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SCHIFF'S

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Provident Mutual Changes its Mind

$17,989,477 Going Away Present

"Never play a guy at his own game," said corner man Charley Goldman, who trained Rocky Marciano. "Nobody makes up a game to get beat at it."

Goldman's maxim is applicable to the insurance game as well as the sweet science. In boxing, a knockout brings a bout to a conclusion; in insurance—particularly the regulation of insurance—the rules are ever-changing and the referees often work for the insurance companies or for the politicians who get money from the insurance companies.

Last August, Provident Mutual Life Insurance Company, the oldest insurance company in America (its roots go back to the Presbyterian Minister's Relief Fund, founded in 1717), agreed to be acquired by Nationwide Financial Services for $1.5 billion in a "sponsored demutualization" in which Provident will convert to a stock company and immediately merge into a Nationwide subsidiary. (A sponsored demutualization is how a stock company acquires a mutual.) Provident's policyholders will be paid primarily in Nationwide stock. Some will receive cash or policy credits.

When a mutual insurance company demutualizes, state insurance departments generally review the transaction and hold a public hearing. The purpose of the hearing, presumably, is to have an open proceeding in which policyholders and the public can participate and, perhaps, influence the outcome of the proposed transaction.

Mutual insurance companies are owned by their policyholders, who are legally disenfranchised and have no say in the management of their company. About the best they can hope for is that their interests are represented fairly by the board of directors, or, if necessary, by state regulators.

The public hearing is the one forum in which mutual policyholders have some chance to affect what happens to their company—at least in theory. In practice, mutual policyholders have virtually no chance at a public hearing; the outcome is as fixed as professional wrestling. We've attended and participated in numerous public hearings regarding mutual conversions. Most of these hearings were similar: insurance-company executives and their investment bankers and actuaries sat before microphones, read statements, and put on scripted performances. On occasion, someone from the insurance department asked a question.

Provident's public hearing on its plan to be acquired by Nationwide was held on May 23 at the Valley Forge Hotel in King of Prussia, Pennsylvania. At the start of the hearing, the rules were described by deputy commissioners Randy Rohrbaugh and Stephen Johnson, and by the insurance department's chief counsel, David Simon. Here's a condensed version of what they said: "The primary purpose of the hearing today is to give all interested persons the opportunity to provide information and comments to the department and to ask questions regarding this proposed transaction. In order to provide a user-friendly setting for the public participants, a formal process is not being utilized. Any member of the public may speak with a minimum of formality or ceremony. In other words, *we want you to feel very free to express your opinions and to ask questions* regarding the proposed transaction."

continued

They obviously didn't want the public to feel too free about asking questions, because there was a caveat: "*Cross-examination of the presenters and commentators will not be permitted.*" The insurance department didn't say where questioning ends and cross-examining begins.

The same rules were in effect on April 6, 1998, at Provident's public hearing regarding its proposed mutual-holding-company conversion. David Schiff attended that hearing and, when it was his turn to speak, questioned—or attempted to question, probe, grill, or interrogate—Provident's executives and representatives. (See *Schiff's Insurance Observer*, May 1998.) The questions weren't difficult, but Provident's executives and bankers refused to respond to most of them. (Honest answers would have been incriminating.) There was no need for Provident's representatives to invoke the Fifth Amendment; deputy commissioner Gregory Martino and deputy chief counsel Stephen Martin didn't want Schiff to ask questions either, and interrupted him incessantly, objecting to his words on the grounds that they were "beyond the scope" of the hearing and constituted "cross-examination."

Joseph Belth, editor of *The Insurance Forum*, also attended the hearing. He made a brief prepared statement and then read a list of 10 questions. A month before the hearing he had made extensive Freedom of Information Law requests with the insurance department. For reasons that remain unclear, the department did not send the requested materials to Belth in time for the hearing. (They arrived at Belth's office on the day that he was attending the hearing.) Among the more than 500 pages of documents Belth received was an internal Provident memo that may have explained the deputy commissioners' behavior.

The memo, written on February 25 (forty days prior to Provident's hearing), was entitled "Consumer Advocate Activity at Principal Mutual's Public Hearing." It was addressed to Provident's general counsel, James Potter, and it was from Provident's vice president, Bill Hunt, who had gone to Des Moines in January 1998 to observe Principal Mutual's public hearing regarding its proposed mutual-holding-company conversion. Hunt's memo summarized questions and statements made at the hearing by Jason Adkins (of Adkins & Kelston) and Schiff, who had opposed Principal's plan and cross-examined its witnesses. The memo closed by saying, "A tactic utilized by both Jason Adkins and David Schiff was to ask the same question in many different ways. It was incumbent upon the Iowa Commissioner to approve or disallow each question in order to minimize the redundancy and not waste time listening to responses which were already on record."

That Provident spent its policyholders' money to scrutinize Adkins's and Schiff's activities is somewhat interesting, but that's not what made the memo noteworthy. On the same day that Potter (Provident's general counsel) received the memo, he faxed it to Lynne Fitzwater, the Pennsylvania Insurance Department's chief counsel. Potter later told us that Fitzwater had requested the memo. Fitzwater told us that she couldn't remember why Potter sent her the memo, or if she discussed it with him. We don't know how many people at the Pennsylvania Insurance Department read the memo, or who Fitzwater discussed it with. We do know that Provident Mutual had unusually close ties to the department. Seven months earlier, Diane Koken had become Pennsylvania's insurance commissioner. For the 22 years prior to that she had worked at Provident, where she was the company's general counsel. The company's mutual-holding-company plan was one of the projects she worked on.

Koken's conflicts of interest were so significant that she recused herself from presiding over Provident's hearing, and from ruling on its plan. But the deputy commissioners and general counsel who took over the task undoubtedly believed that Koken was in favor of Provident's proposed conversion, and they ran the 1998 hearing in a manner that probably met with her approval: they stifled any attempted questioning of Provident's witnesses.

At last month's hearing regarding Provident's sponsored demutualization, Commissioner Koken, once again, did not participate. She delegated her regulatory authority "in order to avoid all appearances of impropriety and bias," said deputy commissioner Rohrbaugh. Avoiding the appearance of impropriety doesn't automatically convey legitimacy on a public hearing or a regulatory finding. Allowing the public to fully participate at a hearing might go a ways towards making proceedings *appear* legit. But that's not how things work in Pennsylvania. Indeed, David Simon, the department's chief counsel, repeated that the public was not supposed to engage in cross-examination. "I want to make that absolutely clear," he said. Members of the public were also asked to limit their questions and comments to five minutes.

Public hearings regarding mutual conversions are generally notable for what *isn't* said. The first witness at the May 23 hearing was Provident's CEO, Robert Kloss. "On June 1, 1995, [Provident's] board formed the Strategic Advisory Committee, of which I was a member, to examine the company's strategic options," he said. "That committee investigated the company's options and, in the end, recommended that Provident reorganize in a mutual-holding-company structure. The board approved a plan to create a mutual holding company in 1998, *but that transaction was not completed due to time constraints and other factors.*"

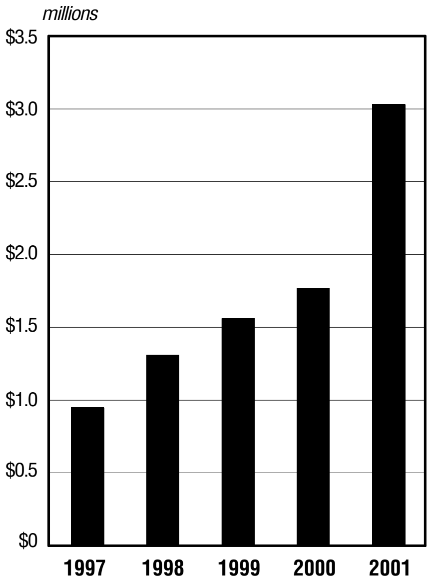
Depending upon one's perspective, Kloss's statement is a half-truth or a halflie. “Time constraints” didn’t prevent the completion of Provident’s mutual holding company, but “other factors” did. Those other factors included attorney Kenneth A. Jacobsen, who represented Provident policyholders in an action against the company. On February 11, 1999, Judge Stephen E. Levin of the Court of Common Pleas in Philadelphia County granted an injunction enjoining Provident from effectuating its mutual-holding-company conversion. Judge Levin found that Provident’s Policyholder Information Statement—which policyholders relied on when voting for or against the conversion—had omitted material information, didn’t fairly address whether the proposed conversion was in the best interests of the policyholders, and was materially misleading. Seven months later, Judge Levin concluded that Provident’s officers had “breached their duty of disclosure” to policyholders, and permanently enjoined Provident from effectuating its mutual-holding-company conversion.

Judge Levin’s decision was a resounding blow to a movement that had spread rapidly through mutual-insurance-company executives suites in the late 1990s. The debate and battle over the propriety of mutual holding companies had suddenly become the largest, most controversial issue in the insurance business. More than $100 billion of mutual policyholders’ value was at stake, and most of the major mutuals favored passage of laws that would allow mutuals to demutualize in a manner that would deprive policyholders of their equity but permit mutual executives to rake in windfalls from stock options. In attempts to get favorable legislation passed, the mutuals and their trade organizations spent tens of millions on manpower, lawyers, investment bankers, and lobbyists.

The mutuals were opposed by a small number of people, the three most vociferous of whom were Jason Adkins, Joseph Belth, and David Schiff. They were in favor of mutual insurance *and* full demutualizations in which policyholders receive what is theirs. They believed that when mutual insurers sold policies by telling people that they would be “owners” of the company, that those words meant something. They were outraged by mutual holding companies and other abuses by mutuals, and were determined to stop them.

It’s good to be the CEO.

Annual compensation for Provident’s CEO, Robert Kloss.



Source: The Insurance Forum

That the words and actions of mutual-holding-company opponents would ultimately play an important role in defeating the mutual-holding-company conspirators can only be described as remarkable, and is a testament to the power that individuals, striving for a common goal, sometimes have. In the end, the mutual-holding-company concept came to be seen as a scheme that cheated policyholders, didn’t work for shareholders, entrenched managements, and then enriched managements. Even Wall Street, where money is prized above principle, didn’t really like mutual holding companies after awhile.

In his May 23, 2002 testimony, Kloss stated that two years earlier Provident’s board had “launched” a “comprehensive review project” to examine industry trends and explore ways for Provident “to move ahead and remain strong.” He said that Provident considered acquisitions and an IPO, but concluded that these were not as advantageous as a sponsored demutualization.

It is fascinating that Kloss, who presided over Provident’s deceptive and misleading mutual-holding-company attempt, now favors a sponsored demutualization—the method that achieves greater value for policyholders than any other form of demutualization. CEOs rarely want to give up control of the companies they head. This is especially true of mutual CEOs, who can’t own stock options in their companies (since there is no stock), and who therefore can’t make a profit from the sale of their company. When Provident’s deal with Nationwide was announced last year, we wondered how it came about that Kloss’s opinion, and that of Provident’s board, could turn 180 degrees. Why would people who had so vigorously pursued an unfair mutual holding company embrace an outright sale to a much larger company?

As the hearing progressed, an answer emerged.

When Kloss finished his statement, Frank Medici, of Morgan Stanley (which will receive $9 million in fees), stated that the sponsored demutualization, in which policyholders will receive about $1.5 billion, was “fair.” (At Provident’s hearing four years earlier, Morgan Stanley stated that the mutual-holding-company conversion—in which policyholders would have received nothing—was also “fair.”)

Next up was Daniel McCarthy of Milliman USA, an actuarial firm that never meets a conversion it doesn’t find fair. (Four years earlier Provident had used Coopers & Lybrand for the actuarial fairness opinion.)

Up to that moment, nothing unusual had transpired. The next witness was Richard Furniss, a principal in the New York office of Towers Perrin, management consultants and actuaries. His company had advised Provident’s board “regarding the competitiveness of certain change-in-control arrangements in place with various senior officers of Provident Mutual.” Naturally, he said that these arrangements were “reasonable.” Among the forms of compensation that Kloss and several other senior executives are slated to receive are the following: 1) severance payments, 2) performance bonuses, 3) immediate vesting on a supplemental employee retirement plan, 4) immediate vesting under an excess defined-benefit plan, 5) two years of health insurance, split-dollar life insurance, and 401(k) matches, 6) six months of executive outplacement services, 7) payments under non-compete agreements, 8) consulting agreements, 9) unused vacation time and, 10) for Kloss, a gross-up payment for taxes. *continued*

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The total amount that Kloss is supposed to receive from these "reasonable" arrangements is $17,989,477. Several other officers are to receive between $1 million and $5 million.

Certainly, Mr. Kloss cannot be blamed for the size of the payments that he'll receive upon leaving Provident. (Nationwide does not intend to keep him on.) The compensation arrangements were approved by Provident's compensation committee, which, Kloss noted, is "an independent committee of the board. There are no inside directors on the committee."

Provident's directors, none of whom will be kept on by Nationwide, are scheduled to receive accelerated lump-sum payments ranging from $162,000 to $270,000. Towers Perrin stated that this was "appropriate."

One policyholder, Richard Yost, who made an eloquent statement at the Provident hearing four years earlier, spoke at the recent hearing, too. "I was wondering why there was such a long time between the merger announcement last August and this public hearing," he said. "After listening to all the compensation presentations, now I guess I know; it took that long to calculate and justify the compensation to Mr. Kloss, Provident's executives, and directors."

Yost then made a statement and asked questions that Provident's directors and officers will never answer to his satisfaction. "I approve of this form [of conversion]," he said, referring to the sponsored demutualization. "It will enable Provident's members to get about $1.5 billion in assets in exchange for their membership interests. If Provident had selected this form of conversion four years ago I would not have even attended a public hearing. I would have been pleased they were doing the right thing for their members, at least in terms of the type of conversion. However, they did not do the right thing then. And I want to say to them, why didn't you do something like this four years ago? Provident would be four years advanced in addressing the need to convert to a stock-company structure. You would have saved the company millions of dollars in conversion-related expenses and your members would already have received compensation that would likely have a current value well in excess of $1.5 billion. Why did you not do this then? You cost your members and the company a great amount of time and money. So now why should your members trust what you say and do?"

Provident's plan of conversion has not been approved by the Pennsylvania Insurance Department—yet. The hearing record will remain open for public comment until July 19, 2002. A decision is expected sometime after that. Policyholders, or anyone else, may want to write to the Pennsylvania Insurance Department and object to Provident's executive-compensation arrangements. Written comments, which should include your name, address, and telephone number, should be submitted to Robert E. Brackbill, Jr., Company Licensing Division, Pennsylvania Insurance Department, 1345 Strawberry Square, Harrisburg, PA 17120. E-mail: RBrackbill@state.pa.us, Fax: (717) 787-8557.

A transcript of the hearing is available at www.ProvidentMutual.com.