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# SCHIFF'S INSURANCE OBSERVER

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# The Education of Commissioner Terri Vaughan

## *Striking it Rich*

BY DAVID SCHIFF

About ten years ago I was having dinner with an insurance commissioner. We'd finished our appetizers and were slicing into our steaks. My dinner companion—let's call him Jeff—was telling me about a complicated insurance-company transaction that had been submitted to his office. He was going to approve it even though he knew it was wrong. I didn't need to ask for an explanation. He offered it.

"My term is up soon," Jeff told me, "and I really need a job in the industry. My kids are in high school and I don't want to have to move out of state."

I didn't say anything.

"My kids," he said, looking me in the eye.

"I understand," I told him.

Although I knew Jeff wouldn't have accepted a suitcase full of cash as a payoff for approving the transaction, I had to ask myself: would that have been so different? To get the sort of job he wanted (or in his view, needed), he was going to sign off on the transaction. Jeff wasn't getting money to endorse a dirty deal, but he *expected* to make money because of it.

Even though Jeff violated the public trust for personal gain, the transaction and his ultimate remuneration were fairly small. Jeff viewed himself as a pawn in a game played by big insurance companies. Other commissioners would have done the same thing in his position. This was business as usual.

Looking back, I've come to the conclusion that the only unusual aspect of the story lay in Jeff's being honest enough to admit to me what he was doing.

*"…and then the insurance commissioner got $1,000,000."*

In New York, where I'm from, I wouldn't have been dining with the commissioners in the first place; the last two wouldn't return my calls. (Granted, I was critical of them, and they probably figured that nothing good would come from speaking to me.) I've had similar problems with other commissioners. But it wasn't always that way.

Ten years ago, in the summer of 1996, I headed to Iowa for a combination road trip and business trip. I called Iowa's insurance commissioner, Terri Vaughan, whom I didn't know, to say I'd like to meet with her while in Des Moines. We set a date.

To a New Yorker, Iowa is the hinterlands. (So are Bloomington, Hartford, Milwaukee, Cincinnati, and everywhere else on the planet.) That's not all bad. When I was in the insurance business, I used to call on clients in the New York metro area. They weren't particularly cordial. I was often kept waiting, then told, "I'm running late . I've only got ten minutes."

But in the hinterlands I was treated like an important visitor. Insurance brokers thanked me for coming to see them. Once, when I walked into one of Marsh & McLennan's small regional offices, I was met with a sign: "Welcome David Schiff."

I'd wanted to go to Iowa ever since I read that it had more towns with less than 1,000 people than any other state. It was the heart of America, far removed from Manhattan, where so much revolved around Wall Street. To me, Iowa was an adventure, and I wanted to tour its back roads and small towns. But I also had a thesis: that it was a better place to do business. Midwesterners weren't as greedy as those on the coasts. Expenses were lower.

Midwestern CEOs were different too, and they didn't get paid as much. I re-called a conversation with Vince Trosino, president of State Farm. Although he ran one of the largest companies in America, his salary was relatively modest. Noting this, I asked if he was interested in money.

"I'm not here to judge," he said. "That's for others. Once you meet your needs, compensation means different things. How many cars, suits, and shirts can I own?" Maybe Midwestern insurance company CEOS weren't inclined to fill their closets with bespoke suits from Gieves & Hawkes, but had Vince wished to do so, he could surely have footed the bill.

Despite Iowa's small population—2.9 million—it's a major insurance state. Iowa's low cost of living and educated population are a big draw for insurance


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**9:00 a.m.** **David Schiff,** editor of ***Schiff's Insurance Observer,*** will tell you what he's riled up about these days. Throughout the conference he will, as always, interrogate the speakers and force them to answer brazen questions.

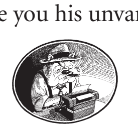
**9:25 a.m.** **Jason Adkins** began his career working for Ralph Nader, and has spent much of his time battling the insurance industry. He founded the ***Center for Insurance Research*** in 1991 and has been a partner at the law firm Adkins, Kelston & Zavez, P.C. since 1998. Jason, who's an indefatigable voice for fairness, reform, and the public interest, will discuss some highlights and low points in insurance litigation, including an overview of the Allied Mutual litigation which resulted in a historic settlement.

**10:30 a.m.** **Andrew Marks** has been an insurance broker for forty-three years and was David Schiff's mentor in the insurance business. Andy, who's one of the most knowledgeable insurance brokers around, is CEO of ***MLW Services,*** a division of Bollinger, Inc. He will take us inside the insurance business and tell all.

**11:15 a.m.** When **John Burns** stepped down as CEO of ***Alleghany Corp.*** in 2004, he left a great record of achievement—long-term shareholder returns in the neighborhood of twenty percent. John has spent his career ignoring fads and the new new thing, focusing instead on creating long-term value for his shareholders. Over the decades, Alleghany has owned (and sometimes sold) a variety of businesses and investments including asset management, steel, minerals, railroads, and, of course, insurance. John will share with us the lessons he's learned from thirty-six years of owning insurance companies.

**Noon** Decent food and fine conversation.

**1:00 p.m.** **Robert Hunter,** director of insurance for the ***Consumer Federation of America,*** has had a long career in insurance. He began as an underwriter at Atlantic Mutual, worked at two rating bureaus, consulted with government agencies, served as Federal Insurance Administrator, founded the National Insurance Consumer Organization, and was the Texas Commissioner of Insurance. Bob, who's an actuary, will give you his unvarnished view.



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companies. Iowa is not prone to some of the problems that afflict other markets. Hurricanes and earthquakes aren't a factor. Redlining isn't a big deal, and the low poverty rate means that affordability isn't much of an issue either. Because of this good fortune, Iowa's insurance market works quite nicely, and state regulators aren't confronted with the difficult issues faced by regulators in, say, California, Florida, New Jersey, or New York. Because of the benign environment, Iowa is considered an attractive market, with plenty of competition. Iowa has hundreds of domestic insurance companies.

Despite Iowa's big insurance industry, the state spends little on regulation. In 1996, its insurance department employed eighty-five people and had a budget of only $5.3 million.

**1:45 p.m.** Since 1981, **Richard Stewart** has been chairman of ***Stewart Economics,*** a consulting firm specializing in insurance and insurance regulation. Dick was a Rhodes Scholar and attorney before becoming First Assistant Counsel to New York Governor Nelson Rockefeller. He served as New York's Superintendent of Insurance from 1967-1970, and was subsequently SVP and general counsel of First National City Bank, then SVP and CFO of Chubb. Over the years, Dick has published influential tracts on insurance regulation, insurer insolvency, underwriting cycles, and insurance insolvency guarantees. He'll tell us what he's thinking about these days.

**2:45 p.m.** A living legend returns for a rare New York performance! **Joseph Belth,** editor of ***The Insurance Forum,*** will be making his third appearance at Schiff's Insurance Conference. Joe, whose articles, speeches, and testimony have shaken up the life-insurance industry, is the author of numerous books and journal articles and is professor emeritus of insurance at the Kelley School of Business at Indiana University. He will let us know what's bothering him.

**3:45 p.m.** **David Schiff** will have his say on the great insurance issues of the day, and discuss where he sees value and solvency (or the lack thereof).

**4:30 p.m.** Attendees will socialize with their fellow insurance mavens and observers, discussing the day's events and making deals over cocktails while taking in the view from the top of the New York Athletic Club.

**6:00 p.m.** There will be an additional reception and dinner for those who want more of a good thing. The venue is the Coffee House, a convivial and somewhat worn-at-the-edges private club devoted to "agreeable, civilized conversation." Attendance is limited to 36 people.

On Tuesday afternoon, August 20, 1996, shortly before 1:00, I entered the Lucas Building in Des Moines, a seven-story government office next to the lavish, gold-domed state Capitol, and went upstairs to meet insurance commissioner Terri Vaughan.

As we sat in her large office and talked, it occurred to me that she and I were not as different as I had expected. We were about the same age and had both gone into the family business. (I'd started at my uncle's insurance brokerage; she'd followed in her father's footsteps as an insurance professor. )

Terri had a Ph.D. in risk and insurance and is an actuary. For a few years in the 1980s she lived in New York where she taught at Baruch College for a year and a half and worked at Tillinghast for two years. She moved back to Des Moines in 1988 and headed Drake University's insurance department for six years. Terri became insurance commissioner in 1994 and, two years later, co-authored her father's textbook, *Fundamentals of Risk and Insurance*, then on its seventh edition.

Terri's background in insurance and academia did not necessarily make her a logical candidate for the commissioner's job, because a knowledge of insurance isn't always a prerequisite. In most states, the commissioner is appointed by the governor, and the qualifications for the job generally have more to do with politics than anything else. (Take the example of New York's current commissioner, Howard Mills. He gave up his seat in the state assembly to be the sacrificial Republican nominee for the senate in 2004; he had no chance of defeating incumbent senator Chuck Schumer in the general election. He lost in a landslide, but a month later, George Pataki, New York's Republican governor, appointed Mills insurance commissioner.)

Terri told me that she was "not a particularly politically involved person," and that she had decided to apply for the insurance commissioner's job when there was an opening in 1994. It all sounded quite casual.

Terri didn't espouse any grand ideas about the role of the regulator—other than an expressed faith in doing a good job—and I didn't discern any particular agenda. The *Des Moines Register* had described her as an insurance "technocrat."

Almost in passing, Terri told me about a new law in Iowa of which she was quite proud—the state's mutual holding company statute, the first in the nation. I didn't pay much attention to this even though I was aware that executives at mutual S&Ls had used the mutual-holding-company format to take advantage of their depositors.

When I left Terri's office that day I didn't suspect that in little more than a year the subject of mutual insurance holding companies and corporate governance at mutual insurance companies would be among the biggest issues in the insurance industry—and highly contentious ones—and that she and I would be on opposite sides in several battles that would play a role in reshaping the future of the mutual insurance industry.

The following year, I began working on an article about insurance in Iowa. As part of my research I took a look at Allied Group, the largest property-casualty insurance company in the state. I noted, that Allied had done a number of transactions with its former parent, Allied Mutual.

Perhaps there was nothing to this, but the situation piqued my interest. I began reading Allied Group's annual reports, 10-Ks, proxy statements, quarterly statements, and prospectuses. I went through Allied Mutual's statutory filings, and later made freedom-of-information-law requests to get additional documents. I reviewed correspondence between Allied's officers and the insurance department, and examined files at the insurance department.

As I looked closer, a remarkable story began to emerge. Over the previous twelve years, John Evans, the diminutive, balding chairman and CEO of Allied Group and Allied Mutual, had masterminded a massive siphoning of business, assets, premiums, and employees from Allied Mutual into Allied Group. As a result of dozens of intricate transactions—

sales, purchases, poolings, transfers, repurchases, loans, fees, and securities swaps—more than $1.5 billion of value had been drained from Allied Mutual into Allied Group, enriching Evans and the companies' officers, directors, and employees by hundreds of millions of dollars, all at the expense of Allied Mutual's policyholders.

In September 1997, *Schiff's* published a fifteen-page exposé, "The Dark Side of Demutualization (or How to Make a Fortune From a Mutual Insurance Company)." Concurrently, I took out a $7,500 half-page ad in the *Des Moines Register* announcing my candidacy for Allied Mutual's board of directors and my proxy fight to gain control of the board on behalf of its policyholders.

The article and my run for the board made headlines in the *Des Moines Register*, and the following week *The Wall Street Journal* carried an article accompanied by a picture of me. By then, the story was all over the trade publications, and regulators across the country were soon discussing the Allied affair. My days were spent talking to reporters, regulators, lawyers, analysts, and activists.

None of this was good news for my old friend Terri Vaughn. A billion-dollar rip-off had taken place twenty blocks from her office without raising the concern of single employee in the insurance department. More troubling still, Terri was a vocal proponent of mutual holding companies, whose structure was now being revealed—by the Allied Mutual scandal—to contain disturbing conflicts of interest and corporate governance problems.

Now, with a national scandal focusing its attention, the Iowa insurance department launched an "investigation" into Allied.

"It will take awhile," Terri told *Bestwire*. "I can't define how long. They're very complex transactions."

She was right. They were complex transactions. Proof of that was that it had taken me six months to go through more than 10,000 pages of Allied documents in order to piece together Evans' intricate dealings and egregious financial legerdemain.

It was good news, I supposed, that Terri now told *Business Insurance* that she was taking the matter "very seriously."

At first I took the commissioner at her word. She hired Coopers & Lybrand to conduct the investigation. To help out, I went back to Des Moines and met with them at the insurance department. We sat in a room with piles of Allied documents on a long conference table. I walked the guys from Coopers through the numerous transactions and showed how they had been engineered by Evans and had benefited him and Allied Group at Allied Mutual's expense. I explained how Allied Mutual's directors had material conflicts of interest in the numerous non-arm's-length deals they approved.

As I made my way through the dozens of instances of Allied's duplicitous transactions, I looked around the room. The guys from Coopers appeared strikingly blasé about the abundant evidence of massive corporate abuse laid out before them.

Over the next month I began to wonder about Terri. She stopped returning my calls. As for the "investigation," nothing seemed to be happening.

Perhaps I shouldn't have been surprised. Allied was one of the largest employers in Des Moines, and its board was comprised of prominent local businessmen. Terri's family also had connections with Allied. Allied paid her father, Emmett Vaughan, to teach a course to its employees. And her husband, Robert Carber, was an executive at CGA Insurance Services, a thirty-person agency that was one of Allied's largest producers. It placed all of its personal lines of business with Allied. CGA was also Allied Life's leading agent.

Although I was a valid nominee for Allied Mutual's board of directors, the company had been trying to prevent my candidacy for months. In late December, Terri finally took action, ordering Allied Mutual to provide me with a "timely and reasonable access to a mechanism for communication" with Allied's policyholders so that I could "meaningfully participate in the elective process."

*Terri Vaughan*

Allied agents bombarded Terri with letters, castigating her for making their client lists available to me (even though she did no such thing). Allied went to court to block her order, arguing that she had exceeded her statutory authority by engaging in rule-making without holding a hearing. The National Association of Mutual Insurance Companies filed an amicus briefs, as did the National Association of Independent Insurers and eight independent agents. The Polk County District Court—displaying a certain partiality to its hometown insurance conglomerate, agreed with Allied's position. Terri could have appealed, held hearings, or given speeches. She didn't.

As far as I could tell, after that she wanted to have as little to do with Allied as possible. In Des Moines, it doesn't pay to get on the wrong side of big insurance companies.

While the fracas over Allied Mutual was going on, Terri and I found ourselves on opposite sides of the mutual-holding-company debate. [For much more on this subject, see the February, May, and October 1998 issues of *Schiff's*.] Terri was a big proponent of mutual holding companies, and in their defense she offered tortured rationalizations about why policyholders didn't really "own" a mutual insurance company—despite the weight of evidence to the contrary. Her point of view just happened to coincide with that espoused by Principal Mutual, which was planning to convert to a mutual holding company.

Principal, of course, was one of the largest insurance companies in America. And, with 12,000 employees, it also happened to be the largest private employer in Iowa. No visitor can pass through Des Moines without noticing the company's presence. Although the skyline is dominated by insurance-company office buildings, one towers over the others: Principal's 44-story post-modern skyscraper.

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On January 23 and 24, 1998, the first big mutual-holding-company battle took place at the Henry Wallace Auditorium in Des Moines, in the form of a public hearing regarding Principal Mutual's application to convert to a mutual holding company. Principal was then worth about $10 billion. What happened at the hearing could determine whether that value would go to the company's 660,000 policyholders or to corporate insiders and institutional investors.

The fight at the Henry Wallace Auditorium looked like a mismatch. Principal had spent tens of millions of dollars on its mutual-holding-company conversion plan. It was represented by LeBoeuf, Lamb, Greene & MacRae, Goldman Sachs, and Milliman & Robertson. Terri Vaughan presided over the hearing. Of course, she was already on the record as a champion of mutual-holding-company conversions.

Principal's primary opposition consisted of two out-of-towners: Jason Adkins, a public-interest lawyer who'd set up a small private practice a few weeks earlier, and myself. Although we'd gotten some attention in previous months for our fights against abuses at mutual insurance companies, most viewed us as quixotic. Over the next couple of years however, our point of view would prevail over that of many of the big mutuals. As it turned out, the Principal hearing was a turning point in the mutual-holding-company war.

The farce that was the Principal hearing has been covered in some detail in these pages, especially in our August 25, 2000 issue. Without recounting the proceedings, here's a brief recap: Commissioner Vaughan cut short questioning, dismissed important facts, and appeared to ignore material conflicts of interest.

Though she later conceded that Goldman Sachs' fairness opinion—which was included in the package mailed to every policyholder—was not "factually supported, analytically complete, and free of…conflict of interest," she approved the conversion anyway, even though policyholders had relied on that fairness opinion when casting their votes.

But there was one hitch, not previously explored in these pages: the law. Section IAC 191-46.4(1)(g) of Iowa's mutual holding company statute contained some odd language, inserted by legislators who presumably, wanted to make sure that a mutual holding company conversion provided a tangible benefit to policyholders.

I will refer to this section as the "inurement provision." Neither Jason nor I paid much attention to it. Principal's conversion plan cheated policyholders in so many ways and was so filled with deceptive and misleading statements that the inurement provision seemed almost incidental.

The inurement provision stated the following:

> [The] plan of reorganization shall include provisions describing a plan how any accumulation or prospective accumulation of earnings by the mutual insurance holding company which is or would be in excess of that determined…to be necessary *shall inure to the exclusive benefit of the policyholders* of its insurance company subsidiaries who are members. [Emphasis added.]

What this means, in English, is that in order to comply with the law, Principal had to describe a plan that showed how the mutual holding company's excess accumulated earnings would "inure to the exclusive benefit of policyholders" who were members of the mutual holding company.

Yet Principal had failed to do this. At the hearing, David Drury, Principal's chairman and CEO, had said that the company would comply with the inurement provision by reinvesting in additional shares of an intermediate holding company.

But doing that wouldn't inure to the "exclusive benefit" of policyholders, as the law required.

On March 24, 1998, two months after the hearing, Terri issued a "request for clarification of record." She wrote that Principal's "submission leaves ambiguous precisely how Principal plans to comply" with the inurement provision, and ordered the company to describe a plan that complied with the inurement provision.

At the hearing, Drury had said that Principal "cannot develop an alternative" to what he had already described. That wasn't true. He didn't like the alternative. No mutual insurance holding company in Iowa would.

A logical way for a mutual holding company to comply with the inurement provision would be for it pay out any excess accumulation of earnings as a dividend to members of the mutual holding company. Doing that, however, would cause the SEC to view a membership interest as a security, which would create an additional layer of regulation that could cost the company hundreds of millions of dollars. In order to avoid this regulation, mutual holding companies (including Principal) make certain representations to the SEC, among them that they do not intend to pay dividends. They also assert that a "membership interest does not provide a member with any reasonable expectation of profits of the mutual holding company." (That's one of the major problems with mutual holding companies.)

Now Drury was in a bind. If Principal complied with Iowa law, the SEC would consider a membership interest in the mutual holding company to be a security, a situation that Principal considered intolerable.

Over the months that followed, Jason, Joe Belth (editor of *The Insurance Forum*, who had entered the fray after the hearing), and myself spent our days on the phone, sharing documents and making our way through the morass of state law, securities regulation, and IRS rules regarding mutual holding companies.

On April 3, Principal's lawyer, Molly Boast of LeBoeuf Lamb, submitted a new "plan" to Terri. She wrote that it was "developed after extensive consultations with the Securities Exchange Commission regarding federal securities law issues related to distributions of excess accumulated earnings by Principal Mutual Holding Company." Boast said the "plan" was "careful to avoid creating an expectation of economic return on membership interests."

The "plan" Boast submitted was not a plan at all. It merely said that Principal would apply any excess earnings "in the manner directed by the commissioner"—provided that Principal could obtain "all confirmations, rulings, and opinions" that it considered necessary. Boast, of course, knew that Principal could not obtain those confirmations, rulings, and opinions.

Clearly, Principal had not described a plan that complied with the inurement provision. This appeared to be a stunning denouement. Principal's conversion would be thwarted because the company was unwilling to comply with a quirky provision of the law.

On April 10, Joseph Belth, faxed a letter to Commissioner Vaughan. Jason Adkins, counsel to The Center for Insurance Research, faxed a letter to her on April 13, as did I.

*continued*

An excerpt from my letter:

> Principal's professed "Plan"…is even less of a "plan" than any of Principal's previous assertions…It requires the commissioner, rather than the company, to describe a plan how any excess capital benefits members. The obligation of describing a plan clearly belongs to Principal…

And that of Jason Adkins:

> The cover letter to the Proposal states that "the Plan is careful to avoid creating an expectation of economic return on membership interests [in Principal Mutual Holding Company], which we believe could result in such interest being characterized as a 'security' under federal securities law."
>
> Note that [Principal] is not trying to avoid breaking other laws—it simply does not want the expense of complying with them…

And this from Joe Belth:

> In response to your request, Principal did not file a plan. Instead, the company backed away from the ambiguous plan submitted previously. Principal has capitulated; it has found that it cannot satisfy the inurement provision and at the same time avoid having membership interests in the mutual holding company deemed to be securities for the purposes of the federal securities law. Under the circumstance, Principal's failure to take the initiative and withdraw its mutual holding company reorganization proposal from consideration leaves you with no alternative but to disapprove the proposal.

Terri Vaughan was now faced with an unusual situation. Principal had spent a huge amount of time and money on its deceptive and misleading mutual-holding-company plan, but it refused to comply with a key provision of the law. What was an insurance commissioner to do?

On May 15, Commissioner Vaughan, the insurance "technocrat," issued an order concluding that Principal's plan and submissions "did not provide sufficient detail to satisfy concerns about fair and equitable distribution of excess surplus." She also wrote that the "legal criteria set forth in the Iowa Code" had not been met.

But she approved the conversion anyway.

Terri was Iowa's insurance commissioner until the end of 2004, when she went back to Drake University, where she is now the Robb B. Kelley Distinguished Professor of Insurance and Actuarial Science.

"At heart, I am an academic," she told the *National Underwriter*. Her final salary as commissioner : $86,231.12.

Eleven months after leaving the commissioner's office, Professor Terri Vaughn joined Principal's board of directors. For this extracurricular work she will be paid $152,700 per year.

Assuming she remains on the board for ten years, the present value of that directorship is more than $1.5 million.

**For the Record**

The article in our February 27 issue, "Buffett and Greenberg: A Long Relationship," reported that Berkshire Hathaway made a low bid for the HSB Group prior to the company's acquisition by AIG in 2000. In a brief note, Warren Buffett wrote in to say there was "never any serious discussion or consideration" of such an offer.

A source close to HSB had put the Berkshire bid at $31 per share.