

# Steal This Insurance Company!

## Demutualization and Its Discontents

Among the by-products of bull markets are the dubious ideas—usually recycled from past bull markets—that become accepted as universal truths. In the 1960s, acquisitions made by conglomerates would supposedly produce perpetual increases in earnings per share. By the beginning of the 1980s, natural resources, which had already soared in value, were certain to soar further. (*BusinessWeek*, in a now-famous cover, declared “the death of equities.”) During the great era of the LBO, excessive debt was considered good because it *forced* companies to be efficient.

All of these investment movements had their apostles or manifestos. *The Magic of Mergers*, a hagiography of Meshulem Riklis—whose leveraged conglomerate would eventually collapse—was published in 1968. The Hunt brothers, whose father made a fortune in oil, went bust speculating in silver. (The Hunts did not see their attempted corner of the silver market as speculation. In a world where *paper*—stocks, bonds, money—was considered suspect, the case was made that tangible assets were the *only* rational investment.)

Last fall a new gospel—*Dow 36,000*—appeared, and rose to near the top of the Amazon.com best-seller list. (At that time, according to Amazon’s website, customers who bought *Dow 36,000* had also bought *Dow 40,000*, *Dow 100,000*, and *The Long Boom*.) Why did *Dow 36,000* appear during a prolonged bull market? Where was *Dow 10,000* in early 1982, when even *Dow 1,000* seemed like a stretch to many?

The Dow Jones average hasn’t fared badly since last fall. *Dow 36,000*, on the other hand, hasn’t fared well. It’s #15,816 on Amazon’s best-seller list. Now, according to Amazon, customers who have bought *Dow 36,000* have also bought *Irrational Exuberance* and *When the Dow Breaks: Insights and Strategies for Protecting Your Profits in a Turbulent Market*.

It’s not coincidence that so many mutual insurers are demutualizing during a bull market (or what might prove to be the early stage of a bear market). The concepts of issuing stock, making acquisitions, and, especially, granting executives stock options have never been more in vogue. To many mutual CEOs,

making deals and growing rapidly has far greater appeal—and is a hell of a lot more fun—than managing a slow-and-steady mutual. For mutual CEOs, this is the dawning of the Age of Taurus.

Between 1966 and 1991, sixteen mutual life-insurance companies demutualized. Since 1996, nine of the 15 largest mutual life insurers have done so (through a full demutualization or a mutual-holding company) or have announced plans to do so.

New Era thinking says that if mutuals *don’t* demutualize they will be unable to compete successfully. This nonsense has been repeated often, particularly by investment bankers who stand to profit from the mutuals’ changing financial structure. (Ironically, right before General American, a mutual-insurance-holding company, blew up last summer because of its \$6.8 billion gamble on interest-rate spreads, Goldman Sachs was prepping the company for an IPO.)

Although there are 1,200 mutual insurance organizations in America (worth perhaps \$250 billion), the 50 largest ones account for the vast majority of mutual surplus and premiums. Still, there are hundreds of decent-sized mutuals.

Now that the big mutuals have lost the mutual-insurance-holding-company war, the most common method of demutualizing is a full demutualization in which policyholders receive 100% of the company. (Mutual-holding companies and subscription-rights conversions are prohibited by a majority of states. They are coercive and unfair and, where permitted, tend to provoke litigation. Furthermore, they’re in disrepute on Wall Street, which makes an IPO—one of the primary motivators—almost impossible.)

A mutual could also demutualize via an outright sale of the company, with the proceeds distributed to policyholders. Although such a sale would, in most instances, be the best deal for policyholders, it’s the least attractive option for the mutual’s management, since they lose control.

A properly executed full demutualization is a fair transaction. Policyholders give up certain rights—ownership of the mutual insurer, the right to have the company run for their benefit, and nom-

inal voting rights—in exchange for stock, cash, or policy enhancements.

When analyzing a demutualization from the policyholders’ perspective, there are two overriding issues: is the transaction the *best possible* one for policyholders, and, has the company provided policyholders with *full disclosure*?

These basic issues are so obvious that one would think that they wouldn’t be issues at all. But they are. Many states’ laws, for example, have been twisted so that mutual-insurance-company directors, when considering a demutualization, can take the “interests” of the “community” into consideration. (The “community,” by the way, can include the CEO, executives, employees, suppliers, local charities, and so on.) “Community interest” laws are bad public policy. Just as a stock company should be run for the benefit of its shareholders, a mutual insurer should be run for the benefit of its policyholders.

Most mutual managements (and stock-company managements, for that matter) desperately want to retain control of “their” companies. In addition to the anti-takeover provisions that are part of demutualization statutes, converted mutuals wield an arsenal of other anti-takeover weapons. These usually don’t serve policyholders or shareholders.

Most large insurers demutualize by distributing stock in conjunction with an IPO. Unfortunately, mutuals routinely conduct IPOs that dilute their policyholders’ value. This is done by selling or issuing shares at significant discounts to book value or intrinsic value. MONY, John Hancock, and MetLife—to pick three prominent examples—all conducted IPOs in which stock was sold at a significant discount to each company’s intrinsic value. (For the record, David Schiff testified at the MONY and John Hancock hearings. Since the problems in MetLife’s demutualization plan were similar to those in MONY’s, and since both hearings were conducted by New York’s insurance commissioner Neil Levin, Schiff saw no point in attending the MetLife hearing.)

Compounding the pricing problems in all three IPOs was the fact that policyholders weren’t even offered *subscription rights*—a chance to buy in at the offering price and thereby avoid economic dilution. Indeed, all three companies, or their

advisors, averred that offering policyholders subscription rights (or something similar) would be so costly and cumbersome that it just couldn't be done.

One wonders about statements made on October 8, 1997 at the public hearing on proposed *mutual-holding-company* legislation held by the New York State Assembly Committee on Insurance. Wolcott Dunham, a partner at the law firm Debevoise & Plimpton, testified that the New York bill contained "additional policyholder protections not found in any other law...If there is an IPO, the company must give eligible members *subscription rights* to buy stock in the offering—unless the Superintendent concurs in the board's decision that giving subscription rights would not be in the best interest of the members." Dunham represented the Life Insurance Council of New York, which helped draft the bill. (The bill did not become law.) He also represented John Hancock and MetLife. Harry Kamen, chairman, CEO, and president of MetLife, testified that all the mutual policyholders *he knew* in New York City "would be very interested in *subscription rights* of an IPO because of the experience of the almost immediate increase in value."

That increase in value has, of course, nothing to do with any magic about insurance IPOs. Rather, it has everything to do with the fact that the stocks of demutualizing companies are usually priced at a significant discount to their true value. (Since mutual executives own no shares in the mutual, they have nothing to lose by doing an IPO at a ridiculously low valuation. It's the policyholders who lose.)

MONEY went public on November 12, 1999, at \$23.50 per share, a price equal to 67% of its book value. The stock is now 36<sup>5</sup>/<sub>16</sub> and the company is *repurchasing* shares.

John Hancock went public at \$17 per share on January 28, 2000. Its stock is now 23<sup>3</sup>/<sub>4</sub>. On November 17, 1999 at a hearing on Hancock's proposed demutualization, chairman and CEO Stephen L. Brown testified under oath why, as part of the complex restructuring, it was fair to cash out many policyholders instead of giving them stock: "The demographics of our policyholder base...are very heavily weighted towards smaller policyholders, older policyholders, people who we felt should not have stock forced upon them, because we feel that...any individual

stock is subject to risk. And I think the people who have commented on this in the past have simply ignored the risk..."

It was sensitive of Brown to be so concerned about his policyholders that he spared them the risk of receiving shares in John Hancock at a dirt-cheap price. The small, old policyholders, according to Brown, were better off being cashed out at the offering price, thereby incurring a tax and eliminating the likelihood of future capital gains.

Six months later, in early May, Brown told a conference-call audience that Hancock was considering a share repurchase, announcing: "We believe our stock is significantly undervalued." At that moment the shares were trading around 20, eighteen percent higher than the offering price.

MetLife went public on May 5, 2000 at \$14.25 per share. The stock is now 23. In late June MetLife announced a board-approved \$1 billion share-repurchase plan. Presumably, MetLife's directors believe that the company's shares are undervalued. (If that's the case, what was the point of an IPO two months earlier at a much lower price?)

Why do mutuals routinely issue stock at low prices and then repurchase shares at much higher prices? The answer is that the mutuals' CEOs don't care about value; they want to take their companies public. In fact, it works out all the better if the IPO price is low. When the CEO's "performance" is measured (by stock appreciation), the record will look particularly good because the stock was starting from a depressed price. The extra appreciation will give the appearance that the CEO has delivered "value" to shareholders and will serve as a justification for a larger salary or a bigger options package.

Insurance regulators shouldn't approve flawed demutualizations like those men-

tioned above, but they do. They don't understand corporate finance, or their interests are aligned with the powers that be—insurance companies, industry organizations, and business associations. The way it currently works, policyholders are, for all practical purposes, disenfranchised from the demutualization process, which, for the most part, takes place behind closed doors.

If policyholders had understood what was happening, they wouldn't have approved the previously mentioned deals as they were structured. If independent (and knowledgeable) policyholder-advocate committees were created to oversee demutualizations, the results would be different.

Policyholders have not been given full disclosure in demutualizations. Instead, they're told what the company wants them to know. Full disclosure is essential because, under every state's law, a demutualization must be approved by a majority of the mutual policyholders who vote (or a majority of the votes if the vote is weighted). If a mutual omits material information in its communications to policyholders, it can't get their informed consent. Without informed consent, the vote is tainted, and so is the demutualization's legitimacy.

Mutual policyholders should be told what they might be losing in a full demutualization, and whether other transactions might achieve better financial results for them. Policyholders should be advised whether management decided *not* to seek alternatives that might have yielded greater value, and why. Policyholders should be told if their value will be diluted, or is likely to be diluted. Policyholders should also be told what their company is worth. (In corporate mergers and acquisitions, it's standard procedure to hire an investment banker to value the company.)

Demutualizations won't make a bad company good. If the incentive of stock options was all it took to achieve superior performance, then every public company would have achieved that already.

The rash of demutualizations taking place will probably end up as a boon for the insurers that remain mutual and maintain a policyholder-oriented focus.

Ten years hence, it wouldn't be surprising to see Northwestern Mutual and State Farm tout the fact that they're owned by their policyholders—unlike stock insurers, which are run for the benefit of their shareholders. ■

