Allied Mutual: Ring of Fire

A Public Hearing in Iowa

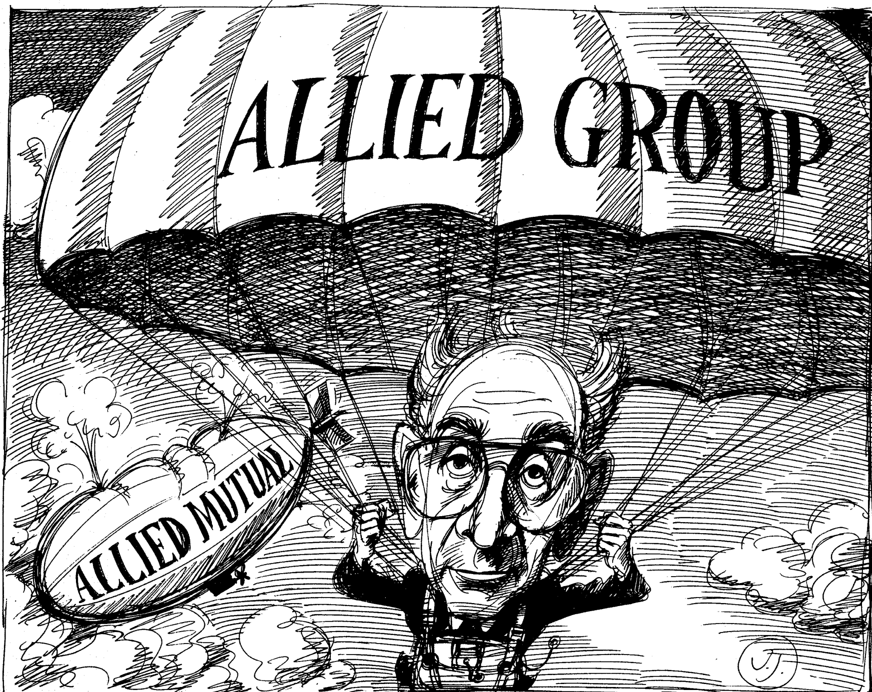
As a result of an astonishing array of asset shuffles orchestrated by Allied Mutual's board between 1985 and 1994 (and exposed in these pages in September 1997), all of Allied Mutual's employees, most of its premiums, and much of its value were transferred to an affiliate, Allied Group. Although Allied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

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

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

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

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



John Evans, chairman of Allied Mutual and Allied Group

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

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

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

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

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

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

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

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

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

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

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

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

Nationwide was correct. By exercising Allied Mutual's preferred voting rights, Allied Mutual's directors could block a deal that wasn't favorable to Allied Mutual. But blocking the deal proposed by Nationwide conflicted with the Allied Mutual directors' *personal* financial interests. If the directors used Allied Mutual's leverage to negotiate a decent price for Allied Mutual—

The Allied Shuffle

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

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

say $600 million—Nationwide would presumably pay that much less for Allied Group, which would have resulted in Allied Mutual's directors and employee-shareholders receiving $20 million and $200 million less, respectively, for their Allied Group shares.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ANDERSEN: I'm sorry. Retention ratios?

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

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

HEARING OFFICER: Overruled.

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

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

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

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

THRALL: Could I have the question read back?

The question was read back.

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

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

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

HEARING OFFICER: Could you simplify that question, please?

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

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

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

ANDERSEN: Extraordinary event, okay.

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

ANDERSEN: Yes.

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

ANDERSEN: Okay.

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

THRALL: I'm going to object as irrelevant.

HEARING OFFICER: Overruled.

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

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

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

HEARING OFFICER: At this juncture the objection is overruled.

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

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

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

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

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

SCHIFF: What is the benefit, then, of the

Allied Mutual Policyholders Get Useless Certificate, Allied Execs Get Money

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

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

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

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

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

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

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

membership certificate?
ANDERSEN: The benefit of the membership certificate?
SCHIFF: Yes.
ANDERSEN: That gives an ongoing right. As long as the policyholder maintains his policy with Nationwide, he'll have all the attendant benefits that he had when he was with Allied, so it keeps the right of mutuality.
SCHIFF: You stated that a significant factor considered—and a benefit to policyholders—is the preservation of mutuality. That's Exhibit 4.
ANDERSEN: That's right.
SCHIFF: Do *Allied Mutual* policyholders, in general, pay lower premiums or higher premiums than policyholders of [Allied Group]?
THRALL: I object.
HEARING OFFICER: Sustained.

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

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

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

Vaughan did neither.

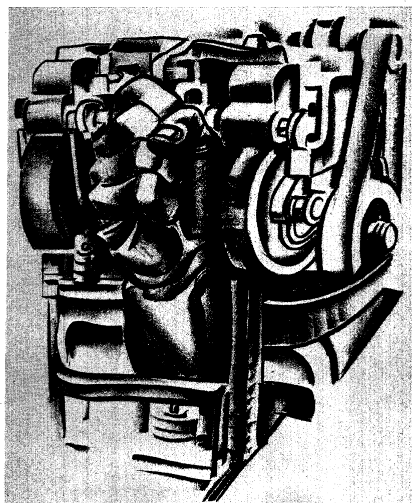
As for Schiff's discovery request (made in accordance with the Iowa Code), for the production of Allied documents that were relevant to the hearing, that went nowhere. (The Insurance Department could have insisted that Allied Mutual produce the documents, but didn't.)

HOLMES MURPHY
THE INSURANCE LEADER

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

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

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



Mutual policyholders, unite!

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

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

What follows is a verbatim transcript of Schiff's cross-examination of Reichardt.
SCHIFF: Hello. Have you reviewed the proxy statement sent to Allied Mutual policyholders?
REICHARDT: No.
SCHIFF: Have you read the intercompany operating agreements?
REICHARDT: No.
SCHIFF: Have you reviewed Allied Mutual's statutory financial statements?
REICHARDT: No.
SCHIFF: Have you reviewed Allied Group's SEC filings?
REICHARDT: I have not.
SCHIFF: Have you reviewed the Form A filing?
REICHARDT: No.
SCHIFF: Have you made any assessment as to what the companies are worth? Either company—Allied Group, Allied Mutual?
REICHARDT: No.
SCHIFF: Have you consulted with any advisors on this?
REICHARDT: No.
SCHIFF: I don't have any further questions.

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

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

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

What Commissioner Vaughan Didn't Say

The Allied Connection

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Continued

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

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

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

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

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

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

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Junk Jurisprudence

Update on Allied Mutual Lawsuit

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Damn the policyholders—full speed ahead! ■