THE RIGHTS OF POLICYHOLDERS IN AN INSURANCE DEMUTUALIZATION

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I. INTRODUCTION

Many insurance companies are organized either as stock corporations or mutual companies. Mutual insurance companies underwrite one half of the total amount of life insurance and one quarter of the total amount of property and liability insurance in force.[1] This division between stock and mutual companies has puzzled commentators because of the differences between the mutual and stock corporation forms.[2] Since the 1930s, many mutual insurance companies have converted to stock corporations.[3] This Article will analyze the legal standards regulating the conversion of a mutual insurance company into a stock corporation, a process known as demutualization.

A. *Differences Between Stock And Mutual Organizations*

A stock corporation is governed by the laws of the state in which it is incorporated, while a mutual insurance company is governed by laws of the state in which it is domiciled.[4] The common shareholders of a stock company have the right to elect its management and to receive dividends from net income.[5] They also may have certain rights under state law if the corporation dissolves, merges, or sells its assets.[6]

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1. *See, e.g.*, Henry Hansmann, *The Organization of Insurance Companies: Mutual Versus Stock*, 1 J.L. ECON. & ORG. 125, 125 (1985).

2. *Id.*; *see also* J.A.C. Hetherington, *Fact v. Fiction: Who Owns Mutual Insurance Companies*, 1969 WIS. L. REV. 1068, 1069.

3. There have been more than 200 conversions since 1930. *See* John C. Gurley & James R. Dwyer, *An Analysis of The Insurance Regulatory Aspects of Demutualization*, *in* DEMUTUALIZATION AND OTHER NEW OPPORTUNITIES FOR INSURANCE COMPANIES 126, 126 (Joseph Diamond & Gerry H. Goldsholle, eds., 1984). In addition, 14 companies converted between 1972 and 1982. *See id.*

4. *See, e.g.*, DEL. CODE ANN. tit. VIII, § 101 (1991); IOWA CODE §§ 518.1-.3 (1991) (setting forth procedures for incorporation, requiring that articles of incorporation be submitted to commissioner for approval, and directing secretary of state to record articles of incorporation upon approval).

5. *See, e.g.*, DEL. CODE ANN. tit. VIII, §§ 151, 212 (1991).

6. *See, e.g.*, *id.* § 262.

A mutual company is owned by its current policyholders, or members,[7] who have the right to elect its directors[8] and receive dividends from the company's net income.[9] Mutual policyholders also may have certain rights under state law if the mutual dissolves or converts to a stock corporation.[10]

The most important difference between a mutual and a stock company is that a mutual cannot sell shares of stock on the equity markets. This limitation makes it more difficult for a mutual company to raise capital because a mutual may do so only by retaining earnings.

Although many mutual insurance companies compete effectively with stock companies, they are probably not as successful economically.[11] In fact, the number of mutual insurance companies has declined since the 1950s,[12] and the assets of mutual insurance companies have grown more slowly than those of their stock counterparts.[13] Indeed, many mutual savings and loans converted to stock corporations in the 1980s.[14]

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7. *See, e.g.*, WASH. REV. CODE ANN. § 48.09.120(1) (West 1984) (stating "A domestic mutual insurer is owned by and shall be operated in the interest of its members.").

8. *Id.* § 48.09.120(2) (providing that each member is entitled to one vote).

9. *Id.* § 48.09.300(1) (providing that directors may pay dividends to members out of surplus funds that are in excess of required minimum surplus and that represent the mutual's net earnings).

10. *See, e.g., id.* § 48.09.360 (West Supp. 1992) (providing policyholders a right to a proportionate share of the company's assets upon liquidation).

11. *See* Henry Hansmann, *Ownership of the Firm*, 4 J.L. ECON. & ORG. 267, 298-300 (1988).

12. Between 1954 and 1981 the number of mutual life insurers decreased from 171 to 135. *See* Hansmann, *supra* note 1, at 137.

13. Richard Jenrette, Chief Executive Officer of the Equitable Life Assurance Society, states: "Overall, mutual insurers have lagged behind stock insurers in growth of assets and capital. Also, domestic financial institutions are undercapitalized when compared with many foreign competitors. Demutualization and subsequent stock sales could improve a company's capital position and enhance its competitive standing with other insurers and other financial institutions." *Equitable to Develop Demutualization Plan*, Bus. Wire, Dec. 11, 1990, *available on* LEXIS, Company Library, Bwire File. One commentator noted mutual companies' share of the life insurance market fell from 69% in 1947 to 43% in 1983, and that the number of mutual life insurance companies has declined since 1954. *See* Hansmann, *supra* note 1, at 137. In 1954 there were 171 mutual life companies while in 1981 there were 135. *Id.* On the other hand, between 1954 and 1981 the number of stock life insurance companies increased from 661 to 1823. *Id.*

14. Nevertheless, stock insurance companies also convert to the mutual form. For example, Blue Cross and Blue Shield of Iowa, which was established as a nonprofit corporation, will become a mutual company. Dale Kasler, *Blues Closer to Being a Mutual Insurer*, DES MOINES REG., Nov. 30, 1990, at 8S. The company will convert to avoid technical requirements of Iowa laws regulating nonprofit corporations that do not apply to mutual insurance companies. *Id.*

B. *Introduction To Demutualization Transactions*

A demutualization, which must be approved by state insurance authorities, transforms a mutual company into a stock company.[15] In most states, the current policyholders, the owners of the mutual company, must approve the transaction by at least a majority vote, and must be compensated for the value of their ownership interests.[16]

There are three types of mutual-to-stock conversions. A conversion may be accomplished by redistributing all of the mutual policyholders' equity, known as surplus, in the form of shares of the new stock corporation.[17] This type of conversion may properly be regarded as a reorganization of the company because the policyholders are exchanging membership in the mutual for shares in the new corporation.

A conversion also may occur when a third party purchases a controlling interest in a mutual company by contributing capital.[18] The policyholders may receive a minority of the shares of the reorganized company, cash payments, or a combination of the two.[19] This type of transaction is properly regarded as a sale of the company, because the purchasing party obtains control of the reorganized company. Demutualization statutes regulating conversions do not expressly acknowledge the difference between a reorganization and a sale of the company, but instead permit both types of conversion.[20] A mutual insurance company may also be demutualized by

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15. *See, e.g.*, CAL. INS. CODE § 4092 (West Supp. 1993); N.Y. INS. LAW § 7312(j) (McKinney Supp 1993); OHIO REV. CODE ANN. § 3913.01 (Anderson 1989); PA. STAT. ANN. tit. 40, § 1010.4 (1992); S.D. CODIFIED LAWS ANN. § 58-5-12 (1990); WASH. REV. CODE ANN. § 48.09.350 (West 1993).

16. *See* ARK. CODE ANN. § 23-69-141(h)(2) (Michie 1987) (three-fourths approval); CAL. INS. CODE § 4092 (West Supp. 1993) (two-thirds); GA. CODE ANN. § 33-14-75(b) (Harrison 1990) (two-thirds); N.Y. INS. LAW § 7312(k)(2) (McKinney Supp. 1993) (two-thirds); OKLA. STAT. ANN. tit. 36, § 2133C (West 1990) (two-thirds); S.D. CODIFIED LAWS ANN. § 58-5-124 (1990) (two-thirds); WIS. STAT. ANN. § 611.76(8) (West 1980) (simple majority). Several statutes expressly require compensation. *See* N.Y. INS. LAW § 7312(A) (McKinney Supp. 1993); OHIO REV. CODE ANN. § 3913.22(B) (Anderson 1989); PA. STAT. ANN. tit. 40, § 1010.3(2) (1992); WASH. REV. CODE ANN. § 48.09.350(3) (West 1993); WIS. STAT. ANN. § 611.76(4) (West 1992).

17. *See, e.g.*, FLA. STAT. ANN. § 628.441 (West 1984). Each policyholder's equity in the insurer is usually determined by apportioning the surplus of the company to each policy. *See, e.g.*, *id*. Policyholders are not entitled, however, to receive any distribution of the legal reserves of the company. *See, e.g.*, N.Y. INS. LAW § 7312(d)(3)(c) (McKinney Supp. 1991). The means of determining surplus and apportioning it to individual policyholders are apparently within the discretion of state insurance authorities. *See, e.g.*, IOWA CODE § 521A.5(2) (Supp 1991) (Commissioner to determine whether surplus is adequate); 40 PA. CONS. STAT. § 1010.2) (1992) (surplus is allocated to policyholder based upon ratio of premiums paid by policyholder over preceeding three years to total net premiums of the company); WASH. REV. CODE ANN. § 48.09.340 (West 1984) (assets of company must exceed liabilities).

18. *See, e.g.*, N.Y. INS. LAW § 7312 (McKinney Supp. 1991).

19. *See, e.g.*, *id.*

20. *See, e.g.*, *id.*

means of a bulk reinsurance transaction. In a bulk reinsurance transaction, a stock company reinsures all of the mutual's policies in return for its assets.

As this Article will explain, policyholders in a demutualization are not protected by the market for corporate control because mutual companies cannot be acquired in hostile tender offers.[21] Despite elaborate statutory protections, the compensation policyholders receive is determined by the directors of the mutual company and state insurance authorities. Moreover, policyholders are unable to respond effectively to a tender offer because they cannot tender policies. Thus, mutual policyholders, unlike corporate shareholders, do not benefit from the constraints of the market for corporate control.

This Article will argue that current state laws do not adequately protect policyholders in mutual-to-stock conversions, and will propose state law reforms to increase policyholder protections.[22] It will discuss the structure of mutual companies and the economic reasons for demutualizations.[23] It will also compare the rules regulating demutualizations with those governing corporate reorganizations under Chapter 11 of the Bankruptcy Code.[24] Finally, this Article will argue that statutes should permit a demutualization only if the mutual's directors sell the company to the highest bidder and distribute the proceeds to policyholders, or if the directors distribute all of the reorganized company's shares to policyholders that in turn may decide whether to sell their shares in connection with a public offering.[25]

This Article will focus on both life and property-casualty mutual insurance companies. Although certain state statutes regulating demutualization apply specifically to either life or property-casualty companies, almost all statutes are applicable to both types of mutual insurers.

II. THE GOVERNANCE OF MUTUAL COMPANIES

There have been several analyses of the governance of mutual insurance companies.[26] Commentators agree mutual insurance companies, unlike stock companies, are governed almost entirely by their own managers and insurance regulators.[27] As this Article shall explain, mutual policyhold-

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21. *See infra* part V.D. The "market for corporate control" refers to the common practice of bidders to make tender offers for publicly traded corporations. *See* Edward B. Rock, *Corporate Law Through an Antitrust Lens*, 92 COLUM. L. REV. 497, 528 (1992).

22. *See infra* parts IV, V.

23. *See infra* parts II, III.

24. *See infra* part V.D.

25. *See infra* parts V.D., VI.

26. *See, e.g.*, Hansmann, *supra* note 1; Hetherington, *supra* note 2; Douglas P. Long, *Governance of Mutual Insurance Companies: A Call For Reform*, 29 DRAKE L. REV. 693 (1980). This section will not attempt to repeat these analyses, but will discuss instead the most important provisions by which mutual companies are governed.

27. *See* Hansmann, *supra* note 1, at 128; Hetherington, *supra* note 2, at 1086-87.

ers lack many of the means to control the management of their companies that corporate shareholders possess.

Cases and statutes have clearly established that the mutual policyholders are the owners of the company.[28] They elect directors and receive dividends from the company's earned surplus or accumulated profits of the company.[29] The dividends then are distributed to policyholders in the form of reduced premium payments.[30]

Unlike corporate shareholders, mutual policyholders are insurance consumers whose primary interest is in the company's ability to pay claims. As insurance consumers, policyholders do not typically monitor management performance.[31] In fact, they exercise far less control over management than do shareholders of a corporation.[32]

A corporation, on the other hand, is owned by individual shareholders who elect directors and receive dividends from net income.[33] Although most shareholders vote with management by giving management their proxies to vote in favor of the management's slate of directors and do not carefully review board decisions, they can sell their shares if the company performs poorly. Under the proxy rules pronounced in the securities laws, management must disclose certain information to the shareholders and the public in connection with a proxy solicitation.[34] In addition, outside investors and potential acquirors can influence management by purchasing shares of stock companies on the open market.

Unlike shares of stock, insurance policies are not freely transferrable. The policyholder has a long-term interest in the survival of the insurance company and cannot transfer a policy without purchasing additional

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28. *See, e.g.*, Rowen v. LeMars Mut. Ins., 282 N.W.2d 639, 662 (Iowa 1979) (holding a mutual company is the unqualified property of its policyholders); *see also* WIS. STAT. ANN. § 611.76, 1971 committee cmt., at 289 (West 1980); Long, *supra* note 26, at 718-19 (citing authorities that state policyholders are the owners of a mutual insurance company). Moreover, if the policyholders do not own the mutual company, it has no owners, which is absurd. Hetherington notes, however, that mutual policyholders have little actual control over managers and argues managers do not have a fiduciary duty to policyholders. Hetherington, *supra* note 2, at 1078-79. He maintains management is viewed as having only contractual duties to policyholders to pay valid claims. *Id.* Hansmann disagrees with Hetherington, however, and argues that although policyholders lack effective control over mutual management, management acts as a fiduciary of the policyholders. *See* Hansmann, *supra* note 1, at 143 n.12. The author agrees with Hansmann, because mutual policyholders must place their trust and confidence in the managers to direct the affairs of the company. *See* Lamb v. Lamb, 464 N.E.2d 873, 876 (Ill. App. Ct. 1984).

29. *See* Hetherington, *supra* note 2, at 1074.

30. *Id.*

31. *Id.* at 1072-73.

32. *Id.* at 1102; *see also* Hansmann, *supra* note 1, at 128.

33. *See, e.g.*, DEL. CODE ANN. tit. VIII, §§ 151, 211(b) (1991).

34. *See* Long, *supra* note 26, at 707-08.

insurance.[35] Under most state statutes, a mutual policyholder is not prohibited from transferring certain membership rights to another person.[36] These rights, which are valid only as long as the policy is outstanding, include the right to receive dividends and vote in elections for the board of directors.[37] There is no public market for insurance policy voting rights because other state laws make it very difficult for an acquiror to challenge management.[38] In fact, a search has revealed no instance in which policyholders defeated management nominees in a board election.[39]

Although it theoretically may be possible for a potential acquiror to challenge management nominees by purchasing voting rights from policyholders, a purchaser first must overcome other obstacles before he can challenge incumbent management. Most states allow mutual insurers to determine the manner of electing directors.[40] These states do not expressly require that management notify policyholders of the location and date of annual meetings at which directors are elected.[41] In addition, most states do not require mutual management to release a list of policyholders to opposition groups.[42] Furthermore, mailings by mutual companies to policyholders

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35. An insurance policy is a contract and cannot be transferred from one policyholder to another without the consent of the other party to the contract; namely, the insurance company. *See* Peterson v. Universal Fire and Casualty Ins. Co., 572 N.E.2d 1309, 1310 (Ind. Ct. App. 1991) (holding insurance policies are contracts and are interpreted under the same rules of construction); Founders Mut. Casualty Co. v. Mark, 302 N.E.2d 142, 144 (Ill. App. Ct. 1973) (holding insurance contract is personal to the insured and does not run with the insured property unless the insurer consents to an assignment of the policy).

36. Long, *supra* note 26, at 717. *But see* N.Y. INS. LAW § 1211(b) (McKinney 1985) (prohibiting any transfer of mutual policyholder voting rights). No state law, however, prevents a mutual company from prohibiting a transfer of voting or dividend rights.

37. *See* Long, *supra* note 26, at 718.

38. Under most laws, each mutual policyholder is entitled to one vote, regardless of the size of the policy. *See, e.g.*, ARIZ. REV. STAT. ANN. § 20.713(B) (1990); N.Y. INS. LAW § 4210(b)(1)-(2) (McKinney 1993); WASH. REV. CODE ANN. § 48.09.120(2) (West 1984). This contrasts with the laws governing director elections in stock corporations, under which each share entitles its holder to one vote. *See, e.g.*, N.J. STAT. ANN. § 14A:5-10 (West 1969). It is readily apparent that it is very easy to accumulate additional votes by acquiring shares. In a mutual insurance company, on the other hand, a potential acquiror cannot accumulate votes by acquiring policies because each member has only one vote. This makes it difficult to challenge management. Indeed, one former insurance executive has written: "Because they are owned by their policyholders, mutuals are insulated from a possible takeover by a foreign entity." Guy N. Ducharme, *The Dark Side of Conversion; Conversion of Mutual Companies to Stock Companies*, BEST'S REVIEW, Jan. 1989 (Life-Health Insurance ed.), *available on LEXIS*, Insurance Library, Brlife File.

39. Hetherington notes contested elections are extremely rare and mentions no instance in which management lost an election. *See* Hetherington, *supra* note 2, at 1079-80. Similarly, Hansmann contends mutual management is unchecked by policyholder votes. *See* Hansmann, *supra* note 1, at 134.

40. *See, e.g.*, IOWA CODE § 518.7 (1991) ("Officers or directors shall be elected in the manner and for the length of time prescribed in the articles of incorporation . . . .").

41. *See, e.g.*, *id.*

42. *See* Long, *supra* note 26, at 704.

concerning the election of directors are exempt from federal proxy rules because mutual insurance policies are not securities.[43] Thus, it is very difficult, if not impossible, for outsiders successfully to nominate an effective opposition slate.[44]

Shareholders of public corporations can participate in proxy fights, which may have at least some probability of success, and can sell or tender shares in response to tender offers.[45] In fact, even a failed proxy fight may influence management to change course.[46] Furthermore, institutional investors, which own large blocks of stock, can often influence management even without waging proxy fights.[47] Institutional investors can also tender large blocks of shares to a third party making a tender offer for the company.[48] Although mutual insurance companies may have policyholders with valuable policies, the policyholders can not exert the same influence as institutional investors. In fact, under most states' insurance codes all policyholders possess the same number of votes.[49] Thus, the management of a

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43. *See id.* at 707-08, 708 n.74 (citing Securities Exchange Act of 1934, 15 U.S.C. § 781(g)(2)(G) (1988) (exempting securities issued by a stock insurance company if the company's domiciliary state suitably regulates proxy solicitations)).

44. Telephone Interview with Bruce Foudree, former Iowa Insurance Commissioner and former president of the National Association of Insurance Commissioners (Apr. 8, 1991); *see also* Hansmann, *supra* note 1, at 134.

45. Under almost all corporate statutes, a shareholder can give a proxy to another person to authorize that person to vote his shares. *See, e.g.,* N.J. STAT. ANN. § 14A: 5-19 (West Supp. 1992). See also Ronald J. Gilson & Reinier Kraakman, *What Triggers Revlon?*, 25 WAKE FOREST L. REV. 37 (1990), in which the authors state:

> Shareholders always retain the choice when a merger, sale of assets, or similar transaction threatens to shift control: they can protect themselves by voting against an unfavorable merger, or, more realistically, by tendering their shares to a competing bidder . . . when the merger is so unfavorable that it attracts a competitive bid.

Id. at 50.

46. *See* Rondald J. Gilson & Reinier Kraakman, Reinventing The Outside Director: An Agenda For Institutional Investors 9 (unpublished manuscript, on file with the author) (discussing establishment of a shareholder advisory committee by Lockheed in response to demands by institutional investors).

47. *See, e.g.*, Matthew L. Wald, *Exxon Head Seeks Environmentalist to Serve on Board: Pension Fund Pressure*, N.Y. TIMES, May 12, 1989, at A1.

48. Institutional investors of corporations can give proxies to other persons to vote their shares at a shareholders' meeting. *See, e.g.,* N.J. STAT. ANN. § 14A: 5-19 (West Supp. 1992); Gilson & Kraakman, *supra* note 45, at 50 (discussing shareholders' ability to tender shares to a bidder); Roberta S. Pomerantz, The Fourth Abraham L. Pomerantz Lecture: Tensions Between Institutional Owners and Corporate Managers, 55 BROOK. L. REV. 55, 91 (1991) ("The [common-law] tradition treats shareholder voting rights as a property interest, and therefore each policyholder is entitled to vote his or her shares in an entirely selfish way . . . .").

49. *See* WASH. REV. CODE ANN. § 48.09.120 (West 1984) (providing each member shall have one vote in election of directors and on matters before corporate meeting, subject to reasonable requirements of duration of ownership and amount of insurance held). *But see* IOWA CODE § 518.7 (1991) (providing officers and directors shall be elected in manner prescribed in articles of incorporation).

stock corporation is subject to the market for corporate control, while that of a mutual company is not.[50]

Mutual insurance companies are subject to the control of the insurance authorities of the states in which they are domiciled, but the degree of oversight varies by state. State insurance authorities review demutualization plans to determine whether the policyholders will be fairly compensated and whether the reconstituted company is solvent and has adequate reserves.[51] In most states, insurance authorities have broad discretion to determine if the plan is "fair and equitable" and adequately compensates policyholders.[52]

State courts review demutualization plans, but have rarely reversed the decisions of insurance officials. A search has revealed few cases in which a court reversed an insurance department decision that allowed a company to demutualize.[53] For reasons that will be discussed, courts are apparently reluctant to overrule decisions of insurance regulators that approve demutualizations.[54] In fact, in *Pierce Insurance Co. v. Maloney*,[55] the court upheld a conversion that had been opposed by the state's commissioner of insurance.[56] Therefore, this Article will argue that, in all likelihood, state insurance authorities or reviewing courts will not adequately protect policyholders' ownership interests in a mutual-to-stock conversion.

50. *See* Hansmann, *supra* note 1, at 134. Hansmann argues the lack of market constraints on mutual managers may lead them to accumulate reserves exceeding that which is necessary to maintain solvency. *Id.* These reserves may be used to finance growth or to "satisfy management's desire for a comfortable margin." *Id.*; *see also* Tim W. Ferguson, *Insurance Is Taking Casualties, but State Farm's Still There*, WALL ST. J., Apr. 23, 1991, at A23 (noting State Farm has a large surplus and is successful).

51. *See supra* note 15. Moreover, state insurance authorities have broad powers to regulate the reserves of insurance companies. *See, e.g.* ARIZ. REV. STAT. ANN. § 20-509 (1990) (providing that director has the power to require a company to increase its reserves if he determines that the reserves are inadequate); N.Y. INS. LAW § 1304 (McKinney 1985) (providing that superintendent may require every insurance company to maintain reserves that exceed those required by statute).

52. *See* N.Y. INS. LAW § 7307(h)(1) (McKinney 1985). See also *infra* part IV for a discussion of state regulation of demutualization transactions.

53. *See, e.g.*, Rowen v. LeMars Mut. Ins. Co., 230 N.W.2d 905 (Iowa 1975) (allowing policyholders to proceed with a suit for breach of fiduciary duty but declining to reverse the decision of the insurance commissioner); Doyle v. Union Ins. Co., 277 N.W.2d 36, 46 (Neb. 1979) (finding a breach of fiduciary duty by directors who approved a demutualization plan and imposing liability despite prior approval of insurance commissioner); Zinman v. Department of Ins., 400 A.2d 689, 691 (Pa. Commw. Ct. 1979) (vacating decision of insurance commissioner approving a demutualization plan because commissioner relied on documents not properly admitted into the evidentiary record).

54. *See infra* parts IV, V.

55. Pierce Ins. Co. v. Maloney, 269 P.2d 57 (Cal. Ct. App. 1954).

56. *Id.* at 64. In *Pierce*, the mutual converted into a stock corporation under a statute giving policyholders a 30 day option to purchase stock in the new corporation. *Id.* at 59. When many policyholders failed to exercise their options the managers sold the stock to their friends and associates. *Id.* The court upheld the transaction, even though the insurance commissioner objected, because it complied with the formal terms of the statute. *Id.* at 63; *see also* Gurley & Dwyer, *supra* note 3, at 129.

III. THE ECONOMIC REASONS FOR DEMUTUALIZATION

A. *The Reasons for Recent Demutualizations*

Although management apparently would want to preserve the mutual form because of the job security it provides, more than two hundred mutual companies have converted to stock companies since 1930.[57] Managers have proposed conversion plans for four reasons: (1) A stock corporation is more able to raise capital; (2) a stock corporation is more able to diversify by creating an upstream holding company; (3) a stock corporation offers an opportunity for increased management compensation through stock option plans; and (4) a stock corporation offers an opportunity for a management buyout of the insurance company. Commentators and management agree the need for additional equity capital has been the most important reason for demutualization.[58]

1. *A Stock Corporation is Better Able to Raise Capital*

A mutual company may seek to raise capital or surplus to finance the introduction of new types of insurance products.[59] Without such growth, mutual companies fear they will be unable to offer policies competitive with those offered by stock companies.[60] A stock insurance company, on the other hand, can raise capital more easily than a mutual because it can sell shares of stock to investors. Borrowing is not a desirable means for mutual companies to raise capital because under state law borrowed funds do not create surplus.[61] Like banks, which may not raise capital by borrowing,

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57. Gurley & Dwyer, *supra* note 3, at 126. In addition, 14 companies converted between 1972 and 1982. *See id.*

58. *See* David F. Babbel & Ransom B. Jones, *Not Whether, But When*, BEST'S REVIEW, Jan. 1988, (Life-Health Insurance ed.), *available on LEXIS*, Insurance Library, Brlife File. Doris Fenske, *Going Public: The Critical Choice*, BEST'S REVIEW, Jan. 1985, (Life-Health Insurance ed.) *available on LEXIS*, Insurance Library, Brlife File.

59. Telephone Interview with Bruce Foudree, *supra* note 44; *see also Equitable to Develop Plan to Demutualizatize*, *supra* note 13.

60. Telephone Interview with Bruce Foudree, *supra* note 44.

61. See Wolcott B. Dunham, Jr., *Demutualization: Legal Considerations*, in DEMUTUALIZATION AND OTHER OPPORTUNITIES FOR INSURANCE COMPANIES, *supra* note 3, at 89, 93; *cf.* WASH. REV. CODE ANN. § 48.09.320 (West 1984) (providing insurer may borrow money to repay expenses with any loan repaid from the earned surplus in excess of the insurer's required minimum surplus). "Surplus" is the statutory form of recording the retained earnings of an insurance company. *See, e.g.*, CA. INS. CODE §§ 12540.05-.06 (West 1988) (setting policyholder surplus requirements for mortgage guaranty insurers, and barring any insurer from declaring dividends other than profits exceeding the surplus, paid in capital and reserve). A mutual company's surplus is not the same as a corporation's retained earnings because the corporation's earnings are calculated under Gererally Accepted Accounting Principles ("GAAP"). *See* Babbel & Jones, *supra* note 58, at 56; Fenske, *supra* note 58, at 104.

mutuals must either increase their premium revenues or decrease their costs to increase surplus.[62] Certain states allow mutuals to issue surplus notes, which create surplus because they are not considered liabilities.[63] Issuing surplus notes to raise capital is impractical, however, because the maximum interest rate is often set by statute and insurance regulators must approve repayment.[64]

A mutual company may also raise capital by forming a downstream stock subsidiary, which can sell shares of stock to the public.[65] There are, however, two difficulties associated with the use of subsidiaries. First, the mutual may only sell less than fifty percent of the shares of the downstream company or it will lose its majority interest and thus control of the subsidiary. Selling the shares of a subsidiary may not be as effective a means of raising capital as demutualization because a share of a subsidiary is not as valuable as a share of a converted company.[66] Second, a downstream holding company may not permit a mutual to diversify as effectively as demutualization because the insurance company and its subsidiaries will not be distinct.[67] Insurance regulators may then examine the noninsurance subsidiaries.[68]

Because many mutuals find issuing surplus notes or forming subsidiaries an unacceptable means to achieve growth, they may attempt to

62. *See* Dunham, *supra* note 61, at 93; *see also* IDAHO CODE § 41-2841 (1991) (providing insurance director must approve the terms of the loan, the interest rate, and the repayment).

63. Dunham, *supra* note 61, at 93; *see also* ARIZ. REV. STAT. ANN. § 20-725 (1990) (providing insurer may borrow funds to be repaid out of its surplus if the director approves the loan); WASH. REV. CODE ANN. § 48.09.320 (West 1984) (allowing mutual companies to borrow in certain situations).

64. *See* Dunham, *supra* note 61, at 93. In fact, one investment banker mentioned surplus notes at a demutualization conference but apparently did not regard issuing surplus notes as an effective alternative means of raising capital. *See* John G. Heimann, Vice Chairman of Merrill Lynch Capital Markets, Remarks at the Hartford Institute of Insurance Taxation Conference on Demutualization 4 (Feb. 4, 1985) (transcript on file with author).

65. Telephone Interview with Wolcott B. Dunham, Jr., Partner with the New York law firm of Debevoise & Plimpton (June 12, 1990). The term "downstream" means that the mutual company owns the subsidiary.

66. *See* Fenske, *supra* note 58; Telephone Interview with Wolcott B. Dunham, Fr., *supra* note 65.

67. Telephone Interview with Wolcott B. Dunham, Jr., *supra* note 65; *see also Equitable to Develop Demutualization Plan*, *supra* note 13 ("Mutuals cannot form upstream holding companies and do not have the same overall structural flexibilty as stock companies [because] affiliates of the mutual company must be direct or indirect subsidiaries.")

68. Under New York law, the superintendent of insurance may examine certain transactions within a holding company system to which a controlled insurer is a party. *See* N.Y. INS. LAW § 1505 (Mckinney 1985). The superintendent also has broad power to regulate transactions between mutual insurance companies and their subsidiaries. *See id.* § 1608 (applying to life insurers). The superintendent may also promulgate regulations. *See id.* § 1612 (applying to property and casualty subsidiaries); *id.* § 1716 (applying to life company subsidiaries).

increase surplus by increasing premium revenues or by decreasing costs.[69] Industry experts maintain, however, that it has been increasingly difficult to raise capital internally in recent years because of price competition.[70] As a result, mutual companies have resorted to demutualization to finance their expansion even though expansion may not be in the best interest of their current policyholders.[71]

The conversion of the Equitable Life Assurance Society was one such response to a long-term capital shortage. After suffering a two hundred million dollar loss in 1990, Equitable announced it would propose a demutualization to be completed in 1992.[72] Richard Jenrette, chief executive officer of Equitable, stated the primary reason for the decision was the company's present need for capital.[73] Demutualization would also allow the company to raise additional capital in the future.[74] Equitable originally announced it would attempt to sell five hundred million dollars of convertible notes to private investors before the demutualization was approved.[75] Once the demutualization was completed, the notes could be converted to shares of stock in the reorganized corporation.[76] Selling the convertible notes would allow Equitable to raise capital before the transaction was completed.[77] Equitable later announced that, due to investor interest, it was considering increasing the amount of the convertible notes offering to as much as one

69. *See* Fenske, *supra* note 58 (stating that because mutuals are more committed to provding insurance at cost they have less money to invest in other ventures); *see also Equitable to Develop Demutualization Plan*, *supra* note 13 (stating that a mutual "can raise capital only through retained earnings–a slow process if the company does not curtail sales to reduce surplus strain caused by the issuance of new policies–and through selling surplus notes or through entering into reisurance transactions").

70. Heimann claimed price competition among property-casualty companies and the cost to life insurers of selling new policies have made it very difficult to raise capital internally. *See* Heimann, *supra* note 64, at 4.

71. *See* WIS. STAT. ANN. § 611.76, 1971 committee cmt., at 290 (West 1980) (prefatory note to § 611.76). The committee argued growth and expansion may raise, rather than lower, the cost of insurance, and that outside capital is not always needed for growth. *See id.* at 289. For example, the committee pointed to State Farm Mutual Automobile Insurance Company, which had grown in 20 years to become the largest automobile insurance company in the United States despite the fact it had financed all of its growth internally. *See id.* The committee also argued the need for capital may often be a pretext for a conversion designed to benefit insiders. *See id.*

72. *See Equitable Plans to Demutualize*, *supra* note 13. Equitable, the third largest life insurance company in the United States, currently has assets of $61 billion. *See Equitable Life Assurance Society of the United States Claims Paying Ability Rating Lowered; Subsidiary Claims Paying Ability Rated "A"*, PR Newswire, Jan. 24, 1991, *available on* LEXIS, Insurance Library, Prnews File [hereinafter *Equitable Rating Lowered*] (discussing assets as of September 30, 1990).

73. *See* Scott J. Paltrow, *Equitable Proposes New Ownership Plan*, L.A. TIMES, Dec. 12, 1990, at 2D.

74. *See id.*

75. *Id.*

76. *Id.*

77. *Id.*

billion dollars.[78] Union Mutual of Maine, another large life insurer, demutualized for similar reasons.[79]

In March 1992, ninety-two percent of Equitable's policyholders voted in favor of the proposed demutualization, which had been slightly modified after the original proposals.[80] In July 1992, Equitable sold shares of stock to the public through a public offering, which raised forty-five million dollars.[81] According to news reports, most of the funds raised in the public offering will be used as capital for general corporate purposes by the company.[82] The policyholders also received shares of stock in the new Equitable.[83] The Equitable is now a Delaware corporation, with an insurance company subsidiary.[84]

Demutualizations have not been limited to the larger insurers; several smaller mutuals have also demutualized to obtain capital. Thomas Kelly, senior vice president of the Life Insurance Marketing and Research Association ("LIMRA") explained, "'[I]n recent times, we've seen four medium-sized mutual companies demutualize because of the need of capital for growth. But no longer was this capital available from the comfortable margins of the past.'"[85] Frederick Townsend, an industry consultant, stated "[A]mong smaller and medium-sized mutual life companies, the trend is to merge or demutualize."[86] In fact, the number of mutual life companies declined by twenty-six percent from 1953 to 1987.[87]

Two examples of the trend among smaller mutual companies are the conversions of Shelby Mutual of Ohio and Maccabees Mutual Life of Michigan. Both companies underwent conversions and were subsequently acquired by third parties. Immediately after the conversion of Shelby

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78. *See* Leslie Wayne, *$203 Million Drop in Surplus Reported by Equitable Life*, N.Y. TIMES, Mar. 5, 1991, at D6.

79. In 1986, Union Mutual of Maine demutualized even though it was financially successful because conversion would allow it to raise additional capital in the future. *See In re* Plan of Recapitalization and Conversion of Union Mut. Life Ins. Co., Final Decision and Order of the Maine Bureau of Ins., at 5 (Aug. 8, 1986) [hereinafter Union Mut. Plan].

80. *See* Eric D. Randall, *Analysts Praise Equitable Stock Sale*, USA TODAY, July 23, 1992, at B3.

81. *See id.* Prior to public offering, Equitable had received a one billion dollar investment from French Insurance Company. *See* Peter Kerr, *Equitable Seeks Radical Change*, N.Y. TIMES, April 7, 1992, at D10.

82. *See* Adam Bryant, *Equitalbe Prices Initial Offering at $9*, N.Y. TIMES, July 16, 1992, at D4. Of the proceeds, smaller portions were provided to Equitable policyholders, and a small portion became part of the surplus of the compnay. *See* Kerr, *supra* note 81.

83. *See id.*

84. Kurt Eichenwald, *Equitable Backs Plan to Go Public*, N.Y. TIMES, Nov. 28, 1991, at D3. Under the plan, the insurance company would become a subsidiary of the new Delaware holding company. *Id.*

85. Jim Connolly, *Product Trends for '90s Emerging*, NAT'L UNDERWRITER, Apr. 3, 1989 (Life & Health/Financial Services ed.), *available on* LEXIS, Insurance Library, Nulife File.

86. Frederick Townsend, *Companies Map Strategies For Survival*, NAT'L UNDERWRITER Feb. 13, 1989 (Life & Health/Financial Services ed.), *available on* LEXIS, Insurance Library, Nulife File.

87. *Id.*

Mutual, which was apparently motivated by a need for new capital,[88] an outside investor purchased most of its equity.[89] Shelby policyholders received one-third of the converted company's stock in the form of preferred shares.[90] The policyholders did not, however, receive the proceeds from the sale to the third party.[91]

In 1989, Maccabees Mutual Life was acquired after demutualization by Royal Financial Corporation, a British insurance company, which made a large capital contribution to Maccabees.[92] Maccabees' policyholders were compensated by cash payments calculated to reflect each policy's contribution to the company's surplus.[93]

Demutualizations also may occur after a mutual company has experienced significant losses, which make it necessary to raise additional capital. After suffering large losses, one mutual company recently demutualized and at the same time was acquired by another insurance company.[94] A former president of the National Association of Insurance Commissioners maintains demutualizations usually are not caused by serious financial troubles; rather, most conversions are motivated primarily by long-term capital needs.[95]

2. *Increased Opportunities For Diversification*

Mutuals often cite regulatory restrictions on diversification as a reason for conversion.[96] Under state law, insurance regulators may examine the affairs of any insurance company.[97] If a mutual company acquires a

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88. Shelby Mutual was not in financial trouble when it converted because its policyholders received conversion payments. Telephone Interview with David Emmens, Litigation Specialist with Shelby Insurance Co. (May 8, 1991). If the company had a negative surplus due to severe losses, the policyholders would not be entitled to receive any payments because their interests would be deemed valueless under state law. *Id.*

89. *See* Prospectus for the Conversion of Shelby Mutual, at 3 (1985) (on file with author).

90. *See id.*

91. *See id.*

92. The company is now named Maccabees Insurance Company. Telephone Interview with Richard McDermott, Associate Corporate Counsel of Maccabees Insurance Co. (July 19, 1990).

93. *Id.*

94. One small company, American Mutual Fire Insurance Company, recently announced it would demutualize after suffering a large loss because of Hurricane Hugo. When the conversion is completed, the company will be acquired by Amerisure, a subsidiary of Michigan Mutual. *See* Robert G. Knowles, *Amerisure Seeks Control of American Mutual*, NAT'L UNDERWRITER, Apr. 23, 1990 (Property & Casualty/Risks & Benefits ed.), *available on* LEXIS, Insurance Library, Nuprop File.

95. Telephone Interview with Bruce Foudree, *supra* note 44.

96. *See* Jeffrey A. Koeppel, *Some Cogent Reasons for Demutualization*, NAT'L UNDERWRITER Feb. 27, 1989 (Life & Health/Financial Services ed.), *available on* LEXIS, Insurance Library, Nulife File; *see also* Union Mut. Plan, *supra* note 79, at 5.

97. *See, e.g.*, ARIZ. REV. STAT. ANN. §§ 20-142(c), 20-156 (1990) (providing that insurance director shall have the authority to enforce the insurance law, promulgate regulations, and conduct examinations of insurance matters, and "shall examine the affairs, transactions,

downstream subsidiary, regulators may examine the subsidiary because it is not separate from the mutual company.[98] Experts on mutual insurance companies insist subsidiaries decrease organizational flexibility.[99]

Stock companies are subject to fewer statutory constraints because they can form upstream holding companies, which can then own various subsidiaries engaged in insurance and other activities.[100] Under this arrangement, the noninsurance subsidiaries are organizations separate from the insurance company, although all are owned by the same holding company.[101] Nevertheless, extra regulation does not appear to be a serious constraint on the activities of mutual companies, as evidenced by two of the largest mutuals, Prudential and Equitable, which owned several financial services subsidiaries through downstream holding companies.[102]

Equitable had argued that demutualization and the creation of an upstream holding company would make future diversification more feasible.[103]

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accounts, records and assets of each authorized insurer as often as he deems advisable"); N.Y. INS. LAW § 309 (McKinney 1985) (providing that superintendent may examine the affairs of any insurance corporation or other insurer doing or authorized to do insurance business in New York); S.D. CODIFIED LAWS ANN. §§ 58-5-118 to -119 (1990) (providing that director may declare insurance company insolvent and begin delinquency proceedings if company's capital is impaired).

98. *See, e.g.*, N.Y. INS. LAW § 309 (McKinney 1985); *see also* Telephone Interview with Wolcott B. Dunham, Jr., *supra* note 65.

99. *See* Koeppel, *supra* note 96.

100. At least in New York, stock companies that own insurance subsidiaries are subject to regulation by insurance authorities. *See* N.Y. INS. LAW § 1505 (McKinney 1985) (allowing superintendent to regulate transactions between a controlled insurer and other subsidiaries of a holding company); *see also* Koeppel, supra note 96 (noting that if a company demutualizes and forms a holding company that will own the insurance company and other business acquisition, "[those] acquisitions can be made in a manner [that] would not reduce statutory surplus" and may limit state regulation of the noninsurance subsidiaries).

101. A holding company owns several corporations. *See, e.g.*, N.Y. INS. LAW § 1501(3) (McKinney 1985) (covering holding companies that own insurers); *see also* David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1616-18 (1991) (discussing holding companies that own several other corporations).

102. Prudential owns Prudential-Bache Securities and several other subsidiaries, while Equitable owns the brokerage house of Donaldson, Lufkin & Jenrette, as well as several other financial services subsidiaries. *See Equitable Rating Lowered*, *supra* note 72; Phillip H. Wiggins, *Prudential Rejects Conversion Plan*, N.Y. TIMES, Mar. 28, 1985, at D10. Foudree insists most mutuals convert to raise capital. Telephone Interview with Bruce Foudree, *supra* note 44. He maintains mutual companies can also effectively raise capital by forming a downstream stock company, which can then sell shares to the public. *Id.*

103. *Equitable to Develop Demutualization Plan*, *supra* note 13. Equitable's CEO, Richard Jenrette, commented, "The Equitable is precluded by its mutual structure from certain transactions, such as acquisitions and joint ventures, with shareholder-ownerd institutions. Equitable wants to be an equal participant on a level playing field." *Id.* Jenrette also noted that "[a]s a mutual, [Equitable is] precluded from raising capital through the sale of equity to investors." *Id.*; *see also* Koeppel, *supra* note 96 (noting that demutualization can allow a company

The company also claimed demutualizing would allow it to raise and allocate capital more efficiently because the stock holding company would be able to raise capital that could then be distributed to its various subsidiaries.[104] Equitable also noted the stock corporation would be able to form joint ventures with other stock corporations, and its subsidiaries would be able to merge with stock corporations.[105] Equitable's subsidiaries presently cannot merge with stock companies because New York law generally prohibits a mutual insurance company from merging with a stock corporation.[106]

3. *Increased Management Compensation Through Stock Options*

Executives of converting mutuals have also cited the need to improve their institutions' managerial quality as a reason for demutualization.[107] Managers believe conversion will enable them to attract and develop a competitive spirit among top management by offering stock options tied to performance.[108] They insist mutuals often lose qualified managers because they cannot pay them as much as stock companies.[109] In fact, Equitable's chief executive officer maintained that a post-conversion Equitable would be better able to retain managers through the use of stock options.[110] Managers also argue conversion will help them focus on the bottom line because the company's stock price will depend on earnings.[111]

Increasing management compensation with stock options may be a questionable rationale for demutualization because mutual companies can offer their executives performance-related salary bonuses. Although performance bonuses only rarely would equal the value of stock options, managers of mutual organizations are compensated in part by job security, which may not exist in a converted company facing pressure to increase earnings. A demutualization is a complicated and costly transaction, during which a company may be required by insurance authorities to requalify all of its

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to increase business diversification because the company can pay in shares of stock for another insurance company).

104. *See Equitable to Develop Demutualization Plan*, *supra* note 13; *see also* Connolly, *supra* note 85 (noting that four medium-sized mutual companies have demutualized in recent years because of the need for capital growth); Koeppel, *supra* note 96 (noting that the need for capital is the primary reason life insurance companies demutualize).

105. *See Equitable to Develop Demutualization Plan*, *supra* note 13.

106. *See* N.Y. INS. LAW § 7102 (McKinney 1985 & Supp. 1993) (generally barring mergers between stock and mutual companies).

107. *See Equitable to Develop Demutualization Plan*, *supra* note 13.

108. *See id.* Richard Jenrett, chief executive officer of Equitable, stated, "Unlike stock companies, mutuals cannot offer stock options as part of [their] incentive compensation to attract and retain talented people. After conversion . . . stock options would be available for use as incentive compensation." *Id.*; *see also* Koeppel, *supra* note 96 (noting that senior employees expect to receive equity participation a part of their compensation).

109. *See Equitable to Develop Demutualization Plan*, *supra* note 13.

110. *Id.*

111. *See* Union Mut. Plan, *supra* note 79, at 5.

policies for sale in each state.[112] It would be wasteful for a company to incur the enormous costs of demutualization only to increase compensation for executives.

4. *Management Buyouts of the Company*

Managers of mutual companies may favor demutualization if they can purchase a controlling interest in the company.[113] Although common before 1930, this practice apparently has become less frequent in recent years.[114] Two commentators have noted some of these conversions were designed to give management ownership of the insurance company for an inadequate price.[115] In response to those transactions, many states enacted laws banning mutual stock conversions. These laws since have been repealed in almost every state.[116]

B. *Is Demutualization Economically Efficient?*

Although the question of whether demutualization is economically efficient cannot be answered definitively, many experts have argued mutual companies are no longer competitive with stock companies. For example, one commentator argues mutual companies rose to prominence in the nineteenth century for economic reasons that no longer exist.[117] Because mutuals are not subject to the constraints of the market for corporate control, their management may not be sufficiently motivated to reduce costs and increase market share. Thus, over time the mutual insurers may not compete successfully with stock companies.[118]

There is substantial, albeit inconclusive, evidence supporting this theory of the mutual insurance company's decline. For many years the assets

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112. Telephone Interview with Richard McDermott, *supra* note 91.

113. *See* Hansmann, *supra* note 4, at 300.

114. *See* Gurley & Dwyer, *supra* note 3, at 128-29.

115. *See id.* The drafters of the revised Wisconsin demutualization statute noted that in many transactions occurring between 1900 and 1930 policyholders were compensated unfairly. *See* WIS. STAT. ANN. § 611.76, 1971 committee cmt., at 287-88 (West 1980) (prefatory note to § 611.76).

116. *See* Gurley & Dwyer, *supra* note 3, at 130. No state now prohibits demutualization. Two states prohibit a simple conversion from mutual to stock but allow bulk reinsurance conversions. *Compare* IDAHO CODE § 41-2855 (stating "a mutual insurer shall not be converted into a stock insurer") *with* IDAHO CODE § 41-2858 (1977) (permitting a mutual insurer to convert by an agreement of bulk reinsurance if the director of insurance finds that each policyholder has received her percentage of the equity in cash); *compare* HAW. REV. STAT. § 431:4-503(a) (1988) (prohibiting the conversion of any domestic mutual into a stock corporation) *with* HAW. REV. STAT. § 431:4-503(b) (1988) (allowing any mutual insurer to enter into a bulk reinsurance transaction with the approval of the commissioner if the agreement provides for reasonable compensation to policyholders).

117. *See Equitable to Develop Demutualization Plan*, *supra* note 13.

118. *See supra* note 13.

of stock companies have grown more rapidly than those of mutuals, and the number of mutual life companies has declined since 1954.[119] These figures indicate few mutual insurance companies have formed since 1954, and many have apparently converted to stock ownership or merged. At the same time, few stock companies have mutualized.[120] In fact, the trend towards demutualization also has dramatically reduced the number of mutual savings and loan institutions.[121] Finally, most authorities and mutual executives agree stock corporations are more performance oriented.[122] If the statistics and observations of most authorities are correct, demutualization probably benefits society.

IV. LEGAL REGULATION OF DEMUTUALIZATION

A. *Introduction to Statutes Regulating Demutualization*

A mutual company may convert to a stock corporation pursuant to a statute, by entering into a bulk reinsurance transaction, or by merging with an existing stock insurance company. Demutualization statutes, which have been enacted by many states, allow a mutual company to transfer all of its obligations to a stock company which then distributes its shares to the general public. The statutes regulate the substantive terms of demutualization plans and the procedures required before plans may be implemented. Eleven states have not enacted demutualization statutes.[123]

Many states have enacted statutes that arguably permit conversions through the use of bulk reinsurance. Reinsurance statutes, which authorize insurance companies to reinsure all liabilities,[124] have been interpreted to permit demutualization by a bulk reinsurance transaction.[125] In a bulk reinsurance transaction a mutual company creates a stock company that reinsures all of the mutual's policies in return for all of its assets.[126] The mutual company is then dissolved and its policyholders receive any remaining assets.[127]

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119. Hansmann, *supra* note 1, at 137.

120. *Id.* (discussing decline in mutual life insurers from a high of 171 in 1954 to 135 in 1981).

121. Between 1976 and 1988, 735 savings and loans converted from mutual to stock ownership. *See* Koeppel, *supra* note 96.

122. *See Equitable to Develop Demutualization Plan*, *supra* note 13.

123. These states include Colorado, Connecticut, Illinois, Iowa, Massachusetts, Mississippi, Missouri, New Hampshire, North Carolina, Tennessee and Texas.

124. *See, e.g.*, OKLA. STAT. ANN. tit. 36, § 2134 (West 1990) (allowing a bulk reinsurance transaction subject to the insurance commissioner's approval).

125. *See* Babbel & Jones, *supra* note 58.

126. *See id.*; *see also* Fenske, *supra* note 58.

127. Louisiana has enacted a statute that grants its insurance commissioner discretion to approve a demutualization. *See* LA. REV. STAT. ANN. §§ 22:801, :806 (West 1978) (authorizing insurance commissioner to approve a demutualization if in the best interests of policyholders).

Several states with demutualization statutes have also enacted reinsurance statutes. In several states demutualization statutes apparently apply to all mutual-to-stock conversions of insurance companies. Washington, for example, permits the conversion of an insurance company by either bulk reinsurance or reorganization, but any conversion must comply with the demutualization statute.[128] In all likelihood, bulk reinsurance transactions would occur only in states without demutualization statutes. Yet, it is conceivable a state with a demutualization statute might view a bulk reinsurance transaction or a merger as an exception to its demutualization statute.

Apparently, few companies have demutualized through bulk reinsurance transactions, because those transactions create significant tax liabilities.[129] As a result, mutuals have lobbied state legislatures to enact demutualization statutes,[130] while other states have enacted statutes allowing individual companies to demutualize.[131] Therefore, bulk reinsurance transactions, while permitted in some states, are not a standard method of demutualization.

Although most states expressly prohibit mergers between mutuals and stock corporations, a few states do permit them.[132] Even in states that allow these mergers, any merger requires either the mutual company to demutualize or the stock company to mutualize.[133] For exammple, if a

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Charles Thompson of the Louisiana Insurance Department maintained that a company could convert to stock ownership by forming a stock company that would reinsure all of the mutual company's liabilities. Telephone Interview with Charles Thompson, staff member of the Louisiana Department of Insurance (Oct. 19, 1990). The mutual company would then be liquidated. *Id.*

128. *See* WASH. REV. CODE ANN. § 48.09.350 (West 1992); *see also* HAW. REV. STAT. § 431:4-504 (Supp. 1992); IDAHO CODE § 41-2858 (1991); OKLA. STAT. ANN. tit. 36, § 58-5-123 (1990); Arkansas has both a demutualization statute, *see* ARK. CODE ANN. § 23-69-141 (Michie 1987), and a merger statute for mutual companies. *See id.* § 23-69-143 (requiring commissioner to apply § 141 "to the fullest extent possible").

129. *See* Fenske, *supra* note 58.

130. Richard Jenrette, Equitable's chief executive officer, stated that his company, "along with other insurers, worked with the New York State Insurance Department to create legislation [that] now allows mutual insurance companies to demutualize." *See Equitable to Develop Demutualization Plan,* supra note 13; *see also* Telephone Interview with Janet Belkin, former vice president and counsel of Equitable Life Assurance Society (Sept. 21, 1990).

131. *See, e.g.*, N.Y. INS. LAW § 7312 (McKinney Supp. 1993); *see also* Telephone Interview with Richard McDermott, *supra* note 91.

132. All states permit insurance companies to merge, *see, e.g.*, N.Y. INS. LAW § 7102(a)(1) (McKinney 1985), but few states allow mutuals to merge with stock companies. *See, e.g.*, *id.* § 7102(b). *But see* ARK. CODE ANN. § 23-69-143 (Michie 1987) (permitting mutual companies to merge with stock companies).

133. Several states allow mutuals to merge with stock insurers and several states prohibit mergers. *Compare* IDAHO CODE § 41-2857 (1991) (prohibiting mergers) *and* OKLA. STAT. ANN. tit. 36, § 2133 (West 1990) *with* ARK. CODE ANN. § 23-69-143 (Michie 1987) (allowing mergers but requiring compliance with demutualization statute if insurance department so requires) *and*

mutual company converted to a stock company, the new stock company could merge with another stock company. Policyholders would probably receive either cash or stock in the acquiring corporation for their ownership interests in the mutual. Many states require both the demutualization and merger to comply with their demutualization statutes.[134] Should a state court hold the demutualization statute inapplicable to cases in which a stock company acquires a mutual company by merger, the insurance commissioner then would have broad discretion to approve that type of transaction. The specific protections a demutualization statute provides would not apply to a transaction governed by a merger statute.[135]

B. *State Law Standards Regulating Demutualization*

State statutes expressly regulating demutualization fall into several broad groups. Many states, including Virginia, have enacted statutes that give state insurance authorities broad discretion to approve conversions.[136] Several states, including Florida, have enacted identical demutualization statutes that provide substantial protections for policyholders.[137] New York, Ohio, Pennsylvania, Wisconsin,[138] and the National Association of Insurance Commissioners ("NAIC"),[139] through its model act, have provided further

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GA. CODE ANN. § 33-14-75(a) (Harrison 1990) (allowing mergers) *and* S.D. CODIFIED LAWS ANN. § 58-5-134 (1990) (allowing mergers).

134. *See, e.g.*, WASH. REV. CODE ANN. § 48.09.350 (West 1992).

135. Merger statutes typically grant insurance authorities broad authority to approve transactions. *See, e.g.*, ARK. CODE ANN. § 23-69-143 (Michie 1987) (providing the commissioner shall approve a merger unless it is inequitable to the policyholders of either insurer).

136. *See* VA. CODE ANN. § 38.2-1005 (Michie 1990).

137. FLA. STAT. ANN. § 628.441 (West 1984). The statutes of Alabama, Arizona, Arkansas, Georgia, Kentucky, Maryland, Montana, Oklahoma, West Virginia and Wyoming are almost identical to the Florida statute. *See* ALA. CODE § 27-27-44 (1986); ARIZ. REV. STAT. ANN. § 20-730 (1990); ARK. CODE ANN. § 23-69-141 (Michie 1987); GA. CODE ANN. § 33-14-76 (Harrison 1991); KY. REV. STAT. ANN. § 304.24-380 (Michie/Bobbs-Merrill 1988); MD. ANN. CODE art. 48A, § 270 (Supp. 1990); MONT. CODE ANN. § 33-3-216 (1991); OKLA. STAT. ANN. tit. 36, § 2130 (West 1990); W. VA. CODE § 33-5-24 (1992); WYO. STAT. § 26-24-147 (1991). Some commentators refer to these statutes as the "Williams model statutes," although they are not a uniform law. *See, e.g.*, Fenske, *supra* note 38, at 102. The state statutes are similar because the insurance codes were redrafted in the 1950s by Robert Williams of Seattle, Washington. Telephone Interview with Joseph McCloud, former state senator of Maine and chairman of committee that redrafted Maine's insurance code (Oct. 3, 1990).

138. N.Y. INS. LAW §§ 7307, 7312 (McKinney Supp. 1991); OHIO REV. CODE ANN. § 3913.20-23 (Anderson 1989); PA. STAT. ANN. tit. 40, § 1010.1-14 (1992); WIS. STAT. ANN. § 611.76 (West 1991).

139. NAIC Life Demutualization Study Group, Draft Reorganization of Mutual Life Insurer Act (1988), *available on* LEXIS, Insurance Library, NAIC File (presented at the Winter National Meeting of the National Association of Insurance Commissioners, Dec. 6-11, 1987) [hereinafter NAIC Draft]. A committee of the NAIC has prepared a draft model act for life insurance companies that is very similar to New York's life insurance demutualization statute enacted in 1988. Telephone Interview with Meir Baruch, former staff member of the New York

protections. Nevertheless, few of the provisions contained in any of these statutes adequately protect the ownership interests of policyholders.

1. *The Demutualization Plan*

A demutualization plan must first be approved by a mutual company's board of directors.[140] The Nebraska Supreme Court has held that directors of a mutual company must carefully examine any company valuation before approving a plan.[141] Review by the board of directors, however, represents only a minimal protection for policyholders.

2. *The Commissioner's Investigation*

After approval by the mutual's board of directors, the demutualization plan must be submitted to the state insurance authorities for their approval.[142] The state authorities often have broad powers to review the plan and investigate the finances of the mutual company. New York, for example, allows its superintendent of insurance to hire consultants to examine the company's finances, and to hire an actuary to examine a life insurance company.[143] State insurance authorities also have broad powers to examine the plan valuation of the company's surplus.[144]

3. *The Standard of Review for the Plan*

Virginia's demutualization statute is typical of those statutes that leave state insurance authorities in charge of the demutualization process.[145] It provides only that a conversion must be approved by the insurance commission, a panel composed of the insurance commissioner and other regulators.[146] Michigan's demutualization statute allows the mutual to submit a plan of reorganization to the insurance commissioner after

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Department of Insurance (July 10, 1990). In fact, the model drafting committee, established in 1987, included several officials of New York's Department of Insurance. *Id.* This draft is not final and the committee has stopped meeting regularly. *Id.* One regulator who worked with the committee said the interest in the NAIC model demutualization statute tapered off in 1987. *Id.* New York's Department of Insurance apparently lost interest in the NAIC draft after the state enacted the life demutualization statute. *Id.*

140. *See, e.g.*, MICH. COMP. LAWS ANN. § 500.5901(2)(a) (West Supp. 1992).

141. Doyle v. Union Ins. Co., 277 N.W.2d 36, 44 (Neb. 1979).

142. *See, e.g.*, ARK. CODE ANN. § 23-69-141(a) (Michie 1987); GA. CODE ANN. § 33-14-75(h) (Harrison 1991); N.Y. INS. LAW § 7312(j) (McKinney Supp. 1993); WIS. STAT. ANN. § 611.76(7) (West 1980 & Supp. 1992).

143. *See* N.Y. INS. LAW § 7312(h)(2) (McKinney Supp. 1993).

144. *See infra* part IV.B.4.

145. *See* VA. CODE ANN. § 38.2-1005 (Michie 1990).

certifying that it will not be "prejudicial" to the insurer's policyholders.[147] After policyholders approve the plan, it must be submitted to the insurance commissioner for final approval.[148] The commissioner has "discretion" to approve or reject the plan.[149] Seldom-used bulk reinsurance statutes also give state insurance authorities broad discretion to review demutualization plans.[150]

Most other demutualization statutes contain a provision that requires state insurance authorities to determine whether a plan is fair and equitable to the policyholders. Florida's statute, for example, provides that the department of insurance must determine that a demutualization plan "is equitable to the insurer's members."[151] Washington similarly requires that a reorganization plan be approved by the insurance commissioner, who must determine first that the plan offers "reasonable compensation" for the policyholder's equity interests.[152] New York's demutualization statute for life insurance companies provides that "a plan of reorganization must . . . be in the best interest of the mutual life insurer and its policyholders; [and] . . . be fair and equitable to policyholders."[153] The New York property-casualty demutualization statute contains a similar provision. After conducting a public hearing, the superintendent of insurance may approve the plan if it "is fair and equitable and is in the best interests of the policyholders and the public."[154] The preliminary draft of the NAIC model demutualization act also requires that any plan be fair and equitable to policyholders.[155]

The "fair and equitable" standard has not been defined by regulators or court decisions. There is no legislative history available that offers a meaningful definition of the standard.[156] At a minimum, the standard must mean that a demutualization plan must not unfairly discriminate between classes of policyholders; any plan compensating one class of policyholders more than others, such as a plan that did not compensate policyholders who have

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146. *Id.*

147. MICH. COMP. LAWS ANN. § 500.5901(2)(b) (West Supp. 1992).

148. *Id.* § 500.5901(3)-(4).

149. *Id.* § 500.5901(4)(c).

150. *See, e.g.*, OKLA. STAT. ANN. tit. 36, § 2134(B) (West 1990) ("A domestic mutual insurer may reinsure all or any part of its business in force . . . with another insurer, stock or mutual, by agreement or reinsurance treaty. . . . subject to the approval of the [i]nsurance [c]ommissioner.").

151. FLA. STAT. ANN. § 628.441(2)(a) (West 1984).

152. WASH. REV. CODE ANN. § 48.09.350(3) (West Supp. 1992).

153. N.Y. INS. LAW § 7312(c) (McKinney Supp. 1993). The superintendent must then approve the plan if it "is fair and equitable to the policyholders and is not detrimental to the public." *Id.* § 7312(j).

154. *Id.* § 7307(h)(1).

155. *See* NAIC Draft, *supra* note 139, § 4 (providing that plan must be fair and equitable to policyholders).

156. The drafters of New York's life demutualization statute did not prepare legislative history, nor did they prepare a committee report. Telephone Interview with Meir Baruch, *supra* note 139; Telephone Interview with Janet Belkin, *supra* note 130.

contributed to the earnings of the company, would not be considered fair and equitable.

The "fair and equitable" standard is utilized in certain reorganization proceedings under Chapter 11 of the Bankruptcy Code. In certain circumstances, the court may confirm a proposed reorganization plan not approved by all classes of creditors if the plan is fair and equitable to a dissenting class that is impaired under the plan.[157] The bankruptcy court also must find that the plan compensates the dissenters to the extent of their allowed claims against the debtor.[158] To determine whether the plan is fair and equitable, the court must value the debtor, often by determining which of several contradictory valuation studies is most accurate.[159] In reviewing a demutualization, insurance regulators must also compare valuation studies.[160] Commentators have argued the bankruptcy court cannot value the debtor as accurately as the market can.[161] If this criticism of Chapter 11 is valid, it follows that insurance regulators cannot be as accurate as the market either. As this Article argues in section V.D., the inaccuracy inherent in the fair and equitable standard should be replaced by a market valuation requirement.

4. *Methods of Valuation*

Few statutes require insurance authorities to use any particular method of valuing a converting mutual, and no state requires the value of the insurer be determined by the market. Florida, for example, allows the insurance department to determine the appropriate method of valuing the company.[162] The statute does not specify whether generally accepted accounting principles ("GAAP"), or the book value of the company's assets, is to be used when determining a company's value.[163] New York's statutes encourage the superintendent to examine demutualization plans closely to determine the insurer's value. The New York property-casualty statute requires the superintendent to order an examination of the company, which must include the appointment of independent appraisers to determine the company's "fair market value."[164] For conversions of life insurers in New

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157. *See* 11 U.S.C. § 1129(b)(1) (1988).

158. *Id.* § 1129(b)(2).

159. *See* Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 135-37 (1986).

160. *See* Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 547-48 (1983).

161. *Id.*

162. FLA. STAT. ANN. § 628.441(2)(c) (West 1984) (requiring each policyholder's corporate equity be determined under a formula based upon the insurer's surplus and be approved by insurance department).

163. *See id.*

164. N.Y. INS. LAW § 7307(c) (McKinney Supp. 1993).

York, the superintendent may also appoint an actuary[165] that presumably would determine the present value of the company's outstanding insurance policies. The NAIC's model act does not specify any particular method of valuing a mutual insurer's surplus.[166]

One court in Nebraska, a state without a demutualization statute, required a mutual company's directors to examine carefully a conversion plan to determine whether the company's valuation was accurate. In *Doyle v. Union Mutual Insurance Co.*,[167] a majority of the directors had approved a demutualization plan that provided an acquiror would receive eighty percent of the equity of the converted company, with twenty percent of the equity acquired by a group of the mutual's managers.[168] The managers, who paid twenty-five thousand dollars to acquire their interest in the converted company, also relied on accountants hired by the acquiror to value the surplus of the company for distribution to policyholders.[169] One director objected to the plan because it did not provide for an independent valuation of the company and because management had made no effort to offer an interest in the company to other investors.[170] The transaction, nevertheless, was approved by the insurance commissioner under a bulk reinsurance statute, and was later ratified by a majority of the company's policyholders.[171]

Following a suit brought by the policyholders, the Nebraska Supreme Court held the approving directors liable for breach of fiduciary duty because they had not properly "inform[ed] themselves" about the demutualization plan before approving it.[172] In fact, the court concluded many directors had not even read the agreement, and criticized the directors for failing to determine whether the valuation study prepared by the acquiror's accountants was accurate.[173] *Doyle* is the only case to hold directors of mutual insurance companies liable for breach of fiduciary duty for failing independently to determine the full value of a mutual insurer pursuant to a demutualization plan.[174]

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165. *Id.* § 7312(h)(2).

166. *See* NAIC Draft, *supra* note 139.

167. Doyle v. Union Ins. Mut. Co., 277 N.W.2d 36, 46 (Neb. 1979).

168. *Id.* at 42.

169. *Id.*

170. *Id.* at 43.

171. *Id.* at 39.

172. *Id.* at 44. The court held the insurance commissioner's approval of the transaction did not shield the directors from liability for breach of their fiduciary duty. *Id.* at 41. In Rowen v. LeMars Mut. Ins. Co., 230 N.W.2d 905 (Iowa 1975), the policyholders challenged the conversion of a mutual company on the ground that managers breached their fiduciary duties to policyholders. *Id.* at 911. The court held the policyholders were not required to exhaust administrative remedies provided by the department of insurance before filing suit, and the case was remanded for trial. *See id.* at 911-12.

173. *See* Doyle v. Union Ins. Mut. Co., 277 N.W.2d at 43.

174. *Id.* at 44. Some courts have not been as willing as the *Doyle* court to intervene on behalf of policyholders. For example, in Ashurst v. Preferred Life Assurance Society, 209 So. 2d 403 (Ala. 1968), the court dismissed a suit by several policyholders who sought a court order to

The *Doyle* court probably would not require the directors of an insurance company to offer an equity interest to the general public or the open market. Instead, directors would probably satisfy the *Doyle* standard and protect themselves from liability by seeking an independent valuation of a company by an investment banking firm.

One state insurance authority has approved a plan valuing the surplus of a company according to generally accepted accounting principles. In the demutualization of Union Mutual in 1986, the Maine insurance department approved the plan which valued the surplus of the company according to GAAP.[175] An accounting valuation of policyholders' equity would, in all likelihood, be far more accurate than the company's book value.

In practice, most companies convert to GAAP accounting standards before proposing demutualization. Industry experts claim GAAP principles allow managers to understand better the actual value of a converting mutual company.[176] In addition, an underwriter of a public stock offering associated with a demutualization usually requires conversion to GAAP principles because it is very difficult to sell securities to the public under a prospectus based on book valuations.[177] Moreover, the Securities Exchange Act of 1933 requires any issuer of securities to obtain a balance sheet disclosing all of the assets and liabilities of the issuer. Securities and Exchange Commision regulation S-X requires that any report by an accoutant "shall state whether the audit was made in accordance with generally accepted auditing standards."[178]

Expert and accounting valuations, while clearly superior to book value, cannot protect policyholders as well as a market test.[179] Indeed, valuations

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distribute the surplus of a nonstock fraternal benefit society after the society converted to a stock company. *Id.* at 411. The society converted to a stock insurance company pursuant to several provisions of the Alabama insurance code. *Id.* at 406 (citing ALA. CODE §§ 28.236-244 (1940)). The plaintiffs alleged the conversion statutes were unconstitutional because they permitted the conversion of the society without the distribution of the surplus. *Id.* The Alabama Supreme Court held the members of the society "did not have a divisible and vested interest in the surplus" of the society. *Id.* at 414. The court also held the surplus of the fraternal society was the property of the members as a group, and thus could not be distributed as a dividend to the shareholders of the converted company. *Id.* at 415-16. Although the case is distinguishable because it involves a fraternal benefit society rather than a mutual insurance company, the decision contradicts policies articulated in the demutualization statutes and the *Doyle* case.

175. *See* Union Mut. Plan, *supra* note 79, at 13.

176. *See* Fenske, *supra* note 38.

177. Fenske, *supra* note 58 (noting that demutualization requires the company to change to GAAP accounting to better assess its current and future earnings). Indeed, Fenske notes that many mutuals have already changed to GAAP accounting because the prior method of keeping track of earnings (surplus) is outmoded. *Id.* Other commentators agree that mutuals must adopt GAAP accounting to demutualize. *See* Babbel & Jones, *supra* note 58; Ducharme, *supra* note 38.

178. 17 C.F.R. § 210.02 (1992).

179. *See* Baird, *supra* note 159, at 136-37, RoThis rule specifically provides:

It shall be unlawful for any person, directly or inde, *supra* note 160, at 547-48.

by experts are only estimates of the insurers' market value.[180] Valuations of a mutual company by potential acquirors will be far more accurate because potential acquirors have the best economic incentives to make proper valuations.[181]

5. *Determining Each Policyholder's Equity*

Most statutes grant state insurance authorities broad discretion to determine the method of distributing policyholders' equity. Florida, for example, requires the demutualization plan to determine each policyholder's equity "under a fair formula approved by the department."[182] In Washington, a converting mutual must pay each policyholder a percentage of its assets.[183] A policyholder's share of the total assets is the proportion of the policyholder's premium payments for the prior thirty-six months to the entire amount of premiums received by the insurer during that period.[184] Michigan's statute does not provide a method for determining compensation for each policyholder.[185]

New York has developed detailed standards for determining the equitable share of each policyholder. According to its property-casualty statute, each policyholder's equitable share is determined by dividing the premiums paid by the policyholder during the three years prior to the demutualization proposal by the total premiums received by the insurer.[186] This formula is similar to Washington's.[187]

The New York demutualization statute that governs life insurance companies provides three formulas for determining policyholders' equity. Under the first formula, policyholders must receive all the insurer's equity in the form of common shares, or a combination of common shares and consideration equal to the proceeds of any public offering of shares.[188] The consideration to be paid to individual policyholders is determined by dividing the company's outstanding policies into classes.[189] The consideration must be allocated in a "fair and equitable" manner.[190] The plan may take into account the estimated proportionate contribution of each class of participating policies

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180. *Id.*

181. *See* Baird, *supra* note 159, at 136-37. Baird argues expert valuations used in reorganization proceedings under Chapter 11 cannot be as accurate as a market valuation by auction. *Id.*

182. FLA. STAT. ANN. § 628.441(2)(c) (West 1984).

183. WASH. REV. CODE ANN. § 48.09.360(3) (West 1992).

184. *Id.*

185. *See* MICH. COMP. LAWS ANN. § 500.5901 (West Supp. 1992).

186. N.Y. INS. LAW § 7307(e)(3) (McKinney 1993).

187. *See supra* text accompanying notes 183-84.

188. N.Y. INS. LAW § 7312(d)(1)(B) (McKinney 1993).

189. *Id.* § 7312(d)(1)(C).

190. *Id.*

and contracts to the aggregate consideration to be paid to the policyholders.[191] This method protects policyholders by ensuring they receive either all of the shares of the insurer, or a combination of shares and the proceeds of a public offering.[192] This method also ensures different classes of policyholders are not subject to discriminatory treatment.

The statute's second method directs the insurer to sell shares of stock at a price equal to its estimated value in the public market.[193] The policyholders' equity is determined in a complicated fashion. First, the insurer must place the policies in force on the date of reorganization into a "closed block of participating business."[194] The insurer must then allocate to the closed block the assets "reasonably expected to be sufficient to support such business" and pay claims.[195] The policyholders' equity is equal to the excess of the insurer's assets accumulated from the operations of participating policies over the sum of the assets allocated to the closed block and the assets necessary to meet reserve requirements.[196] The policyholders' membership interest is to be exchanged for consideration equal to the policyholders' equity, nontransferable preemptive rights to purchase all of the shares of the insurer, and ten percent of the proceeds of the initial public offering.[197] The plan must also create a policyholders' preference account that provides for a payment to policyholders in the event the insurer is liquidated.[198]

This method for determining policyholder's equity will not protect the policyholders as well as the first. Under the second method, policyholders are guaranteed only ten percent of the proceeds of the public offering, but also must receive consideration equal to their equity and nontransferable preemptive rights to purchase all the insurer's shares.[199] Under this section, the company, with the approval of the insurance commissioner, would estimate the total amount of the policyholders' equity. The preemptive rights provision would allow policyholders to invest their equity in the insurer's shares. Policyholders would have a strong incentive to exercise the preemptive rights because that appears to be the only way they could derive any value from them. Policyholders that did not exercise the preemptive rights would apparently forfeit their shares to the company, which in turn could sell them to the public. A better method, this Article will later argue, would be to

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191. *Id.*

192. The NAIC draft model statute sets forth a nearly identical method. *See* NAIC Draft, *supra* note 139, § 5(a) (setting forth a stock/stock proceeds method).

193. N.Y. INS. LAW § 7312(d)(2)(A) (McKinney Supp. 1993).

194. *Id.* § 7312(d)(2)(A).

195. *Id.* § 7312(d)(5)(B).

196. *Id.* § 7312(d)(2)(C).

197. *Id.* § 7312(d)(2)(D),(E).

198. *Id.* § 7312(d)(2)(D). The NAIC statute contains an identical method. *See* NAIC Draft, *supra* note 139, § 5(B) (setting forth a policyholder equity method).

199. N.Y. INS. LAW § 7312(d)(2)(D),(E) (McKinney Supp. 1993).

distribute all the shares to the policyholders, who would then decide whether or not to participate in a public offering.[200] This method would render unnecessary any estimate of the policyholders' equity.

The third method for determining policyholder's equity grants the superintendent of insurance discretion to structure and approve "any method . . . under which the policyholders' membership interest is converted into or exchanged for consideration determined . . . to be fair and equitable to policyholders."[201] The NAIC draft contains a similar provision which requires only that a demutualization plan be acceptable to the commissioner of insurance.[202] This authority might be used to approve demutualization plans that do not provide for a public offering, or that do not grant the policyholders preemptive rights to all shares sold in an offering. In short, this provision permits transactions that do not live up to the requirements set forth in either the first or second methods. Perhaps the third method was designed to apply to a financially troubled mutual company that could not successfully offer shares to the public.

6. *The Public Hearing*

Several states require the commissioner or superintendent of insurance to hold a public hearing before approving a demutualization plan. After a plan is submitted to the insurance commission, in New York and Wisconsin, for example, the superintendent must conduct a public hearing after notification to all policyholders.[203] The insurance department can only approve a demutualization plan after the public hearing.[204] A public hearing is unlikely to offer any significant protection for policyholders because policyholders seldom participate in such hearings.

7. *Notification to Policyholders*

After state insurance authorities examine and approve a demutualization plan, the company must notify all policyholders of its terms and hold a special meeting to seek policyholder approval of the plan. In Michigan, for example, after the commissioner grants preliminary approval of the plan, the mutual company must notify its members of the terms of the plan and the

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200. *See infra* part V.

201. N.Y. INS. LAW § 7312(d)(4)(A) (McKinney Supp. 1993).

202. *See* NAIC Draft, *supra* note 139, § 5(C) (allowing any other method approved by commissioner).

203. N.Y. INS. LAW § 7312(k)(I) (McKinney Supp. 1993); WIS. STAT. ANN. § 611.76(6) (West Supp. 1992).

204. N.Y. INS. LAW § 7312(k)(II) (McKinney Supp. 1993); WIS. STAT. ANN. § 611.76(6)-(7) (West Supp. 1992).

date of the special policyholders meeting to approve the conversion.[205] In Wisconsin, policyholders are notified of the terms of the plan before the public hearing.[206]

8. *The Policyholder Vote*

Almost all statutes require any demutualization plan be approved by a supermajority of the policyholders. Florida, for example, mandates any conversion be approved by three-fourths of the policyholders voting at a special meeting to approve the plan.[207] In Michigan, Washington, and most other states, a plan must receive an affirmative vote of two-thirds of the policyholders voting.[208] In Wisconsin, however, a simple majority vote of the policyholders is sufficient for approval.[209] The supermajority voting provisions are not an effective protection for policyholders because most policyholders will approve a demutualization. They reduce only slightly the odds that a transaction unfair to policyholders will be approved.[210]

Most states require a plan to provide each policyholder with one vote, unless the policy specifies otherwise, and allow policyholders to vote in person or by proxy. Florida's statute sets forth the procedure applicable in most states.[211] The policyholders of a Florida mutual may vote in person or by

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205. MICH. COMP. LAWS ANN. § 500.5901(4)(a) (West Supp. 1990). The commissioner must grant preliminary approval of the plan before the public hearing is held. *Id.* § 500.5901(3).

206. WIS. STAT. ANN. § 611.76(6)(a) (West Supp. 1992).

207. FLA. STAT. ANN. § 628.441(2)(b) (West 1984).

208. *See* MICH. COMP. LAWS ANN. § 500.5901(4)(b) (West Supp. 1991); WASH. REV. CODE ANN. § 48.09.350(3) (1992); *see also* N.Y. INS. LAW § 7307(j) (McKinney 1985) (providing two-thirds vote required for conversion of property-casualty insurer); N.Y. INS. LAW § 7312(k)(2) (McKinney Supp. 1993) (two-thirds vote required for conversion of life insurer). Each policyholder is entitled to one vote unless the charter or by-laws of the insurer provide otherwise. N.Y. INS. LAW § 7312(k)(2) (McKinney Supp. 1993).

209. WIS. STAT. ANN. § 611.76(8) (West 1980).

210. Many scholars have recognized that the passivity of shareholders of large corporations has helped entrench management. *See* Bernard Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 527-28 (1990); Henry Butler & Larry Ribstein, *The Contract Clause and the Corporation*, 55 BROOK. L. REV. 767, 772 (1989). Black points out the fact that a shareholder chooses to vote for management's proposals because one vote is not likely to affect the outcome. Black, *supra*, at 527-28. For the shareholder, therefore, the costs of becoming informed about the election outweigh the benefits. *Id.* Black finds shareholder votes valuable only because they can be purchased (with the share of stock) by third-party bidders for the corporation. *Id.*; *see also* Butler & Ribstein, *supra*, at 772 (noting that scholars have accorded value to the votes of dispersed shareholders only when a third party can purchase them to accumulate a control block).

There is no reason to believe mutual policyholders will be more active than corporate shareholders. A mutual policyholder cannot even cast a vote based on his investment in the company; all policyholders can cast only one vote. Therefore, mutual policyholders are probably more passive than shareholders of corporations.

211. *See* FLA. STAT. ANN. § 628.441 (West 1984).

proxy.[212] They also must receive reasonable notice of the special meeting.[213] For life insurance companies, the plan may limit the right to vote to members holding policies "other than term or group policies, and whose policies have been in force for not less than [one] year."[214] This provision serves to limit voting to individual policyholders of more expensive whole life policies. Term policies, sold by mutuals to compete with stock companies, do not usually participate in the profits of the mutual.[215] The provision also allows the mutual to exclude holders of group policies.

Several states allow the insurance commissioners to waive the policyholder notice and approval provisions if the mutual is in financial trouble. Michigan, for example, provides a summary procedure under which a mutual experiencing serious financial problems may request the commissioner to waive the policyholder notice and approval provisions.[216] Under this provision, the mutual may obtain an investment from an independent party, and is not required to make a distribution to its policyholders.[217] Wisconsin has a similar procedure under which the mutual's directors, with the approval of the commissioner, must determine the insurer's value before conversion.[218] All policyholders, upon conversion, are to receive their equitable shares of the company's value.[219]

Both provisions are problematic, because a third party would not be willing to make a capital contribution for a valueless company. If the company is valuable, the third party should pay the policyholders for it. As this Article will argue, this seems to be an ideal case for an auction requirement.[220]

9. *Requirements for Stock Offerings*

Certain states have adopted substantive requirements for public stock offerings following demutualization. Several prohibit management from offering shares to policyholders at one price while offering them to other investors at a lower price. In Florida, the corporation may not offer shares to the "policyholders at a price greater than to be thereafter offered to others."[221] These protections undoubtedly were inserted in statutes to prevent

212. *Id.* § 628.441(2)(b); *see also* MICH. COMP. LAWS ANN. § 500.5901(4)(a)-(b) (West Supp. 1990).

213. FLA. STAT. ANN. § 628.441(2)(b) (West 1984).

214. *Id.*

215. Term policies are pure insurance contracts. They do not allow the policyholder to build up cash values and are not vehicles for investing. Jonathan R. Macey, *Toward a New Pedagogy*, 93 YALE L.J. 1173, 1183 (1984) (book review).

216. MICH. COMP. LAWS ANN. § 500.5901(6) (West Supp. 1990).

217. *Id.*

218. WIS. STAT. ANN. § 611.76(4)(a) (West Supp. 1992).

219. *Id.*

220. *See supra* part V.D.

221. FLA. STAT. ANN. § 628.441(f) (West 1984).

management from discouraging policyholders from purchasing shares by offering them to policyholders at a higher price than offered to other investors. Without such a provision, management might offer stock to preferred buyers.

Wisconsin limits the price of any stock offered to policyholders to a maximum of "one-half of the median equitable share of all policyholders."[222] This provision is designed to prevent directors from setting the price of shares offered to policyholders higher than "what the smaller policyholders can purchase with their portions of the mutual's value."[223] The provision's drafters were evidently concerned that managers would exclude small policyholders from a stock offering. Although these provisions prevent management from excluding small policyholders from an offering of shares, they fail to offer full protection to policyholders because they do not guarantee an accurate valuation of the company.

10. *Preemptive Rights*

Several states grant policyholders preemptive rights to purchase newly issued shares of converting companies. In Florida the plan must grant each policyholder a preemptive right to purchase "his proportionate part of all of the proposed capital stock of the insurer."[224] This provision benefits policyholders because they have the right to purchase all the shares of the converted company. Management can, however, sell the shares of those policyholders that fail to exercise their preemptive rights.

New York's property-casualty statute also contains a preemptive rights provision mandating that, for three years after the conversion, any issuance of stock must first be offered to the original shareholders of the corporation.[225] Under this provision, each policyholder that decides to exercise his preemptive right would be given an opportunity to make an additional investment in the corporation.[226] Most policyholders-turned-shareholders, however, would not purchase additional shares.

A preemptive rights provision is not necessary to protect a converted mutual's policyholders as long as any subsequent stock offering is made to the public. If the initial distribution of equity fairly compensates policyholders, there is no reason to believe a subsequent public offering would prejudice them. Directors and managers would be motivated in a second offering only to raise additional capital, which benefits policyholders by improving the company's ability to pay claims. Preemptive rights provisions might, however, be designed to prevent management from issuing shares to

222. WIS. STAT. ANN. § 611.76(4)(a) (West 1980).
223. *Id.* § 611.76, 1971 committee cmt., at 291.
224. FLA. STAT. ANN. § 628.441(e) (West 1984).
225. *See* N.Y. INS. LAW § 7307(s) (McKinney 1985).
226. *See id.*

themselves at below-market prices after a demutualization. Granting policyholders the option to purchase the shares would probably deter managers, to some extent, from offering the shares at a below-market price.

11. *Appraisal Rights for Dissenting Policyholders*

Several states require demutualization plans to provide for an appraisal of the equity interest of policyholders that dissent. Florida, for example, grants dissenting policyholders the right to be paid in cash an amount "not less than [fifty] percent of the amount of his equity not so used for the purchase of stock."[227] This provision apparently can prevent policyholders from seeking appraisals of certain percentages of their equity. It discourages policyholders from using the appraisal proceeding and encourages them to use their equity to purchase shares in the stock corporation.

Appraisal provisions do not significantly constrain management actions because they are expensive for policyholders that seek to use them. Furthermore, there is no reason to expect courts will value adequately the surplus of the mutual company.

12. *Anti-takeover Provisions*

Several states, including New York, require anti-takeover provisions in all demutualization plans. Under New York's life insurance demutualization statute, no purchaser can acquire more than five percent of the shares of a converted company for five years after the company converts unless the superintendent of insurance grants approval.[228] An identical Florida statute applies to all stock companies.[229] In the recent conversion of Union Mutual, Maine insurance authorities approved anti-takeover provisions included in the demutualization plan, charter, and bylaws of the newly formed stock holding company, UNUM.[230] These provisions forbade any person from acquiring ten percent or more of UNUM stock for three years after the conversion.[231] The UNUM charter allowed the board of directors to issue additional shares of stock without seeking shareholder approval.[232] The

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227. FLA. STAT. ANN. § 628.441(g) (West 1984).

228. *See* N.Y. INS. LAW § 7312(v) (McKinney Supp. 1993). This provision is stricter than the anti-takeover statute applicable to corporations. *See* N.Y. BUS. CORP. LAW §§ 505(a), 717 (McKinney Supp. 1991) (permitting establishment of shareholder rights plans and modifying business judgment rule).

229. *See* FLA. STAT. ANN. § 628.461 (West Supp. 1991); *see also* Michael S. Helfer & Russell J. Bruemmer, *Federal Banking Law Considerations in Unfriendly Takeovers of Depository Institutions*, 33 AM. U. L. REV. 309, 345 (1984) (discussing ban on acquiring more than 10% of the shares of any converting savings and loan association for one year after a demutualization).

230. Union Mut. Plan, *supra* note 79, at 18.

231. *Id.*

232. *Id.*

charter also provided for a staggered election of board members and required an eighty percent vote to amend the bylaws.[233] Other states have permitted converting mutuals to use anti-takeover provisions.[234]

Despite their apparent pervasiveness, anti-takeover provisions are harmful to policyholders in almost every transaction and should be prohibited. They prevent other acquirors from making tender offers for the shares of converting companies and serve to protect the job security of management.[235] In short, these provisions prevent policyholders from receiving the market value of their ownership interest.

13. *Purchases of Shares by Management*

New York's life insurance demutualization statute also bars management purchases of shares for five years after the conversion unless the purchase is part of a demutualization plan or an approved stock option plan.[236] Two years after a conversion managers may purchase shares on a public market.[237] This provision does not prevent management from acquiring a controlling interest in the converted company, if they do so pursuant to an approved demutualization plan.

The Wisconsin statute bars officers and directors and "persons acting in concert with them" from acquiring more than five percent of the reorganized company's common stock during the first five years after the conversion.[238] The insurance commissioner may waive this prohibition.[239] The Wisconsin statute expresses a general policy that managers should not acquire a converted mutual. The exception threatens, however, to swallow the rule.

14. *Protection of Foreign Policyholders*

The NAIC model statute provides a safeguard for policyholders that are citizens of states other than that in which the converting company is domiciled. The model act requires a foreign converting company to provide the insurance department of the state which enacts the law with a copy of a demutualization plan before the plan takes effect.[240] This provision allows the insurance department to review the plan to determine whether the

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233. *See id.*

234. *See, e.g.*, N.Y. INS. LAW § 7312(v) (McKinney Supp. 1993) (prohibiting for five years any person from acquiring more than five percent of the shares of any class of voting security of the reorganized insurer).

235. Managers greatly fear a demutualization will result in a hostile takeover. *See* Babbel & Jones, *supra* note 58, at 56; Telephone Interview with Richard McDermott, *supra* note 92.

236. N.Y. INS. LAW § 7312(w)(1)(A)-(B) (McKinney Supp. 1993).

237. *Id.* § 7312(w)(1)(D).

238. WIS. STAT. ANN. § 611.76(4)(f) (West Supp. 1991).

239. *Id.*

240. *See* NAIC Draft, *supra* note 139, § 2 (requiring notice of foreign mutual life insurer reorganization).

reorganized insurer will be properly qualified to transact business in the state. States in which converting companies underwrite insurance often require the companies to requalify all of their policies, a process that often takes several years to complete.[241] The NAIC statute may protect foreign policyholders because it allows the insurance department of their home states to request amendments to demutualization plans.

C. *A Recent Demutualization Proposal*

A recent demutualization plan that was modified by insurance regulators highlights the defects in the current regulatory scheme. In 1984, Equitable of Iowa ("Iowa Equitable"), a stock insurance company, sought to acquire Inter-State Assurance Company ("Inter-State"), a small mutual insurer.[242] The management of both Iowa Equitable and Inter-State agreed Inter-State would convert to a stock corporation.[243] In exchange for a ten million dollar contribution, Iowa Equitable would acquire all of the stock of the reorganized Inter-State.[244] Inter-State's policyholders would not be compensated in cash or shares for the change in control.[245] Rather, all of Inter-State's policies and all of its assets as of the effective date of the reorganization would be held in a separate branch of Inter-State.[246] Any of Inter-State's surplus or earnings on the reorganization date would be distributed to the policyholders in the form of dividends or increased insurance benefits over the lifetime of their policies.[247] The amount of the benefits would depend on the actual experience of the members branch.[248]

Although Iowa has not enacted a demutualization statute, the insurance commissioner disapproved the transaction because it was found unfair and inequitable to the policyholders. Despite the fact that Inter-State would benefit from demutualization because it had encountered difficulty financing new types of policies entirely from surplus,[249] the commissioner found the proposed transaction would be inequitable to the policyholders because they would receive no compensation for the value of Inter-State as a going concern.[250] The commissioner found Iowa Equitable's ten million dollar contribution was not a cost to it because Iowa Equitable would acquire all of

241. Telephone Interview with Richard McDermott, *supra* note 92.

242. *In re* Acquisition of Control of Inter-State Assurance Co. by Equitable of Iowa Cos., Order of the Insurance Pet. of the State of Iowa, at 3-31 (Nov. 8, 1984) [hereinafter Equitable Acquisition Order].

243. *Id.*

244. *Id.*

245. *Id.* at 3-31 to -32,

246. *Id.* at 3-31.

247. *See id.* The commissioner noted the distributions would not be complete for 20 years for some policyholders. *Id.* at 3-42.

248. Equitable Acquisition Order, *supra* note 242, at 3-31 to -32.

249. *Id.* at 3-35.

250. *Id.* at 3-40.

Inter-State's shares.[251] The commissioner discredited two valuation studies proposed by Inter-State. Both studies, prepared by actuaries, concluded that dividing existing policies and assets into a separate branch would compensate policyholders for the company's total value.[252] The commissioner correctly determined, however, that dividing the mutual's assets and policies would not compensate the policyholders for the future profits Iowa Equitable would earn from the existing structure, including the sales force, of the mutual.[253] Under the proposed plan Iowa Equitable would receive this structure for nothing.[254]

The commissioner ordered the parties to make several amendments to the plan. First, the amended plan required Iowa Equitable to contribute at least half of its ten million dollar contribution to the policyholders' branch.[255] The amended plan also provided that each policyholder in a class that had produced surplus for Iowa Equitable would receive a "reasonable terminal dividend."[256] The reasonable dividend apparently would be determined by the parties who also were required to hire independent actuaries to investigate the plan's implementation.[257] The commissioner retained the power to veto the parties' choice of the actuarial firm.[258]

The Iowa Equitable proposal illustrates the problems with existing fiduciary protections for policyholders. The commissioner correctly found the proposed plan was unfair and inequitable because the policyholders would not be compensated for the value of the company as a going concern. The commissioner also correctly ruled that the actuarial valuations of the mutual were too low. Nevertheless, the relief ordered by the commissioner, although consistent with current enlightened fiduciary protections for policyholders, did not protect policyholders to the same extent as would a market valuation. In fact, it appears the commissioner roughly estimated that the policyholders were entitled to an initial payment of five million dollars.[259] If the company was sold at an auction, the policyholders might have received much more for their equity interest. Moreover, the amended plan relied on independent actuaries to determine policyholders' compensation, which might have been distributed years later in dividends or increased insurance benefits. In short, an auction would have immediately compensated the policyholders for the present value of their ownership interests.

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251. *Id.* at 3-41.

252. *Id.* at 3-40.

253. *Id.* at 3-41.

254. *Id.* ("Equitable is obtaining something of value–the expectancy of future profits for its Stock Branch–at no cost to itself.").

255. *Id.* at 3-42.

256. *Id.*

257. *Id.*

258. *Id.* After the commissioner issued his order, Iowa Equitable decided to cancel the transaction, claiming the commissioner's amendments would make the transaction an unprofitable investment. Fenske, *supra* note 58.

259. *See* Equitable Acquisition Order, *supra* note 242, at 3-42.

D. *Demutualization Statutes Inadequately Protect Policyholders*

As noted above, current laws do not adequately protect the interests of policyholders in a demutualization because they do not guarantee that policyholders will receive the market value of their ownership interest. The statutes' supermajority voting, appraisal rights, and preemptive rights provisions are similar to provisions contained in state corporation statutes. Those protections would not seriously challenge even an unfair plan because they are incomplete and because it is unlikely that all or a significant number of policyholders would exercise the corporate law protections. In fact, mutual managers, who have lobbied for demutualization statutes,[260] have apparently found acceptable many statutes containing standard corporate law protections.[261] Even if policyholders did exercise their rights to appraisal, the mutual company—not its management—would bear the costs.

None of the other protections guarantees that policyholders will receive the market value of their ownership interests. The most important policyholder protection, the fair and equitable standard, is so vague that it gives state insurance authorities broad discretion to approve plans. Moreover, accounting valuations and valuations by insurance authorities, which are used to determine policyholder compensation under demutualization plans, may well be similar to valuations of insolvent corporations by bankruptcy judges under Chapter 11 of the Bankruptcy Act.[262] Several prominent commentators agree judicial valuations are less accurate than market valuations, and there is no reason to believe insurance authorities would be more accurate than judges.[263] Indeed, it is probable the valuations of policyholder surplus in almost all transactions are too low under existing laws. If the valuation chosen by state insurance authorities is too high the managers or a third party seeking to acquire the company could cancel the plan.[264]

Several recent plans have included anti-takeover provisions, which contribute to the low valuations of policyholders' equity. These provisions, which prevent acquirors from bidding on converting companies, are strongly supported by managers of mutuals.[265] There would be no need to use anti-

260. *See Equitable to Develop Plan to Demutualize*, *supra* note 13.

261. *See, e.g.*, FLA. STAT. ANN. § 628.441 (West 1984). The author has not discovered any articles that contain statements of mutual insurance executives objecting to the standard corporate law protections, such as supermajority voting requirements, appraisal rights, and preemptive rights provisions.

262. *See* Baird, *supra* note 159, at 136-37; Roe, *supra* note 160, at 547-48.

263 *Id.*

264. A high valuation by an insurance department is the equivalent of an asking price for an item that is higher than buyer in the market would be willing to pay. Few customers will be willing to purchase an insurance company if they believe it to be overpriced. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW, 405 (1992).

265. Telephone Interview with Bruce Foudree, *supra* note 44; *see also* Union Mut. Plan, *supra* note 79, at 18-19 (discussing anti-takeover provisions contained in demutualization plans).

takeover provisions unless the state insurance authorities and the company managers believed the unfriendly bids would be higher than the price included in the demutualization plan. Thus, the fiduciary protections of demutualization statutes cannot guarantee policyholders will receive the market value of their interest in a mutual insurer.

V. THE DESIRABLE LEGAL FRAMEWORK

To remedy the deficiencies of the current statutory framework, each state should pass a statute guaranteeing policyholders the market value of their ownership interest in a mutual insurance company. There are several possible reforms: increasing fiduciary standards, requiring the appointment of a lawyer to represent policyholders in a demutualization, and requiring a market valuation of any converting company.

A. *Corporate Law Protections*

As noted above, the corporate law constraints, such as supermajority voting requirements, preemptive rights, and dissenters' rights, inadequately protect policyholders' interests. Although adopting these protections would not adequately protect policyholders, these constraints might provide sophisticated policyholders some leverage in bargaining with the directors and managers. The provisions, which cannot harm policyholders, should therefore be adopted by every state.

B. *Strengthened Fiduciary Standards*

Current law may impose on managers fiduciary duties to policyholders.[266] In some states, policyholders may sue the insurance company's directors for breach of fiduciary duty.[267] In any suit against the directors, the policyholders would argue the directors breached their fiduciary duties by approving a transaction that was unfair and inequitable because policyholders were not adequately compensated.

In states with demutualization statutes—and probably in most states without demutualization statutes—every transaction is reviewed by state

266. *See* Rowen v. LeMars Mut. Ins. Co., 230 N.W.2d 905, 910-11 (Iowa 1975); Doyle v. Union Ins. Co., 277 N.W.2d 36, 46 (Neb. 1979).

267. *See* Rowen v. LeMars Mut. Ins. Co., 230 N.W.2d at 910-11; Doyle v. Union Ins. Co., 277 N.W.2d at 46. In fact, directors and officers of mutuals have often expressed the fear that they will be sued for approving a demutualization plan. Telephone Interview with Bruce Foudree, *supra* note 44. In states where this issue has not been decided, courts should impose fiduciary duties on mutual company directors because the policyholders impose confidence in the directors to protect their interests. *See , e.g.*, Mid-America Nat'l Bank v. First Sav. & Loan, 515 N.E.2d 176, 181 (Ill. App. Ct. 1987); Lamb v. Lamb, 464 N.E.2d 873, 876 (Ill. App. Ct. 1984).

insurance authorities to determine if it is fair and equitable.[268] If state insurance authorities determine a transaction is fair and equitable to policyholders, most courts will be reluctant to upset an enormous transaction.[269] In all likelihood, unless the commissioner fails to consider an important factor when reviewing the plan, the plan would be upheld. The situation would be complicated if the policyholders had previously sought judicial review of the insurance commissioner's order.[270] If the state courts previously had approved the transaction, a subsequent policyholder suit against directors would likely be dismissed under the doctrine of collateral estoppel.[271]

Although the Nebraska Supreme Court held directors liable for inadequately reviewing a demutualization transaction that would have given management an ownership interest for a token price,[272] other courts may not be willing to find directors have breached their fiduciary duties in transactions with less egregious facts. In fact, there are few appellate court opinions on the obligations of directors of a converting mutual.[273] This may indicate that few policyholder suits are filed, or that most of those filed are either dismissed or settled. The current legal regime, which favors upholding transactions, likely promotes settlements that do not greatly benefit policyholders. Contingent fee lawyers, therefore, do not have strong incentives to contest a demutualization.

Policyholders challenging a demutualization plan would be required to define the "fair and equitable" standard. The fair and equitable standard cannot easily be translated into specific rules regulating demutualization transactions. Any plan providing for discriminatory treatment of different classes of policyholders would not be fair and equitable. Other than prohibit-

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268. *See supra* part IV.B.3.

269. One former insurance commissioner felt the risk of liability is low where state insurance authorities have considered and approved a plan. Telephone Interview with Bruce Foudree, *supra* note 44.

270. In some states, any decision by the insurance commissioner approving a demutualization plan may be appealed to a state court. *See, e.g.*, OHIO REV. CODE ANN. § 3913.23 (Anderson 1989).

271. This would be the case if the policyholder suit raised the same issues that the department of insurance considered. *See* United States v. Young, 804 F.2d 116, 117 (8th Cir. 1986) (stating that "collateral estoppel prevents litigation when the identical issue was actually litigated in and necessary to the decision in a prior proceeding concluded by a valid and final judgement."). Even if the issues raised in a subsequent suit were different, a court would probably be unwilling to undo the work of insurance authorities.

272. See *supra* part IV.B.4, which discusses Doyle v. Union Mut. Ins., Co., 277 N.W.2d 36, 46 (Neb. 1979).

273. One of the few cases to reverse a demutualization plan is Zinman v. Commisioner Dept. of Ins., 400 A.2d 689, 691 (Pa. Commw. Ct. 1979) (reversing decision of insurance commissioner to approve a demutualization plan because commissioner relied on documents not properly admitted into the evidentiary record).

ing discrimination among policyholders, "fair and equitable" is very difficult to define.[274]

The fair and equitable standard grants insurance authorities broad discretion to approve transactions that may not be in the best interests of policyholders.[275] Some might argue that a stricter standard governing demutualization plans will require managers and insurance authorities to provide greater compensation for policyholders. A stricter standard will not, however, guide insurance authorities or courts more clearly. For example, if a state requires directors of a mutual to demonstrate by clear and convincing evidence that a proposed conversion was fair and equitable to policyholders, and the directors of a company proposed a conversion plan specifying that certain consideration would be paid to policyholders, the reviewing insurance authorities would be required to determine whether the consideration is fair to the policyholders. The clear and convincing evidence burden might be met by independent valuations of the mutual company. These valuations are often used in support of demutualization plans.[276]

Even if insurance authorities obtained other company valuations that conflicted with those provided by management, they still would be required to guess what the market would pay for the company. Thus, a clear and convincing evidence standard would not improve the accuracy of the company's valuation. If the valuations differed, the insurance authorities could hold hearings on the relative accuracy of the valuations.[277] The hearings would not fully solve the valuation discrepancies because the insurance authorities would be compelled to guess which valuation was correct. Without an accurate valuation of the company, determining the appropriate compensation for policyholders is pure speculation.

The only truly clear and convincing evidence is a cash bid by a third party to pay a certain amount for the company or a successful public offering of the shares of the converted company. Such a market valuation does not rely on the judgment of managers or reviewing authorities. If "fair and equitable" is interpreted to require an auction or a public offering of a mutual company, it will no longer be a traditional fiduciary standard. Thus, it is the author's opinion that modifications to the fair and equitable standard will not make it more effective in protecting policyholders. Instead, statutes should require that an insurance company undergoing demutualization be auctioned and sold to the highest bidder.

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274. This author located no legislative history or court decision purporting to define the standard.

275. *See supra* part II.B.3.

276. *See* N.Y. INS. LAW § 7312(d)(1)(C), (2)(E), (4)(B) (McKinney Supp. 1991); *see also* Equitable Acquisition Order, *supra* note 242, at 3-41.

277. Several statutes require insurance authorities to hold a hearing to determine if a demutualization should be approved. *See* N.Y. INS. LAW § 7312(i) (McKinney Supp. 1993); OHIO REV. CODE ANN. § 3913.21(E) (Anderson 1989); 40 PA. CONS. STAT. § 1010.4 (1992); WIS. STAT. ANN. § 611.76(6) (West 1992).

Some states might add a clear and convincing evidentiary standard to their demutualization statutes to encourage a more careful review of demutualization plans by regulators. This may encourage more effective review by regulators, but would still require regulators and courts to guess the company's value.

Another alternative is to require managers seeking to purchase a significant equity interest in the converted company to prove the transaction was fair to policyholders by clear and convincing evidence. This might encourage regulators and courts to examine more carefully transactions that involve self-dealing. Such a step would not, however, significantly control the actions of managers and directors.

It is arguable such a clear and convincing standard would deter management from proposing demutualization transactions because they would prefer to acquire the company, or not demutualize at all. This potential harm seems unlikely because the clear and convincing standard is only a weak form of review. It would not prevent managers from acquiring a mutual company if they could convince state insurance authorities to approve the transaction. The managers would not be required to bid against other buyers to prevail. Furthermore, many demutualizations in which managers do not acquire an equity interest would remain unaffected by such a minor change in the standard of review. Finally, the other incentives encouraging managers to propose demutualization would remain unaffected as well.[278]

Imposing more explicit fiduciary requirements on directors and officers of converting companies almost certainly would not guarantee policyholders the market value of their investment in the mutual company. Rather, directors and insurance authorities would be encouraged to obtain professional valuations of the mutual company. Independent studies and accounting valuations would almost always underestimate the company's true market value. Thus, additional fiduciary requirements would not offer the same protection for policyholders as would a genuine market valuation.

C. *Appointing a Lawyer to Represent Policyholders*

Although fiduciary standards will not adequately protect policyholders in a demutualization proceeding, they might benefit from a requirement that counsel be appointed to represent their interests by serving a function similar to appointed creditors' counsel in bankruptcy proceedings. Appointed counsel could oppose transactions perceived to be unfair to policyholders and also could negotiate with directors and state insurance authorities during the formulation of a demutualization plan. To preserve independence, counsel should be appointed by a court rather than by state insurance authorities.

278. *See Equitable to Develop Demutualization Plan*, *supra* note 13. Managers of a converted company would be eligible for lucrative stock option plans and would probably earn higher salaries. Telephone Interview with Bruce Foudree, *supra* note 44.

The lawyer would be compensated by court order at the conclusion of the demutualization.

Appointing a lawyer would not guarantee policyholders the market value of their ownership interest in a mutual insurer. Like a bankruptcy judge, an appointed lawyer could not predict accurately the auction value of a converting company.[279] Although an appointed lawyer provision would not solve all of the problems with the demutualization process, it might benefit policyholders in particular cases.

D. *Requiring an Auction or Public Offering*

A market valuation procedure would require a converting company to make a public offering of shares or offer an equity interest to third parties. Such a market valuation provision would be similar to the proposals by Roe and Baird to reform reorganization proceedings under Chapter 11 of the Bankruptcy Code.[280]

An insolvent corporation may be reorganized if all of its creditors consent to the plan or, in the event one class of creditors objects, if the judge nonetheless confirms the plan over objection.[281] Commentators have criticized the existing bankruptcy reorganization process because bargaining is costly and often results in lengthy delays,[282] which often are caused by differences over the value of the insolvent corporation.[283] If the value of the insolvent corporation was clear, the rights of each class of creditors could be determined without delay.[284] During negotiations, senior creditors—those with the highest priority—are motivated to propose a low valuation for the firm because they will obtain control of the firm.[285] On the other hand, junior creditors and equityholders—those with the lowest priority—are motivated to propose a high valuation for the firm.[286] Thus, it is often very difficult for the parties to agree on a reorganization plan.

Under the Bankruptcy Code, the court must approve all reorganization plans; in practice, however, courts almost always confirm plans approved by all creditors.[287] If one class of creditors objects to the plan, the court nonetheless may approve it if it is fair and equitable to the dissenting class

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279. *See* Roe, *supra* note 160, at 547-48.
280. *See infra* text accompanying notes 296-306.
281. 11 U.S.C. § 1129(b) (1988).
282. *See* Roe, *supra* note 160, at 540-47.
283. *See* Baird, *supra* note 159; Roe, *supra* note 160, at 540-47.
284. *See* Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 778 (1988).
285. *Id.* at 778-79.
286. *Id.* at 779.
287. *Id.*

and provides that class with compensation equal to what it would receive if the company was liquidated.[288]

To determine whether a dissenting class of creditors has been appropriately compensated, the court must value the firm. Courts, like directors of insurance companies and insurance commissioners, compare valuation studies to value insolvent corporations.[289] Commentators argue a judicial estimate cannot be as accurate as a market valuation of the insolvent corporation.[290] Courts often adopt compromise positions, such as allowing a reorganized corporation to carry debt to resolve different positions on the value of an insolvent corporation.[291] These compromise solutions often leave reorganized corporations with inefficient capital structures.

Both Professor Douglas Baird and Professor Joseph Roe have proposed Chapter 11 reforms that require some type of market valuation for insolvent corporations. Baird argues a court cannot value insolvent corporations as well as the market, and therefore should hold a public auction of the debtor's assets.[292] In sum, Baird favors using a Chapter 7 liquidation for *all* bankruptcies.[293] According to Baird, third parties can best determine the value of the debtor because they have the best incentives to make the proper choice.[294] A third party bidder bears the risk it will undervalue the debtor company because it will lose the auction.[295] It also bears the risk it will overvalue the debtor because it will not earn a competitive return on its investment.[296]

Under Roe's proposal, a court facing conflicting proposed valuations would order a recapitalization of the insolvent corporation with new shares.[297] Ten percent of the new shares then would be sold by an underwriter on the market.[298] The value received by the underwriter for the shares would indicate an extrapolated enterprise value.[299] The residual value of the enterprise would be calculated by subtracting the proceeds of the public offering from the enterprise value.[300] The residual value then would be

288. *See* Roe, *supra* note 160, at 536-48; *see also* 11 U.S.C. § 1129(b)(1), (2) (1988); Peter F. Coogan, *Confirmation of a Plan Under the Bankruptcy Code*, 32 CASE W. RES. L. REV. 301, 325-26 (1982).

289. *See* Roe, *supra* note 160, at 547-48.

290. *Id.*

291. *See* Roe, *supra* note 160, at 548, *see also* Baird, *supra* note 159, at 136-37; Bebchuk, *supra* note 284, at778-79.

292. *See* Baird, *supra* note 159, at 136-37.

293. *Id.* at 145.

294. *Id.* at 136-37.

295. *Id.*

296. *See* Baird, *supra* note 159, at 136.

297. *See* Roe, *supra* note 160, at 559-60.

298. *Id.* at 559.

299. *See* Roe, *supra* note 150, at 559-60.

300. *Id.* at 559.

allocated among the creditors according to their order of priority.[301] In the case of a mutual insurance company the residual value would belong to the policyholders.[302]

A mutual company undergoing a conversion is similar to an insolvent corporation. However, policyholders, unlike equityholders in a bankruptcy proceeding, are not represented in a demutualization proceeding and do not have the opportunity to propose a valuation of the company.[303] If they could estimate the firm's value, policyholders could be counted on to accurately value the firm because they would fear increased compensation payments to them would render the company unable to pay claims.

An acquiror seeking to purchase a mutual would favor a low valuation of the company to avoid costly payments to the policyholders. Managers seeking to hold a public offering to finance ambitious growth plans and generous stock options would also favor a low valuation to avoid costly payments to policyholders. Under current law the insurance department must settle any disparity in valuation based on proposals by management.[304] A market valuation provision would eliminate the uncertainty created by the valuation process, and instead would rely on the market for the valuation of the firm.

The market valuation proposal for converting mutual companies is based on a combination of the Roe and Baird proposals. Under current laws allowing demutualization, the directors decide whether to propose a demutualization plan.[305] Therefore the directors, together with the insurance commissioner or superintendent, also choose the method of reorganizing the firm. The directors might decide to reorganize the firm by distributing all of the mutual company's equity to policyholders or third parties. A distribution

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301. *Id.*

302. Bebchuk would assign each class of creditors an option to invest in the firm, which could only be exercised if all prior claimants were compensated. *See* Bebchuk, *supra* note 284, at 790-91. The market would value the options but no claimant would receive less than what it was entitled to receive. *Id.*

303. The author has not found any conversion statute that allows policyholders to select a representative to negotiate with management and the state insurance commissioner. Moreover, the author is unaware of any state statute that would allow policyholders to propose a valuation of the company.

304. *See* note 304. Under current laws, mangement or the insurance commissioner could propose a valuation. *See* N.Y. INS. LAW § 7312(h) (McKinney Supp. 1993) (superintendent may appoint qualified disinterested persons "to advise him on any matters related to the reorganization"); WIS. STAT. ANN. § 611.76(3) (West 1980) (commissioner has authority to appoint appraisers to value the company). Presumably the board of directors, which proposes the demutualization plan, has the authority to propose a valuation of the company. A former insurance executive has written that assessing the value of the policyholders' interests in the mutual is very difficult. Ducharme, *supra* note 39. Ducharme also noted that it is difficult to value the company's distribution system. The first problem is deciding who should value the system: actuaries, management, the agency force, or an independent consultant. *Id.*

305. *See, e.g.*, N.Y. INS. LAW § 7312(e) (McKinney Supp. 1993); PA. STAT. ANN. tit. 40, § 1010.3(l) (1992); WIS. STAT. ANN. § 611.76(2) (West 1980).

to policyholders would be classified as a reorganization of the company, while any distribution to third parties would be classified as a sale of the company. The policyholders, as the owners of the firm, would be entitled to receive the proceeds of any sale of the firm.

If the directors elect to sell the firm to a third party, they would be required to hold an auction and sell the company to the highest bidder. The auction requirement would protect the policyholders against a transaction designed to preserve management's job security.

If the directors chose to offer stock to the public without offering it to policyholders, they would be required to distribute all proceeds of the offering to the policyholders. This transaction would constitute a sale of the firm to many parties.

The directors might also include policyholders in a public offering of the shares of the converted company. Under this plan, the corporation would distribute a pro rata allocation of the shares of the corporation to each policyholder. The directors and the underwriters would set the public offering price of the stock. Policyholders could choose whether to participate in the public offering or whether to hold their shares. This requirement would protect the policyholders against an offering price below market value. If the value of the shares increased after the offering, the policyholders would be able to sell their shares.

A mutual's directors might object to this proposal for a public offering because it would not allow them to raise capital by selling additional shares to the public. They could sell additional shares not owned by policyholders to the public in the initial offering if policyholders receive the proceeds. The policyholders, as the owners of the mutual, are entitled to receive the proceeds of its sale. If the reorganized company was permitted to sell additional shares and keep the proceeds, policyholders would be deprived of a portion of the firm's value. Under this rule, insurance authorities would not be required to decide how many shares in a public offering would be allocated to the policyholders.

After the initial offering of policyholders' shares, the directors may raise capital by selling additional shares to the public. In a second public offering the directors would be motivated to secure the highest price for the shares to increase the amount of capital available for the company. The policyholders would have been fully compensated for their ownership interest. Therefore, a state law that grants policyholders preemptive rights to participate in any second offering would not be needed to properly compensate policyholders. Such a law might be enacted to prevent managers from distributing shares to themselves after a demutualization.

This method of holding the first public offering would also prevent the directors from using anti-takeover provisions to retain control of the converted company. At the public offering, a third party might buy a large percentage of the shares to acquire control of the firm. Furthermore, policyholders that held their shares after the public offering could sell their shares on the market to any third party.

There are important corporate law precedents for the auction requirement. In *Revlon, Inc. v. MacAndrews & Forbes Holdings*,[306] the court required directors to hold an auction for the firm once management, while attempting to ward off a hostile takeover, had concluded that the firm would be sold.[307] In *Revlon*, a hostile acquiror made a tender offer for the company.[308] After several bids and countermeasures, Revlon's management and directors proposed a plan under which management and a leveraged buyout firm would purchase the company.[309] The hostile acquiror then offered a higher amount for the company.[310] In response, the leveraged buyout firm increased its offer, and the board granted it a lock-up option on several assets and a no-shop provision, effectively blocking the hostile offer.[311] The court struck down the options and required Revlon's board of directors to obtain the highest value for the company's shareholders when it became apparent to the board that the company would be sold.[312]

Some commentators have argued an auction requirement should not be required in all friendly transactions because a single buyer might be more willing to invest in information concerning the value of the corporation.[313] Nevertheless, others argue an auction requirement would be beneficial because it would prevent the management from accepting a transaction that is unfair to shareholders but that may preserve management jobs.[314]

When a demutualization involves a sale of the firm to a third party, the auction requirement is favored because there is a great risk management that will attempt to preserve its own job security at the expense of policyholders.[315] Mutual policyholders, unlike corporate shareholders, lack the

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306. Revlon, Inc. v. McAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

307. *Id.* at 180.

308. *Id.* at 177.

309. *Id.* at 178.

310. *Id.*

311. *Id.* at 178-79.

312. *Id.* at 185.

313. *See* Gilson & Kraakman, *supra* note 45, at 50-51 (arguing the auction requirement should not apply in a friendly merger transaction because (1) shareholders can protect themselves by voting against the merger and (2) shareholders benefit from competing bids). The "information" referred to here is the knowledge the acquiror would require to determine the value and prospects of an acquired company. The acquiror may realize the company's assets would be more valuable if put to a new use. Telephone Interview with Professor Reinier Kraakman of the Harvard Law School. (Jan. 23, 1991).

314. *Cf.* Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?* 44 BUS. LAW. 247, 262-64 (1989) (noting a target's board of directors and top management are unlikely to evaluate objectively a hostile offer).

315. Managers may want to accept a lower offer price for a mutual company if the offeror promises to retain the managers in their current positions. This is especially true when the

protection of the public market. If the management of a public company announces a merger proposal, another acquiror may make a tender offer, which will force a re-evaluation of the transaction.[316] Mutual policyholders are not currently protected by the possibility of a tender offer because they cannot sell policies on a public market or respond to the tender offer in any other manner.[317]

Requiring an auction and prohibiting anti-takeover devices, however, may discourage management from proceeding with a demutualization, even when it is a socially beneficial transaction. An auction would increase the likelihood of an unfriendly acquisition and greatly increase the probability existing management will be terminated. Thus, incumbent management may elect not to demutualize when it would be a desirable decision, and it is unlikely courts would be willing to hold managers liable for failing to propose a demutualization plan.

The practice of awarding "golden parachutes"[318] to managers of corporations that are potential targets of hostile acquirors could be imitated in the mutual insurance context to encourage management to propose demutualizations. The value of the parachutes should be limited by state law because the cost of the parachutes would be borne by the policyholders. States could limit the value of the parachutes to the value of the officers' future salary as mutual employees. The laws might even allow the managers to compensate themselves with an additional bonus, with the total parachute reaching 150% of future lost salary.[319] This would encourage reluctant managers to propose socially beneficial transactions.

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bidder offering a higher price for the company has promised to replace the managers with its own employees.

316. Stock companies are occasionally acquired in hostile takeovers. *See* Edward B. Rock, *Corporate Law Through an Antitrust Lens*, 92 COLUM. L. REV. 497, 528 (1992) (discussing premuims shareholders have received when corporations have been acquired in hostile takeovers). It is less likely, however, that a mutual company will be acquired in a hostile takeover. *See* York P. Freurd, *No Easy Answers*, BEST'S REVIEW, Aug. 1989 (Life-Health Insurance ed.), *available on* LEXIS, Insurance Library, Brlife File; Stephen J. Wall & James Michael, *Name Your Game Plan; Survey of Insurance Company Mangement Strategy*, BEST'S REVIEW, Aug. 1989 (Life-Helath Insurance ed.), *available on* LEXIS, Insurance Library, Brlife File.

317. Some might argue an auction requirement would endanger the solvency of converting insurers by encouraging bids that overvalue assets. Some of the companies might become insolvent, especially if the acquiror uses debt to finance the purchase. This argument has little merit because state insurance authorities can prevent insolvency by carefully exercising their power to determine the necessary reserves for an insurance company. *See, e.g.*, FLA. STAT. ANN. § 624.408 (West 1984).

318. Golden parachutes are severance pay arrangements for senior executives of corporations that take effect upon a change in control of the company. Louis Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COL. L. REV. 249, 255 n.31 (1983).

319. The 150% figure is an approximation, designed to induce managers to auction the mutual company. If one were to offer the mangers only 100% of their total compensation they would presumably be less likely to propose the demutualization and sale of the mutual insurance

It may be argued that if demutualizations benefit society, mutual managers should be encouraged to propose transactions that allow them to acquire the company.[320] Professor J.A.C. Hetherington maintains that if management is not allowed to propose transactions allowing it to retain control, few, if any, demutualizations would occur.[321] Proponents of this view might disapprove of the auction or public offering requirement on the ground that management needs enormous incentives to propose demutualization transactions. The problem with this view is that it would allow management to structure transactions as it sees fit, subject only to the review of state insurance authorities. As explained above, review by state insurance authorities, without more, does not adequately protect policyholders.[322] Allowing golden parachutes in the event management loses control likely would encourage management to propose socially beneficial transactions without letting them control the process.

Indeed, management has important additional incentives to propose demutualization plans, even when state law requires an auction. Most important of these incentives, of course, is the need to raise capital to fund the insurance business.[323] Moreover, management may prevail in an auction and purchase a converted insurer. If the insurer is acquired in a friendly transaction, the incumbent management may receive increased compensation. If the company remains independent after a public offering, management may structure the transaction to compensate itself with stock options.

The auction requirement should apply to all demutualization plans, including bulk reinsurance and merger plans. With respect to a proposed merger, ther merger would be delayed until an auction of the mutual company had taken place. Statutes allowing the mutual to bypass the proposed auction requirement should be repealed.[324]

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company which they control. On the other hand, if one were to offer the managers 10% of their future compensation, they would have no personal economic incentives to propose demutualization. The goal of the parachutes is to prevent *Revlon*-like manager behavior, which harms the interests policyholders. *See generally*, Revlon v. McAndrews & Forbes, Inc., 506 A.2d 173 (Del. 1986).

320. The comment to the 1971 version of the Wisconsin demutualization statute notes managers favor conversions as long as they do not lose control. The drafters considered management control of the demutualization process a serious but manageable problem with proper regulatory oversight. *See* WIS. STAT. ANN. § 628.441, 1971 committee cmt. (West 1984) (prefatory note to § 611.76). The drafters apparently believe that regulators would be able to determine the market value of the policyholders' ownership interest.

321. Hetherington, *supra* note 2, at 1097 n.88. Hetherington insisted that as long as the valuation of the company is accurate, management control of the reorganized company is not a problem. *Id.* at 1098. Hetherington evidently believes insurance authorities would be able to determine the correct valuation of a company by reviewing valuations.

322. *See supra* part IV.B.

323. Telephone Interview with Richard McDermott, *supra* note 92.

324. This applies even if the mutual company is in financial trouble. If a public auction is held and third parties make bids, that means that the firm has market value and should be sold

E. *The Advantages of Uniformity*

A statute regulating demutualization transactions should be adopted by every state because most mutual companies have policyholders in many states. Uniformity would work to the advantage of policyholders because it would enable insurance authorities in different states to apply the same standards to transactions. Transactions that deviate from these norms could be scrutinized easily by both regulators and counsel for policyholders. This increases the likelihood policyholders will be fairly compensated in a demutualization. A system of uniform laws would also serve the converted companies by making it easier for them to requalify their policies in the states in which they do business.[325] Thus, uniformity would reduce the enormous costs of a mutual-to-stock conversion and promote fair treatment of policyholders.

VI. CONCLUSION

The existing statutory and common law applicable to demutualizations does not guarantee mutual policyholders the market value of their ownership interests in the company because the regulatory scheme depends on valuation estimates by insurance authorities or courts. To remedy this situation, states should require a market valuation of any converting mutual company through an auction or a public offering of shares. A market test would obviate the need for fiduciary constraints and simplify the entire demutualization process.

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for the highest price. If there are no bids at the auction, and this is exceedingly unlikely, the mutual company should be allowed to convert as it sees fit.

325. *Id.* Insurance industry commentators also fear a demutualization will be disrupted if states other than the domicile state review the transaction on behalf of resident policyholders. *See generally* Douglas B. Clark, *The Need For a Model Bill*, BEST'S REVIEW, Jan. 1985 (Life-Health Insurance ed.), *available on* LEXIS, Insurance Library, Brlife File. "Out of state insurance departments may use their authority to approve policies to review a demutualization plan." *Id.*