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SCHIFF'S INSURANCE OBSERVER

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The Bad Commissioner; Provident's CEO Payoff

The Sweet Goodbye

"As through this world I've wandered," sang Oklahoma-born Woody Guthrie in *Pretty Boy Floyd*, "I've seen lots of funny men; some will rob you with a six-gun, and some with a fountain pen."

Pretty Boy Floyd robbed banks, especially in Oklahoma. During the early years of the Depression, when banks were foreclosing on farms throughout the Midwest, Floyd, who was known to share his ill-gotten money with the impoverished, became something of a folk hero—a dust-bowl Robin Hood.

Holding up banks is a bad way to make a living. The take is small, the risks are high, and bank robbery is illegal in all 50 states. Siphoning assets from a mutual insurance company is a dandy way to make a living, however. It differs from bank jobs in that the risks are low, the take is large, and regulators in none of the 50 states object if legal tender disappears from a mutual and reappears in its CEO's pocket.

Robert "Fountain Pen" Kloss, Provident's recently departed CEO, knows a thing or two about finagling moolah from a mutual insurance company. He'll receive $18,000,000 from "change-in-control" agreements triggered by Provident's decision to merge into Nationwide in a transaction known as a sponsored demutualization. Kloss's 18,000,000 simoleons is, perhaps, a harbinger of things to come. If a schnorrer at a mid-sized mutual like Provident ($550 million of statutory surplus) can pull down that much for a mediocre deal, one wonders just how much someone at a really big company can get.

In our May 1998 issue we wrote about Provident's deceptive attempt to convert to a mutual-holding-company, and the sham public hearing that was held by the Pennsylvania Insurance Department regarding the attempted conversion. Although Kloss, Provident's board, and the Pennsylvania Insurance Department approved of Provident's scheme, the Reverends David Drain and Michael Shea did not, and were forced to do what God-fearing men must sometimes do: hire Kenneth A. Jacobsen, Esquire, to file a class-action lawsuit on behalf of policyholders.

In 1999, Judge Stephen E. Levin of the Court of Common Pleas in Philadelphia concluded that Provident had omitted material information from its Policyholder Information Statement (which policyholders relied on when voting for or against the conversion) and had misled its policyholders. In a stinging decision that shook up the mutual-holding-company-conversion business, he opined that Provident's officers "breached their duty of disclosure" to policyholders. In September 1999 he permanently enjoined Provident from effectuating its mutual-holding-company conversion.

In a better world, companies would boot out officers who breached their duty. But Provident's board isn't part of *that* world. Instead, it rewarded its breaching officers with golden parachutes that would be triggered if the company was sold—even for a piddling price.

In August 2001, Provident (which has about $9 billion in assets), announced that it would be acquired by Nationwide Financial Services in a sponsored demutualization. When the deal closed on October 1, 2002, Provident's policyholders received total consideration of about $1.1 billion—a figure that approximates Provident's book value and is only 11 times its average earnings over the last few years.

Provident Mutual, like all insurers, is in a regulated industry. In theory, Provident is monitored by the regulators in every state it does business. Provident's primary regulator, however, is the Pennsylvania Insurance Department, headed by Diane Koken.

Koken knows Provident well. She began working there in 1975 and eventually became vice president, general counsel, and secretary. In 1997, Pennsylvania's governor, Tom Ridge (now director of the Department of Homeland Security), appointed her to the post of insurance commissioner. "Diane Koken will guard aggressively the interests of the millions of Pennsylvanians who are insurance consumers," he said erroneously, "while safeguarding the competitive position of Pennsylvania's insurance companies, which employ hundreds of thousands of Pennsylvanians."

Koken returned the compliment: "The Ridge Administration and its insurance department have an enviable record of accomplishments over the past two-plus years, and I plan to do everything I can to continue that record." The recent insolvencies of Pennsylvania-domiciled Reliance, PHICO, and Legion make it harder to say that the insurance department still has an enviable record of accomplishment.

Koken's independence and judgment are questionable. While at Provident she was involved in crafting the company's mutual-holding-company plan. In 1998, in her first year as commissioner, she recused herself from ruling on the company's mutual-holding-company conversion. She also recused herself from ruling on Provident's sponsored demutualization this year, delegating responsibility to a deputy in order to remove "any possible conflict of interest or appearance thereof," as the Department put it.

Koken's recusals notwithstanding, her close ties to Provident raise issues about the Department's treatment of Provident's attempted mutual-holding company conversion and sponsored demutualization. Why, in both instances, did the Insurance Department refuse to hold public hearings in which witnesses could be sworn and cross examined? Why did the Department permit Provident to keep important information secret until after the hearings began? (Each hearing lasted less than a day.) Why did the Department overlook the flaws in Provident's plans, and why was it so willing to accept "fairness" opinions from bankers and consultants who would opine favorably when paid a lot of money to do so?

Although Koken was supposedly concerned about even the *appearance* of conflict of interest, there's no reason she couldn't have protected policyholders by preventing abusive aspects of Provident's conversion plans. Instead, she did nothing.

We don't know how close the relationship between Provident and the Koken administration is, but there's evidence that it's too close.

In January 1998, Provident sent its vice president, Bill Hunt, to Des Moines to observe Jason Adkins' and David Schiff's participation in the public hearing on Principal Mutual's mutual-holding-company conversion. On February 25, 1998, Hunt sent a memo to James Potter, Provident's general counsel. The memo, "Consumer Advocate Activity at Principal Mutual's Public Hearing," summarized Adkins' and Schiff's statements, tactics, and testimony. The memo was apparently used to prepare Provident and others for Adkins' and Schiff's participation at the Pennsylvania Insurance Department's hearing on Provident six weeks later.

Although Provident viewed Adkins and Schiff as adversaries, one wouldn't expect the Pennsylvania Insurance Department to share that view and collude with Provident. Yet the evidence—Hunt's memo and the Department's behavior at the hearing—points in that direction.

The same day that Potter (Provident's general counsel) received Hunt's memo, he faxed it to Lynn Fitzwater, the Pennsylvania Insurance Department's chief counsel. "Here is the revised paragraph of the Exec. Summary," he wrote. "We would like to retain the ESOP text. *Also included with this fax is a memo on the Principal hearing.*" [Emphasis added.]

Hunt's memo described Adkins's and Schiff's final testimony as "long-winded," and closed by saying, "A tactic utilized by both Jason Adkins and David Schiff was to ask the same question in many different ways. It was incumbent upon the Insurance Commissioner to approve or disallow each question in order to minimize the redundancy and not waste time listening to responses which were already on the record."

The Department got the message—that it was incumbent upon it to disallow questions. At the hearing six weeks later, the Department's "hearing officers" interrupted almost every question Schiff asked. (Adkins had boycotted the hearing after learning that there would be no questioning of witnesses.) They told him that it wasn't appropriate for him to ask so many questions, and that the hearing wasn't even the proper forum for his questions. There was no other forum, however.

Since Schiff was silenced at the 1998 hearing, he decided not to attend the 2002 hearing. On July 8, 2002 he wrote to the Department objecting "to the executive and director compensation and severance agreements that were put in place at Provident Mutual." He urged the Department to reject these agreements. "It is inappropriate for the executives and directors of a mutual insurance company to be paid off because they exercise their fiduciary responsibility and approve the sale of 'their' company," Schiff said.

"Had policyholders been fully informed of these outsized executive and director compensation agreements they might not have voted for them. Furthermore, policyholders should have been advised of the executive compensation arrangements prior to the hearing so that they could be discussed at the hearing."

Schiff said that he was "deeply concerned by the close ties that Provident has to the commissioner," and was concerned that the Department "will, once again, approve a plan that is bad for policyholders."

He continued: "The Department recently brought a lawsuit against Saul Steinberg, former CEO of Reliance, seeking to recover hundreds of millions of dollars, asserting that he was 'draining' money from the company. I suggest that the Department reject Provident's lavish payoffs to its directors and executives. It is time for the Pennsylvania Insurance Department to put an end to abusive compensation at Pennsylvania insurance companies."

Schiff didn't hear back from the Department. He did receive a verbose letter from Provident's director of communications, Chuck Hall. Here's an edited version of that letter.

July 19, 2002

Dear Mr. Schiff:

Your letter to the Pennsylvania Insurance Department (the "Department") has been forwarded to us for response.

Regarding your concern that the compensation level of Provident's management is somehow inappropriate, we note that an independent consulting firm was retained by the Company to review the level of compensation received by its senior managers. After conducting an analysis of the compensation paid from 1999 to 2001, the independent consultant concluded that Provident has maintained senior management compensation at conservative levels in comparison to market.

Next we address your concerns regarding payments to be made to Provident's management as a result of the merger with Nationwide. The purpose of the change-in-control agreements is to continue to provide financial protection for the Company's senior executives in the event of a change in control of Provident, thereby making it more likely that an executive would view a potential merger or sale which could result in a change of control from the perspective of the Company and its constituencies rather than from his or her own viewpoint.

A well-respected and experienced independent consulting firm concluded that the compensation potentially payable under the change in control agreements is reasonable in total, and on an individual-by-individual basis, in light of comparable practices.

Regarding payments to be made to the outside directors of Provident, Provident had agreements in place with some of its current and retired directors for them to provide post-retirement advisory services as members of the Company advisory committee. Because Nationwide determined that it will not appoint any of the current directors of Provident to the advisory committee after the sponsored demutualization, Provident will accelerate and pay at closing these advisory fees.

An independent consultant concluded that such payments are reasonable in light of competitive practice. Moreover, acceleration of the advisory fees payments alleviates any concern of director entrenchment motivated by a desire to preserve both ongoing directors fees and retirement benefits.

The concern you have raised regarding the alleged "close ties that Provident has to the commissioner" is unfounded. Provident has not had any communication with the commissioner related to or since the proposed sponsored demutualization plan. The rigor and thoroughness of the Department's process used to analyze the transaction has been unprecedented.

We understand that the Department has noted your comments regarding these matters and that your correspondence and our letter will be placed in the files of the Department and have been made available to the public by the Department.

Sincerely,
Chuck Hall
Director of Communications

Hall's letter was dated July 19, the last day that the hearing record for public comment remained open.

On July 2, Joseph Belth, a Provident Mutual policyholder and editor of the indispensable *Insurance Forum*, wrote a letter to the Department. The last paragraph of Belth's letter dealt with the severance packages that would be paid to Provident's six senior officers: "The $36 million to be paid to six departing executives of Provident is excessive, in my opinion. My reaction is visceral, and my opinion is based on intuition. I acknowledge that I am not an expert on executive compensation [editor's note: Belth has been publishing data on insurance executives' compensation since 1975], and that a consultant paid by Provident has expressed the opinion that Provident's severance packages are 'reasonable and consistent with industry and broader market practice.' I think they are not reasonable. If they are indeed 'consistent with industry and broader market practice,' then perhaps severance packages in general are excessive. Further, I acknowledge the Department will not be able to retain an executive compensation consultant who will express the opinion that the packages are excessive, because a consultant expressing such an opinion would be committing economic suicide. Nonetheless, I hope the Department will insist that the severance packages be reduced substantially."

Belth has still not received a response from the Department or from Provident.

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