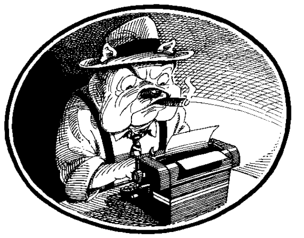

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Watch Kemper Very Closely

The Lumbermens Shuffle

During the first week of 1999, Illinois' governor, Jim Edgar, signed a bill permitting mutual insurers domiciled in the Land of Lincoln to convert to mutual insurance holding companies (MIHC). For those who may have forgotten, the MIHC is a neutron-bomb form of corporate structure: it knocks out policyholders but leaves a mutual's directors and officers standing.

The actual process by which a bill is introduced into the legislature, works its way to the governor's office, and is eventually signed into law, differs somewhat from the process that we were taught in high-school civics class. Legislators, for example, didn't think up the MIHC. (Ninety-nine percent would be hard pressed to explain it.) Instead, they were approached by insurance companies and their executives and lobbyists, and by insurance trade organizations, who proposed the idea. Legislators didn't draft the MIHC bills, the insurance industry—which makes significant contributions to politicians' coffers—did.

Because MIHC laws are complex and affect policyholders in ways that aren't easily understood, there was little in the way of well-funded opposition to MIHCs (although virtually every consumer group has gone on record opposing them). In 1997, Jason Adkins, the Boston-based attorney and renowned policyholder activist, dragged David Schiff to Springfield, Illinois for a day of lobbying against a pending Illinois MIHC bill. The two men held a press conference and wandered around the capitol building in a daze, chatting with any legislator who would listen. Although the bill didn't get anywhere that year, Adkins and Schiff were short on cash. If they'd had a spare $5 million they probably could have killed the bill permanently.

On the other hand, The Kemper Insurance Companies (the trade name for Lumbermens Mutual and its subsidiaries), have enormous resources, and were the major force behind the MIHC legislation. Eventually, their money and political clout got a law on the books.

It would be unseemly to suggest that Lumbermens Mutual gave Governor Edgar a suitcase full of cash to sign legislation that could benefit Lumbermens' CEO, David Mathis. Indeed, paying off the governor would constitute a bribe, which is illegal, even in Illinois. Furthermore, it would be unseemly even to suggest that Governor Edgar's actions *could* be influenced by the prospect of financial reward.

Shortly after signing the MIHC legislation, Edgar, then 52, finished his second (and final) term in office. Edgar had been a longtime public servant, having spent 30 years in state government, and was, presumably, on the lookout for work in the private sector. As fortune would have it, work came his way quickly. On February 26, seven weeks after he'd signed the MIHC bill, Kemper announced that the former governor had been elected to its board of directors. As a director, Edgar received at least $83,000 last year. *Schiff's*, of course, is not suggesting that Kemper is giving Edgar this pile of dough for the helpful services he performed as governor. We're merely noting a coincidence: that Edgar received the lucrative appointment to Kemper's board shortly after signing legislation that Kemper wanted badly.

Kemper's push for MIHC legislation is noteworthy because Kemper has a history of curious dealings with its publicly-held stock subsidiaries. Let's examine some of them.

On April 1, 1989, Lumbermens entered into an unusual swap with Kemper *Corporation* (a public company then 49%-owned by Lumbermens Mutual). Lumbermens transferred to Kemper Corporation 9.6 million Kemper Corporation shares valued at $30.89 per share—about $300 million. In return, Kemper Corporation transferred its national property-casualty company, American Motorists, to Lumbermens. After the transaction, Lumbermens' ownership of Kemper Corporation was reduced to 38.6%.

The deal worked out better for Kemper Corporation than for Lumbermens. Between 1989 and 1995, American Motorists reported $94 million in pretax operating losses, while Kemper Corporation's stock appreciated 62%.

The transaction was rife with conflicts of interest: Lumbermens and Kemper Corporation had identical boards of directors and similar management teams. Of course, it was pure coincidence that these directors and managers did a better job for Kemper Corporation—in which some of them owned shares or options—than they did for Lumbermens, in which *none* of them owned shares or options (because Lumbermens was, and still is, a mutual).

On August 2, 1993, Lumbermens—which at this point shared five directors with Kemper Corporation—closed on another unusual assets-for-stock swap with Kemper Corporation. Lumbermens transferred 17.4 million Kemper Corporation shares—about a 35% stake—to Kemper Corporation in exchange for Kemper Reinsurance Company and National Loss Control Service Corporation. Although the transaction was valued at $610 million, Lumbermens received $409 million of tangible assets, $396 million of which were attributable to Kemper Re.

Kemper Corporation hit a home run on this deal. By ridding itself of Kemper Re, it was able to remove an albatross—uncertainty about the adequacy of loss reserves—from its balance sheet.

David Mathis, then chairman and CEO of Kemper Corporation—but not a director of Lumbermens—was particularly optimistic about the deal. "I believe that this transaction [with Lumbermens] contributes to our goal of building value and represents a major milestone in the development and future success of Kemper Corporation," he wrote in the annual report.

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Upon completion of this swap, Lumbermens' ownership in Kemper Corporation had been reduced to 1,250,000 shares—less than a 4% stake.

When a mutual insurance company (Lumbermens, for instance), engages in asset sales and swaps with a publicly-held affiliate (Kemper Corporation, for example), history has shown that the deals tend to work out better for the publicly-held affiliate (and its directors and officers) than for the mutual. Despite any "fairness opinions" obtained by Lumbermens and Kemper Corporation, the transactions were especially profitable for Kemper Corporation (and its officers and directors who were shareholders). This profitability came at the expense of Lumbermens Mutual and its policyholders.

To recap: In 1989 and 1993, Kemper Corporation traded American Motorists and Kemper Re to Lumbermens for 27,000,000 shares of Kemper Corporation.

Let's see what happened to Kemper Corporation's stock and to the insurance companies Lumbermens received for that stock.

At the beginning of 1996, Zurich acquired Kemper Corporation for $49.80 per share, or $2 billion. (David Mathis, Kemper Corporation's chairman and CEO, then rejoined Lumbermens, and is chairman and CEO.) The Kemper Corporation shares that Lumbermens traded to Kemper were then worth approximately $1 billion. American Motorists, which Lumbermens received in return, is not as valuable. After losing $94 million (pretax) through 1995, it earned $85 million (after tax) from 1996 to 1999, and policyholders' surplus is $415 million.

As for Kemper Re, after acquiring it, Lumbermens discovered—surprise!—that it was underreserved, primarily for asbestos and environmental liabilities. In 1996 it increased its reserves by $300 million. At that time, Kemper Re was rated 'A-' by Best—a low rating for a large reinsurer. In order to fund the additional reserves, boost Kemper Re's surplus, and get an upgrade, Lumbermens contributed $400 million of capital to Kemper Re.

In 1998, General Electric purchased Kemper Re for $500 million—only $100 million more than what Lumbermens had contributed to the company two years earlier.

The bottom line: Lumbermens didn't get the $1 billion it would have received from the sale of Kemper Corporation in 1996 (absent the previously mentioned transactions). Instead, it netted $100 million for Kemper Re and still owns American Motorists and National Loss Control Services, which are worth, perhaps, $500 million. Thus, Lumbermens missed out on at least $400 million because of its deals with Kemper Corporation.

Since Lumbermens has had such an unlucky history with its publicly-traded affiliates, its organizational plans should be of concern to its policyholders—especially its 238 national-account policyholders. If Lumbermens sets up another publicly-traded subsidiary or attempts to convert to a MIHC, we'd be willing to bet that policyholders will get burned once again.

Lumbermens should remain a mutual or do a full demutualization in which policyholders receive 100% of the company. Since policyholders have several billion dollars at stake, some of them may wish to call the former governor, Jim Edgar, and ask him what's going on. Although Edgar didn't return our call, he may talk to a national-account policyholder. That's the least he can do for his $83,000 in annual fees.