# Did Allied Mutual Con Conning?

## *How to Make $80 Million in Four Days*

In our February 1998 issue (see pages 5 and 6) we discussed an embarrassing fairness opinion that Conning & Company, an investment firm specializing in the insurance industry, provided for Allied Mutual.

You may recall that Allied Mutual and its affiliate, publicly traded Allied Group, entered into a stock swap on November 2, 1992. (The two companies' interlocking boards of directors were controlled by John Evans, who was chairman and CEO of both companies. All of Allied Mutual's employees and most of its directors were Allied Group shareholders.) The stock swap was peculiar: Allied Group issued to Allied Mutual 1,827,222 shares of its perpetual non-convertible 6¾% preferred stock (an implied value of $52 million). In return, Allied Mutual transferred 6,166,875 Allied Group common shares to Allied Group.

This was a terrible deal for Allied Mutual but a great deal for Allied Group, John Evans, and other directors and officers. Allied Mutual was swapping its Allied Group shares that represented $8.8 million in annual earnings. In exchange it was receiving Allied Group preferred stock that had a fixed value and paid only $3.5 million in annual dividends.

Given that the stock swap was not an arm's-length transaction, Allied *Mutual* was in need of an investment banking firm to say that this cockeyed deal was fair. (Evans and his cronies would profit from Allied Group's coup, even though it was achieved at Allied Mutual's expense.) Conning & Company was hired; it issued the requisite fairness opinion and collected a nice fee.

Conning made grave errors, however. In opining that the stock swap was fair, it cited a number of factors, two of which were particularly important. One, incredibly, was that "absent the [stock swap]" Allied *Mutual's* stock in Allied Group would grow so rapidly that it would "constitute a progressively disproportionate position among Allied Mutual's assets." In effect, Conning was saying that it was better for Allied Mutual to own Allied Group preferred shares, which wouldn't appreciate, than Allied Group common shares, which would appreciate rapidly. (Conning refused to discuss its fairness opinion or its novel investment thesis. But Conning manages a lot of money, and we know that it prefers to buy securities that appreciate rapidly rather than those that don't appreciate at all.)

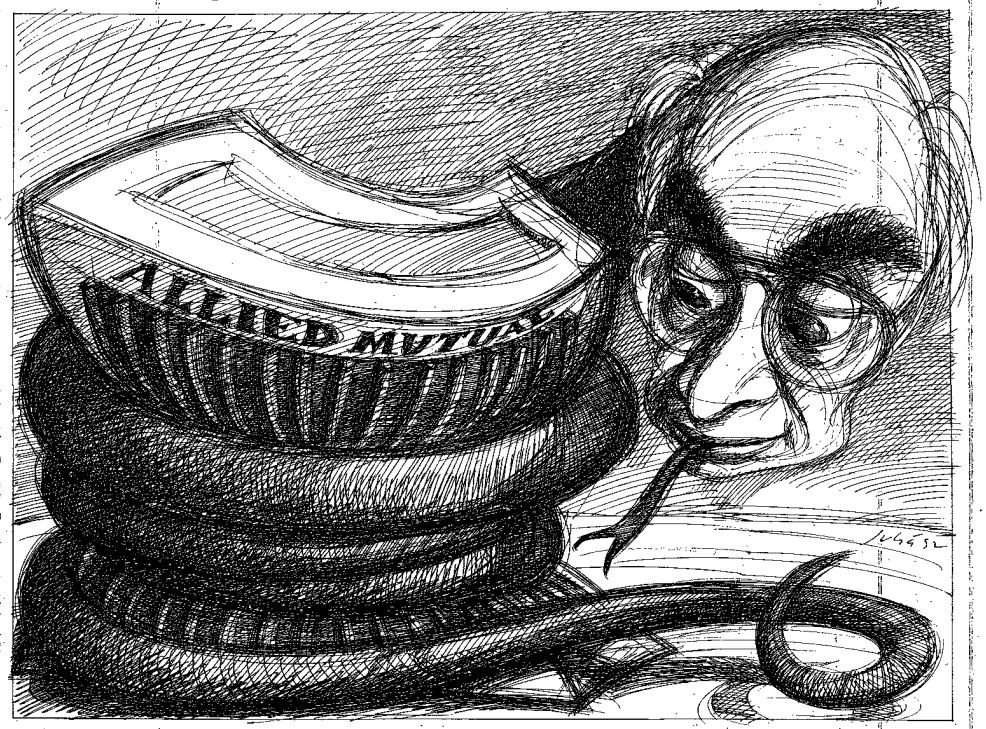
Conning cited another key factor in support of the position that the swap was fair to Allied *Mutual*: "The positive impact...on the capital structure of Allied Group will improve Allied *Group*'s [Emphasis has been added because Conning was supposed to be representing the interests of Allied *Mutual*] access to capital markets to support future growth...Allied Mutual benefits from such growth due to economies of scale in shared resources and facilities."

This statement, delivered on Monday, November 2, was wrong. Allied Mutual would not benefit from the economies of scale in shared resources and facilities.

Four days later, on November 6, Allied Mutual and Allied Group—both controlled by John Evans—made a filing with the Iowa Department of Insurance to amend their reinsurance pooling agreement. The amendment removed Allied Mutual as the "pool administrator" and replaced it with an Allied Group subsidiary, AMCO Insurance Company. Instead of allocating expenses in proportion to each insurer's premiums (which had been the past practice), the amended agreement allocated expenses in a way that resulted in a disproportionate percentage of expenses being shifted from AMCO to Allied Mutual. As a result, on almost identical books of business from the same pool of premiums, Allied Mutual's expense ratio rose from 42% to 45%, while AMCO's fell from 45% to 32%. Over the next six years, this expense shift would cost Allied Mutual about $80 million, and earn $80 million for Allied Group.

John Evans summed up his tricky deal succinctly: the pooling change is "an opportunity to flow every dollar of [expense] savings to [AMCO's] bottom line."

Unfortunately, the Iowa Department of Insurance didn't have the foggiest idea what was going on. Two-and-one-half years later, in its triennial examination report, the Department described the reinsurance pooling agreement as if expenses were *still* being shared proportionately. (The insurance department




*John Evans, chairman of Allied Mutual and Allied Group*

didn't become aware of the pooling-agreement expense shift until David Schiff raised objections to it. Then Commissioner Terri Vaughan did something shocking—nothing.)

It's not clear whether Conning knew, when it issued its erroneous fairness opinion, that a plan to alter the reinsurance pooling agreement would be submitted to the insurance department *four days later*—thereby nullifying one of the key factors that it cited in opining that the stock swap was fair to Allied Mutual. It seems clear, however, that if Conning wasn't aware of the imminent pooling change, then it *should* have been aware of it—if not before, then after it went into effect on January 1. (Upon becoming aware, Conning should have withdrawn its fairness opinion.)

Conning should have known about the pooling change because it held itself out as an expert on Allied. In its fairness opinion, it wrote: "We are familiar with Allied Mutual and Allied Group and *maintain research coverage on the common shares of Allied Group* [emphasis added]." What kind of research coverage could a well-known investment banking firm like Conning provide if it didn't even understand the ramifications of the pooling change that was set in motion four days after it gave its fairness opinion?

If Conning says that it didn't know about the pooling change, then one must ask: Is cunning Conning claiming it was conned?

Let's examine evidence contained in SEC filings, insurance department documents, annual reports, and a letter from Iowa's Department of Justice in response to our Freedom of Information request.

Conning's fairness opinion was delivered to Allied Mutual's board on November 2, 1992. If, at that time, Allied Mutual's directors—who owed a fiduciary duty to Allied Mutual and its policyholders—had *already* decided to amend the pooling agreement, then Conning should have been told about it, since it was a material fact. Had Conning been aware of the change, one presumes that it wouldn't have issued a fairness opinion containing a material misstatement.

If that presumption is correct, we can infer that on November 2, 1992, Conning wasn't told about the pooling-change filing that was to be made four days later. That would suggest two possible scenarios: 1) Allied Mutual's directors knew about the upcoming pooling change and didn't tell Conning, or 2) Allied Mutual's directors *didn't* know that they would decide to change the reinsurance pooling agreement a few days later.

Although Evans and Allied haven't answered our questions in the past, we're pretty sure that they would say that on November 2, when Conning was giving its fairness opinion, they had no plans to amend the pooling agreement. (It seems unlikely that they'd admit the alternative—that they knew about the change and deceived Conning.)

If we accept this scenario—that Allied Mutual's directors didn't know about the pooling change—then we'd probably have to believe something along the following lines: On November 2, after the Conning opinion was issued, Allied Mutual's directors approved and completed the stock swap. That afternoon, a senior executive at Allied Mutual came up with the idea of amending the pooling agreement. The idea was discussed with executives at Allied Group, who took the matter to their board (essentially the same people who were on Allied Mutual's board). Allied Group's board gave the word to proceed. Employees at the two companies (*all* employees worked for both companies) then agreed upon the structure of the new pooling agreement and hired lawyers to draft a term sheet. Once the term sheet had been finalized and reviewed by Allied Mutual's general counsel, it was submitted to the boards of Allied Group and Allied Mutual. During the two or three days that *all* of this activity took place, *all* of Allied Mutual's directors forgot about Conning's fairness opinion, especially the part about Allied Mutual benefiting from "economies of scale in shared resources and facilities." Because Allied Mutual's directors didn't remember Conning's fairness opinion, they approved the change in the pooling agreement and submitted the term sheet to the insurance department on Friday.

If this is John Evans' explanation, it's a tortured one.

In September 1997, *Schiff's Insurance Observer* published a long article about the asset shuffles and unusual intercompany transactions that had made a fortune for Allied Group and Evans—at Allied Mutual's expense. (There were a dozen transactions in addition to the pooling shenanigans described above.) We detailed how Evans had masterminded these transactions and we demonstrated that, because of his track record and irreconcilable conflicts of interest as a director and major shareholder of Allied Group, he was unfit to serve as a director of Allied Mutual.

David Schiff became a candidate for Allied Mutual's board. His plan—which was thwarted when an Iowa judge ruled, in effect, that Allied Mutual didn't have to hold a fair election—was to liberate Allied Mutual from Evans' clutches and return Allied Mutual's assets, which through contrivance and ingenuity, were then in the possession of Allied Group.

Schiff traveled to Iowa regularly, gave speeches, met with his brethren in the media, and wrote countless letters to the insurance department and to Commissioner Vaughan. That Vaughan did virtually nothing is a sad commentary on the inadequacies of state regulation, which has often been a race to the bottom in which legislators (and regulators), in the name of economic development, try to entice insurance companies to move to and remain in their state by permitting them to engage in practices not permitted in other states. Although we're not convinced that federal regulation is the solution, it does have one advantage over state regulation: it's more difficult to buy the U.S. Senate than a state senate.

Even when good laws are in place, insurance regulators are usually hampered by a lack of funding. (Although Iowa has an insurance fraud bureau, when we were there, it was inactive because it had no money.)

Being insurance commissioner usually doesn't lead to higher office, but it can lead to higher remuneration. Former commissioners often go to work for the companies they formerly regulated, or for law firms hired by the companies they formerly regulated. (One former Iowa commissioner was on Allied Group's board and another was Allied Mutual's lawyer.)

Although Commissioner Vaughan had a relatively small budget, she possessed something more powerful than money: a bully pulpit that could be used

to take a stand against the kind of disgraceful transactions of which John Evans was a master. But Vaughan lives and works in Des Moines, a city where almost every large office building belongs to one insurance company or another. Taking on the insurance business in Des Moines is like taking on the movie business in Hollywood.

It's remarkable that the Iowa Department of Insurance finds time to crack down on penny-ante brokers. (On March 29, 1999 an insurance broker was fined $250 and his license was suspended because he failed to report a change of address to the insurance department.) Yet it looks the other way in matters involving *billions* of dollars.

Martin Frankel, who ran off with $200 million or so, is a wanted man. Because John Evans knew how to shuffle assets in a way that was approved by the insurance department, Allied Group ended up with $1.6 billion worth of assets that had once belonged to Allied Mutual. For his efforts, Evans made $50 million and now resides in Carmel and Palm Springs.

On May 5, 1998, after eight months of criticism from Schiff (and a lawsuit by a policyholder represented by Jason Adkins), Allied Mutual and Allied Group discontinued the amended pooling agreement that had piled expenses onto Allied Mutual. Allied Group didn't repay the $80 million that it had made off Allied Mutual, and Allied Mutual policyholders never got the chance to benefit from the *new* agreement: before the year was over, Allied Group was taken over by Nationwide for $1.6 billion. Concomitantly, Allied Mutual was absorbed by Nationwide Mutual in a transaction in which its policyholder-owners received virtually nothing.

As for Terri Vaughan, her lack of initiative proved to be a good career move. In an unusual move, Iowa's new governor (a Democrat), reappointed her even though she had been given the job by his Republican predecessor. It seems that Vaughan's look-the-other-way attitude had made her popular with powerful insurance companies who were glad to keep her in office. To them, she's like Calvin Coolidge, about whom Will Rogers said, "The people wanted nothing done, and he did it." ■