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Mutual Life Companies as Acquisition Targets?

They Will Likely Constitute Next Consolidation Wave, Form of Which Remains to be Seen

By E. William Bates II and Elizabeth M. Schubert

The life insurance industry has experienced a major transformation in recent years, characterized by a significant amount of consolidation activity among stock life insurance companies and a wave of demutualizations among mutual life insurers.

Among the reasons cited for such consolidation and demutualization activity are the need for greater scale (i.e., to be able to spread costs over a larger premium base), to access new distribution channels and to provide broader product offerings.

The drivers for this activity are as strong now as they have ever been. However, for those companies seeking growth through consolidation, the number of potential stock life insurance company acquisition targets is diminishing. Attention is increasingly being focused on mutual life insurance companies.

These mutual companies will very likely form the next consolidation wave. However, the form these consolidations will take remains to be seen. Problems inherent in the mechanisms currently available to the stock life insurer seeking to acquire a mutual company may render such a transaction prohibitive absent compelling circumstances and ultimately delay (but likely not prevent) the consolidation trend involving mutual life insurers.

Stock vs. Mutual

Insurance companies historically have been organized in two different forms: stock companies and mutual companies. In stock insurance companies, shareholders own stock in the company in anticipation of a return of profit, and stock insurers have the ability to sell equity securities in the capital markets. Mutual insurers, on the other hand, are owned by their policyholders, or members, and have a limited ability to raise capital other than through internally generated profits or the sale of a specialized form of debt known as surplus notes. Mutual insurers generally have several restructuring alternatives available for achieving greater scale, including mutual company mergers and demutualizations (either into a stock insurance company or through the formation of a mutual insurance holding company (MIHC)).

While a merger between two mutual companies permits the resulting company

to achieve greater scale, such mergers do not solve the capital-raising dilemma. As a result, the most extensive consolidation trend has been among stock life insurers. Between 1988 and 1998, the number of stock life insurers declined approximately 34 percent, while the number of mutual life insurers declined approximately 17 percent.

Nonetheless, many mutual companies have demutualized and issued stock so that they too can benefit from consolidation.¹ With this industrywide focus on growth and capital raising, mutual companies are likely to become acquisition targets with increasing frequency, raising a variety of issues with limited precedent to guide them or their acquirors.

In many states, including New York, a direct merger between a mutual company and a stock company is prohibited. In New York, a stock company desiring to acquire a mutual insurer must do so through what is known as a sponsored demutualization or otherwise wait until a mutual insurer that has otherwise announced a demutualization plan completes the demutualization process before proceeding with such an acquisition.

Sponsored Demutualization

Section 7312 of the New York Insurance Law, as amended, sets forth the requirements for reorganizing a New York-domiciled life insurer into a stock life insurer, including a sponsored demutualization in which a majority or all of the common shares of a converting life

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insurance company is acquired by another institution.² Although §7312 contains the basic framework for effecting a sponsored demutualization, it provides the Superintendent of Insurance of the State of New York with broad discretionary authority over the terms and conditions of a sponsored demutualization.

A sponsored demutualization is accomplished through a reorganization plan that is adopted by the Board of Directors, approved by the mutual company’s members and is subject to approval by the superintendent. Section 7312 provides that the plan must: demonstrate a purpose and specify reasons for the proposed reorganization; be in the best interest of the mutual life insurer and its policyholders; be fair and equitable to the policyholders; provide for the enhancement of the operations of the reorganized insurer; and not substantially lessen competition in any line of insurance business. Section 7312 also requires the superintendent to hold a public hearing upon the fairness of the terms and conditions of the plan of reorganization, the reasons and purposes for the mutual life insurer to demutualize and whether the reorganization is in the interest of the mutual life insurer and its policyholders, and not detrimental to the public.

The concept of acquiring a controlling interest in a demutualizing life insurer as part of the conversion process is not a new concept, but there are relatively few examples of such acquisitions involving large mutual life insurers. AXA’s sponsorship of the demutualization of The Equitable Co. Inc. in 1992, pursuant to which AXA acquired a 49 percent equity interest

in Equitable, remains the only sponsored demutualization of a New York-domiciled mutual company, but that transaction may not constitute good precedent because of Equitable’s troubled financial position at the time.

On the other hand in February 2000, American Mutual Holding Co., an Iowa-domiciled MIHC that itself was demutualizing and is now known as AmerUs, announced an agreement whereby Indianapolis Life Insurance Co., an Indiana-domiciled mutual insurance company, would demutualize and concurrently be acquired by AmerUs.

Indianapolis Life’s decision to be acquired in a sponsored demutualization appears to reflect a strategic decision to combine with a larger organization for the consolidation benefits noted above. Similar types of transactions may become more frequent. Whether current mutual insurance companies will become the focus of the next wave of consolidation depends upon how potential acquirors view the impediments unique to the process of sponsoring a demutualization contained in §7312 (for New York demutualizations) or substantially similar provisions (for other state-domiciled demutualizations). These impediments include the greater time, risk and expense involved in effecting a sponsored demutualization, at least compared to a typical stock-for-stock merger transaction.

The time period from the commencement of negotiations with respect to a sponsored demutualization until consummation, absent compelling circumstances (such as a distressed insurer), is much

longer than the time period in which a typical stock merger agreement can be consummated. Absent a consolidation, the time to complete the demutualization process alone can range from 12 to 36 months.³ Developing a demutualization plan, initiating discussions with state regulators, making filings with the Securities and Exchange Commission (SEC), obtaining approval of the target’s board of directors and the actuarial process of allocating equity for life-time policies can take a year or longer.

Obtaining the final approvals required by the policyholders and state and federal regulators can easily take an additional year. As a result, if the acquisition currency utilized by the acquiror/sponsor will consist of its equity securities, the market for equity securities of the acquiror may be adversely affected by the overhang arising from the prospective issuance of securities in the sponsored transaction.

The lengthy time period for the transaction also heightens the risk that another potential acquiror will show an interest in acquiring the target mutual insurance company. The sponsor/acquiror will need to convince the superintendent that it is in the policyholders’ interest for the reorganization agreement to provide protection mechanisms, such as lock-up options or an investment agreement, termination fees and expense reimbursement and limited fiduciary out provisions, that are typically negotiated in stock-for-stock transactions.

While the number of hostile acquisitions in the life insurance industry is very limited, typically because of the importance of retaining the target’s management and maintaining a stable relationship with regulators, a potential acquiror will likely insist on traditional deal protection mechanisms in order to justify its investment of substantial time and money in a sponsored demutualization. The acquiror should be able to further argue to the superintendent that the cost of any reasonable deal protections (such as the payment of termination fees) will be borne not by the policyholders but by the third-party acquiror that successfully top the initial acquiror’s purchase price.

The lengthy time period also exacerbates the pricing concerns of the acquiror and the target, where equity securities of

the acquiror will constitute part of the acquisition consideration. This is true whether the transaction is priced on a fixed-price basis (which may require the acquiror to issue substantially more securities, if its securities decline in value) or on a floating basis, possibly resulting in less value for the target's policyholders in the demutualization. Appropriately negotiated collar mechanisms should ameliorate these concerns and address satisfactorily the competing concerns of the acquiror and the interests of the policyholders.

Another risk that a sponsored demutualization will encounter is the need to convince the superintendent that the acquisition (particularly the consideration to be paid) is fair and equitable to the policyholders. Ultimately, the consideration that policyholders receive for their membership rights should be the fair market value of their ownership interests in the mutual life insurer.

In a typical demutualization, the conversion is accompanied by an initial public offering, which permits the stock market to establish that fair market value. The superintendent, in making its determination that the acquisition is fair and equitable to the policyholders, will need to rely on less certain means of valuing the company, such as actuarial analyses and fairness opinions. The superintendent could require some type of "market check" to permit a validation of pricing, but such a mechanism would only add time and uncertainty to an already unsettling process for a mutual life insurer. Moreover, the now fairly typical termination provisions that would be contained in the reorganization agreement and that permit the mutual insurer to terminate the agreement in the event of a superior third-party offer should also provide additional comfort to the superintendent concerning the fairness of the consideration being offered.

It also may be difficult to entice management to opt into a sponsored demutualization, since demutualization statutes often restrict the ability of officers and directors of the reorganized insurer from acquiring beneficial ownership of securities for some time period. Section 7312 provides that no director, officer or employee of the mutual insurer or reorganized insurer, including family

members and their spouses, may acquire in any manner beneficial ownership of securities for a period of five years following the distribution date, unless the acquisition is (a) made pursuant to a stock option plan approved by the superintendent, (b) made pursuant to the plan or reorganization, (c) made by employees, including their family members and their spouses, from an SEC-registered broker or dealer at then-quoted prices on the date of purchase, or (d) made by officers or directors, including their family members and their spouses, at least two years after the distribution date from an SEC-regis-

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The superintendent's past practice with respect to stock-option plans, as evidenced in the demutualizations of MetLife and Mutual of New York, has permitted the grant of options to employees of the mutual insurer only on and after the first anniversary of the distribution date and has required that any option granted could not be exercised earlier than the second anniversary of the distribution date. The exercise price for such options must be equal to the fair market value of the underlying stock at the date of grant.

It is not clear how the superintendent

would view an agreement by the acquiror that is included in the reorganization agreement, whereby the acquiror agrees to grant to specified employees, on the first anniversary of the distribution date, a specified number of options from the acquiror's option plans. An acquiror should be able to argue successfully that such an agreement complies with the policy underlying the superintendent's precedent and even provides the superintendent the opportunity to approve the specific option grants, but there is no clear precedent in the context of a sponsored demutualization and thus no assurance of receiving the necessary approval.

To the extent that the issuance of stock options will ensure the cooperation of the target's management, this can be critical to the success of a sponsored demutualization. Insurance managers and state regulators generally maintain good relationships, so management cooperation is generally considered essential in facilitating the state regulatory approval process for a transaction. In addition, the ability to provide managers an equity stake in the restructured company is crucial to aligning their interests with those of the new organization and creating incentives to increase the new entity's operational efficiency.⁴

For example, effective mutual managers are accustomed to gearing their management approach toward achieving long-term profitability. Stock company management, in contrast, tends to focus more on the short-term view by emphasizing quarterly earnings to sustain a strong market capitalization position. Without financial motivation, a typical manager of a demutualized insurer may have less incentive to adapt his vision and work ethic to the new strategies needed to ensure the success of the restructured company. Studies show that stock life insurers whose chief executives have stock options outperform mutuals.⁵

In addition to restrictions on stock-option grants, no officer, director or employee may receive fees or other consideration, other than regular salary, director's fees or consideration as a policyholder in connection with any proposed reorganization. While this provision might prevent a significant alteration of salary structures, this

should not be a significant deterrent in those circumstances in which mutual company officers receive greater cash compensation, as compared to a public stock insurer's officer's compensation, in part due to the lack of equity incentives available to a mutual company's officers. Moreover, an acquiror should also be able to justify bringing compensation of such former mutual company officers in line with similarly situated employees in their own organizations.

The sponsoring entity will likely be required to bear the cost and expenses incurred in connection with the plan of reorganization, which will include, among other things, legal fees, appraisal and actuarial fees incurred by the mutual life insurer and the insurance department, as well as printing and mailing expenses. The sponsoring institution will be required to bear all such costs whether or not the plan of organization takes effect, unless the superintendent determines it is in the policyholders' interest to waive this condition. Such expenses are likely to range in the tens of millions of dollars for a moderate-size acquisition.

While it is not unusual for the acquiror in a public company acquisition in effect to bear the expenses of the transaction, it is the several sets of actuarial fees and counsel for the mutual insurer, the state insurance department and the acquiror that, together with the significant numbers of policyholders to whom a mailing is required, are likely to increase the cost of such acquisition by more than a nominal amount when compared to stock-for-stock acquisitions.

Legal Challenges

Beyond the cost of the sponsored demutualization transaction, the sponsoring institution will more than likely face legal challenges from policyholders during the demutualization process. The sponsor will also incur the potential for related liabilities after the transaction has been consummated. The recent demutualizations of John Hancock, MetLife and Mutual of New York all faced legal challenges from policyholders.

In addition to the possibility of post-transaction challenges from policyholders, demutualizing life insurers have also had

to account for claims from policyholders who could not be located at the time the transaction was approved. For example, John Hancock had to set aside \$62 million to cover claims for the beneficiaries of more than 40,000 policyholders who could not be located at the time of demutualization and were estimated to have passed away. The company has since spent approximately 40 percent of this set-aside to locate its lost policyholders.⁶

It remains to be seen whether the mutual life insurance industry will experience a surge of sponsored demutualizations, other than in “rescue” situations where the superintendent has significant incentive to act quickly to protect policyholders. Of the obstacles presented, the time period will be the most troublesome issue for any significant sponsored demutualization. While cooperation among the acquiror, target mutual insurer and the superintendent can shorten the time period considerably, the period is still likely to be lengthy.

Another possible but unprecedented solution may be to attempt to bifurcate the demutualization process, by permitting the consummation of the acquisition prior to a determination of the appropriate allocation of the consideration among policyholders and creating a trust in which the acquisition consideration (the acquiror's stock and/or cash) is deposited, such amount to be equal to full value for the mutual life insurer. Following this step, the trust would then allocate such consideration among the former mutual insurers' various members based upon their contributions to historical surplus.

One of the negative aspects to such an approach is that there will be a delay before policyholders receive the consideration for their interests in the mutual insurer. If the acquisition currency is a security of the acquiror, the policyholders as a group would have market risk with a very limited ability to offset such risk. Moreover, such bifurcation may not reduce the time periods substantially because of the need to have completed a substantial part of the actual analyses before a final acquisition price could be determined. Such a bifurcation is unprecedented,

but a novel approach may be necessary to solve the perplexing time and uncertainties that are entailed in a sponsored demutualization.

Otherwise, the best approach may ultimately be for potential acquirors to wait until the consummation of a demutualization plan. Although any acquisition of more than five percent of a demutualized life insurer's voting securities within a five-year period following the distribution date will require approval of the superintendent, a number of the issues that arise solely as a result of the demutualization process, such as pricing and other timing considerations, would not be involved.

¹ Seventeen mutual insurance companies have demutualized since 1986. Levinson, Alan, “Insurers Go Public,” *Strategic Finance*, July 1, 2000, at 68. Most others are at least exploring the option of doing so. Mutual Company Reorganizations, article at <http://www.glenndaily.com/mhc/htm>.

² New York does not permit mutual insurers to utilize the somewhat controversial mutual insurance holding company structure. Therefore, this article will focus on mutual insurance companies only; however, similar concepts would apply in other states in which MIHCs are permitted.

³ Testimony of Jason B. Adkins, executive director of the Center for Insurance Research, before the New York State Assembly Standing Committee on Insurance, Oct. 8, 1997. Levinson, *supra* note 1.

⁴ Note, “Developing a Demutualization Strategy for Private Equity Firms,” 110 *Harv. L. Rev.* 1904, 1907 (1997).

⁵ Id. Upton, Thomas, “Demutualization in the U.S. Life Industry,” Standard & Poors (1998), at www.standardandpoors.com/ratings/insurance/demutualization.htm.

⁶ “Wanted: Dead or Alive,” *Forbes*, April 17, 2000, at www.forbes.com/forbes/00417/6509172a.htm.

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