



# SCHIFF'S

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## INSURANCE OBSERVER

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## Principal Financial Group Capitulates

### *Throws in Towel on Ill-fated MIHC*

THE PRINCIPAL FINANCIAL Group announced yesterday that its board of directors has approved management's recommendation to demutualize Principal Mutual Holding Company and convert the entity into a stock company.

While this development was expected (see "Principal Announces Demutualization 'Study': A Blow to the Mutual Holding Company Movement," *Schiff's Insurance Observer Evening Telegraph Edition*, March 3, 2000) it is, nonetheless, a stunning dénouement to a bitter battle over the fate of one of America's largest mutual insurance companies.

In 1997 and 1998, Iowa-domiciled Principal Mutual made a full-throttle attempt to snooker its policyholders by trying to push through an abusive mutual-insurance-holding company (MIHC) conversion.

Principal's MIHC-conversion attempt was notable for several reasons: it was the largest MIHC conversion attempted, and it was the first to encounter significant opposition.

The opposition didn't come from the usual suspects. No insurance commissioner opposed the plan, nor did legislators or strike-suit lawyers. When the public hearing regarding Principal's proposed conversion convened at The Henry Wallace Auditorium in Des Moines on January 23, 1998, it looked like it would be a lopsided battle. In one corner was Principal Mutual, along with its lawyers, LeBoeuf Lamb, its investment banker, Goldman Sachs, and its actuary, Milliman & Robertson. Although the insurance commissioner ostensibly acts as a judge at

these hearings, Iowa's commissioner, Terri Vaughan, had already gone on record as an ardent supporter of the MIHC concept.

Principal's opposition was a small band of guerrilla activists who were offended by the unfairness of the MIHC concept. The principal players in the Principal opposition were Jason Adkins, a public-interest lawyer from Cambridge, and David Schiff, an insurance observer from New York. They were joined by Anamaria Lloyd, a Principal agent (and policyholder), and David Winters, a money manager (and Principal policyholder).

Also in attendance were various mutual executives who wanted to see what Adkins and Schiff were up to. Among the attendees were representatives of Provident Mutual, which was trying to pull off its own abusive MIHC. (One month later, James Potter, Provident's executive vice president and general counsel, faxed an internal Provident memo, "Consumer Advocate Activity at Principal Mutual's Public Hearing," to Lynn Fitzwater, the Pennsylvania Insurance Department's counsel. The memo attempted to describe Adkins' and Schiff's modus operandi, and closed by saying, "It was incumbent upon the Iowa Commissioner to approve or disallow each question in order to minimize the redundancy and not waste time...")

The implication of the Provident memo was clear: that Terri Vaughan silenced Adkins and Schiff, and that the Pennsylvania Insurance Department should do the same. (The Pennsylvania insurance commissioner was Diane Koken, former general counsel of Provident. The Pennsylvania Insurance Department apparently took the Provident memo to heart.)

### Shady Testimony

The Principal hearing was marked by some intriguing testimony, as Principal and its hired hands tried to evade ques-

tions and disavow the past. Principal's chairman, CEO, and president, David Drury, did not distinguish himself. Although he'd worked at Principal since 1966, his testimony under oath would lead one to believe that he had no idea of what was happening at the company.

For example, he was asked a simple question by Lloyd (who was a Principal agent): "Do we policyholders own the company, Mr. Drury, or was that just a sales line?"

Drury responded with the obfuscation that had then become the mantra of mutual CEOs: "The issue of whether or not policyholders actually own, with that word, a mutual insurance company, is one that lawyers have argued about for many years."

Although lawyers *hadn't* argued about that for many years—why would they unless they were getting paid?—Principal Mutual's own sales material stated that the company was "a mutual company, *owned by its policyholders*. Dividends are paid only to policyholders." [Emphasis added.] By disavowing that policyholders were owners, Principal could argue they weren't losing anything in the MIHC conversion, since they didn't "own" anything to begin with.

Drury also gave testimony that didn't accurately describe "the contribution principle"—the method by which dividends are paid to mutual policyholders. Jason Adkins asked Drury, "Is it fair to say that policyholders currently have an ongoing...expectation and right to share in excess revenues of the corporation beyond those needed to pay claims and other business obligations?"

Drury wouldn't respond directly. Instead, he said that policyholders "have a right to share in the experience on the *blocks of business* they are involved in..." [Emphasis added.] He wouldn't admit that policyholders have a right to share in the experience of *the company as a whole*.

Drury's statement was misleading at best. Principal Mutual had previously defined a participating policy as one "which entitles the member to participate in the *divisible surplus* of an insurance company through policyholders dividends..." [Emphasis added.] Principal's participating policies contained the following language: "Your policy shares in our divisible surplus." (The divisible surplus is simply the total amount of funds that the company's

board has determined will be distributed in the form of dividends.)

Mutual insurance companies pay dividends based on the *contribution principle*, which the Actuarial Standards Board defines in the following manner: "The contribution principle requires that aggregate divisible surplus be distributed among policyholders in the same proportion as the policies are considered to have contributed to divisible surplus."

As Joseph Belth wrote in the *Insurance Forum*, "It is important to note that the contribution principle says each policy receives a dividend that is *in the same proportion* that the policy is considered to have contributed to the divisible surplus of the company. The contribution principle does *not* say each policy receives a dividend that *equals* what the policy is considered to have contributed to the divisible surplus of the company."

**Editor and Writer** . . . . . David Schiff  
**Production Editor** . . . . . Bill Lauck

**Publisher** . . . . . Alan Zimmerman  
**Subscription Manager** . . . . . Pat LaBua

**Editorial Office**  
*Schiff's Insurance Observer*  
300 Central Park West, Suite 4H  
New York, NY 10024  
Phone: (212) 724-2000  
Fax: (212) 712-1999  
E-mail: David@InsuranceObserver.com

**Publishing Headquarters**  
*Schiff's Insurance Observer*  
SNL c/o Insurance Communications Co.  
321 East Main Street  
P.O. Box 2056  
Charlottesville, VA 22902  
Phone: (804) 977-5877  
Fax: (804) 984-8020  
E-mail: Subscriptions@InsuranceObserver.com

For questions regarding subscriptions please call (804) 977-5877.

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The matter of dividends may seem esoteric, but it went toward the heart of the MIHC debate. The dividends a participating policy in a mutual receives are akin to dividends that shareholders in a company receive. If you own one share of IBM, for instance, your one share will receive the same dividend per share as someone who owns 10,000 shares. Drury's explanation of Principal's dividend paying habits—that dividends are based on the profitability of a particular *block of business*, and not upon any ownership in the enterprise—did not comply with the standard of the contribution principle.

### Sales Practices

Schiff asked Drury: "Are you aware, or is it your knowledge, or have you ever been told, or is it your understanding that many agents of your company" sell insurance by telling policyholders that they are *owners*?

"I have no direct knowledge of that," Drury responded.

Since the envelopes Principal used to deliver policies stated that the company was "a mutual company owned by its policyholders," one wonders how Drury, who professed to be familiar with Principal's operations, could give his answer with a straight face.

Throughout his testimony, Drury discussed issuing stock and making acquisitions for stock and cash. Yet, in response to Schiff's question, "How much is Principal Mutual worth?" he ultimately stated, "I don't have an opinion as to what ... the market would assign as a current value to the company."

When Schiff suggested that Principal was worth about \$10 billion, Principal's attorney objected, stating that "Mr. Drury has already said that he doesn't have the expertise to make such an assumption."

"If he doesn't have expertise, why would he want to acquire companies?" Schiff queried.

"I have expertise on my staff," Drury said, "and we hire expertise from investment bankers in these areas. I don't have personal expertise."

### The Amazing Mr. Silverstein

Principal's investment bank was Goldman Sachs, and its investment banker was Howard Silverstein, a

Goldman Sachs managing director. Silverstein has extensive experience in the insurance field. He worked in the investment banking business for 25 years, had overseen Goldman Sachs' investment banking activities for the insurance industry, and served as co-head of Goldman Sachs' worldwide financial institutions group.

When questioned by Principal's lawyers, Silverstein cited nine recent acquisitions of life insurance companies. He mentioned the price of six of these acquisitions (in each case over \$1 billion) and added that these deals "were by no means the only acquisitions in the life insurance industry over the last few years, but they are amongst the largest." He discussed the advantage of "be[ing] able to use stock as an acquisition currency" and cited several billion-dollar acquisitions that involved stock. He also cited AmVestors' acquisition by AmerUs (another Iowa-domiciled company), which had closed the previous month.

The valuation of Principal Mutual was an important issue because if policyholders were told that they might receive, on average, about \$15,000 in a full demutualization, they would be unlikely to vote for a MIHC conversion in which they received nothing.

When Schiff attempted to get Silverstein to provide "a very broad number" or "a rough ballpark figure" as to what Principal Financial Group was worth, Silverstein claimed that Goldman Sachs "had done no work that would allow us to come to any sort of reasonable view that would be responsive to your question."

When Schiff persisted, Principal's lawyer objected.

Schiff said, "I think [Silverstein] is familiar with valuations." He then addressed Silverstein: "I know that you have a rough idea of what these kinds of companies go for." Silverstein, a supposed expert in insurance-industry finance and investment banking, responded only by saying, "I didn't know we had mind readers in the room."

One didn't need to be a mind reader to know that Goldman Sachs and Howard Silverstein had a rough idea of the ballpark value of Principal. One only had to be a reader of the November 13, 1997

SEC filing for the AmerUs/AmVestors deal in which Goldman Sachs acted as AmVestors' advisor and received a fee of \$3.5 million for its work. That document stated the following: "Goldman Sachs, as part of its investment banking business, is continually engaged in the valuation of businesses and their securities in connection with mergers and acquisitions, negotiated underwritings, competitive bidings, secondary distributions of listed and unlisted securities, private placements, and valuations for estate, corporate and other purposes." A November 7, 1997 letter from Goldman Sachs to Principal Mutual's Board contained identical language.

The November 13 filing also explained that Goldman *had recently made an analysis of the valuations of large life insurance companies*. The filing said the following: "Goldman Sachs reviewed and compared certain financial information relating to AmVestors and AmerUs to corresponding financial information, ratios and public market multiples...for selected publicly traded large-capitalization life insurance companies and annuity companies..."

"Goldman Sachs' analyses indicated that (a) 1997 P/E Ratios ranged...from 14.4x to 20.7x for the Selected Large-Cap Life Companies with a median of 16.0x...1998 P/E Ratios ranged from...12.6x to 17.7x...with a median of 14.4x...Price/Book Ratios ranged from 1.69x to 3.53x for the Selected Large-Cap Life Companies with a median of 2.49x..." Goldman Sachs had also performed a *selected transactions analysis* which gave more valuation parameters for deals that had taken place.

Furthermore, just two weeks before the Principal hearing, several investment funds affiliated with Goldman Sachs invested \$115 million in Mutual Life Insurance Company of New York (MONY), and received surplus notes and warrants to purchase 7% of MONY's common stock upon its demutualization.

Considering the magnitude of the fees Goldman Sachs has been paid, the analyses performed by Goldman Sachs, Goldman Sachs' direct investment in MONY, and Silverstein's senior position at Goldman Sachs—Silverstein's claim that he was unable to provide even a

very broad number or a rough ballpark figure of Principal's value cast grave doubts on his veracity and suitability as a witness.

## Conflict of Interest

As part of the transaction, Goldman Sachs gave the deal its blessing by issuing what is commonly known as a fairness opinion. As Schiff argued in a letter to Commissioner Vaughan: "Goldman Sachs' fairness opinion is invalid because Goldman Sachs has an unconscionable self-interest in the transaction. As it shamelessly admits, 'in the event Principal determines to undertake a related public or private financing transaction, we also have certain rights to act as lead manager or lead underwriter or lead placement agents or lead purchaser thereof.' In simple language, Goldman Sachs has certain rights to buy—for its own account—securities issued by subsidiaries of Principal Mutual Holding Company. Consequently, it is in Goldman Sachs' interest to purchase these securities at the lowest possible price, while it is in Principal's interest and its policyholders interest to have these securities sold at the highest possible price. This conflict of interest is irreconcilable. As a result, the commissioner can not give weight to a fairness opinion issued by Goldman Sachs on a transaction in which it stands to subsequently profit."

Schiff also noted that Goldman had served as the co-manager of Principal's offering of \$300 million of surplus notes, and had represented Principal in another matter, as well.

Ironically, by raising the issue of Goldman's conflict of interest, Schiff actually *helped* Vaughan accomplish the transaction. Prior to Schiff's complaint, Vaughan had not considered Goldman's conflict of interest problematic. Once the issue was raised, however, she was faced with a problem. If she relied on the fairness opinion in approving the transaction, she might leave her approval open for a reversal by a judge. Therefore, Vaughan did something unusual (and upsetting to Goldman). When she approved Principal's MIHC conversion she wrote in her "findings of fact" that she accorded Goldman's fairness opinion no weight: "If

fairness opinions are to be useful, they must be factually supported, analytically complete and free of any hint of conflict of interest. Goldman Sachs' opinion meets none of these criteria." She cited Goldman's "important business relationship" with Principal and added: "The [fairness] opinion—proffered at the same time Goldman Sachs was receiving an engagement to serve as the lead manager of a possible underwriting which will only occur if the transaction is approved by policyholders and regulators—lacks credibility given the lucrative side agreement." (As a result of the fairness opinion imbroglio, standard operating procedure has changed. Now, investment banks give their fairness opinion first and, once the deal is approved, are immediately hired as investment banker or underwriter.)

Vaughan went on to say, however, that *no fairness opinion was required* for the plan to be approved. (She didn't address an important issue: that policyholders received the fairness opinion and, presumably, relied on it when voting for the plan.)

## A Failure

In a press release announcing Principal's expected demutualization, David Drury said that, "without a doubt, [the] MIHC has been a tremendous success and enabled us to do many things...While [the] MIHC has clearly served us well, the marketplace has changed significantly, and demutualization provides organizational flexibility and a better alternative to access capital as we continue to invest in global expansion, as well as in new products, services, and technology for the benefit of our customers."

In fact, Principal's MIHC has been a failure. It has cost the policyholders money, wasted time and energy, and accomplished nothing that a demutualization couldn't have accomplished years ago. The MIHC was always an abusive structure, and the primary change in the marketplace is that investors don't want to own share in MIHC subsidiaries.

Principal said that it expects to complete its demutualization in the first half of 2001.

Sometime in late 2001, Howard Silverstein and Goldman Sachs will be able to provide a rough, ballpark figure of what Principal is worth. ■