Edited Excerpt on Mutual Form from Howell E. Jackson & Edward L. Symonds, Jr., Regulation of Financial Institutions 551-78 (West 1999)

Section 5. The Mutual Form

We now turn our attention from the primary focus of insurance regulation -- the relationship between insurer and insured -- to issues of organizational form. One peculiarity of the insurance industry is that many major firms are organized as "mutuals" -- that is legal entities that lack traditional equity shareholders. For example, in the life insurance industry as of 1994, mutual insurance companies held forty-one percent of industry assets. Moreover, six of the ten largest life insurance companies were organized in mutual form. On the property-casualty side, mutuals are somewhat less significant (holding more than a quarter of sector assets), but still constituted a substantial segment of the industry.

The focus of attention in this section of the casebook is the "demutualization process," which consists of the legal arrangements whereby mutuals change their corporate form, either through liquidation or conversion into more traditional stock corporations. Demutualization is not unique to insurance companies, and has applications to other types of financial intermediaries, most notably savings and loan associations and savings banks, which also often organize themselves in mutual form. While this section is primarily concerned with the demutualization of insurance companies, we also consider briefly a parallel development in the savings bank industry.

A. Demutualization of Insurance Companies

To understand the demutualization process, one must first have a general appreciation of the legal relationship between mutual insurance companies and their policyholders. That relationship is explored in the following excerpt:

J.A.C. Hetherington, *Fact v. Fiction: Who Owns Mutual Insurance Companies*
1969 Wis. L. Rev. 1068, 1970-84

THE MUTUAL POLICYHOLDER AS AN OWNER

The formal legal status of the mutual insurance policyholder is somewhat analogous to that of the stockholder in a stock company. Like the shareholder, he is said to be the owner of the corporation. The black letter "rule" has often been repeated by courts and text writers. In part, the mutual policyholder is thought to be an owner because superficially he looks like one. He has the right to elect the management of the company, a function traditionally reserved to the owners of a business enterprise. He is also owner by a process of elimination: in the case of a mutual organization, the only available candidates are the members, and in a mutual insurer this means the policyholders. However, the meaning of "ownership" is neither specific nor obvious; it varies with the context and the subject matter to which it is applied. In our law of business associations, the owner is generally identified and characterized by his exposure to the risk of personal liability in the event of insolvency, or at least the risk of loss of his investment; his right to the profits; and finally, his right and, usually his ability to control the management. An examination of the relationship between the mutual policyholder and the insurer clearly revels that he substantially lacks all three of these attributes.

A. *Risk*

Generally, mutual insurance policyholders are not exposed to personal liability as a result of the insolvency of the mutual insurance carrier. An exception exists in the case of assessable policies which may be issued by mutual insurers, but in practice are issued only during the formative stages of the enterprise. Assessable policies are not issued by the large established commercial mutual, and in Wisconsin may not be issued by life insurers. As a practical matter, therefore, mutual policyholders, like shareholders, are not exposed to personal liability for the debts of the corporation on insolvency. Again, like shareholders, the risk to which they are exposed in the event of insolvency, is the loss of whatever ownership interest they may have in the company. The extent of this exposure depends on the amount of the investment, which varies greatly from one type of insurance to another, and from one policyholder to another.

At the outset, it will be helpful to consider the premium paid by the mutual nonlife policyholder as consisting of two elements: first, the portion which covers the cost of the protection he is buying, including the operating costs of the company. The determination of the amount of this part of the premium is based on the losses anticipated by the company on the basis of past experience and other factors, including its expenses of operation. The second portion of the premium consists of any excess over the first amount. Any such excess is a direct contribution to the surplus of the company.

Policyholders generally pay premiums for their insurance in advance of the period of coverage. The period of the payment may be annually, quarterly, monthly, or even weekly in life, health and accident, and automobile insurance; in homeowners' property-liability insurance the premiums may be paid every three years. With respect to the portion of the premium which covers the cost of the insurance coverage purchased, the policyholder is like any other buyer who pays in advance for a product or service. As a buyer who paid in advance the policyholder is a "financing buyer," a creditor of the insurer. He resembles, for example, the purchaser of a magazine subscription who has not yet received all the issues for which he has paid. As the period of subscription or policy progresses, the buyer receives in installments the product for which he has paid. The amount of unearned premium at any given time is an investment by the policyholder in the company in the same way that a magazine subscription is an investment in the publishing company by the subscriber. Both are purchasers of a product who, like any financing buyer who has not received the product or service he has paid for, is a creditor of the seller. If the contract is terminated (and the buyer is not liable for breach), prima facie he is entitled to recover from the seller the amount of the prepayment. And like any creditor, he is exposed to a risk of loss if his debtor becomes insolvent and is unable to return the prepayment or provide the product or service contracted for. The risk of loss of his unearned premium resulting from insolvency is the same from the standpoint of the policyholder, as the loss he sustains if the insurer is unable to pay a claim arising under his policy, except that it is likely to be less serious. Protection against this customer risk is the *raison d'etre* of insurance regulation. This risk is distinguishable from the characteristic risk of an owner of an enterprise that his property (or his investment in the case of limited liability) is chargeable with the debts owed by the enterprise to others. Policyholders of stock insurance companies are subject to the same nonproprietary risk. The risk of the insolvency of the supplier is always on the buyer who prepays. In one respect, this is a particularly important risk for the insurance buyer, as compared with other purchasers of goods and services. The insured buys a continuing future and contingent performance which the supplier can provide only if it remains solvent. For this reason, the financial "solidity" of the insurer is of the greatest importance to him. . . .

In one respect, however, the mutual policyholder is more than a customer. This is because he has a pro rata interest in the company's surplus. This surplus is derived from two sources: first, the amount of premium paid in by policyholders which exceeds the costs, including administrative expenses of the insurer's performance under its outstanding policies. The second source of surplus is investment earnings.

As is demonstrated in the following section this investment is inaccessible to the policyholder, except in unusual circumstances over which he has no control. It is therefore questionable whether this interest in surplus should properly be regarded as an investment which the policyholder may "lose" if the insurer becomes insolvent. The importance of such a loss, should it occur, would be minimal to the insured, since it is an investment over which he has no control and from which he derives no benefit. The loss of this investment is not a subject of any importance in insurance insolvency proceedings which are exclusively concerned about the inability of the company to pay claims under its outstanding policies and the loss of protection suffered by all policyholders. These again are losses and risks which the policyholders suffer as customers, not as investors.

B. *Profits*

The fight to share in profits after all creditors of the enterprise have been paid is the essence of ownership of a business. The mutual policyholder shares in the "profits" of the enterprise principally through dividends paid on his policy. Dividends are usually not paid in cash, but are applied on the next premium. In some companies, they are "deducted from premiums in advance" so that the policyholder sees nothing that looks like a dividend. In either case, for income tax purposes, mutual dividends are considered a return of previously paid premium and are not income to the policyholder. Dividends are that portion of the previously paid premium which exceeds the cost of the protection under the policyholder's contract. However, the entire excess is generally not returned, because surpluses are accumulated by the insurer for purposes of expansion.

As "owners"of the company, and through it of its assets, mutual policyholders should have a legally or equitably recognizable claim to share in the accumulations of assets made by the company during their time as policyholders. They have none. In property-liability companies, the full extent of their claim to the company's surplus, is their right to receive whatever dividend the board of directors may declare.

Life companies are often required to pay some portion of the surplus back to policyholders. Surplus is determined after "such contingency reserve as may be deemed necessary" is first deducted. The courts have uniformly held that life policyholders have no claim against the insurer beyond their rights under the terms of their insurance contracts. . . . [T]hey have neither control of, nor legally enforceable claim to, the portion of surplus, which the company may lawfully accumulate.

Furthermore, in the absence of a statute or a controlling policy provision, the management may terminate the policyholder's membership by canceling or refusing to renew his policy, and may exercise this right for any or no reason. This power of expulsion from the membership group is antithetical to any conception of the policyholder as an owner, especially since the departing member takes nothing with him and has nothing to sell. Traditionally, the owner of a business enterprise has the right, subject to limitations imposed by law, to terminate the association of employees, suppliers and customers with the enterprise. The fact that policyholders in a mutual insurance company, like policyholders in any insurance organization, may be "fired" by the management who are theoretically their employees, is strongly indicative of the non-proprietary character of their relationship to the company. . . .

C. *Control*

With minor exceptions, the business and affairs of mutual insurance companies are by statute required to be managed by a board of directors elected by the policyholders. For a variety of reasons, policyholder participation is minimal, and the procedure has far less actual or even potential significance than it does in a widely held stock corporation. . . . .

The practice in both property-casualty and life companies plainly reflects the almost total nonparticipation of policyholders in the selection of management. In the great mutual life companies in Wisconsin and elsewhere, the management is routinely returned to office, without difficulty or interruption, by the votes of a few dozen policyholders. The same is true of property-liability company management. Sometimes in property-liability companies permanent proxies are used, which enable management to vote without consulting the policyholders.

Voting practices in the mutual insurance industry contrast sharply with the practices in publicly held stock companies. Under either organization, management is reelected without opposition in the vast majority of cases, but in a stock company, at least fifty percent of the shares must be voted. An elaborate and expensive effort to inform the electorate is combined with the annual solicitation of proxies. Though shareholder opposition is exceptional, a regular reading of the *Wall Street Journal* during the annual meeting season clearly shows it is not rare. Among commercial mutual insurance companies, on the other hand, there are no exceptions. The conclusion is inescapable that mutual policyholders not only do not select the management, they exert no influence on management through the election process.

The autonomy enjoyed by management of mutual insurance companies has led to more than one creative plan of reorganization. Consider the transaction before the court in the following case:

Allyn v. Hull
99 A.2d 128 (Conn. 1953)

The plaintiff as insurance commissioner of the state of Connecticut instituted this action against five individuals who formerly had been directors of the Madison Mutual Fire Insurance Company. His main purpose was to obtain a declaratory judgment concerning the disposition of the company's assets. The court sustained a demurrer addressed to the complaint. From the judgment subsequently rendered for the defendants upon the refusal of the plaintiff to plead over, the latter has appealed.

The complaint alleges the following facts: The Madison Mutual Fire Insurance Company, hereinafter called the company, was organized under a special charter in 1855. Over the succeeding years, policies insuring against loss by fire and other casualties were issued to various persons, many of whom abandoned their interest in the company upon the expiration or other termination of their policies. In February, 1946, the defendant Steele, as attorney for the company, wrote to the insurance commissioner, inquiring about the mechanics of liquidation. The commissioner replied that '[t]here appears to be no provision in the Connecticut Insurance Law which would vest this Department with jurisdiction over a liquidation of this nature. While there are provisions under which the Commissioner has authority in the liquidation of an insolvent domestic insurance company, the Madison appears to be solvent with a surplus of approximately $20,000.00 according to its 1945 annual statement. Our conclusion, therefore, is that the Directors should proceed in this matter under the general law governing corporate liquidations.'

On May 15, 1946, the five defendants and one other were directors of the company. On that date they voted to write no new business and to renew no existing policy after May 31, 1946. They also voted to accept a proposal of the New London County Mutual Fire Insurance Company to reinsure, for the single premium of $2500, all risks outstanding on June 1, 1946. The risks were then represented by policies in the total face amount of $301,850, held by 198 persons. Of the 198, six were the company's directors, to each of whom had been issued, on May 31, 1946, a new five-year policy for $1000. These six policies were excepted from the contract of reinsurance with the New London company. As the policies held by the other 192 persons expired, after June 1, 1946, they were not renewed but each policyholder received from the company a cash dividend equal to the amount of the premium he had paid. At the expiration of all policies except those held by the directors, the company still had undistributed assets approximating $17,000.

In 1949, the company again wrote to the insurance commissioner concerning the further disposition of its assets. The commissioner replied that 'this is purely a legal matter over which we have no jurisdiction.' On May 31, 1951, five policies, being renewals of those written on the same date in 1946, were issued to the five defendants, who still remained directors of the company. The sixth of the original directors' policies had been previously canceled.

Thereafter, the five directors entered into negotiations with the Glover Insurance Agency of South Norwalk for the sale of the charter. On February 5, 1952, the directors met in special meeting and, purporting to act as the sole policyholders, voted to distribute to themselves the company's remaining assets, less such an amount as would meet any unpaid bills. On February 7, 1952, the company wrote five new policies in the names of persons designated by the Glover agency. At the annual meeting of the company held on the same day, those five persons and the defendants elected themselves directors, and at a subsequent directors' meeting, those representing the Glover interests were elected to the various offices. The defendants then resigned as directors. Purporting to act under the vote of February 5, 1952, the defendants distributed to themselves the company's assets of $19,240, which included $2000 paid for the charter. The several grounds of demurrer, addressed to the complaint, revolve around the one question determinative of this appeal. That question, as the parties concede, is whether the plaintiff has the legal right or power to institute this action.

The plaintiff is a state official whose office was created by the General Assembly. General Statutes § 6025. Like other comparable public officials, he has only such power and authority as are clearly conferred or necessarily implied. State v. Hartford Accident & Indemnity Co., 138 Conn. 334, 339, 84 A.2d 579; Mechem, Public Officers, § 511; 43 Am.Jur. 68, § 249. Section 6029 prescribes his powers and duties. It requires him, among other things, to 'see that all laws respecting insurance companies are faithfully executed.' Undoubtedly, this vests him with a wide range of discretion. American Casualty Ins. & Security Co. v. Fyler, 60 Conn. 448, 460, 22 A. 494. That discretion, however, cannot be exercised on everything bearing directly or indirectly upon the subject of insurance. See Noyes v. Byxbee, 45 Conn. 382, 385. The legislative mandate which we have quoted does not endow him with limitless authority to do whatever he thinks he ought to do. The statute does not speak of laws relating to insurance. It refers to laws respecting 'insurance companies.' The authority granted by it to the plaintiff, therefore, is circumscribed. The statute permits him to supervise the activities of insurance companies only so far as to see that they fulfil the obligations imposed upon them by law. It gives him no power over the directors of insurance companies in their individual capacities.

The complaint does not purport to state a cause of action against the company. Indeed, the company is not even a party defendant. Nor has the action been brought against the defendants as directors. In short, the plaintiff seeks to compel neither the company nor its directors to execute any legal duty. The gist of the complaint is that the defendants, as individuals, should respond because of some act of alleged misconduct. Justification for the maintenance of the present action cannot be found in § 6029.

The plaintiff maintains that, on the face of the admitted facts, a grievous wrong, intentional or otherwise, has been done to 192 policyholders. Whether this is so, or what rights, if any, they may have under a different alignment of parties, we do not determine on this appeal. We go no further than to hold that this plaintiff is without power to bring the instant action. However commendable may be his purpose, the plaintiff lacks the necessary authority to sue as he has done.

Comments and Questions

Do you agree with the Connecticut court's decision in this case. Was the transaction abusive? Who should have been entitled to receive the remaining surplus in Madison Mutual? Why didn't the former policyholders challenge the transaction instead of the Attorney General?

As the Hetherington excerpt and *Allyn* case indicate, traditional legal structures offer limited control over the management of mutual organizations. Over the years, economic studies of the performance of mutual insurance companies have generally confirmed that these firms operate less efficiently than their stock counterparts. In additional, mutual firms are disadvantaged in their ability to raise funds in the capital markets and to diversify through holding company affiliates. Given the drawbacks of the mutual ownership form, the continuing importance of the mutual form in the insurance industry is something of an anomaly, particularly inasmuch as stock corporations and partnerships dominate most other fields of business activity.

Some analysts attribute the presence of mutual insurance firms to historical accident. During the 19th Century, when the insurance industry grew to maturity in the United States regulatory supervision was relatively lax. At the time, the general public favored mutual life insurance companies because they were perceived to be less prone to risk-taking than stock corporations. This tendency was particularly important in the life insurance field where firms made relatively long-term commitments and policyholders needed assurances that firms would not change investment policies before those commitments were honored. On the property-casualty side, mutual firms were also thought less prone to opportunistic pricing and perhaps more adept at appropriately classifying policyholder risks. Legislative reforms at the turn of the century, most prominently the Armstrong Commission of 1905, encouraged many stock life insurance companies to convert into mutual form.

Over the past few decades, as the regulation of insurance companies has become more effective, the desirability of retaining such a large portion of the industry in mutual form has increasingly become a subject of debate. Policy analysts have questioned whether the form is simply a remnant of historical accident, and managements of mutual firms have increasingly chafed at the organization limits of this business form. In response to these pressures, a number of state legislatures, most notably New York where many of the larger mutuals are domiciled, have elected to eliminate old prohibitions on demutualizations and adopted new statutes to facilitate the process. See *Going Public: The Critical Choice*, Best's Review -- Life-Health Insurance Edition (Jan. 1985). Although the pace of insurance company demutualizations is still relatively slow, a trend in that direction has begun.

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B. Conversion of Insurance Companies and Savings Banks

[R]elatively few mutual life insurance company have actually implemented demutualization plans. Demutualization of savings and loan associations and mutual savings banks has, in contrast, been highly popular over the past two decades. Hundreds of savings associations and savings banks have completed demutualization transactions (also known as conversions), and mutual thrifts now constitute a minority of an industry they once dominated. In the early 1990s, roughly 100 mutuals converted each year. At this rate of conversion, mutual thrifts could become extinct early in the 21st Century. A series of recent savings demutualizations are described in the following article.

Getting In on Savings Bank Conversion
N.Y. Times, Feb. 5, 1994, § 1, at 34

When the Green Point Savings Bank converted to stock ownership a week ago, its stock soared 27 percent on the first day of trading. Depositors who bought shares of the Flushing, Queens, institution in advance booked a tidy paper profit.

Similar deals remain plausible. Although bank regulators and Congressmen are concerned about windfalls going to bank officials and have put such conversions on hold, their efforts may merely delay the inevitable. About 1,200 mutual savings institutions remain, and 75 have more than $500 million in assets.

"Any bank over $500 million is a good prospect for demutualization, " said Paul A. Bauer, president of Bauer Financial Reports, a bank research firm in Coral Gables, Fla. "The only way for them to grow is to generate some capital." So even if you missed out on the deal for Green Point, a small deposit at another mutual savings bank may be worth more than its face value some day. Depositors in conversions have generally been allowed to acquire a certain amount of stock before outsiders, although additional restrictions are possible.

The initial stock offering can be as low as half the book value. "As a short-term investment, the price usually rises 30 to 40 percent over the offering," Mr. Bauer said. "And if the thrift then takes the money and uses it properly, it should get up to one and a half times book." Market professionals have opened savings accounts at large mutual savings banks for this potential profit. In response, many banks restrict new accounts to state residents.

A key and recurring question in the regulation of conversions (or demutualizations) is how to allocate the accumulated value that often exists in mutual institutions. The following article proposes one approach. Would you support it?

Robyn Meredith, *CBO Wants U.S. to Share in Thrift Executive Bonanzas*
Am. Banker, Mar. 1, 1994

The Congressional Budget Office on Monday added its voice to those calling for the government to share in the windfalls that occur when mutual thrifts sell stock for the first time. While the CBO did not say thrift executives should be denied all benefits from such deals, the agency debunked the argument that managers deserve a share of the equity because they helped build the thrift and were paid less than their counterparts at publicly held institutions.

"Management has already been paid for performing those functions," the CBO said. "Compensation relative to the assets or to the number of employees at thrifts is slightly higher at mutual savings and loans than at stock-owned savings and loans," the congressional agency said. The nation's 1,240 mutual thrifts, which have more than $230 billion in assets, have been converting to stock ownership in large numbers lately, particularly in states with laws that permit management to capture a large share of the equity. . . .

> Under current regulations, "since no one actually owns the equity in the institution, the existing value is captured as a windfall gain by the initial stockholders," the CBO said. "The federal government has a reasonable claim to a portion of these gains by virtue of the role deposit insurance has played in helping thrifts accumulate their net worth." The CBO said that had the government granted itself an option to buy 15% of the thrift conversion stock issued in the first three quarters of 1993 and exercised those options, it "would have made the government about $60 million richer." . . . .
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> [One industry spokesman] said that if all management perks are stripped from stock conversions, "at least half of those would decide that it would be safer for them" to stay mutual. "I think it is bad anytime you discourage capital from coming into the industry. . . . Some of those that have excess capital now who might be conversion candidates and who probably would need the capital as (interest rate) spreads narrow and as rates increase might not have the same incentives to go forward."

Does the government have a legitimate claim on the retained earnings of mutual savings banks?