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Liberty Mutual Attempts $6-Billion Ripoff

The Return of the Mutual Holding Company

Liberty Mutual Insurance Company (along with its mutual-insurance-company affiliates, Liberty Mutual Fire Insurance Company and Employers Insurance of Wausau), is the largest mutual insurer to attempt a mutual-insurance-holding-company (MIHC) conversion. Liberty is the largest workers compensation carrier in the country, and the eighth largest property-casualty group.

Readers of this newsletter know that we've been an active opponent of abusive forms of demutualization. We've described the MIHC as a neutron-bomb conversion: it knocks out policyholders but leaves the mutual's officers and directors standing.

In its attempt to alter its corporate structure, Liberty is trying to use a method—the MIHC—that has been discredited by investors, consumer groups, insurance activists, policyholders in the know, and many in the insurance industry.

Liberty's approach to policyholders—essentially telling them to go to hell—is breathtaking. Whether Liberty can successfully pull off a $6-billion heist in broad daylight in downtown Boston remains to be seen, and is one of the big issues of the day.

Liberty has many things in its favor, not the least being the unlimited amount of policyholders' money it can spend to advance an agenda that shafts these policyholders. (Policyholders get nothing in Liberty's MIHC conversion; Liberty's management, on the other hand, will receive up to 18% of the company in the form of stock and options.)

Several obstacles still stand between Liberty and its conversion to an MIHC: approval by policyholders, approval by the insurance department, negative public opinion, and, we assume, lawsuits.

It's easy to trick policyholders into voting for an MIHC conversion that's bad for them: just give them misleading information and deceptive "disclosure." Based upon the draft of Liberty's MIHC plan that's included on the company's website, Liberty is putting this over quite successfully.

As for the insurance department, it's usually a pushover, and appears to be working closely with Liberty to squeeze the plan through.

Public opinion, however, is a wild card. Ultimately, that's what derailed the MIHC movement the first time around, and caused Prudential, John Hancock, MetLife, New York Life, Guardian, and others to cave in and embrace either full demutualization or full mutuality. Liberty is a big company in a big city, and once the press and public begin to comprehend the enormity of the company's expropriation of policyholders' money, there may be a harsh reaction to Liberty's behavior. People don't like insurance companies to begin with, and they like them even less when they're absconding with their money.

Finally, Liberty will not be able to convert to an MIHC unopposed. The Center for Insurance Research—which has stepped into the ring many times before—is actively opposing the conversion. (For more on them and Liberty, we recommend you to the Center's website, www.TheWatchDog.org.)

There are additional roadblocks facing Liberty. The Massachusetts Democratic Party has passed a resolution opposing this conversion, and legislation has been proposed that, if passed, would place a one-year moratorium on MIHC conversions.

That's not all. Last Friday, The Boston City Council held a public hearing to explore the impact on Boston policyholders of Liberty's proposed conversion. The hearing was unusual, but welcome. (The City Council doesn't regulate insurance, but understands that under a full demutualization, Liberty's policyholders will get about $4 billion to $6 billion, whereas under an MIHC they would get nothing.)

continued

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Liberty refused to testify at the City Council hearing. "While the division of insurance deliberates on our application, it would be inappropriate for us to appear in other governmental forums to discuss our filing," was Liberty's disingenuous statement, delivered by letter, to Brian Honan, chairman of the City Council's banking and community-investment committee.

Linda Ruthardt, Massachusetts' insurance commissioner, also conjured up an excuse to skip the hearing, claiming that since she would have to rule on Liberty's conversion, it wouldn't be right for her to speak before the City Council. Of course, Ruthardt could have appeared in her capacity as insurance commissioner—rather than as judge of Liberty's MIHC—and simply discussed MIHCs and the regulatory process in general. Instead, she chose not to appear at a public forum where she might be asked some tough questions and held accountable.

The day's most confused testimony came from two men from the Boston Housing Authority, which uses Liberty Mutual for its workers comp. The men—who seemed to take comfort in the fact that "workers comp is highly regulated"—said that the Housing Authority had been placing its sizable comp policy with Liberty since 1997, primarily because Liberty had been the *low bidder*. They then averred that the Housing Authority would "not be affected" if Liberty became an MIHC. What they didn't address—or perhaps didn't understand—is that under a full demutualization, the Boston Housing Authority would receive a significant sum—perhaps millions—whereas it would receive nothing under an MIHC. If low-cost insurance is the Housing Authority's goal, why wouldn't it want a full demutualization as opposed to an MIHC?

Nathaniel Orenstein of the Center for Insurance Research, Jason Adkins of Adkins & Kelston, and David Schiff of *Schiff's Insurance Observer* also testified and answered questions. (Orenstein's written statement is at www.thewatchdog.org/lmw/hearing.html.) An edited version of the fairness opinion delivered by Schiff appears below.

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I'm pleased to be able to appear before the City Council to testify and express my opinion about the impact that Liberty Mutual Insurance

Company's proposed conversion from a mutual company to a stock company will have on policyholders.

I've been intimately involved with the insurance industry and, in particular, the mutual insurance industry, including mutual-insurance-holding-company (MIHC) conversions and demutualizations. I have spoken, testified, or otherwise participated in numerous state conversion hearings, industry forums, National Association of Insurance Commissioners' meetings, and other public forums regarding the conversion of mutual insurance companies. In all instances, including this one, I have appeared *pro bono*.

In arriving at my opinion, I have reviewed, among other things, the draft of Liberty Mutual's policyholder information statement, the draft letter to policyholders from chairman Edmund F. Kelly, Liberty Mutual's annual reports, statutory financial data and summaries of information about Liberty Mutual contained in *Best's Insurance Reports*, Liberty Mutual's "Overview" "Why MHC?" and "MHC Fact Sheet," relevant sections of the applicable Massachusetts law, Liberty Mutual's website, and documents relating to Liberty Mutual on the Massachusetts Division of Insurance's website.

Liberty Mutual's proposed conversion is detrimental to the interests of virtually all policyholders for numerous reasons, including the following: 1) it doesn't protect and preserve the interests of Liberty Mutual's policyholders; 2) it isn't fair and equitable to policyholders; 3) the policyholders' vote won't be valid because it will be based upon an "information statement" [Liberty Mutual's] that contains material misrepresentations and omissions that will induce policyholders to vote in a manner contrary to that which they would vote if given proper disclosure; and 4) the format of Credit Suisse First Boston's fairness opinion is fatally flawed and will induce policyholders to vote in a manner contrary to their interests.

It's worth noting that the interest of policyholders in a stock-insurance company differs significantly from that of shareholders: policyholders seek sound insurance at a low cost while shareholders seek high investment returns. The adverse consequences of this *inherent* conflict are not adequately disclosed to policyholders in Liberty Mutual's draft information statement.

Liberty Mutual's information statement doesn't adequately disclose the risks to policyholders associated with the fact that under the corporate governance structure proposed in the plan, the directors of what is currently Liberty Mutual Insurance Company will have a fiduciary responsibility to put the interests of the *shareholders* ahead of the interests of policyholders. Right now, the directors' primary fiduciary responsibility is to policyholders.

The information statement doesn't give policyholders a comparison of an MIHC conversion with a full demutualization. Liberty Mutual Insurance Company policyholders are not informed that, under a full demutualization, they would receive an estimated $4 billion to $6 billion—an average of $6,060 to $9,090 per policyholder—whereas under an MIHC conversion they would receive nothing but a "membership interest." (In a letter to the SEC staff requesting a "no-action letter," Liberty Mutual will state—or has already stated—that a membership interest "has no independent value" and provides policyholders with "no reasonable expectation of profits.")

Liberty Mutual has worded its draft information statement in such a way that a policyholder is led to believe that he is *guaranteed* that there will be no material change in his rights, benefits, interests, values, and future prospects. This statement is inherently unknowable and misleading.

Furthermore, the information statement doesn't adequately disclose to policyholders the risk that, as a result of Liberty's conversion to an MIHC, there is a greater likelihood that, over time, premiums will be increased (and any future dividends decreased) *vis à vis* what they would have been otherwise, as a result of the company's change in focus.

The information statement doesn't adequately disclose to policyholders the risks associated with outside investors or public shareholders. It is likely that, in order to achieve the higher returns associated with shareholder-owned companies, the reorganized Liberty will take on greater risks or employ more leverage in an attempt to achieve greater profits and a higher return-on-equity *for shareholders*.

Liberty Mutual's information statement doesn't adequately disclose to policyholders the risks associated with the issuance of stock, or the acquisition of other companies for stock under the MIHC structure. If stock is issued at a price below intrinsic value—as history has shown, this is likely—then policyholders will suffer *economic* dilution. Contrary to Liberty Mutual's assertion, an MIHC is not an efficient vehicle for accessing equity markets compared to a stock company that isn't part of an MIHC structure.

Credit Suisse First Boston's fairness opinion is fatally flawed and, therefore, will deceive policyholders into voting for a reorganization that most would not vote for otherwise. If policyholders are deceived into voting for a transaction, they have not given their informed consent. Without informed consent, the required policyholder vote is tainted.

What does Credit Suisse First Boston's opinion that the transaction is "fair" mean? In a financial transaction, *fairness* is about money and value. If a full demutualization (or an MIHC and immediate full demutualization) would provide policyholders with $6,060 to $9,090, then it is extremely difficult to opine that an MIHC conversion that provides policyholders with *nothing* is "fair." Perhaps that's why Credit Suisse First Boston states that its opinion "does not address…any decision…to proceed with *any other potential transaction*…[emphasis added]." If Credit Suisse First Boston has not considered transactions other than the proposed MIHC conversion—especially a full demutualization that would provide $4 billion to $6 billion to policyholders—then it is in no position to offer *any* opinion regarding the fairness of Liberty Mutual's reorganization.

Because a mutual-insurance-holding company is so detrimental to policyholders' interests, if policyholders are asked to vote upon an MIHC conversion, it's appropriate for them to receive warnings akin to those on cigarette packages. Burying disclosures, risk factors, and warnings within lengthy documents is insufficient and deceptive.

Liberty Mutual is undoubtedly reluctant to provide the proper and appropriate disclosures because it knows that if it did, it wouldn't be able to obtain the majority vote required for approval of the conversion.

Based upon the foregoing, Liberty Mutual's proposed conversion is unfair and inequitable to policyholders individually and as a group.