

With new law, Delaware may become the domicile of demutualization

August 23, 2010

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Delaware is not currently a hotbed for mutual insurance companies: SNL data lists three Delaware-domiciled mutuals, of which only one reported material net premiums written last year. But if a coalition of public and private interests have their way, that could soon change.

Gov. Jack Markell on Aug. 18 signed H.B. 453 into law — a measure that is intended to encourage the redomestication of “orphaned” mutuals to Delaware and their subsequent demutualization either of their own volition or in sponsored conversions conducted in tandem with M&A transactions. It’s a target market that one of the bill’s proponents says could include 400 or more mutual insurers.

The law firm of Stevens & Lee and affiliated investment bank Griffin Financial Group LLC first approached the Delaware Insurance Commissioner in 2009 with an idea to promote the redomestication of mutual insurance companies to Delaware and encourage capital formation under a modernized, cost-effective statutory framework. Numerous states have enacted demutualization statutes, with many coming in the 1990s to facilitate conversions involving large life insurers. But the Delaware law is particularly noteworthy in that it is designed to bring business to the state rather than to simply allow for a large insurer already in place to convert to a stock ownership structure.

“If State Farm, to use an absurd example since they’re in no need of capital, wanted to get this done in Indiana, they could get this done. But a small mutual in Arkansas, for example, they don’t have a huge constituency or huge political power,” Jeffrey Waldron, senior managing director at Griffin Financial, told SNL. “The thought here is that this would be an option for them.”

The Delaware legislation adopts a subscription-rights model that is structured along the same lines as federal thrift conversion regulation. Policyholders are granted first right to buy stock of a converting mutual based upon an independent appraisal. The law is similar to a Pennsylvania statute under which the companies that became known as Penn Millers Holding Corp., Eastern Insurance Holdings Inc., Mercer Insurance Group Inc. and Old Guard Group Inc. had been formed.

Pennsylvania also served as the site for the sponsored demutualization of the former Provident Mutual Life Insurance Co., which set the stage for Nationwide Financial Services Inc.’s October 2002 acquisition of the company. More recently, ProAssurance Corp. used a sponsored demutualization to help effectuate the acquisition of the Illinois-domiciled Podiatry Insurance Co. of America and its affiliates. The Delaware law would also facilitate such arrangements.

“Suppose again you’re a company in Arkansas that is a mutual that says, ‘We think we need to affiliate with a larger company.’ As a mutual, they have very limited ability to do that,” Waldron explained. “They could merge with another mutual, but that’s it. ... This would allow them to approach a stock company and say, ‘Do a sponsored

demutualization and offer your stock to our policyholders as part of a process where we redomesticate to Delaware.”

Although sponsored demutualizations have not occurred with great frequency in recent years, other kinds of conversions continue to take place with some regularity. Security Benefit Mutual Holding Co., which in 1998 converted to a mutual insurance holding company from a mutual insurer, recently completed its full demutualization after fallout from the global financial crisis called the future of the company’s life insurance subsidiary into doubt. The company now known as Farm Bureau P&C Insurance Co. became a unit of the newly formed Farm Bureau Mutual Holding Co. as part of a 2009 conversion to a mutual insurance holding company structure.

“The strategic flexibility and access to capital this reorganization makes possible will help position the company for a level of growth that surpasses what it could have achieved as a mutual,” Farm Bureau P&C said in the management’s discussion and analysis section of its 2009 annual statement.

The Delaware law also allows for MIHC conversions. But unlike statutes in a number of other states, Waldron said, it requires converting insurers to offer stock to policyholders. That could serve to head off some of the concerns of policyholder advocates, such as Schiff’s Insurance Observer writer and editor David Schiff, who campaigned in the 1990s against several Iowa MIHC conversions.

“Doing an [MIHC conversion] in which policyholders might never receive anything, I think, runs a lot of risks for the company and may not be all that fair to policyholders,” Waldron said.

The subscription-rights model is premised on a philosophy that policyholders do not “own” the insurance company in the traditional sense, but hold the highest rights of any constituency. As Waldron explained, policyholders’ interest in the mutual insurer ceases if they permit their policies to lapse, and insurers can unilaterally nonrenew policies without providing any consideration in return. Policyholders also cannot sell or transfer their interests.

“When it’s been litigated — for example, when the federal thrift conversion legislation first came out in the 1980s and in some insurance cases — [the rulings] usually come out on the side that mutual members are not the equivalent of owners,” Waldron said.

Large life insurance company demutualizations such as those that resulted in the formation of John Hancock Financial Services Inc., MetLife Inc., Prudential Financial Inc. and Principal Financial Group Inc. (subsequent to the Iowa-based company’s period in an MIHC structure) have tended to follow a distribution model in which a converting company’s surplus is distributed to policyholders in conjunction with a public offering of stock. That process may be economically impractical for smaller companies, however.

The target market for these subscription-rights demutualizations primarily includes property-and-casualty insurers with surplus of anywhere from \$10 million to \$500 million. Waldron said he expects the motivation of insurers to demutualize will generally be

company-specific, based on concerns surrounding management succession or a desire to obtain capital for growth.

Penn Millers' 2009 subscription offering, for instance, followed 122 years as a mutual and had been driven by the company's desire to target profitable, long-term growth opportunities in its core agribusiness and commercial business insurance segments in the future. Griffin served as placement agent for the offering, which raised gross proceeds of \$54.4 million.

The "compelling" economics of conversions make them possible in most market environments, Waldron said, as evidenced by the level of interest in the Penn Millers transaction — an offering that, the company said, attracted orders worth in excess of \$72.5 million. But the process of redomestication followed by demutualization could take some time to gain traction around the industry.

"The mutual industry is not historically a fast-mover," Waldron said. "From the time I first talk to a company to the time that they do something is probably a couple of years."

Markell has been lauded for reaching out to private industry to encourage job growth, including in the financial services sector. The state earlier this summer succeeded in its efforts to land the headquarters of SLM Corp., or Sallie Mae, the large student loan company that is based in the Virginia suburbs of Washington, D.C. Waldron is hopeful that the state will market itself to mutuals in the same way it has promoted revisions to its captive insurance laws, an initiative that resulted in the addition of eight Delaware-domiciled captives during a six-month period ended in January.

After all, as Delaware Insurance Commissioner Karen Weldin Stewart told SNL earlier this year in connection with the pending sale of the Delaware-domiciled American Life Insurance Co.: "Why wouldn't you want to be incorporated in Delaware?" *i*