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SCHIFF'S

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Burning in Water, Drowning in Flame

That Old Feeling

The insurance industry has it good, and that's bad. As the property/casualty industry's capital swells to $325 billion, it's easy to forget that an abundance of capital is to the insurance business what a 16-ounce prime steak is to a patient in the cardiac-care ward.

In New Jersey, where the average personal auto-insurance expenditure (the highest in the nation) approximates the per capita GNP of Vietnam, the recent gubernatorial election pitted the candidates in a war of words over who would slash auto insurance rates more. Across the country in California, Al Checchi, a leveraged-buyout artist who has made $500 million or so, is self-financing a run for the governor's mansion. One of his platforms: *insurance companies* make too much money.

It is ironic that politicians are upset that auto insurers have had seven fat years. What they don't realize is that auto insurance—the largest property/casualty line based on premiums—is poised to enter a lean era marked by rate cutting, commission cutting, relentless competition, increased penetration by direct marketers and internet sellers, and regulatory wrath. (That's *our* thesis, anyway.)

"It's a matter of principle: unless we get a big fee, Goldman Sachs never condones a mutual-insurance-holding-company conversion that screws the policyholders."

Although virtually every insurance company has a stated goal of earning a 15% return on equity, insurance is not a 15% return-on-equity business over the long term. It is a cyclical business whose products are, for the most part, commodities. People buy auto insurance, annuities, and all sorts of other products, but they don't specifically *ask* for Travelers auto insurance or SunAmerica's annuities. They buy what they are sold, or what is cheapest.

Dowling & Partners, the Hartford-based securities firm, has noted that the property/casualty industry suffered negative cash flow from underwriting last year—paid losses exceeded incurred losses on an industry-wide basis. In short, results appear to be deteriorating and profits are being generated by the release of prior years' reserves.

Scott McIntyre, Jr., chairman and general manager of United Fire & Casualty in Cedar Rapids, writes in his recent let-

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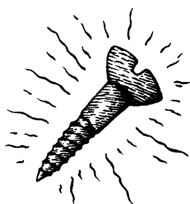
Nightmare at the Mutuals



Threat from within! The conspiracy begins to unravel.

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ter to shareholders that 1997 "was a difficult year not to make money in the insurance business—unless one were in the managed care business. A booming stock market made even the most inept insurance-company managements look good."

Over the last 31 years McIntyre has succeeded in an endeavor at which many have failed—building a fine multiline company. He has done so through good judgment, a healthy sense of skepticism, prudent underwriting, and sound long-term equity investments. It's worth mentioning that United Fire & Casualty also boasts a handsome debt-free balance sheet, an attribute that's likely to come in handy some day.

McIntyre, who is a something of a legend in Iowa (our home away from home these days), is wary of the current boom times. "The outlook for growth this year is not encouraging, and we are not going to pursue business we believe to be inadequately priced," he reports. We suspect that McIntyre's prudence has to do with two factors: his personality and the reality that it's *his* money on the line: he controls 14.44% of United Fire & Casualty's stock (1,547,118 shares worth $63 million).

McIntyre says that his company's most important asset is its people—a truism spouted by most companies—but his words carry a different meaning from those of others. "While I was indisposed most of the year," writes McIntyre, who was hospitalized, "[the company's employees] performed admirably and demonstrated that if CEOs aren't completely unnecessary, they are a very expensive luxury that certainly aren't worth nearly what they're paid." (His total compensation—$348,000, no stock options—tips the scale at the low end.)

"The trend towards consolidation, which has been sweeping all financial services, continues to gain momentum in the property and casualty business," writes McIntyre with bemusement. "Two recent mergers that particularly interested us were Safeco's acquisition of American States and St. Paul's pending acquisition of USF&G...Like USF&G, United Fire & Casualty is often referred to in the trade by its initials, UF&C, and the similarity has sometimes caused confusion. When we were small and unknown, we took it as a compliment. Later, as USF&G lost its way and got into trouble, it became an embarrassment. Therefore, we were pleased when the St. Paul announced they would spend $2.8 billion to solve our problem of mistaken identity."

Wall Street was also pleased by this combination (despite the cautionary tale of USF&G that appeared in the December 1996 issue of *Schiff's Insurance Observer* on the occasion of the insurer's centennial). Although USF&G had become, by 1921, the largest Casualty & Surety company in America, and therefore had size, financial might, synergy, economies of scale, and many other supposed advantages, it managed to blow its big lead time and again. Every 20 or 30 years it made a stupendous blunder—bad underwriting, bad investments, absurd diversifications—that would take it to the brink, if not beyond. (In 1933 it received a bailout from the Reconstruction Finance Corporation.) The lesson to be learned from USF&G's mistakes, and from those of The Home, Continental, and others that fell by the wayside, is an old one: insurance is a business in which results must often be judged over many decades. As the great insurance investor Shelby Cullom Davis noted years ago, "It is the long view rather than the short view. It is the waves that count rather than the ripples; the tides in man's affairs rather than the waves."

Right now, however, many are focusing on the ripples. The insurance industry—a beneficiary of the harmonal convergence of rising financial markets and an unexpected improvement in previous years' reserves—is flush. It has plenty of capital but a dearth of opportunities. In that respect it is reminiscent of the boy who knows every position in the *Kamasutra* but doesn't know any girls.

Lack of good opportunities, however, is apparently no hindrance in a roaring bull market. *Newsweek* recently took note of the 54-year-old footwear consultant who sold his 1989 Range Rover—he called it "a bad investment"—and placed the proceeds in what he considered a sure thing: the stock market.

The total amount of money in mutual funds—a bit less than $5 trillion, half of which is in equity funds—now exceeds that in the banking system, and the number of mutual funds has grown at an 18.1% annual rate over the last 10 years, from 1,100 to 5,800. This figure exceeds that of Big Board stocks by 60%. (Our source is *The Financial Times.*)

In 1913 explorer Sir Ernest Shackleton placed an ad in *The London Times*, looking for brave souls to follow him to Antarctica: "Men wanted for hazardous journey. Small wages, bitter cold, long months of complete darkness, constant danger. Safe return doubtful. Honour and recognition in case of success."

The journey taken by insurance-company honchos is not physically hazardous—but the strategies employed by their companies reminds us that a safe return is not assured. Unlike Shackleton's adventurers, who stood to receive only honor and recognition as their reward, insurance company bosses—many of whom have received sumptuous compensation and stock-option packages (see "USF&G & Blake")—stand to reap even more outsized gains should their speculations actually hit the jackpot.

Perhaps nowhere has money fever ignited a trend so antithetical to companies' mission statements than at America's mutual life insurers, many of whom seek to embark upon acquisition sprees after reconstituting themselves as mutual insurance holding companies. This irony is not lost on Jim Grant, editor of *Grant's Interest Rate Observer*, who writes, "It has somehow been fated that even the mutual life insurance companies—speculative wall-

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U S F+G+Blake

NORMAN BLAKE, chairman, president, and CEO of the once-great-but-now-mediocre USF&G, will receive the following payments as part of USF&G's merger with St. Paul:

Cash severance	$11,188,843
Tax "gross-up" payment	9,601,951
Bonus and long-term incentive	1,099,094
Lump sum supplemental retirement	15,325,358
Deferred cash award	2,117,753
Consulting fee	725,000

Blake will also receive incentive awards, St. Paul stock appreciation rights, and continuing medical benefits.

The St. Paul–USF&G proxy statement, which detailed these payments, did not say what Blake would have received had USF&G achieved greatness once again.

flowers for most of the 20th century under the regulatory law that grew out of the Armstrong Commission—will have climbed aboard the bull before the animal is felled by a bolt of lightning."

Grant is no play-by-play announcer of the ripples in the financial markets; he is a watcher of the tides and an observer of the shifting tectonic plates that lie beneath the markets' surface. Kenneth Tynan wrote that "a good drama critic is one who perceives what is happening in the theatre of his time. A great drama critic also perceives what is *not* happening." Grant, a financial historian of unparalleled erudition, is well aware of what is *not* happening. A speech he gave at Morgan Stanley's International Client Conference in New York summarizes his thoughts (and serves as a good starting point for the rest of ours):

"Late in the 19th century—decades before the federal safety net was rigged underneath the high-wire act of American banking—George Gilbert Williams, president of the Chemical bank, was asked for the secret of his success. 'The fear of God,' he replied, quietly but firmly.

"Today, fear—the fear of just about anything—is in a headlong retreat. Courage is on the march. Anyone temporarily lacking courage can find it in the stock market or by watching the daytime television programs in which the stock market outshines even the dazzling Susan Lucci...

"My topic today is the credit cycle. I believe that there is one, to sound an opening note of controversy. And I believe that it is very ripe...It will end—sooner rather than later, I believe—in a state of euphoria...Today, as in early 1929, there is said to be only one cycle in financial markets and business activity—the up cycle. To me, however, the down cycle and the up cycle are, like cufflinks, a matched set. Fundamentally, what causes busts is booms. It is the errors of the up cycle...that help to precipitate the down cycle. Cycles are inevitable because people miscalculate. In the heat of a boom, they miscalculate optimistically..."

From our vantage point, it seems the insurance industry is well past the stage of optimism; it has become a true believer in its divine right to compound its net worth at a double-digit rate for eternity.

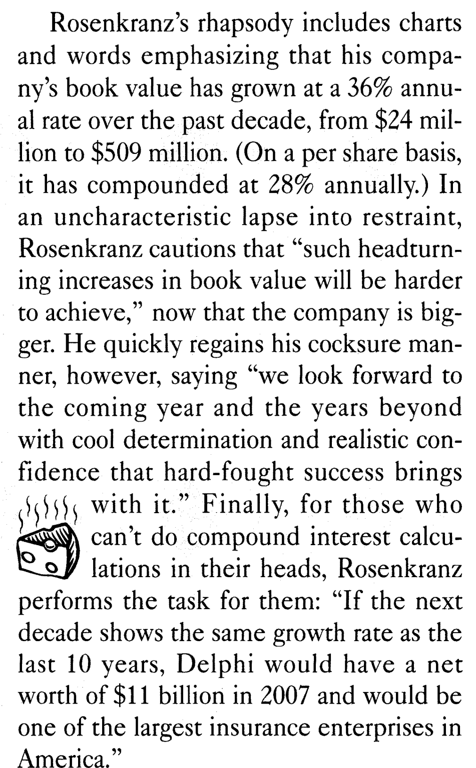
For Robert Rosenkranz, chairman and CEO of Delphi Financial Group, which sells annuities, long-term disability, and excess workers compensation, the last decade has been kind. His strategy of high leverage and aggressive investments has led to riches, though not necessarily honor. Rosenkranz is given to hyperbolic rhetoric, and his "Letter to Shareholders" has the ring of an internet stock-market chat room. "Behind us lies a breathtaking panorama of accomplishment," he wrote recently. "Looking forward, we see vast opportunity stretching far into the distance, toward which we are eager to keep traveling."

Delphi's cost of borrowing, he noted, has "dropped markedly over the past decade," from 340 basis points over LIBOR to "only 45 basis points." Rosenkranz does not attribute this to an excess of speculative funds, a financial mania, or a desperate stretch for yield on the part of investors. Instead, declares that his company's reduced cost of capital is "a testament to the *gilt-edged* creditworthiness we have achieved [emphasis added]. There are varying opinions as to what constitutes a "gilt-edged" credit, but we suspect that few people other than Rosenkranz would use that phrase for a company whose debt is rated "BBB" by Standard & Poor's, just a couple of notches above junk. (Delphi's insurance subsidiaries, Reliance Standard and Safety National, are rated "A" and "A-," respectively, by A. M. Best. The "gilt-edged" debt is issued by Delphi, the holding company.)

Rosenkranz continues: "[Delphi] has the financial muscle equal to its ambitions. Delphi's stock, once thinly traded, now is highly liquid, and is held by the nation's premier mutual funds and most prestigious institutional investors, which are able to write big checks should we wish to issue additional stock." Rosenkranz does not venture an opinion as to whether the source of these big checks might dry up if, for example, 54-year-old footwear consultants and other like-minded people decide that the stock market is no longer a sure thing.

On the other hand, Delphi's profits are a sure thing—or so says Rosenkranz, who calls them "an earnings stream you can *bank*" [emphasis added]. In fairness, we note that he stopped short of saying that this earnings stream was insured by the FDIC.

Rosenkranz's rhapsody includes charts and words emphasizing that his company's book value has grown at a 36% annual rate over the past decade, from $24 million to $509 million. (On a per share basis, it has compounded at 28% annually.) In an uncharacteristic lapse into restraint, Rosenkranz cautions that "such headturning increases in book value will be harder to achieve," now that the company is bigger. He quickly regains his cocksure manner, however, saying "we look forward to the coming year and the years beyond with cool determination and realistic confidence that hard-fought success brings with it." Finally, for those who can't do compound interest calculations in their heads, Rosenkranz performs the task for them: "If the next decade shows the same growth rate as the last 10 years, Delphi would have a net worth of $11 billion in 2007 and would be one of the largest insurance enterprises in America."



Although Rosenkranz is headquartered in New York, his mind-set, like that of many other insurance executives, is evidently somewhere near Beardstown. Readers of this publication may recall that our April 1995 issue had nothing kind to say about the Beardstown Ladies, authors of several best-selling "How-to" investment books. We dismissed their flagship primer as "pseudo-erudite

hokum" and "black-box bunkum" that was "short on anything really useful." That it now turns out the Beardstown Ladies were not great investors and did not achieve the 23.4% compounded return they claimed—their true returns were only 9.1%, far *below* the averages—has not daunted their true believers, many of whom, it seems, are running insurance companies.

It is human nature to take the more recent past—as Mr. Rosenkranz does—and project it out over the long term. Thus, insurance executives now see opportunities *everywhere.* Business they wouldn't have touched a few years ago is suddenly inviting—at a discount to the old rates. Territories that were abandoned are now viewed as ripe for expansion. Marginal lines that had been discarded are now considered exciting *niches.* And companies that hadn't repurchased their stock when it was low are now buying it in by the truckload—at all-time highs.

Optimism—an emotion rarely seen in times of stress—abounds; it virtually oozes off the pages of insurance-company annual reports. Chubb, for example, has become a great believer in repurchasing its shares, spending $825 million last year. Chairman and CEO Dean O'Hare went so far as to tell shareholders that "additional share repurchases at current prices [the stock was then $80] represent a good value." Why, if that's true, wasn't Chubb loading up on its shares two years earlier when they were at half that level?

Chubb is a fine company, but at 18 times earnings and 2.4 times book value, the phrase "good value" seems something of a stretch. Value, of course, is relative. Chubb has spent millions trying to get a toehold in China—so far without success; it still doesn't have an operating license. "When you talk about entering the Chinese market it's not a two- or three- or five-year experience," said Ian Lancaster, Chubb's Greater China regional manager, to Dow Jones International News. "It's a 15- or 20- or 25-year exercise." Lancaster added that Chubb doesn't expect a "real payback" for 30 years.

Compared with sending your money on a hazardous journey to a distant country where its safe return is doubtful and a real payback is expected to take 30 years—18 times earnings and 2.4 times book value sounds positively *cheap.*

RLI Corp. is a successful company that writes specialty property/casualty lines through independent agents. Forty percent of its business is in California and 42% of its investment portfolio is in common stocks. It is the stock portfolio, rather than the risk of earthquakes and crazed regulators, that gives us greater pause. In recent years, Gerald Stephens, RLI's founder and president, has emphasized his company's "comprehensive earnings" to shareholders. (Comprehensive earnings are defined as after-tax earnings plus any changes in *unrealized* investment gains or losses.)

"It was a marriage made in heaven—Bob had 500 shares of Travelers and I had 500 shares of Citicorp."

Obviously, good equity investments make a world of difference in a company's book value over time. Berkshire Hathaway, Cincinnati Financial, and Erie Insurance are exemplars of insurers that did well underwriting but made a fortune investing the assets they garnered from underwriting. Because they invested more of their assets in stocks than in bonds (compared to the average insurer), their reported earnings understated their results. That's because unrealized gains show up on the balance sheet, not the income statement, and stocks have *generally* yielded less than bonds. (We say "generally," because such was not always the case. From 1935 until 1959, the yield on the Dow Jones Industrial Average exceeded the yield on Moody's Aaa bond index. During that period, however, insurance companies evinced the same interest in owning stocks as Joe Namath evinced in broken-field running.)

Comprehensive earnings is a valid concept, but an investor must be careful in placing a multiple on such earnings, because capital appreciation is not assured. "A well-managed insurance company, like RLI, is a wonderful institution because we generate three streams of income as reported in comprehensive earnings," writes Stephens, whose equity portfolio is run by an outside investment manager. "Together, they give our shareholders reason to expect more from their investment in RLI than they would elsewhere in our industry. It amazes me that many of our competitors do not take advantage of the most potent of these streams: unrealized gains from an equity portfolio."

Jonathan Michael, the company's number two man, echoes Stephens' sentiments. Indeed, he sounds as if he just returned from a trip to Beardstown. When asked whether he worries about a "market dip," he responds by saying he would view it as "a buying opportunity," stating that "over any three-, five- or 10-year period, the stock market *will* [emphasis added] have shown improvement, and it *will* [emphasis added, again] have outperformed the bond market by a long shot." Michael did not add the typical mutual-fund fine print disclaimer—that "past performance cannot guarantee future results"—a warning worth pondering with the S&P 500 trading at 28 times earnings and the NASDAQ Composite floating at a lofty 67.5 times earnings.

It is also worth noting that RLI has not always been a raging bull. In 1988, when stocks were cheap, equities comprised 15% of its invested assets and 39% of its shareholders' equity. Today, equities make up 42% of its invested assets and 94% of its shareholders' equity.

Markel Corporation, which has invested well over the long term, also takes note of "comprehensive earnings." Vice chairman Steve Markel, however, is a low-key fellow who knows a lot about markets. "With the stock market trading at all-time highs, we are cautious and concerned about where the market might be headed," he writes. "However, we have never tried to time the market. We focus

on individual securities of companies which we believe will generate good returns, and we invest in these companies at what we believe to be fair values."

Markel does not tout his own stock, either. "We have no desire for our stock to trade at levels either significantly higher or lower than its intrinsic value. Unfortunately, there is no exact science in determining that number. Today the stock is priced higher in relationship to many determinants of value than in previous years."

Markel Corporation does not give its employees stock options. Instead, it makes full recourse loans (at a subsidized interest rate) to employees wishing to purchase company stock. We think that policy makes a lot of sense. Stock options—which carry no risk—don't align employees' interests with those of shareholders. Full-recourse borrowed money does.

Rather than grow the old-fashioned way—policy by policy—insurance honchos prefer the excitement of a big acquisition (or several smaller ones), which they invariably believe are accretive to earnings. Thus, every insurance-company wallflower is a beauty in the eye of some beholder—even if that insurer lacks the ability to underwrite profitably or is priced so highly that it helps to be a wild optimist to see its merits. The Hartford, for example, which less than 30 years ago was taken over in a less-than-friendly acquisition by Harold Geneen's since-dismantled conglomerate, ITT, has now paid 4.4 times statutory surplus for Omni Group, a small writer of non-standard auto. And General Motors Acceptance Corp. recently shelled out 2.1 times statutory surplus for Integon—an excellent company if one does not consider the fact that it lost its shirt underwriting.

In 1953, Charles Wilson, General Motors' former boss, famously testified before a Senate committee hearing regarding his nomination as Secretary of Defense that he always thought that "what was good for General Motors was good for our country and vice versa." Although Sandy Weill, Travelers' resident magician, called his pal, Federal Reserve chairman Alan Greenspan, prior to publicly announcing the concept of Citigroup, not everyone believes that what is good for Travelers is good for the country, and vice versa. In fact, there are skeptical muckrakers who wonder whether the deal is even good for Travelers and Citicorp—much less the country.

This proposed merger of giants is not without precedent. In fact, it is reminiscent of an unconsummated "deal" that caused a stir 30 years ago. In 1968, having just bagged Reliance Insurance Company through some audacious financial maneuvering, Saul Steinberg's upstart Leasco set its sights on Chemical Bank, a card-carrying member of the Establishment whose directors included Anglo-Saxon commanders from AT&T, DuPont, U.S. Steel, IBM, Texaco, and the New York Stock Exchange.

Leasco did not rely on the investment banking services of the House of Morgan. In its acquisition of Reliance it dealt with a firm run by descendants of the House of Abraham, an audacious group then known as Carter, Berlind and Weill (yes, *that* Weill). Leasco's concept of acquiring Chemical for "funny money"—a package of warrants and convertible debentures—did not sit well with Chemical's chairman, William Renchard, who promptly designated one of his employees, Robert Lipp (yes, *that* Robert Lipp, now vice chairman of Travelers Group), with the task of devising a strategy to fend off Leasco, which many viewed as a Trojan horse, filled with creative accounting techniques and a stock of dubious value. Almost immediately, New York Governor Nelson Rockefeller—whose family's bank, Chase Manhattan, would several decades later be absorbed by Chemical—quickly urged the New York legislature to pass laws designed to thwart a takeover such as that contemplated by Leasco. At about the same time, Leasco's levitating stock began to feel the pull of gravity—despite the company's grand vision of synergy, acquisitions, and accounting wizardry. In a matter of weeks it was down 30%.

Politics, markets, and the powers-that-be had come together, and Leasco's plans were quickly scotched. Thus, the world will never know what might have happened had a brash 29-year-old financial impresario with a hearty appetite for risk succeeded in his vision of combining a venerable insurance company with a major bank.

Although the Citigroup deal garnered the biggest headlines, the synergy in that merger of titans pales besides that of Conseco's stock acquisition of Greentree Financial. Indeed, Conseco (a life insurance, annuity, and supplemental-medical-insurance company) and Greentree (the biggest lender to mobile-home buyers) are truly a match made in heaven. Both employ aggressive accounting methods and both provide their staggeringly well-compensated CEOs with staggering numbers of stock options.

The transaction, of course, "is expected to be immediately accretive to Conseco's earnings per share," notes that company's press release. (The press release did not say whether it would still be accretive some years down the road.)

Stephen Hilbert, Conseco's very rich chairman, said that the deal "expands our distribution capabilities and provides extensive cross-marketing opportunities under the umbrella of our emerging national brand." It was suggested that if only 1% of Conseco's customers were to take out a $36,000 mobile home loan from Greentree, a great deal of money could be made.

On the other hand, what if some sort of reverse synergy transpired? Suppose, for a moment, that 2% of Conseco's customers cashed in their annuities, dumped their cancer-insurance policies, and used that money to repay their high-cost Greentree loans. The possibilities, of course, are endless.

Perhaps the deal that best exemplifies the spirit of the times, however, is the Cendant-AIG battle for American Bankers. You may recall that AIG bid $47 per share and Cendant then came in at $58. It was matched by AIG, but then upped its bid to $67 per share, at which point AIG dropped out and pocketed a handsome breakup fee.

Cendant, which has grown exponentially through the magic of mergers, wasn't planning to shell out the full $3.1 billion price tag for American Bankers in cash. Only 51% would be paid in a form that is recognized as "legal tender for all debts public and private" (Federal Reserve notes, in other words). The other 49% would be paid in a currency recognized by a bevy of befuddled biddies from Beardstown: common stock. Given that Cendant's stock was, at that moment, changing hands at a not-inconsiderable 31 times earnings (before some slight accounting miscalculations readjusted its price), the deal made eminent sense—that is, in the sense that nothing makes

much sense anymore.

There were analysts of the old school, however, who thought the price sounded high. "American Bankers by itself is not worth this much," said Steven Schwartz, of ABN Amro Chicago Corp., to *The Wall Street Journal.* Schwartz didn't stop there, however. He went so far as to say that AIG's original $47 offer—which was $20 per share lower than Cendant's final bid—was "a fair price."

Schwartz, who resides on the planet earth, did not go so far as to say that $0 would be a fair price, however.

Although $0 sounds like a paltry sum, perhaps not so coincidentally, it is the exact figure that Schwartz's employer, ABN Amro Chicago Corp,. has said is "fair" for FCCI Mutual's policyholders to receive in a mutual-insurance-holding-company conversion in which the policyholders' rights would be extinguished.

It would be ludicrous to compare the fairness of AIG's $47 offer for American Bankers with a $0 offer for FCCI. After all, when Mr. Schwartz told *The Wall Street Journal* that $47 per share was "fair," *he was not being paid for his opinion.* He was merely talking on the telephone.

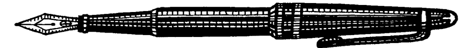
It was, undoubtedly, more difficult for ABN Amro Chicago Corp. to justify FCCI Mutual's plan that would pay policyholders nothing per policy, nothing per share, and nothing per any other known unit of measurement. In fact, ABN Amro Chicago Corp. had to put in many hours and do a considerable amount of work—for which it was well paid—to come to the conclusion that it was fair for FCCI Mutual's policyholders to receive nothing. While nothing sounds like a meager price for an insurance company worth somewhere in the neighborhood of $400 million, perhaps policyholders will be able to recoup some of their value by selling the television rights to their story. After all, *Seinfeld*, a show that has not done badly, is said to be about nothing.

Many industry leaders seem to believe that acquisitions are the alchemists' secret that will allow them to reap great profits. Mutual-life-insurance-company executives such as the duplicitous Harry Kamen at MetLife and the tricky Sy Sternberg at New York Life (for more on Kamen see our February issue; for more on Sternberg see page 18) lament the fact that they have no stock to use as currency to make acquisitions. Sternberg told a New York Assembly hearing that "what we are concerned about is that as competitors become bigger their cost to operate decreases. It's simply economies of scale." Like Kamen, Sternberg believes that New York Life must become a mutual insurance holding company (rather than do a full and equitable demutualization), and that it should be out there buying up insurance companies. That prices for insurance companies have left the stratosphere and entered the ionosphere is, apparently, besides the point. (If prices were cheap, one suspects that AIG, which has long wanted to expand its U.S. life insurance operations and whose shares command a hefty price-earnings multiple, would be buying everything. For the record, it is not.)

The foolishness espoused by Kamen, Sternberg, and many of America's largest mutuals—at NAIC meetings, conferences, and public hearings—has saddened us. We have now come to believe that many of America's largest mutual life insurers are run not by bumbling bureaucrats, as is the popular wisdom, but by conspiring kleptocrats.

If Kamen and Sternberg are truly interested in an acquisition that would involve synergy, cost savings, and economies of scale, they need look no farther than each others' eyes. MetLife is located at 1 Madison Avenue, and New York Life is just two blocks away, at 51 Madison Avenue. A merger of these two giant mutuals is so logical, so compelling, and so easy that it should be a natural.

There's just one hitch: no one gets any stock options when two mutuals merge.



Warren Buffett on Risk

"Many investors who are 'innocents'—meaning that they rely on representations of salespeople rather than on underwriting knowledge of their own," writes Warren Buffett, chairman of Berkshire Hathaway, whose annual report is always an important read, "have come into the reinsurance business by means of purchasing pieces of paper called 'catastrophe bonds.' The second word in this term, though, is an Orwellian misnomer: a true bond obliges the issuer to pay; these bonds, in effect, are contracts that lay a provisional promise to pay on the purchaser.

"This convoluted arrangement came into being because the promoters of the contracts wished to circumvent laws that prohibit the writing of insurance by entities that haven't been licensed by the state. A side benefit for the promoters is that calling the insurance contract a 'bond' may also cause unsophisticated buyers to assume that these instruments involve far less risk than is actually the case."

It is worth noting that the "unsophisticated buyers" to whom the droll Buffett is referring, are institutional investors, not 54-year-old footwear consultants.

Buffett continues: "Truly outsized risks will exist in these contracts if they are not properly priced. A pernicious aspect of catastrophe insurance, however, makes it likely that mispricing, even of a severe variety, will not be discovered for a very long time. Consider, for example, the odds of throwing a 12 with a pair of dice—1 out of 36. Now assume that the dice will be thrown once a year; that you, the "bond buyer," agree to pay $50 million if a 12 appears; and that for 'insuring' this risk you take in an annual 'premium' of $1 million. That would mean you had significantly underpriced the risk. Nevertheless, you could go along for years thinking you were making money—indeed, easy money. There is actually a 75.4% probability that you would go for a decade without paying out a dime. Eventually, however, you would go broke.

"In this dice example, the odds are easy to figure. Calculations involving monster hurricanes and earthquakes are necessarily much fuzzier, and the best we can do at Berkshire is to estimate a range of probabilities for such events. The lack of precise data, coupled with the rarity of such catastrophes, plays into the hands of promoters, who typically employ an 'expert' to advise the potential bond-buyer about the probability of losses. The expert puts no money on the table. Instead, he receives an up-front payment that is forever his no matter how inaccurate his predictions. Surprise: when the stakes are high, an expert can invariably be found who will affirm—to return to our example—that the chance of rolling a 12 is not 1 in 36, but more like 1 in 100. (In fairness, we should add that the expert will probably believe that his odds are correct, a fact that makes him less reprehensible—but more dangerous.)

"The influx of 'investor' money into catastrophe bonds—which may well live up to their name—has caused super-cat prices to deteriorate materially. Therefore, we will write less business in 1998."

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Auto Insurance Report

The Authority on Insuring Personal and Commercial Vehicles

Vol.5#27/218 **April 27, 1998**

Inside

Feds reverse themselves on shrinking size of SUVs. **Page 8**

No-fault debate rages on pages of *USA Today*. **Page 8**

A rarity: drunk driver convicted of murder in death of 4-year old. **Page 8**

Georgia drunk-driving arrests decline sharply from 1991-1996. **Page 8**

The Grapevine

Newspapers Catch On To Falling Auto Insurance Rates

The San Francisco Examiner, The New York Times, The Miami Herald, The Wall Street Journal and other newspapers around the country are catching on to the story that auto insurance rates are starting to come down. Regulators are getting an opportunity to take credit, consumer groups are turning it into an opportunity to bash insurers, and insurers are carefully trying to figure out how to position themselves in the new environment. The newspaper stories are important because they create an expectation among customers that insurers will be forced to fulfill. Once the newspapers are onto the story, television and radio are sure to follow soon. Insurers that don't join the rate-cut-

Please see GRAPEVINE on Page 8

New Diminished Value Software Stirs Controversy With Insurers, Repair Shops, And Consumers

Are **James Lynas** and **Jack Morrow** just small footnotes in the annals of the auto insurance business? Or will they leave a lasting market that will be most profoundly felt in the pocketbook of the average auto insurance company?

Right now it is too soon to say how it will turn out, but one thing is for sure, Lynas and Morrow, purveyors of "diminished value" software, are certainly stirring things up. The two are at the forefront of an effort by body shop owners to force insurers to stop pushing for lower-cost, and they feel are lower-quality, repair strategies. They are the owners of **Wreck Check** and **Accident Check**, software packages that can be used by auto repair experts to quantify the diminished value of a vehicle following an accident.

Lynas started the ball rolling about two and a half years ago with Wreck Check. Without the benefit of seeing

Please see DIMINISHED on Page 2

New Jersey Update:

NJ Assembly Passes Auto Reform; Seeks End Of Territorial Rate Cap

Editor's note: Last week we offered an analysis of the auto insurance reform ideas being discussed in New Jersey. This week we offer a brief report on recent developments. We will complete our state focus report when there is a final resolution of the proposed legislation.

The **New Jersey** Assembly has passed a slightly amended version of the Senate's proposed auto insurance reforms, which include a 15% rate rollback.

The major twist is the Assembly is calling for the elimination of territorial rate caps which keep urban rates within 35% of the statewide average. Suburban legislators are trying to end the subsidies their constituents pay for ur-

Please see NEW JERSEY on Page 7

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Allied Mutual's Dirty Secrets

A Brief Treatise on Disclosure

On December 19, 1997, Terri Vaughan, Iowa's insurance commissioner, issued a formal order "In the matter of Allied Mutual Insurance Company." The purpose: "to protect policyholder interests and assure a fair and democratic process for governance." Commissioner Vaughan believed that Allied Mutual's upcoming election process was improper, and that it was "Allied's intention to deny" David Schiff reasonable access to participate in a fair election. Despite the fact that Schiff was a valid nominee for Allied Mutual's board, Allied not only refused to put his name on the ballot, *it didn't even plan to send out a ballot*. Instead, it planned to send its 220,000 policyholders a proxy card that gave them no practical choice other than appointing John Evans, Douglas Andersen, and Jamie Shaffer as proxies to vote in the policyholders' stead at the Allied Mutual annual meeting.

(Evans and Andersen are directors of Allied Mutual and Allied Group, and all three men are large shareholders in Allied Group. Evans was the mastermind of the more-than-a-dozen asset shuffles between Allied Mutual and Allied Group that resulted in $500 million of value ending up in Allied Group, rather than in Allied Mutual. As a result of these transactions, Evans, Andersen, and Shaffer have made tens of millions, and Allied Group's directors, officers, and employees have made about $250 million—at Allied Mutual's expense. Prompted by a detailed analysis of these transactions in this publication, the Iowa Department of Insurance has been investigating Allied Mutual since last October.)

Allied Mutual refused to comply with Commissioner Vaughan's order; thus began a battle in which Allied went to court and got the order stayed. The stay was subsequently overturned, then reinstated. A short while later, Allied mailed proxies to all of its policyholders.

On March 3, the stay intact, Allied Mutual held its sham election. The number of policyholders in attendance was estimated at less than 100 (most of them, it is believed, were employees). Security was tight: on hand were two gun-toting policemen and numerous dark-suited security personnel wearing earphones and carrying walkie-talkies—an unusual sight at a mutual insurance company's annual meeting. Schiff flew in from New York, spoke in protest, and received 13 votes. (The outcome of the election wasn't in doubt because Schiff had been denied access to any means of communication with policyholders and was thus unable to solicit proxies.)

Allied Mutual, which solicited uncontested proxies on behalf of its candidates via a mailing to all policyholders, claimed to receive 25,000 votes. However, Ellen Phillip Associates, the independent firm that tabulated the vote, informed *Schiff's Insurance Observer* that approximately 60 ballots were cast. Schiff has written to Commissioner Vaughan regarding this discrepancy, but has not yet received a response.

On April 24, oral arguments were heard in Polk County District Court regarding Commissioner Vaughan's order, and a ruling is expected to be handed down within a couple of months. It is likely that any ruling will be appealed by the losing side (the parties in this matter are the Iowa Commissioner of Insurance and Allied Mutual.)

Although Commissioner Vaughan's order provided Allied with numerous ways for Schiff to participate in the elective process—without requiring Allied to disclose confidential information (that Schiff did not seek), such as the names and addresses of policyholders—the order did not go far enough as it didn't require Allied Mutual to disclose material information that would affect the way policyholders voted.

On December 22, Schiff wrote Commissioner Vaughan a letter stressing the importance of full disclosure. An edited version of that letter, with a few additional comments thrown in for good measure, follows:

LET ME FIRST COMMEND YOU for your December 19th order. While it is a step in the right direction, it doesn't address one of the most crucial aspects necessary to assure a fair election—the disclosure of Allied Mutual's directors' material conflicts of interest.

Webster's Collegiate Dictionary defines "conflict of interest" as "a conflict between the private interests and the official responsibilities of a person in a position of trust." That aptly describes the situation at Allied Mutual.

Conflicts of interest are generally dealt with in one of several ways: 1) The conflict of interest is merely disclosed; 2) The conflict of interest is disclosed, and the party with the conflict recuses himself from participating in the matter involving the conflict; 3) The conflict of interest is disclosed, but it is of such a nature that the conflict must be *eliminated* because mere disclosure is inadequate.

The first type of conflict might be one in which a lawyer who serves on a public company's board also receives legal fees. In that instance, the fees would be disclosed to shareholders.

The second type of conflict might be one in which a company is investing in a company owned by a director. In that instance, it would be proper for the director to disclose his conflict and recuse himself from voting on the matter.

The third type of conflict—an unconscionable or irreconcilable conflict—might be one in which a director serves on the boards of both Coca-Cola and PepsiCo.

Prior to becoming Iowa's insurance commissioner, for example, you undoubtedly disclosed that you were a member of EMC Group's board of directors. [*Editor's note*: EMC is a large property/casualty insurance company.] Mere disclosure would not have been a satisfactory resolution once you were confirmed as commissioner; the conflict would have to be eliminated. The choice was yours: you could either serve as commissioner or you could serve as an EMC director, but you could not serve as both.

Here are two well-known examples of conflicts of interest and how they were dealt with at one of the largest insurance companies:

1) In 1960, Prudential Insurance Company's president, Carroll Shanks, resigned after *The Wall Street Journal* reported that Owen Cheatham, the founder of Georgia-Pacific and a member of Prudential's board, had arranged for Shanks (who served on Georgia-Pacific's board) to buy 13,000 acres of timberland for $8.4 million. The $8.4 million was lent to Shanks for *one day* by Bank of America (of which Cheatham was a director). Shanks immediately sold the land to Georgia-Pacific for cash and a stream of timber production payments, the net effect of which was that Shanks, without taking risk, was able to save $400,000 in taxes. The conflict of interest was intensified because at the time of the transaction Georgia-Pacific had $65 million in outstanding loans from Prudential.

2) Some years later Prudential's presi-

dent, Donald MacNaughton, served on IBM's board, but resigned in 1973 when IBM got into a legal battle with Memorex, in which Prudential owned a significant stake.

All six of Allied Mutual's directors have at least one of the following unusual and irreconcilable conflicts of interest: they are large shareholders of Allied Group, they serve on Allied Group's board, or they work at Allied Group.

Allied Group, a New-York-Stock-Exchange-listed company, has disclosed its conflicts of interest with Allied Mutual to its shareholders. Its December 15, 1989 proxy statement, for example, says that there are "inherent conflicts of interest in transactions between" Allied Mutual and Allied Group. Allied Group's 1996 10-K says that "the operations of [Allied Group] are interrelated with the operations of Allied Mutual." Allied Life Financial Corporation's November 17, 1993 prospectus lists as a "Risk Factor" the "conflicts of interest" among Allied Life, Allied Group, and Allied Mutual.

Allied Mutual, however, has shamelessly kept its *policyholders* in the dark about these conflicts and those of its own directors.

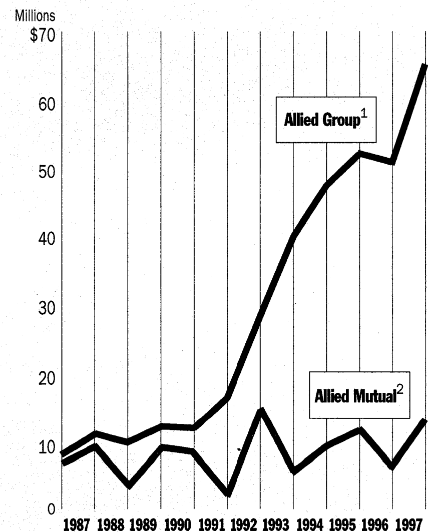
Every state insurance department is interested in conflicts of interest. That issue is raised in question 10c of the General Interrogatories of the statutory annual statement. The Iowa Insurance Department's 1994 Examination Report of Allied Mutual, for example, notes that the company's board has a Coordinating Committee to deal with conflicts of interest between Allied Mutual, Allied Group, and Allied Life. The members of the Allied Mutual's Coordinating Committee (composed of outside directors who are presumably independent), are James Kirkpatrick and C. Fred Morgan.

On March 31, 1997, Allied Mutual's directors had the following beneficial ownership of Allied Group shares, adjusted for the recent 3-for-2 split (*Editor's note*: Allied Group's stock recently traded at $30):

Director	Shares
John Evans	515,235
Harold Evans	49,681
Douglas Andersen	192,316
James Callison	26,116
James Kirkpatrick	239,168*
C. Fred Morgan	? ? ?

Allied Group's Earnings vs. Allied Mutual's

Allied Mutual once owned all of Allied Group. Ten years later, after a dozen asset shuffles, Allied Mutual doesn't own any of Allied Group. By sheer coincidence, Allied Group and its insiders have made a fortune while Allied Mutual has stagnated.



1–GAAP accounting. 2–Statutory accounting. Excludes Allied Mutual's non-recurring capital gain of $24,051,000 in 1993. Source: Allied Group, A.M. Best.

Kirkpatrick's shares are as of February 28, 1994, which was the last time information about him was reported in Allied Group's proxy. (Kirkpatrick is the former president of Allied Group's property/casualty operations.) I don't know whether Morgan owns shares in Allied Group, but he is an *employee* of Allied Group. [*Editor's note*: On February 11, Allied Mutual's secretary, Sally Malloy, made the startling admission that "Allied Mutual does not maintain records on the Allied Group stock ownership of Morgan... [or] on the Allied Life Financial stock ownership of Kirkpatrick and Morgan."]

All of Allied Mutual's directors, due to their stock ownership in, or employment by, Allied Group, have material conflicts of interest in representing Allied Mutual. Question 10c of the General Interrogatories asks, "Has the company an established procedure for disclosure to its board of directors or trustees of any material interest or affiliates on the part of any of its officers, directors...?" Since every member of Allied Mutual's board has a conflict, however, an affirmative answer to this question is meaningless; the directors are merely disclosing their conflicts to each other.

Both Allied Group and Allied Life disclose a significant amount of information to their shareholders, including compensation, stock ownership, and all sorts of "other arrangements and transactions." As is well documented, Allied Group has become successful while Allied Mutual has languished. Allied Group made $65 million in 1997; Allied Mutual—which once owned *all* of Allied Group—made $13.7 million. Although both companies participate in a pooling arrangement, Allied Mutual's combined ratio was 101% while Allied Group's was 94.4%. The difference is the result of higher expenses charged to Allied Mutual by an Allied Group subsidiary.

As Allied Group has prospered and Allied Mutual has languished, Evans, Andersen, Kirkpatrick, and others have made tens of millions of dollars from their Allied Group stock.

As a group, Allied Mutual's directors have conflicts of interest that, to the best of my knowledge, are unprecedented in modern times. The question, therefore, is this: should these conflicts of interest simply be disclosed, or should they be eliminated? I believe they should be eliminated.

Iowa law governing mutual insurance companies is silent on this matter—probably because it was never anticipated that such a situation *could* exist in a mutual insurance company. The principle of disclosing conflicts of interest is well established. The proper people for one to disclose a conflict of interest to are those with whom one's interests conflict. In Allied Mutual's case, the people affected by the directors' conflicts are the policyholders. As the owners or principal beneficiaries of the company, the *policyholders* have the right to be informed about these unusual conflicts. They have the right to know for whom they are voting and to whom they are assigning their proxies. They deserve to be told that the directors of Allied Mutual have a huge financial interest in Allied Group and that, in the words of Allied Group, this results in "inherent conflicts of interest." These conflicts of interest should be *fully disclosed.* In fact, it is unconscionable *not to disclose* such conflicts. Mutual policyholders have every right to expect that directors of their company are not faced with

conflicting self-interests that are likely to be detrimental to the policyholders' interests. [*Editor's note*: This is a key element in the mutual-insurance-holding-company debate.]

The issue, therefore, is who should disclose these conflicts of interest? The answer is obvious; the onus of disclosure resides with those that have the conflict: John Evans, Harold Evans, Andersen, Callison, Kirkpatrick, Morgan, and Allied Mutual.

Your order of December 19 does not require Allied Mutual or its directors to inform Allied Mutual policyholders of the company's and the directors' conflicts of interest. One of the reasons I'm running for the board of Allied Mutual is because of a breakdown in the system: somehow Allied Mutual has come to be controlled by people whose financial interests differ materially from those of Allied Mutual's policyholders. I can attempt to make policyholders aware of the conflicts of interest at Allied Mutual—and am prepared to spend money doing so if I believe that it will bring about reform that creates fairness and has a positive result for Allied Mutual's policyholders. However, it should not be incumbent upon me—or any other nominee—to have to disclose the egregious conflicts of interest that Allied Mutual's directors are fighting to conceal from the policyholders they profess to represent. That burden of disclosure rests with Allied Mutual and with the directors themselves. They are the *only ones* from whom disclosure is satisfactory.

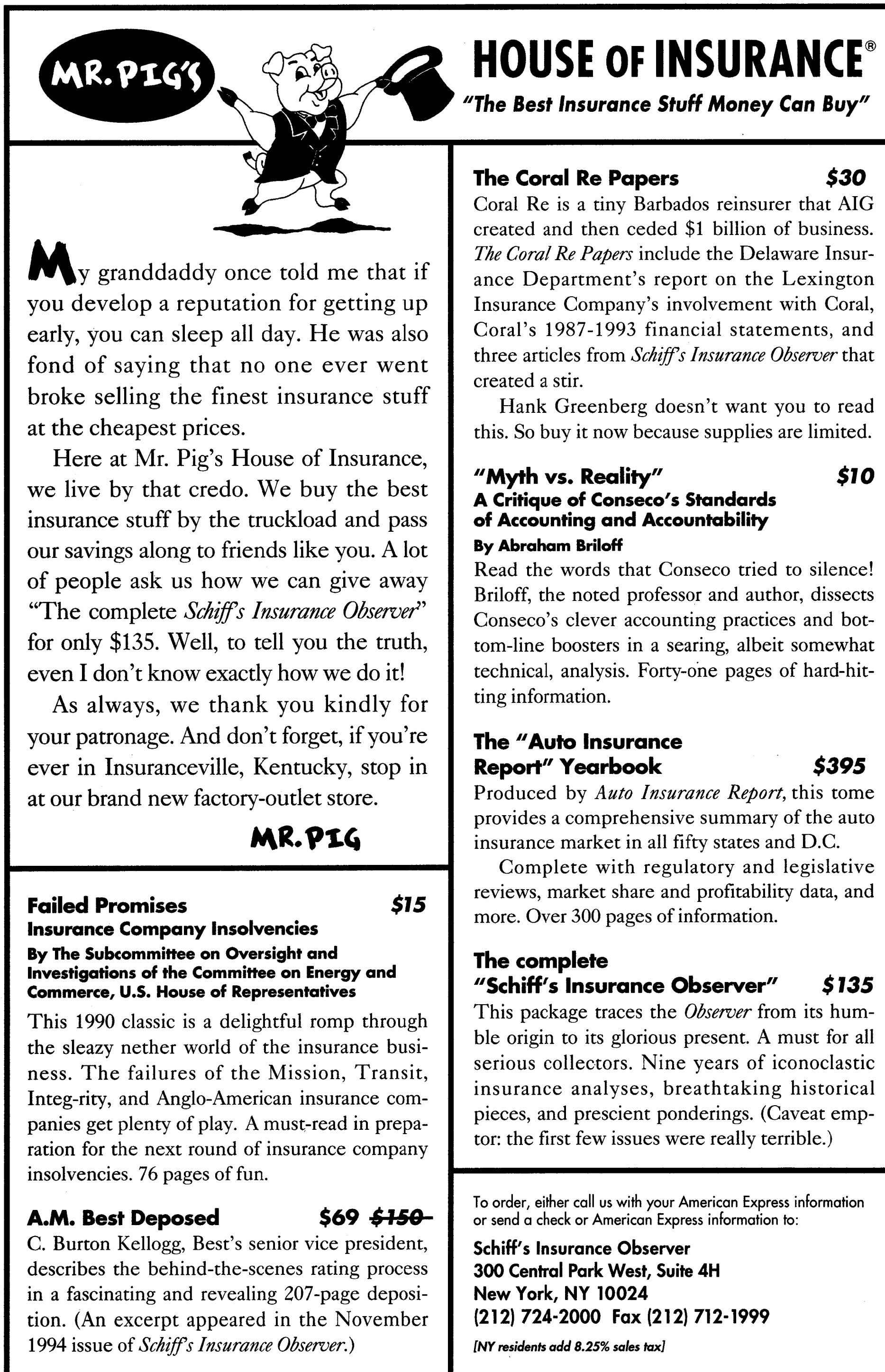
It would be nice if we lived in a world where such conflicts did not arise. It would be nice if we didn't have to make decisions or take action that put us at the risk of being unpopular. Ernest Hemingway said that "guts" was "grace under pressure." He meant that our character is defined by how we respond to a difficult situation. In *Profiles in Courage*, John F. Kennedy told the stories of politicians who took difficult-but-right positions—often at personal cost to themselves.

I, of course, cannot put myself in your shoes. I do know, however, what is right and fair, and I am fortunate that in my role as an independent writer I don't have to report to anybody. My goal has been to write about issues that I think are important, and to describe them in an unflinching, albeit amusing, manner.

I expect that Allied will exert political pressure. I've been told by several Allied agents that the company has asked them to write complaints about your order to the governor and to the insurance department. [*Editor's note*: In April, an Iowa state senator, Mary Lundby, at the request of an Allied lobbyist, drafted an amendment to a pending bill that would have prohibited the Insurance Department's investigation of Allied Mutual. When asked about this amendment, Senator Lundby said that after further consideration she decided it was bad public policy and would not support it.]

The purpose of insurance regulation is to protect policyholders. If we want a fair election—and how can one argue against that?—then it is incumbent upon the directors to tell their policyholders the truth. You, as commissioner, are the final line of protection.

Regulation should not be so arbitrary that it depends upon an outside nominee to step forward with disclosures that would otherwise be kept hidden. ■



Who Owns a Mutual Insurance Company?

In a simpler time, before the technological breakthroughs that led to the inventions of reload stock options, golden parachutes, and other executive bonanzas, it was well known that mutual insurance companies were owned by their policyholders.

Now, as mutual insurers seek to turn themselves into mutual insurance holding companies and financial-services conglomerates, mutual-insurance executives, with the help of well-paid lawyers and investment bankers, are renouncing the axiom that policyholders are owners.

thePrincipal

"Principal...is a mutual company, owned by its policyowners. Dividends are paid only to policyowners."

1984: Principal Mutual brochure

"The issue of whether or not policyowners actually 'own'—with that word—a mutual insurance company, is one that lawyers have argued about for many years."

January 23, 1998: Principal Mutual chairman & CEO, David Drury, in sworn testimony. (David Drury has worked at Principal since 1966.)

—

The Guardian

"A mutual company is owned by its policyowners. We work for the benefit of our policyowners."

1998: Joseph D. Sargent, president & CEO, Guardian Life, on the company website

"Since this is a mutual company, you are more than a customer, you are an owner."

1998: Northwestern Mutual president & CEO, James Ericson, in a form letter welcoming new policyholders

"We do not agree, however, that discussion of case law or 'ownership' of a mutual insurer is either necessary of helpful. At best, it will only serve to demonstrate that there are conflicting legal and academic theories as to whether these rights constitute 'ownership' rights."

January 20, 1998: William B. Fisher, vice president & general counsel of Massachusetts Mutual, in a letter to the NAIC on behalf of his employer, Guardian Life, Northwestern Mutual, and others.

—

National Association of Mutual Insurance Companies

"Unlike stock insurance companies, which are owned by investors who may have no other connection with the company, mutual insurance companies are owned by their policyholders...Unlike stock companies, mutual companies exist solely to serve the needs of the policyholders, and not to provide investment profits to shareholders."

April 17, 1998: Website, National Association of Mutual Insurance Companies

"Under our current mutual structure...you [the policyholder] have *voting rights*—to elect members of the company's Board of Directors, and you have *contract rights*—the benefits and provisions outlined in your insurance or annuity contract."

1998: Brochure signed by David O'Maley, president & CEO, Ohio National, a mutual insurance company. [O'Maley said nary a word about *ownership rights.*]

PROVIDENT MUTUAL

"It is the policyowners who own [Covenant Life]."

September 8, 1993: Robert W. Kloss, president, Covenant Life (a mutual that was subsequently merged into Provident Mutual), in a letter to the Board of Corporators.

"It's a very difficult question that can't really be answered in terms of a mutual life insurance company."

April 7, 1998: Robert W. Kloss, CEO of Provident Mutual, at an insurance department public hearing, in response to the question, "Do you believe that policyholders own the company?"

—

thePrincipal

"[*Policyholders* who are] members maintain majority control [of Principal Life after its conversion to a mutual insurance holding company]."

November 7, 1997: A brochure signed by Principal Mutual's chairman & CEO, David Drury, regarding the company's proposed mutual-insurance-holding-company conversion.

"The directors of a stock corporation [such as a converted mutual] have a fiduciary duty to manage the corporation for the benefit of its *shareholders* collectively [emphasis added]."

February 24, 1998: Richard W. Skillman, a tax attorney at Caplin & Drysdale, in a letter to the IRS on behalf of the Mutual Life Insurance Company Tax Committee, to which Principal Mutual paid $91,123 in 1997. [This letter was uncovered and first made public by Joseph Belth, editor of the indispensable *Insurance Forum*, P.O. Box 245, Elletsville, IN 47429, (812) 876-6502.]

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"Checklist for Investing in Mutual Deals...Demonstrated commitment to balancing interests of shareholders and policyholders, *rather than to interests of policyholders alone* [emphasis added]. Demonstrated commitment to returning any excess capital to shareholders."

November 7, 1997: Credit Suisse First Boston research report by Caitlin Long, *The Mutuals Are Coming!*

"It is our opinion that [Ohio National's mutual insurance holding company conversion] is fair to policyholders."

February 12, 1998: Credit Suisse First Boston "fairness opinion" for Ohio National's conversion which provides "no consideration" to policyholders. Credit Suisse First Boston has provided investment banking services to Ohio National, and is acting as its "financial advisor" in connection with the conversion. Credit Suisse First Boston has the right to manage the company's IPO and is providing advice concerning the granting of stock options to Ohio National's management.

—

"Own a piece of the Rock."

Prudential's famous slogan

"We have concluded that our policyholders would benefit most from a full demutualization [as opposed to a mutual insurance holding company]. Such a move would distribute the full value of the company to eligible policyholders, and at the same time maintain their insurance benefits."

February 1998: Arthur F. Ryan, Prudential's chairman and CEO, on his company's decision to break with the mutual-life-insurance-industry cabal and acknowledge that policyholders are owners.

The Bucket's Got a Hole in It: Mutual Insurance Bait and Switch

MUTUAL INSURERS USED TO SAY that their policholders owned the company—no longer. Now, a $300-billion fleecing is being attempted. It involves mutual insurance companies and their trade organizations, lawyers, investment bankers, lobbyists, and assorted cronies. Their goal: converting mutuals into mutual insurance holding companies.

Although a full demutualization has always been considered an equitable means of converting a mutual to a stock company, mutual executives now bristle at the thought of giving their policyholders stock or cash. They also dislike the idea of being accountable to shareholders, even though these same executives are eager to get their hands on stock options and other "incentives."

Hence the invention of the mutual insurance holding company—a neutron-bomb corporate reorganization that wipes out the policyholders' equity but leaves the mutual's officers and directors standing—and very rich.

The Facts	Full Demutualization	Mutual Insurance Holding Company
The Players	UNUM, Equitable, MONY, Prudential, and all four major Canadian mutual life insurers	MetLife, New York Life, Principal Mutual, Provident Mutual, John Hancock, Massachusetts Mutual, Northwestern, Guardian, AmerUs, Ameritas, Ohio National, FCCI Mutual, Pacific Mutual, and others
Who owns the mutual?	The policyholders	Mutual-insurance-company CEOs refuse to answer
What policyholders (members) receive	100% of the company	"Membership interests"
Value received by policyholders	Stock or cash. In Prudential's case, estimates range from $20 billion to $30 billion.	Membership interests with "no independent value"
Control of company upon conversion	Shareholders (the former policyholders). SEC regulations provide protection.	Policyholders get one vote regardless of the size or number of policies they own. Accordingly, the directors and officers control the mutual insurance holding company through nomination requirements that are impossible to meet.
Who profits?	Policyholders	Officers, directors, employees, and outside shareholders
What the policyholder is told	Transaction is fair because policyholders receive 100% of the value of the company	Transaction is fair because nothing has really changed. Policyholders will control the company and "benefit."
What the SEC is told	Policyholders will receive valuable securities	Policyholders will receive "membership interests" which have no value and are not securities.
What the IRS is told	The company is controlled by stockholders, to whom the board owes a fiduciary responsibility.	The company is controlled by stockholders to whom the board owes a fiduciary responsibility. Company is not controlled by policyholders.
Conflicts of interest	Minimal	Abundant
NAIC's involvement	Not clear	Drafting a "white paper." Hopelessly confused and torn by varying interests.
The investment bankers	Goldman Sachs and others	Goldman Sachs and others
The attorneys	LeBoeuf, Lamb; Debevoise & Plimpton; Sidley & Austin; Lord, Bissell & Brook, and others	LeBoeuf, Lamb; Debevoise & Plimpton; Sidley & Austin; Lord, Bissell & Brook, and others

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Provident Breaks Covenant with Policyholders

A Report from the Battlefield

On the sunny afternoon of April 6, 1998, David Schiff got into his beat-up 1987 Saab and headed from Manhattan towards the Valley Forge Hilton in Pennsylvania. The purpose of Schiff's trip was to speak at a public hearing held by the Pennsylvania Department of Insurance regarding Provident Mutual Life Insurance Company's plan to convert to a mutual insurance holding company. This would be the third mutual-insurance-holding-company hearing Schiff had spoken at in as many months. In late January he had gone to Des Moines for Principal Mutual's hearing (which will be the subject of an article in the next issue), and in February he had flown to Florida for an afternoon to make a brief speech at FCCI Mutual's hearing, which was held at the Orlando airport.

Schiff had hopes that his visit to Valley Forge would be more bucolic; he had visions of the countryside where General George Washington had spent the winter of 1777-78, and was surprised to discover that the Valley Forge Hilton is adjacent to the King of Prussia Mall, an endless concrete stretch of late-20th-Century commerce.

Provident Mutual, located in nearby Berwyn, is a sizable company: it has $37 billion of life insurance in force, $8 billion in assets, $844 million in equity, an overfunded pension plan, and 300,000 policyholders. It was important to Schiff for many reasons, not the least of them being that as a result of its 1994 acquisition of Covenant Mutual, it lays claim to being America's oldest insurance company.

Covenant, founded in 1717 as the Presbyterian Minister's Relief Fund, was incorporated in 1759 with the catchy moniker, "The Corporation for Relief of Poor and Distressed Presbyterian Ministers, and of the Poor and Distressed Widows and Children of Presbyterian Ministers." As far as Schiff could tell, the only "relief" that Provident was providing under its mutual-insurance-holding-company plan of conversion was to relieve policyholders of their ownership in Provident. As a result, Schiff felt compelled to go within spitting distance of the giant shopping mall and object to Provident's plan, which, like all other mutual-insurance-holding-company plans to date, is a paradigm of conflicts of interest, inadequate disclosure, misleading statements, and other nasty characteristics that decent people tend to find objectionable. (Among the decent people who object to Provident's plan are the Reverends David Ross Drain and Michael Shea, plaintiffs in a class-action lawsuit against Provident.)

Schiff's agenda was overt: he planned to make a public statement at the hearing and ask a few easy questions to Provident's management and its "experts"—Derek Kirkland of Morgan Stanley and Ken Beck, an actuary at Coopers & Lybrand. (It is a small world. Two weeks earlier Schiff and Beck had spoken at an intimate mutual-insurance conference sponsored by the Fells Road Group, and Coopers & Lybrand is the firm hired by the Iowa Division of Insurance to investigate Allied Mutual.)

At seven o'clock that evening, Schiff went to the Hilton's lobby to meet with Joseph Belth, the 68-year-old founder and editor of *The Insurance Forum.* Although Schiff and Belth have known each other for about eight years and speak frequently (sometimes several times a day), this was their first face-to-face meeting.

Belth, who sold life insurance in the 1950s, is professor emeritus of insurance in the Kelley School of Business at Indiana University. He is a towering figure in the field of insurance journalism; for 25 years he has been exposing deception, fraud, and shady behavior in the life-insurance industry. His method involves resolute tenacity, voluminous knowledge, and the skillful discovery of important material through freedom-of-information laws (and, of course, through confidential sources.)

Belth has published his newsletter without ever missing a monthly deadline. (Schiff, whose publishing schedule is rather quirky, admires Belth's consistency as well as his content.) Although *The Insurance Forum* probably has the largest circulation of any independent insurance newsletter, like all insurance publications it is obscure when measured by the standards of mainstream popular journalism. Nonetheless, Belth received the George Polk Award in 1990, an honor on a par with the Pulitzer Prize. (Other winners include Edward R. Murrow, David Halberstam, Seymour Hersh, and I. F. Stone.)

Belth is a precise and exacting man: determined, stubborn, and a stickler for detail. His appearance is plain and straightforward, as is his prose. His words are carefully chosen and his arguments are as clean as the windows at Saks during the Christmas rush. If one were to define Belth in a word, it might be this: fair.

Over the previous year, Belth had become increasingly disturbed by the actions of the nation's richest and most powerful mutual life insurance companies. As a result of their quiet assault on state legislators, at least 16 jurisdictions have passed laws permitting mutuals to convert into mutual insurance holding companies. Provident, whose very name implies prudence and frugality, is not the first life insurance company to attempt such an abusive conversion, nor is it the largest or even the most egregious. It is notable nonetheless, if for no other reason than it is the one in which Belth—who has not made the rounds of NAIC meetings and public hearings recently—has chosen to draw a line in the sand and prepare to do battle. His weapon of choice is a time-honored one which, throughout history, has changed the world—words.

Belth is not alone in his concern about the mutual-insurance-holding-company conversion scheme, although in all of America there are only a few others who share his passion and outrage. Indeed, for those few, the inequity of what the mutual industry is attempting has become an exhausting obsession. One charter member of this concerned cadre is Jason Adkins, a firebrand from Cambridge, Massachusetts. Adkins, who founded the Center for Insurance Research—a tiny nonprofit public policy and advocacy organization—has led a behind-the-scenes counterattack against the mutuals. He has represented policyholders, filed lawsuits, sought injunctions, drafted position papers, attended dozens of NAIC meetings and public hearings, and argued so effectively against the giant mutuals that he has earned their lasting enmity.

It is a sad commentary on the current state of mutuality that at a Business Strategy Network conference in New York last month, "Restructuring of the Mutual Insurance Industry," Michael Sproule, executive vice president and chief financial officer of AmerUs, (formerly American Mutual and

now the ugliest mutual-insurance-holding-company conversion of them all), lambasted Adkins by implying that his goal was money. In 1997 Sproule received $610,102 in compensation plus options on 60,000 shares of AmerUs stock. His pay last year alone is more than the 38-year-old Adkins, who graduated from Harvard Law School, has made in his *entire* career, which has been devoted to public-interest work. It is hard to say whether Sproule's comments were the result of ignorance, avarice, or an inability to understand why a man would speak out (at considerable personal expense) against something he believes is wrong.

Adkins, who since the beginning of this year has worked at a start-up law firm, Adkins & Kelston, knows all too well that there is little money on his side—that the big money is made representing the mutuals in their march to the sea. Money, however, is not what motivates Adkins, nor is it what drives the dedicated young activists at the Center for Insurance Research—Paula Isola, Brendan Bridgeland, and Aaron Bartley—all of whom are making a difference.

The final, and perhaps most unlikely member of the Belth-Adkins cadre of mutual-insurance-holding-company opponents, was Schiff, an affable curmudgeon from New York, who, unlike Adkins and Belth, dislikes being called a "consumer advocate." (To him the phrase implies a knee-jerk reaction rather than a reasoned decision. Besides, is there anyone who claims to be a "consumer *adversary?*") Schiff leads a comfortable life. Before becoming a full-time muckraker he worked in the insurance and securities businesses for 20 years, and served on six corporate boards. (He has only one directorship now, but plans to double that when elected to Allied Mutual's board.) A recent article in *Grant's Interest Rate Observer* said the following:

> The indispensable element that Schiff brings to the subject, beyond his considerable experience and knowledge, is a burning outrage. He is up in arms about the mutual insurance holding company, and has no use for the [subscription rights demutualization], either…
>
> Resembling a certain Marquis Roux of Corsica, who, during the Seven Years War of the 18th century, distinguished himself by declaring war upon Britain in his own name and private capacity, Schiff is moving against a Des Moines-based enterprise, Allied Group, a downstream stock company connected to Allied Mutual. An exposé last fall in *Schiff's Insurance Observer* documented conflicts of interest and questionable shuffling of assets between the stockholder-owned company and the mutual life insurance operating company. Not stopping there, Schiff ran for a seat on the board of Allied Mutual with the announced intention of kicking out Allied Group's management and "making the policyholders whole." To date, he has not succeeded, although, like the marquis, he has caused his adversary to learn his name.

As Schiff and Belth met in the hotel lobby, they shook hands for the first time. The two men sat down on a couch and began exchanging information about the latest outrages and developments in the mutual-insurance-holding-company battles. Before they headed to the hotel restaurant for dinner, Schiff took four books by Belth from his briefcase and asked Belth to inscribe them, which he did.

Jason Adkins, who has logged many miles fighting against unfair conversions, was not at the dinner table that night, nor would he be at the hearing the following day. He had sent a letter of protest to the commissioner announcing his boycott of the proceedings. In his opinion it was impossible to prepare for the hearing because there was "no access to information, no established rules or rights, and no clear purpose." In short, according to Adkins, "it would be no hearing at all." Belth and Schiff had little doubt that Adkins would be proved correct.

The hearing commenced at 8:56 the following morning. It was presided over by Deputy Commissioner Gregory Martino, rather than by Commissioner Diane Koken, who had recused herself because of a significant conflict of interest: for the 22 years preceding her appointment as commissioner in 1997, she had worked for Provident Mutual, most recently as general counsel, vice president, and secretary. Given Pennsylvania's hostility to mutual policyholders, the specter of Commissioner Koken's conflict of interest loomed large over the proceedings and their aftermath.

Eight other members of the department were on hand, along with three representatives from Tillinghast-Towers Perrin, the actuarial firm retained by the department. At the table to the deputy commissioner's left and speaking on behalf on Provident were Robert Kloss, president and CEO; James Potter, executive vice president and general counsel; Derek Kirkland of Morgan Stanley; and Ken Beck of Coopers & Lybrand. Their statements may as well have been lifted directly from the official mutual-insurance-holding-company conversion playbook.

During the course of the day people went to the microphone and commented on Provident's plan. Many were outraged by it, although several agents and others spoke in favor.

As the day wore on, Schiff began to wonder when he would get to speak (he had been the third person to sign up on the speakers' list). Perhaps it was coincidence, but neither Belth nor Schiff got to speak until after lunch, by which time the reporter from *The Philadelphia Inquirer*—the only paper covering the event—had left. When Belth's turn came, he read a brief prepared statement. His objections included the following: "1) the plan involves termination or dilution of our ownership interests without compensation [Belth is a policyholder], 2) the plan creates the possibility of conflicts of interest for officers and directors, 3) the plan would prevent our participation in the future growth of the organization, 4) the plan may result in a reduction of policy dividends in the future." Belth then read 10 pointed questions and returned to his seat.

From that moment on, he was a whirlwind—writing letters and commentaries, demanding answers, disseminating material, and uncovering incriminating documents, including an internal memorandum that Potter, Provident's general coun-

Drawing by Frank Cotham; © 1998 The New Yorker Magazine, Inc.

sel, had faxed to Lynne Fitzwater, the insurance department's counsel, on February 25. The memorandum, "Consumer Advocate Activity at Principle [sic] Mutual's Public Hearing," described the activities of Schiff and Adkins 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…"

Kloss, Provident's president, began his response to Belth by saying, "Thank you for your comments and we appreciate your support as a policyholder…" Kloss, in fact, had *thanked* every speaker, whether their statements were pro or con.

It was then Schiff's turn to speak. When he finished an hour later, Kloss would not thank him, and Adkins' predictions would be borne out.

The following is an edited version of what took place:

SCHIFF: How long have you been at Provident Mutual?

KLOSS: Since November 1, 1994.

SCHIFF: And prior to that you were…

KLOSS:…at Covenant Life Insurance Company.

SCHIFF: How many years had you been there?

KLOSS: Is this relevant to the plan?

SCHIFF: It's very relevant.

KLOSS: I'll be happy to answer your questions about the plan; I will not be happy to answer questions about the past.

SCHIFF: Would it be fair to say that you have a deep familiarity with both Covenant and Provident Mutual and most aspects of the company?

KLOSS: I believe I do.

SCHIFF: Are you familiar with the sales practices of the company and have you been in the past?

KLOSS: I repeat, I'm here to deal with the plan. I'm not here to waste the Department's time.

SCHIFF: It's simply a yes or no question.

STEPHEN MARTIN, deputy chief counsel for the Pennsylvania Insurance Department, intervened.

MARTIN: [To Schiff] One thing I do want to make clear from the beginning is this is not going to be a cross examination. If you have comments, I'll be happy to include them on the record. If you have questions regarding the plan of conversion and how it will apply to policyholders, I will be happy to allow those on the record.

SCHIFF: If he simply answered the question it would save a lot of time. [To Kloss] Do you believe that the policyholders own the company?

KLOSS: I've made this statement several times today, Mr. Schiff. I think you've heard me three times make the statement about ownership. It's a difficult question that can't really be answered in terms of a mutual life insurance company. [Kloss's standard line was that policyholders have *policy contract rights* and *membership rights*. Like other mutual executives seeking to convert their companies to mutual insurance holding companies, he will no longer say that policyholders are *owners* of the insurance company.]

SCHIFF: Do you believe that your salespeople told policyholders—or are you aware that they told policyholders—that they were the *owners* of the company?

GREGORY MARTINO, deputy insurance commissioner for the Pennsylvania Insurance Department, intervened.

MARTINO: [To Schiff] That is way beyond commenting on, and asking questions about, the plan of conversion.

SCHIFF: They're simple questions that can be answered yes or no. If we don't want to get to the truth—I thought that was the purpose of a public hearing.

Deputy chief counsel STEPHEN MARTIN intervened.

MARTIN: [To Schiff] That is the purpose—to hear your comments and to hear what you have to say about the plan.

SCHIFF: It's relevant what the management believes and what they tell the policyholders in their written statements and what they have told them previously. This goes to the essence of the company. [To Kloss] Have you ever said that the policyowners own the company?

KLOSS: I'm going to stick with my comment, sir.

Deputy commissioner MARTINO intervened.

MARTINO: [To Schiff] There are many people after you who want to make comments who have been waiting patiently all day.

In fact, there were only three speakers after Schiff, and their comments took about an hour. The hearing concluded early, at 4:18 in the afternoon.

Schiff spent the next few minutes requesting that Provident submit sales literature, training materials, and opinions from lawyers, accountants, actuaries, and investment bankers.

He then asked a question of James Potter, Provident Mutual's executive vice president, general counsel, and secretary.

SCHIFF: [To Potter] When did you request the no-action letter [from the SEC]? Can that be disclosed or is it top secret?

POTTER: They will be part of the record. It was a confidential request, and the confidentiality period ran today [April 7], so as of today the SEC released its confidentiality treatment of the no-action letter. So it is all available in the public file.

When Schiff received the SEC's no-action letter the following day it became apparent that the decision to keep it confidential belonged solely to Provident. Debevoise & Plimpton, Provident's attorney, had written to the SEC asking for confidential treatment on the grounds that it "believe[d] that publication of the matters set forth in the Letter prior to the public hearing on the Plan would have an adverse effect on the conversion process." Incredibly, the insurance department received this letter at least two weeks prior to the public hearing *but permitted it to remain a secret.*

The no-action letter stated that the confidentiality period ran until April 7 "*or such earlier date that any information…is made publicly available by or on behalf of*" Provident. [Emphasis added.]

Since Provident *was not bound* by any confidentiality requirements of the SEC, it could not have been "released" from any confidentially treatment on April 7. It was Provident's request and decision to keep the information confidential.

On April 17, Schiff wrote to Deputy Commissioner Martino and asked him to request Mr. Potter to submit a sworn affidavit stating that the SEC would not permit Provident to release the request for the no-action letter, and the no-action letter, prior to April 7, 1998.

After more comments, Schiff addressed Kloss.

SCHIFF: [To Kloss] You were the president of Covenant Mutual. Covenant was run by a group above the Board of Directors called "Corporators." You wrote them a letter in September of 1994 [the correct date was actually September 8, 1993] and you said, "It is the policyowners who own the company"—the company being Covenant Mutual.

Covenant Mutual was a mutual like Provident, and it was merged into Provident. That's why I was curious when you changed your thinking [about who owns a mutual]. Is there a particular time period?

KLOSS: Mr. Schiff, I wish you'd deal with relevant subject matters.

Deputy commissioner MARTINO intervened.

MARTINO: Mr. Schiff, as I mentioned here earlier…

SCHIFF: [To Kloss] You mentioned you had considered various alternatives [to a mutual insurance holding company]. Approximately how much is Provident Mutual worth? This goes to the essence of value because you're asking policyholders to vote on something [the conversion] and

there are alternatives. They may choose not to go for this.

KLOSS: We did not engage investment bankers or actuaries or accountants to do a fair evaluation of what Provident Mutual would be worth.

SCHIFF: Do you have an approximate idea? You mentioned growth by acquisition in your testimony.

KLOSS: It would be most inappropriate to speculate what a company is worth without doing the appropriate work.

SCHIFF: So wouldn't it be most inappropriate to recommend a [conversion] without doing that type of work?

Deputy commissioner MARTINO intervened.

MARTINO: [To Schiff] Again, I'm going to…

SCHIFF: Let me ask Mr. Kirkland [a question.]

Derek Kirkland is the co-head of Morgan Stanley's Global Insurance Group, and had given testimony on behalf of Provident Mutual earlier. Morgan Stanley is Provident's financial advisor, and Kirkland had stated for the record that Morgan Stanley is "continually involved in the valuation of securities..."

Kirkland said that his firm had become familiar with Provident over the past several years, "having provided investment banking advisory services to the company in connection with analyzing its restructuring alternatives." He also submitted an exhibit containing a list of recent insurance industry stock offerings that were lead or co-lead by Morgan Stanley. Kirkland also said that his firm planned to deliver a fairness opinion regarding the mutual-insurance-holding-company conversion to Provident's board in the near future.

SCHIFF: [To Kirkland] Do you have an opinion about what Provident Mutual is worth?

KIRKLAND: No. We have not evaluated what Provident Mutual is worth.

SCHIFF: I take it you're familiar with the Morgan Stanley index of mutual companies and life insurance companies?

Deputy commissioner MARTINO intervened.

MARTINO: I'm not sure where you're going and I'm not sure what that has to do with it.

SCHIFF: I'd like to get some understanding of what the company is worth. Am I being told that no one in this company—including the investment bankers—has any idea?

MARTINO: I tell you what—we recognize your question for the record. If they can respond to that, they will do that.

SCHIFF: [To Kirkland] What percentage of GAAP book value do [life insurance companies] trade at?

KIRKLAND: There's a wide, wide variation.

While that's true, the average life insurance company was then selling for approximately twice its GAAP book value.

SCHIFF: [To Kirkland] Would you say that a good life-insurance company would sell for a multiple of GAAP book?

Deputy commissioner MARTINO intervened.

MARTINO: You're going way beyond the scope [of this hearing].

SCHIFF: [To Martino] I don't know what the scope is. What could be more essential to the plan of conversion than understanding what the financial ramifications of alternatives are to policyholders? We have experts here and this is a perfect opportunity to get them to answer questions.

Deputy chief counsel STEPHEN MARTIN intervened.

MARTIN: [To Schiff] This is not the forum for cross examination of the experts or the company representatives. This is the forum for you to use your expertise—which is considerable—and tell us what it is about this plan that you do not care for or what you believe is not in the best interest of policyholders.

SCHIFF: [To Kloss] I think Provident policyholders should be told approximately how much the company could be sold for—a rough estimate. If it were twice book—and there are approximately 300,000 policies—that could be $5,000 per policyholder.

Policyholders can't possibly make an informed decision unless you provide them with the proper information, which you have not done.

In this brochure you sent [to policyholders], you said the plan "maximizes the value of our subsidiaries." Who does it maximize value for? I take it that it is not the members since I assume that you have written in your [request for a] no-action letter that the members "have no expectation of profit." Is that correct?

KLOSS: The SEC letter will be part of the record.

Although Provident's request for a no-action letter was a damning document that had been kept secret by Provident and by the Department of Insurance, Schiff's assumption was correct. The request for the no-action letter stated that a membership interest in Provident Mutual Holding Company "simply does not entail for a member any 'reasonable expectation of profits.' "

SCHIFF: [To Kloss] Do you expect that over the next 10 years you will issue stock to the public?

KLOSS: I can't answer that today. That will be a board decision based upon proper circumstances and facts. At the time there are no plans.

Four months earlier, on December 17, 1997, Provident's accounting firm, Coopers & Lybrand, had written to the Internal Revenue Service on Provident's behalf stating the following: "Although such a public offering is not being contemplated to occur simultaneously with the Conversion, the enhanced capital resulting from such an offering is one of the principal reasons why the conversion is being considered. It is the Company's intent to undertake such an offering at the appropriate time when the optimum market conditions exist."

Schiff asked Mr. Kirkland a question.

SCHIFF: [To Kirkland] Will the members of Provident Mutual Holding Company profit from [the conversion]?

Although Schiff suspected that Provident's request for a no-action letter had said that policyholders had "no expectation of profits," he was curious to hear what Morgan Stanley—which was giving the thumbs up on the conversion—had to say.

Mr. Kloss interrupted, and did not permit Kirkland to answer the question.

KLOSS: Mr. Schiff, it would be inappropriate to answer that question.

SCHIFF: A man who has written the fairness opinion! It would be inappropriate?

Deputy chief counsel STEPHEN MARTIN intervened.

MARTIN: Mr. Schiff, this is not cross examination. This is not the forum for that.

SCHIFF: Which is the forum for that, then?

MARTIN: We can't permit this kind of cross examination. That's not why we're here.

SCHIFF: These are the essential questions, and if we eliminate the essential questions, you're right—there's no purpose being here. Let me ask one more question. [To Mr. Kirkland] Is there any value to a mutual holding company membership? Yes or no? Or is it worthless?

KIRKLAND: [No answer]

SCHIFF: Okay. I'll request that the Department ask the company to answer.

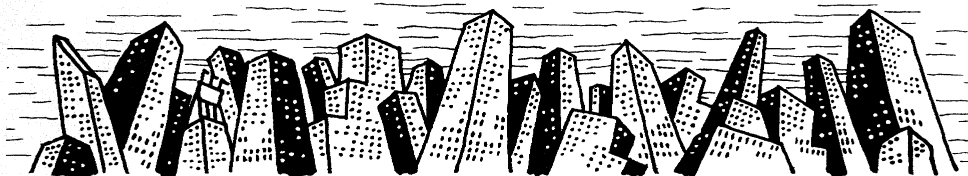
MARTINO: You can certainly put those in the record. You can ask your questions.

The following week Schiff submitted a letter to Deputy Commissioner Martino seeking various documents under statutes governing access to public records.

He also asked Martino to request that Provident provide answers to 38 questions.

Copies of Schiff's letter will be sent for free to any subscriber of *Schiff's Insurance Observer* who provides a self-addressed envelope stamped with 55¢ of postage.

For those interested in Provident Mutual—and in the mutual-insurance-holding-company-conversion process—we recommend ordering the "Provident package." It consists of the April, May, and June issues of *The Insurance Forum*, and is available for $25 from *The Insurance Forum* at P.O. Box 245, Elletsville, IN 47429, (812) 876-6502. Don't be a cheapskate. Order now. ■



On the Road

V. J. Dowling, of Dowling & Partners Securities, may well be the best insurance analyst in the world. In-the-know investors prize his Hartford-based firm's research for its insight, clarity, and—yes—wit. Indeed, savvy institutional investors look forward to Monday mornings simply because they know that Dowling's *IBNR Insurance Weekly* will be on their desks when they arrive at work. (Don't even *bother* calling about this report unless you're prepared to shell out around $20,000 per year—a bargain for such valuable material.)

Dowling and his team of analysts are ubiquitous, scouring the country for information. Although they log endless miles by plane, the firm owns also owns a DowlingMobile—a custom-built Dodge Ram Van RoadTrek whose amenities include four seats up front, a cut-out floor, raised ceiling, bathroom, tables, microwave, beds, kitchen, television, two cellular phones, cellular faxes, computers, and an office area. It is, in Dowling's words, a "poor man's private jet."

Dowling, intrepid researcher that he is, has been known to roam America in this specially equipped vehicle, investigating insurance companies in out-of-the-way locales. During one "summer vacation" he even made the rounds with three little Dowlings in tow. ("Hey Dad, can we skip Yosemite and visit Mercury General again?")

Schiff's Insurance Observer would love to hitch a ride on the next road trip.

The Company You Keep

In 1994 New York Life, a mutual insurance company, spent $2.5 million recapping its landmark Madison Avenue headquarters with 26,000 gold-baked tiles and recovering the building's five-story spire in gold. It has never been suggested that Sy Sternberg, New York Life's chairman and CEO, has put any of that gold in his own pocket. Indeed, such an act would be inappropriate.

When Mr. Sternberg testified at a New York Assembly hearing on mutual insurance holding companies chaired by Assemblyman Pete Grannis last fall, he spoke of New York Life's great sense of tradition. He explained that New York Life had "a mutual culture" and was "a cooperative." Describing his job as a "stewardship," Mr. Sternberg—in all seriousness—told the inquisitive Grannis that "the customers control the company." (He forgot to mention that less than 1% them are sent a ballot to vote for the board of directors.) Such forgetfulness aside, Mr. Sternberg, who truly feels his policyholders' pain, said that if New York Life were to demutualize and give its policyholders stock—stock which might be worth $10 billion or so—the policyholders might one day "wake up and read about some venture capital firm making a hostile bid for New York Life Insurance Company."

Under this grisly scenario, policyholders who owned shares might lose sleep deciding how to reinvest the proceeds they'd receive upon New York Life's takeover. That clearly troubles the compassionate Mr. Sternberg, who articulated why he favors the mutual-insurance-holding-company approach, where management will be entrenched and policyholders, who will have received nothing, won't have to worry about a takeover: "I want to be able to go back to our policyholders and say to them, 'You are still in control and you will be in control. Do not lose sleep.' "

Mr. Sternberg's concern for his policyholders' sleeping habits is undoubtedly the reason he laid to rest one of the nagging issues at the heart of the debate over mutual insurance holding companies and their publicly-held subsidiaries: conflicts of interest. "In the real world," Mr. Sternberg said, "and the real world is 99% of the time—there is an *absolute* alignment between what the mutual policyholders want and what these outside shareholders would want."

Although we always thought that policyholders wanted insurance at the lowest possible cost and shareholders wanted the highest possible return—desires that are mutually exclusive—Mr. Sternberg explained that if, under the mutual-insurance-holding-company structure, New York Life's stock company were to do an IPO, its prospectus would state that "management will tilt in the direction of the mutual policyholders."

He then addressed a situation that, according to his previous statement, had only a 1% chance of happening: "If, in fact, there is a *conflict*, we will vote in favor and make management decisions in favor of the mutual policyholders. That will be explicitly stated in any S-1 [prospectus]." Then Mr. Sternberg gave a "specific example"—that of Express Scripts, a New York Life subsidiary that issued shares to the public six years ago. (New York Life currently owns a 44% stake worth about $650 million.) Mr. Sternberg assured the skeptical Grannis that New York Life would, if it became a mutual insurance holding company, "bias decisions [in the stock company] towards the policyholders," rather than towards public shareholders.

Mr. Sternberg's testimony sounded rather like what Huckleberry Finn might have called "a stretcher," which is why we decided to take a peek at Express Scripts' proxy statement for ourselves. And guess what we found? The situation at Express Scripts was only 180 degrees different from that described by Mr. Sternberg, who, as it happens, is a director of Express Scripts.

Under a section titled "Certain Relationships and Related Transactions," Express Scripts' proxy statement explains that "in an effort to minimize conflicts" of interest with New York Life, "any material transaction with a related party" [*read* New York Life] must be approved by the Audit Committee directors, a majority of whom may not be officers, directors, or employees of New York Life or its subsidiaries. In fact, this provision is *written into Express Scripts' bylaws* and may not be changed without "the affirmative vote of a majority of the outstanding Class A common stock." (New York Life owns Class B stock.)

We're the first to admit that it would be unfair to indict Mr. Sternberg's entire testimony merely because the most important part of it was wrong. Likewise, we're sure that Mr. Sternberg would be the first to admit that, when he said directors would "bias" their "decisions" towards policyholders rather than shareholders, he didn't mean to imply that these directors would violate their fiduciary responsibilities. As New York Life's attorney, Woolcott Dunham of Debevoise & Plimpton (who was sitting to Mr. Sternberg's right), surely knows, directors must make their own decisions and can't be legally bound to vote the

way New York Life tells them to vote. And, as even a Debevoise & Plimpton summer intern knows, corporate directors have a fiduciary responsibility to act in the interests of *shareholders*, not policyholders.

No one who knows of Mr. Sternberg's fine reputation would ever accuse him of intentionally misleading the State Assembly's standing committee on insurance. That is why there can be no doubt that Mr. Sternberg's failure to tell the committee of *his own conflict of interest*—that he personally owned 3,000 shares of Express Scripts (current value about $250,000)—was an oversight made by a man who stays up late worrying that his policyholders might one day awaken to the news that their company is the target of a hostile takeover. Nor should even the most hardened cynic think less of Mr. Sternberg because he forgot to mention that his son owns 180 shares of Express Scripts (worth about $15,000).

As Mr. Sternberg testified, New York Life is a "cooperative" run by its policyholders. Although he didn't say that policyholders are "owners," Webster's Collegiate Dictionary said it for him; it defines a "cooperative" as "an enterprise or organization owned by and operated for the benefit of those using its services." As one of New York Life's 3,000,000 policyholders, Mr. Sternberg is, therefore, an owner of the company. While there are those who might say he behaves as if he owns the *whole* company rather than just one-three-millionth of it, such statements are unseemly.

On the other hand, we must fess up to the shameful admission that we are a tad wary of Mr. Sternberg's intentions. So the next time we pass that grand Italian Renaissance base of New York Life's 70-year-old limestone tower, we'll cross Madison Square Park and take a gander at the building's spire—just to make sure that Mr. Sternberg has not made off with any of those 26,000 golden tiles.

Politics and Insurance

WE'RE NO FAN of New York's superintendent of insurance, Neil Levin, a Republican whose actions on the mutual-insurance-holding-company front are a combination of gross ignorance and political toadying.

It is ironic that while Levin has been fronting for MetLife and New York Life to get legislation passed that would enable them to strip their policyholders of $40 billion or so, he has been actively pursuing a fair cause (although in financial terms, a far smaller one)—seeking the recovery of funds from European insurers on behalf of Holocaust victims. Of course, recovering assets for Holocaust victims plays well in an election year (especially in New York, where a Republican governor, Pataki, and a Republican senator, D'Amato, are running for re-election). The proposed mutual-insurance-holding-company bill, however—which is perhaps the largest expropriation of private property ever attempted by legislative means—is sufficiently complex that it has doesn't lend itself to a sound bite on the evening news.

Another irony: although Levin favors the mutual-insurance-holding-company bill—which deprives individuals of private property rights—he steadfastly defends the private property rights of insurance companies at a time when many other commissioners and elected officials are calling for across-the-board rate cuts in response to the profits racked up by auto insurers. Levin, rightly so, has resisted such demagoguery.

Levin favors competition, which he believes (as do we) inures to the benefit of consumers over the long term. According to John Calagna of the New York Insurance Department, New York has reduced bureaucracy and introduced flex rating (so that any rate change of 7%, either up or down, can go into effect right away). The result: rates declined 0.6% last year.

Insurance is not a monopoly, and practices that encourage competition are good for consumers in the long run—although such practices can lead to unpleasant market dislocations. Intense competition, failure, and fluctuating prices (like a soaring S&P 500), are all part of the free market.

One would hope that when auto insurance experience deteriorates, rates begin to rise, and consumers start complaining, Levin will still favor the free-market approach.

On the other hand, it's unlikely that he'll be insurance commissioner when that time arrives, and that two Republican incumbents will then be running for re-election.

The Devil Inside Sandy Weill

ON MARCH 31, *The Wall Street Journal* reported that two senior executives at Salomon Smith Barney, a subsidiary of Travelers Group, were fired from their jobs. The reason: they shared pornographic material with associates via the firm's e-mail system.

According to Carol Heimann, a Travelers Group spokesperson, this is a violation of the company's policy "prohibiting the electronic transmission of offensive images or text." This policy applies to *all* Travelers Group companies. Indeed, Salomon Smith Barney's employee handbook states that Big Brother is watching you closely: "There is no personal privacy when you use Salomon Smith Barney's equipment and services...[the firm] may monitor, copy, access or disclose any information or files that you store, process or transmit."

Possession of pornography is, of course, perfectly legal. Ms. Heimann and Travelers, however, refused to provide us with copies of the images that resulted in the employees' dismissal, nor would they describe the images or tell us who decided that the images were "offensive." She also declined to say what standard Travelers applies in making such decisions.

Indeed, we were unaware that Sandy Weill, Travelers' chairman and CEO, was such a bluenosed prig, especially in light of Weill's own *obscene* behavior: the many hundreds of millions of dollars of options he's

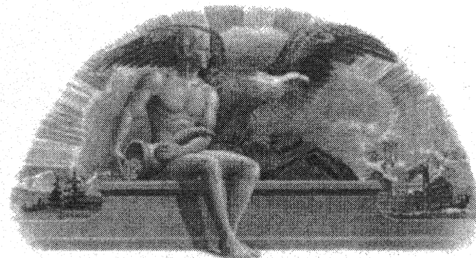


Illustration on Travelers Group's stock certificate

been granted; the eyesore five-story neon orange umbrella logo he emblazoned on the company's New York headquarters; and his executive responsibility for the despicable sales practices of Primerica Financial Services, the sleazy life-insurance bucket shop formerly known as A. L. Williams.

According to *Liar's Poker*, Michael Lewis's classic account of Salomon Brothers in its mid-1980s heyday, hotshot bond traders and salesman were then known as "Big Swinging Dicks." The irony of that reference will not be lost on anyone who takes a gander at a Travelers Group stock certificate: it depicts an Adonis-like nude man holding a cornucopia. Although the man's private parts are concealed, the cornucopia—a massive, curved goat's horn—protrudes a good 20 inches or so from the man's groin. This conspicuous phallic symbol represents—we assume—abundance, fertility, and potency.

If you want to keep your job at Travelers—and, perhaps, at Citigroup—don't e-mail a picture of that stock certificate to your associates. ■

David Schiff: private insurance observer checking out a lead.

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New York, where theater critics prowl the Deuce and the Great White Way. Tin Pan Alley, dance halls, cabarets. Late nights at the Stork Club, sipping champagne cocktails and flirting with the hat-check girls. So much to write about.

Minsky's Burlesque, the Palace Theater at 47th and Broadway—look closely and you'll see Damon Runyon or Grantland Rice.

Nearby is Jack Dempsey's restaurant, where reporters start drinking early and don't stop until long after deadline. This is a town full of newsprint: *The Herald-Tribune*, *The Journal-American*, *The World-Telegram*, and so many others.

Toots Shor's is on 51st Street—right around the corner from Swing Street, Birdland and Bop City. With all this action it's a wonder that anyone would bother writing about insurance.

Yet someone has to do it…and that someone is a hard-boiled muckraker named David Schiff—a man ill-suited for a desk job and unfit for a high-paying trade such as steamfitter or metallic lather.

Insurance is a rough beat and a 24-hour mistress. For gazetteers like Schiff there can be no day, there can be no night, there can be no sleep. It's a life lived on the dirty downtown streets, in the shadows of old office buildings, and under the dim glow of flickering streetlights. An insurance inkslinger like Schiff can't even enjoy a public lunch with an underwriter at the Insurance Club or stroll down John Street in broad daylight.

Meetings with confidential sources—many of whom have no qualms about transferring risk for money—take place after midnight in the deserted tunnels of the old Interborough Rapid Transit Company. Here, way beneath the empty city streets, the curmudgeonly chronicler of the business of risk must always be on the lookout for roving packs of wild investment bankers. These vicious denizens of The Street—with their custom-tailored pinstripes and tungsten-carbide souls—will leave a man of letters floating face down in Sheepshead Bay if it means an extra basis point for them. (You can't even imagine what they'll do for two basis points.)

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