Policyholders' Rights in Demutualization

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In insurance, unlike most other industries, the mutual corporate form is important in competition, regulation and history. The mutual form itself, and changes from stock to mutual and from mutual to stock, long have been prominent issues of public policy in insurance. The intensity of interest varies over time. It is high now, and the reason is that corporate form is a key to two aspects of competition and even survival: access to capital and ability to adapt to the changing market for financial services.

Although the question is important to both life and property-casualty insurance companies and many issues are common to both, this article is confined to the life industry. The stakes are higher, we have less recent experience and, for historical reasons, the questions of principle are widely regarded as more difficult.

The place to start is with the reasons that we have life insurance at all. Then we can move to the reasons for the mutual form, the questions raised when a mutual company proposes to change to stock company form, and the rights of policyholders if demutualization occurs.

Life insurance long has been America's leading way of saving, investing and providing for one's children. In the nineteenth century, workers had large families, short life expectancies, almost no corporate or government benefits and few ways to save small sums of money at interest. Life insurance answered their needs. Today life insurance is thought of as protecting family values both because it does and because, in its early golden age, it did so far better than anything else.

Life insurance is thought of as a rich and staid industry, with old mutuals being the most of both and eternally consecrated to the gentle tenets of mutuality. This may be true today, but the beginnings were quite different.

The 1840s were a busy decade for the founding of life insurance companies. Yet after the New York fire of 1835 bankrupted many stock fire insurers and the panic of 1837 wiped out so much investment capital, there was not much money around for setting up insurers, and the stock company form hardly inspired investor confidence.

So practical businessmen set up mutuals, including Mutual Of New York, New York Life and Mutual Benefit Life. The idea was to have the sponsoring insureds chip in something toward the capital, either by premiums plus capital subscription notes or by premiums alone. It was a good idea and it worked well.

However, early mutuals ran thin. New York Life started with $55,000 of capital. When Northwestern Mutual faced its first death claim, the president had to take out a personal bank loan to pay it. So the early mutual life companies were formed for two

straightforward business reasons: the socioeconomic need for life insurance and the difficulty of meeting that need through the stock form of organization.

The life insurance business of the mid-nineteenth century differed from today's in two respects important to the mutual form. First, it was not capital intensive, and second, policyholders all were in the same boat.

Since the mutuals had so little capital, it was fortunate, or necessary, that life insurance did not need much capital. The main reason it did not was that front-end sales commissions were low. Mutual Benefit paid 5% of first year premium and 2.5% each year thereafter — approximately one tenth of fire insurance commissions then or life insurance commissions now.

The mutual form also was appropriate to the way companies did business then and, indeed, until well into this century. The business was individual ordinary life insurance, without group, annuities or health coverage. A company used a single mortality table, a single crediting interest rate and a single participating dividend plan. There was a community of interest among policyholders which underpinned the mutual principle.

The first steps toward life insurance's becoming the capital-intensive business we know today are traceable to a very popular product which always was controversial and now is extinct and nearly forgotten — the deferred dividend policy or semi-tontine. Under such a policy, dividends were paid only on policies in force 10 or 20 years after they were taken out. If the insured died or the policy lapsed in the meantime, little or no dividends were paid.

A Flawed Success Story

Under the accounting rules of the day, the deferred dividends did not have to be set up as a reserve liability. Instead, the premiums just added to surplus until the deferred dividends were paid. So the companies built large surplus accounts which made it possible, for the first time, to change to a sales system which motivated agents better but used up capital rapidly—the large first-year commission which was charged off when paid. When the tontine was outlawed after the Armstrong investigation, the industry was left with its capital-intensive marketing system but was deprived of the product which generated capital in its early years.

The big point about the latter nineteenth century was that life insurance was a spectacular money machine. The "Big Three" — Mutual Life, New York Life and Equitable — had more than half the market. At one point, Mutual Life was bigger than the Bank of England. Life insurance was a great American success story, but a flawed one.

As life insurers were amassing investable assets in the 1890s, American industry was being merged to soak up the excess productive capacity of the industrial revolution, capacity which no longer could be disciplined by price and production agreements after the antitrust laws. Merging up industries the size of railroading, steel and oil required huge securities underwriting power. The investment bankers did not have it, but the life insurers did.

In a management split just after the turn of the century, the Equitable Life Assurance Society (then a stock company) was the prize in a fight for control between J. P. Morgan and Kuhn, Loeb. It was the leadership of finance capitalism of the "robber baron" era in an all-out fight over a huge financial institution.

In the course of the fight, the Equitable and other companies, stock and mutual, were shown to have been guilty of all sorts of profligacy with other people's money. In the progressive era, that was enough to get a strong public response. Consequently, the New York State Legislature appointed a committee to investigate the goings-on in life insurance. The committee's chairman, Senator William Armstrong, long has been lost to history, but its energetic counsel, Charles Evans Hughes, became governor for his efforts, and nearly President.

The investigators found abuses everywhere they looked. But the main areas were excess commissions, leading to misrepresentation (mainly of expected tontine dividends); delegation of investment authority to outsiders and disregard of the interests of policyholders in governing the company. The first three areas were and are the subject of specific statutory prohibitions, limits and rules which took effect in 1907. The fourth, the interest of policyholders, was vindicated as well. For our present purposes, exactly how it was done is the key point in the Armstrong Report.

The Armstrong Report favored the mutual form and observed that insurance was "fundamentally mutual in principle," though nowhere did the report say that the policyholders of a mutual company owned the company.

In general, the report looked upon policyholders of all forms of companies as contract holders who were owed fiduciary duties by management, duties which had been flouted by managements in prior years. As to governance and treatment of others, one of the challenges to the Armstrong Committee was that it was about the first to apply strict fiduciary ideas to financial businesses. The Committee had to carry the whole load. There were no securities laws, little insurance regulation and only rudimentary legal rules as to obligations to those who invested in, bought from, or otherwise relied upon, a business corporation.

As to how the life insurance business was conducted, the Armstrong Committee confronted the situation of all policyholders still in the same boat, where common interests easily could be identified. So it treated them alike. A policyholder was a policyholder.

The Committee's conclusions as to fiduciary duties appear today to be basic good sense. The recommendations for strict observance of policyholder rights and protection against management abuse and self-dealing appear ahead of their time. The observation as to inherent mutuality, and the bias toward the mutual form, seem correct in context.

Overall, the Armstrong Report is an outstanding proclamation for corporate participatory democracy and the fiduciary duties of management towards customers. It is not a manifesto for customer ownership. Just as the first wave of mutuals was for reasons of finance, the second, following Armstrong, was for reasons of reform.

Implications For Today

The distinction between participation and fiduciary duties on the one hand, and ownership on the other, becomes clear and meaningful when we consider Armstrong ideas in light of today's facts.

The first idea is regulation. At the time of the Armstrong Report, insurance regulation was rudimentary and largely subservient to the regulated industry. That no longer is true of state insurance regulation and, at the federal level, entire institutions to protect investors and the public have grown up.

The second idea is how business is done. At the time of Armstrong, policyholders of a given company were treated largely alike as to price, benefits, options, credited interest, actuarial assumptions of mortality and lapse, and dividends. That fact naturally led to a feeling of the inherent appropriateness of the mutual form.

But that no longer is how the life insurance business works. Now an insurer uses different actuarial assumptions for different categories of policyholders, different cost allocations, different dividends. It has many separate investment accounts for pensions, for variable life and for universal life (the last thoroughly unbundling prices and yields for the buyer to see and to choose and combine for himself). Policyholders no longer are in the same boat.

Third is the idea of contributions of policyholders. At the turn of the century, the prevailing deferred dividend policy gave policyholders an accumulation of rights which could be forfeited if they died or left. The policyholder did have some kind of right to the accumulated property of the insurance company — a right which might deserve recognition if the company changed form.

Again, the underlying business facts have changed. The semi-tontine is gone. Policyholders now receive their benefits as they go along, either in the form of annual dividends or as crediting and withdrawal rights under the new, interest-sensitive products such as variable and universal life. As a result, today's policyholder has no accumulated credit interest other than to his cash values. Since it now takes from 10 to 15 years to work off the front-end selling cost of ordinary life insurance, one could even say that in his early years the policyholder has a negative equity in the company.

Fourth is the idea of competition. The role of the life insurance business in protecting the family has changed. Certainly it no longer enjoys the hegemony over the consumer's savings dollar that it did in the Armstrong days — down from about half in 1905 to less than a third now. Institutions other than traditional insurers are offering life insurance and substitutes for life insurance. One thing is sure: more is to come. Some of the competitors are tough, impatient and well-financed.

Many people believe that the future of financial services will be in affiliation among present institutions rather than either in prohibiting affiliation or in granting radically broader powers to one or more of today's participants. The reasons essentially are historical and

practical. The institutions differ so much in their public and business roles, their attitudes toward risk and leverage, their prevailing corporate cultures and their known regulatory systems.

If these differences do exist, then any corporate form that discourages affiliation on a basis which preserves the corporate integrity and resources of the affiliates will be at a disadvantage. The mutual company is clearly at such a disadvantage.

A mutual cannot be acquired. Its downstream acquisitions usually are out of accumulated profits and for cash rather than securities. Deals are done in the world of GAAP, but if a mutual buys at a premium over book, it has to exclude both the resulting goodwill and all other favorable GAAP adjustments on its statutory accounts.

Life insurance, which started with little capital thanks to the mutual form, now is fiercely capital intensive. The main reason is the high front-end commission, made possible by the dazzling but defunct semi-tontine, but there are other and newer reasons as well.

Margins are narrower, so mistakes in marketing or actuarial assumptions draw more upon capital. The investment in technology needed to support such vital new products as universal life, which invite customer transactions, is far greater than that needed for the quieter products of the past. Competing with giant institutions in the changing and unstable market for financial services requires capital that a stable and unchanging market does not. The mutual form severely limits a company’s access to outside capital.

Exploring The Methods

If we assume that the sound public policy decision in favor of allowing demutualization indeed will be made, the question remains on what terms. There seem to be four general alternatives, each with its attractions and its problems.

The first method is to require the distribution of all the surplus, in cash or increased policy benefits, to current or recently past policyholders. This amounts to a liquidation of the company.

The second is to do the same thing, but in stock rather than in cash. It would conserve money but would impair future capital raising and, more dramatically, surely would invite contests for control after demutualization. The contests would be either by hostile tender or by assertion of superior rights by, say, large group policyholders. Either way, the object might be to close the company down in order to capture for the new owners the profits from a seasoned book of business once it was freed of the financial drain of new sales.

The third way to demutualize is to have a distribution or sequestration of part of the surplus, for present or eventual distribution to policyholders, on terms determined to be fair by the insurance commissioner, the legislature or the courts. The problem may be called one of thrusting onto the political process an unguided decision as to constituency entitlement. Of more practical significance, it is a problem of uncertainty and unpredictability, which are the natural enemies of business planning. Most managers would just not dare to take the chance.

The final method is to keep the surplus, represented by cash and the ability to issue undiluted shares in the whole company, in the company. The policyholders would get nothing more or less than their contract rights as holders of participating insurance policies. Does this suggest that nobody owns a mutual? Does it violate the mutual principle? Most of all, is it consistent with the interests of policyholders? These are good questions which need answers.

Two Unvarying Rules

Whatever alternative is chosen, however, two rules should remain constant. The first is that management of the mutual should have no financial interest in the conversion. They should receive no fees, no shares in any initial distribution, no piece of a takeover or liquidation. While they might, in the market or as a form of incentive compensation, acquire stock once the market independently had established a price, they should not be able to acquire stock before then. One reason the question of demutualization is so vexing is that there have been enough instances of its use for management enrichment to make us rightly wary.

The second rule is that both policyholders and the domiciliary insurance department would have to approve the change. The Armstrong principle of policyholder participation in governance of the mutual company still is valid. Insurance department approval is an obvious requirement, but deserves a caveat.

Departments are accustomed to working within vague guidelines such as public interest, fairness or the interest of claimants and policyholders. But that would be unwise here, as it would leave the departments without clear principles to apply to terribly difficult actuarial and political issues. The pure solutions — everything or nothing — would be easiest to deal with, but even they should be set out in statute or regulation in advance of an individual case.

It is clear which one of the four broad alternatives is most in the interest of the insurance company as a continuing corporate entity: the fourth. That is the one which lets the company conserve its equity and its ability to raise equity. Life insurance today, unlike life insurance at the beginning, is capital intensive. Competing in a merging financial services sector will be capital intensive.

The remaining question, however, is whether the fourth alternative is consistent with the interests of policyholders. It is widely believed not to be in the policyholders' interest, but that view may change when we look carefully at the real interests of policyholders.

Policyholder's Rights

In the normal course of events, the rights of policyholders of a mutual life insurance company are like those of policyholders of a stock company — contract rights including, in the case of participating policies, the right to whatever dividends are declared at the end of the year. But what about abnormal events? If the mutual is liquidated, perhaps its surplus goes to policyholders, although it might as well escheat to government or go to a charity

designated in the corporate charter. The point is that companies just do not think about their liquidation until they have to. It is a failure, not a strategy.

Should demutualization be treated as just a form of liquidation? It would not seem so, as demutualization is a move to survive and to avoid liquidation. It will be more productive first to examine the three interests of policyholders in general: security, stability and continuity.

A policyholder's first interest is in having a secure insurance company. If you buy a policy, you want yourself or your beneficiaries to get paid. This interest is especially sensitive in life insurance, where the buyer usually will not be around to defend the interests of beneficiaries.

Second is the interest in a stable company. A policyholder wants a company which will responsibly service and renew his coverage and pay dividends upon it. We buy insurance in order to get stability and security, so the policyholder has a specific, limited interest in the continuation of the company.

Third is a general interest in the company itself. As the Armstrong Report pointed out, this interest is mostly in fair governance and treatment, for "a life insurance company, normally, is not organized for the purpose of making money for its policyholders," meaning speculative money. Liquidations are messy and expensive and tend to benefit the wrong people generally, and liquidators and lawyers in particular. In any event, this third interest surely is subordinate.

The Case Remains Open

We are free to decide whether and on what terms to permit the demutualization of life insurers. Contrary to what we may have believed over the years without close examination, the question is not closed and certainly not foreclosed by the great Armstrong constitution of the mutual principle and of life insurance regulation itself.

Policyholders must have a voice in any corporate changes of the magnitude of demutualization, and they must be treated fairly. But to give them a speculative right to consume the company in the declared cause of perpetuating it is not in the public interest.

While absolutely protecting the policyholders and the company itself against abuse by predatory managements or outsiders, we should give these venerable institutions the chance to evolve intact into a more viable modern form. The question of demutualization of life insurance companies can be expected to generate a spirited debate, for it may alert us to the nearness of great issues. It is indeed an instance of an old question — whether and how to change the legal forms of private property and economic activity when circumstances seem to call for change.

Some of our great debates have centered around that question: the argument in Roman times over separating the ownership, possession and benefits of property; the dispute over separate law for the big productive units of the Middle Ages, the manors, monasteries

and guilds; in England five centuries past, the lawsuits and legislation over transferring land against the terms of an ancestor's grant; and in the 1800s, the alien idea of a corporation as a legal person created on private initiative.

Those debates demanded the best intellectual energies of their time. They hung undecided for hundreds of years. In each instance, the apparently radical change was made, and it is difficult to envision the shape of economic activity today if those changes had not been made. Our mutual life company question seems small by comparison, yet it involves hundreds of billions of dollars and touches millions of lives. And we do not have five centuries to decide this question. We may not have even 10 years.

This brings us back where we began, with a question of adaptation and access to capital. It is a question whether those sound business objectives can be achieved consistently with sound public policy and respect for our heritage.

However modest our present question in the scale of history, it still is urgent. The decisions about financial services in America are being made right now and all around us. They are not being made in an orderly way, but they are being made, and they will stick if the public takes what these decisions have to offer.

With mutual life companies, we in business and regulation have a chance to make one of those decisions rationally; we just have to think clearly and fast. The alternative is not that the decisions will not be made, but that decisions will be made by default or by someone else, and time will pass us by.

Life insurance is an important American institution. Mutual companies are half of it, and if they are to continue their role, mutuals must adapt to what the American family needs. Perhaps they will adapt and perhaps they will not, but we ought to give them the chance — there is no historical or public policy reason not to do so.