Allied Mutual's Dirty Secrets

A Brief Treatise on Disclosure

On December 19, 1997, Terri Vaughan, Iowa's insurance commissioner, issued a formal order "In the matter of Allied Mutual Insurance Company." The purpose: "to protect policyholder interests and assure a fair and democratic process for governance." Commissioner Vaughan believed that Allied Mutual's upcoming election process was improper, and that it was "Allied's intention to deny" David Schiff reasonable access to participate in a fair election. Despite the fact that Schiff was a valid nominee for Allied Mutual's board, Allied not only refused to put his name on the ballot, *it didn't even plan to send out a ballot*. Instead, it planned to send its 220,000 policyholders a proxy card that gave them no practical choice other than appointing John Evans, Douglas Andersen, and Jamie Shaffer as proxies to vote in the policyholders' stead at the Allied Mutual annual meeting.

(Evans and Andersen are directors of Allied Mutual and Allied Group, and all three men are large shareholders in Allied Group. Evans was the mastermind of the more-than-a-dozen asset shuffles between Allied Mutual and Allied Group that resulted in $500 million of value ending up in Allied Group, rather than in Allied Mutual. As a result of these transactions, Evans, Andersen, and Shaffer have made tens of millions, and Allied Group's directors, officers, and employees have made about $250 million—at Allied Mutual's expense. Prompted by a detailed analysis of these transactions in this publication, the Iowa Department of Insurance has been investigating Allied Mutual since last October.)

Allied Mutual refused to comply with Commissioner Vaughan's order; thus began a battle in which Allied went to court and got the order stayed. The stay was subsequently overturned, then reinstated. A short while later, Allied mailed proxies to all of its policyholders.

On March 3, the stay intact, Allied Mutual held its sham election. The number of policyholders in attendance was estimated at less than 100 (most of them, it is believed, were employees). Security was tight: on hand were two gun-toting policemen and numerous dark-suited security personnel wearing earphones and carrying walkie-talkies—an unusual sight at a mutual insurance company's annual meeting. Schiff flew in from New York, spoke in protest, and received 13 votes. (The outcome of the election wasn't in doubt because Schiff had been denied access to any means of communication with policyholders and was thus unable to solicit proxies.)

Allied Mutual, which solicited uncontested proxies on behalf of its candidates via a mailing to all policyholders, claimed to receive 25,000 votes. However, Ellen Phillip Associates, the independent firm that tabulated the vote, informed *Schiff's Insurance Observer* that approximately 60 ballots were cast. Schiff has written to Commissioner Vaughan regarding this discrepancy, but has not yet received a response.

On April 24, oral arguments were heard in Polk County District Court regarding Commissioner Vaughan's order, and a ruling is expected to be handed down within a couple of months. It is likely that any ruling will be appealed by the losing side (the parties in this matter are the Iowa Commissioner of Insurance and Allied Mutual.)

Although Commissioner Vaughan's order provided Allied with numerous ways for Schiff to participate in the elective process—without requiring Allied to disclose confidential information (that Schiff did not seek), such as the names and addresses of policyholders—the order did not go far enough as it didn't require Allied Mutual to disclose material information that would affect the way policyholders voted.

On December 22, Schiff wrote Commissioner Vaughan a letter stressing the importance of full disclosure. An edited version of that letter, with a few additional comments thrown in for good measure, follows:

LET ME FIRST COMMEND YOU for your December 19th order. While it is a step in the right direction, it doesn't address one of the most crucial aspects necessary to assure a fair election—the disclosure of Allied Mutual's directors' material conflicts of interest.

Webster's Collegiate Dictionary defines "conflict of interest" as "a conflict between the private interests and the official responsibilities of a person in a position of trust." That aptly describes the situation at Allied Mutual.

Conflicts of interest are generally dealt with in one of several ways: 1) The conflict of interest is merely disclosed; 2) The conflict of interest is disclosed, and the party with the conflict recuses himself from participating in the matter involving the conflict; 3) The conflict of interest is disclosed, but it is of such a nature that the conflict must be *eliminated* because mere disclosure is inadequate.

The first type of conflict might be one in which a lawyer who serves on a public company's board also receives legal fees. In that instance, the fees would be disclosed to shareholders.

The second type of conflict might be one in which a company is investing in a company owned by a director. In that instance, it would be proper for the director to disclose his conflict and recuse himself from voting on the matter.

The third type of conflict—an unconscionable or irreconcilable conflict—might be one in which a director serves on the boards of both Coca-Cola and PepsiCo.

Prior to becoming Iowa's insurance commissioner, for example, you undoubtedly disclosed that you were a member of EMC Group's board of directors. [*Editor's note*: EMC is a large property/casualty insurance company.] Mere disclosure would not have been a satisfactory resolution once you were confirmed as commissioner; the conflict would have to be eliminated. The choice was yours: you could either serve as commissioner or you could serve as an EMC director, but you could not serve as both.

Here are two well-known examples of conflicts of interest and how they were dealt with at one of the largest insurance companies:

1) In 1960, Prudential Insurance Company's president, Carroll Shanks, resigned after *The Wall Street Journal* reported that Owen Cheatham, the founder of Georgia-Pacific and a member of Prudential's board, had arranged for Shanks (who served on Georgia-Pacific's board) to buy 13,000 acres of timberland for $8.4 million. The $8.4 million was lent to Shanks for *one day* by Bank of America (of which Cheatham was a director). Shanks immediately sold the land to Georgia-Pacific for cash and a stream of timber production payments, the net effect of which was that Shanks, without taking risk, was able to save $400,000 in taxes. The conflict of interest was intensified because at the time of the transaction Georgia-Pacific had $65 million in outstanding loans from Prudential.

2) Some years later Prudential's presi-

dent, Donald MacNaughton, served on IBM's board, but resigned in 1973 when IBM got into a legal battle with Memorex, in which Prudential owned a significant stake.

All six of Allied Mutual's directors have at least one of the following unusual and irreconcilable conflicts of interest: they are large shareholders of Allied Group, they serve on Allied Group's board, or they work at Allied Group.

Allied Group, a New-York-Stock-Exchange-listed company, has disclosed its conflicts of interest with Allied Mutual to its shareholders. Its December 15, 1989 proxy statement, for example, says that there are "inherent conflicts of interest in transactions between" Allied Mutual and Allied Group. Allied Group's 1996 10-K says that "the operations of [Allied Group] are interrelated with the operations of Allied Mutual." Allied Life Financial Corporation's November 17, 1993 prospectus lists as a "Risk Factor" the "conflicts of interest" among Allied Life, Allied Group, and Allied Mutual.

Allied Mutual, however, has shamelessly kept its *policyholders* in the dark about these conflicts and those of its own directors.

Every state insurance department is interested in conflicts of interest. That issue is raised in question 10c of the General Interrogatories of the statutory annual statement. The Iowa Insurance Department's 1994 Examination Report of Allied Mutual, for example, notes that the company's board has a Coordinating Committee to deal with conflicts of interest between Allied Mutual, Allied Group, and Allied Life. The members of the Allied Mutual's Coordinating Committee (composed of outside directors who are presumably independent), are James Kirkpatrick and C. Fred Morgan.

On March 31, 1997, Allied Mutual's directors had the following beneficial ownership of Allied Group shares, adjusted for the recent 3-for-2 split (*Editor's note*: Allied Group's stock recently traded at $30):

Director	Shares
John Evans	515,235
Harold Evans	49,681
Douglas Andersen	192,316
James Callison	26,116
James Kirkpatrick	239,168*
C. Fred Morgan	? ? ?

Kirkpatrick's shares are as of February 28, 1994, which was the last time information about him was reported in Allied Group's proxy. (Kirkpatrick is the former president of Allied Group's property/casualty operations.) I don't know whether Morgan owns shares in Allied Group, but he is an *employee* of Allied Group. [*Editor's note*: On February 11, Allied Mutual's secretary, Sally Malloy, made the startling admission that "Allied Mutual does not maintain records on the Allied Group stock ownership of Morgan... [or] on the Allied Life Financial stock ownership of Kirkpatrick and Morgan."]

All of Allied Mutual's directors, due to their stock ownership in, or employment by, Allied Group, have material conflicts of interest in representing Allied Mutual. Question 10c of the General Interrogatories asks, "Has the company an established procedure for disclosure to its board of directors or trustees of any material interest or affiliates on the part of any of its officers, directors...?" Since every member of Allied Mutual's board has a conflict, however, an affirmative answer to this question is meaningless; the directors are merely disclosing their conflicts to each other.

Both Allied Group and Allied Life disclose a significant amount of information to their shareholders, including compensation, stock ownership, and all sorts of "other arrangements and transactions." As is well documented, Allied Group has become successful while Allied Mutual has languished. Allied Group made $65 million in 1997; Allied Mutual—which once owned *all* of Allied Group—made $13.7 million. Although both companies participate in a pooling arrangement, Allied Mutual's combined ratio was 101% while Allied Group's was 94.4%. The difference is the result of higher expenses charged to Allied Mutual by an Allied Group subsidiary.

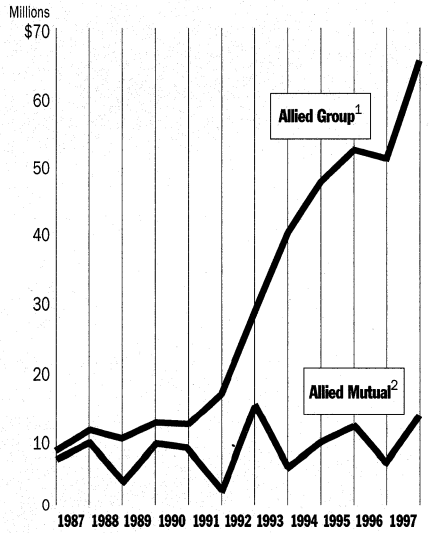
As Allied Group has prospered and Allied Mutual has languished, Evans, Andersen, Kirkpatrick, and others have made tens of millions of dollars from their Allied Group stock.

As a group, Allied Mutual's directors have conflicts of interest that, to the best of my knowledge, are unprecedented in modern times. The question, therefore, is this: should these conflicts of interest simply be disclosed, or should they be eliminated? I believe they should be eliminated.

Iowa law governing mutual insurance companies is silent on this matter—probably because it was never anticipated that such a situation *could* exist in a mutual insurance company. The principle of disclosing conflicts of interest is well established. The proper people for one to disclose a conflict of interest to are those with whom one's interests conflict. In Allied Mutual's case, the people affected by the directors' conflicts are the policyholders. As the owners or principal beneficiaries of the company, the *policyholders* have the right to be informed about these unusual conflicts. They have the right to know for whom they are voting and to whom they are assigning their proxies. They deserve to be told that the directors of Allied Mutual have a huge financial interest in Allied Group and that, in the words of Allied Group, this results in "inherent conflicts of interest." These conflicts of interest should be *fully disclosed*. In fact, it is unconscionable *not to disclose* such conflicts. Mutual policyholders have every right to expect that directors of their company are not faced with

Allied Group's Earnings vs. Allied Mutual's

Allied Mutual once owned all of Allied Group. Ten years later, after a dozen asset shuffles, Allied Mutual doesn't own any of Allied Group. By sheer coincidence, Allied Group and its insiders have made a fortune while Allied Mutual has stagnated.



1–GAAP accounting. 2–Statutory accounting. Excludes Allied Mutual's non-recurring capital gain of $24,051,000 in 1993. Source: Allied Group, A.M. Best.

conflicting self-interests that are likely to be detrimental to the policyholders' interests. [*Editor's note*: This is a key element in the mutual-insurance-holding-company debate.]

The issue, therefore, is who should disclose these conflicts of interest? The answer is obvious; the onus of disclosure resides with those that have the conflict: John Evans, Harold Evans, Andersen, Callison, Kirkpatrick, Morgan, and Allied Mutual.

Your order of December 19 does not require Allied Mutual or its directors to inform Allied Mutual policyholders of the company's and the directors' conflicts of interest. One of the reasons I'm running for the board of Allied Mutual is because of a breakdown in the system: somehow Allied Mutual has come to be controlled by people whose financial interests differ materially from those of Allied Mutual's policyholders. I can attempt to make policyholders aware of the conflicts of interest at Allied Mutual—and am prepared to spend money doing so if I believe that it will bring about reform that creates fairness and has a positive result for Allied Mutual's policyholders. However, it should not be incumbent upon me—or any other nominee—to have to disclose the egregious conflicts of interest that Allied Mutual's directors are fighting to conceal from the policyholders they profess to represent. That burden of disclosure rests with Allied Mutual and with the directors themselves. They are the *only ones* from whom disclosure is satisfactory.

It would be nice if we lived in a world where such conflicts did not arise. It would be nice if we didn't have to make decisions or take action that put us at the risk of being unpopular. Ernest Hemingway said that "guts" was "grace under pressure." He meant that our character is defined by how we respond to a difficult situation. In *Profiles in Courage*, John F. Kennedy told the stories of politicians who took difficult-but-right positions—often at personal cost to themselves.

I, of course, cannot put myself in your shoes. I do know, however, what is right and fair, and I am fortunate that in my role as an independent writer I don't have to report to anybody. My goal has been to write about issues that I think are important, and to describe them in an unflinching, albeit amusing, manner.

I expect that Allied will exert political pressure. I've been told by several Allied agents that the company has asked them to write complaints about your order to the governor and to the insurance department. [*Editor's note*: In April, an Iowa state senator, Mary Lundby, at the request of an Allied lobbyist, drafted an amendment to a pending bill that would have prohibited the Insurance Department's investigation of Allied Mutual. When asked about this amendment, Senator Lundby said that after further consideration she decided it was bad public policy and would not support it.]

The purpose of insurance regulation is to protect policyholders. If we want a fair election—and how can one argue against that?—then it is incumbent upon the directors to tell their policyholders the truth. You, as commissioner, are the final line of protection.

Regulation should not be so arbitrary that it depends upon an outside nominee to step forward with disclosures that would otherwise be kept hidden. ■