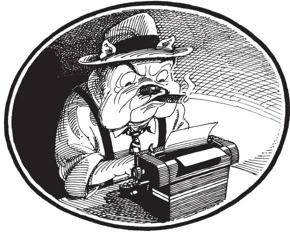

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Reliance, Arthur Levitt, 1969 Senate Hearings

The Prey Testifies, Part 3

This is the final installment of our article about the 1969 hearings on the insurance industry held by the Senate Judiciary Committee's Subcommittee on Antitrust and Monopoly. Topics covered at the hearing included state regulation, solvency, non-renewal, and conglomerates. On the following pages we present Addison Roberts' prepared statement and questions asked of him by Senator Philip A. Hart and counsel Jerry Cohen.

Roberts joined Reliance Insurance Company in 1938 and became president in 1964. When Leasco, run by twenty-nine year old Saul Steinberg, set out to take over Reliance in 1968, Roberts was strenuously opposed to any transaction. Reliance was an old-line company whose board was populated by many of the most prominent businessmen in Philadelphia. Almost everything about Leasco's attempt to take over Reliance would strike the establishment as, well, unsavory. Leasco was a small upstart, run by a wheeler-dealer from Brooklyn. Its stock was wildly overvalued.

Although Roberts criticized Leasco's offer and brought a lawsuit accusing Leasco and Cogan, Berlind, Weill, & Levitt of conspiring to manipulate Reliance's stock, he soon capitulated and endorsed the takeover. Unbeknownst to Reliance's shareholders, he had been promised a big raise, a five-year contract, and a pile of options (from which he would make a large profit). In 1972, following a lawsuit, Judge Jack Weinstein found that Roberts had "abandon[ed] his duty to shareholders in return for personal benefits." Roberts, who was old enough to be Steinberg's father, remained president of Reliance until 1974. By that point, Reliance was plagued with problems, and Roberts was replaced. He remained a member of the board until 1977. He died in 1992.

"One stodgy old-line insurance company—to go"

Mr. Addison Roberts: [*prepared statement*] My name is A. Addison Roberts, and I am president of the Reliance Insurance Companies. I appear before you today at the invitation of your chairman to comment on the effect the conglomerate and non-insurance acquisitions in the property and casualty field will have on the industry's ability to underwrite the automobile insurance needs of the American public.

In my opinion, the long-run effect of non-insurance companies acquiring property and casualty insurance companies will tend to constrict the market for automobile insurance—unless profit performance within our industry improves. During the past decade, the property and casualty insurance companies' profit performance has been considerably less than that of all industry.

In many states, rate levels are not adequate. Price adjustments have not kept pace with the inflation in our claim costs and increased accident frequency. Unfortunately, many regulatory officials have not allowed rate adjustments to reflect these increased costs.

Under our economic system, capital flows from less productive industries to industries where the financial returns are more rewarding. Thus, it seems logical to conclude that if the profits from automobile insurance are substandard compared with other industries, the removal of capital will follow—which, in turn, will ulti-

mately cause a market constriction with respect to the insuring public.

Inquiry has been made as to the advantages and disadvantages of the acquisition of an insurance company by a non-insurance company. The apparent advantages to the insurance company are:

(1) *Diversification*: Usually non-insurance corporations are free to engage in numerous lines of business that insurers are prohibited from entering.

(2) *Flexibility*: Insurance companies traditionally have been restrained or discouraged from use of preferred stocks, debentures, or similar types of non-equity financing.

(3) *More intensive management of assets*: Many investment analysts feel there is considerable room for improving the rate of return on investment portfolios.

(4) *Opportunity to assist in management, marketing, and related services*: For example, Leasco Data Processing Equipment Corp., which acquired ninety-seven percent of Reliance Insurance Co.'s stock, has an immense capability in the management sciences field and particularly in the information system area. Reliance's voluminous paperwork may be reduced, automated, and managed more effectively through Leasco's assistance.

The disadvantages, if any, are not readily apparent. Because the insurance business is affected with a special public interest, its combination with non-insurance activities may raise a question of public policy. In a regulated industry such as insurance a major concern has been for the policyholder, while the non-insurance companies major concern logically is directed toward the stockholder.

Inquiry has been made as to the method by which acquisitions are made in the property and casualty insurance field and the reasons for such acquisitions. For many years most acquisitions have been made for common stock or cash. However, in most of the recent takeover bids there has been a tendency to use subordinated debentures or preferred stock. Warrants have also been used as part of the purchase price. The advantage in using debentures is that the interest paid is tax-deductible. There are several reasons for the acquisition of property and casualty companies by outside interests:

(1) Historically, property and casualty insurance stocks have sold at substantial discounts from liquidating value, thus, a non-insurance company could acquire substantial assets at a bargain price.

(2) Quite a few companies have what is called "surplus surplus"— large accumulations of assets in excess of those needed for policyholders' protection. These surplus funds may be channeled into more productive enterprises.

(3) Many property and casualty companies have substantial unrealized capital gains in their portfolios. By using pooling-of-interest accounting, a non-insurance company may sell such securities at any given time and include the difference between their cost and sale price in earnings. This is a significant advantage. Traditionally, such realized capital gains were not included in the earnings of insurance companies but were a surplus adjustment.

Roberts didn't call this pooling-of-interest accounting "hocus pocus," but that's what it was. Reliance Insurance Company, for example, had large unrealized gains in its stock portfolio. Had it sold those stocks, the "profit" would not have been included in its earnings (it was a balance-sheet adjustment). Leasco, once it owned Reliance, could sell the stocks and include the gains in earnings (even though, it "paid" full value for the stocks when it acquired Reliance). The boost to Leasco's "earnings" from the sale of stock—though nothing but artifice—may have confused some into believing that the company's earnings power was greater than it really was. (For more on this subject see Schiff's*, June 1993, pp. 3 and 4.)*

Mr. Roberts: ...(4) Property and casualty companies enjoy a substantial cash flow.

(5) These companies have an image of being sluggishly managed—which leads outsiders to believe that there exists considerable opportunity for improved performance.

In the past several years there has been a growing trend in the property and casualty insurance industry for companies to form a holding-company structure. They have been motivated by diversification opportunities, flexibility, and the desire to improve their own profit performance so as to become more competitive with all industry.

Today's restricted underwriting policies are brought on by over-regulation, an outmoded method of compensating victims of highway accidents, and possibly by an overly large number of insurance carriers in comparison to the needs of the public.

Senator Hart: Thank you. You indicate that one of the reasons for acquisition of the casualty and property companies by non-insurers is that insurance companies have the image of being sluggishly managed.

Mr. Roberts: I would not differ with you there, Senator.

Senator Hart: Do you really think that Leasco, for example, was concerned about improving the management efficiency of Reliance? That is what Mr. Levitt suggested.

Mr. Roberts: Well, I think you should ask Leasco what its motives were in that respect, but my impression—

Senator Hart: That is what he suggests as a primary motive.

Mr. Roberts: I did not say the insurance companies have bad management. I just say that the public image of insurance is of a sluggish industry. Over the years I have dealt with a great many financial analysts, and many characterize property and casualty companies—particularly the old line agency companies—as being less aggressively managed than they should be.

Senator Hart: If you eliminate that, what are the reasons that bring the non-insurer in?

Mr. Roberts: The primary thing a conglomerate would find interesting would be the [ability to run] the large amount of unrealized capital gains through the earning account. Let us suppose the company has $100 million in unrealized capital appreciation in its earnings account. If you put a ten times price-earnings multiple on that you can say that is worth a billion dollars in the stock market. Traditionally, the insurance analysts did not include anything in earnings except underwriting results plus investment income. That was the yardstick. They did not consider realized capital gains as earnings.

In Reliance's case, we have a surplus of over $250 million brought about in large measure by quite a few mergers, and this represents the accumulation over a long period. But during that period, our rate of return was not good. During most of those years Reliance's common stock was selling at a sharp discount, which made some people so unkind as to say that property and casualty companies were worth more dead than alive.

Senator Hart: It was my impression that Reliance was in the process of forming a

holding company before the Leasco acquisition.

Mr. Roberts: That is correct.

Senator Hart: What motives would persuade the public or an insurance company to form a holding company to engage in the other businesses?

Mr. Roberts: Our motive was to put the "surplus surplus" in the holding company in order to try to put that capital to work in more productive industries.

Senator Hart: Let us make the question academic, unrelated to your plan. How do you jibe that with your state legislation that, in most cases, would prohibit an insurance company from undertaking non-insurance business in order that a policyholder be protected?

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Mr. Roberts: I think that there are certain companies that have sufficient capital—"surplus surplus"—that can be taken out of the industry and put to more productive use without restricting the current business of the insurance company or affecting its solvency.

Senator Hart: Who would decide that? Who makes the judgment and what review, if any, is there of it?

Mr. Roberts: I think you have to take into consideration the quality and type of investment performance, the underwriting results. You have to look at many factors. There are no simple yardsticks to measure this. This is something that the insurance commissioners of the various states are going to have to direct their attention to in a more significant way than they have in the past.

Senator Hart: The financial press has been suggesting that conglomerates are overvalued. If a conglomerate acquired an insurance company and, in order to borrow, pledges the assets, would not the policyholders in the acquired insurance company be jeopardized?

Mr. Roberts: I would be surprised if the conglomerate used the reserve and surplus in that method. It would seem to me they would take the funds out of the insurance enterprise, which is a separate corporate entity, either by dividends or by some type of spin-off.

Senator Hart: The same financial writers suggest that certain non-insurance companies are overpriced, based on earnings per share. Your statement comments on the fact that warrants and debentures have recently been used in takeovers. Assuming the accuracy of the statement (that the non-insurer was overpriced), does not the insurance-company stockholder give more than he gets?

Mr. Roberts: I suppose there are many ways of looking at that. The marketplace puts numbers on particular pieces of paper and they are traded, and what to one person is overpriced is to another person a ballgame.

I happened to be on the south side of the takeover and, naturally, I thought at the time our paper was much more solidly based than the companies that were seeking to acquire our stock, but the marketplace did not reach that same conclusion, and I am not sure that I have any reason to quarrel with it. It is the free play of the marketplace, and sometimes the marketplace—as you know—is not completely right.

Anyone could have sold his Reliance stock and taken hard cash. So you could not say they were getting paper that was overpriced. They did not have to take that paper, and since it was not a tax-free deal, the alternative was very simple.

Roberts' point is that Reliance's shareholders could have sold their stock in the open market rather than tendering it to Leasco.

Leasco's original proposal was tax-free for Reliance shareholders. After Roberts negotiated with Leasco (and got a sweet deal for himself), the so-called better deal that Leasco offered—although nominally higher in value—was no longer a tax-free exchange.

Senator Hart: You described the value to you of the Leasco counsel and assistance resulting from its enormous pool of talent and resources in the computer field.

Mr. Roberts: Management science—software.

Senator Hart: What about reciprocal agreements between Leasco and Reliance?

Mr. Roberts: Any contract that we might enter into would have to be an arm's-length dealing for a very simple reason: we have separate entity that has 2,200 minority stockholders still left and we cannot run this like it is all in one ownership.

Senator Hart: Mr. Cohen.

Mr. Cohen: [*chief counsel to the Senate Judiciary Committee*] I guess the hardest question for anybody to understand—maybe you can answer it—is how a company with $75 million in assets can take over a company with $750 million of assets. At the time of the acquisition you had ten times the amount of assets that Leasco did. How can this sort of thing happen?

Mr. Roberts: They were working with a price-earnings ratio that was around eighty times earnings. Reliance was selling around $30, which was about ten times earnings. Generally speaking, a high-multiple company can offer to take over a much larger company with a lower price-earning ratios, and if they do it using debentures and preferreds, you will find out that there is no problem doing that.

Mr. Cohen: It gets down to—

Mr. Roberts: Reliance, with a conservative [dividend] payout to stockholders, was in a target position. When the Leasco situation developed, we didn't know who

it was. By the middle of last May our stock had risen from $30 to $50 without any prediction of better earnings or anything. The board of directors directed me to go around the country and see who I could find who would be interested in making a deal with Reliance, because they said the company was now going to be sold.

Roberts then went into a rather lengthy discourse of the numbers of the deal, attempting to explain how a company with a high p/e ratio could acquire Reliance using convertible preferred stock and warrants and how this would be accretive to the acquirer's earnings per share.

Mr. Roberts: I talked to many people, many conglomerates. The boys ran the slide rules and what you get down to is that a high-multiple company can acquire a low-multiple company, and they can do it without dilution. Somewhere down the line you ask the question: if there are debentures, how will they be paid off?

Under Steinberg's aegis, Reliance remained massively leveraged until the end.

Mr. Cohen: This suggests that we are dealing with a movement that isn't concerned with the substance of a company, just the mathematics.

Mr. Roberts: That is right.

Mr. Cohen: The acquiring company issues preferred stock, debentures, and warrants. The warrants are nothing more than a promise to convert at a later date, so that costs them nothing at the present. All they have to worry about is paying the interest on the debentures and preferred stock. In fact, there is probably enough in your policyholders' surplus to pay off most of the debentures right now, isn't there?

Mr. Roberts: Well, yes. They could use it for the purpose if they elected to.

Mr. Cohen: They really bought your company with your own money!

Mr. Roberts: I have heard this said before.

Mr. Cohen: This is what happened in your case, isn't it, the way you describe it?

Mr. Roberts: They issued paper on this company, and their company had better market acceptance than our paper, and that is the reason it was selling at a high multiple. Their company was looked upon as a growing company in a rapidly expanding industry, while Reliance was looked at as being in an industry that doesn't have a good image. This was reflected in the marketplace. Our company was selling at a forty-percent discount of its liquidating value.

You are right. The purchaser hasn't put any money yet on the warrants. In our case, the fellow has a warrant which gives him the right to buy a share of Leasco common stock at $87, but those warrants trade at $20 or $40 or whatever the price might be in the market. People are willing to buy them in a free market. You cannot say that is not a value.

Mr. Cohen: But how free is the market? This same brokerage house [Cogan, Berlind, Weill & Levitt] was touting your stock to its mutual fund clients. On one hand they are "finding" you [Reliance], and, having found you, they are telling their clients that here is a good buy which it was, because after they found you, your stock went from around $30 to about $90.

Mr. Roberts: $99⅞ was the high.

Mr. Cohen: Having advised their mutual-fund clients to buy the stock (which they are recommending to Leasco), when the price goes up and Leasco makes its offer, the same brokers now have the stock from their mutual fund clients which they can turn over to Leasco for which Leasco pays them additional fee.

Mr. Roberts: That is correct.

Mr. Cohen: That isn't the open marketplace, is it?

Mr. Roberts: Let me put it this way: some people define it as open marketplace and others define it differently. The fact of the matter is either is correct. In my judgment what happened was that the firm Mr. Levitt is connected with suggested to quite a few people that they should buy Reliance stock because it was going to be involved in a merger, and they would make some money.

I was very concerned about this and tried to stop it but couldn't find any legal basis to. I didn't want Reliance Insurance Company to be taken over by outside interests, to be frank about it. I vigorously opposed this, but it didn't involve a horizontal or vertical antitrust situation. It didn't involve an insider situation. I went to the SEC and they told me that they were powerless to do anything on this.

I certainly felt strongly about [the takeover] last year. I felt this was not a good thing. Let's be honest about it. Reliance Insurance Company was sold for a cold-blooded reason: it was in an industry that was having a substandard profit performance, and as long as capital markets are free to move, they will. And what happened with our company is that we got knocked silly for just that reason.

Maybe we should have declared a big dividend and taken our surplus way down so it wouldn't have been so glamorous to outside interests. We didn't do this and we were sitting ducks. We were probably too oriented toward policyholder considerations.

Mr. Cohen: There is a little irony here.

Mr. Roberts: I wish we had withdrawn the capital of Reliance so that I would not have been a sitting duck to be acquired by an outside company. I preferred to be an independent operator. I guess I have the normal amount of vanity.

Mr. Cohen: You are saying that having your company bought with its own policyholders' surplus [is the result of how Wall Street viewed insurance companies].

Mr. Roberts: That is correct. But isn't that the purpose of a free market? That is why you have these exchanges and allow this free trade. Some people put one type of valuation on a security and others put an entirely different one on.

Mr. Cohen: Except when we are talking about Wall Street. Now we are talking—to a large extent—how institutional investors look at a company, and whether they have a different purpose than a smaller investor.

Mr. Roberts: I think this raises question of public policy that you gentleman are correctly directing you attention to.

Mr. Cohen: It has been suggested that we are not really talking about the man in the street. We are talking about Wall Street from the point of view of how the institutional investor now looks at securities.

Mr. Roberts: Well, in a way haven't we seen a shift? It started out with markets of individuals, great family fortunes. Then we moved into the period in which you had the professional managers, of which I assume I was one sometimes. Now we move one step forward, to that in which the financial people are becoming the people who dictate what is happening.

I can remember when Louis Wolfson tried to acquire Montgomery Ward [*Editor's note: Wolfson waged a proxy fight for control in 1954 and 1955*], and at that time

some of the biggest mutual funds in the country took the position that that if you didn't like the management and couldn't support management, you sold your stock.

Mr. Cohen: I guess the key question is what happens to the insurance industry when the professional insurance managers are replaced by financial managers?

Mr. Roberts: I think you'll see a constriction in the market if the free market is allowed to prevail *unless* profitability in the property and casualty business becomes greater. The flow of capital always goes to the high return. We people who are managers in the insurance companies had been much more policyholder oriented than stockholder oriented, but outsiders have come in and have taken the play away from us in quite a few companies.

Mr. Cohen: You pointed out here that it is hard for you to make a profit underwriting because of the effect of inflation, low rates, regulation, the negligence system. No matter how efficient a noninsurer may be in substituting his management for your management, it isn't going to solve any of those problems—is it?

Mr. Roberts: Irrespective of who deals in the insurance business, you are going to see a contraction in the number of companies. It is a little ironic that it only takes a half dozen motor companies to produce eight to ten million automobiles a year, yet it takes 800 to 1,000 insurance companies to sell the insurance.

Mr. Cohen: Of course, there is no question that a lot of these factors are beyond the control of any management. Do you have a solution to all of this?

Mr. Roberts: No, I do not.

Mr. Cohen: What you are really saying is that as long as Wall Street looks primarily at profitability based on price-earnings ratios, as long as this is the method of judging what the stock of a company should be selling for, this trend that we see now is likely to continue.

Mr. Roberts: Yes. I do not know of anybody who buys a stock with any other reason than thinking that the stock is going to reflect something pricewise.

Mr. Peter Chumbris: [*chief counsel for the minority*] You stated earlier that if you had reflected on it, perhaps you would not have allowed the surplus surplus to be so great, and, therefore, might not be so susceptible to takeovers. That would be a lesson, then, to other insurance companies as to how they should look at their surplus.

Mr. Roberts: Sir, I think quite a few of them are learning the lesson. I had the dubious distinction of being the first to be hit on this. Others have profited.

Senator Hart: You said that after the lesson had been learned by the Reliance experience, others were doing something about that surplus surplus. They have just two choices, do they not? To write more insurance or to form holding companies. Which way are they going?

Mr. Roberts: Well, Senator, I do not think their short-range alternative is to write more insurance. They are considering forming holding companies, considering diversification opportunities which they think will be more profitable. Only time will tell whether that expectation will be realized. ■

Reliance Insurance Company became the largest insurance-company insolvency of all time. Its "surplus" is estimated to be negative $3 billion.