The world's most dangerous insurance publication℠

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INSURANCE OBSERVER

Whistling Past the Graveyard

Waiting for the Man

Despite a 17-year run in which property-casualty insurance companies' adjusted net worth has grown 1,100%, the people who run these companies have professed a good deal of optimism this year. Many have told analysts—who else listens so intently?—that rates will go up, or at least stop going down. (You'd think that grown insurance executives would know better than to try to predict the future. Many can't even predict the past: their loss reserves.)

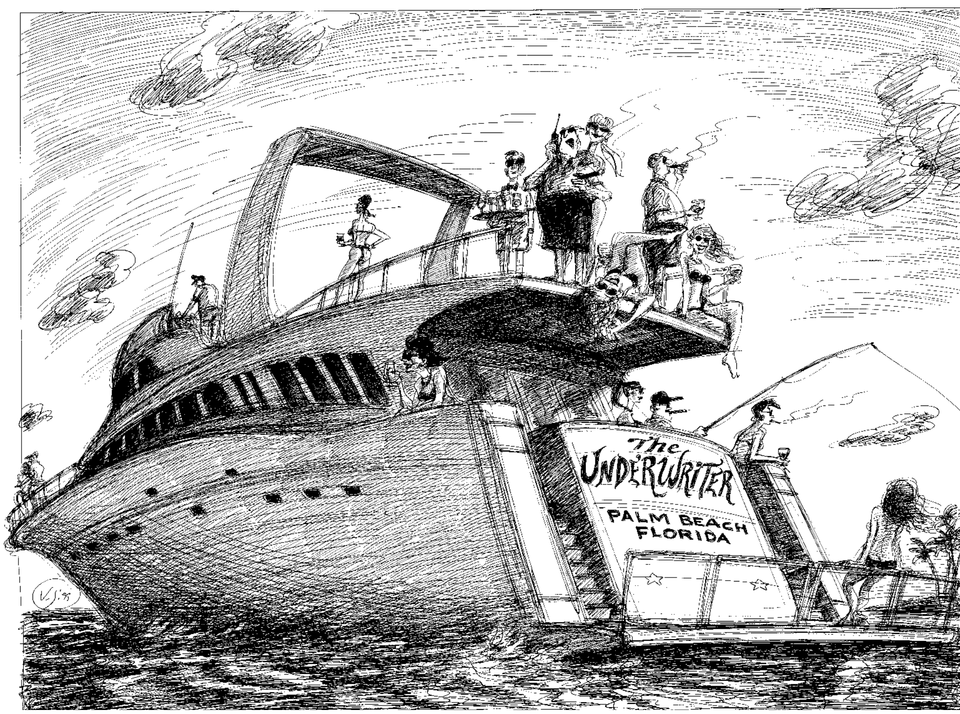
Hank Greenberg, AIG's chairman and the greatest man in the insurance business, went on record not long ago, saying "the worst is over." It was big news for a moment.

Two other comments by Greenberg are also of note, although they haven't even been mentioned by any member of the media: 1) Last year "saw the first signs of a more sensible industry approach to underwriting;" and 2) "There were signs during the year...that an upturn [in insurance pricing] was close at hand." We cite these two comments because Greenberg made them to AIG's shareholders—in 1990 and 1991.

Back then, many thought that the property-casualty cycle was *obliged* to adhere to a three-year schedule. Greenberg's inability to predict a turn in pricing hasn't hurt AIG's results, just as Warren Buffett's inability (and unwillingness) to predict the direction of the stock market hasn't hurt Berkshire Hathaway's results. The best insurance companies tend to do well in hard markets and make it through soft markets relatively unscathed.

Despite the property-casualty industry's $330 billion of capital, many Wall Street analysts predict that insurance companies will achieve higher earnings next year. Certainly there are troubling signs: written premiums and paid claims have grown faster than loss reserves, which raises issues about the quality of earnings. If things are bad, the analysts figure, that will force the market to harden, which is good for everyone—except those who buy insurance.

While sectors of the market will firm (some sooner, some later), a hard market won't be greeted by cheers all around, because a hard market is a reaction to pain. Money must be lost, and insurance companies must feel fear, before excess profitability materializes. We don't say this out of any cold-shower, Calvinistic



"Damn it, Johnson! If you don't cut claims, we'll have to cut expenses."

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Weltanschauung. We say it because that's the way the law of supply and demand works: when there's a lot of supply, prices tend to stay down.

So there will be pockets of opportunity in the industry, but companies that are properly capitalized will be in the best position to avail themselves of these opportunities. (We are intrigued by the workers' comp market simply because it has been so bad, and have spanned the alphabetical gamut by making modest investments in Argonaut and Zenith National, at prices below book value.)

One doesn't have to be an optimist to find opportunities in the insurance business. In fact, optimists can be dangerous—they tend to *imagine* opportunity where none exists. Although we've been bearish on the industry for what seems like ages—and particularly wary of personal auto (see *Schiff's*, May 1998, page 1)—our bearishness hasn't prevented us from owning and buying insurance-company stocks. In our January 1995 issue, for example, we noted that we'd purchased shares in eleven insurance businesses. (This turned out to be a cyclical bottom for insurance stocks.) Lately, we've been buying stock in a number of reasonably capitalized out-of-favor property-casualty companies selling below book value. Despite our purchases, we don't feel optimistic. On the other hand, when buying a bargain, one doesn't need *everything* to go right. When securities are priced for the worst, one merely needs the worst *not* to happen to make money.

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Over the years we've tried to approach the insurance industry as a realists, and have espoused plenty of opinions contrary to the prevailing wisdom. A recent reading of a decade's worth of articles confirms (to us, anyway) that our cautious contrarianism has served our readers well. Since 1999 marks our tenth anniversary, we'll take this opportunity to recommend that newer readers buy "The Complete *Schiff's Insurance Observer*" a/k/a "David Schiff's Lost Decade," from Mr. Pig's House of Insurance. (See page 28.)

At one end of the insurance-stock universe there are a reasonable number of "cheap" stocks in companies with decent balance sheets and pretty good market positions. Light years away, at the other end of the universe, is AIG, whose stock trades at 28 times earnings and 430% of book value. It is priced for perfection, or something close to that. (We noted this last October, too, when the stock was not only at a lower multiple of earnings and book value, but at a lower price.) If AIG is worth 430% of book value, why, one wonders, don't the people who are buying it at that valuation take a flyer on W. R. Berkley and Loews, both of which are selling below book value (and both of which we've bought below book value)? The answer, we must assume, lies in the nature of markets. There is no way to tell when, if ever, AIG will go out of style, or when, if ever, Berkley and Loews will come into style. For our money, however, we feel more comfortable with what's currently cheap and unfashionable.

Our comments shouldn't be interpreted as any negative feeling on our part about Hank Greenberg, or AIG. We just see a disconnect between the value of his company and the value of its stock. (The same could be said of Coca-Cola, General Electric, and others.)

On January 13, Greenberg spoke at the Joint Industry Forum, and three of his comments caught our ear. They are worth repeating. Speaking about the high prices being paid for many insurance companies, he quipped, "there ought to be an acquisition discount," rather than an acquisition premium. We'll bet that there will be a number of acquisition discounts in the next year.

Greenberg, a man not known for his easy-going manner, doesn't mince words: "If anyone thinks workers' comp reserves are profitable, they're in dreamland," he said sharply. But even Hank Greenberg can't talk sense into an overcapitalized market. Markets are bigger than people, governments, and even AIG.

Finally, he asked a rhetorical question: "When are the auditors going to stop" signing off on the financial statements of companies that are underreserved?

We think we know the answer. They'll stop signing off when they usually do: after it's too late.

The insurance business, as we have noted before, is the investment business. Insurance companies take in money and invest it. The best insurance companies get their money at no cost (by underwriting profitably), and then invest it skillfully, earning above average returns with below average risk. They then repeat the process.

The concept of taking in premiums and investing them is so appealing that people who fancy themselves good investors want to get into the insurance business. (As Warren Buffett has pointed out, "float"—the funds that offset reserves—is a wonderful thing. And as Martin Frankel knows, life insurance companies have a lot more float than property-casualty companies.)

Although the insurance business looks appealing, it is a difficult one in which to earn superior returns over prolonged periods. An insurance company is often a Rube Goldberg contraption: a money-losing machine. It works like this: 1) Underwriter issues underpriced insurance policies; 2) premiums from underpriced insurance policies are invested in overpriced assets; 3) actuaries, struggling to achieve corporate objective, use complex computer models to predict that underpriced policies are profitable; 4) actuaries use different computer models to predict that overpriced investment assets will have above average returns; 5) insurance company acts upon the belief that steps 1-4 make sense; and 6) hires more people to repeat process.

Sometimes things go awry. Despite having underpriced its policies or made bad investments, an insurance company may avoid being hit with significant losses for quite some time.

The money-losing contraption may also fail to work if the insurance company makes the acquaintance of a reinsurance company that has its own money-losing machine. Since a reinsurance company, in its most pristine form, is just a pile of capital, an underwriter, and a money manager, it can be a purer form of money-losing machine. A reinsurance company may well believe that it can take pieces of underpriced primary policies but make up the difference by investing well. Or it may only believe that it can find a greater fool on whom it can lay off its risk. (This isn't so silly—the reinsurance market knows no borders, and the world is filled with fools.)

In January, when the 30-year Treasury was 100 basis points lower than it is now, one small insurer that was invested in Treasurys told *Insurance Finance & Investment (IFI)* that it planned to outsource its money management because it wanted more credit risk—"something that will earn some decent interest," an executive at the company said. (If this company had only gone *short* Treasurys...)

The same issue of *IFI* quoted a knowledgeable fellow discussing the life-insurance opportunities in Eastern Europe. He was advising companies not to enter the Czech Republic (it was too crowded), and suggested, instead, that they expand into Poland—despite the fact that 30 Western insurance and finance companies had *already* applied for licenses there.

Around the same time, one of the world's largest securities firms published a detailed report on Skandia, the "leading non-life insurer in the Nordic area." The firm's analysts concluded that a "reasonably generous" valuation for the company was 104 krona per share. "On valuation grounds [What other grounds are there?] the price is full," the analysts wrote—a reasonable conclusion given that the stock was at 127 krona, 23 krona more than "full" value). What didn't seem reasonable, however, was the firm's opinion of the stock. For the short term it was "neutral"; for the "long term" it was "accumulate." (Why is it good for long-term investors to pay more than full value?)

We didn't ask any analysts for their opinions of InsWeb, the Internet insurance marketplace, which went public on July 23 at $17 per share and shot up to $44, giving it a market cap of $1.5 billion. The stock has now sunk back to its offering price, and sports a more modest market cap of $600 million, not bad for an insurance business that had $8 million of revenues and $23 million of expenses for the first six months of 1999. (In our March issue we called "Internet-stock mania" a "good example of a current speculative bubble.")

Although it doesn't have earnings, InsWeb has a good website, and you can probably save some money on your auto insurance by spending 20 minutes there. More memorable than the website, however, is the prospectus for InsWeb's IPO. It lists 41 "risk factors" (8,477 words in all)—a world record, we believe, for a company in the insurance business.

Rather than invest in Polish life insurers, overvalued Swedish non-life insurers, or risk-laden Internet insurance businesses, there is an alternative: short-term Treasurys. Another alternative can be found at www.BHLN.com, which, to our knowledge, offers the best single-premium-deferred-annuity (for those who want a long-term guaranteed rate). The website belongs to Berkshire Hathaway, and the annuities are sold directly by Berkshire Hathaway Life and carry no commission. The rate you will receive will be equal to the yield of a U.S. Treasury strip with a comparable term. (On the day we took a look, the interest rate was 6.22%, and it was *guaranteed* for up to 70 years. You choose the term.)

This is a brilliant product for Berkshire to sell. Essentially, the company is borrowing money at the same rate as the U. S. Treasury—plus whatever expenses are associated with issuing the annuity, which has a $40,000 minimum.

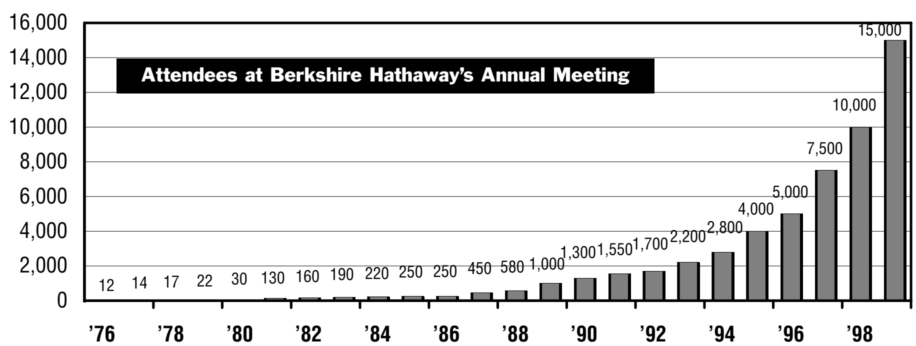
It's worth noting that while others are setting up shop in Poland and the Czech Republic, Berkshire is selling a prosaic product here in America. It's doing in annuities what GEICO has done in auto insurance.

The window of opportunity for annuities probably won't stay open for too long, however. Other companies will become aggressive and offer yields that are too high, driving profit from that line, at least temporarily.

By that time, however, Berkshire will have accumulated assets cheaply and, more importantly, while the going was good.

A Bull Market in Attendance: Berkshire Hathaway's Annual Meeting

For those who don't feel like schlepping to Omaha every Spring, edited (but still long and wonderful) transcripts of Berkshire Hathaway's annual meeting are available from *Outstanding Investor Digest*, 295 Greenwich St., PMB 282, New York, NY 10007. Phone: (212) 925-3885.



Sources: Berkshire Hathaway, *Omaha World-Herald*. Figures for 1977-79 and 1982-84 are estimates made by *Schiff's Insurance Observer*.

Reliance: Will Raters Pull The Trigger?

At the Crossroads

Of the 25 largest property-casualty insurance companies, none is more vulnerable to a rating downgrade than Reliance Insurance Company. "Although the Best and S&P ratings of the Reliance Insurance Group are not as high as many of the insurance companies with which Reliance Insurance Group competes," reads Reliance Group's 10-K, "management believes that the current ratings are adequate to enable the Reliance Insurance Group to compete successfully."

When Reliance Group issued securities in 1993, its prospectus warned that "a downgrade in [Reliance Insurance Company's] Best rating below A- could adversely affect" its competitive position. While Reliance's ratings may now be "adequate," what the company said in 1993 still holds. Without an A- rating from Best, Reliance would be adversely affected, much as the 1927 Yankees would have been adversely affected without Ruth and Gehrig.

If Best lowers Reliance a notch to B++, large brokers and companies that deal with Reliance would be inclined to take their business elsewhere as quickly as possible. Reliance, a major writer of workers' comp and commercial liability, would be in a position similar to that of The Home in 1994, when Best downgraded it from A- to B+.

Reliance's stock, never our cup of tea, is now as popular as a pot of Darjeeling at Starbucks, declining from 17$\frac{5}{16}$ to below 5 during the past year. (In May 1998, chairman and CEO Saul Steinberg unloaded 500,000 shares at prices between 17 and 18.) Among the reasons for the stock's poor performance are Reliance's deficient reserves, recent losses, and involvement with Unicover.

Unicover is a manager of a troubled workers' compensation pool/facility that has—we don't know how else to describe it—exploded. Reliance acted as a "front" for as much as $1.5 billion of Unicover premiums under multi-year contracts. Reliance earned a fronting fee and retroceded 100% of the premiums to a number of other reinsurers. Some of these reinsurers—and their retrocessional reinsurers—are expected to experience whopping losses. Lawsuits and allegations have been flying. Although Reliance isn't a party to the lawsuits, it's caught in the middle: its paper is on the line, and the company, therefore, is exposed to significant losses if its retrocessionaires back out or are unable to fulfill their obligations. It's uncertain when, how, or if a solution to the Unicover matter can be worked out. (Numerous insurance companies are involved.) But time is Reliance's enemy. If the matter drags on—and there's no reason to think it won't—the overhanging cloud will hurt weaker companies like Reliance, which lacks the financial strength and flexibility of AIG, Chubb, Liberty Mutual, or Zurich. (The Unicover fiasco aptly demonstrates that there's no such thing as a free lunch. There are risks to acting as a "front"—even when an insurer is dealing with strong reinsurers.)

Saul Steinberg, chairman and CEO of Reliance Group

Reliance, which has about $1.3 billion of statutory capital, has other issues to deal with, as well. Reliance Group has $710 million of debt, $520 million of which matures by next year. (Another $171 million matures in 2003.) Complicating matters is Reliance's heavy investment in affiliates (Zenith National, which is being sold for $184 million, and LandAmerica, whose parabolic stock chart resembles Reliance's). Reliance also owns 13.8% of Symbol Technologies stock, worth $450 million at recent prices.

As an investor, Steinberg has demonstrated a penchant for big—and often risky—bets. He has an eye for value, but plays a dangerous game. For decades he was feared and reviled as a corporate raider, and he proved himself to be an accomplished greenmailer, as well. Companies used to tremble when Reliance filed a 13-D stating that it had bought a good-sized position in their stock "for investment purposes only." But no one is trembling anymore (except, perhaps, Reliance's shareholders and insureds).

Most of Reliance's investments are in fixed-income, and the portfolio is of a higher quality than in the past. Still, 25% is in BBB-rated bonds (two notches above junk), 13% is in junk, and another 6% is in unrated issues.

If we were in Saul Steinberg's shoes, we'd be selling some or all of Symbol and LandAmerica—not because we think these are bad investments, but because having a stronger, more liquid balance sheet outweighs the risk that goes with the potential reward from these investments. (LandAmerica is an affiliate of Reliance, and Steinberg is on

Symbol's board. As a result, the securities that Reliance owns are not as liquid as they might otherwise be.)

In order to support itself, Reliance Group relies on dividends from Reliance Insurance Company. But dividends won't repay Reliance Group's debt when it comes due. More important, can Reliance Insurance Company, which must upstream dividends to provide cash to its parent, keep its A- rating? That question, we suspect, is being pondered—and then repondered—in Oldwick, New Jersey, home of A. M. Best.

Best has always been reluctant to lower major commercial-lines insurers below A-. (An A- from Best has been viewed as the boundary between secure and vulnerable, even though, technically, it is not. In 1994, Best classified its ratings below B+ as "vulnerable.") Regardless of how Best defines its ratings, savvy brokers and commercial insureds don't consider "B++" and" B+" Best ratings to be "investment grade."

If Best downgrades Reliance to B++, it would probably produce a black-hole effect: the lower rating drives away good business, which weakens the company, which drives away more business, which weakens the company further. This continues (rapidly) until the company is sucked into an abyss and put into rehabilitation by regulators, or sold.

In theory, property-casualty companies should be more insulated from the black-hole effect than should life insurers, since—except for unearned premiums—insureds cannot generally ask for their money back. On the other hand, commercial insureds will jettison their insurance companies faster than individuals will switch life insurers.

So A. M. Best is probably pondering the situation and wondering what to do. Does it sit tight, "work with" the company and hope for the "best"? But what if S&P or Moody's downgrades Reliance to vulnerable, triggering the black-hole effect? Then Best is left looking foolish, and its ratings may be viewed as less reliable than those of its competitors. (Moody's rating for the Reliance Insurance Group is Baa2—two notches above vulnerable—and S&P's current rating, which is on creditwatch, is "A"—four notches above vulnerable.)

If Best isn't concerned, then it should be. Best's ratings are, in a sense, less discerning than those of its competitors, in part because it has fewer rating categories. Best's ratings are A++, A+, A, A-, B++, B+ and so on, while the other raters use variations of the following: AAA, AA+, AA, AA-, A+, A, A-, and so on. The other rating agencies have 10 categories of "secure" or "investment grade" ratings; Best has only six, giving it less room to maneuver on the downside. (For the other raters, BBB-, or its equivalent, is the lowest secure rating.)

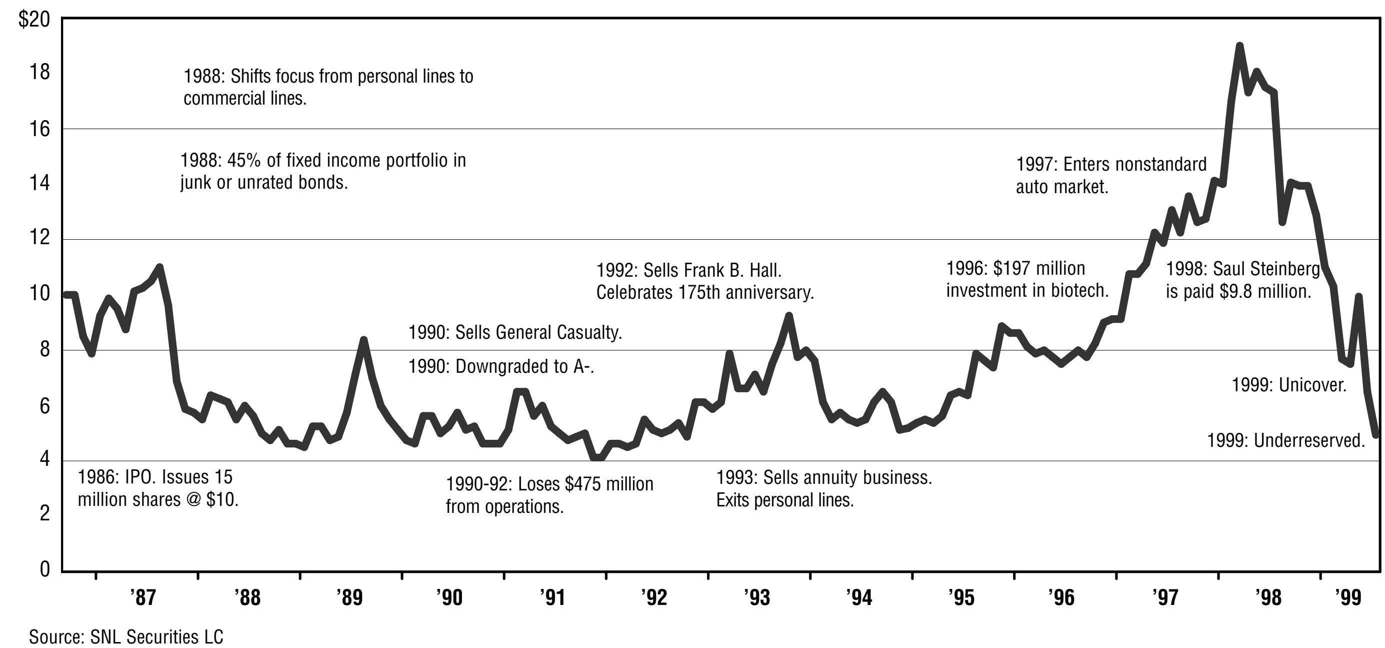
For years we've written that Best should, and would, switch to a rating scale similar to its competitors. But it hasn't. That's been a mistake. Since ratings are meant to represent shades of financial strength, if an agency has more shades in its palette, its ratings can be more nuanced.

Reliance may be fine. There may be no crisis, no liquidity crunch, no more reserve problems. It may refinance without a hitch, and its predominately commercial insureds may not give a hoot about its less-than-stellar financial strength. But when buying commercial insurance, especially long-tail casualty insurance, it makes little sense for an insured to choose a weaker company over a stronger one, other factors being fairly close.

As for pricing, it's worth paying up for financial strength. Security, after all, is what insurance is about.

Reliance Group Holdings 1986 to 1999: What a Long Strange Trip it's Been

Over the years, Saul Steinberg, Reliance Group's chairman, has been a corporate raider, greenmailer, wheeler-dealer, master of clever accounting techniques, philanthropist, big-time spender, and wildly overpaid executive. Back in his raiding days, he talked about how companies "should be more responsive to stockholders." Despite Reliance's poor performance, Steinberg has consistently been one of the highest paid CEOs in the insurance business. Investors who have held Reliance shares since it went public in 1986 are just about even (including dividends).



Source: SNL Securities LC

Did Allied Mutual Con Conning?

How to Make $80 Million in Four Days

In our February 1998 issue (see pages 5 and 6) we discussed an embarrassing fairness opinion that Conning & Company, an investment firm specializing in the insurance industry, provided for Allied Mutual.

You may recall that Allied Mutual and its affiliate, publicly traded Allied Group, entered into a stock swap on November 2, 1992. (The two companies' interlocking boards of directors were controlled by John Evans, who was chairman and CEO of both companies. All of Allied Mutual's employees and most of its directors were Allied Group shareholders.) The stock swap was peculiar: Allied Group issued to Allied Mutual 1,827,222 shares of its perpetual non-convertible 6¾% preferred stock (an implied value of $52 million). In return, Allied Mutual transferred 6,166,875 Allied Group common shares to Allied Group.

This was a terrible deal for Allied Mutual but a great deal for Allied Group, John Evans, and other directors and officers. Allied Mutual was swapping its Allied Group shares that represented $8.8 million in annual earnings. In exchange it was receiving Allied Group preferred stock that had a fixed value and paid only $3.5 million in annual dividends.

Given that the stock swap was not an arm's-length transaction, Allied *Mutual* was in need of an investment banking firm to say that this cockeyed deal was fair. (Evans and his cronies would profit from Allied Group's coup, even though it was achieved at Allied Mutual's expense.) Conning & Company was hired; it issued the requisite fairness opinion and collected a nice fee.

Conning made grave errors, however. In opining that the stock swap was fair, it cited a number of factors, two of which were particularly important. One, incredibly, was that "absent the [stock swap]" Allied *Mutual's* stock in Allied Group would grow so rapidly that it would "constitute a progressively disproportionate position among Allied Mutual's assets." In effect, Conning was saying that it was better for Allied Mutual to own Allied Group preferred shares, which wouldn't appreciate, than Allied Group common shares, which would appreciate rapidly. (Conning refused to discuss its fairness opinion or its novel investment thesis. But Conning manages a lot of money, and we know that it prefers to buy securities that appreciate rapidly rather than those that don't appreciate at all.)

Conning cited another key factor in support of the position that the swap was fair to Allied *Mutual*: "The positive impact...on the capital structure of Allied Group will improve Allied *Group*'s [Emphasis has been added because Conning was supposed to be representing the interests of Allied *Mutual*] access to capital markets to support future growth...Allied Mutual benefits from such growth due to economies of scale in shared resources and facilities."

This statement, delivered on Monday, November 2, was wrong. Allied Mutual would not benefit from the economies of scale in shared resources and facilities.

Four days later, on November 6, Allied Mutual and Allied Group—both controlled by John Evans—made a filing with the Iowa Department of Insurance to amend their reinsurance pooling agreement. The amendment removed Allied Mutual as the "pool administrator" and replaced it with an Allied Group subsidiary, AMCO Insurance Company. Instead of allocating expenses in proportion to each insurer's premiums (which had been the past practice), the amended agreement allocated expenses in a way that resulted in a disproportionate percentage of expenses being shifted from AMCO to Allied Mutual. As a result, on almost identical books of business from the same pool of premiums, Allied Mutual's expense ratio rose from 42% to 45%, while AMCO's fell from 45% to 32%. Over the next six years, this expense shift would cost Allied Mutual about $80 million, and earn $80 million for Allied Group.

John Evans summed up his tricky deal succinctly: the pooling change is "an opportunity to flow every dollar of [expense] savings to [AMCO's] bottom line."

Unfortunately, the Iowa Department of Insurance didn't have the foggiest idea what was going on. Two-and-one-half years later, in its triennial examination report, the Department described the reinsurance pooling agreement as if expenses were *still* being shared proportionately. (The insurance department

John Evans, chairman of Allied Mutual and Allied Group didn't become aware of the pooling-agreement expense shift until David Schiff raised objections to it. Then Commissioner Terri Vaughan did something shocking—nothing.)

It's not clear whether Conning knew, when it issued its erroneous fairness opinion, that a plan to alter the reinsurance pooling agreement would be submitted to the insurance department *four days later*—thereby nullifying one of the key factors that it cited in opining that the stock swap was fair to Allied Mutual. It seems clear, however, that if Conning wasn't aware of the imminent pooling change, then it *should* have been aware of it—if not before, then after it went into effect on January 1. (Upon becoming aware, Conning should have withdrawn its fairness opinion.)

Conning should have known about the pooling change because it held itself out as an expert on Allied. In its fairness opinion, it wrote: "We are familiar with Allied Mutual and Allied Group and *maintain research coverage on the common shares of Allied Group* [emphasis added]." What kind of research coverage could a well-known investment banking firm like Conning provide if it didn't even understand the ramifications of the pooling change that was set in motion four days after it gave its fairness opinion?

If Conning says that it didn't know about the pooling change, then one must ask: Is cunning Conning claiming it was conned?

Let's examine evidence contained in SEC filings, insurance department documents, annual reports, and a letter from Iowa's Department of Justice in response to our Freedom of Information request.

Conning's fairness opinion was delivered to Allied Mutual's board on November 2, 1992. If, at that time, Allied Mutual's directors—who owed a fiduciary duty to Allied Mutual and its policyholders—had *already* decided to amend the pooling agreement, then Conning should have been told about it, since it was a material fact. Had Conning been aware of the change, one presumes that it wouldn't have issued a fairness opinion containing a material misstatement.

If that presumption is correct, we can infer that on November 2, 1992, Conning wasn't told about the pooling-change filing that was to be made four days later. That would suggest two possible scenarios: 1) Allied Mutual's directors knew about the upcoming pooling change and didn't tell Conning, or 2) Allied Mutual's directors *didn't* know that they would decide to change the reinsurance pooling agreement a few days later.

Although Evans and Allied haven't answered our questions in the past, we're pretty sure that they would say that on November 2, when Conning was giving its fairness opinion, they had no plans to amend the pooling agreement. (It seems unlikely that they'd admit the alternative—that they knew about the change and deceived Conning.)

If we accept this scenario—that Allied Mutual's directors didn't know about the pooling change—then we'd probably have to believe something along the following lines: On November 2, after the Conning opinion was issued, Allied Mutual's directors approved and completed the stock swap. That afternoon, a senior executive at Allied Mutual came up with the idea of amending the pooling agreement. The idea was discussed with executives at Allied Group, who took the matter to their board (essentially the same people who were on Allied Mutual's board). Allied Group's board gave the word to proceed. Employees at the two companies *(all* employees worked for both companies) then agreed upon the structure of the new pooling agreement and hired lawyers to draft a term sheet. Once the term sheet had been finalized and reviewed by Allied Mutual's general counsel, it was submitted to the boards of Allied Group and Allied Mutual. During the two or three days that *all* of this activity took place, *all* of Allied Mutual's directors forgot about Conning's fairness opinion, especially the part about Allied Mutual benefiting from "economies of scale in shared resources and facilities." Because Allied Mutual's directors didn't remember Conning's fairness opinion, they approved the change in the pooling agreement and submitted the term sheet to the insurance department on Friday.

If this is John Evans' explanation, it's a tortured one.

In September 1997, *Schiff's Insurance Observer* published a long article about the asset shuffles and unusual intercompany transactions that had made a fortune for Allied Group and Evans—at Allied Mutual's expense. (There were a dozen transactions in addition to the pooling shenanigans described above.) We detailed how Evans had masterminded these transactions and we demonstrated that, because of his track record and irreconcilable conflicts of interest as a director and major shareholder of Allied Group, he was unfit to serve as a director of Allied Mutual.

David Schiff became a candidate for Allied Mutual's board. His plan—which was thwarted when an Iowa judge ruled, in effect, that Allied Mutual didn't have to hold a fair election—was to liberate Allied Mutual from Evans' clutches and return Allied Mutual's assets, which through contrivance and ingenuity, were then in the possession of Allied Group.

Schiff traveled to Iowa regularly, gave speeches, met with his brethren in the media, and wrote countless letters to the insurance department and to Commissioner Vaughan. That Vaughan did virtually nothing is a sad commentary on the inadequacies of state regulation, which has often been a race to the bottom in which legislators (and regulators), in the name of economic development, try to entice insurance companies to move to and remain in their state by permitting them to engage in practices not permitted in other states. Although we're not convinced that federal regulation is the solution, it does have one advantage over state regulation: it's more difficult to buy the U.S. Senate than a state senate.

Even when good laws are in place, insurance regulators are usually hampered by a lack of funding. (Although Iowa has an insurance fraud bureau, when we were there, it was inactive because it had no money.)

Being insurance commissioner usually doesn't lead to higher office, but it can lead to higher remuneration. Former commissioners often go to work for the companies they formerly regulated, or for law firms hired by the companies they formerly regulated. (One former Iowa commissioner was on Allied Group's board and another was Allied Mutual's lawyer.)

Although Commissioner Vaughan had a relatively small budget, she possessed something more powerful than money: a bully pulpit that could be used to take a stand against the kind of disgraceful transactions of which John Evans was a master. But Vaughan lives and works in Des Moines, a city where almost every large office building belongs to one insurance company or another. Taking on the insurance business in Des Moines is like taking on the movie business in Hollywood.

It's remarkable that the Iowa Department of Insurance finds time to crack down on penny-ante brokers. (On March 29, 1999 an insurance broker was fined $250 and his license was suspended because he failed to report a change of address to the insurance department.) Yet it looks the other way in matters involving *billions* of dollars.

Martin Frankel, who ran off with $200 million or so, is a wanted man. Because John Evans knew how to shuffle assets in a way that was approved by the insurance department, Allied Group ended up with $1.6 billion worth of assets that had once belonged to Allied Mutual. For his efforts, Evans made $50 million and now resides in Carmel and Palm Springs.

On May 5, 1998, after eight months of criticism from Schiff (and a lawsuit by a policyholder represented by Jason Adkins), Allied Mutual and Allied Group discontinued the amended pooling agreement that had piled expenses onto Allied Mutual. Allied Group didn't repay the $80 million that it had made off Allied Mutual, and Allied Mutual policyholders never got the chance to benefit from the *new* agreement: before the year was over, Allied Group was taken over by Nationwide for $1.6 billion. Concomitantly, Allied Mutual was absorbed by Nationwide Mutual in a transaction in which its policyholder-owners received virtually nothing.

As for Terri Vaughan, her lack of initiative proved to be a good career move. In an unusual move, Iowa's new governor (a Democrat), reappointed her even though she had been given the job by his Republican predecessor. It seems that Vaughan's look-the-other-way attitude had made her popular with powerful insurance companies who were glad to keep her in office. To them, she's like Calvin Coolidge, about whom Will Rogers said, "The people wanted nothing done, and he did it."

Step Right Up and See the Amazing Conseco!

Feats that Baffle the Ocular Spectrum

Stephen Hilbert, the silver-tongued insurance shaman who's chairman, president, and CEO of Conseco, is a piece of work. Over the last decade he's become rich by buying life insurance companies with borrowed money. Some nitpickers might dwell on some of Conseco's practices: the use of leverage, the really cool accounting, Hilbert's nifty dealings with an LBO fund formed by Conseco, the lavish stock-option plan, Hilbert's "sale" of his Conseco stock (acquired through options) to Conseco, Hilbert's fancy "reload" stock options, and the Trump Tower condo that Hilbert sold to Conseco. But who cares about nitpickers?

Some might say that Hilbert is a guy who delivers the goods. Others might say he's too smooth—that his perfectly polished pitch rings with so much chutzpah that they'd be scared to own his stock.

For the moment, all we're going to say is that the hundreds of millions of dollars that Hilbert has made from unloading his Conseco shares seem to agree with him.

Just look at him. Ten years ago he was a flabby schlub with oversized eyeglasses and a big gold bracelet on his wrist. Now he's lean, fit, and tanned—you might even say handsome. He dresses like a Master of the Universe and exudes absolute confidence.

Conseco's stock, however, is trading around 28—half its 1998 high, and a long way from the "closer to $70 than $50" that Hilbert predicted in the pages of the *American Banker* last year.

Earlier this year, Hilbert told shareholders that "in 1998, as before, we didn't spend much time wringing our hands about our stock price."

We haven't seen Hilbert's hands for a while, but if he isn't wringing them it may be because he's too busy cursing his stock's deflation. (Although any malaise he feels about his stock's collapse may be tempered by the hundreds of millions he garnered from selling it at advantageous prices.)

Actually, we don't buy Hilbert's line that he didn't do much hand wringing. Conseco is still leveraged, and the parent company is not rolling in free cash flow. And, indifference to Conseco's stock price is not a trait associated with either Hilbert or Conseco. On February 16, 1995, Conseco's general counsel, Lawrence Inlow, tried—by implied threat—to prevent 77-year-old Professor Abraham Briloff, the Emmanuel Saxe Distinguished Professor at Baruch College, from making a speech. The speech, slated to be delivered at a small insurance conference in New York organized by Executive Enterprises, was to be a dissection of Conseco's accounting practices.

In tortured syntax, Inlow wrote to Executive Enterprises, stating that while Briloff "purports to have only academic *interests* [emphasis added] in making [his] attacks, we are not convinced that academic discussion is his sole motivation." Implying that Briloff was in cahoots with shortsellers, he continued: "Professor Briloff often chooses examples for his scrutiny which also just happen to be companies with significant amounts of short-selling in their stocks."

Inlow wrote that Briloff's previously published comments had been made "under the guise of freedom of the press," but that "his appearance at your seminar would be taking these attacks one step further." Inlow claimed that Briloff's remarks at the conference "would constitute 'commercial speech' and, therefore, would be judged under a different set of standards." He stated that "to permit Professor Briloff to engage in his campaign to defame Conseco" (i.e., allowing the professor to give his talk) would be "unwise" and might "subject Executive Enterprises to potential liability."

Conseco's bullying failed. David Schiff was among the 20 or so people in the audience on March 3, when Briloff gave a great speech. Afterwards, Briloff inscribed Schiff's copy of Briloff's classic book, "Unaccountable Accounting." (Conseco had been invited to join in a debate, but declined.)

This brings us to Conseco's sale of 3.1 million shares of its stock to Warburg Dillon Read on June 29, 1999—one day before the end of the quarter. The sale—a forward roll—took place at $29\frac{1}{16}$. The final price, however, will be determined on December 15, when Conseco can either (1) repurchase the shares at the issuance price, or (2) have Warburg sell the stock. (If Warburg sells the stock for more than $29\frac{1}{16}$, it will give the excess back to Conseco. If it gets less than $29\frac{1}{16}$, Conseco will have to issue more shares to make up the difference.)

The purpose of the transaction appears to be twofold: 1) Conseco wanted an upgrade from S&P, and to accomplish this had to get its debt-to-equity ratio (not including preferred stock) below 25%. Issuing the shares helped do the trick; 2) Rather than sell stock at a guaranteed price of $29\frac{1}{16}$—which might seem puzzling after blabbing that its shares are undervalued—Conseco entered into a more complex transaction, betting that its stock would be higher on December 15.

While that may happen, we'd bet that it won't be anywhere near the $70 figure Hilbert bandied about last year. ■

An Important Notice

BEGINNING THIS MONTH, *Schiff's Insurance Observer* has made important changes that will provide you with better service. We've done a deal in which my friend, Reid Nagle, will become publisher of *Schiff's*. Reid's company, SNL Securities LC, has become a nonvoting shareholder in Insurance Communications Co., which owns *Schiff's*.

If you're not familiar with SNL, then you ought to be. It's a research and publishing empire (well, almost) that focuses on banks, thrifts, REITs, insurance, finance, and more. SNL employs about 200 people and publishes databases, newsletters, dailies, weeklies, monthlies, magazines, quarterlies, journals—you name it. SNL will be taking care of all the publishing, subscription, fulfillment, and financial activities for *Schiff's*.

Of course, I'll continue writing "the world's most dangerous insurance publication." Give me a call, send an E-mail, or mail a letter. (My top secret phone, address, and E-mail information is listed under "Editorial Office" in the masthead on page 2.)

For *publishing* matters—information about your subscription, giving a gift subscription, ordering from Mr. Pig's, receiving our new fax and E-mail service, etc.—please call my friends at SNL. They can be reached at (804) 977-5877. Their complete address and information is in the masthead under "Publishing Headquarters."

David Schiff

How MetLife Won WWII

Inventing History

"History is more or less bunk," said Henry Ford in 1916. "We want to live in the present, and the only history that is worth a damn is the history we make today."

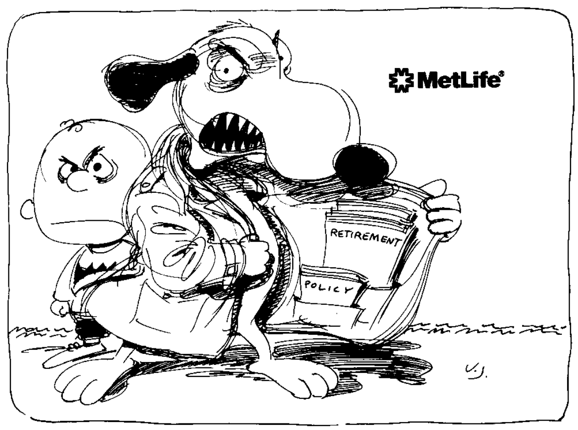
When you're really rich you can afford to *make up* history, much as Ford did through his newspaper, *The Dearborn Independent*, which published the anti-Semitic *Protocols of the Elders of Zion*.

The Metropolitan Life Insurance Company, whose roots go back to 1863—the year of Ford's birth—is, as evidenced by its new advertising campaign, also of the belief that history is bunk.

(Although we'll soon discuss MetLife's new propaganda, we'd be remiss if we didn't say something about the company's execrable behavior in recent years. In 1997 and 1998 it launched a massive assault against its policyholders, the goal of which was to enact mutual-insurance-holding-company legislation in New York, and elsewhere. At hearings held by Assemblyman Pete Grannis, MetLife's chairman Harry Kamen gave such misleading testimony—see "The Big Fix," *Schiff's*, February 1998—that it's sure to be omitted from the next installment of the company's corporate history. (For more, see *Dirty Harry Misses His Target* on page 12.)

For years, MetLife's advertising has relied on the warm feelings engendered by the "Peanuts" characters. Using the Peanuts gang made sense; after all, people *like* Charlie Brown and they don't like insurance companies. Although Snoopy is only a dog, he put a more human face on a faceless insurance giant than Harry Kamen ever could.

But times have changed, and Snoopy, who once battled the Red Baron, is passé. MetLife's new ad campaign, initiated several months ago, suits this year's "greatest generation" zeitgeist well. The two-page inaugural spread that appeared in *The Wall Street Journal* on March 15, tells how the company helped immigrants at the turn of the century, how it helped farmers during the Depression, and how it helped win World War II. Although MetLife does not claim that it helped save Private Ryan, it comes close.



History isn't bunk, but MetLife's ad is. Let's start from the top. "The best investment will always be in the human spirit," reads MetLife's ad. "For 130 years, MetLife has believed that social responsibility" is "good business" and is a "cornerstone" of the company's philosophy, the ad continues. "To us, one of the wisest investments a company can make is in the well being of its customers, as well as in the ideas, causes, and dreams they champion."

MetLife says that almost a century ago, out of concern for the newly arrived immigrants, it founded its Immigrant Service and Citizen Bureau, which helped tens of thousands of newly arrived people become citizens. Whatever the truth of this claim, it remained unmentioned by the company's authorized biographer, Pulitzer Prize-winning historian Marquis James (*The Metropolitan Life: A Study in Business Growth*, Viking Press, 1947). James had this to say about the political climate of the early 20th Century and about MetLife's concern for the huddled masses: "Working people remembered the long-standing opposition to organized labor; to the eight-hour day; to workmen's compensation; to the abolition of child labor and contract labor; to inspection of mines, factories, and workshops; to the use of public funds for the relief of private distress in hard times. Certainly the Metropolitan Life Insurance Company was the avowed champion of none of those measures"—even though the majority of its 5,000,000 clients were working-class people who owned industrial life policies.

MetLife's ad stretches the truth elsewhere: "When the Great Depression caused thousands of farms to fail, MetLife, through our Farm Management Program, stepped in to help individual farmers get back on their feet." That's one way of looking at it. James, who was paid by MetLife to write its history, had a different take: "Probably 50%" of the farmers who owed MetLife money "lost their land, at least temporarily, through forced sales." MetLife foreclosed on so much property that it became, with 2,000,000 acres, the largest owner of farmland in the country. There is, of course, nothing wrong with foreclosing on farmland when farmers are in default of their obligations. "Metropolitan could not lose sight of the fact that it was handling the money of its policyholders," noted James. Contrast this with Harry Kamen's statement that "borrowers" comprise one of MetLife's constituencies (See *Dirty Harry Misses His Target* on page 12.)

The largest part of MetLife's ad is an attempt to parlay the current interest in World War II for its own benefit: "History again beckoned during World War II, when MetLife helped the Allied cause by devoting a remarkable 51% of our assets to war bonds, a sum that was the equivalent of paying the salaries of 1.5 million soldiers for nearly four years. This support made MetLife the single-largest private *contributor* [emphasis added] to the Allied cause." Embellishing this statement are a dozen images from World War II: dogs tags, propeller planes, medals of honor, soldiers posing with the comrades, troops landing in amphibious carriers, Rosie the Riveter, soldiers on V-E day, and so on.

While it's true that MetLife was a large owner of government bonds—between 1941 and 1945, government bonds grew from 21.5% to 48.4% of the company's assets—a bond is not the same as "paying the salaries" of soldiers. A bond is a loan, and it must be repaid.

As for MetLife being the "single-largest private contributor to the Allied cause," James' authorized corporate history didn't see it that way: "Though eventually the company sent 6,702 men and women into the military services, its personnel difficulties were never comparable to those of the war industries." According to James, "the war did not turn the life insurance business upside down—as it did the automotive business, for example...In time of war...the life insurance firms preserved something of the normal way of life." In fact, the amount of life insurance in force rose about 20% during America's involvement in the war.

Furthermore, the opportunity cost of MetLife's $3.65 billion investment in Treasurys was borne by the *policyholders*: "The company's heavy investment in government bonds was the principal factor in the decline of its investment yield," wrote James. This caused "an increase in premiums and the reduction of dividends."

Finally, MetLife did not invest in government bonds solely out of patriotism. Chastened by its unwitting speculative investments (mortgages and railroad bonds) in the 1920's, chairman Frederick H. Ecker, became, like many others, risk averse to such an extreme that he was unable to differentiate risk from safety, speculation from investment. In 1941, for example, he helped defeat a bill that would have allowed New York life insurance companies to invest in common stocks. "If the stock is sound," testified Ecker, who was then 74, "the obligation [bond] of that company is more sound; and our belief is that we are wiser in adhering to the practice of buying the obligations rather than the equities in corporate enterprise."

In a letter of November 25, 1941—two weeks before America's involvement in the war—Ecker supplemented his testimony: "I say again, there is no place for common stocks in the life-insurance companies' portfolio." At that time the Dow Jones Industrial Average yielded 6%, while Treasurys yielded a meager 2½%. About six months later the Dow Jones would bottom out at 93 (that's not a misprint), while fixed-income securities were approaching a bear market that wouldn't end until 1984.

Although Harry Kamen wasn't willing to talk to us about MetLife's ad, John Calagna, of the company's public affairs office, was. "Our ads focused on certain events in our history that we're proud of," said Calagna, who didn't write the ads and shouldn't be held accountable for their wretched content. "We feel good about our history."

We forgot to ask Calagna whether anyone at MetLife had *read* the company's history.

Dirty Harry Misses His Target

Does Charles Schulz Know About This?

On October 8, 1997, at a public hearing held by the New York State Assembly's standing committee on insurance, Harry Kamen, then MetLife's CEO, gave a fascinating display of corporate arrogance, validating the distrust that many people feel about insurance companies. His testimony was bad for the insurance industry and, more significantly, contrary to the interests of MetLife's mutual policyholders (though not contrary to the interests of MetLife's senior executives).

Kamen is a fair-skinned, unobtrusive looking fellow, and if you've seen him on the tennis courts at the East Hampton Tennis Club, where he and David Schiff have been members for the past 30 years, you'd never suspect that this nebbishy-looking guy who appears as a smiling "Peanuts" cartoon character in MetLife's 1997 annual report is, in reality, a cunning flimflammer who'd think nothing of taking Linus's blanket or pulling the football away when Charlie Brown tries to kick it.

At the New York State Assembly's public hearing, Kamen claimed that MetLife would be at a terrible disadvantage if it couldn't adopt the mutual-insurance-holding-company structure (a structure which would have deprived MetLife's policyholder-owners of the value of their company), and that MetLife needed to make acquisitions for stock under the mutual-insurance-holding-company structure in order to remain vital. He didn't explain why he couldn't merge with other mutuals, such as next-door neighbor New York Life (which also claimed it would be at a disadvantage if it couldn't become a mutual insurance holding company and buy companies for stock). Nor did Kamen give a good reason why MetLife couldn't do a full demutualization and then make acquisitions for stock.

Kamen scoffed at public-interest-lawyer Jason Adkins' statement that MetLife was worth about $36 billion, or $3,000 per policyholder (the source of Adkins' estimate was the editor of the world's most dangerous insurance publication). Instead, Kamen asserted that MetLife was only worth $12 billion, its statutory capital. (GAAP book value was around $14 billion, and most decent life insurance companies are bought or sold at multiples of GAAP book value.)

Moments after testifying that MetLife wasn't worth much, Kamen did an about-face and said that *other* companies—ones MetLife might like to buy—were worth sizable multiples of GAAP book value. (Kamen said he needed stock to buy such companies.)

Given Kamen's testimony about what it cost to buy life insurance companies, didn't he know that his $12-billion figure for MetLife was ridiculously low? Perhaps more importantly, did he use that $12-billion figure anyway, in an attempt to discredit Adkins and to make a full demutualization (in which policyholders would receive their fair share of the company) appear less lucrative for policyholders? Since Kamen has never returned our calls, we presume he is unwilling to answer these questions.

Kamen's disdain for his mutual policyholders, and for history, was remarkable. He did not refer to MetLife's mutual policyholders as "owners"—doing so might entitle them to their equitable share of MetLife—instead, he called them *constituents*. He also characterized as constituents holders of MetLife's surplus notes, and people who lived in Peter Cooper Village and Stuyvesant Town—*investments* owned by MetLife. Later, in a letter to *The Wall Street Journal*, he added a new constituency: those who had borrowed money from MetLife.

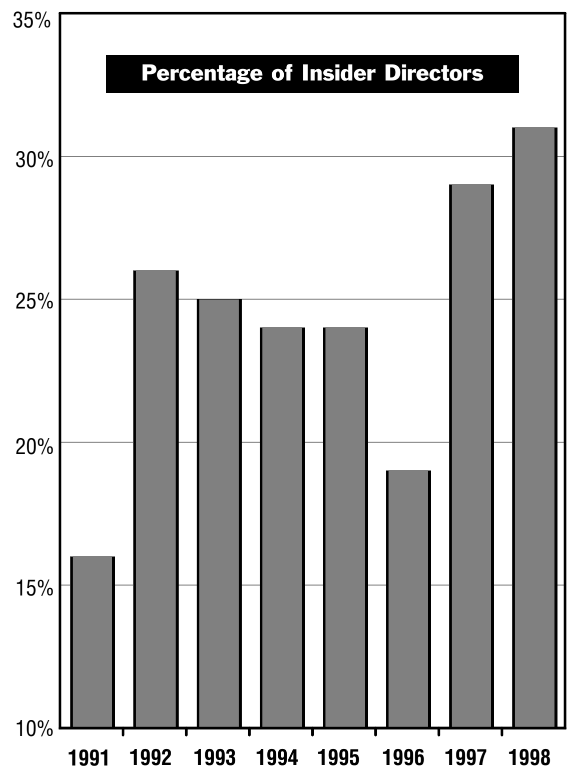
Kamen, professing to be concerned about the public weal, said that if the mutual-holding-company bill was not passed it would be bad for New York State and New York City. He suggested that jobs, revenues, and taxes could be lost, and that MetLife might move elsewhere.

As we predicted, Kamen's expensive and time-consuming effort to deprive MetLife's policyholders of their company backfired. MetLife is now demutualizing, which it could have done years ago—and should have done if it wanted to make acquisitions for stock and grant stock options to management. (We have never argued that mutuals should demutualize. It has been our position that if they choose to do so, then they should do full demutualizations in which the value of the company is distributed to policyholders, generally in the form of stock or other consideration. We are opposed to mutual insurance holding companies and to Pennsylvania-style subscription-rights demutualizations, in which policyholders receive nothing, company insiders receive plenty, and conflicts of interest abound.)

Good grief, Harry Kamen!

MetLife's Inside Job: Board of Directors

The percentage of MetLife directors who are either current employees or retired employees has almost doubled since 1991. Back then the company had 19 directors, two of whom were employees and one who was the retired CEO. Now MetLife has 16 directors, three of whom are employees and two of whom are retired CEOs.



Update on Misleading Advertising

The IMSA Follies

Our last issue contained a lengthy article documenting dozens of examples of deceptive advertising and sales practices employed by insurance companies.

The insurance companies' response has, for the most part, been exactly what you might expect: they haven't changed a thing.

General Electric still implies that it provides some sort of extra-special guarantees to its insurance-company subsidiaries.

Frontier's United Capitol still advertises that it is rated "A" when, in fact, it's rated "A-" by Best.

AIG runs an ad that states in big letters, "because our reputation is solidly backed by Triple-A-rated financial strength, you can rest assured that the AIG Companies will be there for you." The fine-print disclaimer at the bottom implies otherwise. Perhaps that's because the AIG *Companies* will not be there for you—the only insurance company that will be there is that one that issued the policy.

And MassMutual would have you believe that funds held in its money-management subsidiaries are available to pay insurance claims.

To the best of our knowledge, the only insurance company mentioned in our article that's corrected its marketing is Condor, a subsidiary of Amwest.

Of course, why should an insurance company change its ways just because of an article in a quaint insurance newsletter? Indeed, it would be presumptuous for us to assume that *every* company we mentioned had even read our words.

We did, however, write to MassMutual to inquire about its misleading ad. We also asked if the company approved of the practices of one of its agents, Chase Insurance Agency, which was selling life insurance under the name "Chase Manhattan Private Bank," and using a sales illustration that mentioned a "premium vanish plan." (These practices are prohibited in New York State.)

MassMutual didn't respond to our letter. We also wrote to the Massachusetts Insurance Department and to the New York State Insurance Department. (The sales illustration in question had been made to a New York resident.) Guess what? Neither of these state agencies responded, either.

We also wrote to the Insurance Marketplace Standards Association (IMSA), which claims to be dedicated to ethical market conduct in the advertising, sale, and service of individual life insurance and annuities. IMSA's consumer brochure says that its members (most major life-insurance companies) must "review [their] advertising materials regularly to assure that they are honest and clear."

Because IMSA's mission is nothing less than ethics itself, we felt certain that our lengthy letter to executive director Paul Mason would elicit a response. It's been six months, however, and we haven't heard a word.

Perhaps IMSA has been too busy to respond. Earlier this year it kicked off a promotional campaign with full-page advertisements in *Best's Review*, *Broker World*, *Independent Agent*, *Life Association News*, *Life Insurance Selling*, and *The National Underwriter*. IMSA's website noted "plans to publish a full-page advertisement in the April 2nd edition of *USA Today*." The ad, the website explained, was designed "so IMSA member companies can reprint [it] to promote the company's IMSA membership to consumers and agents."

IMSA's website also said that "Paul Mason will be available through a series of media events to provide updated IMSA information to interested parties." Although we're a member of the media and an interested party, it seems that IMSA prefers to talk to interested parties that are not *too* interested in ethical market conduct.

That IMSA is a sham isn't really a surprise. It's not an independent watchdog; it's a creation of the life-insurance industry and is run out of the headquarters of the American Council of Life Insurance (ACLI). As far as we can tell, IMSA is as interested in ethics as J. D. Salinger is interested in appearing on the cover of *People* magazine.

IMSA is in reality a marketing tool whose top-secret mission is to burnish the life-insurance industry's reputation by providing its "member companies" with the imprimatur of the IMSA logo. Many unknowing purchasers of life insurance will undoubtedly mistake that logo for an independent, unbiased seal of approval.

Perhaps that's the ultimate irony: that IMSA, an organization purportedly dedicated to ethical market conduct in the advertising, sale, and service of individual life insurance, can be used by its members to advance their use of unethical market conduct, lack of disclosure, and misleading advertising.

The IMSA seal of approval has the same value as a degree from a mail-order diploma mill: it's worth the paper its printed on.

Agents and Brokers: Thoughts on the Market

"Burn Your Way Out"

In May we received a phone call from a subscriber, an insurance agent in South Carolina, who told us something unusual: "We're seeing *price firming* in the $50,000-to-$250,000-premium account in South Carolina."

Although chief executives at many insurance companies have claimed to see price firming, we've tended to discount their words because most of them are so far removed from the playing field that they're like football coaches forced to do their jobs from the Goodyear blimp.

But our subscriber in South Carolina—we'll call him "Rowland Berigan"—runs an independent agency with a dozen employees, and, like most agents, knows his clients personally and has to answer to them if he wants to stay in business. Unlike big-insurance-company CEOs, independent agents don't have golden parachutes, the cost of which can be passed on to shareholders (or, in some cases, mutual policyholders). If an agent screws up, the "downsizing" that occurs will be in his lifestyle; if one of the big boys screws up, that's not necessarily the case. (Take Saul and Robert Steinberg, brothers who together own 41% of Reliance Group. In 1998 they received $6.3 million and $6 million in bonuses, ostensibly for the fine job they did. But in August 1999, Reliance announced that it was $227 million underreserved—a figure that approximates 1998's operating income. Question: will the Steinbergs return their bonuses?)

Anyway, back to Rowland Berigan, who said that he was seeing premium increases on "all types of commercial accounts." While he singled out auto, he told us the firming was pretty much across the board: "The trucking market in South Carolina has grown extremely tight." Harleysville is firming, and CNA is aggressively trying to get price increases. (Exactly how does a company get price increases these days?) "The other markets are getting a lot more picky," too.

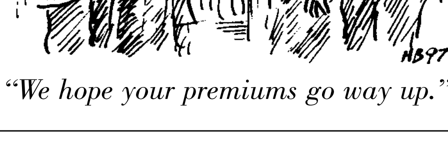
While we don't doubt that Berigan was telling us what he was seeing, he's just one agent in one region who sees a limited amount of business. We wanted to know whether anyone else was seeing the same thing.

Thus began our search for signs of the price firming that's been alluded to by the guys who run publicly traded insurance companies. Our search wasn't conducted in a manner that would yield statistically significant results. For that matter, we're not convinced that statistically significant results would be significant. Even if one could determine that rates or written premiums were increasing, it would be difficult to say whether they were increasing *relative* to risk, exposure, or policy terms. Limits might be higher or coverages might be broader. Insureds could be using higher deductibles or self-insurance programs—although at these prices, why bother? Or they might be doing the opposite.

We soon got ahold of a smart and energetic agent we know as "Doc," who told us that he'd experienced firming with "one carrier—and one carrier only—the Hartford." He said he'd been shocked when he submitted "an excellent risk" to them—$50,000 plus—and they said, "No thank you."

In Doc's territory—a town that saw its heyday many generations ago—$50,000 accounts are big accounts, and he could hardly believe that Hartford hadn't even considered this one. "It was an excellent risk," he said again, also noting that Hartford had once been a good market for stand-alone workers' comp. "They would deviate it," he said. "Now they're not doing that."

Discussing the market in his area, Doc said that "Erie Insurance isn't as competitive anymore." (Of course, not being "as competitive" isn't the same thing as raising prices.) Travelers, said Doc, was the most aggressive company—it "still throws the rulebook away and does whatever it pleases."



"We hope your premiums go way up."

Doc was sounding rather gloomy. "Personal lines is very tough." He said he was feeling competition from GEICO, the Internet, and payroll-deduction programs. To hear him tell it, there are dozens of companies fighting for every piece of business in his town. And there are too many insurance brokers and not enough business.

"Why don't you merge with some of the other brokers?" we asked.

"I can't find many people I'd want to merge with."

Listening to Doc, you'd think that his business is absolutely terrible, but it's not. "I'm growing," he said, "but I'm concerned about my future five or ten years out."

We continued our search and eventually got around to chatting with our man in Iowa, Ted Zylstra, who runs the Tulip City Agency in Pella. "Rates have stopped going down—perhaps," Ted remarked. He said he was seeing "a little hardening" in personal lines, and had noticed that the markets "are not being quite so forgiving" for poor risks.

"I think workers' comp has bottomed out," he continued. "Our January 1 rate change was a non-event, and a number of classifications went up. You don't have all the stand-alone workers' comp carriers looking for business. We were getting hit on once a week, but I don't seem to be hearing from them anymore."

Ted doesn't see commercial rates heading up, but he wasn't upset. (He spoke highly of Cincinnati Insurance Company and of West Bend Mutual, a regional company that writes mainly in Wisconsin, Illinois, Iowa, and Minnesota.) "We've been able to put business on the books. If 1999 continues as it has, it's going to be a really good year."

Our hunt for signs of rising rates continued, and eventually took us to Michigan Slim, one of our many agent friends.

"The insurance business is still contaminated," Slim said. "They can't give it away cheap enough. CIGNA, Chubb, and CNA have said they need minor increases, but prices are so low compared to what they were—and medical costs, legal costs, and jury claims haven't gone down. You wonder, what kind of business is this? How much were they overcharging five years ago?"

Slim didn't say anything that could please an insurance company. "Hartford and Citizens (Allmerica) are buying business. So is Travelers. No old house is up to code. I won't write a policy unless it's written at replacement cost based on current building codes. I don't want an E&O lawsuit. Agents should be aware of E&O claims, but they just want to make a sale," he said, fed up with everything.

"What is this business coming to? The average American citizen will be buying over the Internet because it's cheaper. Agency expenses are going up. GE, AIG, and Hartford are giving 30% or 40% off on groups. The cost of fixing a car is mind-shattering. A little ding is $400."

Speaking of virtually every insurance company he does business with, Slim said, "The policies *issued* by the insurance companies are atrociously wrong. If you need to correct them, it takes months. They've cut expenses by eliminating help."

Before we ended our conversation, he repeated an old saw that's probably true: "On a broker's good business you're overpaying, and on the bad business you can never pay enough."

There was a time when "Manley Halliday" loved State Farm, for which he's been an agent since its premiums were around $500 million. (They were $35 billion last year.) He speaks fondly of the "marketing partnership and relationship" that State Farm *once had* with its agents.

"The future for independent-contractor agents at State Farm is very much in jeopardy," said Halliday, who believes that State Farm is on the road to becoming a direct writer or Internet-based insurance company, rather than an exclusive-agent company. (While we're skeptical of Halliday's thesis, we find it worth pondering.)

Halliday continued: "State Farm's management has decided to fix what isn't broken—the State Farm marketing agency. On one hand, State Farm says there will always be a State Farm agent. What seems to be happening," Halliday explained, "is that its definition of what a State Farm agent is, is markedly different from what it was in previous years. In Arizona, its opened a 'full service' office with more than one agent—and claims-and- service people *who are State Farm employees*.

"The management team is trying to coerce and cajole agents to accept a new contract that would have remuneration based on profit and loss—and on life insurance sales."

None of this strikes us as bad business, but it sure as hell bothers Halliday and some other State Farm agents. From our perspective, however, it seems that State Farm is trying to retain a balance between the exclusive-agency organization that has served it well for 50 years, and the reality that its largest line—auto insurance—will become ground zero in the Internet insurance war. (By the way, the war hasn't really started yet; companies are just moving their troops into position.)

"State Farm is opening up Connecticut." Halliday said angrily: "The agents are State Farm *employees* rather than independent contractors," and were being paid a 4% commission. "You can't run an agency on that commission structure, so, obviously, State Farm is going to run it."

State Farm had no comment on its commission structure, but for years we've been saying that, for the most part, there's not a lot of room for commissions in personal auto.

"Agents are demoralized that the future doesn't include the old line," Halliday concluded.

We noted that Allstate and Nationwide have been aggressively expanding their distribution systems (moves we have some doubts about), and asked whether reduced commissions and lower expenses weren't something of a necessity. And by the way, what about the market firming?

Halliday said that it wasn't essential to have the lowest price—he'd been doing fine without it.

After chatting with brokers across the country we decided that the reported price firming is like sightings of the Loch Ness monster—people talk about it but no one sees it.

So we met with an old friend who goes by the name "Irving Pilgrim" (but only when he's criticizing companies that he does a lot of business with). "We don't see signs of firming," Pilgrim said. "Rates aren't going down; they're staying even. We seeing a flattening of the market. The carriers were once using HPR (highly protected risk) loosely; they now seem to be retreating. They're becoming stricter about their underwriting standards." He added that this hadn't led to any increases in premiums or rates.

"Some of the business is moving from the more responsible companies to what we call 'the village idiots'—the companies that are still writing aggressively."

According to Pilgrim—a very successful broker in New York who has been around for a long time—not being aggressive, at least under certain circumstances, can also be a problem. "Chubb is being idiotic. They're asking for increases 'on the basis of principle.' They're chasing away the good business. We can't sell renewals at higher rates to companies with good loss ratios! Chubb is going to lose good business and suffer from adverse selection."

Insurance companies have been faced with this sort of dilemma for 200 years. Should they pull back or withdraw from the market—and damage their relationships in the marketplace? And if they pull back, what do they do with their infrastructure (middle management, underwriters, claims examiners, and the fancy chef in the private dining room)?

Should the companies grit their teeth, bear the financial pain, and wait for an upturn? Should they hedge by laying off more risk on reinsurers (who may not be around to pay claims ten years down the road), or should they continue writing business and hope that redundant reserves and some future underreserving can get them through the cycle? But what if the cycle refuses to turn in time?

In the overcapitalized property-casualty market, underwriting has become a balancing act. If you're a public company and you err on the side of conservatism, your company becomes a target for takeover. (We have no objections to that, but the guys who run the companies hate it.) Throw conservatism to the wind, however, and there's a good chance that the numbers will get ugly sooner or later.

As Ted Zylstra, our man in Iowa, said of insurance companies, "Buy your way in, burn your way out."

The Early Days of Insurance Broking

"The Risks of Losing Money Are Slight"

The first insurance brokers appeared on the New York City scene after the Great Fire of 1845 had decimated many of the local insurance companies. Prior to that time, there hadn't been much need for brokers' services: coverages had been rudimentary, and property insurance limits in excess of $100,000 were unusual. Most insurance companies operated as direct writers or through captive agents and wanted nothing to do with the brokers. But as the city grew, a number of enterprising businessmen induced some local insurance companies to pay them a commission for bringing in business. By the late 1850's there were about 50 brokers in New York, and they were prospering.

"The Panic of 1857 caused many merchants to fail," said one of New York's first brokers, Cornelius DuBois, of Frank & DuBois, in 1907 (in a speech that is the source of much of what follows). "Something had to be done by their friends to provide for them. In this way, a number of additional insurance companies were started, for no other purpose than to give the presidency to some merchant who had failed."

According to DuBois, the brokerage business was also populated by losers. "Men who had been unsuccessful in other lines of business" became brokers because the business required no capital, and they wasted no time "importun[ing] their friends to allow them to attend to their insurance." (Professional licensing standards barely existed: a man needed just two customers, each paying $2 in premium, to be registered as a broker.)

As the property-insurance industry grew, independent agents and brokers began exerting greater control over the placement of insurance business, forcing insurance companies to compete harder for business. This led to upward pressure on commissions and downward pressure on premiums. By the 1860's, agents had gained binding authority, something that would, over the next 130 years, cause severe losses to companies that handed the pen to the wrong people.

In 1862, when the New York Board of Insurance Brokers was formed, commerce was primitive. Gold bars—not Internet stocks—were viewed as a repository of value, the Atlantic Cable and the telephone didn't exist, and the widespread commercial use of electricity was more than a generation away. The telegraph was just catching on. Indeed, so primitive was the business environment that "the universal practice of employing stenographers in one's office had not yet commenced," DuBois recalled.

America was growing rapidly, however, and expansion led to private fortunes and an increasing density of property value. The confluence of money and property created a greater demand for insurance, and—in brokers' minds—a greater need for insurance brokers. Insurance companies (which tended to view brokers as rapacious salesmen looking for an easy buck), thought otherwise.

The battle between brokers and insurance companies peaked in 1868, with the distribution of a circular signed by 26 insurance companies, which read in part: "The insurance brokerage system is, in the judgment of the undersigned, an evil to both Insurance Companies and their customers, with little compensating good."

Brokers were blamed for everything from an increase in the "voluntary destruction of property by fire," to inducing insurance carriers to "accept risks of character so doubtful...that they should not be insured." (Judging from lawsuits involving Unicover and Stirling Cooke, one might argue that little has changed. On the other hand, we're not aware of any instance in which a broker *forced* a carrier to write a policy.)

The insurance companies' diatribe concluded: "Customers can place their own insurance better than brokers can." The circular did not achieve its objective; within 40 years 19 of its 26 signatories were out of business. Meanwhile, the brokers flourished. In 1874, New York City had 147 insurance companies and 362 brokers. By 1907, 95 of those insurance companies were gone, while the brokers' ranks had grown to 7,730.

DuBois, who made his living from commissions, was not—at least in 1907—of a mind to bite the hand that had fed him: "I yield to no man in this city in my admiration and respect for...the majority of underwriters...who try to do right." Instead, he reserved his criticism for insurance policies with lots of *exclusions*, which he referred to as "phraseology [that] would debar the Company from admitting [its] liability." (By present-day standards, many of the old exclusions sound arcane: some policies, for example, excluded coverage if an insured operated his factory at night.)

Reinsurance was not common in DuBois' era, and insurance for large risks was generally arranged by having *all* companies write a small policy. Not surprisingly, DuBois felt that it was necessary for a broker to remain on friendly terms with *all* underwriters.

Many of DuBois' observations still hold true. "I know of no other business that is capable of producing such satisfactory results, in return for such a small investment of money, as the insurance brokerage business," he said. "One can conduct a modest business on little or no capital, and an exceedingly large business on less capital than it would take to run an insignificant factory of very modest pretensions."

As DuBois correctly noted, "The risks of losing money are slight." (He knew that the same could not be said of underwriting.)

These days, it's common for folks to speak of "core competencies" and "niches." While those words—in connection with insurance—might have confused DuBois, *his* words about making money in the insurance business—"A specialty is what brings [it] in: whether on one line or another, it matters not"—demonstrate that the basics don't change as rapidly as we like to think.

DuBois understood what many after him came to realize: "The [insurance] companies remunerate you for bringing them the business originally, and they keep on remunerating you for not taking it away...The broker can secure new customers every year and his income becomes larger as he grows older...These are the reasons, gentlemen, why one prefers brokerage to underwriting."

Mutual of Omaha, Sort of

A Modest Proposal

Over the past couple of years we've written hundreds of pages of letters to state insurance regulators. We've requested documents that we had a right to see, urged fair treatment for policyholders, and asked questions. Our letters have generally been ignored.

That's why we didn't bother to write to Timothy Hall, who was Nebraska's insurance commissioner, to object to his decision earlier this year to permit Mutual of Omaha to keep the word "Mutual" in its name in the event that it demutualized. (Hall had told Mutual of Omaha that it would have to include a disclaimer stating that it was a stock company.)

Had we written to Hall to protest his decision, we'd have explained why permitting a stock company to use the word "mutual" in its name is inherently deceptive and misleading: people would invariably mistake the company for a real mutual, regardless of any disclaimer.

We didn't write that letter to Hall because we suspected that our words wouldn't have any effect. Besides, our pals at the Center for Insurance Research had already written a good letter.

We wrote a different type of letter to Commissioner Hall: one in which we said we were considering forming a Nebraska-domiciled stock insurance company called Mutual of Nebraska. We told him that we believed that using the word "Mutual" in the company's name would help us sell insurance, as many prospects would be likely to mistake the company for a *real* mutual and therefore think that it would be run for their benefit rather than for ours. To meet the rigorous standards of the Nebraska Insurance Department, we offered to include a disclaimer that our to-be-formed faux mutual was a stock company.

Jeanette Smith, general counsel to Nebraska's Department of Insurance, responded to our modest proposal, sending a checklist of information that's required before forming an insurance company in Nebraska. She also included sections of the Nebraska Insurance Code that address insurer names. Section 44-352, which she highlighted, states that it is "unlawful for any insurance company to permit the use of its name...in such a way as to deceive or mislead the public."

We were taken aback. Wouldn't Mutual of Omaha, which employs many people in Nebraska, be deceiving and misleading the public if it became a stock company and continued to use "Mutual" in its name? And why would an insurance commissioner permit such blatant deception and misleading behavior?

"Schiff's" insurance company

The reason is simple. In Nebraska, an insurance company is permitted to engage in deceptive and misleading behavior, provided that the insurance commissioner says that this deceptive and misleading behavior is not deceptive or misleading.

Section 44-6113 of the Nebraska Code states that a mutual insurer converting into a stock company "may continue to use the word 'mutual' in its name if (1) the name includes a word or words that identify the new stock insurer as a stock insurer, and (2) [the commissioner] finds that the continued use of the word 'mutual' in its name is not likely to mislead or deceive the public."

The Nebraska code does not explain how a commissioner could find, as Hall did, that the public is not likely to be misled or deceived if a stock insurer calls itself a mutual.

As for our "Mutual of Nebraska," it's open for business (but only in Nebraska). We have not obtained, or even applied for, a license to operate an insurance company in Nebraska, and don't intend to. Such formalities are time consuming and can be a real hassle, especially for a small company.

Mutual of Nebraska is eager to appoint agents to sell its products. No prior experience is necessary, and the sales-training program is a snap. All an agent has to do is learn the company's slogan, a catchy Latin phrase that will probably mislead or deceive the public: "caveat emptor."

A Matter of Control

AIG's LARGEST SHAREHOLDER is Starr International Company (SICO), a Bermuda corporation controlled by AIG's senior officers. AIG's most recent proxy statement revealed that "SICO held 169,666,944 shares, or 13.67% of the outstanding AIG common stock."

"Schedule Y" is an organizational chart included in insurance companies' statutory filings. SICO is at the top of AIG's Schedule Y. AIG owns 65% of 20th Century Industries, an insurance holding company that specializes in low-cost, direct-written, preferred-risk automobile insurance.

Question 7(a) in the "general interrogatories" section of insurance companies' statutory statement, asks the following: "Does any foreign (non-United States) person or entity directly or *indirectly* [emphasis added] control 10% or more of the company?"

In its annual statement for year end 1998, 20th Century answered "no" to question 7(a). At that time SICO indirectly controlled more than 10% of 20th Century. Hank Greenberg was chairman of AIG and 20th Century.

While this matter is no big deal in itself, it raises an interesting issue: does anyone at insurance departments bother to read the stuff that's filed with them?

The California Insurance Department, 20th Century's primary regulator, couldn't have paid too much attention to the Schedule Y showing that 20th Century was part of the AIG holding company group. That's because the Schedule Y was illegible: it was in print so small that it couldn't be read, even with a magnifying glass.

Although, AIG's organizational chart is complex—there are about 600 subsidiaries—there is no good reason to file an unreadable chart. On the other hand, AIG is so complex that no one can understand it anyway.

By the way, we hear that Arizona demanded a legible copy of the Schedule Y.

A World of Risk, An Era of Speculation

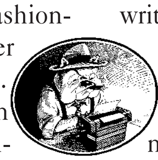
Register Now for "Schiff's Insurance Conference"

Whither the insurance industry? Convergence, downsizing, diversification, soft markets, consolidation, catastrophes, and shifting distribution channels have created a "new era." Or so many would have you believe.

History, however, might lead you to a different conclusion.

Yes, the insurance industry is at a crossroads. It *always* is. The conditions affecting the industry today aren't precisely the same as they were in the past, but they aren't so different, either. As in baseball, the players and teams are always changing, but the rules remain pretty much the same.

Insurance has always *appeared* so attractive: insurance companies generate cash and accumulate assets. It is fashionable these days to invest a greater proportion of those assets in stocks. As little old ladies in Beardstown will tell you, stocks always appreciate over the long haul. Risk, apparently, does not exist.



Good times are intoxicating, and it's human nature to take the recent past and extrapolate it far into the future. Thus, personal auto insurance will always make money, and acquisitions will lead to greater profitability. While most insurance companies claim that they're focusing on their "core competencies," their definition of "core competencies" seems to change every five or 10 years.

When a major insurance company with a long, checkered past recently announced that it was boosting its loss reserves by $150 million to $250 million, analysts, rating agencies, and the financial press all expressed the same reaction: surprise!

Schiff's Insurance Observer has written many an article about this company over the last seven years, so we weren't surprised: we were shocked, shocked that others were surprised.

Like pork bellies, insurance is a commodity whose price is ultimately established by supply and demand. Demand for insurance is relatively stable. The supply of insurance, on the other hand, is unstable—mainly because it exists in the minds of underwriters, insurers, reinsurers, rating agencies, and (occasionally) insurance buyers. Unlike newsprint, bananas, and Tommy Hilfiger clothing, insurance capacity can be created out of thin air, with the stroke of an underwriter's pen.

The insurance industry is cyclical, although the cycles don't recur according to any printed timetable. They recur due to the very nature of markets: profits encourage new players to enter the business, which puts pressure on prices, which causes profits to shrink and, eventually, to disappear. Losses drive the marginal players out of business, which creates a shortage of capacity, which causes prices to rise, which creates profits, which entices new capital into the industry, which causes the cycle to repeat itself.

Despite vast historical precedent, many would have you believe that the underwriting cycle has been eradicated. Even if, somehow, that were so, has the economic cycle become defunct? Are we to believe that economic cycles have no effect on the insurance business? Have variable annuities, for example, become a staple, or is the demand for variable annuities tied to the demand for stocks, which is joined at the hip with economic prosperity?

For that matter, are insurance companies in the insurance business, the investment business, or the financial-services business? Are they spreaders of risk, managers of risk, accumulators of assets, or, simply, unwitting accumulators of risk?

If banks want to enter the insurance business, one presumes it's because opportunities in the banking business are less attractive. If that's so, why do insurance companies want to become bankers, or quasi-bankers?

If property/casualty rates are inadequate, why is growth desirable? How many competitors does it take before a "niche" ceases to be a niche? Why do many stock insurance companies repurchase shares above book value while mutuals demutualize by selling shares below book value? And how can every insurance company achieve its stated goal of double-digit growth and a 15% return on equity?

Our speakers (who are listed in the next two columns) will delve into these questions and others, and provide a haven of reason in an insurance world filled with madness.

JEFFREY GREENBERG, president of the **Marsh & McLennan Companies**, is a true insurance industry insider. He spent 17 years at AIG, was chairman of Marsh & McLennan Capital, and is a director of ACE Limited. Jeff, who will become CEO of Marsh & McLennan by the end of 1999, has had a rare view from the top of the industry, and he will share that view—and his experiences and insights about relevant matters—with us.

After graduating from Harvard Business School at 21, **WILLIAM R. BERKLEY** began his career managing money. He gravitated to insurance because he considered insurance companies to be attractive investments. Today, **W.R. Berkley Corporation**, which Bill started at the ripe old age of 22, is a billion-dollar insurance holding company. (Bill does not limit himself to insurance; in his spare time he has run a host of other businesses, including those in banking, chemicals, distribution, food, and money management.) Bill has always had an eye for value, an awareness of risk, and a willingness to act independently. He will tell us what he's thinking about these days.

JAMES GRANT, editor of ***Grant's Interest Rate Observer***, is a writer and financial historian of unparalleled erudition. His métier is "markets," which encompasses everything from the Baltic Freight Index, gold, and insurance companies, to overvalued Internet stocks, undervalued Japanese securities, and the demand for credit. Way back in the 1980s, Jim was the most vocal (and eloquent) critic of junk bonds (and junk-bond laden life-insurance companies). Jim is the author of several books, including the classics *Money of the Mind* and *The Trouble With Prosperity*. His comments will be of great interest to folks in the insurance industry. Insurance companies, after all, are essentially risk-taking investment pools that employ financial leverage.

One problem with most security analysts is that they work for big Wall Street firms that are often too eager to garner lucrative underwriting and investment-banking business. That environment is not ideal for independent thinkers. **V.J. DOWLING** is the proprietor of **Dowling & Partners Securities**, an independent institutional stock-brokerage firm that specializes in property/casualty stocks. V.J. is from the old-fashioned school of security analysis—he focuses on fundamentals rather than on "momentum," market psychology, new-age economics, or other mumbo jumbo. He subjects insurance-company balance sheets to microscopic analysis, scrutinizes loss reserves and reinsurance treaties, and understands—in our opinion, better than any analyst—the underlying factors that drive the industry and the companies. A prolific writer and compelling speaker, he will share his outlook on various sectors of the property/casualty industry, and tell us where he sees value (or lack thereof).

CHRISTOPHER DAVIS is no stranger to long-time readers of *Schiff's Insurance Observer*. Five years ago we wrote a glowing profile of the then 29-year-old thoroughbred money manager who loved insurance stocks. At that time the **Davis Funds** had $300 million under management. Today the figure is $25 billion. Before entering the investment business, Chris considered becoming an Episcopal priest and got his Masters in philosophy and theology. (His grandfather, the insurance investor Shelby Cullom Davis, later told him that this was the perfect training because "in the investment business you need your philosophy and then you've got to pray like hell.") Mutual funds co-managed by Chris have received Morningstar's highest rating: 5 stars. Chris will talk about how he does what he does and, perhaps, share the secret of the "Davis double play."

JASON ADKINS is an indefatigable consumer activist and lawyer who has helped bring about a revolution in the mutual insurance industry. After working for Ralph Nader he founded the Center for Insurance Research, which has waged (and, for the most part, won) an epic battle against abusive demutualizations and mutual-holding company conversions. Jason, a partner at **Adkins & Kelston, P.C.**, is a forceful advocate for proper disclosure, fairness, and the public interest. His thoughts on the insurance industry, dissemination of information, and regulation will fascinate and surprise you.

DAVID SCHIFF began working—reluctantly—in the insurance business in 1974. He has held a number of jobs over the years, the best of which has been writing ***Schiff's Insurance Observer***, which he founded in 1989. In addition to ~~interrogating~~ chatting with the other speakers, David will have his say on the great insurance issues of the day.

The Weirdest 'Billion-Dollar' Insurance Business

Warning Flags at Unistar Financial

Beginning Saturday, July 16, I published a series of columns in *SNL Insurance Daily* that broke an unusual story about Unistar, a dubious insurance business whose stock was trading at a $1.5-billion market capitalization on the American Stock Exchange. Unistar's "reinsurers" include many prominent companies. My columns interested a sufficient number of people that my phone began ringing incessantly. It didn't stop for a week.

Although the columns were copyrighted and distributed to a limited audience of institutional investors, the text, or its content, soon made its way to reporters, analysts, insurance-industry executives, and Internet chat rooms. (Later in the week *SNL Insurance Daily* put out a press release, available on PR Newswire.)

By Wednesday, trading in Unistar's stock was halted on the American Exchange. On Thursday, by which time I'd published about 6,000 words, a short article on Unistar appeared in *The Wall Street Journal's* influential "Heard on the Street" column.

I'm reprinting my columns below in edited and updated form. They were written quickly, in a less polished style than usually appears here. To give readers a feeling of immediacy, I'm keeping them in the order in which they appeared. This is a sample of the writing I'll be doing from time to time in a fax and E-mail service available only to subscribers of *Schiff's Insurance Observer*.

This service will called *Schiff's Insurance Observer, Evening Telegraph Edition*. I've chosen the old fashioned *Evening Telegraph* moniker—as opposed to, say, E*Schiff@News—in the belief that in this age of chatter and sensationalism, it's wise to consider the past as well as the future. (To receive your complimentary copies of our *Evening Telegraph Edition*, refer to the ad on page 11.)

Over the years, due to printing and timing constraints, I've had to forgo writing about numerous important matters that would become breaking stories—simply because I didn't have an appropriate outlet. Thanks to my affiliation with SNL (see page 9), that's no longer the case. I'm rid of the headaches that come with being a publisher, and can spend more time writing. (I can also spend more time sleeping, travelling, hiking, listening to jazz in smoky after-hours joints, and pondering the meaning of life.)

By the way, all of this will improve *Schiff's Insurance Observer* and provide better service and value for subscribers.

Finally, I'm looking forward to the great wealth and fame that is sure to come from these endeavors.

✦

Up so Long it Looks Like Down

Dallas is a rich man
With a death wish in his eye.

—"Dallas" by Jimmie Dale Gilmore

NEW YORK, MONDAY, JULY 19 — On July 15, shares in Dallas-based Unistar Financial Service Corp. (AMEX: UAI) plunged 14⅞ to 41⅝, and trading on the American Stock Exchange was temporarily halted, pending news from the company. In a press release issued that afternoon, Unistar's Chairman and CEO Marc A. Sparks stated, "There has been absolutely no material adverse development in our business affairs, nor any other undisclosed news, to account for the recent unusual market decline in our stock price."

The real story of Unistar—which owns a piddling insurance company, International Surety and Casualty, as well as a string of recently-acquired retail auto-insurance agencies—is not why the stock collapsed, but why it ever went up. At its recent high of 61⅝, Unistar boasted a market cap of about $1.5 billion. (By comparison, 20th Century Industries and Mercury General, two first-class auto-insurance companies, have market caps of $1.6 billion and $1.9 billion.)

Unistar's SEC filings and promotional material make amusing reading. In 1998, International Surety & Casualty did a reverse takeover of a dormant Nevada shell, Caldera, that had no operations or assets. The combined companies were given a fancy moniker, Unistar, and a 1-for-15 reverse stock split was engineered. (International Surety was owned by something called International Fidelity Holding, which was owned by Marc Sparks, F. Jeffrey Nelson [Unistar's president], and Nicole Clayton Caver. Collectively, they received 19,777,000 shares of Unistar.)

Whether International Surety & Casualty had much in the way of value is a matter of opinion. What isn't is the fact that as of December 31, 1998, it was operating under Regulatory Administrative Oversight by the Texas Department of Insurance. There was not much, however, for the Texas Department to oversee. For the year ending 1997, International Surety reported $3 million in premiums and showed a loss of $433,000. Policyholders' surplus was $3 million ($2.3 million of which was in common stock—highly unusual for any insurance company, much less one with just $4.8 million in assets).

Unistar's year-end 1998 financial statement shows a net worth of $85 million, but at least $91 million of its reported $149 million in assets is intangible. This includes a Bermuda license ($5 million) and $84.1 million of "customer lists" that materialized when Unistar bought something called U.S. Fidelity Holding Corp. for 3,975,000 shares. U.S. Fidelity, which belonged to Sparks and Nelson, owned a small premium-finance operation and managing general agencies writing storefront non-standard auto insurance.

Unistar's financial statements don't have the transparency that allows one to analyze the company properly. This much, however, is clear: for the three months ending March 31, 1999, Unistar reported total revenues of $19.5 million, including $14.6 million from "commissions and fees earned." The unaudited financials note that "gross written premiums" were $44.2 million.

Unistar's April 30, 1999 proxy statement lists Sparks and Nelson as the beneficial owners of 2,365,000 and 1,198,000 Unistar shares, respectively. It isn't clear who owns the rest of the 19,777,000 shares issued to them and Caver. (Neither Unistar nor its auditor, Karlins Arnold & Corbitt, returned my phone calls.)

What is clear is that Unistar is highly promotional. Its website says the company "anticipates completing 1999 with a revenue run rate [whatever that means] exceeding $400 million and $500 million in 2000." Since last year, Unistar has put out 56 press releases, many announcing roll-up acquisitions of small auto-insurance brokers.

One press release says that Unistar

Unistar Financial: Try and Figure This Out

The balance sheet is loaded with dubious intangible assets (customer lists and a Bermuda license). Not counting intangibles, assets exceeded liabilities by $6,211,632.

Assets	
Equities	$ 346,932
Cash	5,865,430
Finance Contracts Receivable	38,453,842
Premiums Due	1,684,575
Due from Reinsurers	347,712
Property & Equipment	3,535,328
Customer Lists	86,175,838
Bermuda Reinsurance License	5,000,000
Investments	6,283,155
TOTAL ASSETS	$149,333,092

Liabilities	
Reserve for Commissions & Loss Adjustment Expenses	$ 5,340,000
Unearned Premiums	2,750,499
Unearned Commissions & Policy Fees	6,179,651
Amount Due Reinsurer	1,923,256
Notes Payable	38,571,437
Accounts Payable & Accrued Liabilities	6,675,099
Taxes	1,122,955
Deferred Income Tax	1,805,989
TOTAL LIABILITIES	$64,368,886
SHAREHOLDERS' EQUITY	**$84,964,206**

Source: Unistar 10-K, December 31, 1999. Financial Statement audited by Karlins, Arnold & Corbitt, Woodlands, TX

intends to become a billion-dollar insurer by giving superior service. The press release speaks of a "shared vision," and of giving stock options to employees as an incentive. Among the "visionaries" cited by Unistar as engendering this "philosophy," is the man who built McDonald's, "Ray Krock" [sic]. (The proper spelling of the name is "Kroc"—one wonders whether Unistar's misspelling is a Freudian slip.)

Unistar's "progress report" says that "top line growth, along with convergence, scale and technology, are keys to success...Unistar has become a market leader in all of these areas." Market leader?

The same report claims that Unistar's "reinsurer asset base" is $30 billion. Since the assets of Unistar's reinsurers don't belong to Unistar, it seems that Unistar is trying to bask in the reflected glow of its big-name reinsurers, an unsavory promotional technique. The progress report also notes, in all seriousness, that "with Unistar's strategy of vertical integration, 2 x 2 really does equal 12." Even in the Sixties—the heyday of "synergy"—people only claimed that "1+1=3."

Over the last 11 months, Unistar's shares have soared from about zero to 61⅝. In recent months, the stock has generally moved up a bit each day, the result, one presumes, of persistent buying. (Who were these buyers, and why were they buying?) On July 14, however, the buyers went on strike, and Unistar shares began falling fast. Trading was halted on July 15. On July 16, trading opened, but was halted 13 minutes later with the stock down 4 1/16 to 37. When trading resumed at the end of the day, the stock was down another 10.

There was no "official" reason for Unistar's decline. On the other hand, *reason* has little to do with Unistar's stock price. Does anyone know why a tiny insurance brokerage and an unrated insurance company should sport—even at the new lower stock price—a $680 million market cap? Why not a $68 million market cap, which would bring the stock to 2⅞? Or a $6.8 million market cap?

Perhaps someone will provide answers to these questions, and while doing that, take a good look at the trading in Unistar's stock.

At 2:28 on Friday, July 16, Unistar issued a press release blaming the usual suspects for the drop in its stock. "We've got a lot of shortsellers out there. It's disappointing to see such a malicious attack," Marc Sparks, told Reuters. "Fundamentally, the company is in great shape." Of Unistar's 24,000,000 shares, only 900,000 shares—just 4%—are available for trading, Sparks said. He also denied allegations "posted by anonymous people on financial Web sites that the company may have hired an investor relations firm to pay brokers to promote the stock."

The Reuters article continued: "Unistar has hired an agency to find out who the shortsellers are and to trace the people behind the online messages, Sparks said, adding he would 'bet' that it's a competitor spreading the rumors."

It isn't clear which competitors Sparks might be referring to, but the largest writers of non-standard auto insurance are Allstate and Progressive, two giants whose CEOs probably haven't heard of Unistar.

Regarding Unistar's investigation into the alleged shortselling, perhaps Sparks will also ask the "agency" he's hired to find out why the stock went up in the first place—and who was touting it on the rise.

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Strange Happenings

NEW YORK, TUESDAY, JULY 20 — Call in the SEC. Last week, sometime between the hours of 9:30 a.m. on July 14 and 4:00 p.m. on July 16, $850 million disappeared.

The missing capital belonged to the shareholders of Unistar Financial Service Corp., and it disappeared when the company's stock plunged from 61⅝ to 27—on no news—amid order imbalances, halted trading, and a press release by the company blaming shortsellers for the stock's decline.

Prior to its stock collapse, Unistar had a market cap of $1.5 billion. Based on market cap alone, it was one of the 60 largest publicly-held insurance businesses. Even with its new and improved $792-million market cap (the stock closed at 32½ yesterday, up 5½), it ranks

as one of the top 100. Based on its SEC filings and statutory financial statements, Unistar and its insurance subsidiaries don't rank as much of anything.

The burning question, therefore, is, why did Unistar's market cap collapse by only $850 million last week? And why does it still have a market cap of $792 million?

Although the answers aren't clear, it *is* clear that Unistar, its affiliates, and some of its shareholders have been involved in a stunning array of unusual transactions.

According to its press releases, Unistar is an up-and-coming writer and producer of non-standard auto insurance. It is said to be a consolidator that is "rolling up" small non-standard auto-insurance brokerages. Unistar is also a managing general agency that transacts business through its tiny, non-rated insurance company (now called Unistar Insurance Company) and through State & County Mutual Fire Insurance Company, a Texas county mutual that acts as a fronting company for auto insurance. Unistar also owns a premium-finance business and an offshore reinsurance business. Unistar's public-relations materials say that the company owns body shops and claims-appraisal companies.

A perusal of Unistar's SEC filings and other material leave one with the impression that the company talks the talk but may not walk the walk.

Unistar, the public company, was formed in August 1998 when two Texans, Marc A. Sparks and F. Jeffrey Nelson, merged International Fidelity Holding (the parent of International Surety & Casualty Company, an insurer domiciled in the Lone Star state) into a dormant public shell, Caldera. (Caldera's filings were made by its secretary, Toronto attorney Ronald K. Mann, who was also a director of publicly traded American Eco Corp. Sparks, Nelson, and Nicole Clayton Caver received 19,777,000 out of 20,000,000 shares of the shell company, which was renamed Unistar.)

According to Unistar's 8-K filing, Sparks, Nelson, and Caver had been "the sole shareholders of International Fidelity Holding."

Unistar's 1999 10-K and proxy make no mention of facts that many investors would find interesting: that International Surety & Casualty was previously named TCL Fire & Casualty, and that Unistar's president, F. Jeffrey Nelson, had been TCL's president. (TCL was owned by Nelson's family.) At year-end 1994, TCL was down to just $459,000 in assets, and, since August 26, 1997, has been operating under Regulatory Administrative Oversight by the Texas Department of Insurance. (International Surety is now called Unistar Insurance Company.)

TCL's former parent, Texas Central Life Insurance Company—of which Nelson was also president—was no gem, either. In May 1992 it was placed under the supervision of the Texas Department of Insurance, and was released four months later pursuant to a rehabilitation plan. In 1995, Texas Central had the distinction of being one of 12 companies to be rated "C (Marginal)" by A. M. Best. Texas Central was eventually put into receivership by the Texas Department of Insurance.

In 1994, Sparks, in return for stock and warrants, sold his company, Cambridge Construction Services Corp., to American Eco Corp., a publicly traded Canadian "provider of industrial support, specialty fabrication and environmental remediation services to...[the] energy, pulp and paper, and power-generation" industries. (American Eco, which is heavily leveraged and has experienced losses, is the same American Eco of which Ronald Mann, Caldera's secretary, was a director.)

Somewhere along the way, Sparks joined with Nelson, whose insurance company was apparently in need of capital. On October 20, 1997, International Fidelity Holding contributed 250,000 shares of American Eco to International Surety & Casualty to beef up the insurer's balance sheet. The publicly traded American Eco shares were valued at the market price of $6.50 each. The insurance company subsequently sold 30,500 of these shares for about $295,493. American Eco's stock has since collapsed—it's now $1.60. Unless International Surety had sold more shares of America Eco (and SEC filings indicate that it didn't), its statutory capital, which was listed at $3 million at the end of 1997, would show a significant decline, all other factors being equal.

On September 30, 1998, shortly after merging into Caldera, the public shell, Sparks' and Nelson's Unistar acquired U.S. Fidelity Holding Corp., which, according to a Unistar press release, owned Great Southern (described as Unistar's "flagship" auto-insurance wholesaler), Eagle Premium Finance, and Eagle Claims Corp. (These three companies had been part of Sparks' and Nelson's International Fidelity Holding until December 31, 1997.)

Unistar purchased U.S. Fidelity in a "stock for assets" transaction in which it issued 3,975,000 shares to the owner of U.S. Fidelity. The acquisition was accounted for in a manner that added $84.1 million of "shareholders' equity" to Unistar's books in the form of "customer lists." This fancy accounting gave Unistar a reported shareholders' equity of $76.3 million. Absent the customer lists, Unistar would have had *negative* $10.5 million in shareholders' equity on September 30, 1998.

U.S. Fidelity's primary business is premium-financed nonstandard private-passenger auto insurance. Nonstandard business has a low renewal rate—typically around 70%—and financed nonstandard has an even lower renewal rate. Given the low retention rate, it's fascinating that Unistar has chosen to capitalize U.S. Fidelity's customer lists and write them off over—don't faint—40 years! In a Q & A on Unistar's website, Sparks says that in the insurance industry, customer lists are referred to as "coveted books of business." He also says that Unistar's "hundreds of thousands of loyal policyholders represent an enormous asset." He doesn't explain why nonstandard auto insurance policyholders would be loyal—after all, if they could get insurance in the standard market, they probably would. Its unlikely that even 50% of the nonstandard policyholders currently written through Unistar's storefront brokers and wholesale brokerage will be on the books in five years.

Accounting methodology aside, one wonders how Sparks and Nelson were able to convince the owners of U.S. Fidelity to exchange an insurance business supposedly worth at least $84.1 million for a mere 3,975,000 Unistar shares. After all, only 44 days earlier, Sparks, Nelson, and Caver had received 19,777,000 shares for International

Fidelity Holding, which had not only been losing money, but had a tangible net worth of just $1.1 million (*including* the $1.4 million in American Eco stock).

Perhaps the reason U.S. Fidelity's shareholders were willing to accept such a relatively small amount of shares for their company had something to do with the fact that, until moments before Unistar acquired it, U.S. Fidelity was owned by Sparks and Nelson. Immediately prior to the acquisition, however, they transferred their U.S. Fidelity shares to Rockford Partners, Ltd., a Tortola, BVI corporation. This transaction, according to an SEC filing, was "in satisfaction of pre-existing obligations...resulting from historic working capital provided to U. S. Fidelity." Although Rockford Partners thus acquired about 16% of Unistar's shares, Unistar's 1999 proxy does not list Rockford as a shareholder.

Rockford Partners' mailing address is in Hamilton, Bermuda, care of its president, Deborah L. Paterson. Paterson also serves as secretary of STG Investments, Ltd., a Liberian corporation controlled by a British Virgin Islands company called Consolidated Nominees Limited. STG Investments is a "non-managing Class C member" of Deere Park Equities, L.L.C., an Illinois limited liability company whose managing member is Douglas A. Gerrard.

Until December 18, 1998, when he resigned from the board, Gerrard was a director of Unistar.

Engineering News-Record describes Gerrard as "a former options and currency trader who, in 1996, founded Deere Park Capital Management, a company that says it has made $250 million of private placements of debt and equity." SEC filings describe Deere Park's ownership interest in Dominion Bridge Corp., and a 1997 article in the Montreal based *Financial Post* noted that Gerrard "represent[ed] the interests of American Eco Corp."

A private-placement memorandum put out by Greystone Capital in Atlanta, which was attempting to raise $100 million for Unistar, listed Gerrard as the owner of 2,000,000 Unistar shares as of March 15, 1999. Unistar's proxy, filed as of April 30, 1999, doesn't list Gerrard as owning any shares.

Leonard B. Feldman, a former commodities and futures trader, is also a member in Deere Park. Unlike Gerrard, he's still a director of Unistar. As of April 30, 1999, Feldman and his wife owned 2,055,000 shares of Unistar, now valued at worth $67 million, down from $125 million at their peak.

How did Feldman acquire this stake in Unistar? According to a 13-D filing, "The source and amount of funds or other consideration used by Mr. and Mrs. Feldman in acquiring 2,000,000 [Unistar] shares...was their investment in International Fidelity Holding Corporation, a Texas corporation, which was acquired by [Unistar] in a stock-for-stock exchange approved by the [Unistar's] stockholders on August 17, 1998."

Unistar's 8-K filing, however, said that Sparks, Nelson, and Caver were "the *sole shareholders* [emphasis added] of International Fidelity Holding." A June 9, 1998 filing with the Texas Insurance Department listed Sparks, Nelson, and Caver as each owning one-third of International Fidelity.)

The question, therefore, is what happened to the 19,777,000 shares that Sparks, Nelson, and Caver got? Unistar's April 30, 1999 proxy lists Sparks and Nelson as owners of 2,365,000 and 1,198,000 shares, respectively. (Caver isn't listed at all.) That leaves 16,214,000 shares, ostensibly worth $527 million, unaccounted for.

The whereabouts of these shares is of interest, in good part, due to the extraordinary $1.5-billion valuation accorded Unistar on the floor of the American Stock Exchange. This valuation bore no reasonable relationship to revenues ($19 million in the first quarter), annualized earnings per share (24¢), or book value ($3.83 per share including the customer list; 24¢ per share not including it). Unistar's valuation seems equally ridiculous compared with the valuations of other insurance brokers, insurance companies, or insurance-service providers.

During the 30 trading days ending July 16, total volume was 1,190,600 shares—about 40,000 shares per day—with about 80% of the trades taking place in the $50 to $61 range.

Because Unistar's financial statements and filings are unusual, to say the least, the company's shares would tend to be viewed as suspect by prudent investors. Furthermore, Unistar's promotional material is filled with shameless puffery and nonsensical hype: "Our staff has hundreds of years of auto insurance experience," exclaims Sparks, several pages after stating that the company has 326 employees. (That works out to one year of auto insurance experience per employee—assuming the employee count is correct.)

Writes Sparks, "We don't get hung up

Unistar writes nonstandard auto insurance.

over the inadequacies of conventional accounting." That's for sure.

Despite the warning signs—or perhaps because of them—Unistar's stock soared to an incredibly high level. And, the recent sharp decline notwithstanding, it's still at a wildly irrational level that defies gravity.

Why did the stock go up? Was it, as it appeared on the surface, simply the result of persistent buying? If so, who would have bought such a stock? And who would have recommended it?

Certainly, Unistar would have profited from a high stock price to the extent that it could make acquisitions for stock. (It appears to have made some relatively small ones.) And Unistar's shareholders—presumably Sparks, Nelson, Rockford Partners, and other insiders, directors, and original shareholders—would benefit if they were able to sell their shares at overvalued levels. But did they sell or convey their shares?

Which brings us back to the question: what happened to the shares that Sparks, Nelson, Caver, and Rockford received?

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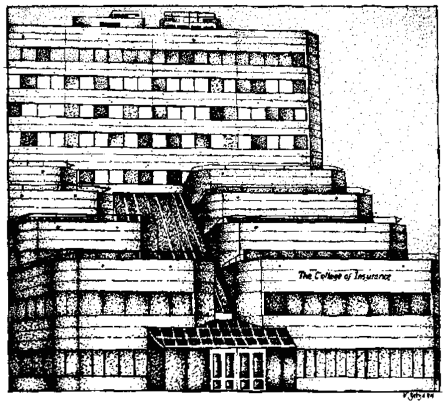
The Sweet Smell of Excess

NEW YORK, WEDNESDAY, JULY 21 — (UAI: 27⅝ down 4⅞) Unistar, for those who haven't read this column recently, is the billion-dollar-market-cap nonstandard auto-insurance business that almost no one I know had ever heard of.

Given the company's unusual pedigree, convoluted SEC filings, and curious accounting practices, it's safe to say that Unistar's days of obscurity are over. The question that investors, insurers, reinsurers, and insurance brokers must now ponder is whether Unistar—the company and the stock—can endure whatever rigors accompany the light that will shine down upon the company's finances, financial dealings, and business strategy.

Will broad daylight resurrect Unistar's fallen stock? Or will it have an effect similar to that of the sun's rays on a vampire?

Yesterday's article closed with a pressing question: what happened to 16,214,000 Unistar shares—now worth $448 million—that were owned by the company's honchos, Marc A. Sparks and F. Jeffrey Nelson? Although SEC filings from last year indicate that these gentlemen (and Sparks' associate, Nicole Caver) possessed 19,777,000 Unistar shares, the company's recent proxy statement shows Sparks and Nelson owning 3,563,000 shares.



The College of Insurance

Few people would give a hoot about Unistar if it were still the dormant penny-stock shell that it was a year ago. And few would care about the company if its stock hadn't levitated from approximately zero to 61⅝ before collapsing late last week, and closing at 27⅝ yesterday. (In what is surely an ironic twist, the collapse began one day after Unistar announced a 2-for-1 stock split. Although splits are essentially meaningless, callow investors sometimes ascribe magic to them. In any event, Unistar can now save itself the cost of issuing new shares for the stock split, since the market has already performed a split on Unistar's stock.)

Many questions remain to be asked. Why, for example, did Unistar sport a market cap of $1.5 billion last week—a price equal to 250 times questionable earnings, 79 times unaudited first-quarter revenues, and an infinite multiple of tangible book value? The answers might become obvious if the SEC, the American Stock Exchange, or the Royal Canadian Mounties take a gander at Unistar's trading records and figure out who's been buying and selling for the last 11 months.

An investigation, one presumes, would be welcomed by chairman and CEO Sparks, who last Friday claimed that Unistar was the victim of an attack by shortsellers. (He said that Unistar had hired an agency to uncover the identities of these assailants.)

By Monday July 20, in what was certainly a swift job of sleuthing, Unistar's vice chairman, James G. Leach, identified those who had allegedly been abusing Unistar's stock—competitors—adding that their actions appeared to be malicious and illegal.

Since the issue of stock manipulation was raised by Sparks and Leach, let's dwell on it for a moment. Securities manipulation can work several ways. While it's possible for shortsellers to manipulate a stock down, it isn't always easy. On the American Stock Exchange, a short sale can be executed only on an uptick, of which there weren't many when Unistar's stock was collapsing. Also, one must generally borrow shares before shorting them, and thinly traded stocks like Unistar are difficult to borrow. Furthermore, a manipulator who's shorting a stock can make only a fixed amount—the value of the stock shorted—whereas he can lose an unlimited amount. On the other hand, a manipulator who can drive up a stock's price and then sell his shares, can make a huge multiple of his investment. (You could make $50 million with little risk—aside from that of going to jail—if you could run your stock from 1¢ to $10, then unload 5,000,000 shares.)

Although Unistar was a prolific issuer of press releases during the period when its stock was soaring, I'm not aware that it issued any press releases complaining about malicious "longs" (as opposed to "shorts") were moving the stock to preposterous heights. Indeed, Unistar's press releases and public-relations material would have provided plenty of fuel to "longs" who may have been buying for reasons that had nothing to do with irrational exuberance.

So, Messrs. Sparks and Leach, ask the SEC and the American Exchange to investigate the buying on the upside, as well as the selling on the downside.

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Too Much of Nothing

NEW YORK, THURSDAY, JULY 22 — (UAI: 27⅝, Trading Halted) In a confidential private-placement memorandum dated March 15, 1999, Unistar, which was seeking to raise $100 million, warned potential investors that an investment in its shares "involves a high degree of risk," and emphasized that the "shares should not be purchased by persons who cannot afford the loss of their entire investment." At that time Unistar's stock was 38. After peaking last week at $61\frac{5}{8}$, the stock collapsed, closing at $27\frac{5}{8}$ on Tuesday. Trading was halted all day Wednesday.

Although an investment in Unistar clearly involves risk, it would be overly harsh to characterize Unistar's common stock as the worst investment in the universe. As an investment, Unistar's shares are more appealing than, say, residential real estate on Venus or equities listed on the Martian Stock Exchange.

In fact, it can't even be said that Unistar is the worst investment on Earth. Before making such a statement one might, for example, want to see if it were possible to purchase a health spa in Chernobyl or an X-rated video store in downtown Teheran.

But let's say that one didn't care to go to the trouble of finding the worst investment on Earth—that merely finding a terrible *insurance* investment would suffice—what criteria would one look for?

For starters, one would want a stock selling for at least 100 times earnings and an infinite multiple of tangible book value. Naturally, the issuer of that stock should be engaged in a highly competitive line of business, and the issuer's financial statements should lack the disclosures usually made by public companies. It would also be nice if the company's chairman had gone bankrupt in 1987 and were now making cocksure pronouncements about the company's financial statements. It would be even nicer if these puffed-up pronouncements were at odds with the company's audited financials. (It goes without saying that the company in question would not be audited by a Big Six accounting firm.) And, it would be icing on the cake if the company owned an insurer that had violated the Texas Insurance Code.

While hundreds of companies may fit this description, I'm aware of only one: Unistar.

On March 31, 1999, Unistar had 24,370,422 shares outstanding, 19,777,000 of which had been issued the previous August in connection with the acquisition of International Fidelity Holding, whose primary asset was International Surety & Casualty Company (formerly TCL Fire & Casualty, now Unistar Insurance Company). Some indication of International Surety's quality can be gleaned from a certified letter sent by the Texas Department of Insurance to F. Jeffrey Nelson, International Surety's president, on August 26, 1997.

Conditions were present at International Surety, the letter said, "which indicate that the condition of the company is such as to render the continuance of its business hazardous to the public."

International Surety & Casualty had violated the Texas Insurance Code in the following ways: 1) it had written performance surety bonds and exposed itself, on one risk, to a loss in excess of 10% of its surplus without having adequate reinsurance; 2) it hadn't received premium payments due from its affiliate, Great Southern General Agency, in a timely manner; 3) its books and records didn't accurately reflect its financial affairs; 4) it hadn't dealt with its affiliates in an arm's-length manner.

Unistar says its reinsurers include GE Re, American Re-Insurance, Trenwick, Odyssey Reinsurance, St. Paul Re, Folksamerica Re and Lumbermens.

The insurance company was placed under Regulatory Administrative Oversight, where it remains to this day.

Marc A. Sparks, the boss at Unistar, is given to bold projections. On Unistar's website (unistarfinancial.com) he makes grandiose statements about his company's prospects and finances. He responds to the question: "Isn't Unistar a relatively new company and doesn't this affect shareholders' risk?" by saying, among other things, "It's important to recognize that most segments of our company have been around for quite some time. Our property and casualty insurance company was formed in 1983."

Sparks chose not to mention that 16-year-old Unistar Insurance Company had violated the Texas Insurance Code, and that the insurer's previous parent, Texas Central Life Insurance Company (run by Unistar's president, F. Jeffrey Nelson) went into receivership in October 1996.

Nor did Sparks mention that he'd personally filed for Chapter 7 bankruptcy.

But why dwell on the past when the present is so interesting. "During the fourth quarter," writes Sparks, "we earned $4.2 million EBITDA on revenue of $36 million." Unistar's audited financial statements say otherwise: "total revenues and other income" for 1998 were $15 million.

Although it's not clear how Sparks arrived at his $4.2 million EBITDA figure, Unistar's 1998 audited financials report that "net cash used in operating activities" was negative $4.7 million.

Such discrepancies aside, let's assume that Unistar, as an insurance agency and managing general agency, is growing as rapidly as it says it is in the nonstandard market. Unistar claims that its premium volume was $36 million in the fourth quarter of 1998, and $44 million in the first quarter of 1999. Assuming that growth rate held—Unistar says it's writing 614 policies per day—second-quarter premiums would have been $54 million, bringing total written premiums for the past nine months to $133 million.

A significant percentage of these premiums are supposedly written through one or more fronting companies, then reinsured with what Unistar refers to as a "panel of reinsurers" with "over $24 billion in asset power." According to Unistar, the panel for 1999/2000 treaty year consists of GE Re, American Re-Insurance, Trenwick America Reinsurance, Odyssey Reinsurance, St. Paul Re, Folksamerica Reinsurance, and Lumbermens.

Among the companies no longer appearing on Unistar's panel are Underwriters Re, Signet Star, SAFR Reinsurance, and Sydney Reinsurance.

Question: are Sparks' financial history, Unistar Insurance Company's regulatory history, and the discrepancies between Unistar's SEC filings and Sparks' comments, of interest to the reinsurers who are apparently footing the underwriting risk for Unistar's hypergrowth?

Although I'm generally wary of insurance companies that grow rapidly in a soft market, many reinsurers (and investors) are not. The nonstandard auto insurance market is reasonably efficient. I don't see gaping holes of opportunity in which tiny brokers and insurance companies with unusual histories can make outsized profits.

In the personal-lines auto insurance business, one usually gains new business on the basis of price. (Service, and commissions to agents, are also important.) New business that's written solely on price stands a good chance of being unprofitable unless the underwriter has some advantage, i.e. a lower expense structure, better claims handling (which reduces the ultimate cost of claims), a lower-cost distribution system, underwriting superiority, or a lower cost of capital. Since Unistar appears to have none of these advantages, one must ask whether the business that it's writing is profitable for the reinsurers.

That's particularly important because some unspecified, (but perhaps significant) percentage of Unistar's reported "earnings" comes from contingent reinsurance commissions. The company's reinsurance contracts "provide ceding commissions for premiums written," reads a note to Unistar's consolidated financial statements, "*which are subject to adjustment* [emphasis added]. The amount of ceding commissions is determined by the loss experience for the reinsurance agreement term. The reinsurer provides commissions on a sliding scale with maximum and minimum achievable levels." The text goes on to explain that the reinsurers provide Unistar with "provisional commissions." Unistar recognizes these commissions as revenues based on the current loss experience.

If Unistar's business isn't profitable for the reinsurers, at least two things might happen: 1) Unistar's contingent commissions could, if not disappear, be reduced; 2) Unistar might have trouble finding reinsurers.

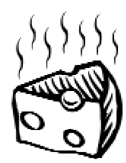
A name that keeps popping up when one enters Unistar's universe is that of American Eco (Nasdaq: ECGO), a Canadian company whose stock has collapsed from 15 to 1.60 over the last two years.

In 1994, Sparks sold his company, Cambridge Consulting, to American Eco for stock and warrants.

Unistar was created through a reverse takeover of a penny-stock shell called Caldera. Caldera's secretary was Ronald K. Mann, a Toronto attorney who sat on American Eco's board.

Unistar Insurance Company's surplus was beefed up by an infusion of 250,000 shares of American Eco. (The shares are now worth a fraction of their contribution value.)

Douglas Gerrard (a former Unistar director) and Leonard Feldman (a current Unistar director) have been involved in at least one investment with American Eco, a company by the name of Dominion Bridge.



Now things really get complicated. On July 24, 1998, American Eco sold certain convertible notes to USIS Acquisition, L.L.C. for $5.0 million in cash and a $12.9 million secured promissory note repayable on January 29, 1999. USIS Acquisition converted the notes into 5,295,858 shares of U.S. Industrial Services (OTC Bulletin Board: USIS), then secured its promissory note to American Eco by pledging these shares as collateral.

USIS Acquisition is a Delaware LLC managed by Albert V. Furman III (Furman's office is in Dallas, Unistar's hometown). The sole member of USIS Acquisition is Arctic Circle, Ltd., a British Virgin Islands corporation. Public filings show that Furman was the only officer and director of Arctic Circle, and that none of Arctic Circle's shareholders had voting control.

Now things get stranger.

A mere four months after acquiring its stake in U.S. Industrial, USIS Acquisition advised American Eco that it wouldn't be able to repay its note. American Eco then took ownership of the pledged U.S. Industrial shares. As a result, on December 31, 1998, American Eco owned 81.9% (7,175,858 shares) of U.S. Industrial Services.

U.S. Industrial doesn't appear especially valuable; in early April its stock price was 37.5¢. But then something happened: U.S. Industrial's shares rose fiftyfold to 18 1/8, giving the company a market cap of $158 million. There seems to be no reason for U.S. Industrial's market cap—except for an unusual press release on May 17, in which U.S. Industrial announced that it would "pursue strategic opportunities in the insurance industry." (Given the state of the insurance market, that ought to make a stock go down, rather than up).

The press release noted that James G. Leach, Unistar's vice chairman, would be "providing strategic direction to U.S. Industrial, " and at the end of the press release Marc A. Sparks was listed as a contact.

Then, on July 1, U.S. Industrial announced "a definitive agreement to acquire International Fidelity Holdings Corp., a 16-year-old reinsurance company based in Dallas, Texas." U.S. Industrial, which plans to change its name to InterStar Group, didn't return my phone calls.

What's so amazing about this transaction (aside from its overall strangeness) is that Unistar—which has issued at least 56 press releases since last year, on everything from the name change of an affiliate to news about a race car it was sponsoring in the Indianapolis 500—didn't issue a press release about its agreement to sell International Fidelity, the deal that had accounted for the issuance of 82% of Unistar's stock last year.

As if all this weren't strange enough, in a footnote to its 10-Q filing last week, American Eco stated that it had entered into an "option agreement" to sell its U.S. Industrial shares for $1.90 per share. At that time U.S. Industrial was trading at $18 per share.

All of these transactions raise questions. Why is Unistar selling International Fidelity to U.S. Industrial? Why did American Eco enter into an option agreement to sell its U.S. Industrial shares for 10% of their market price? Who has the option to buy American Eco's U.S. Industrial shares (which represent an 82% interest in the company)? And why is U.S. Industrial trading at a level that belies the mundane nature of its assets? [When this column was published on July 22, U.S. Industrial was still trading around 18. The stock collapsed that day, however, and is now trading at 6—a price that still seems way too high.]

According to the Texas Department of Insurance, Rockford Partners—the Tortola-based entity to which Sparks and Nelson transferred a 16% percent interest in Unistar last year—never made a Form A filing, which is required whenever more than 10% of an insurance company changes control.

If Rockford Partners is controlled by Sparks and Nelson, perhaps no filing was required. However, Unistar's SEC filings indicate that Rockford Partners is not controlled by Sparks and Nelson.

As for the 19,777,000 Unistar shares that Sparks, Nelson, and Caver received last year—but no longer own (according to Unistar's Sec filings)—no Form A filings have been made in connection with those shares either.

Finally, what became of the 16,214,000 shares once owned by Sparks and Nelson?

It's hard to imagine that an orderly market in Unistar's shares will resume until some questions have been answered.

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This Wheel's on Fire

NEW YORK, FRIDAY, JULY 23 — Over at the American Stock Exchange, trading in the shares of Unistar remained halted for the second day in a row. At the time of the trading halt, Unistar shares were fetching $27.62 apiece, about $27.61 more than they were fetching a year ago.

If we take the company's filings and press material at face value, one can attribute the remarkable rise in Unistar's stock to its acquisition of Unistar Insurance Company (formerly International Surety & Casualty, and before that, TCL Fire & Casualty), and to its exciting acquisitions in the nonstandard auto insurance arena.

Since Unistar is planning to sell its insurance holding company to U.S. Industrial (OTC Bulletin Board: USIS) for a few million dollars, one can presume that Unistar's $660 million market cap has little to do with its insurance company. (By the way, we suspect that there will be no sale of Unistar Insurance Company until an *extra* thorough examination of Unistar, U.S. Industrial, and the controlling shareholders of both companies has been completed by the Texas Department of Insurance.)

So if Unistar's value isn't in its insurance company (which Unistar acquired for 19,777,000 shares of its 24,370,422 shares outstanding), where is the value?

Marc Sparks and F. Jeffrey Nelson, the honchos at Unistar, sold another company they owned, U.S. Fidelity Holdings, to Unistar last year. Although U.S. Fidelity had little in the way of tangible assets, Unistar beefed up its shareholders' equity by capitalizing $84.1 million of "customer lists" on its balance sheet (and then amortizing them over 40 years).

Let's say that U.S. Fidelity's operations have increased in value by 50% since last year, and are now worth $126 million. If you care to believe those assumptions, Unistar is worth $5.25 per share—plus anything else of value that it might own. (We're assuming that the company has no liabilities, contingent or otherwise.)

What else does Unistar have? Well, it bought a bunch of insurance agencies, issuing 115,000 shares for their assets. If we assume that Unistar didn't overpay for the agencies, and we value the shares issued at $61⅝ each (the stock's all-time high), that adds another $7 million (29¢ per share) to Unistar's value, which would make Unistar worth $5.54.

Marc Sparks claims that when Unistar evaluates an acquisition candidate, it "buy[s] the well-run operation at a premium [to book value] every time."

Of course, people's definition of what is a "well-run operation" can differ, and I suspect that Sparks' definition differs greatly from mine.

In January 1999, Unistar acquired Amscot Auto Insurance Agency, which was said to have 19 offices in Florida.

Although I have no first-hand experience regarding the quality of Amscot's operation, Bill Nelson, Florida's commissioner of insurance, didn't think much of the company. He wore a wire, went undercover, and bought insurance from one of Amscot's offices last year. Feeling he had been ripped off, he conducted a fraud investigation, the result of which was that Amscot pled guilty to racketeering charges for various fraudulent insurance practices. As part of a plea agreement, Amscot's owner, Ian MacKechnie, accepted a lifetime ban prohibiting him from selling insurance. He also agreed to sell Amscot within six months.

Five months later, Unistar bought Amscot.

Let's assume that Unistar got a bargain on its Amscot investment, and that Amscot is actually worth $25 million (a hefty sum for a small firm with a foul pedigree)—that adds another $1 per share to Unistar's value, bringing the grand total to $6.64.

That's not a bad value for stock that was trading at $27\frac{5}{8}$—if you happen to be short. If you happen to be long it could spell trouble.

✦

The Debacle

NEW YORK, MONDAY, AUGUST 2 — (AMEX: UAI, trading still halted.) Unistar, the nonstandard auto insurance business that, as recently as two-and-one-half weeks ago, boasted a $1.5 billion market cap, is more than just a penny stock whose bubble has burst. It is a lesson in the excesses that occur not just in financial markets, but also in insurance and reinsurance markets.

Although Unistar—the stock and the company—was filled with warning signs, including those emblazoned on its private placement memorandum to issue stock, "investors" bought its shares. And major reinsurers (GE Re, American Re, Trenwick, Odyssey, St. Paul, and Folksamerica) are, apparently, assuming the risk for substandard auto business written by Unistar's storefront brokers and wholesalers through a tiny fronting company. Although I don't know how much risk the reinsurers have assumed, the question that's worth asking is not "Will the reinsurers make or lose money?", but "Do the reinsurers know what they're doing?"

In the wake of the Unicover fiasco, that question can't be asked often enough.

Is it wise for a reinsurer to do business with a company that has unusual financial statements? Is it wise to do business with a company whose SEC filings raise more questions than they answer? Is it wise to do business—in a softening auto-insurance market—with anyone who claims to be able to grow from virtually nothing to $1 billion in premiums in a few years?

Trading in Unistar's shares was halted on July 21 at $27\frac{5}{8}$, pending a review of the Unistar's listing by the American Exchange. While I don't know whether the next trade in Unistar will take place on "the Curb," I suspect that when the stock does trade, its price will be measured in pennies rather than in dollars.

Mark Sparks, Unistar's chairman and CEO, blamed shortsellers for the collapse in his stock, but it's unclear why shortselling that allegedly took place the week before last would prevent Unistar's stock from trading now.

Sparks claimed that Unistar's float is about 900,000 shares, yet the company's filings leave it murky as to what became of approximately 16,214,000 shares that Sparks and his associates once owned. If these shares were sold, why were there no registration statements, insider filings, or Form A filings?

Sparks now claims that he's been considering taking Unistar private. While Unistar's balance sheet displays no evidence of an ability to retire 900,000 shares at recent prices, we're pretty sure that if Sparks were to make a cash bid at that level, the transaction would be greeted with a mixture of anger, relief, and most of all, amazement.

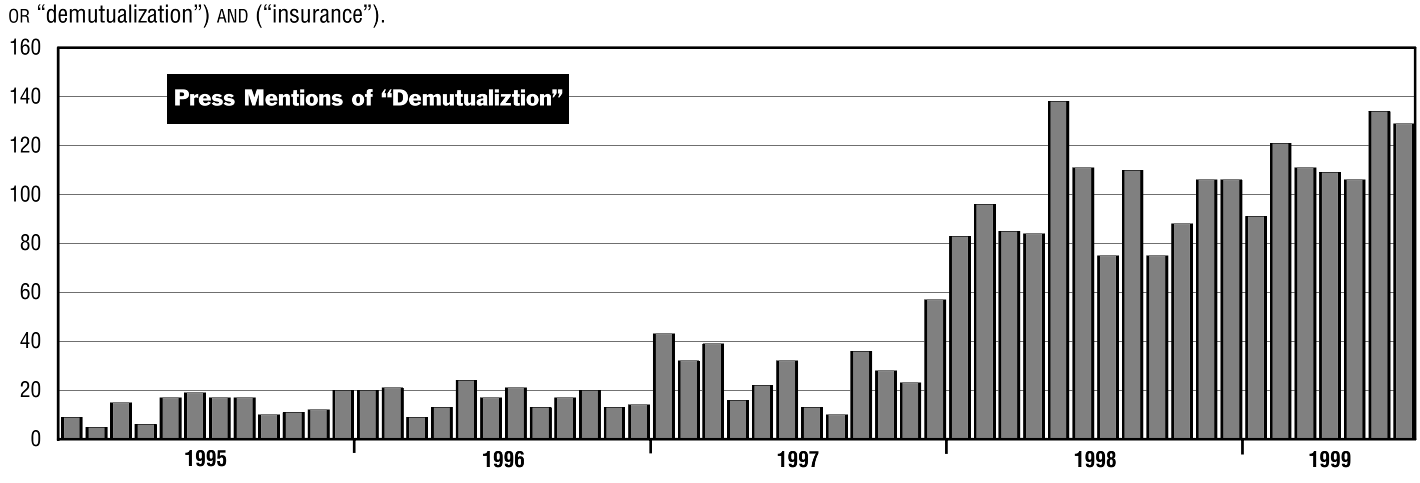
✦

As we went to press, trading in Unistar's shares had still not reopened, and regulators were taking a good look at the company. The deal to sell Unistar Insurance Company was cancelled, and, to the best of our knowledge, Unistar's subsidiaries are still writing business with licensed insurance companies and well-known reinsurers.

This, too, shall pass.

A Bull Market in Demutualizations

The number of times demutualization was mentioned in the press. We did a Dow Jones New Retieval search with the following criteria: ("demutualize" OR "demutualization") AND ("insurance").



Source: Dow Jones News Retreival

THE INSURANCE BEAT

Boosting Surplus to Zero

The *Asia Pulse* recently reported that South Korea's 29 life insurers had $76.4 billion in assets and $80.5 billion in liabilities. Ten insurers had positive capital and 19 had negative capital.

The ones with negative capital are "being called upon to boost their *ability for payment ratio* to 0% by September," the *Pulse* noted. It added that a few companies would probably be "reprimanded" for missing the deadline.

Hello, Sucker

One privilege of being an American Express member is that now and then the company tries to sell you some expensive, unnecessary insurance.

A friend of ours who has an American Express Corporate card recently received a letter from Kenneth J. Ciak, president of AMEX Assurance Company:

> Dear Mr. Sucker:
>
> As a successful small business executive, you're constantly on the go. That's why the American Express Corporate card suits you so well...
>
> But did you know that the corporate card can be a particularly valuable asset when you fly? It can, automatically, with the Executive Flight Protection Plan.

The letter explained that if Mr. Sucker enrolled in the plan he could get up to $1 million of travel accident coverage every time he charged a scheduled airline ticket to his corporate account. If Mr. Sucker enrolled right away, he'd receive a small digital alarm clock.

Upon enrolling, "each time you fly, you'll have the added peace of mind that comes from knowing that your loved ones have extra security through the Executive Flight Plan," wrote Mr. Ciak.

Although enrollment is free, the actual "executive flight protection" is not. It costs $14 per person per covered trip for $1 million in coverage. If Mr. Sucker makes a round-trip flight every other week, he will pay $728 per year.

Mr. Ciak didn't explain why executives need "extra security" when they fly—as opposed to extra security when they travel by car. (Based on fatalities per 100 million miles traveled, it's 100 times safer to go by plane than car.) If one needs insurance for accidental death, then one should have the proper amount of life insurance.

In another letter sent a little while later, Mr. Ciak tried to convince Mr. Sucker to acquire the "added peace of mind" that comes from enrolling in AMEX Assurance's "Executive Baggage Protection Plan," which cost $6.50 per round trip ($169 per year, based on a round-trip flight every other week).

Mr. Sucker informed us that he decided to forgo all the "added peace of mind" offered by American Express. Instead, he spent his money on something he really wanted—an airline ticket.

Häagen-Lindner

You could spend forever following the complex financial exploits of Carl Lindner, the corporate raider, wheeler-dealer, and clever fellow who controls Cincinnati-based American Financial Group, a holding company for Great American and a host of other insurers.

In December 1997, American Financial bought $138,000 of ice cream from United Dairy Farmers, owned by Lindner's brother. (To the best of our knowledge, December is not the peak month for ice cream sales in Cincinnati.)

The company's proxy statement said that "American Financial Group believes that the financial terms" of this transaction were "comparable" to that which would apply had the deal been with an unrelated party.

We take Lindner at his word. (That American Financial Group, in a previous incarnation under his management, had signed a consent decree with the SEC is irrelevant). After all, why would a public company controlled by Lindner buy approximately 50,000 quarts of ice cream in December from Lindner's brother's company, if that ice cream wasn't a good buy (and tasty, too)?

During 1998, American Financial paid $144,000 for coupons redeemable for ice cream from United Dairy Farmers. The 1998 proxy explained that these coupons were to be used as gifts for employees at the company Christmas party.

Changing the Denominator

MBIA Insurance Corporation—originally Municipal Bond Insurance Association—does not, as it once did, confine itself to insuring municipal bonds. It also insures financings for credit-card receivables, equipment leases, pools of mortgages, bank obligations, and a mélange of other transactions in which an issuers' credit can be enhanced by MBIA's triple-A rating.

While MBIA's 25-year track record is impressive, it's conceivable that 25 years is not adequate to measure the risk of the occasional financial meltdown. (1974 marked the end of a harsh bear market and the beginning of the great bull market.)

In its 1997 annual report, MBIA noted that since its inception in 1974, it had insured more than $456 billion in *par value*, and that incurred losses had been a mere $34 million. "Our underwriting decisions have been right 99.992% of the time," the company boasted.

In July 1998, Allegheny Health, a Pennsylvania hospital group, went bankrupt, and MBIA incurred its largest loss ever: $181 million. MBIA's 1998 annual report put this in a more favorable light by changing the denominator used to measure losses. It noted that over the years it had insured $1 trillion of *debt service* (what happened to *par value*?), and that gross losses had amounted to "just" $276 million. "Our underwriting decisions have been right 99.97% of the time," wrote MBIA.

Viewed another way, through 1997 MBIA had been *wrong* .008% of the time. By 1998, however, its wrong ratio had at least quadrupled, to .03%.

That's a fine record; but not as fine as it was.

At year-end 1998, MBIA had $596 billion of insurance in force, $10 billion of investments, and $3.8 billion of surplus. Based upon 1998 par value insured, if MBIA is right 99.6% of the time, it will be out of business.