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SCHIFF'S

INSURANCE OBSERVER

July 11, 2005
Volume 17 • Number 10

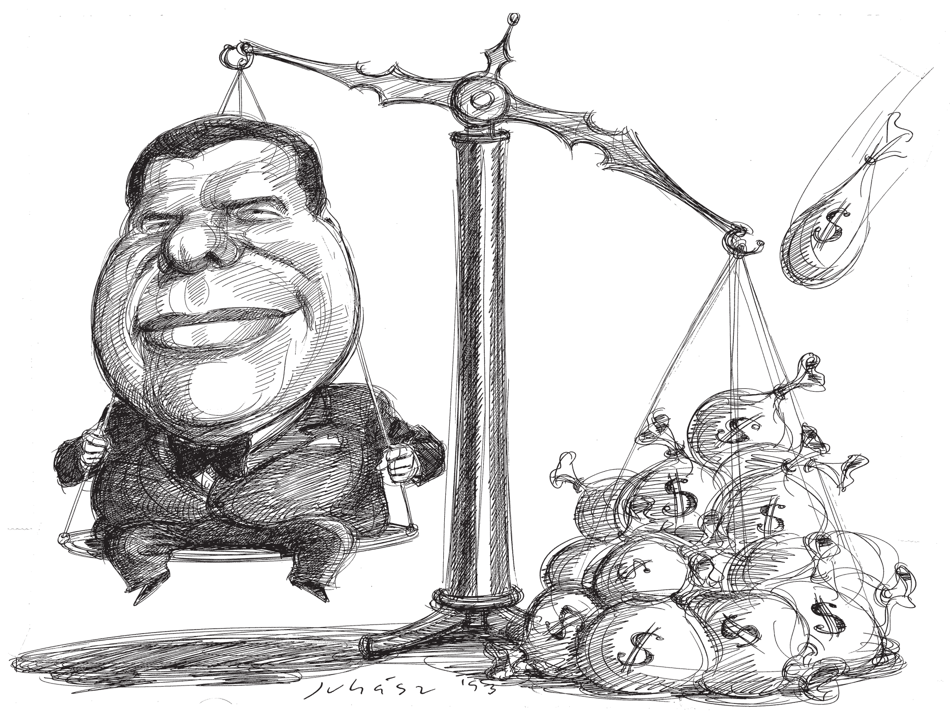
Reliance, Arthur Levitt, 1969 Senate Hearings

Bonfire of the Conglomerateurs

The Boeing 727-100 is a fine plane. It measures 133 feet long with a 108-foot wingspan, sports a distinctive "T tail," and is powered by three rear-mounted Pratt & Whitney engines. It cruises at 570 miles per hour, has a range of 3,110 miles, and can seat 131 passengers. The Boeing 727 owned by Reliance Insurance Company differed from the standard 727 that transported billions of passengers around the world: it was equipped with five bedrooms and other lavish amenities.

Saul Steinberg, Reliance's former chairman and CEO, was notorious for his high-living ways, but it wasn't until Reliance achieved insolvency and became a ward of the state that Steinberg's extravagant travel habits irked Diane Koken, Pennsylvania's insurance commissioner. In 2002, in her capacity as liquidator of Reliance Insurance Company, she sued Steinberg and many of Reliance's directors and officers, alleging that they breached their fiduciary duty and acted in a reckless and negligent manner that cost Reliance about $500 million or so.

The lawsuit exposed Koken as a killjoy. She complained, for example, that between 1997 and 1999 more than half the use of Reliance's 727 was for personal trips taken by Steinberg and his brother Robert. (They flew, among other places, to China, Spain and Greece, and to golf outings in Florida, Puerto Rico, Hawaii and Mexico.) She also carped about Steinberg's use of Reliance's Sikorsky S76-B helicopter for trips from Manhattan to his country house eighty-five miles away in Quogue.



Reliance Insurance Company honcho Saul Steinberg in 1993

Koken's primary objections to Steinberg's air travel were that he did not properly reimburse or compensate Reliance for his personal use of the plane and helicopter, and that he did not, in public reports, properly disclose the value of his personal use.

Obviously, Reliance didn't *need* a Boeing 727 and Sikorsky helicopter, but Steinberg's use—or abuse—of them is not what caused the company's failure. Koken's lawsuit also raised the issues of bogus tax payments, dividends, loans, improper accounting and reserving, improper disclosure, and other means that Steinberg allegedly used to siphon money from Reliance Insurance Company to its parent company, Reliance Group Holdings.

We won't ask why the Pennsylvania Department didn't notice these alleged misdeeds *before* Reliance went bust. Steinberg, after all, was well known as an overcompensated, high-rolling speculator, and it was no secret that he had been milking Reliance Insurance Company for decades. From 1986 to 1999, for example, under the watchful eye of the Pennsylvania Insurance Department, Reliance Insurance paid $2 billion in dividends to its parent company. The money was used to service Reliance Group's debt and to pay dividends to its shareholders (Steinberg owned most of the shares).

The Pennsylvania Insurance Department had decades to intervene and preserve Reliance's solvency, but did not do so. Reliance, which is now about $3 billion in the hole, is in the long process of being liquidated. As for the merits of Koken's case against Steinberg, they will remain subject to debate. Earlier this year the insurance department settled with Steinberg. Reliance's D&O carriers agreed to pay $85 million and Steinberg did not admit any wronging. But he did agree that for the next fifteen years he will not serve as an officer or director of any insurance company doing business in Pennsylvania, nor will he hold a controlling interest in any such company.

In May 1968, Leasco Data Processing Equipment Corp., Saul Steinberg's six-year-old *leasing* company, which had $75 million of assets, announced that it wanted to take over Reliance Insurance Company. A 150-year-old bastion of the Philadelphia establishment, Reliance had $750 million in assets and $250 million of surplus. Its management didn't want to be acquired—especially not by a brash twenty-nine-year-old multimillionaire.

Leasco was a small company compared with Reliance, but its hot stock was selling for about eighty times earnings. (Leasco's so-called "earnings"—which came to about $1.4 million—were not of high quality, and several years later would turn to losses.)

The Reliance Insurance Company, on the other hand, was the antithesis of a glamour stock. Among its failings was the fact that it was extremely conservative and ultra-solvent. As a result, it was out of favor and its shares were cheap, especially in comparison with "go-go" stocks like Leasco. Like many other good-sized "fire and casualty" insurance companies, Reliance was something of a sitting duck. At year end 1966, for example, its stock was $32—eight-and-one-half times earnings and 62% of book value. Its $150-million market cap was far below its $235-million book value.

By traditional measurements, Reliance was substantial and Leasco was not. But since traditional measurements were of little interest to many investors in 1968, Leasco was able to take over Reliance for $4.4 million in cash and a package of convertible preferred stock and warrants (derisively referred to as "Chinese paper").

Leasco's acquisition of Reliance would not have happened during a more rational moment in financial history. In the mid-1960s, data-processing companies, conglomerates, and companies whose names ended in "onics" (i.e., electronics) were bid up to absurd levels; like dotcom stocks in the 1990s, they were the "new new thing." Fire and casualty stocks were out of favor because investors didn't think they were earning respectable returns on capital; at the same time, fire and casualty companies had much more capital than they needed to operate their businesses.

In August 1967, Ed Netter, a 34-year-old insurance analyst with Carter, Berlind & Weill, published a research report, "The Financial Services Holding Company," which calculated Reliance's "capital redundancy" (or "*surplus* surplus") to be $80 million. That meant that if one could buy *all* of Reliance for $32 per share ($150 million), withdraw the redundant capital ($80 million), for a net investment of $70 million one would own an old-line insurance company with $155 million in surplus.

Leasco, of course, didn't have $150 million, but it did have a wildly overvalued stock and was able to exchange its overvalued securities for undervalued Reliance shares. Leasco's acquisition of Reliance can be viewed as an early intersection of insurance, conglomerates, and hostile takeovers, and was a milestone in insurance history and finance. Reliance Insurance Company became the cornerstone of Steinberg's fortune, although his mismanagement of the company would eventually result in the largest insurance failure of all time.

If there was such a thing as the golden age of conglomerates, it was the 1960s. Some that were then shaking up the scene include City Investing, Gulf + Western, ITT, Litton, LTV, National General, Northwest Industries, Norton Simon, Rapid American, Teledyne, and Textron. (Only Textron still exists as a public company today.)

Royal Little is generally considered the father of the conglomerate concept. At fifty-two, after spending his career in the cyclical, low-margin textile industry, he embarked on what he would later call the "concept of unrelated diversification," transforming American Woolen, his struggling textile company, into the successful conglomerate Textron. In his entertaining autobiography, *How to Lose $100,000,000 and Other Valuable Advice,* Little stated that the goals of this strategy were to "eliminate the effect of the business cycles on the parent company by having many divisions in unrelated fields," "eliminate Justice Department monopoly problems by avoiding acquisitions in related businesses," and "eliminate a single industry's temptation to overexpand at the wrong time." Little wanted to acquire reasonably sized companies with broad product lines and long-range potential. He wanted to buy companies in which the managers were "young, competent, [and] hungry."

Over the years, Textron bought diverse businesses including Bell Helicopter, Franklin Life, E-Z Go (golf carts), General Cement, Schaefer (pens), and Speidel (watch bands). Although Little was a wise man and a great businessman, a good number of other conglomerateurs were hucksters, promoters or speculators who merely glommed onto the lingo of the times. In *A Random Walk Down Wall Street,* Burton Malkiel describes the jargon that conglomerateurs used to bedazzle Wall Street in the 1960s:

> They talked about market matrices, core technology fulcrums, modular building blocks, and the nucleus theory of growth. No one from Wall Street really knew what the words meant, but they all got the nice, warm feeling of being in the technological mainstream.
>
> Conglomerate managers also found a new way of describing the businesses they had bought. Their shipbuilding businesses became "marine systems." Zinc mining became the "space minerals division." Steel fabrication plants became the "materials technology division." A lighting fixture or lock company became part of the "protective services division." And if one of the "ungentlemanly" security analysts … had the nerve to ask how you can get 15 to 20 percent growth from a foundry or meat packer, the typical conglomerate manager suggested that his efficiency experts had isolated millions of dollars of excess costs; that his marketing research staff had found several fresh, uninhabited markets; and that the target of tripling profit margins could be easily realized within two years.

The stocks of conglomerates were often bid up to silly levels on the dubious premise that diversified companies are recession-proof and that "1+1=3" synergies can be achieved over and over again from acquisitions. Armed with richly valued stocks, some conglomerates pursued takeovers aggressively, troubling many people.

The 1960s conglomerateurs did not invent hostile takeovers. The first modern "corporate raider" was Robert R. Young, who waged an unsuccessful proxy fight for control of Chesapeake & Ohio Railway in 1938. (In 1954, after one of the great proxy battles of all time, he gained control of New York Central.) Other corporate raiders from the 1940s and 1950s include Lou Wolfson (who fought a proxy contest for Montgomery Ward), Charles Green, Art Landa, Leopold Silverstein, and Thomas Mellon Evans (the central character in Diana Henriques' invaluable book, *The White Sharks of Wall Street: Thomas Mellon Evans and the Original Corporate Raiders*.)

During the late 1960s, many old-line insurance companies were taken over by companies outside the insurance industry: National General acquired Great American, City Investing acquired The Home, American Express acquired Fireman's Fund, and Leasco acquired Reliance. Leasco's acquisition was noteworthy: despite its lack of substance it was able to take over a much larger company. Shortly after Leasco bagged Reliance, it really shook up the establishment by making a brief run for Chemical Bank, then one of the country's largest banks.

Takeovers provoked shock, outrage and articles, and many people were disturbed by the fact that established companies could suddenly be taken over by upstarts. How was such a thing possible? Was it good for society? In February 1969, the U.S. Senate Judiciary Committee's Subcommittee on Antitrust and Monopoly commenced hearings on the insurance industry. Topics covered included state regulation solvency, nonrenewal, and conglomerates.

To be continued tomorrow.

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Editor and Writer . . . . David Schiff
Production Editor . . . . Bill Lauck
Foreign Correspondent . . Isaac Schwartz
Editorial Associate . . . Yonathan Dessalegn
Copy Editor . . . . John Cauman
Publisher . . . . Alan Zimmerman
Subscription Manager . . . . . . Pat LaBua

Editorial Office
Schiff's Insurance Observer
300 Central Park West, Suite 4H
New York, NY 10024
Phone: (212) 724-2000
Fax: (434) 244-4615
E-mail: David@InsuranceObserver.com
Website: InsuranceObserver.com

Publishing Headquarters
Schiff's Insurance Observer
SNL c/o Insurance Communications Co.
One SNL Plaza, P.O. Box 2056
Charlottesville, VA 22902
Phone: (434) 977-5877
Fax: (434) 984-8020
E-mail: Subscriptions@InsuranceObserver.com

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