shares to MONY policyholders.

MONY, however, for reasons that were not explained in Mr. Mulroy's letter, chose not to embark on this sort of fair and equitable process. In fact, were I not inured to such language, I would have been shocked by Mr. Mulroy's aside—that "no senior officers or directors [of MONY] are allowed to participate in any IPO at all and no other employees or agents of MONY will receive subscription or other special participation rights in the IPO." As Mr. Mulroy knows, MONY, as a mutual company, is not run for

"Gee, these new twenties look just like Monopoly money."

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the benefit of its senior officers, directors, employees, or agents. It is supposed to be run for the benefit of its mutual policyholders.

Although MONY's plan isn't "fair and equitable," I can understand that, given the fact that the offering is scheduled imminently, you are in a difficult position and may be reluctant to disapprove MONY's application. If that's the case, here's a plan that can, at least in part, remedy the situation:

> MONY will proceed with its offering, but shares equal to 25% of all shares sold in the offering shall be set aside for MONY policyholders to buy *subsequent* to the offering. These shares—which will be similar to the underwriters' overallotment or "green shoe"—will be issued by MONY *at the offering price*, but will be restricted from sale for a period of 90 days so as to not disturb the offering and distribution process. MONY shall notify all policyholders of their right to purchase these shares, and shall allocate the shares in a fair and equitable manner.

Finally, because of MONY's behavior in this matter, I recommend that an additional six-month waiting period be added to the time period before which any MONY officer or director may purchase shares, or receive options and restricted stock grants, or any other form of remuneration tied to the stock price.

I would be pleased to discuss this matter with you in greater detail.

Sincerely,
David Schiff

The next evening, Neil Levin approved MONY's plan, and MONY sold $304 million of stock at $23.50 per share—67% of book value—in a deal that was vastly oversubscribed. When MONY's stock opened on the New York Stock Exchange the following morning, the first trade was at $29. Thus, the favored clients of Goldman, Sachs and the other underwriters reaped a virtually risk-free profit of $71 million.

Two weeks later Schiff received the following letter from the New York Insurance Department:

Dear Mr. Schiff:

This letter is to acknowledge receipt of your letter dated November 10, 1998. Your comments have been noted.

Sincerely,
Joanne Girard, Senior Insurance Examiner

For more on the New York Insurance Department's attitude about fairness, see page 31. ■

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Tune In, Turn On, and Buy Insurance

Internet Insurance Market May Blow Your Mind

The following article is by Brian Sullivan, editor of the weekly newsletter Auto Insurance Report. *Sullivan probably knows more about auto insurance than anyone and has no peer as a writer on the subject. (Maybe that's why he's able to work from his home overlooking the Pacific.)*

Auto Insurance Report *is available from Risk Information, Inc., 33 Lindal Street, Laguna Niguel, California, 92677, Tel. (949) 443-0330. Subscriptions are $647 per year.*

When it comes to the Internet, you've got a friend in the business—that is, if you're an insurance company. InsWeb is out there with a site (www.InsWeb.com) specifically designed with insurers' interests in mind.

Started with the help of financing from Nationwide, InsWeb has been the most obvious Internet entry point for many insurers who didn't want to go it alone. From a standing start three-and-one-half years ago, the InsWeb marketplace now receives 3,000,000 annual visitors, up from 600,000 a year ago.

InsWeb is well positioned to take advantage of the burgeoning interest in shopping on the Internet. It has invested in technology and has marketing partnerships to lure consumers and a sales effort to lure insurers.

InsWeb was founded in March 1995 and spent its first year getting the technology and infrastructure in place. In 1996 it began pitching insurers on an Internet market where they could sell their products. Although term life seemed like an easier Internet sale—it's a standardized product with fewer underwriting variables—InsWeb, unlike other Internet ventures, decided to sell auto insurance, even though the product's complexity meant a longer development period. (The auto-insurance market, with $115 billion in annual premiums, is far and away the largest property-casualty line of insurance.)

InsWeb initially faced a classic "chicken or egg" dilemma. Why would insurance companies join InsWeb if it had no consumer traffic? And why would a consumer go to InsWeb if it had no insurance product?

Nationwide Insurance bought into the concept, however, and made its rates available. In January 1997 it became the first company to offer policies online through InsWeb. (Since most of Nationwide's business is written through captive agents in the East, it offered policies in the West, where it sells through direct response.)

In addition to Nationwide, InsWeb's investors include AMS (the agency-automation and comparative-rating company owned by CNA), Century Capital, Marsh & McLennan, and Softbank Group. InsWeb's management, however, still controls the company.

In 1997 InsWeb embarked on an aggressive program to build consumer traffic, signing deals with 41 Internet sites that could direct business its way. (Essentially, InsWeb buys interactive advertising on these Internet websites; visitors to these sites see InsWeb's logo and can jump to its site by clicking on the logo.) These deals, as well as an increase in the product offered, have helped increase traffic significantly. InsWeb now has 27 carriers, 17 of which offer auto insurance. Kevin Keegan, InsWeb's president, believes that InsWeb is about halfway home in auto insurance; he thinks that 30 carriers are necessary to provide consumers with the full range of choices that will be attractive to them.

Last February, InsWeb began a brand-awareness ad campaign on radio, targeting a 25-to-45-year-old audience in the San Francisco area. One purpose of the radio ads was to measure the cost of creating brand awareness. As InsWeb grows, it's trying to gain an understanding of how much it will have to spend to support its brand with advertising, and what the return on such an investment might be.

Keegan says that the ad campaign has been successful, and that there's a willingness among people in the audience to reconsider the way they purchase insurance. He declined to provide specific figures about the ads' effect on InsWeb's traffic, however. (The campaign's success can be measured by tracking the number of quotes offered, according to zip code.)

As for InsWeb's impact, let's run some numbers. To be conservative, we'll say that InsWeb's 3,000,000 visits are made by only 1,000,000 people, and that their average premium is the national average of $650. That would mean that InsWeb has *some* influence on $650 million in insurance premiums (about 0.5% of the auto-insurance market.)

"Bodily-injury and property-damage liability. Hold the collision and comprehensive."

Fourteen percent of InsWeb's 250,000 monthly visitors actually spend the time to complete an application. "We're generating 35,000 leads a month," Keegan says, noting that it typically takes 20 minutes to fill out the InsWeb forms on the Internet. (That's about how long it took us.) For most auto-insurance buyers, this 20 minutes will be an excellent investment of time: an Internet site with a sufficient number of insurers should provide a consumer with half a dozen or more quotes from carriers large and small.

There is no more efficient way to shop for insurance. By traditional means one can't get a *single* quote in much less than 20 minutes. Try calling GEICO or any other direct-response insurer. Visit an agent. Fill out a form and mail it to AIG. None of these takes much less than 20 minutes when you add up the time.

It's also important to realize that there are two aspects of "Internet time." The first is what we call "Internet years." Like "dog years," these equal seven human years. For example, in the non-cyberspace world it would take decades for an entirely new insurance-distribution channel to develop. With the Internet, it will take about three years.

The second aspect has to do with people's perception of time: seven minutes online is like one minute doing something else. Don't ask us to explain (we can't), but folks will invest enormous amounts of time roaming around the Internet. In the early stages of exploration it's not uncommon for someone to roam for hours, generally late into the night.

An important part of what an Internet marketplace can provide insurance companies is the *willingness of customers* to do a great deal of the work necessary to generate a quote. The expense of taking down proper underwriting information is eliminated on the Internet.

Another expense that Keegan and InsWeb hope to eliminate is the cost of "no." By pre-screening applicants and offering quotes to only those drivers who fit an insurer's specific underwriting standards, InsWeb expects to generate better leads. By the time an insurance company spends a cent on an InsWeb lead, it can be fairly confident that the lead is someone it would like to sell a policy to. For insurers with highly specific markets—ultra-preferred and high-risk nonstandard come to mind—this pre-screening is especially valuable; insurers could logically expect a higher close rate on these leads than on those generated by direct mail or television advertising.

InsWeb's Auto Insurance Markets

AIG	Kemper
American Family	Liberty Mutual
Amica	Nationwide (Western)
Auto Club South	Progressive
Avomark (Ohio Casualty)	Reliance*Direct*
CNA	State Farm
Country Companies	TIG
Hartford (AARP)	Tri-State Consumer
GE Auto (Colonial Penn)	

January 1999

"If the typical close rate is one-in-seven," says Keegan, speaking of traditional direct-mail or phone responses, "we think we can make it one-in-three by matching the right consumer with the right carrier."

To be successful, Keegan must sell insurers on his way of looking at the numbers. "If acquisition costs are $450, we can take $150 out by data entry and pre-screening of applicants," he says.

"We offer carriers two major things. One is reach—reach to people who want to shop and be serviced this way. The second is the cost takeout. One of our original charters was to help the insurance industry market its products more efficiently. Our mission has been to reduce costs for carriers and to work closely with them while creating a well-recognized brand on the Internet."

Note that lead generation is not at the top of the expense-saving list. While insurers can reasonably expect to save money when business starts to flow on the Internet, there's no free lunch. There are costs to maintaining an Internet presence, providing information to a comparative rating service, and building new systems. There are finder's fees to those who generate the leads. InsWeb—or any other marketplace—must spend money to generate traffic to its site. InsWeb's costs include interactive advertising placed on other Internet sites, brand-awareness advertising, computer programming, staffing, product development, maintenance, and a category we like to call "other." Still, there should be savings.

How hard is it to convince insurance companies to get on the bandwagon? The Internet, Keegan says, "is pre-sold in the carriers' minds before we come to the scene. They watch the same news channels and read the same magazines as everyone else in the world, and see the Internet becoming more and more important. They're already predisposed to the idea that the Internet must become a part of their business."

As we see it, insurance companies have three choices: they can go it alone, they can join forces with a central marketplace, or they can do both (our preferred strategy).

"Ours is a transactional model, not an agency model," says Keegan. "We get paid based on leads forwarded. Our mission is to facilitate the sale of insurance."

Some insurance companies (Kemper, for example), are channeling InsWeb's leads to agents; others (AIG and Reliance *Direct*) are sending the leads to a call center; still others (CNA) are trying both. Not all companies have bought into the concept of providing *quotes* on line. State Farm, which writes 20.5% of all personal auto, is a conspicuous example. To get a State Farm quote on InsWeb, consumers must choose an agent from State Farm's agent locator. That agent will then provide the quote.

Unlike Intuit's InsureMarket (www.InsureMarket.com), which provides prices from various companies, InsWeb has decided that it will *not* provide prices from insurers who aren't willing to offer a policy online. Keegan and his management team are convinced that providing a quote without the opportunity to buy a policy will frustrate consumers.

Which strategy is the winner remains to be seen. Intuit's InsureMarket has moved more forcefully than InsWeb has in offering prices, and it is a useful service that provides tangible information. If that strategy brings more consumers to its page, Intuit will be able to offer more leads to insurers. That might bring insurers into the fold (forcing them to offer a policy online), regardless of how they feel about Intuit's aggressiveness.

But if Keegan and InsWeb are right—that consumers value the ability to buy a policy more than the ability to collect information—then perhaps InsWeb will win the hearts and minds of consumers and insurers.

Ultimately, a successful Internet insurance marketplace will have to offer a wide range of company prices and multiple opportunities to buy a policy on the

Internet (or come very close to buying a policy on the Internet). In the end, there may be many Internet insurance markets, much as there are many insurance agencies in the same territory that offer the same products.

Can insurance companies remain outside this cyberworld? Unlikely. Just as banks can't prohibit newspapers from publishing interest rates on certificates of deposit, insurance companies can't prevent Internet markets from publishing insurance prices.

Still, some companies are resisting. Farmers Insurance, for one, feels that selling over the Internet through comparative rates will encourage customers to choose the cheapest policy, rather than the best overall value (price + service = value). Having positioned itself as a high-quality, *full-service* insurer, it is declining to participate on the Internet insurance marketplace. While this may be a sound strategy today, it won't remain such for long. Insurers simply won't have the option of sitting on the sidelines.

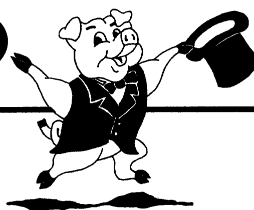
"We're really neutral to distribution," Keegan insists. Although the Internet appears to be most advantageous to direct-response insurers, given the cost savings InsWeb expects to deliver, Keegan argues that there are substantial benefits for agency carriers.

Keegan knows that with the rapid pace of technological change, the future isn't what it used to be. So InsWeb has built an internal consulting group to help insurers offer their own Internet solution. "Not every consumer is going to want to go to a marketplace. He may have been doing business with one carrier for a generation," says Keegan. "We'll provide the technology for an individual carrier to set up its own single-carrier site."

Historically, policyholders have shown considerable loyalty to their insurance providers. (This may be due as much to inertia as to anything else.) The Internet markets will change everything. Pricing transparency enhances competition, which drives down the cost of insurance, which lowers agents' commissions, which changes the way customers are serviced, which affects policyholders' attitudes about insurance companies, which changes their feeling of loyalty to insurance companies, which affects renewal rates, which alters the cost of insurance, and so on.

Welcome to the brave new world. ■

MR. PIG'S



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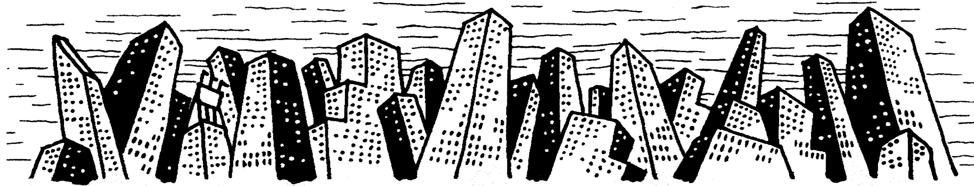
On the Road with InsWeb by Sal Paradise

To hit the open road in my car—to drive through industrial New Jersey past factories and bridges and warehouses and then steel mills and farms and Indiana limestone quarries, and on to Chicago with its hootchy-kootchy joints where bop and blues are played by half-mad musicians, then through the heart of America with its plains and wheat and cows, past snow-capped mountains and through the lonely low desert that stretches to the Pacific—I needed to renew my auto insurance.

"InsWeb, man," said Dean Moriarty as we ate pork-chops in Harlem. I logged on later that night while drinking a $7 bottle of Chilean Merlot called "Prosperity" and listening to lonely Jack Teagarden's melodic trombone on WKCR.

I don't buy collision or comprehensive, my car's too old and beat up, but it moves, so I've used GEICO for at least 10 years, and in all my travels on desolate roads and lost highways I've never had a ticket or an accident. I'm a "preferred risk" paying $1,104 a year.

Twenty minutes on InsWeb went by quickly as I drained "Prosperity" while Teagarden's '58 Capitol session played in the background, and a few days later, quotes were delivered by the postman. Colonial Penn was at $1,161, AIG $664, and Tri-State Consumer $654 (but it had the wrong limits). AIG, run by the great Greenberg who works at the top of the glorious New York skyscraper 70 Pine, could save me $440, but like Tri-State and Colonial Penn it wanted me to fill out paper forms and give them back to the postman. I had tenor saxes to hear and late nights to explore and didn't feel like filling out more forms, so I called GEICO and told them my story and the man at the other end of the line—a man who sits all day in a cubicle waiting for policyholders to call—on the spot reduced my premium to $804. I gave him my Visa number and it was done—a half hour of my time and a savings of $300 a year thanks to Dean Moriarty!



THE INSURANCE BEAT

Some Heritage

LAST OCTOBER, tiny Texas-based Lincoln Heritage Corp. went public, raising a few million bucks. The company, through its subsidiaries Lincoln Memorial Life and Memorial Service Life, sells "pre-need" insurance that's used to fund funeral contracts.

When the folks at the much larger Lincoln Heritage Life Insurance Company in Springfield, Illinois, heard about Lincoln Heritage Corp. in Texas, they didn't like it and filed a lawsuit alleging trademark infringement. The Springfield-based Lincoln Heritage, which has been around since 1964 and is a major peddler of "final-expense" and "pre-need" insurance, believes that it is the rightful owner of the Lincoln Heritage name.

The lawsuit apparently didn't faze the Texas boys. "Lincoln Heritage CEO Upbeat About Funeral Insurance," read a recent Dow Jones News Service headline. The accompanying article, by Bob Sechler, reported that Nicholas Powling, CEO of the Lincoln Heritage in Texas, thinks funerals are a growth business. Indeed, the morbid Powling "is optimistic about his company's long-term prospects when he considers the nation's aging baby-boomer population."

Pre-need and final-expense insurance are high-priced, low-limit life-insurance products that are targeted to low-income suckers who tend to be getting on in years. One never needs pre-need insurance. And why overpay now for your final expenses?

Honest Abe is rolling over in his grave.

Come on Baby, Light My Fire

SANDY WEILL, CITIGROUP'S co-CEO, is known for his cost-cutting. Indeed, he is such a bold cost-cutter that Citigroup's downsizing of its redundant employees started at the top—well, almost the top. Jamie Dimon, Weill's right-hand man, was recently let go.

Cost-cutter extraordinaire Robert Lipp, co-CEO of Citigroup's consumer business, told *Fortune* that he'd really like to get rid of the orchids in the Citibank lobby. "It's symbolic," he said. "Everybody takes his lead from the top people."

Some costs, however, are not symbolic. Weill likes having a fireplace in his office, so when he moved to Citicorp's space last year he had one installed. The price: a mere $100,000.

A Lesson in Fairness

THE SETTING: a full-day conference, *Demutualization of Life Insurance Companies*, held in November by the New York Society of Security Analysts. The man at the podium: Marty Carus, chief of the New York Insurance Department's Life Bureau. The subject: Mutual of New York's demutualization and IPO, which had occurred the previous day.

Mr. Carus was on the defensive. The previous speaker (a world-renowned insurance-newsletter writer), had used his genial demeanor and wry wit to chastise New York Insurance Commissioner Neil Levin for permitting Mutual of New York (MONY) to sell its shares at bargain-basement prices in an IPO that diluted the policyholder-owners and didn't give them a chance to buy stock at the giveaway offering price. (The offering was underwritten by Goldman, Sachs and others, who sold the shares to their favored clients, many of whom then flipped them for an immediate 25% gain.)

The Insurance Department, said Carus, had deemed that MONY's plan of demutualization was "fair and equitable"—the statutory requirement.

A man in the audience noted that the plan would have been *more* fair if the Department had heeded the advice of the newsletter writer who had testified at MONY's demutualization hearing that policyholders be given subscription rights or be provided with an alternative mechanism for buying stock at the offering.

Snapped Carus, "The statutory prescription [for a demutualization] is not that the plan be the *fairest* and most equitable that could be possibly be devised."

Policyholders beware: in Marty Carus's world "fair and equitable" comes in many degrees: There is *sort of* "fair and equitable," *slightly* "fair and equitable," *rather* "fair and equitable," *plain old* "fair and equitable," *more* "fair and equitable," *very* "fair and equitable," *highly* "fair and equitable," *extremely* "fair and equitable," and "fairest and most equitable."

With a low hurdle like "fair and equitable," it's no wonder that MONY's plan sailed through the Insurance Department.

Name Change

A HIGHLY PLACED OFFICIAL in the New York Insurance Department has suggested that a large New York life insurance company change its name to the "Most Equitable Life Assurance Society."

Say it Ain't So, Joe

IN OCTOBER we wrote about Joe DeAlessandro, the former National Union president who had become Chairman and quasi-President of Century Industries, a money-losing penny-stock company that issues press releases touting big earnings that never seem to materialize. Century likes the insurance business. Through Underwriters Insurance Group (UIG), it owned a piece of insurance broker B.R.I. Coverage, run by Don Ferrarini. (B.R.I. became D.O.A. in 1995, and Ferrarini was recently convicted of conspiracy, insurance fraud, securities fraud, and more.) UIG also owned Covent Insurance Co., which was liquidated in 1995. In 1994, Century tried to buy Prestige Casualty, overseen by insurance con-man John Goepfert, who, with Seymour Pollack—an associate of Meyer Lansky and convicted stock swindler—was convicted for a scam at Casualty and Indemnity Company (Belize). Prestige went bust.

Last year, Century said it would raise $10 million and form a Florida insurance company (run by DeAlessandro), that would write homeowners insurance. A press release projected $3.8 million in profits. On December 16, 1998, Sobel & Co., Century's fourth accounting firm in six years, resigned. On December 18, DeAlessandro resigned. On December 23, Century "dismissed" Sobel & Co., which had already resigned. On February 8, 1999, Century announced that it was changing "its direction to participate in the Internet Information Technologies Industry."

Century's SEC filings didn't disclose that DeAlessandro was *also* Chairman and CEO of Universal Property & Casualty Insurance Co. (UPCIC), another recently formed Florida insurance company that writes homeowners insurance. UPCIC is the principal subsidiary of Universal Heights, a penny-stock company whose largest shareholders are Norman Meier and his son.

Meier was a director of Prestige Casualty (which Goepfert oversaw and Century tried to buy). John E. A. Kidd, former chairman of Meier's Columbia Pharmaceutical, was president of Turks & Caicos reinsurer Savoy Re, now defunct, which was full of bogus assets. Kidd's wife Wendy was a shareholder of Prestige Casualty. Universal Heights shareholder Shephard Lane is an attorney whose clients have included Ferrarini, Goepfert, and Columbia.

DeAlessandro is also president of Kentucky National and Rutgers Casualty.

Where have you gone, Joe DeAlessandro?

SOMEDAY I'LL WRITE ABOUT INSURANCE...

David Schiff, the editor and writer of *Schiff's Insurance Observer*, circa 1973.

Even as a misanthropic young man meandering through the streets of New York in a psychedelic haze, David Schiff knew that he wanted to write about the insurance business. Of course, his options were somewhat limited. With his abysmal grades, poor attitude, and aversion to work, most careers were simply out of the question.

Insurance, however—where intellect, judgment, and competence are not prerequisites—not only welcomed a pensive curmudgeon like Schiff, but gave him the greatest job in the world as well: observing the rampant dementia, deceit, and sophistry in the industry and chronicling it in a fearless newsletter beholden to no one.

So Schiff lucked out. He spends his days waist-deep in insurance-company filings, financial statements, trade publications, and actuarial reports. His nights are spent penning cutting-edge exposés, groundbreaking analyses, and hard-hitting commentary in his trademarked tone of acerbic irreverence.

Yes, Schiff's job is so much fun that he ought to be willing to do it for free, but he dreams of the fabulous wealth and international renown that come from owning a successful newsletter about the insurance business. So subscribe to *Schiff's Insurance Observer* (or send someone a gift subscription).

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