2015 HOUSE INDUSTRY, BUSINESS AND LABOR

HB 1313

2015 HOUSE STANDING COMMITTEE MINUTES

Industry, Business and Labor Committee
Peace Garden Room, State Capitol

HB 1313
1/27/2015
22606

☐ Subcommittee
☐ Conference Committee

Ellen LeTang

Explanation or reason for introduction of bill/resolution:

Conversion of a mutual property & casualty insurance company to a stock insurance company & demutualization of domestic mutual insurance companies.

Minutes: Attachment 1

Chairman Keiser: Opens the hearing on HB 1313.

Pat Ward~Nodak Mutual Insurance Company: (Attachment 1). I did pass out 3 technical amended which

4:51

Representative Becker: If you have the option to do a full conversion versus the 49.9% and the company has a value, if you are converting and offering stock. You are able to give the full equity value of the company to the new shareholders or you have the option to sell 50% of the equity through shares, who owns the other 50% of the shares. Are they considered non-distributed shares?

Wards: Yes, that would be my understanding how it would work. If you offered less than the full value, you would at the time that you make that offer; you would evaluate what you are selling and spread that across the policy holders. Say, if you are going to offer 40% for sale, the other 60% would be held in the way that it was. The 40% that you used to raise capital would be offered first to the shareholders to raise cash; the value would be set under the formula provided in here. Then the shareholders would have the option of being the first ones to buy or they could be allowed to be sold to the public. There is a certain period that they have to consider the offer. There are also provisions in here for Insurance Commission prior approval of a plan. Then you run it pass the policy holders for a vote and need a majority vote.

Representative Kasper: If the demutualization plan is for keeping 51% ownership? Does the company down the road, make another decision to sell more of the 51% that they retain or make the decision of whatever percent, is that it forever?

Ward: They can go on, sell 20% at a time and eventually sell it all and demutualize completely and then become a stock company, completely 100% owned by the stockholders. The reason you will keep the 5i% is to keep control of the company and not run the risk.

Representative Kasper: Is the stock being sold in the holding company or stock being sold in the subsidiary that becomes the stock company or both?

Ward: My understanding is the stock is being sold in the stock company that is being created.

Vice Chairman Sukut: Who is purchasing that stock to hold a 51% control?

Ward: If you sell more than 50% you will not hold total control.

Chairman Keiser: We have a mutual company and the folks have two rights. They have coverage and membership and the right for membership is the right to vote. You sell 40% so you have 60% that's still in a mutual company where the people in that company have those rights. Now you have 40% sold to stockholders, they don't have to have coverage in that company. Then the company is very profitable. Now what happens to the profit? Would the 60% stay in the mutual to help reduce rates for the people who are still in the mutual and 40% of that profit would be distributed to the stockholders?

Ward: Those are all possibilities.

Chairman Keiser: Can all the profit be distributed to the stockholders and no benefit of the mutual holders.

Ward: I don't believe so because that 60% would be retained for members and policy holders. There is a value to that interest and that value would not be diluted 100% by selling 40%. As the capital is raised, it goes into the company that raised the capital.

Chairman Keiser: They would retain those rights and if 51% sell, it would not be a mutual company?

Ward: It would not be a mutual company.

Representative Kasper: If this bill were to pass, the company that is currently a mutual company could create a mutual holding company. The mutual holding company is not the stock that is going to be sold and be retained by the mutual holding company who would be the original. They create a stock underneath the mutual holding company and that is where we are determining how much of that stock we are going to sell, whereby the mutual holding company, to retain control, would retain 51% in the holding company and sell 49% to the public. Is that the correct picture?

Ward: That's correct.

Representative Kasper: The stock company is the company that sells the insurance policies. The stock company that spun off is now the insurance company selling the insurance policies. The profitability of the stock company because the mutual company owns 51%, will be determined by the mutual company board to what is going to happen to profitability.

Ward: You're right.

Representative Laning: The policy holders would determine and vote on how much stock would be sold? Who determines whether you get a 100% stock sold on the stock company or only 49%?

Ward: The board of directors would make a decision in that regard. They would go out to the commissioner to approve this plan of conversion and then they would go to the policy holders to approve the plan of conversion.

Representative Frantsvog: The policy holders are not making the decision to sell?

Ward: They are not exactly making the decision to sell but they still retain their voting right to have a say in that vote.

Chairman Keiser: If 51% said that we don't approve it, it's not going to go forward.

Ward: Correct.

Representative M Nelson: Page 11, the optional provision of plans of conversions.

Ward: On page 6, are required provisions of plan of conversions. So every plan of conversions has certain required provision that have to be in there. Assuming you have done those, then you have some optional plans of conversion. Basically, to put limitations on how much of the stock can be purchased by the officers, directors and employees. There is a waiting period before the directors can obtain ownership rights which is 3 years. It's to protect the members and the purchasers of the stock.

Representative M Nelson: What is an example of a fair and unfair equable formula?.

Ward: Those are outlined in the 2nd paragraph, page 11.

Representative M Nelson: I was confused but here it limits it to 35% and 25%, but the way I read it, the commissioner could approve a higher number if he wanted to?

Ward: Paragraph 2, on page 11, I think the definition of fair is your question and my answer is that this optional provision defines it.

Representative M Nelson: The alternative plans, a domestic mutual insurance company could merge with a foreign mutual company?

Ward: I believe that they could now if it is approved by the commission under the current provisions.

Chairman Keiser: Page 5, line 3, what is the definition of "immediately". Can we put a time limitation on that?

Ward: I'm not sure why that is there. I will work with them.

Representative Ruby: It's talking about the decision; maybe it's time for the decision.

Representative Becker: Explain why I would not need to be worried that this wouldn't be a great way to gloss over and a way for a back door for directors to become big time owners of a company without due process.

Ward: I don't know where it will end up. The due process is in the bill in the procedures of the statue.

Representative Becker: There are not ways to circumvent the process that you just declared it goes to policy holders, to public, then to directors? There is a process to circumvent putting officers and directors in front either of those two?

Ward: I didn't see any. I'm comfortable about the due process.

Chairman Keiser: You have members join a little mutual insurance company and they are the owners, I now get some documentation saying we are going to convert and you have the first right of refusal, there are a lot of people who are going to say, what does this mean? The people may not take this option, which would mean the board of officers might be in a position to know the financial condition and have a wonderful opportunity here. Isn't that the same case whether it's a mutual company or not? If I'm not in the mutual company but I buy insurance from Prudential, I can still buy stock in Prudential and benefit?

Ward: Yes, you can. Being a member and policy holder in a mutual company, I don't feel like I own that company.

Representative Amerman: If they decide to sell 49% to the members who get first chance to buy stock, can they buy equally or can one person buy more?

Ward: The first right to buy would be the percentage of the value as it's determined under these formulas of what they own. They could buy basically, through the valuation system, whatever that percentage is. They wouldn't necessarily be able to buy more unless they are buying it on the market.

Chairman Keiser: Anyone else here in support of support of HB 1313, opposition, neutral. Closes the hearing on HB 1313.

2015 HOUSE STANDING COMMITTEE MINUTES

Industry, Business and Labor Committee
Peace Garden Room, State Capitol

HB 1313
1/28/2015
22713

☐ Subcommittee
☐ Conference Committee

Ellen LeTang

Explanation or reason for introduction of bill/resolution:

Conversion of a mutual property & casualty insurance company to a stock insurance company & demutualization of domestic mutual insurance companies.

Minutes: Attachment 1-2

Chairman Keiser: Opens the work session on HB 1313. What are the wishes of the committee?

Representative Kasper: Did we do any amendments?

Chairman Keiser: Yes. (Attachment 1).

Representative Kasper: Moves to adopt the amendments.

Vice Chairman Sukut: Second.

Voice vote, motion carried.

Chairman Keiser: (Attachment 2). This is the dark side of demutualization and how to make a fortune from a mutual insurance company. The Allied invasion and Representative M Nelson will address this later in the hearing.

3:16

Edward Moody~Director of Insurance Company Licensing Examinations for the Insurance Department:

Chairman Keiser: Did you have any concerns?

Moody: We too were concerned when we saw the up to 35% ownership by members of the directors and officers of the company. In the plan of reorganization or conversion, the members get a 100% interest and of those interests to the officers and directors would be subordinate. The department would make sure that any communication with the members

would convey the importance of the value they would be giving up to the officers and directors if they chose to not to exercise their election.

Representative M Nelson: How do we rectify the conflict of interest they have between providing service at the best price of the mutual insurance company and maximizing the return on the other company which they are also the board of, for maximizing the return on the stock?

Moody: That's a hypothetical that we haven't ever had to deal with it. We do have situations of conflict of interests and we have dealt with them by having them recused themselves from any votes that may impact them.

Representative M Nelson: If the board had stock, wouldn't they all have to recuse themselves? How would they function?

Moody: Again, it's a hypothetical we don't see. I don't know.

Representative Kasper: The market will take care of your concern and determine who is going to buy your product.

Representative M Nelson: (Attachment 2 handed out earlier). I handed out an article that summarizes the concerns. Talks about the handout that companies have demutualized, done very well, watched out for their holders and then there is also there is the Allied example.

Chairman Keiser: Your concern should be greatest right now before they demutualize. Everything you have said does exist but it has nothing to do with demutualization. We do have regulators right now that examine for solvency, governess and all the criteria that you have talked about. If a company goes south, where were the regulators because insurance companies do go south, whether they are mutual companies or any other form? Does that have anything to do with this?

Representative M Nelson: Yes, I think it does because many of those transactions are mentioned there. I can't support this bill and it opens a can of worms for someone who could to this and it didn't raise a red flag with the insurance commission and the only safety valve is the insurance commissioner.

Chairman Keiser: Stock and mutual companies can go insolvent, so we can't have any form of company. Further questions? What are the wishes of the committee?

Representative Ruby: Moves a Do Pass as Amended on HB 1313.

Vice Chairman Sukut: Second.

Roll call was taken for a Do Pass as Amended on HB 1313 with 12 yes, 2 no, 1 absent and Vice Chairman Sukut is the carrier.

15.0450.02001
Title.03000

Adopted by the Industry, Business and Labor Committee

January 28, 2015

SB 1-28-15

PROPOSED AMENDMENTS TO HOUSE BILL NO. 1313

Page 7, line 10, replace "subparagraph c" with "item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1"

Page 8, line 31, replace the first "1" with "2"

Page 10, line 2, after "in" insert "item 3 of"

Page 10, line 2, replace the first "c" with "a"

Page 10, line 2, replace "1" with "2"

Renumber accordingly

Date: Jan 28, 2015

Roll Call Vote: 1

2015 HOUSE STANDING COMMITTEE
ROLL CALL VOTES
BILL/RESOLUTION NO. 1313

House Industry, Business & Labor Committee

☐ Subcommittee ☐ Conference Committee

Amendment LC# or Description: _____

Recommendation: ☒ Adopt Amendment
☐ Do Pass ☐ Do Not Pass ☐ Without Committee Recommendation
☐ As Amended ☐ Rerefer to Appropriations
Other Actions: ☐ Reconsider ☐ _____

Motion Made By Rep Kasper Seconded By Rep Sukut

Representatives	Yes	No	Representatives	Yes	No
Chairman Keiser			Representative Lefor		
Vice Chairman Sukut			Representative Louser		
Representative Beadle			Representative Ruby		
Representative Becker			Represenative Amerman		
Representative Devlin			Representative Boschee		
Representative Frantsvog			Representative Hanson		
Representative Kasper			Representative M Nelson		
Representative Laning					

Total (Yes) _____ No _____

Absent _____

Floor Assignment passed

If the vote is on an amendment, briefly indicate intent:

voice vote
motion carried

Date: Jan 28, 2015

Roll Call Vote: 2

2015 HOUSE STANDING COMMITTEE
ROLL CALL VOTES
BILL/RESOLUTION NO. 1313

House Industry, Business & Labor Committee

☐ Subcommittee ☐ Conference Committee

Amendment LC# or Description: 15.0450.02001

Recommendation: ☐ Adopt Amendment
☒ Do Pass ☐ Do Not Pass ☐ Without Committee Recommendation
☒ As Amended ☐ Rerefer to Appropriations
Other Actions: ☐ Reconsider ☐ _____

Motion Made By Rep Ruby Seconded By Rep Sukut

Representatives	Yes	No	Representatives	Yes	No
Chairman Keiser	X		Representative Lefor	X	
Vice Chairman Sukut	X		Representative Louser	X	
Representative Beadle	X		Representative Ruby	X	
Representative Becker	AB		Represenative Amerman		X
Representative Devlin	X		Representative Boschee	X	
Representative Frantsvog	X		Representative Hanson	X	
Representative Kasper	X		Representative M Nelson		X
Representative Laning	X				

Total (Yes) 12 No 2

Absent 1

Floor Assignment Rep Sukut

If the vote is on an amendment, briefly indicate intent:

REPORT OF STANDING COMMITTEE

HB 1313: Industry, Business and Labor Committee (Rep. Keiser, Chairman) recommends **AMENDMENTS AS FOLLOWS** and when so amended, recommends **DO PASS** (12 YEAS, 2 NAYS, 1 ABSENT AND NOT VOTING). HB 1313 was placed on the Sixth order on the calendar.

Page 7, line 10, replace "subparagraph c" with "item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1"

Page 8, line 31, replace the first "1" with "2"

Page 10, line 2, after "in" insert "item 3 of"

Page 10, line 2, replace the first "c" with "a"

Page 10, line 2, replace "1" with "2"

Renumber accordingly

2015 SENATE INDUSTRY, BUSINESS AND LABOR

HB 1313

2015 SENATE STANDING COMMITTEE MINUTES

Industry, Business and Labor Committee
Roosevelt Park Room, State Capitol

HB 1313 Engrossed
3/24/2015
Job Number 25328

☐ Subcommittee
☐ Conference Committee

Committee Clerk Signature Ella Liebelt

Explanation or reason for introduction of bill/resolution:

Relating to title insurance limitations on risk

Minutes: Attachments

Chairman Klein: Called the committee to order.

Pat J. Ward, Nodak Mutual Insurance Company: In support of the bill. Written Testimony Attached (1). (1:06-5:45)

Chairman Klein: You referenced the current demutualization law that we have. Is that something we did that long ago, I thought it was something we worked on in the last twenty years?

Pat Ward: I know that last session there was a bill that put in a similar process for demutualization for a health insurance company.

Chairman Klein: It has been discussed within the board or was this brought to the membership back at the annual November meeting?

Pat Ward: I believe this has been discussed at this point at the board level. In the bill there are procedures you would have to follow before offering it to the members. You would need to formulate a plan and run that plan past the Insurance Commissioner and have the Insurance Commissioner approve the plan and then there is a mailing that would go out to all of the members. The members would have the right to vote and this bill as currently written requires the majority vote of the members and the majority vote of the board before they could start this process.

Chairman Klein: The majority vote of the membership, so when I get that card in the mail, is that how that would work? It says the annual meeting will be held at so and so time. If only twenty people show up and it is eleven to nine.

Pat Ward: I believe there is an actual letter that goes out to the policy holders that is drafted and approved with the Insurance Commissioner. Whether or not those proxies would apply, I would suspect that they would.

Senator Sinner: In regard the policy holders, if I went and got a membership tomorrow would I have the same rights as a customer who has been there for fifty years?

Pat Ward: I believe you would and I think that is one of the problems. It would seem to me it would be unfair to the policy holder that has been who has been a member forever as opposed to the one who is new to the deal. (10:59-12:01)

Senator Burckhard: How much stock do you expect the policy holders will buy if this passes? It says they will have the first right to buy stock.

Pat Ward: I don't know. I think it is going to depend on what that value is and how much of it is offered. (14:41-16:17)

Senator Poolman: Asked how many members and how many board members.

Pat Ward: Said he didn't know how many members there were but there are a dozen board members.

Senator Poolman: Under your testimony it talks about the fact that fifty one percent of the stock must be retained and that the board members or the insiders as they are discussed in your testimony can buy thirty five percent which leaves fourteen percent for that remaining thousands of members, right?

Pat Ward: No the amount that the insiders could ever purchase ultimately would be limited to thirty five percent of the total number of shares issued. He goes on to explain how that would work. (17:00-18:27)

Senator Poolman: Then fifty one percent is not issued so out of that forty nine percent that is left they can't have more than thirty five percent of that, not the entire value?

Pat Ward: That is correct, that is the way that I am reading it. They have to acquire it in the open market the same as any other investor. (18:41- 19:26)

Chairman Klein: So the fifty one percent is off the table and the other forty nine percent the board could have up to thirty five percent of that forty nine percent?

Pat Ward: No that would be thirty five percent of a hundred percent of the forty nine percent.

Chairman Klein: In visiting with my agent, he had no clue that Nodak was even having this discussion and that was two weeks ago. Is he one of the few that has no knowledge or are we waiting until we get something passed and more information so we can get it to the agents?

Pat Ward: My understanding is at this point this has only been a board level discussion and until a law like this is passed there wouldn't be an opportunity to do this or offer it. (20:52-22:15)

Chairman Klein: This will be voted on in between by the current policy holders?

Pat Ward: Yes.

Chairman Klein: Asked for anyone else in support and then for opposition.

Representative Nelson: In opposition to the bill. Written Testimony Attached (2) and (3). (23:19-32:44)

Chairman Klein: I was thinking as the board of these two organizations, there is some crossover isn't there? A number of individuals serve on the Nodak board and also serve on the Farm Bureau board?

Representative Nelson: There is some but the control of the Nodak board no longer rests with the Farm Bureau board.

Senator Murphy: What would you say if Nodak was just starting out as a stock company, it takes away all of your angst doesn't it? Isn't it because of where it is coming from that makes it a problem as far as you can see?

Representative Nelson: It is not just where it is coming from. With any company if they went through a complete demutualization, if the current members got their value out I would have no problem with that whatsoever. What we have here is we have a case where the members aren't going to get their capital out, they will have an opportunity to buy shares but a lot of them won't do it. Then they are in the position of being part of this mutual insurance company but once the subsidiary is set up they don't really have control of what is going to happen on anymore and they will have to rely on this board that they in theory control and the board itself is now in a fiduciary conflict of interest. He goes on to explain what he feels will happen within the company. (33:50-35:54)

Senator Miller: Asked what would be the responsibility of the consumer to vote with their feet if their insurance costs get too high?

Representative Nelson: That can and does happen. You have people moving all the time which creates some of the angst in sometimes in a mutual insurance company of this guy who just bought in having the same vote as the guy who has been there his whole life. It gets to be a dangerous thing when you are mixing coop ownership and stock ownership into the same pot because one is one man one vote and the other is one share one vote and it really becomes a mix that is difficult to control. (36:22-39:21)

Senator Poolman: Mr. Ward's testimony talks about the fact that the company can't buy stock unless it is an open market offer made to all shareholders. Can they just send a letter out that says, this is going up for sale on the stock market, on such and such a day we are

opening it up and then it's may the odds be ever in your favor if you beat us to it, good for you and if not we can buy up whatever we want. How does that work?

Representative Nelson: It certainly is interesting trying to figure out exactly how the flow would be and I don't think there is necessarily just one way. The way I would visualize this happening is to presubscriptions that you as a policy holder would get a letter saying as a policy holder you have the right to purchase so many shares. I don't know if you would necessarily require the check but you would require the company by such and such a date that they want to exercise that option to buy those shares. When I read the bill, I read presubscription, so the board could presubscribe up to thirty five percent of the shares and then I believe any excess shares could also be presubscribed. (39:52-40:52)

Chairman Klein: You heard this bill over in the House and were there any discussions, did you make these comments or did you come to a realization that there is some bad stuff here? I am assuming there has to be some corrections here trying to make it as good as we can get it. What you're thought is that it is a bad idea period?

Representative Nelson: We had one person testify in the House and that was it. There might be fixes here but they are above me.

Neil Alldredge, National Association of Mutual Insurance Companies: I guess I am in the middle of this. We are the National Association of Mutual Insurance Companies we have mutual in our name. Obviously we would prefer all insurance companies to be mutual insurance companies and we would prefer that the mutual companies that we have in our membership always be mutual. Nodak is a member company of ours and that also makes this a little interesting for us to negotiate these kinds of things when we have a member company is taking a path may depart from the mutual sort of brotherhood in all of this. He said they would prefer that nobody would do this but if they are that they would do it in a particular kind of way. The way the bill is structured now it would not be the preferred way of a company pursuing this. We have some changes that we have shopped around with Senator Klein and Representative Keiser and with Nodak. We don't have agreement yet on those changes but I think we are getting there. (42:50-49:58)

Chairman Klein: Said that he had forwarded some changes after the House met and sent them upstairs to have them drafted and this is what we arrived at. Proposed Amendment Attached (4).

Senator Sinner: One of the reasons that we were told in meeting with this Nodak group was they needed to do this to raise capital, expand their business, grow their business and my response is why and to whose benefit?

Neil Alldredge: It is a good question. There is no question that it is harder for mutual companies to raise capital than a stock company. There are options to raise capital. He talks about the options in raising capital. (50:49-52:22)

Chairman Klein: Asked Neil to go over the amendments and explain what we are doing and why you think it is necessary.

Neil Alldredge: He said he would put these in a couple of categories. There are some process changes here in terms of the way the company would go about notifying the policy holder and the vote that the policy holder would have to make. Then there is some substantive kind of protections in place as well. So there is two different kinds of changes we have going through here today. He goes over the amendments. (54:10-1:01:45)

Senator Murphy: Asked if part of the formula included taking out for someone being paid on claims.

Neil Alldredge: Said that it would be likely be more of a straightforward valuation based on the number of years. You probably wouldn't go through the whole exercise of who has had claims because that would be more of a contractual issue about coverage and claims. We are talking here about purely the value of the limited ownership interest that every policy holder has in a mutual.

Senator Miller: Asked if they could force ownership of stock on a person, could you issue stock to all of the members and if they could legally become owners of it regardless if they want to or not.

Neil Alldredge: You couldn't force them to buy it. You could gift it to them. There is nothing in the bill that would allow that to happen and I am not aware of any states that have done that before. He continues going over the amendments. (1:03:26-1:08)

Senator Murphy: Asked him to help him out with the dynamics here.

Neil Alldredge: We do have stock companies that are allowed to be members but they are not allowed to be on their board of directors. (1:08:25-1:09:50)

Senator Poolman: With this amendment does the valuation in payout happen before they have been given the opportunity to buy stock?

Neil Alldredge: It would be simultaneous almost. So you would make the offer to buy stock and what would first happen is you have to figure out who does, so whatever number of policies holders exercise their rights, they would be out of the pool of this valuation question and then you would go through the process of determining the balance of those policy holders, how you would value their ownership interest. That would be part of the plan and that plan would be exercised and then the conversion would go on from there. (1:10:10-1:10:42)

Senator Poolman: And then whatever stock was not purchased then the company can go in and purchase or anybody else but they have given the shareholders the opportunity to buy that so if there is anything left they can scoop that up as well and under this bill within six months they can be giving those out as stock options to the board.

Neil Alldredge: Six months in the original bill, the House version.

Chairman Klein: This would also address some of Representative Nelson's issues with the thirty five percent it won't all be sent off to the board.

Neil Alldredge: It is trying to address some of those it is not a perfect solution.

Senator Poolman: So they have that opportunity to buy that thirty five percent but all of that extra stock is available to the company to then turn around and make available?

Neil Alldredge: Correct or again anybody else in the public could buy them.

Senator Sinner: The policy holders who decide to subscribe to the stock. Do they get any value for what they have in the company?

Neil Alldredge: Their value would be in the form of the stock.

Senator Sinner: But the public that comes in and buys the stock gets the exact same. So if a person says they are not going to sign up for this but wait and get their share of the deal and wait and get the stock the same as the guy down the street is going to buy it and I will win both ways.

Neil Alldredge: You could see it that way but my guess is that because this is a presubscription offering you probably are going to be able to buy it at a better price, the policy holders would be.

Senator Sinner: You suspect that the policy holder who buys stock is going to get a better deal initially. That is some of their policy holder equity value coming out that way. We don't know that.

Neil Alldredge: It is pure speculation. We don't know that. It all gets down to how they value the stock. He continues with the amendments. (1:13:55-1:15:07)

Chairman Klein: We have some direction but we will need to continue to work on some things. If we can get something crafted that at least gives us a good direction. I am going to ask the department to come up.

Edward Moody, Director of Insurance Company Licensing and Examinations: Said he wanted to clarify a few points, Nodak is more than adequately capitalized. They have a hundred and twenty one million dollars' worth of surplus and in order to maintain a competitive risk based capital and the relationships of the premiums written to the surplus they would only need somewhere around forty million. So needing capital isn't really an issue and the other point that was made regarding ERM and the ability to geographically diversified, they have a very robust free insurance program so they mitigate that risk. As far as the issuing of the stock, the way the department sees it there are at least five different parties. First would be the members who were under the subscription plan, then the officers, directors and employees and whoever else is allowed under the statute, depending on which amendment is past. You also have the employee benefit plan which automatically gets ten percent. That is separate from the twenty five to thirty five percent of the stock. After those parties have the chance to partake in the offering it would then be opened up to the open market or to some other person, either detailed in the conversion plan or made known to the commissioner that they wanted to buy the rest of the stock. It doesn't actually

have to go into the open market. After the conversion the officers and directors stock plan would have a chance to buy stock in the open market. He continues to talk about the amendments and how he reads them and said in reviewing the proposed amendments he does feel they make them better for the members. (1:16:48-1:22:52)

Chairman Klein: You make some great points here but I sense you would like them to stay exactly the way they are. I think you would have to be involved in how we are going to get to the end here if this thing happens to move forward. I sense there are some regulation issues that also would draw the attention of the insurance department.

Senator Sinner: I noted in the bill that there is a fee of ten thousand dollars, is that going to be adequate?

Edward Moody: It is a minimum of ten thousand and then it is based on the assets. When we did a calculation based on Nodak assets the fee would be over a hundred thousand dollars that the department would receive. We would also be able to charge for any third party investment professionals.

Chairman Klein: I think there are some issues we need to address here. I am going to close the hearing on 1313.

2015 SENATE STANDING COMMITTEE MINUTES

Industry, Business and Labor Committee
Roosevelt Park Room, State Capitol

HB 1313
3/30/2015
Job Number 25597

☐ Subcommittee
☐ Conference Committee

Committee Clerk Signature Eva Luckelt

Explanation or reason for introduction of bill/resolution:

Relating to title insurance limitations on risk

Minutes: No Attachments

Chairman Klein: Asked for the committee to move to HB 1313. In the last week or so we've had a lot of discussion. There has been a lot of good information. There has been a lot of work being done by the National Association of Mutual Insurance Companies. Which in fact early this morning I did get a note from Neil Alldredge who is at the same conference with Jim Alexander from Nodak and they are hammering out their differences and I was just told this morning that we may be having that come by us electronically. We should probably wait to see what sort of arguments or debates we are going to have on that. Once again our role is to see if we can make this seamless. I don't want to open this whole hearing up again but we spoke about and what the department has in current language why do we need something separate. It seems to me in visiting with the department that we provided rule for demutualization not that many years ago.

Matt Fischer, Financial Analyst for the North Dakota Insurance Department: The current administrative rules that are on the record took affect back in 2000. Under those current rules it lays out how a company can demutualize, convert into a stock company, and create a mutual holding company. So the law is already there. (2:00-2:33)

Chairman Klein: So as we look at this legislation is this different considerably from your ability to use what you have in current code?

Matt Fischer: What this would do, this legislation is scrap out what is currently in law. It would scrap out the current demutualization code section, which would also take out the administrative rules that are currently in law right now. It would get rid of everything and it would enact a completely new legislation, a new law for demutualization of a mutual insurance company.

Chairman Klein: Is that going to make it more seamless for other companies or is this an impediment?

Matt Fischer: When we look at the current administrative rules, what we understand from the new law is, what is currently in law they can do now, what they are proposing. The new law would give them a few more abilities that aren't specifically written in the code now. So it lays out a few more items that aren't currently in there. What is in there now doesn't say they can't do it, it just not written down. So this broadens up some abilities for them.

Chairman Klein: Asked if this would restrict them from coming to the department and saying this is what we are doing, this is what you have in the code or it doesn't say this in code. Does the commissioner have the authority to answer some of those questions or to allow them to do what they want if he sees that it is being a reasonable move?

Matt Fischer: Yes it does. The current law would allow them to create their proposed plan of conversion, bring it to the commissioner for the commissioner's review and approval and it does allow them to detail the plan as they want to go forward.

Senator Murphy: Did you just ask him why we need 1313 and if we do need it?

Chairman Klein: I am trying to get there and trying to see what we are fixing if we already have something in the books. I have been trying to dig into this because originally I heard we were doing this because under the current statute we couldn't but I am hearing different stories now and I am just still trying to understand. Certainly 2000 is a long time ago, some things could have changed and maybe an update isn't out of the question either.

Senator Murphy: Asked Matt Fischer if he thinks they need this bill.

Matt Fischer: I haven't had that discussion directly with the commissioner myself. What we wanted to do is lay out what the current law says right now and what they are proposing and let that decision be up to you, whether or not this law is necessary.

Senator Campbell: You said that there were a couple of minor things that you didn't elaborate on that they can do but the current law doesn't say they can. Can you elaborate on those?

Matt Fischer: One of the specific items that the new legislation will allow, it would go to a subscriptions rights model. Where under the current law it doesn't specifically say how they need to go about converting. Under the subscription rights model it allows the current members of the mutual holding company to automatically get for no fee a subscription that would allow them to purchase stock in the newly converted company. What the current law doesn't speak to is how they need to do that. It doesn't lay out that they have to go to a subscription rights model that is one way and the other way is they could gift the stock to the members. An example, they would convert to the mutual company and then they would come up with some sort of equation on how they want to distribute the capital to current members and then you would just get your shares of stock for being a member of the mutual company.

Senator Campbell: It doesn't have to come to an annual meeting for the shareholders to vote? They have the amount of capital three folds of what they need so the existing

members wouldn't have input then or to purchase a subscription when they might have capitol coming from their one hundred and fifty million?

Matt Fischer: That is not true. The vote still has to go to the members and that was under this old law as well. Basically how it will work is the board of directors will craft a conversion plan and they will vote on it and when that happens it comes to the commissioner's office and it will also have to go to the members for their vote. (7:41-7:58)

Chairman Klein: A vote of the majority of the members or a majority of the folks who participate or return their card?

Matt Fischer: The bill passed by the House read strictly a majority of the members present and voting or by proxy. They have amended so that it would change to a two-thirds majority.

Senator Sinner: What are the requirements of the board to notify the members, the policy holders?

Matt Fischer: The law details how they go about informing the members. The board would have to approve the plan of conversion first before it would go to the members for their consideration.

Senator Sinner: They don't have to notify anybody until they have already approved a plan?

Matt Fischer: That would be our understanding of it.

Senator Sinner: Can you speak how Nodak Mutual selects their board members?

Matt Fischer: The bylaws dictate how they select the board. (9:42-10:10)

Senator Sinner: My understanding is that all the members are chosen by the board so they are kind of a club. The members don't select the board the board selects the board.

Chairman Klein: Certainly that would be a question that we ponder here but back in the Poolman years when we had the issue where they thought it was being too closely held the commissioner asked that there be a division there. I believe at one point they could serve on both boards and now they had to create two boards.

Matt Fischer: Yes the Farm Bureau Board and the Nodak Board I believe at once were one in the same. However that has changed, currently the board is made up of there are four members on the Nodak Board who are also on the Farm Bureau Board.

Senator Poolman: You spoke to the difference between the subscription rights and the gifting of the stock. Is that under current administrative rule at the discretion of the commissioner when they bring their plan? Who decides which route they can go?

Matt Fischer: That is up to the plan. As the rules stand now the company would approve a plan of conversion and bring it to the commissioner for his review and approval. It does not state whether or not it has to be gifted or go to the subscription rights law.

Senator Poolman: Do they make up their plan, bring it to the commissioner and then go for a vote, is that the order?

Matt Fischer: Yes the board will approve the plan of conversion and then it comes to the commissioner for his review and approval and then I believe it then goes to the members for their approval.

Chairman Klein: One of the comments was that the direction of the board of directors and the leadership that helped build that surplus, there is a fine line as to why the board members would be in line for the thirty five percent and we also heard ten percent would go to the employees in their 401 or whatever their employee benefits are. What I understood was as a member I would get the opportunity to buy stock at a price fixed or determined by the board, is that how you read this?

Matt Fischer: That is correct.

Chairman Klein: So I would have that option of determining whether I wanted to be an investor in the newly formed holding company?

Matt Fischer: How it would work as we understand the bill is that a mutual holding company would be created and the current company as it stands would be converted to a stock company. When you get your subscription rights and decide to exercise those rights you would be buying stock in a converted stock company, not the mutual holding company because in the mutual holding company there is no stock that is available for purchase. (14:31-14:59)

Chairman Klein: And if I said as a policy holder why would I want to buy one hundred shares of Nodak stock other than an investment because I know it is a solid company and I have been doing business with them for whatever years.

Matt Fischer: That would be a correct statement.

Chairman Klein: Is there only going to be a certain amount of stock available to the policy holders or the public?

Matt Fischer: The plan of conversion will set up the number of shares that would be available. Our understanding is and the way it was presented, it was talking about a forty nine percent offering but it is going to be up to the board of how many shares they want to make available to the members, to the public and any other interested investor at that time.

Chairman Klein: We are having some good discussion here and we are trying to get our arms around this. It is a big deal and it is a big deal for the State and for the policyholders. Once again we are talking about a company that has one hundred and thirty million dollars.

Pat Ward, Representing Nodak Mutual Insurance Company: Said he isn't prepared to answer all of the questions but he will do his best. He said that he got an email from Jim Alexander an hour ago that said they have agreed on changes and that they would have an email for them with the changes they agreed upon. He said that they do feel they need this bill because it spells out the rights in a clear and statutory fashion of what the policyholders will have. He addressed some of the questions on what the bill does and said it is important to read the bill and that if they would read it a few times it will come together. He went over the bill and the process on how it would work. He commented on the one hundred and thirty million dollars that they have in surplus and reserves at this point and said they don't want to be just a borderline solvent company they want to be a lot more than that. If there is an opportunity out there to buy another company and you need to raise fifty million dollars more so that your financials stay good, that is kind of what they are looking at. They are looking at having the opportunity to strike if there is a good investment out there. He said that stock companies and mutual companies are regulated by the commissioner. They don't give up any regulation by becoming a stock company. (18:16-27:25)

Chairman Klein: As I listened to Matt and the fact that we potentially have enough rules on the books to do what we wanted to do and you pointed out that this bill makes it a lot more clear. Would I be concerned then that we are restricting the commissioner's ability to make any decisions by making everything in law so concise that it removes any flexibility? We can spend so much time making new laws that there is no flexibility and that would restrict or handcuff the commissioner from making decisions because it is in here.

Pat Ward: I don't think this bill does that. I think this bill spells out that the ultimate arbiter is still the commissioner. In my opinion I believe there are many safeguards and many protections and that ultimately it is still the commissioner who is going to have the final word if we decide to do something like this. If an opportunity comes along it has to go through him.

Chairman Klein: I will get the amendments and we will continue to work this through. He adjourned the meeting.

2015 SENATE STANDING COMMITTEE MINUTES

Industry, Business and Labor Committee
Roosevelt Park Room, State Capitol

HB 1313 Engrossed
4/1/2015
Job Number 25699

☐ Subcommittee
☐ Conference Committee

Committee Clerk Signature Eva Liebelt

Explanation or reason for introduction of bill/resolution:

Relating to title insurance limitations on risk

Minutes: Attachment

Chairman Klein: Called the committee to order. He said he got the amendments on his desk this morning. He had asked the department to come and explain the amendment. He had copies of the amendment and a marked up version of the bill handed out, Attachments (1) and (2).

Edward Moody, Director of Insurance Licensing and Examining of the North Dakota Insurance Department: He goes over the marked up version of the bill and explains the changes. (4:28-8:00)

Chairman Klein: So the b language doesn't conflict with the c language, which are two different issues there?

Edward Moody: Right one is the plan of conversion itself and then the c language is the method for allocating the subscription rights amongst the members and other parties. One is an integral part of the other but it doesn't necessarily have to be a part. They don't have to issue subscription rights but if they do they also have to meet that condition that the method of allocation is fair and equitable.

Chairman Klein: Who determines that?

Edward Moody: The commissioner and that would be done through a hearing.

Chairman Klein: The hearing process will be necessary to get this all off of the ground anyway, this creates the process.

Edward Moody: Correct. He begins again going over the changes in the bill. (9:13-10:07)

Chairman Klein: Another concern was they would lose a rating on the national level if the capital was to low?

Edward Moody: Yes they currently were upgraded to an "A" but in the past for the longest time they were a "B" and the forty million that the department quoted wouldn't have been sufficient to retain their "A". (10:15-10:52)

Senator Campbell: Would a tier one capital be like forty million?

Edward Moody: Right now solvency two which would impose the similar tier one and tier two capital requirements on insurance companies like they do in banking, isn't in affect but in essence the forty million dollars you could consider a tier one. We use is risk based capital and the credit ratings of the third party credit agency which have their own method of determining what is adequate capital. He begins again with the changes. (11:23-14:07)

Chairman Klein: So I am going to get a notice in the mail that explains what is happening, am I going to be able to understand that?

Edward Moody: We hope so. Any notice will be subject to approval by the department and we will make sure it is as readable and understandable for the lay person as we can.

Chairman Klein: I think that is important because we want to make sure that the members and the agents will understand this. It will eventually come to a meeting where everyone will be able to voice their opinion.

Edward Moody: That is correct and I would like to go over that after we have talked about all of the amendments. We will be talking about that as we go through this and at the end I can tie it all together. He begins again with the changes. (15:22-16:27)

Senator Sinner: Asked about the members being able to mail in a ballot.

Edward Moody: The plan of conversion does allow members to vote by proxy which could include the mail or on the internet.

Senator Sinner: Said he understood you could give your proxy to someone else to vote but you cannot mail in your vote.

Edward Moody: I guess that makes sense with the definition of proxy but again without having the specifics of the plan of conversion. That would be detailed in the plan of conversion. How the members are able to vote, if they have to be physically present or by proxy and then if by proxy what are the terms and conditions, also how much a member gets in terms of the votes.

Chairman Klein: That is what Senator Sinner hit on. I am spending so much in premiums every year versus a two year customer. Is that what you are talking about with the conversion, all of these things will be determined somewhere along the line and will have to be approved by the commissioner.

Edward Moody: That is correct. He continues with the changes. (19:32-22:23)

Senator Murphy: So what, I don't understand that. What is going on here?

Edward Moody: What is going on with this paragraph is if the plan of conversion does use subscription rights this paragraph specifies that they have to be valued in accordance with the Black-Scholes model. The Black-Scholes model has a number of inputs being the strike price, which is basically the price you are going to be offering the stock, the market value of the stock, the implied volatility of that stock, how it trades in the market, and the implied interest rate. The last thing would be the length of time for expiration of the subscription rights. He begins going over the changes. (22:33-24:21)

Senator Murphy: Is this language you crafted or are you taking it from some model language?

Edward Moody: Inserted by NAMIC, National Association of Mutual Insurance Companies, it goes from the federal model.

Chairman Klein: And that again is to protect the policy holders. We want to make sure that everybody gets something here.

Edward Moody: He begins going over the changes again. (25:17-26:05)

Senator Murphy: Is this kind of clamping down on the insider trading kind of thing or a benefit of being in the corporation, trying to make it more of an even playing field?

Edward Moody: I believe that is NAMIC's intent that they wanted to restrict it just to the members but the way the bill is drafted, eliminating that doesn't really prevent someone from issuing subordinate subscription rights because there is an alternate plan of conversion. I believe it was what you said, leveling the playing field so it is tilted more favorably towards the members.

Chairman Klein: Getting back to the three to two any particular reason for the period of two years from the date of completion?

Edward Moody: I am not sure we have no input on it. I believe the federal model had three years and why they wanted to move it to two I don't know.

Senator Campbell: So this section in provisions, unless the person put specific verbiage in there not allowing that to happen, no self-given golden parachutes and so forth, they could do anything right? Wasn't that one of the concerns a lot of people had was giving the board of directors or the CEO's perks or padding or golden parachutes.

Edward Moody: They can propose whatever they like in the plan of conversion that is why the department was so insistent that the one line that it is fair and equitable to the members and the converting mutual be inserted because that is the leverage the commissioner has to make sure that all participants are treated fairly and equitably. (28:11-28:31)

Chairman Klein: Obviously if the language wasn't necessary they wouldn't have stricken it but it must have been worked out with both groups. This isn't restricting Nodak but the other language is the part that will give us the comfort for the policy holder.

Edward Moody: There is one slight difference, these subordinate subscription rights were issued without payment and the way the rest of the bill reads you will see, "without paying", has been deleted. So if now they even if they were to attempt to offer subordinate subscription rights to non-members they have to pay for those rights. That is where they are changing the ground more in favor of the members. He continues with amendments and then addresses some previous questions. He talked about how the process would work. He said that the members will have forty-five days to respond back, to the notice that is sent to them, before the hearing is held. The commissioner will have thirty days to issue a finding. Then a date will be set for the members to vote on the plan. Once they vote on it 2/3 of the members voting have to approve the plan. After they approve the plan it will come back and then the department would process the conversion. (29:20-33:55)

Senator Sinner: The commissioner issues his findings thirty days after the hearing and if the finding is that the plan is approved then the company sets a date for the membership voting. Is it not a minimum of forty-five days before the voting of the meeting occurs?

Edward Moody: I will have to refer to the actual bill itself. It is on page 5, line 28, forty-five days is correct.

Senator Sinner: This is a big deal for the commissioner to review this plan is thirty days enough and are there options to extend that time?

Edward Moody: I believe that anything that is not specified in the bill would be able to be determined in a rule.

Senator Sinner: When we talk about subscription rights to the members how do they come up with a value, is there a model?

Edward Moody: The model is just to value the subscription rights. There is a totally separate process to value the converting mutual entity. That is usually done by looking at their peer group in terms of what multiples they sell. They would retain an independent third party expert to make that determination and then the department has that option under the bill to hire our own investment expert to perform the same valuation to challenge the value that they have developed. (36:22-37:41)

Chairman Klein: That falls under the ability to charge a fee to the company?

Edward Moody: That is correct.

Senator Campbell: Asked if he was comfortable with the changes and if it is protecting the shareholders?

Edward Moody: Said the department feels they would be able to do their duty to protect all of the stakeholders involved in the transaction but it would be up to you to decide whether or not this bill is complete.

Senator Sinner: Said that he is most concerned about the members and making sure they are treated fairly and if that was his primary concern and making sure the company stays solvent?

Edward Moody: Actually the department wants to protect all of the stakeholders on an equitable and fair base, in addition to making sure the insurance entity is adequately capitalized.

Senator Sinner: Asked about the board notifying its members that it is considering this.

Edward Moody: Said that this is a normal process and the way that cooperate governance works.

Chairman Klein: After we pass this the legislation we will certainly get that process going. It is still a long work in process. Until we pass this so the board can sit back and determine what the rules are for them or the directors they can move through that and start establishing their plan.

Edward Moody: That is correct.

Senator Poolman: Moved the amendments, 15.0450.03004.

Senator Campbell: Seconded the motion.

Chairman Klein: Asked the committee for discussion. He said that the folks at NAMIC and Nodak have worked out a lot of the details and he is confident with what they have here and that the department is also satisfied.

Senator Sinner: Said he would like to see that before the management goes into developing a plan that they would go to the membership and get a vote from the membership.

Senator Campbell: Said that isn't typical protocol and that they have over twenty-seven thousand Nodak members and if they do that they would come back potentially with twenty-seven thousand ideas.

Senator Sinner: Not necessarily. My thought is you send out something and you could have a hotline where they can call in with questions and you give them a yes or no. The people on the board of directors do not own this company. They own very little of this company and many own nothing of this company. This board of directors is also self-sustaining they are not elected from the members. They are elected from the board, they pick their own successors.

Chairman Klein: I think we understand that but I don't think we can send that message. I think it has to be sent by someone else. I think we have an understanding of the issue that you are addressing but I don't know that there is any way that we as a legislature can make that happen.

Edward Moody: Said that yes there is a concern about the board of directors but that is why they vote for the board of directors. (50:21-51:17)

Chairman Klein: The clerk will call the roll on the amendments.

Roll Call Vote: Yes-7 No-0 Absent-0

Senator Sinner: Moved a do pass as amended.

Senator Poolman: Seconded the motion.

Roll Call Vote: Yes-7 No-0 Absent-0

Senator Klein will carry the bill.

15.0450.03004
Title.04000

Prepared by the Legislative Council staff for
Senator Klein
March 31, 2015

1313
4/1/15

PROPOSED AMENDMENTS TO ENGROSSED HOUSE BILL NO. 1313

Page 3, line 22, replace "twenty or more than thirty-five" with "forty-five"

Page 3, line 23, after "proposed" insert "subsidiary"

Page 3, line 24, after "the" insert "stock of the"

Page 3, line 24, remove "through"

Page 3, line 25, remove "the purchase of all the stock of the converted stock company"

Page 4, line 1, replace "a majority" with "two-thirds"

Page 4, line 4, replace "a majority" with "two-thirds"

Page 4, line 23, after the underscored period insert "The application fee is in addition to other direct costs incurred by the commissioner in reviewing the proposed plan of conversion."

Page 5, line 3, remove "Immediately, the commissioner shall give written notice to the converting mutual"

Page 5, remove line 4

Page 5, line 5, remove "reasons for the decision."

Page 5, line 8, after "b." insert "The plan is fair and equitable to the converting mutual company, the members of the converting mutual company, and the eligible members of the converting mutual company;

c."

Page 5, line 8, remove the second "and"

Page 5, line 9, replace "c." with "d."

Page 5, line 9, replace the underscored period with "; and

e. The converted stock company will have the amount of capital and surplus deemed by the commissioner to be reasonable for its future solvency."

Page 5, line 14, replace "may" with "shall"

Page 5, line 18, after "7." insert "The commissioner shall give written notice of any decision to the converting mutual company and, in the event of disapproval, a detailed statement of the reasons for the decision.

8."

Page 5, line 19, after "conversion" insert "no later than forty-five days before the meeting"

Page 5, line 19, remove "briefly but fairly"

2013

Page 5, line 20, after the underscored comma insert "must inform the member how the proposed plan of conversion will affect the member's membership rights,"

Page 5, line 22, after the underscored period insert "The notice must provide instructions on how the member can obtain, either by mail or electronically, a full copy of the proposed plan of conversion."

Page 5, line 25, replace "8." with "9."

Page 5, line 26, replace "a majority" with "two-thirds"

Page 6, line 1, replace "9." with "10."

Page 6, line 3, replace "a majority" with "two-thirds"

Page 6, line 5, replace "10." with "11."

Page 6, line 9, after "approved" insert ", which must include the record of total votes cast in favor of the plan"

Page 7, line 8, after "proposed" insert "subsidiary"

Page 7, line 9, remove "all"

Page 7, line 21, replace "total price" with "pro-forma market value"

Page 8, line 2, remove "all"

Page 9, line 2, replace "amount" with "value"

Page 9, line 10, after "5." insert "The dollar value of a subscription right based upon the application of the Black-Scholes option pricing model or another generally accepted option pricing model. In connection with the determination of stock price volatility or other valuation inputs used in option pricing models, the qualified independent expert may assume that the attributes of the converted stock company will be substantially similar to the attributes of the stock of the peer companies used to determine the estimated pro-forma market value of the converted stock company. The term of a subscription right is a minimum of ninety days for the sole purpose of determining the value of a subscription right.

6. The plan must provide that each eligible member has the right to require the mutual company to redeem such subscription rights, in lieu of exercising the subscription rights allocated to each eligible member, at a price equal to the number of subscription rights allocated to each eligible member multiplied by the dollar value of the subscription right as determined by the qualified independent exert pursuant to subsection 4. The obligation of the mutual company to redeem subscription rights arises only upon the effective date of the plan. The redemption price payable to each eligible member must be paid to the member within thirty days of the effective date of the plan. Alternatively, the converted stock company may offer each eligible member the option of receiving the redemption amount in cash or having the redemption amount credited against future premium payments. An eligible member that does not exercise their subscription rights, and which also fails to affirmatively request redemption of the member's subscription rights before the expiration of the subscription offering, nevertheless is deemed to have requested redemption of the member's subscription rights and shall receive the redemption amount in cash in the manner otherwise provided in this subsection.

7."

Page 9, line 17, replace "6." with "8."

Page 9, line 30, replace "7." with "9."

Page 10, line 13, replace "8." with "10."

Page 10, line 23, replace "9." with "11."

Page 10, line 25, replace "10." with "12."

Page 10, line 26, replace "three" with "two"

Page 11, remove lines 9 through 29

Page 11, line 30, replace "3." with "1."

Page 12, line 13, replace "4." with "2."

Page 12, line 13, replace the first "the" with "that"

Page 12, line 14, remove ", without payment,"

Page 12, remove lines 22 through 24

Page 12, line 25, replace "c." with "b."

Page 12, line 28, replace "d." with "c."

Page 15, line 24, replace "Except as provided for in a plan of conversion approved by the commissioner, a" with "A"

Renumber accordingly

Date: 4/1/15
Roll Call Vote #: 1

2015 SENATE STANDING COMMITTEE
ROLL CALL VOTES
HB 1313 Engrossed

Senate Industry, Business and Labor Committee

☐ Subcommittee

Amendment LC# or Description: 15.0450.03004

Recommendation: ☒ Adopt Amendment
☐ Do Pass ☐ Do Not Pass ☐ Without Committee Recommendation
☐ As Amended ☐ Rerefer to Appropriations
☐ Place on Consent Calendar

Other Actions: ☐ Reconsider ☐ _____

Motion Made By Senator Poolman Seconded By Senator Campbell

Senators	Yes	No	Senators	Yes	No
Chairman Klein	x		Senator Murphy	x	
Vice Chairman Campbell	x		Senator Sinner	x	
Senator Burckhard	x				
Senator Miller	x				
Senator Poolman	x				

Total (Yes) 7 No 0

Absent 0

Floor Assignment _____

If the vote is on an amendment, briefly indicate intent:

Date: 4/1/15
Roll Call Vote #: 2

2015 SENATE STANDING COMMITTEE
ROLL CALL VOTES
HB 1313 Engrossed

Senate Industry, Business and Labor Committee

☐ Subcommittee

Amendment LC# or Description: 15.0450.03004

Recommendation: ☐ Adopt Amendment
☒ Do Pass ☐ Do Not Pass ☐ Without Committee Recommendation
☒ As Amended ☐ Rerefer to Appropriations
☐ Place on Consent Calendar

Other Actions: ☐ Reconsider ☐ _____

Motion Made By Senator Sinner Seconded By Senator Poolman

Senators	Yes	No	Senators	Yes	No
Chairman Klein	x		Senator Murphy	x	
Vice Chairman Campbell	x		Senator Sinner	x	
Senator Burckhard	x				
Senator Miller	x				
Senator Poolman	x				

Total (Yes) 7 No 0

Absent 0

Floor Assignment Senator Klein

If the vote is on an amendment, briefly indicate intent:

REPORT OF STANDING COMMITTEE

HB 1313, as engrossed: Industry, Business and Labor Committee (Sen. Klein, Chairman) recommends **AMENDMENTS AS FOLLOWS** and when so amended, recommends **DO PASS** (7 YEAS, 0 NAYS, 0 ABSENT AND NOT VOTING). Engrossed HB 1313 was placed on the Sixth order on the calendar.

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Page 3, line 23, after "proposed" insert "subsidiary"

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Page 5, line 22, after the underscored period insert "The notice must provide instructions on how the member can obtain, either by mail or electronically, a full copy of the proposed plan of conversion."

Page 5, line 25, replace "8." with "9."

Page 5, line 26, replace "a majority" with "two-thirds"

Page 6, line 1, replace "9." with "10."

Page 6, line 3, replace "a majority" with "two-thirds"

Page 6, line 5, replace "10." with "11."

Page 6, line 9, after "approved" insert ", which must include the record of total votes cast in favor of the plan"

Page 7, line 8, after "proposed" insert "subsidiary"

Page 7, line 9, remove "all"

Page 7, line 21, replace "total price" with "pro-forma market value"

Page 8, line 2, remove "all"

Page 9, line 2, replace "amount" with "value"

Page 9, line 10, after "5." insert "The dollar value of a subscription right based upon the application of the Black-Scholes option pricing model or another generally accepted option pricing model. In connection with the determination of stock price volatility or other valuation inputs used in option pricing models, the qualified independent expert may assume that the attributes of the converted stock company will be substantially similar to the attributes of the stock of the peer companies used to determine the estimated pro-forma market value of the converted stock company. The term of a subscription right is a minimum of ninety days for the sole purpose of determining the value of a subscription right.

6. The plan must provide that each eligible member has the right to require the mutual company to redeem such subscription rights, in lieu of exercising the subscription rights allocated to each eligible member, at a price equal to the number of subscription rights allocated to each eligible member multiplied by the dollar value of the subscription right as determined by the qualified independent exert pursuant to subsection 4. The obligation of the mutual company to redeem subscription rights arises only upon the effective date of the plan. The redemption price payable to each eligible member must be paid to the member within thirty days of the effective date of the plan. Alternatively, the converted stock company may offer each eligible member the option of receiving the redemption amount in cash or having the redemption amount credited against future premium payments. An eligible member that does not exercise their subscription rights, and which also fails to affirmatively request redemption of the member's subscription rights before the expiration of the subscription offering, nevertheless is deemed to have requested redemption of the member's subscription rights and shall receive the redemption amount in cash in the manner otherwise provided in this subsection.

7."

Page 9, line 17, replace "6." with "8."

Page 9, line 30, replace "7." with "9."

Page 10, line 13, replace "8." with "10."

Page 10, line 23, replace "9." with "11."

Page 10, line 25, replace "10." with "12."

Page 10, line 26, replace "three" with "two"

Page 11, remove lines 9 through 29

Page 11, line 30, replace "3." with "1."

Page 12, line 13, replace "4." with "2."

Page 12, line 13, replace the first "the" with "that"

Page 12, line 14, remove ", without payment,"

Page 12, remove lines 22 through 24

Page 12, line 25, replace "c." with "b."

Page 12, line 28, replace "d." with "c."

Page 15, line 24, replace "Except as provided for in a plan of conversion approved by the commissioner, a" with "A"

Renumber accordingly

2015 CONFERENCE COMMITTEE

HB 1313

2015 HOUSE STANDING COMMITTEE MINUTES

Industry, Business and Labor Committee
Peace Garden Room, State Capitol

HB 1313
4/10/2015
26015

☐ Subcommittee
☒ Conference Committee

Ellen LeTang

Explanation or reason for introduction of bill/resolution:

Conversion of a mutual property & casualty insurance company to a stock insurance company & demutualization of domestic mutual insurance companies.

Minutes: Attachment 1, 2

Representative Sukut: Opens the conference hearing on HB 1313.

Representative Sukut: Senator Klein would you go through the amendment is and why.

Senator Klein: When the bill came over, we had a visit from the national association mutual insurance companies who had a couple of issues with the bill. They got together with Jim Alexander from NoDak to iron out some of the differences they had. Together they came out with what the amendments turned into. What we laid out was to make sure that the insurance department also saw these as favorable to be able to regulate and do the job they need to. Everyone came together on these amendments and I explained the amendments to Representative Sukut. Pat Ward made a nice sheet that explains the amendments, (Attachment 1). The most important thing that we were looking at it making sure that current policy holders were treated fairly and that they understood the whole conversion process of what's is going on. If you ask anybody today, they say, what is mutualization? Goes over the attachments. (Attachment 2).

8:20

Representative Hanson: Can you explain number 6 on page 10.

Senator Klein: The definition I received, it specifies that the converting mutual companies require to redeem subscription right for their cash value if the member elects not to participate in the stock offering. The company could also credit the member's future premiums for the value of the rights, regardless of whether the member elects the cash option. If they do not exercise their subscription rights to purchase the stock, they are automatically deemed to have requested the cash option and will be paid the cash value of the options. So there is something in it for the policy holders.

Representative Hanson: Without that specification, we want to make sure those policy holders were getting that option of retaining their value it they decide not to participate?

Senator Klein: That's my understanding.

Representative Sukut: Everyone is basically on board with what we are working with. I would entertain a motion.

Representative Hanson: Move the House accede to the Senate amendments.

Senator Murphy: Second.

Representative Sukut: Further discussion.

Roll call was take on HB 1313 for the House to accede to the Senate amendments with 6 yes, 0 no, 0 absent. Members present were: Representative Sukut, Representative Kasper, Representative Hanson, Senator Klein, Senator Poolman and Senator Murphy.

Date: 4/10/2015

Roll Call Vote #: 1

2015 HOUSE CONFERENCE COMMITTEE
ROLL CALL VOTES

BILL/RESOLUTION NO: 1313 as (re) engrossed

House Industry, Business and Labor Committee

Action Taken:
- ☒ **HOUSE accede to Senate Amendments**
- ☐ **HOUSE accede to Senate Amendments and further amend**
- ☐ **SENATE recede from Senate amendments**
- ☐ **SENATE recede from Senate amendments and amend as follows**

- ☐ **Unable to agree**, recommends that the committee be discharged and a new committee be appointed

Motion Made by: Representative Hanson Seconded by: Senator Murphy

Representatives	Apr 10			Yes	No		Senators	Apr 10			Yes	No
Representative Sukut	X			X			Senator Klein	X			X	
Representative Kasper	X			X			Senator Poolman	X			X	
Representative Hanson	X			X			Senator Murphy	X			X	
Total Rep. Vote							Total Senate Vote					

Vote Count Yes: 6 No: 0 Absent: 0

House Carrier No carrier Senate Carrier No carrier

LC Number _____ . _____ of amendment

LC Number _____ . _____ of engrossment

Emergency clause added or deleted

Statement of purpose of amendment

REPORT OF CONFERENCE COMMITTEE

HB 1313, as engrossed: Your conference committee (Sens. Klein, Poolman, Murphy and Reps. Sukut, Kasper, Hanson) recommends that the **HOUSE ACCEDE** to the Senate amendments as printed on HJ pages 1416-1418 and place HB 1313 on the Seventh order.

Engrossed HB 1313 was placed on the Seventh order of business on the calendar.

2015 TESTIMONY

HB 1313

House IBL Committee
January 27, 2015

TESTIMONY OF PATRICK J. WARD IN SUPPORT TO HB 1313

Good morning Chairman Keiser and Members of the House IBL Committee.

My name is Pat Ward. I represent Nodak Mutual Insurance Company in support of HB 1313.

This bill changes current North Dakota law with respect to demutualization of a domestic insurance company. Many states are modernizing their current demutualization law to move in this direction.

A hot topic in the insurance industry today is enterprise risk management. You will be seeing some Senate bills coming over which deal with this issue and require insurers to self-evaluate and make reports on their ability to withstand severe or unexpected events such as an unusual number of catastrophe losses or a financial crisis like 2008 and 2009.

A mutual insurance company has limited ways to raise capital. It can do so through retained earnings, a merger transaction, a surplus note or a merger transaction. Demutualization allows a mutual company to sell stock and become a stock or capital company. It makes it much easier for a company to raise capital and meet its enterprise risk requirements.

A mutual company by law is a company with no capital stock. Policyholders can be members of the mutual insurance company and are no longer really owners of such a company. Ownership is an imprecise term and membership in a mutual insurance company is not equivalent of ownership.

Ten jurisdictions including Minnesota, Kansas, Michigan, Pennsylvania, Delaware and Illinois have already moved to this subscription rights model of demutualization. It gives policyholders the first right to buy stock, clarifies that they do not own the company. It more easily permits affiliations with other companies than under the mutual holding company model act.

Many of these laws, like the current North Dakota law, date back to a time in history when mutuals were small, community based entities.

In a mutual insurance company policyholders have two sets of rights. One is the contractural right to insurance coverage and the other is membership rights. In a mutual holding company, these policyholder rights are preserved but separated into two separate legal entities. The contractual right to insurance remains with the licensed insurance company which becomes a stock company as part of the process but their membership rights are transferred to a new mutual holding company that initially owns 100 percent of the stock and must always own at least 51 percent of the voting rights.

The updated demutualization model we are advocating is called a subscription rights model. This model gives a company the flexibility to raise cash either through a full conversion which would be to sell 100 percent of the stock or a minority stock offering whereby the mutual holding company, usually through a newly formed intermediate holding company, offers no more than 49.9 percent of its equity to policyholders and the public using the standard conversion method. This method would permit a mutual to raise meaningful capital and still maintain control of the company. It leaves the option of later

demutualizing the rest of the company to raise additional capital. In either event, the policyholders have a right of first refusal to buy the stock when it is offered.

Passing this legislation will benefit North Dakotans because it will allow mutuals to raise capital and grow, hopefully creating jobs. It helps insure solvency, will keep North Dakota competitive with other states, and could be used as a tool to attract additional mutuals to North Dakota.

We urge a Do Pass on HB 1313 and I will try to answer any questions.

P:\PWARD\Legislative 2015\Testimony in Support of HB1313.doc

Jan 27, 2015

PROPOSED AMENDMENTS TO HOUSE BILL NO. 1313

Page 7, line 10, replace "subparagraph c" with "item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1"

Page 8, line 31, replace "paragraph 1" with "paragraph 2"

Page 10, line 2, replace "subparagraph c of paragraph 1" with "item 3 of subparagraph a of paragraph 2"

Renumber accordingly

15.0450.02001
Title.03000

Adopted by the Industry, Business and Labor Committee

January 28, 2015

PROPOSED AMENDMENTS TO HOUSE BILL NO. 1313

Page 7, line 10, replace "subparagraph c" with "item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1"

Page 8, line 31, replace "1" with "2"

Page 10, line 2, after "in" insert "item 3 of"

Page 10, line 2, replace the first "c" with "a"

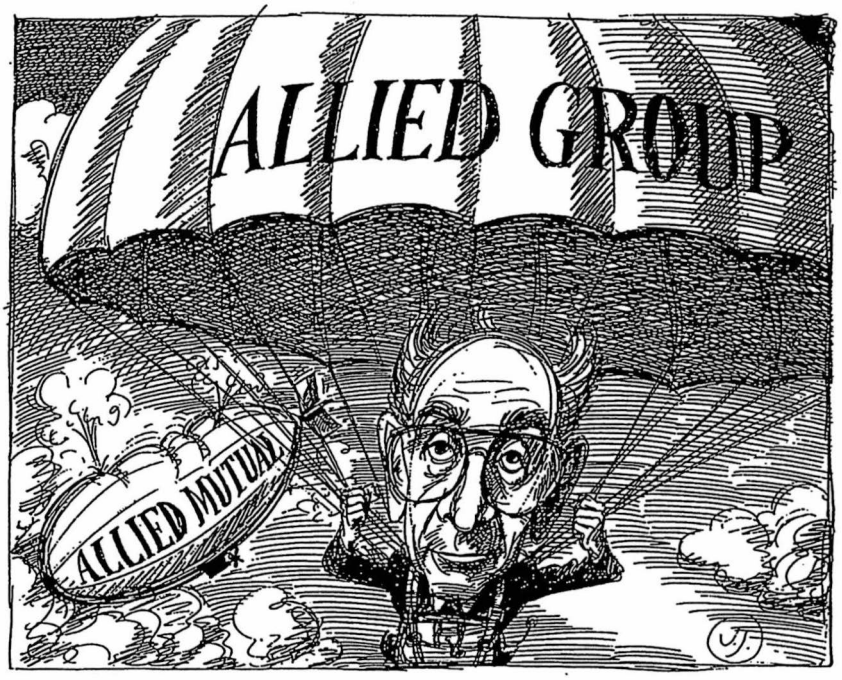
Page 10, line 2, replace "1" with "2"

Renumber accordingly

HB 1313 Jan 28, 2015 (1)

The Dark Side of Demutualization (or How to Make a Fortune From a Mutual Insurance Company)

The ALLIED Invasion



As chairman of Allied Mutual and Allied Group, John Evans faced numerous conflicts.

In theory a mutual insurance company is a wonderful thing: a collective where insureds pool their risk and resources for the common good. Because a mutual is not beholden to shareholders—it has none—its mandate is to serve its policyholders.

Mutual insurance has a long, noble tradition, and many mutuals are exemplars of prudence and success. One need look no farther than State Farm, America's largest insurance company, to see what has been accomplished under this form of ownership.

Although mutuals have done quite nicely for more than two centuries, the concept itself has been called into question of late. A small number of mutuals have gone so far as to demutualize, abandoning the cooperative form altogether. Equitable Life and UNUM are notable examples. It is ironic that, in an industry awash with capital, the most common objection to mutual ownership is that it is difficult for a mutual to raise capital, particularly equity capital. (Mutuals can't issue stock; they often raise money by issuing surplus notes, a form of long-term debt.) While access to the equity markets offers companies the opportunity to expand their capital, dozens of insurers, including AIG, Chubb, St. Paul, and Travelers, are now, in a sense, telling the stock market to shove it—they are repurchasing their shares by the truckload, shrinking their capital.

Another common objection to the mutual form of ownership is that mutuals can't grant stock options, thus making it difficult for them to attract and retain good people. We have not, however, noticed any correlation between policyholders' value and stock options. In life insurance, where policies are easily compared, most of the companies with the best 20-year interest-adjusted cost indices are mutuals. (This phenomenon is not unique to insurance. Vanguard Group, the highly efficient low-cost mutual fund giant, is a mutual.)

One capital-raising gambit used by some mutuals is a downstream holding company (a stock subsidiary that owns an insurance company) that sells shares to the public. Among those employing this approach are Allied Mutual, Employers Mutual, Harleysville Mutual, Nationwide Mutual, and State Automobile Mutual. In these situations the mutual and the stock company generally share the same management, board of directors, facilities, employees, and agents. The problem with this structure is that it creates conflicts of interest; management is faced with two mutually exclusive responsibilities: providing policyholders with insurance at the most efficient cost, and providing shareholders with the highest return on their investment.

Policyholders of the mutual probably assume that conflicts arising from this problematic situation will be dealt with fairly, that management—which has a fiduciary responsibility to protect and preserve the mutual's assets (but usually owns shares in the stock company)—won't put its financial interests ahead of the policyholders'.

Employers Mutual, for example, the large Des Moines-based writer of commercial insurance, has balanced its policyholders' interests with those of its stock company's shareholders. Although Employers' managers could have raked in big profits for themselves by favoring the stock company, they have acted responsibly, placing the policyholders' interests ahead of their own.

By way of comparison, policyholders of a large Iowa mutual located a few blocks from Employers have to wonder whether they've been given the shaft...

At first glance, the Allied Insurance Group appears to be a model insurance company. It is conservative, successful, and the antithesis of flashy—just what you'd expect of a company headquartered in Des Moines. Its core market is the Midwest, where it is primarily a writer of personal lines, which account for two-thirds of its $800 million in premiums. Allied, which carries an A+ rating from Best, sells through multiple distribution channels: independent agents, exclusive agents, direct marketing, and banks. (Because of this approach as well as its dictatorial stance, Allied is often resented by its own agents, who refer to it as "the company you love to hate.")

Allied has kept its costs under control, set adequate reserves, and is a better-than-average underwriter, sometimes showing a combined ratio below 100. In some ways it is stodgy in the extreme: its "approach to

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financial management" is "protective," meaning that it buys high-grade bonds and shuns common stocks.

Allied is actually two separate organizations: Allied Mutual, founded in 1929, and Allied Group, a stock company formed by the mutual in 1974. Allied Mutual owned 100% of Allied Group until 1985, when the latter company went public, selling a 21% interest. Today, Allied Group—which was once by far the smaller of the two companies—is worth four times as much as Allied Mutual. It has prospered and its management has grown rich while Allied Mutual has languished. Although the two companies are still affiliates, Allied Mutual has a negligible financial interest in Allied Group.

Therein lies one helluva story.

If you're a shareholder of Allied Group you might speak reverentially of John Evans, president and chairman from 1974 to 1994. (Now 69 and "semiretired," he serves only as chairman.) Evans is a short, serious-looking man with a bald pate and a smattering of white hair. He wears somber suits, white shirts, and traditional ties. Despite his low-key appearance, Evans is a wheeler-dealer who, between 1985 and 1993, engineered a dozen or so transactions—sales, purchases, poolings, transfers, stock repurchases, loans, etc.—that cumulatively made more than $500 million for Allied Group. These transactions are noteworthy because virtually every one of them turned out to be a good deal for Allied Group (from which Evans received stock options, stock grants, and convertible preferred stock) and a poor deal for the party on the other side. Evans, in other words, batted 1.000 while his opponent struck out every time. Most intriguing, however, is that all of these transactions were with the same party—Allied Mutual, which Evans has run since 1964. (Evans was the third generation of his family to head Allied Mutual, which was started by his grandfather.)

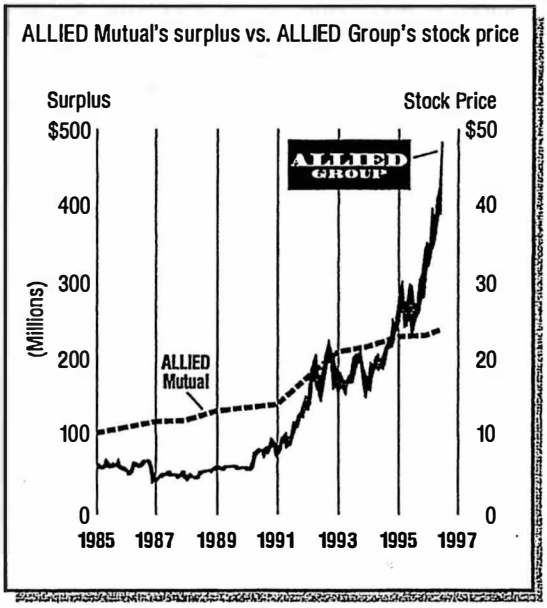
Was it just coincidence that Allied Mutual, in which Evans had no financial interest, would fare so poorly in these transactions, while Allied Group, in which Evans and other employees and directors had a significant stake, would make out so well? When viewed as a whole, these complex intercompany transactions have now added more than $500 million of value to Allied Group—value that otherwise might have belonged to Allied Mutual's policyholders—but if they have provided any benefits to Allied Mutual we haven't detected them.

The transaction that set the stage took place on October 30, 1985, when Allied Group, then a wholly-owned subsidiary of Allied Mutual, consummated an initial public offering, raising $16.8 million by selling 21% of its stock at $5.33 per share—a price approximating book value. The proceeds from the offering did not go to Allied Mutual; they were contributed to Allied Group's insurance companies, thereby "increasing [their] underwriting capacity." (This increase would assume great importance later on.)

Whether Allied Mutual needed to raise capital is debatable. The company has long written at a reasonable premium-to-surplus ratio and its book of business—personal lines for the most part—has a short tail and is not particularly volatile. By arranging for its subsidiary's stock to be sold at book value (which was well below its intrinsic value) Allied Mutual was making a dilutive move akin to selling a 21% interest in a $100 bill for $15.

Even if raising capital by issuing stock at book value was justified, it's difficult to justify the granting of large amounts of stock options to employees at that low price—which further diluted Allied Mutual. Evans, who'd been running Allied Mutual for decades, received a bonanza for engineering a deal in which part of the mutual's assets (Allied Group) was sold for less than takeout value. (He got options on 234,516 shares—about 1.6% of the company—while 11 other employees received options on a total of 475,943 shares.) These grants immediately separated Evans' interests from those of his employer, Allied Mutual, and its policyholders. From that moment on he would profit if Allied Group prospered, even if that prosperity was achieved to the detriment of Allied Mutual.

ALLIED Mutual Languishes, ALLIED Group Soars



At the time of its public offering Allied Group was, according to its SEC filings, little more than a shell: "[Allied Group's] continued profitability is largely dependent upon the continued successful operation of Allied Mutual, which provides facilities, employees, and all services required to conduct the business of the [Allied Group] on a cost-allocated basis. All the officers of Allied Group are officers of Allied Mutual and two-thirds of Allied Group's directors are directors of Allied Mutual." Allied Mutual had 1,000 employees; Allied Group had none.

Allied Mutual and Allied Group also participated in a premium pooling agreement, which was explained in Allied Group's prospectus:

> Allied Group cedes to Allied Mutual all of its insurance business and assumes 38% of all business in the pool. All premiums, losses, loss-settlement expenses, and underwriting expenses are prorated among the parties on the basis of participation in the pool...Allied Mutual provides data processing, professional claims, financial, investment, actuarial, auditing risk management, risk improvement, marketing and underwriting services, *the costs of which are shared by the pool members* [emphasis added]."

In plain English: Allied Mutual and Allied Group shared all premiums and expenses, with Allied Mutual keeping 62% of the total and Allied Group keeping 38%. As time went on, this arrangement would change dramatically—to Allied Group's benefit and Allied Mutual's disadvantage.

The following year, 1986, Allied Group started Western Heritage Insurance Company, a surplus-lines insurer whose marketing efforts would be carried out by Allied Mutual agents. (Allied Group's annual report referred to these agents as "a readily available distribution system.") Western Heritage did not pay Allied Mutual for the privilege of using its "distribution system," nor did it pool

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its premiums—which were quite profitable—with the other Allied premiums; the benefits accrued solely to Allied Group.

On January 1, 1987, Allied Group formed another company, Allied Group Information Systems (AGIS), "to provide all data processing services for the Allied companies." Ironically, Allied Group had no employees of its own—it would use Allied Mutual employees to staff AGIS. AGIS would then turn around and sell the services provided by these employees back to Allied Mutual. Allied Group's 1987 annual report noted that Allied Group received $4.7 million in data processing fees from Allied Mutual and that "AGIS has already contributed to the profit base of Allied Group." From a policyholders' point of view (don't forget, they're the ones who owned Allied Mutual) it would have made more sense for Allied Mutual, which was much larger and had all the employees, to own AGIS and charge Allied Group for services. That, however, would have made Evans' stock options less valuable.

On January 1, 1987, Allied Group's share of the Allied pool was increased from 38% to 41% despite the fact that Allied Mutual had no pressing need to give up profitable business. (Its premium-to-surplus and gross-leverage ratios were far superior to the norms established by A.M. Best.) This pooling change was a boon for Allied Group; with a stroke of the pen (and at no cost) it increased its premiums by 9% and received a larger percentage of the pool's assets. The increased assets corresponded with Allied Group's increased responsibility for a larger percentage of the pool's reserves. But since the Allied pool was mature and, in general, adequately reserved, Allied Group was taking on little risk. Yet it, rather than the Allied Mutual, would earn investment income on these assets before the claims were settled.

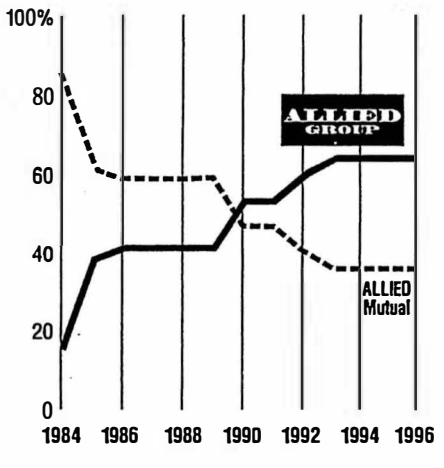
At Allied Group's annual meeting in May of 1988 an unusual "executive equity plan" was introduced: John Evans and others were to receive 10-year stock options with an exercise price of 44¢ per share. At that time Allied Group's book value was $6.38 per share, making Evans' 295,313-share grant worth $1.75 million on day one. (Evans, who, like all employees, worked for Allied Mutual, received 46% of the options granted under the plan. The options he received are now worth about $13 million.) Although Allied Group's shareholders had to approve the executive equity plan, such an occurrence was a foregone conclusion because Allied Mutual, which Evans had been running for 24 years, still owned 77% of Allied Group's shares. "This majority stock ownership," stated Allied Group's proxy, "gives Allied Mutual the ability to determine whether the proposals presented at the annual meeting are approved." Naturally, the stock-option plan was approved. Concurrently, stock options were offered to nine Allied Group directors (six of whom were also directors of Allied Mutual.)

In the late 1980s Allied Group was not the Wall Street darling it would later become, and its stock, which was then listed on Nasdaq, traded at a discount to book value. Earnings had been flat, but growth, which for the most part had been achieved by siphoning premiums and fees from Allied Mutual, had been impressive. Between 1984 and 1988 Allied Group's premiums almost quadrupled.

Although Evans told Allied Group's shareholders that the company had "an incredible future" and that its stock was "a favored buy," it was hard to see where he was coming from. Yes, Allied Group was a good company, but how would it achieve above-average growth? In the ensuing years the answer became clear: Evans would engineer a series of transactions with Allied Mutual—transactions that would make Allied Group (and its officers, directors, and employees) a fortune.

The ALLIED Insurance Pool

ALLIED Group's percentage of the pool has quadrupled over the years.



In 1988, "in recognition of [Allied Group] stock's value for shareholders," Allied Group spent $1.2 million to repurchase shares at $4.94, a price well below book value, and lower than the IPO price three years earlier. Clearly, Evans believed that the stock was a bargain. But why didn't Allied Mutual, which had far more capital, buy the Allied Group shares, thereby profiting from this undervaluation? Evans, through his options and shares, would personally profit if Allied Group repurchased its shares at a price below their intrinsic value, but he wouldn't profit if Allied Mutual bought the shares instead.

In 1989 Allied Group acquired Dougherty Dawkins, an investment banking firm. To finance the deal it borrowed $7.8 million from Allied Mutual. Once again, the obvious questions: How did Allied Mutual's policyholders benefit by bankrolling Allied Group? Why didn't Allied Mutual, which had the capital, buy Dougherty Dawkins itself? One thing is certain: Evans would profit personally (through his shares and options) from a good deal made by Allied Group.

Eager to learn more about these unusual transactions, we left several messages for Evans at his Allied office, but our calls were not returned. When we finally tracked him down at his Pebble Beach home he declined to discuss matters, suggesting that we speak instead with Douglas Andersen, the current president of the Allied companies. Andersen's office referred us to Jamie Shaffer, senior vice president and CFO, to whom we'd previously spoken, albeit briefly. Shaffer requested that we put our questions in writing—which we did. When we followed up, he said that he was too busy to respond.

In October 1989 the interlocking boards of Allied Mutual and Allied Group approved an Evans tour de force: a complex four-part restructuring plan that would nearly eviscerate Allied Mutual, all the while creating enormous value for Allied Group's other shareholders. The basics were as follows: 1) Allied Group traded its subsidiary, Allied Life, to Allied Mutual in return for half of Allied

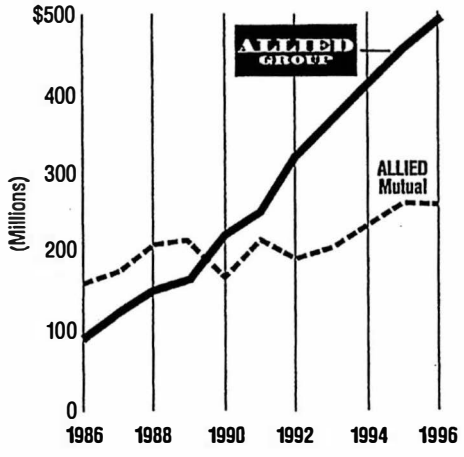
pg 3

Mutual's remaining interest in Allied Group, 2) Allied Mutual's 1,600 employees were transferred to Allied Group, 3) Allied Group established a leveraged ESOP (employee stock ownership plan), which gave the employees 37% of the company at a bargain-basement price, and 4) Allied Group's share of the Allied pool was increased from 41% to 53%.

Due to the "inherent conflicts of interest between the related parties," lawyers and investment bankers were hired by Allied Group and Allied Mutual to "insure the fairness of the restructuring plan." Allied Mutual was also represented by two of its outside directors, Hershel Langdon and Charles Colby. (Both would leave Allied Mutual's board in 1993. Colby then became a director of Allied Group, of which he now owns 17,896 shares, worth $805,320.)

One Always Grows, The Other Doesn't

Premium Volume:
ALLIED Group has left ALLIED Mutual in the dust.



Despite the money lavished on shysters and bean counters to "insure fairness," the result of the restructuring should come as no surprise: Evans and Allied Group made a killing. And Allied Mutual? As they say in the fight game, it received a one-way ticket to Palookaville. From December 31, 1989 (right before the deal took place) to the end of 1996, its premiums and surplus have grown at paltry annual rates of 2.9% and 8.4%, respectively. During the same period Allied Group's premiums and stock have grown at annual rates of 17.1% and 29%, respectively.

Let's examine the transaction closely and see how this happened.

As the first leg of the deal, Allied Group "sold" its Allied Life subsidiary to Allied Mutual in exchange for 6,075,000 Allied Group shares.

Life insurance has always been little more than a sideline for the Allied companies. Allied Life was a piddling insurer ($19 million in statutory surplus) that sold mainly through Allied property/casualty agents. It inherently lacked many of the strengths—distribution, efficiency, economy of scale—that the Allied property/casualty companies enjoyed. Nonetheless, it was valued at $36.5 million—$5.4 million more than its GAAP book value. Perversely, the 6,075,000 Allied Group shares that Allied Mutual parted with were valued at $6.01 per share, an $8-million discount to their book value of $44.5 million.

Thus, Allied Mutual bought a dud of a life-insurance company at a 17% premium to book value and sold a good property/casualty company at an 18% discount to book value. Based on price-earnings ratios the deal looks equally one-sided. Allied Mutual paid 13.4 times earnings for Allied Life and sold its Allied Group stock at 9.2 times earnings.

How could Allied Mutual's board of directors allow the company to enter into such a deal? One year before the restructuring, Allied Group (then 77% owned by Allied Mutual) had decided its stock was undervalued and repurchased shares at $4.94. In the year following the repurchase, Allied Group posted results that Evans called "remarkable"—revenues rose 20%, earnings per share increased 23%, and book value per share grew to $7.37. Yet Allied Mutual's board, spearheaded by John Evans and rife with conflicts of interest, now decided that Allied Mutual should sell a huge chunk of its Allied Group stock at an adjusted price only slightly higher than the dirt-cheap price Allied Group paid to repurchase its shares a year earlier.

Allied Group sold its life-insurance company to Allied Mutual for 17% more than its book value and repurchased its own shares from Allied Mutual at an 18% discount to book.

Today, the shares of Allied Group that Allied Mutual traded away are worth $273 million, while Allied Life, which it received in return, is worth about $50 million.

Six individuals who served as directors of both Allied Mutual and Allied Group owned shares or options in Allied Group and would stand to profit from the mother lode Allied Group would mine at Allied Mutual's expense. They were James Hoak, Jr., chairman of Heritage Communications; James Callison, president of Midwest Wheel and a director of Heritage Communications; William Hancock, a retired senior vice president of Allied Mutual; Mark Putney, CEO of Iowa Power and Light; Harold Evans, group vice president of Aluminum Company of America, younger brother of John Evans, and recipient of $75,000 in "management consulting services"; and John Evans himself, the supreme commander of the Allied companies.

We tried to contact each director (Mr. Hancock is deceased) but only one, James Hoak, returned our call. "I haven't thought about Allied for seven or eight years," he said during a cordial but uninformative conversation. "I don't really know the insurance business. I remember that there was a mutual and a stock company but I didn't even remember being on both boards." As for his stock options, Hoak, who told us he serves on "five or six other boards," said he thought he'd forfeited them when he ceased being a director.

Three other Allied Group directors—B. Rees Jones, a lifelong Allied Mutual employee; Donald Willis, president of Willis & Moore, a general insurance agency; and Harold Carpenter, president of George A. Rolfe Co., a manufacturer of agricultural equipment—had previously served on Allied Mutual's board but no longer owed allegiance to Allied Mutual.

Did Evans know that selling the property/casualty company below book value and buying the life company above book value might not be a good deal for the mutual? "Management believes that the future long-term profitability of property-casualty operations will be greater than the profitability of life operations," said Allied Group's proxy statement. *Continued*

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As chairman, CEO, and largest individual shareholder of Allied Group, Evans would benefit from the swell deal Allied Group was getting. The proxy made that clear: "[Allied Group] expect[s] higher long-term profits...as a result of the Allied Life sale...[and] will realize an increase in book value per share, from $7.27 to $8.60." Conversely, Allied Mutual's tangible net worth would decline because of the deal.

The next two pieces of the restructuring were equally dexterous.

Allied Mutual's board of directors concluded that a leveraged ESOP would be a more "cost-effective means of providing benefits" to employees than the defined-benefit retirement plan in place. Of course Allied Mutual, the employer of virtually all personnel at both companies, could not, as a mutual, issue stock. So on January 1, 1990, its 1,600 employees were transferred to Allied Group, which then became the direct employer of all persons working for the Allied companies. After 61 years in business, Allied Mutual was bereft of employees.

Prior to this transfer, personnel expenses for Allied Mutual and Allied Group had been "allocated either according to the pooling agreement" noted Allied Group's proxy, "or on the basis of annual time and cost studies." Allied Mutual did not make a profit by providing Allied Group the use of its employees. This arrangement would supposedly continue once all the employees had been shifted to Allied Group: "[Allied Group] anticipates that similar cost allocation methods will be utilized in the future," said the company's proxy. (Three years later, that would change.)

Once the employees had been transferred, the leveraged ESOP was instituted. In granting stock to the employees, the percentage of Allied Group owned by Allied Mutual would decrease. If the ESOP paid full value for its stock, however, Allied Mutual would suffer no diminution. But if the ESOP got a bargain, Allied Mutual would, again, end up with the smaller "half" of the pie.

Bear in mind that in the preceding Allied Life swap, Allied Mutual's Allied Group stock had been valued at $6.01 per share—a price befitting a Kmart blue-light special. Once that exchange was completed, Allied Group's book value rose from $7.27 to $8.60 per share (because it had repurchased shares below book value and sold its life company above book value). Based on this increase in book value, Allied Group's intrinsic value was probably $10 to $11 per share. As you may have guessed, the ESOP (of which John Evans was a participant) didn't pay anywhere near that for its stock.

The deal worked like this: Allied Group contributed $1 million to the ESOP, which then borrowed $35 million (guaranteed by Allied Group) to buy, at $6.66 per share, 5.4 million shares of Allied Group 8% Convertible Preferred stock. Each share paid an 8% annual dividend and was convertible into one share of Allied Group common stock. Thus, the ESOP was paying just 77% of book value to buy convertible preferred stock that was far better than the common: it had a liquidation preference and paid a 53¢ annual dividend versus 21¢ for the common. Assuming that a convertible preferred with such terms is worth a 25% premium to common stock, the ESOP was, in effect, buying common stock at $5.33 per share—about half its true value. Allied Group's proxy stated the following:

> The size of the ESOP was approved by the Compensation Committee of the Board of Directors of Allied Mutual...pursuant to the advice of Hewitt Associates and management. ["Management," of course, meant John Evans and company.] Under assumptions made by management...it was determined that the ESOP could result in a cost-effective means of providing employee benefits [and is] in the best interests of Allied Mutual...The projected present value of the required employer contributions to the ESOP over 15 years is approximately $23,260,000. This is compared with the estimated present value of the required contributions to the existing defined benefit pensions plan over the next 15-year period, which is approximately $28,229,000.

Allied concluded that the ESOP would save it a whopping $5 million (present value) over the following 15 years. Immediately prior to the formation of the ESOP, Allied Mutual owned 66% of Allied Group. Immediately afterwards its interest was reduced to 38%. Today the 5.4 million shares the ESOP bought for $36 million are worth $243 million. Some savings!

As a result of the ESOP, Allied Mutual's interest in Allied Group was diluted and it missed out on about $130 million of stock-market profits.

There was another justification for the ESOP (and, for that matter, the entire restructuring): to "*generate additional surplus capital* [emphasis added] to increase the business of Allied Group's property/casualty subsidiaries to take advantage of perceived opportunities." As we shall see, the restructuring was not necessary to generate—and Allied Mutual did not benefit from—this additional capital. But the ESOP participants, including John Evans, did.

On January 1, 1990, the final piece of the restructuring was enacted: Allied Group's percentage of the Allied pool was raised from 41% to 53%. In its annual report Allied Group boasted that this pooling increase "gave [it] all the advantages of an acquisition without any of the drawbacks." Here's why. Allied's pool is a clean personal-lines business with better-than-average experience. Allied Group was taking on a big chunk of seasoned premiums without any of the risks that writing new business usually entails. As a result, in 1990 its premiums grew from $163 million to $219 million. This gain was Allied Mutual's loss. Its percentage of the pool dropped from 59% to 47%, and its premiums fell from $213 million to $168 million.

Allied Group benefited from the pooling change in another way: it assumed $47.5 million of reserves from Allied Mutual and received $47.5 million in assets on which it would earn investment income until those reserves were paid out. Evans proudly told Allied Group's shareholders that "our performance was enhanced by the transfer of assets accompanying the change in our pooling agreement."

Evans explained Allied Group's increase in the pool by noting that $28 million from the ESOP stock sale had been contributed to Allied Group's property/casualty subsidiaries. This "infusion of capital," as he called it, allowed Allied Group to take on a larger share of the pool.

Evans' statement was baffling. The $36 million generated from the sale of stock to the ESOP was an *infusion of debt* (because Allied Group guaranteed the ESOP's borrowings), not an infusion of equity. Had the Allied companies needed capital, Allied Mutual could have issued surplus notes, then used that additional capital to justify *shrinking* Allied Group's percentage of the pool. But Allied Mutual had no apparent need for additional capital. It's 1989 premium-to-surplus ratio was a modest 1.6-to-1. And Evans would not profit if Allied Mutual's share of the pool increased.

Jamie Shaffer, senior vice president and CFO of Allied Mutual and Allied Group, insisted that the pooling change was justified because Allied Group's insurance com-

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panies were growing faster than Allied Mutual's and that the Allied Group companies were contributing a greater share of premiums to the pool.

Perhaps; but how is it that Allied Group ended up with the fast-growing insurance companies while Allied Mutual ended up with the slow-growing ones? In 1984 Allied Group had instituted the AIDCO program, which gave agents who wrote exclusively for Allied access to low-cost personal-lines products written through an Allied Group subsidiary, Allied Property and Casualty Insurance Company. According to agents and Allied Group employees, Allied Mutual policies are pricier than those issued through the AIDCO program and through another Allied Group subsidiary, Depositors Insurance Company, which bypasses agents entirely, soliciting business via direct mail and telemarketing. (On one occasion, when we called the Allied home office and asked if we could be referred to an agent, we were told that Allied could handle our needs directly, without one.) Since the market is competitive, it's not surprising that business would flow to the Allied companies with the lowest priced product. By 1996, AIDCO agents were responsible for 26.5% of the total premiums in the Allied pool.

Once the restructuring was complete, the relationship between Allied Group and Allied Mutual had been altered radically: Allied Mutual owned 37.1% of Allied Group and the ESOP owned 36.7%. Although Allied Mutual's surplus was 40% greater than Allied Group's, its premiums were now 25% less. Allied Group had all the property/casualty employees, and it had profited from the way its life-insurance company had been sold to Allied Mutual.

Evans would make millions of dollars (through his options and stock) as a result of these transactions. In his "chairman's letter" to Allied Group's shareholders in early 1990, he downplayed his cleverness. "Just because you're smart doesn't mean you can't be lucky," he wrote. (His invocation of "luck" reminds us of the scene from *Night After Night* in which an older woman, admiring Mae West's necklace, blurts out, "Goodness! What lovely diamonds," and West responds, "Goodness had nothing to do with it.") Evans' closing comments to Allied Group's shareholders were more telling: "The restructuring itself will yield immediate advantages and boost long-term profit potential. I don't know whether we'll be lucky throughout the 1990s, but I expect us to be smart."

One might have thought that Evans, having created a situation that had enriched himself and his fellow employees so greatly, would allow the battered Allied Mutual the dignity of a standing eight-count. Indeed, Allied Group's 1989 annual report hinted that the carnage might be curtailed: "The proposed restructuring...is expected to provide the capital resources necessary for the growth of the property-casualty subsidiaries for the foreseeable future." Allied Mutual, however, was punch drunk and bloodied, and Evans, as relentless as Jake LaMotta, would, over the next few years, deliver a combination of body blows that would knock it clear out of the ring.

The following year, 1991, was a relatively good one for Allied Mutual—Evans didn't make it enter into any new transactions with Allied Group. The good times, unfortunately, would not last forever.

In February 1992 Allied Group completed a public offering in which it issued 3,881,250 new shares at $8.22 per share. In one sense this was a strange deal: Allied Group was issuing stock at a 10% discount to book value, which, of course, diluted Allied's Mutual's interests. But it was also dilutive to Evans—who has crowed that he's a "serious investor who watch[es] the stock price."

But Allied Group would make up for issuing shares on the cheap by assuming a bigger portion of the Allied pool. To do

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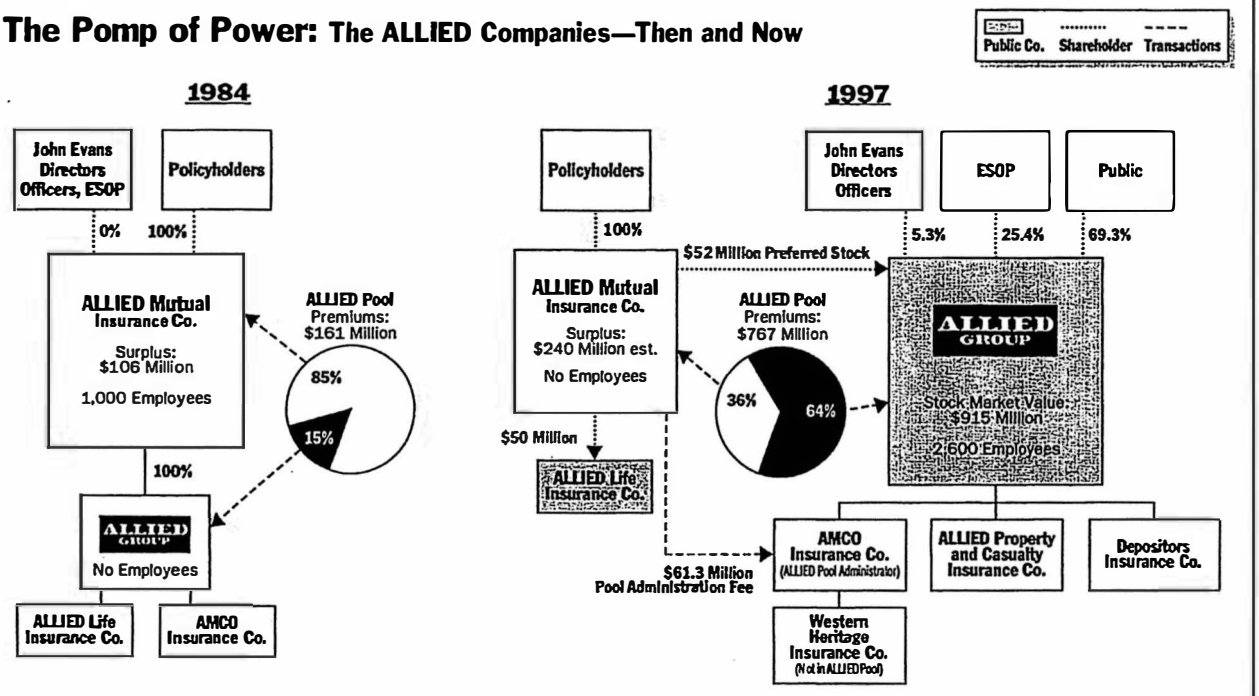
The Pomp of Power: The ALLIED Companies—Then and Now



that, however, it needed more statutory surplus. ("What we needed was capacity," it told shareholders.) The $30 million raised in the offering hit the spot—it was contributed to Allied Group's insurance companies, allowing them to "increase [their] participation in the Allied pool" from 53% to 60%.

Why, one wonders, did Allied Mutual permit its share of the pool to be reduced? One "objective" of the restructuring two years earlier had been to "fully utilize [Allied Mutual's] capital resources." Writing less business seems contrary to that goal. In fact, Allied Mutual could have bought the shares that Allied Group was issuing and still have had the bucks to increase its percentage of the Allied pool.

Because of the pooling change, Allied Mutual's premiums declined 10% in 1992, to $191 million, a figure only 9% higher than 1987's premiums. By comparison, Allied Group's premiums had soared from $121 million to $320 million over five years.

Allied Group has always taken a cautious approach to new business. "We've never been so driven by growth," Evans told Allied Group's shareholders with a straight face, "that we entered territories blindly." He didn't mention that when you can assume premiums from a mature pool like Allied's, growth is not much of a concern. After all, why stretch for new business—with all the risks that entails—when the pool's profitable renewal business was, apparently, theirs for the asking?

Between November 1992 and February 1993, Evans, who floats like a butterfly and stings like a bee, would execute four deft moves in rapid succession. By March, the once proud Allied Mutual would be reduced to little more than a spectral shell, done in by its doppelgänger, Allied Group.

The first transaction occurred in November, when Allied Group issued to Allied Mutual 1,827,222 shares of perpetual nonconvertible 6 3/4% preferred stock, valued at $28.50 per share—an implied worth of $52 million. In return Allied Mutual relinquished 4,111,250 Allied Group shares then trading at about 12⅞. Allied Group's 1992 annual report said that this "exchange helped Allied Mutual increase its investment income and met one of our priorities by providing long-term capital at a fixed cost." Let's examine those statements.

Since the preferred-stock dividend was $1.92 per share, Allied Mutual would receive $3.5 million a year in perpetuity. By contrast, Allied Group's common stock paid out 34¢ in 1993, which would have yielded Allied Mutual $1.4 million. Thus it was factually correct to say, as Allied Group did, that Allied Mutual's "investment income" would "increase."

On the other hand, Allied Mutual's "look-through" earnings plummeted. Allied Group earned $37 million in 1993. The 4,111,250 shares that Allied Mutual traded away represented a 23.9% stake in those earnings, so Allied Mutual was essentially foregoing $8.8 million ($37 million in earnings times 23.9%) to pick up an extra $2.1 million in dividends ($3.5 million from the preferred minus the $1.4 million common dividend).

Allied Group's 1992 annual report noted the obvious—that the preferred-for-common swap "will increase earnings per share for the holders of the common stock if [Allied Group's] fully diluted earnings per share exceed the cost of the [preferred stock's] dividend of $1.92 per share." (Allied Group's earnings, not surprisingly, exceeded the cost of the preferred stock dividend.)

Jamie Shaffer, Allied Group's chief financial officer, defended the preferred-for-common swap by noting that both companies had obtained fairness opinions. He also told us that at that time Allied Mutual had been "criticized for having too great an investment in subsidiaries." In the 1996 Allied Group annual report, however, Shaffer pointed out what a good deal Allied Group had made. He called the preferred—

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in which Allied Mutual was bagged—a "source of low-cost capital."

The whole transaction seemed strange from the start. Why would Allied Mutual want to own $52 million of unregistered, illiquid Allied Group preferred stock that paid 6¾%—and not a basis point more—until the end of time? Allied Group, apparently, wouldn't have touched such a piece of paper. Its $608-million investment portfolio contained no preferred stock, and the average maturity of its bonds was six years. By contrast, the $52-million slug of Allied Group preferred on Allied Mutual's books represented 12.7% of its $394 million in investments and 22.4% of its policyholders' surplus. To make matters worse, long duration assets such as perpetual preferred stock are an inherent mismatch with the short duration of Allied Mutual's liabilities (reserves).

Today the 4,111,250 shares Allied Mutual traded away are worth $185 million; the preferred stock, however, is still worth about $52 million. Some deal.

On January 1, 1993, Allied Group's participation in the Allied pool increased from 60% to 64%, while Allied Mutual's decreased to 36%. More significantly, the pooling agreement between the two companies was amended: AMCO Insurance Company, an Allied Group subsidiary, replaced Allied Mutual as the "pool administrator."

During the years that Allied Mutual had been the pool administrator, expenses had been allocated based upon each company's participation in the pool (e.g., a 25% participant picked up 25% of the expenses). But under the amended agreement, AMCO charged the other pool members fees greater than its actual expenses: 12.85% of written premiums for underwriting services, 7.25% of earned premiums for unallocated loss-settlement expenses, and .75% for premium collection services—20.85% total. Since Allied Group's expense for these services was about 18.85% in 1993, it immediately made a 2% profit on Allied Mutual's share of the pool (which contributed $4.65 million to Allied Group's earnings that year).

The amended pooling agreement was contrary to the spirit of Allied Mutual's 1990 transfer of employees to Allied Group, the purpose of which had been to "provide for employee incentives and benefits in light of statutorily-required amendments" to Allied Mutual's defined benefit plan. The ESOP, as you recall, was supposed to be a cost-effective way for the Allied companies to provide employee benefits—not a means for Allied Group to profit from Allied Mutual. In fact, Allied Group said at that time that it "anticipate[d]" that personnel expenses for it and Allied Mutual would continue to be allocated the way they always had been. The amended pooling agreement altered that allocation significantly.

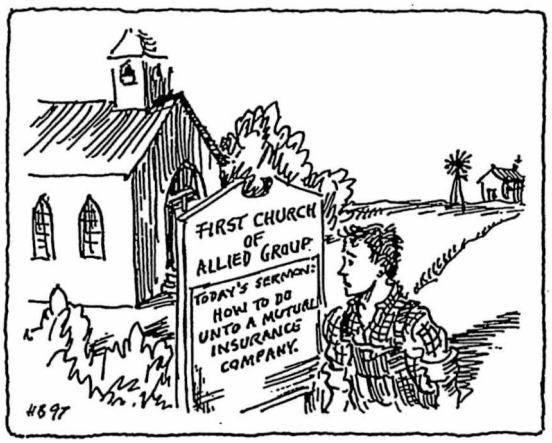
In 1993, Evans told Allied Group's shareholders that "property-casualty is a nickel and dime business," and that one must pay attention to "every penny." Evans is an expert at doing just that—especially when the pennies belong to Allied Group, in which he owns stock and options. "Having [AMCO] named administrator of the Allied pool," he boasted, "is an opportunity to flow every dollar of savings straight to the bottom line"—Allied Group's bottom line.

Jamie Shaffer was more ebullient, *kvelling* that he felt "a sense of pride in the growth plan" he'd helped to structure. "AMCO has new opportunities to profit from increased efficiencies," he said of the amended agreement, "and other participants have more predictable expense levels." Shaffer was right on the money: Allied Group did have new opportunities to profit, and Allied Mutual's expenses were more predictable—*more predictably higher*.

"If we didn't already have our current financial structure," Shaffer blabbed in Allied Group's 1993 annual report, "I'd be lying awake nights trying to invent it. Our relationship with Allied Mutual through the pooling agreement is such a plus. The mutual company can concentrate on building surplus to assure policyholders of its continued solvency; our property-casualty segment can run lean enough to earn an attractive return on equity for you." At that moment, Allied Mutual's surplus was $209 million—approximately the same as Allied Group's—yet its premium-to-surplus ratio was an ultraconservative 1-to-1, versus 1.72-to-1 for Allied Group. It seems that Allied Mutual's policyholders were already *more* assured of their company's solvency than were Allied Group's policyholders.

Shaffer's comments raised many questions: Why was "earn[ing] an attractive return on equity" good for Allied Group but not for Allied Mutual? How did taking a smaller portion of the pool and paying AMCO fees allow Allied Mutual to "concentrate on building surplus?" And why, if Allied Mutual has concentrated on building its surplus, has its surplus plodded along at a marginal rate during the greatest bull market in history? Between January 1, 1993 and December 31, 1996, Allied Mutual's surplus grew from $175.5 million to $231.5 million, a 7.17% annual rate. During the same time Allied Group's earnings per share and stock grew at annual rates of 15.7% and 25.5%, respectively. (Since Allied Group's books are kept according to GAAP, policyholders' surplus—a statutory accounting concept—is a less meaningful measure of its success than earnings per share or stock price.) Finally, why are slow growth and paltry profits a better way for Allied Mutual to "assure" its "continued solvency" than the strong growth and hefty profits that Allied Group has racked up?

Six years earlier, in its 1987 annual report, Allied Group extolled the virtues of the *shared-expenses* pooling agreement then in place: "Participating in the pooling agreement *produces more stable underwriting results for all companies in the pool* [emphasis added] and reduces the risk of loss for any one participant by spreading the risk among all the participating companies." By 1996, Allied Group was singing out of a different hymn book: "The [amended] pooling arrangement provides [the Allied companies] more predictable expense levels," said the company's 10-K, and "AMCO has opportunities to profit from the efficient administration of underwriting, loss adjusting, and



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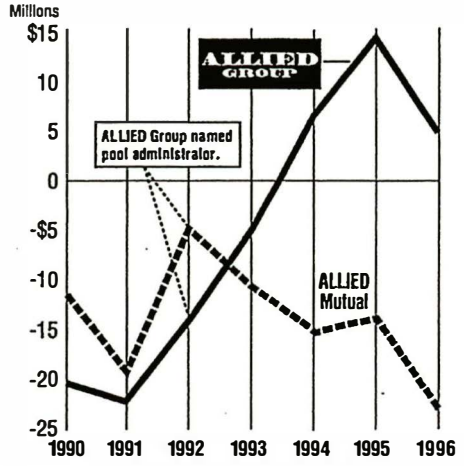
premium collection activities..."

To see the effect the amended pooling agreement has had on the fortunes of Allied Mutual and Allied Group, one need only compare the two company's underwriting results. In the three years preceding the amendment, Allied Group, whose share of the pool ranged from 53% to 60%, experienced a cumulative underwriting loss of $56.7 million; Allied Mutual's underwriting loss was $36.2 million. (Both companies still made money due to investment income.)

Once the amended pooling agreement took effect, however, Allied Group began showing underwriting profits while Allied Mutual's underwriting losses increased. Over the next four years Allied Group earned $21.4 million from underwriting. Allied Mutual, burdened by the amended pooling agreement, lost $63 million from underwriting. (See chart at right.)

Dirty Pool? Underwriting Results

Allied Mutual and Allied Group were once equal participants in the Allied pool. That changed in January 1, 1993, when AMCO (an Allied Group subsidiary) was named pool administrator. Since then Allied Group has recorded underwriting profits from the pool while Allied Mutual has reported increasing losses.



Source: A. M. Best

Since premiums and claims are pooled, all members of the Allied pool have virtually the same "pure loss ratio" (62.5% in 1996). So how did Allied Mutual lose money while Allied Group made money? The answer lies in the "pennies" Evans was counting. Last year Allied Mutual's underwriting expenses and loss-adjustment expenses equaled 45.3% of premiums earned. By comparison, AMCO's expenses totaled 32.5%.

Let's take a closer look at the effect the amended agreement had on both companies' results. In 1996, the four members of the Allied pool—Allied Mutual (36%), AMCO (46%), Allied Property & Casualty (12%), and Depositors (6%)—had a combined underwriting loss of $17.7 million. Had expenses been allocated pari passu, Allied Mutual, with its 36% share, would have lost $6.4 million (36% of $17.7 million). Instead, with its higher expenses, it lost $23 million. Conversely, Allied Group's $5.3-million underwriting profit would have been an $11.4-million loss, but for the amended pooling agreement that allowed it to charge fees to, and earn profits from, Allied Mutual. The result: Allied Group's income was boosted by $16.7 million (and Allied Mutual's loss was deepened by the same amount). That meant that after taxes, Allied Group's 1996 earnings got a positive jolt of $11.9 million, or 58¢ per share. (Thus, without the amended pooling agreement, Allied Group's 1996 earnings per share of $2.31 would have been $1.73 per share—25% less.) Earnings were boosted in 1993, 1994, and 1995, in the same manner.

If Allied Mutual's directors hadn't approved the amendment to the pooling agreement, Allied Group wouldn't have achieved such rapid earnings growth, and its stock wouldn't have reached such lofty levels. At a recent price of 45, it is trading at 16 times the last 12 months' earnings of $2.83 per share. If one were to adjust Allied Group's earnings downward by 25% (factoring out the underwriting differential between Allied Group and Allied Mutual), Allied Group's trailing 12 months' earnings per share would be only $2.12. Assuming a multiple of 12 times earnings (slower growth, lower multiple) the stock would be changing hands somewhere around 25½.

"Alfred and I plan to demutualize."

In June and July, Evans sold 100,000 Allied Group shares at prices ranging from $38.81 per share to $44.77. During the same months his wife Jane registered 100,000 shares. (Shares are generally registered prior to their sale.)

Unlike Evans, Allied Mutual never got to profit from the spectacular rise in Allied Group's stock over the last few years. Just seven weeks after the amended pooling agreement took effect, Allied Mutual, under Evans' direction, sold the last of its holdings—1,462,500 shares at $16.44. In its annual report, Allied Group noted with self-serving arrogance that "the sale of the mutual's shares served all stockholders by increasing the float without diluting earnings or book value."

Thus, when the dust settled, Allied Mutual had sold its entire interest in Allied Group, given up 64% of the Allied pool, parted with all its employees, and—worse—was stuck paying fees to Allied Group for various services. Today Allied Group is worth about $915 million. And what did Allied Mutual receive for parting with everything? Not much: $24 million in cash, $52 million of Allied Group preferred stock, and Allied Life, worth about $50 million. The grand total: $126 million.

After the whirlwind of activity that led to riches for Allied Group and emasculation for Allied Mutual, Evans could have rested on his laurels. He was now quite wealthy and, when you get right down to it, there's not much you can spend your money on in Des Moines, anyway. But he was eager to replay the success he'd had with Allied Group, this time using Allied Life, of which he was chairman, as the medium. (As you may recall, Allied Mutual had repurchased Allied Life from Allied Group in an unusual 1990 restructuring, giving up Allied Group stock that would later be worth $273 million.)

In November 1993 Evans arranged for Allied Life to go public. As in the past, the offering was no bonanza for Allied Mutual. It sold shares at $11.16 each (about book value) and received $19 million in cash. Engineering this small public offering must have consumed a great deal of Evans' time;

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otherwise why would Allied Life's "compensation committee"—Harold Evans and James Callison, who were also directors of Allied Mutual and Allied Group—have granted Evans ten-year options on 26,650 shares?

There's an old saw that a hooker has the best product in the world: *she sells it but still owns it.* The same might be said of Evans. As chairman of Allied Group he'd sold Allied Life back to Allied Mutual, profiting handsomely from the deal. Now he would profit once again from the sale of Allied Life, through options granted to him. (Douglas Andersen and Jamie Shaffer, Allied Group's current CEO and CFO, respectively—both of whom have been at Allied for ages and made a bundle as a result of the previous deals—each got options on 13,325 Allied Life shares.)

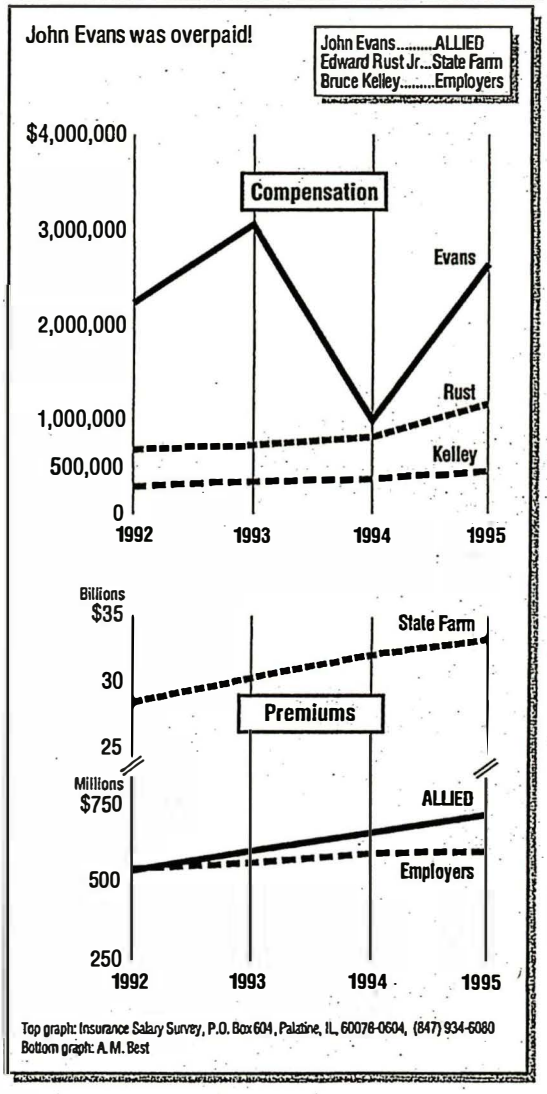
The Allied Life options were a relatively minor deal, even for a penny-pinching potentate like Evans—he'll probably make less than $750,000 from them over time. That's because Allied Life is a small company ($80.7 million in revenues, $46.5 million of statutory capital) with no mutual affiliate from which to siphon premiums and fees. In fact, it had to *pay* Allied Group $4.7 million in fees for "human resources," "joint marketing," and computer services over the last three years.

Evans made his *big* money from Allied Group and Allied Mutual. According to the ever-handy *Insurance Salary Survey* (P.O. Box 604, Palatine, IL 60078, [847] 934-6080), his cumulative compensation for the four years ending in 1995 was $8.9 million, making him, as far as we can tell, the highest paid mutual property/casualty executive in the country. Edward Rust, for example, chairman and president of State Farm (which is 50 times larger than Allied) got $3.5 million during the same period, and Bruce Kelley, president and CEO of Employers Mutual and EMC Insurance Companies (a Des Moines company the same size as Allied) got $1.4 million.

Despite their lower pay, Rust and Kelley did much better jobs for their mutuals than Evans did for his. From the end of 1985 (when Allied Mutual took Allied Group public) to the end of 1996, Allied Mutual's surplus grew from $102.8 million to $231.5 million—an annual rate of 7.66%. During the same period State Farm's surplus grew from $10.12 billion to $30 billion and Employers Mutual's surplus grew from $98.2 million to $410.8 million—annual rates of 10.38% and 13.89%, respectively.

So why did Evans get paid so much? That question is best put to the interlocking boards of Allied Mutual and Allied Group. But while we're on the subject of Evans' compensation, why did *Allied Mutual* own something called Allied Jet Center, Inc., which was, apparently, the corporate moniker for a Learjet? Did Allied Group share the cost of maintaining the Learjet, and did Evans use it to fly to his homes in California? Why, if it was once necessary, did Allied Mutual, as Jamie Shaffer informed us, get rid of the jet a couple of years ago? Did that decision have anything to do with Evans' stepping down as CEO at the end of 1994 and spending more time in California?

Small Insurance Company, Big Salary



Top graph: Insurance Salary Survey, P.O. Box 604, Palatine, IL, 60078-0604, (847) 934-6080
Bottom graph: A.M. Best

Although Evans relinquished the titles of CEO and president, he remained chairman of all the Allied companies, and his imprimatur was everywhere. A photo accompanying Allied Group's 1996 "message to shareholders" shows Evans in a standing pose while Douglas Andersen and Jamie Shaffer sit at a table in front of him.

Celebrating its tenth year as a public company, Allied Group used the opportunity to rewrite history: "We achieved growth the same way we achieved greater profitability: by implementing strategies that reflected...*our Iowa-rooted conservatism* [emphasis added]."

Implying that a regional brand of conservatism had something to do with Allied's success was vintage Evans bunkum. Conservatism is a disposition to preserve that which is established, a tendency towards gradual change rather than sudden shifts. Evans' contorted stratagems—from thimblerigging the Allied pool to deracinating Allied Mutual's labor force—cannot, by any stretch of the imagination, be labeled conservative. And that label is too simplistic for Iowa, with its intriguing contradictions, as well.

Iowa has always had a predilection for moderation, as well as, in the words of historian Dorothy Schweider, "a strong impulse toward social reform": before the Civil War it passed prohibition laws, and abolitionist feelings ran strong. Iowa embraced the Republican party (the party of Lincoln), granted constitutional rights to black men, and was home to the first state university that admitted women. Iowa, as John Gunther noted, is "the heart of agrarian America," yet the Populist party, which swept through neighboring western states like a prairie fire, never took hold there; but native-son Henry Wallace was the country's vice president from 1941 to 1945 and ran for president in 1948 under the Progressive ticket. Iowa voted for Dukakis in 1988 and Clinton in 1992 and 1996.

In short, "the Iowa-rooted conser-

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vatism" to which Evans refers is misleading. But Iowa *is* filled with well-educated, hard-working, churchgoing, temperate folks who eschew ostentation and would be repulsed by Evans' feculent business dealings—if they only knew.

"We'll take a calculated risk," Evans told Allied Group's shareholders in 1996, echoing the basic principles of insurance, "but we won't trust to chance." That sums up Allied Group's interaction with Allied Mutual: it seems that little was left to chance. Allied Mutual was incapable of making a good deal. Allied Group (in which Evans had a big stake) could do no wrong, acquiring through a variety of maneuvers: the Allied insurance companies that grew the fastest, loans from Allied Mutual, a quadrupling of its share of the Allied pool, Allied Mutual's employees, and fees for computer- and investment-management services from Allied Mutual. Allied Group relieved itself (at Allied Mutual's expense) of its overvalued capital-intensive life-insurance company in exchange for undervalued shares of the reliable property/casualty company, bought back its shares in exchange for a pungent perpetual preferred stock, and garnered a lucrative contract to "administer" the Allied pool.

It's hard to discern any risk in these transactions, much less a *calculated one*. (Actually, Evans' greatest risk was that Allied Mutual's policyholders would notice what was going on and string him up from the highest tree.)

Although one of the purposes, ostensibly, for taking Allied Group public was to generate additional capital for Allied Mutual and its subsidiaries, Allied Mutual didn't *need* additional capital, much less need it so badly that it should have sold its birthright: Allied Mutual's cash proceeds from the sale of its Allied Group shares totaled $24 million.

As for Allied Group, over the years it raised $86 million from various public stock offerings, but spent $83 million repurchasing its shares—$31 million in cash and $52 million in preferred stock—approximately what it took in from the public.

The open-market repurchases bring up the familiar issue of Evans' dichotomous behavior. In February 1993, for example, Allied Mutual had, under Evans' direction, blown out the last of its Allied Group stock, receiving $16.44 per share. What was the purpose of this sale (other than to "serve" Allied Group)? Allied Mutual had no pressing need for capital and its balance sheet was better than Allied Group's.

Within a year Evans would do an about-face and oversee Allied Group's *repurchase* of shares at a *higher* price—$16.96 per share. This would prove to be as good a buy as Allied Mutual's sale was bad: over the next three years Allied Group's stock tripled. Once again, Evans profited from Allied Group's propitious repurchase but lost nothing as a result of Allied Mutual's untimely sale.

The sale of Allied Mutual's final block of Allied Group stock is even more puzzling in light of recent changes in Allied Mutual's asset mix. For quite a while Evans avoided common stocks, investing primarily in high-grade bonds. At year-end 1992, Allied Mutual had $175 million of surplus and $397 million in assets, but just $2.2 million in stocks—0.6% of assets. In 1996, Allied Mutual finally caught a touch of bull-market fever and raised its stock portfolio to 4.4% of assets, or $23 million (which is $1 million less than it received from its last sale of Allied Group shares). Had Allied Mutual simply held these Allied Group shares it would have made an additional $42 million.

Although Allied Mutual hasn't had an equity interest in Allied Group since 1993, the preferred stock it owns allows it to "nominate for election" (read *appoint*) two of the ten directors on Allied Group's board. Given the inherent conflicts of interest between the two companies, these directors should play the role of Allied Mutual's champion and protector. To do this, however, they would need to be independent of Allied Group and its management. (It goes without saying that they shouldn't have any financial interest in Allied Group.)

Were it not such a brazen disregard for propriety, Allied Mutual's selection of Evans and his brother Harold to represent the company's interests on Allied Group's board would be farcical, because it's difficult to imagine two directors more ill-suited than these. On the other hand, Allied Group's shareholders had every reason to fancy Evans: he'd masterminded the intricate chain of events that had made them a fortune—at Allied Mutual's expense.

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Whether Evans' dismal record at Allied Mutual (compared to his splendid record at Allied Group) is attributable to bad luck, ineptitude, or conflict of interest doesn't matter; he has done a miserable job for Allied Mutual's policyholders and shouldn't be their nominee for Allied Group's board.

In fact, if an outraged-and-determined New York journalist has his way, Evans won't be on Allied Mutual's board, either: he'll be booted out, along with all the other board members. This journalist, one David Schiff, is now an outside, independent nominee for the board, and has submitted a plan to liberate the company from Evans and Allied Group and return at least $385 million to policyholders. (For more on this, see the following article.)

Evans and his pals will, undoubtedly, defend their orchestration of the Allied Mutual and Allied Group intercompany transactions. They will assert that these deals were reviewed and approved by boards of directors, coordinating committees, investment bankers, lawyers, and, in some instances, the Iowa Insurance Department. They will declare that advisors were hired and fairness opinions were issued; that certain matters were voted for by Allied Group's shareholders. They will state that Allied Mutual's policyholders duly elected every director. They will note that financial statements were gone over by independent auditors and that the insurance companies were examined by state insurance departments. They will aver that Allied received high ratings from Best and Standard & Poor's, and that documents were filed with the SEC, Nasdaq, and the New York Stock Exchange. And they will protest that our analysis has been made with the benefit of hindsight—that no one could have foreseen that each and every deal would be a boon for Allied Group and a bust for Allied Mutual. They may even say that they are shocked—shocked that things turned out so badly for Allied Mutual. (Or perhaps they'll take a different tack and maintain that Allied Mutual has done...admirably!)

But so what if sumptuously rewarded investment bankers and lawyers—surprise!—signed off on transactions? Big deal if low-paid bureaucrats and overworked regulators approved, but missed the ramifications of, intricate pooling arrangements and stock transactions. Allied Mutual's directors—the last line of defense—were charged with the responsibility of watching out for the policyholders. John Evans may have been their friend, colleague, or brother, but their allegiance rightfully belonged to Allied Mutual. Whether the directors' poor decisions were due to negligence, ignorance, or bad luck—the disembowelment of Allied Mutual Insurance Company happened on their watch.

We'll be the first to admit that calling attention to directors' disposition to be rubber-stamping yes-men is a bit like complaining that an outhouse stinks. Unfortunately, insurance-company directors often serve the same function as Calvin Coolidge, who, according to Will Rogers, "didn't do anything, but that's what the people wanted done."

Although complacency is not a desirable

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trait in a mutual-insurance-company board, it may not be too damaging a quality when a company is run by people like Bruce Kelley or Ed Rust. On the other hand, giving John Evans a pliable board is like giving a two-year-old a chainsaw—something bad is likely to happen.

There's an investment angle to this story, and it is the sale of Allied Group stock. (For the record, we are neither long nor short and don't intend to take a financial position.) Allied Group has profited by riding—no, by *taking*—Allied Mutual's coattails. From 1985 to 1993 it grew rapidly by increasing its share of the Allied pool from 38% to 64%, and its earnings were boosted by outsmarting Allied Mutual in a variety of ways. Since 1991, however, Allied Group's annual premium-growth rate has slowed to 14.75% (10.3% since 1994). Earnings per share have grown much faster, though—23.6% compounded annually—in part because of fees charged to Allied Mutual (which accounted for 25% of Allied Group's 1996 earnings). But Allied Group's relationship with Allied Mutual is approaching a state of entropy—there isn't as much left to reap as there once was (Allied Mutual made $12 million in 1995 and $6.8 million in 1996), and whatever is reaped now will be less meaningful to Allied Group. (Allied Group made $52.3 million in 1995 and $51 million in 1996.)

Although its earnings were up almost 50% in the first half of 1997 due to improved experience in personal auto and homeowners, Allied Group may be sitting on the equivalent of a toxic waste dump: the *manner* in which it has achieved much of its growth over the years. If Allied Mutual's policyholders decide that they're mad as hell and aren't going to take it anymore, they might stage a revolt that culminates in the overthrow of Evans and the board, the elimination of excess fees paid to Allied Group, and the reversing of a decade's worth of cheap-jack maneuvers and gossamer transactions. Such an occurrence would have a devastating effect on Allied Group's earnings, balance sheet, and stock price (and a correspondingly beneficial effect for Allied Mutual's policyholders).

It is possible, of course, that this apocalyptic scenario is no more than the fanciful dream of a quixotic muckraker. Evans may be many things, but he is not stupid; Allied Mutual and Allied Group are intertwined through a variety of long-term contracts and agreements that were designed by well-paid lawyers.

Yet we sense a turning of the tide, a move towards reform. Not so long ago, shareholders of public companies were disenfranchised too, but activists—at first a few small individuals, then corporate raiders, public pension funds, and mutual funds—demanded accountability. This simple truth is often forgotten: mutual insurance companies are not the property of their directors or employees—they belong to their policyholders.

Policyholders' long period of quiescence may be coming to an end. And if it does, that may cause a few sleepless nights for John Evans, Allied Mutual's directors, and Allied Group's shareholders. ■

ALLIED Mutual Chronology

1929

Allied Mutual formed in Iowa. Amended articles of incorporation later state that "the purpose and object of the corporation shall be to engage in the business of insurance...upon the mutual plan."

1964

John Evans, 36, succeeds his father as head of Allied Mutual.

1974

Allied Mutual forms a downstream holding company, Allied Group.

1985

Allied Group goes public, raising $16.8 million by issuing shares at a price approximating book value. Allied Mutual's ownership decreases to 79%. Allied Mutual's 1,000 employees provide all services for Allied Group and administer the Allied pool.

Stock options granted, including 234,516 to John Evans. Douglas Andersen and Jamie Shaffer each get 43,268.

1986

Allied Group forms Western Heritage Insurance Co., which doesn't cede business to the Allied pool even though it markets through a "readily available distribution system"—Allied Mutual agents.

1987

Allied Group forms Allied Group Information Systems (AGIS) and begins charging fees to Allied Mutual. Allied Group increases its share of the Allied pool to 41%.

1988

Evans receives 10-year options to purchase Allied Group stock for 44¢ per share. (Book value is $6.38 per share.) Other employees receive similar options. Allied Group directors (many of whom also serve on Allied Mutual's board) are offered Allied Group stock options.

1990

Big restructuring plan: Allied Group sells Allied Life to Allied Mutual for 17% premium to book value and repurchases its own shares from Allied Mutual at an 18% discount to book value. (By 1997 Allied Life is worth $50 million and Allied Group's repurchased shares are worth $273 million.)

Allied Group's percentage of the Allied pool is raised to 53%. "[Increasing the pool] gave us all the advantages of an acquisition without any of the drawbacks," says Allied Group.

All Allied Mutual employees are transferred to Allied Group.

Allied Group's ESOP borrows $35 million (guaranteed by Allied Group) to buy Allied Group convertible preferred stock at a bargain-basement price, thereby diluting Allied Mutual. Allied Group employees will make $243 million as a result.

Allied Mutual's ownership of Allied Group is now reduced from 78% to 40%. Allied Group's employees own 37%.

1992

Allied Group's share of the Allied pool increases again—to 60%.

Allied Group issues $52 million of 6¾% nonconvertible preferred stock to Allied Mutual in exchange for 4,111,250 shares of Allied Group owned by Allied Mutual. Allied Group later refers to this preferred stock as "a source of low-cost capital." Today, the preferred stock is worth $52 million, but the shares Allied Mutual parted with are worth $185 million.

1993

Allied Group's share of the Allied pool increases to 64%. AMCO (an Allied Group subsidiary) replaces Allied Mutual as the administrator of the Allied pool. Breaks tradition and begins charging fees to make a profit. Evans calls this deal "an opportunity to flow every dollar of savings straight to the bottom line"—Allied Group's bottom line. As a result, Allied Group earns $21.4 million from underwriting over the next four years while Allied Mutual loses $63 million.

Under Evans' direction, Allied Mutual sells the last of its Allied Group stock at $16.44. Says Allied Group: "The sale of the mutual's shares served all stockholders by increasing the float without diluting earnings or book value."

Allied Life goes public. Evans, Andersen, and Shaffer get stock options.

1994

Allied Group repurchases stock at a higher price than that at which Allied Mutual sold out. Allied Group's stock triples in next three years.

Allied Mutual's executives apparently dislike traveling on scheduled flights: the company owns a Learjet.

1995

Evans receives $8.9 million in compensation between 1992 and 1995. He is now *Allied Mutual's* nominee for Allied Group's board.

1997

Allied Mutual is worth $240 million. Allied Group is worth $915 million. Evans is still chairman of Allied Mutual, Allied Group, and Allied Life. His shares are now worth $15.5 million.

STOP David Schiff is nominated for Allied Mutual's board by dissident policyholder. Will attempt to gain seat held by James Callison. Also seeks to boot out the current board, reverse previous transactions with Allied Group, and return at least $385 million to Allied Mutual's policyholders.

Power to the policyholders!

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HTTP://WWW.INSURE.COM

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The Liberation of Allied Mutual

How I Plan to Seize Control of Allied Mutual

by David Schiff

I'm a fan of mutual insurance; it's worked for a long time. I'm also a fan of stock insurance companies. Many have done well for their policyholders *and* their shareholders.

The concept of mutuality, however, is under attack. In New York, which is noted for its conservative insurance regulation, Governor Pataki has proposed a nasty mutual-holding-company law that would allow mutuals to put their insurance companies into holding companies and sell stock in these holding companies to—who else?—the public.

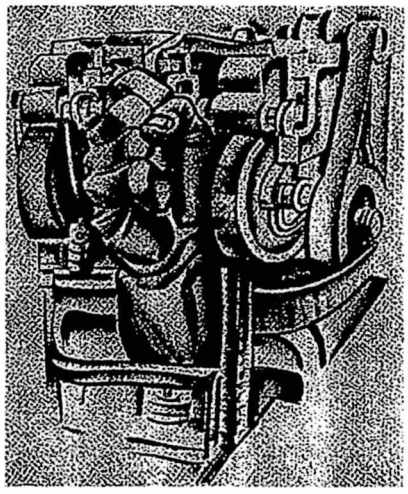
In theory this may not *always* be bad; in practice it stinks. Nonetheless, many mutual-insurance-company executives embrace demutualization because it's a way for them to expand their companies' capital and engage in that great American pastime—making acquisitions. Whether that's good for the policyholders is, apparently, beside the point. Once a mutual is partially converted to a stock company, its executives can wrap their hands around the stuff that dreams are made of—stock options—and, with a little "luck," make a bundle, like John Evans. Although Allied Mutual isn't the only mutual insurance company to have taken a beating from its stock-company affiliate, it's the most egregious example I've ever come across.

Last year I traveled through Iowa, which has 149 domestic mutuals, and visited several of the largest, some of which have publicly-held affiliates and some of which don't. (Iowa is on the front lines of the demutualization business, and Allied was one of the earliest to leave the trenches and go over the top.) I didn't meet with Allied—neither Evans nor Andersen was available—but I'd seen Evans do his shtick at insurance conferences over the years and was vaguely familiar with the success of Allied Group's stock.

When I delved deeper into the Allied Insurance companies this summer I became appalled—not just by the clever deals and asset shuffling, but by the shameless way Evans and his fellow executives boasted of their exploits to Allied Group's shareholders (e.g. "Having [AMCO] named administrator of the Allied pool is an opportunity to flow every dollar of savings straight to [Allied Group's] bottom line"). Evans' hubris left me aghast. How, I wondered, was it possible to preside over the transfer of more than $500 million of value from Allied Mutual to Allied Group without someone—a regulator, a consumer activist, a strike-suit lawyer—screaming bloody murder? Didn't *anyone* care about the policyholders? After all, Allied Mutual—*all mutuals*—are supposed to be run for the benefit of their policyholders.

When Kent Forney, a partner at Bradshaw, Fowler, Proctor & Fairgrave, in Des Moines, taught law, he used to make this analogy: "A policyholder's interest in the surplus of a mutual insurance company is roughly akin to a spouse's dower right, which is an inchoate right that can't be enforced until there's a dissolution of the marriage by divorce or death. Similarly, a policyholder's interest in the surplus can't be enforced until there's dissolution of the insurance company." But, notes Forney, unlike a spouse's dower right, the value in a mutual insurance company belongs to the policyholders—they just don't have the individual right to compel the mutual to pay it out to them.

Somewhere along the way Allied Mutual seems to have forgot that its purpose was not to provide stock-market profits for Evans and his fellow employees. "The purpose and object of [Allied Mutual]," states the company's amended and restated articles of incorporation, "shall be to engage in the business of insurance...upon the mutual plan." Evans and the other Allied Mutual directors were fiduciaries; they were supposed to watch out for Allied Mutual, not worry—as those who were on both boards had to—about earning a high return on equity for Allied Group.



Policyholders of Allied Mutual, unite!

Hugo Gellert, "Machinery and Large-Scale Industry 44," Courtesy Mary Ryan Gallery

As I researched the Allied article—reviewing financials, reading documents, pondering transactions—I came to the conclusion that I wouldn't entrust Evans with the screw-off cap of an empty bottle of muscatel, much less the directorship of a large mutual insurance company. I was reminded of Alexander Woollcott's quip that a stockbroker is a man who takes your fortune and runs it into a shoestring. Woollcott apparently never met the chairman of a mutual insurance company who owned stock in its publicly-held affiliate.

I imagined that Evans had some convoluted rationalization for the disparate results experienced by Allied Mutual and Allied Group—something along the lines of the 1968 Associated Press dispatch from Vietnam quoting a U.S. Army Major saying "It became necessary to destroy the town to save it."

But Evans didn't return my calls, nor did any of the other directors besides Hoak, who displayed a curious inability to recall details concerning his tenure on both boards.

It was around this time that I decided to do what anyone in the world is entitled to do: run for Allied Mutual's board, take control of the company, and set things straight. You see, I have as much right to be on Allied Mutual's board as John Evans does. "Directors need not be residents of Iowa," states Allied Mutual's articles of incorporation, "and need not be Members [policyholders] to qualify for election to office." In fact, the requirements are surprisingly simple: "Nominations for membership on the board of directors...[must be] presented in writing, signed by the Member...at least 60 days prior to" the annual meeting. That's it.

Since Allied Mutual has about 100,000 policyholders, I knew it wouldn't be difficult to find someone to nominate me. But I wanted to keep my intentions under wraps—this was a sensitive subject, after all—so I asked my ex-wife, the writer Joyce Walter (whose novel, *The Hallie Lawrence Story*, is one of the funniest books I've ever read), if she had any objections to becoming an Allied Mutual policyholder. Joyce knows as much about insurance as I know about

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Schiaparelli cocktail dresses, but she's always been a champion of the masses and was glad to help. So I located an Allied agent, took care of the arrangements, and paid a $200 premium. Her policy arrived in the mail three weeks later, along with a document signed by Douglas Andersen, Allied Mutual's president, stating that she "is a member of the company and is entitled to vote...at all meetings."

In compliance with Allied Mutual's requirements, Joyce formally nominated me in a letter addressed to Evans and Andersen. (I drafted the letter and she signed it.) To ensure that the nomination would arrive promptly, I personally took it to Federal Express.

I also enclosed a letter outlining my reasons for seeking election to Allied Mutual's board, and suggested that it would make matters easier for me (and better for the policyholders) if the current board would, in accordance with Article 9, Section G, resign *en masse* immediately after appointing me (and my slate of first-class fiduciaries) as directors of Allied Mutual. To show that there were no hard feelings, I offered to send each Allied Mutual director a bottle of Dom Perignon upon his resignation.

Assuming that the directors reject my offer—as I expect them to—I'll wage a proxy fight and get elected at Allied Mutual's annual policyholders meeting, which is scheduled for one o'clock on Tuesday March 3, 1998, at the home office in Des Moines. Since Allied Mutual has a staggered board, only one seat, that held by James Callison, will be up for grabs this year.

Before I get into the details of my plan, I'll pose a rhetorical question: Can a lone muckraker, armed with a Power Macintosh 6500/250 and a budget that can barely buy a round-lot of Allied Group stock, walk through the mean streets of Des Moines, seize a seat on the board of a large mutual, and wrest control from an entrenched chairman and his obliging understrappers?

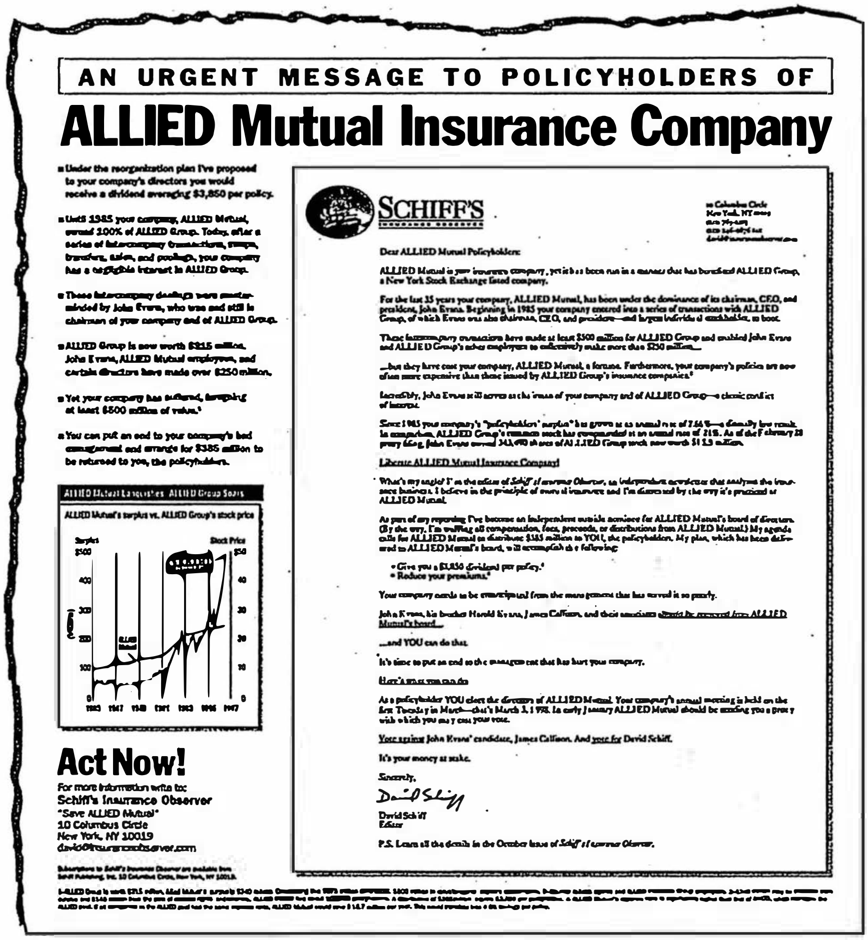
Ordinarily that would be unthinkable. But Allied is no ordinary mutual: it is a vassal bound in feudal service to a tyrannical lord. It has seen its assets sold for *bupkis*, its employees taken, and its premiums diverted. It is encumbered by administrative fees levied by Allied Group, and, not surprisingly, is only marginally profitable. The final insult: Allied Mutual's policyholders generally pay higher premiums than Allied Group's policyholders do for essentially the same coverage.

In short, Allied Mutual is like a pile of oily rags (the hazard we were warned of in Insurance 101): it's an explosion waiting to happen. That's why I can overthrow the board. Ultimately, people will not allow such an inequitable situation to continue. That Evans has, for so long, pressed down upon the brow of Allied Mutual a crown of thorns is a testament to policyholders' ignorance, regulatory folly, a lack of scrutiny, and a general sense of complacency. But that's coming to an end.

Because Allied Mutual's policies tend to be more expensive than Allied Group's, Allied Mutual's policyholders are not benefiting from their company's surplus; they'd actually be better off with Allied Group policies. Allied Mutual's *real* beneficiary is Allied Group; it receives administrative fees and, through the Allied pool, the *use* of Allied Mutual's surplus, which enables the Allied companies to write more premiums, thereby allowing AMCO to earn more from its administrative fees.

There's a good solution to this situation, and it's the backbone of my campaign for the board. Allied Mutual should reverse the myriad transactions in which it was bested by Allied Group: the pooling changes, the stock swaps, the administrative fees—everything. Since that may involve technical difficulties (and since Allied Group won't immediately agree to this), Allied Mutual might have to hire lawyers and consider seeking some kind of compensation for at least a decades' worth of sniggering schlock-house transactions. Although Allied Mutual was once much larger than Allied Group, its $240 million of surplus is now about one-quarter of Allied Group's $915 million market cap. Perhaps the two companies could simply split the difference—$675 million—and do away with legal bickering.

Even if it receives a large payment from Allied Group, Allied Mutual won't have the wherewithal to administer its book of business (after all, it has no employees). There-



An ad that *Schiff's Insurance Observer* is running in *The Des Moines Register.*

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fore, it should sell its $300 million in premiums (which had a 62.5% pure loss ratio last year) to the highest bidder. Investment bankers (not the ones who did the fairness opinions) can handle this, and I wouldn't be surprised if Allied Mutual gets $125 million, maybe more. As a matter of fact, Allied Mutual's book of business would fit quite nicely with Allied Group's operations.

What will Allied Mutual be worth when this has been accomplished? Well, it started with $240 million in surplus. Add $125 million from the sale of its book of business, plus whatever is received in settlement from Allied Group (half of $675 million?). Throw in $20 million or so for the equity in its loss reserves and the total is somewhere between $385 million and $725 million.

Whatever the final figure turns out to be, it belongs to the policyholders. Since there are approximately 100,000 of them, that's $3,850 to $7,250 apiece. Whether the best way to distribute this is by declaring a dividend, by liquidating Allied Mutual, or by some other means, is a matter that will require the assistance of accountants and lawyers (doesn't everything?). We'll hire the best when I'm Allied Mutual's chairman, and get the money back to the policyholders as soon as possible. (By the way, I'm waiving all compensation and director's fees, and Joyce will waive any proceeds or distributions that would ordinarily be due her as a policyholder.)

To kick off my campaign for Allied Mutual's board I've placed an ad in *The Des Moines Register* (see previous page), briefly explaining the situation and seeking the support of policyholders. Although the election is five months away, I have a feeling that it will turn out to be an uneven battle: Evans and the other Allied Mutual directors won't stand much of a chance. Through their actions they have demonstrated that they aren't fit to be on Allied Mutual's board, and their agenda—whatever it is—has not served the policyholders.

I have a suspicion that once Allied Mutual's gimcrackery gyrations, chop-shop poolings, and irreconcilable conflicts of interest are exposed to the light of day, the policyholders, the regulators, the press, and the public will demand change. The time is right, and I hope my actions will serve as an inspiration for mutual policyholders, as a wake-up call for regulators and legislators, and, at long last, as deliverance for the true owners of Allied Mutual.

Power to the policyholders! ■

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#1

Senate IBL Committee
March 24, 2015

TESTIMONY OF PATRICK J. WARD IN SUPPORT OF ENGROSSED HB 1313

Good morning Chairman Klein and Members of the Senate IBL Committee.

My name is Pat Ward. I represent Nodak Mutual Insurance Company in support of Engrossed HB 1313.

This bill changes current North Dakota law with respect to demutualization of a domestic insurance company. Many of these laws, like the current North Dakota law, date back to a time in history when Mutual's were small, community based entities. Many states are modernizing their current demutualization law to move in this direction because the current form is unworkable and is seldom ever used.

A mutual insurance company has limited ways to raise capital. It can do so through retained earnings, a merger transaction, a surplus note, a quota share or demutualization. Demutualization allows a mutual company to sell stock and become a stock or capital company. It is the only option which makes it much easier for a company to raise capital and also meet its enterprise risk requirements.

A hot topic in the insurance industry today is enterprise risk management. You have already seen some Senate bills which deal with this issue and require insurers to self-evaluate and make reports on their ability to withstand severe or unexpected events such as an unusual number of catastrophe losses or a

financial crisis like 2008 and 2009. Capital expansion might allow companies to reduce their exposure to such shocks.

A mutual company by law is a company with no capital stock. Policyholders can be members of the mutual insurance company but are not really owners of such a company. Ownership is an imprecise term and membership in a mutual insurance company is not equivalent of ownership. It consists primarily of voting rights and membership rights.

Ten jurisdictions including Minnesota, Kansas, Michigan, Pennsylvania, Delaware, Mississippi, Rhode Island, Texas, DC, and Illinois have already moved to this subscription rights model of demutualization. It gives policyholders many protections including the first right to buy stock and places many protections on director and officer involvement in the conversion to a stock company. It more easily permits affiliations with other companies than under the older versions of the mutual holding company model act.

In a mutual insurance company policyholders have two sets of rights. One is the contractural right to insurance coverage and the other is membership rights. In a mutual holding company, these policyholder rights are preserved but separated into two separate legal entities. The contractual right to insurance remains but is with the licensed insurance company which becomes a stock company as part of the process. Their membership rights are transferred to a new mutual holding company that initially owns 100 percent of the stock and must always own at least 51 percent of the voting rights.

The updated demutualization model we are advocating is called a subscription rights model. This model gives a company the flexibility to raise cash either through a full conversion which would be to sell 100 percent of the stock or more likely a minority stock offering whereby the mutual holding company, usually through a newly formed intermediate holding company, offers no more than 49.9 percent of its equity to policyholders and the public using the standard conversion method. This method would permit a mutual to raise meaningful capital and still maintain control of the company. It leaves the option of later demutualizing the rest of the company to raise additional capital. In either event, ***the policyholders have a right of first refusal to buy the stock when it is offered as well as several other protections built into the model.***

Passing this legislation will benefit North Dakotan citizens because it will allow mutuals to raise capital and grow, hopefully creating jobs. It will give policyholders a chance to become an owner of the company. It helps insure solvency, contains several protections for members in the conversion process, will keep North Dakota mutual companies financially competitive with those in other states, and could be used as a tool to attract additional mutuals to North Dakota. We have run this by our Insurance Commissioner and he has no objection to passage of this bill as it provides a great deal of involvement and oversight by DOI of any company using it to convert to a stock company.

We urge a Do Pass on Engrossed HB 1313 and I will try to answer any questions.

- The bill subordinates the right of insiders to buy stock to the rights of policyholders.
- An insider cannot purchase stock in any greater percentage than all policyholders combined and as a group insiders cannot acquire more than 35% of the total number of shares issued.
- Insiders cannot sell their stock for at least a year after closing.
- They cannot purchase stock other than through a stockbroker who can only broker a trade on the open market – thus the insiders cannot try and scoop up the stock from unsuspecting shareholders at bargain prices.
- The company cannot buy back stock for 3 years after the conversion unless it is an open market offer to purchase made to all shareholders – again, no insider deals.
- The company cannot adopt any stock based compensation plan (providing stock options or restricted stock awards) until at least 6 months after the conversion. Therefore, insiders cannot slip a benefit plan in for themselves as part of the deal. They can only adopt a benefit plan six months after the conversion when the shareholder base presumably consists of long term shareholders.

3/24/15 #2

HB1313

Chairman Klein and members of the Senate IBL Committee, I am Representative Marvin Nelson from District 9.

HB1313 represents a problem, it sets up a conflict of interest between the board of the mutual insurance company and the board of the for profit company formed by the mutual insurance company.

This creates the conflict that the board of the for profit company has the responsibility to maximize profits, the easiest place to get those profits is the parent company.

This is a rather strange situation since it comes from the NoDak Mutual Board. The current board makeup is due to the ND Insurance Commissioner taking control of the company due to a conflict of interest between North Dakota Farm Bureau and NoDak Mutual. Both were controlled by the same board.

Now, the NoDak Mutual Board is asking you to legalize them setting up the same sort of conflict of interest. A conflict of interest which would really exist for every mutual insurance company in the state as soon as we pass the law.

I am handing out an example of a worse case scenario where a parent company was gradually taken over by a subsidiary which originally started at 21%. It took years, but over the course of years, the President of both companies in a series of decisions basically moved 500 million dollars and all the employees from the mutual company to the company of which he owned a major share. Would this happen, I don't know, but 1313 makes it possible for it to happen here.

The only real protection is that the insurance commissioner must approve things initially. The vote and such of the members is, at least in the case of NoDak, no protection at all. If you read through the article on Allied Group, think of the dozen or so transactions and whether or not each would by themselves be a red flag. I think none of them by themselves would have been disallowed, yet the end result was the bleeding of the mutual company.

The Dark Side of Demutualization (or How to Make a Fortune From a Mutual Insurance Company)

The ALLIED Invasion

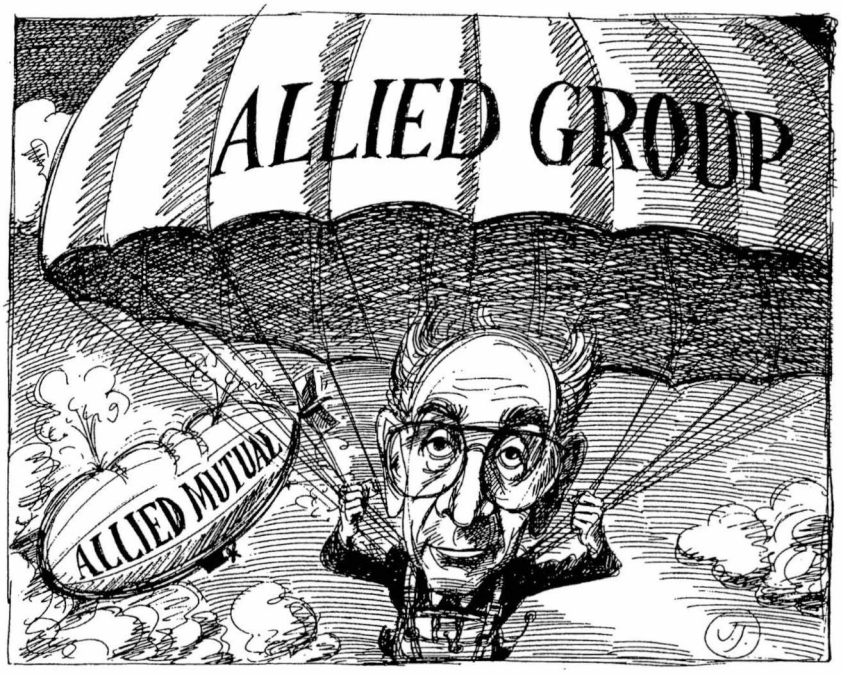
In theory a mutual insurance company is a wonderful thing: a collective where insureds pool their risk and resources for the common good. Because a mutual is not beholden to shareholders—it has none—its mandate is to serve its policyholders.

Mutual insurance has a long, noble tradition, and many mutuals are exemplars of prudence and success. One need look no farther than State Farm, America's largest insurance company, to see what has been accomplished under this form of ownership.

Although mutuals have done quite nicely for more than two centuries, the concept itself has been called into question of late. A small number of mutuals have gone so far as to demutualize, abandoning the cooperative form altogether. Equitable Life and UNUM are notable examples. It is ironic that, in an industry awash with capital, the most common objection to mutual ownership is that it is difficult for a mutual to raise capital, particularly equity capital. (Mutuals can't issue stock; they often raise money by issuing surplus notes, a form of long-term debt.) While access to the equity markets offers companies the opportunity to expand their capital, dozens of insurers, including AIG, Chubb, St. Paul, and Travelers, are now, in a sense, telling the stock market to shove it—they are repurchasing their shares by the truckload, shrinking their capital.

Another common objection to the mutual form of ownership is that mutuals can't grant stock options, thus making it difficult for them to attract and retain good people. We have not, however, noticed any correlation between policyholders' value and stock options. In life insurance, where policies are easily compared, most of the companies with the best 20-year interest-adjusted cost indices are mutuals. (This phenomenon is not unique to insurance. Vanguard Group, the highly efficient low-cost mutual fund giant, is a mutual.)

One capital-raising gambit used by some mutuals is a downstream holding company (a stock subsidiary that owns an insurance company) that sells shares to the public. Among those employing this approach are Allied Mutual, Employers Mutual, Harleysville Mutual, Nationwide Mutual, and State Automobile Mutual. In these situations the mutual and the stock company generally share the same management, board of directors, facilities, employees, and agents. The problem with this structure is that it creates conflicts of interest; management is faced with two mutually exclusive responsibilities: providing policyholders with insurance at the most efficient cost, and providing shareholders with the highest return on their investment.



As chairman of Allied Mutual and Allied Group, John Evans faced numerous conflicts.

Policyholders of the mutual probably assume that conflicts arising from this problematic situation will be dealt with fairly, that management—which has a fiduciary responsibility to protect and preserve the mutual's assets (but usually owns shares in the stock company)—won't put its financial interests ahead of the policyholders'.

Employers Mutual, for example, the large Des Moines-based writer of commercial insurance, has balanced its policyholders' interests with those of its stock company's shareholders. Although Employers' managers could have raked in big profits for themselves by favoring the stock company, they have acted responsibly, placing the policyholders' interests ahead of their own.

By way of comparison, policyholders of a large Iowa mutual located a few blocks from Employers have to wonder whether they've been given the shaft...

At first glance, the Allied Insurance Group appears to be a model insurance company. It is conservative, successful, and the antithesis of flashy—just what you'd expect of a company headquartered in Des Moines. Its core market is the Midwest, where it is primarily a writer of personal lines, which account for two-thirds of its $800 million in premiums. Allied, which carries an A+ rating from Best, sells through multiple distribution channels: independent agents, exclusive agents, direct marketing, and banks. (Because of this approach as well as its dictatorial stance, Allied is often resented by its own agents, who refer to it as "the company you love to hate.")

Allied has kept its costs under control, set adequate reserves, and is a better-than-average underwriter, sometimes showing a combined ratio below 100. In some ways it is stodgy in the extreme: its "approach to

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financial management" is "protective," meaning that it buys high-grade bonds and shuns common stocks.

Allied is actually two separate organizations: Allied Mutual, founded in 1929, and Allied Group, a stock company formed by the mutual in 1974. Allied Mutual owned 100% of Allied Group until 1985, when the latter company went public, selling a 21% interest. Today, Allied Group—which was once by far the smaller of the two companies—is worth four times as much as Allied Mutual. It has prospered and its management has grown rich while Allied Mutual has languished. Although the two companies are still affiliates, Allied Mutual has a negligible financial interest in Allied Group.

Therein lies one helluva story.

If you're a shareholder of Allied Group you might speak reverentially of John Evans, president and chairman from 1974 to 1994. (Now 69 and "semiretired," he serves only as chairman.) Evans is a short, serious-looking man with a bald pate and a smattering of white hair. He wears somber suits, white shirts, and traditional ties. Despite his low-key appearance, Evans is a wheeler-dealer who, between 1985 and 1993, engineered a dozen or so transactions—sales, purchases, poolings, transfers, stock repurchases, loans, etc.—that cumulatively made more than $500 million for Allied Group. These transactions are noteworthy because virtually every one of them turned out to be a good deal for Allied Group (from which Evans received stock options, stock grants, and convertible preferred stock) and a poor deal for the party on the other side. Evans, in other words, batted 1.000 while his opponent struck out every time. Most intriguing, however, is that all of these transactions were with the same party—Allied Mutual, which Evans has run since 1964. (Evans was the third generation of his family to head Allied Mutual, which was started by his grandfather.)

Was it just coincidence that Allied Mutual, in which Evans had no financial interest, would fare so poorly in these transactions, while Allied Group, in which Evans and other employees and directors had a significant stake, would make out so well? When viewed as a whole, these complex intercompany transactions have now added more than $500 million of value to Allied Group—value that otherwise might have belonged to Allied Mutual's policyholders—but if they have provided any benefits to Allied Mutual we haven't detected them.

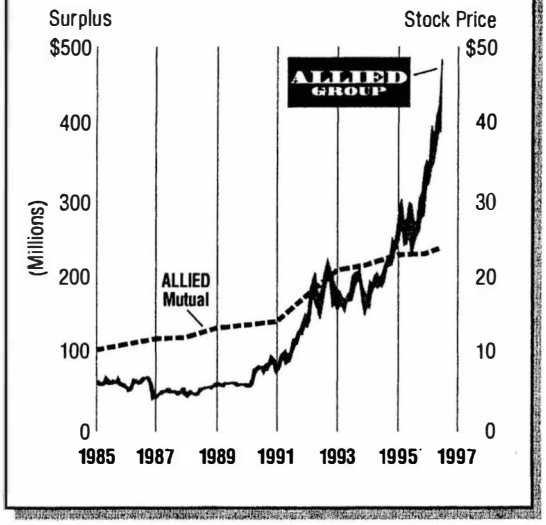
The transaction that set the stage took place on October 30, 1985, when Allied Group, then a wholly-owned subsidiary of Allied Mutual, consummated an initial public offering, raising $16.8 million by selling 21% of its stock at $5.33 per share—a price approximating book value. The proceeds from the offering did not go to Allied Mutual; they were contributed to Allied Group's insurance companies, thereby "increasing [their] underwriting capacity." (This increase would assume great importance later on.)

Whether Allied Mutual needed to raise capital is debatable. The company has long written at a reasonable premium-to-surplus ratio and its book of business—personal lines for the most part—has a short tail and is not particularly volatile. By arranging for its subsidiary's stock to be sold at book value (which was well below its intrinsic value) Allied Mutual was making a dilutive move akin to selling a 21% interest in a $100 bill for $15.

Even if raising capital by issuing stock at book value was justified, it's difficult to justify the granting of large amounts of stock options to employees at that low price—which further diluted Allied Mutual. Evans, who'd been running Allied Mutual for decades, received a bonanza for engineering a deal in which part of the mutual's assets (Allied Group) was sold for less than takeout value. (He got options on 234,516 shares—about 1.6% of the company—while 11 other employees received options on a total of 475,943 shares.) These grants immediately separated Evans' interests from those of his employer, Allied Mutual, and its policyholders. From that moment on he would profit if Allied Group prospered, even if that prosperity was achieved to the detriment of Allied Mutual.

ALLIED Mutual Languishes, ALLIED Group Soars

ALLIED Mutual's surplus vs. ALLIED Group's stock price



At the time of its public offering Allied Group was, according to its SEC filings, little more than a shell: "[Allied Group's] continued profitability is largely dependent upon the continued successful operation of Allied Mutual, which provides facilities, employees, and all services required to conduct the business of the [Allied Group] on a cost-allocated basis. All the officers of Allied Group are officers of Allied Mutual and two-thirds of Allied Group's directors are directors of Allied Mutual." Allied Mutual had 1,000 employees; Allied Group had none.

Allied Mutual and Allied Group also participated in a premium pooling agreement, which was explained in Allied Group's prospectus:

> Allied Group cedes to Allied Mutual all of its insurance business and assumes 38% of all business in the pool. All premiums, losses, loss-settlement expenses, and underwriting expenses are prorated among the parties on the basis of participation in the pool. . . Allied Mutual provides data processing, professional claims, financial, investment, actuarial, auditing risk management, risk improvement, marketing and underwriting services, *the costs of which are shared by the pool members* [emphasis added]."

In plain English: Allied Mutual and Allied Group shared all premiums and expenses, with Allied Mutual keeping 62% of the total and Allied Group keeping 38%. As time went on, this arrangement would change dramatically—to Allied Group's benefit and Allied Mutual's disadvantage.

The following year, 1986, Allied Group started Western Heritage Insurance Company, a surplus-lines insurer whose marketing efforts would be carried out by Allied Mutual agents. (Allied Group's annual report referred to these agents as "a readily available distribution system.") Western Heritage did not pay Allied Mutual for the privilege of using its "distribution system," nor did it pool

its premiums—which were quite profitable—with the other Allied premiums; the benefits accrued solely to Allied Group.

On January 1, 1987, Allied Group formed another company, Allied Group Information Systems (AGIS), "to provide all data processing services for the Allied companies." Ironically, Allied Group had no employees of its own—it would use Allied Mutual employees to staff AGIS. AGIS would then turn around and sell the services provided by these employees back to Allied Mutual. Allied Group's 1987 annual report noted that Allied Group received $4.7 million in data processing fees from Allied Mutual and that "AGIS has already contributed to the profit base of Allied Group." From a policyholders' point of view (don't forget, they're the ones who owned Allied Mutual) it would have made more sense for Allied Mutual, which was much larger and had all the employees, to own AGIS and charge Allied Group for services. That, however, would have made Evans' stock options less valuable.

On January 1, 1987, Allied Group's share of the Allied pool was increased from 38% to 41% despite the fact that Allied Mutual had no pressing need to give up profitable business. (Its premium-to-surplus and gross-leverage ratios were far superior to the norms established by A.M. Best.) This pooling change was a boon for Allied Group; with a stroke of the pen (and at no cost) it increased its premiums by 9% and received a larger percentage of the pool's assets. The increased assets corresponded with Allied Group's increased responsibility for a larger percentage of the pool's reserves. But since the Allied pool was mature and, in general, adequately reserved, Allied Group was taking on little risk. Yet it, rather than the Allied Mutual, would earn investment income on these assets before the claims were settled.

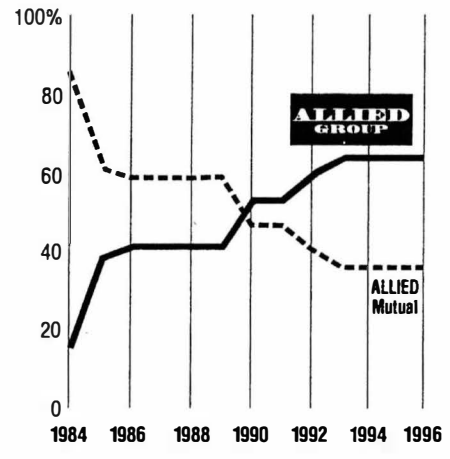
At Allied Group's annual meeting in May of 1988 an unusual "executive equity plan" was introduced: John Evans and others were to receive 10-year stock options with an exercise price of 44¢ per share. At that time Allied Group's book value was $6.38 per share, making Evans' 295,313-share grant worth $1.75 million on day one. (Evans, who, like all employees, worked for Allied Mutual, received 46% of the options granted under the plan. The options he received are now worth about $13 million.) Although Allied Group's shareholders had to approve the executive equity plan, such an occurrence was a foregone conclusion because Allied Mutual, which Evans had been running for 24 years, still owned 77% of Allied Group's shares. "This majority stock ownership," stated Allied Group's proxy, "gives Allied Mutual the ability to determine whether the proposals presented at the annual meeting are approved." Naturally, the stock-option plan was approved. Concurrently, stock options were offered to nine Allied Group directors (six of whom were also directors of Allied Mutual.)

In the late 1980s Allied Group was not the Wall Street darling it would later become, and its stock, which was then listed on Nasdaq, traded at a discount to book value. Earnings had been flat, but growth, which for the most part had been achieved by siphoning premiums and fees from Allied Mutual, had been impressive. Between 1984 and 1988 Allied Group's premiums almost quadrupled.

Although Evans told Allied Group's shareholders that the company had "an incredible future" and that its stock was "a favored buy," it was hard to see where he was coming from. Yes, Allied Group was a good company, but how would it achieve above-average growth? In the ensuing years the answer became clear: Evans would engineer a series of transactions with Allied Mutual—transactions that would make Allied Group (and its officers, directors, and employees) a fortune.

The ALLIED Insurance Pool

ALLIED Group's percentage of the pool has quadrupled over the years.



In 1988, "in recognition of [Allied Group] stock's value for shareholders," Allied Group spent $1.2 million to repurchase shares at $4.94, a price well below book value, and lower than the IPO price three years earlier. Clearly, Evans believed that the stock was a bargain. But why didn't Allied Mutual, which had far more capital, buy the Allied Group shares, thereby profiting from this undervaluation? Evans, through his options and shares, would personally profit if Allied Group repurchased its shares at a price below their intrinsic value, but he wouldn't profit if Allied Mutual bought the shares instead.

In 1989 Allied Group acquired Dougherty Dawkins, an investment banking firm. To finance the deal it borrowed $7.8 million from Allied Mutual. Once again, the obvious questions: How did Allied Mutual's policyholders benefit by bankrolling Allied Group? Why didn't Allied Mutual, which had the capital, buy Dougherty Dawkins itself? One thing is certain: Evans would profit personally (through his shares and options) from a good deal made by Allied Group.

Eager to learn more about these unusual transactions, we left several messages for Evans at his Allied office, but our calls were not returned. When we finally tracked him down at his Pebble Beach home he declined to discuss matters, suggesting that we speak instead with Douglas Andersen, the current president of the Allied companies. Andersen's office referred us to Jamie Shaffer, senior vice president and CFO, to whom we'd previously spoken, albeit briefly. Shaffer requested that we put our questions in writing—which we did. When we followed up, he said that he was too busy to respond.

In October 1989 the interlocking boards of Allied Mutual and Allied Group approved an Evans tour de force: a complex four-part restructuring plan that would nearly eviscerate Allied Mutual, all the while creating enormous value for Allied Group's other shareholders. The basics were as follows: 1) Allied Group traded its subsidiary, Allied Life, to Allied Mutual in return for half of Allied

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Mutual's remaining interest in Allied Group, 2) Allied Mutual's 1,600 employees were transferred to Allied Group, 3) Allied Group established a leveraged ESOP (employee stock ownership plan), which gave the employees 37% of the company at a bargain-basement price, and 4) Allied Group's share of the Allied pool was increased from 41% to 53%.

Due to the "inherent conflicts of interest between the related parties," lawyers and investment bankers were hired by Allied Group and Allied Mutual to "insure the fairness of the restructuring plan." Allied Mutual was also represented by two of its outside directors, Hershel Langdon and Charles Colby. (Both would leave Allied Mutual's board in 1993. Colby then became a director of Allied Group, of which he now owns 17,896 shares, worth $805,320.)

Despite the money lavished on shysters and bean counters to "insure fairness," the result of the restructuring should come as no surprise: Evans and Allied Group made a killing. And Allied Mutual? As they say in the fight game, it received a one-way ticket to Palookaville. From December 31, 1989 (right before the deal took place) to the end of 1996, its premiums and surplus have grown at paltry annual rates of 2.9% and 8.4%, respectively. During the same period Allied Group's premiums and stock have grown at annual rates of 17.1% and 29%, respectively.

Let's examine the transaction closely and see how this happened.

As the first leg of the deal, Allied Group "sold" its Allied Life subsidiary to Allied Mutual in exchange for 6,075,000 Allied Group shares.

Life insurance has always been little more than a sideline for the Allied companies. Allied Life was a piddling insurer ($19 million in statutory surplus) that sold mainly through Allied property/casualty agents. It inherently lacked many of the strengths—distribution, efficiency, economy of scale—that the Allied property/casualty companies enjoyed. Nonetheless, it was valued at $36.5 million—$5.4 million more than its GAAP book value. Perversely, the 6,075,000 Allied Group shares that Allied Mutual parted with were valued at $6.01 per share, an $8-million discount to their book value of $44.5 million.

Thus, Allied Mutual bought a dud of a life-insurance company at a 17% premium to book value and sold a good property/casualty company at an 18% discount to book value. Based on price-earnings ratios the deal looks equally one-sided. Allied Mutual paid 13.4 times earnings for Allied Life and sold its Allied Group stock at 9.2 times earnings.

How could Allied Mutual's board of directors allow the company to enter into such a deal? One year before the restructuring, Allied Group (then 77% owned by Allied Mutual) had decided its stock was undervalued and repurchased shares at $4.94. In the year following the repurchase, Allied Group posted results that Evans called "remarkable"—revenues rose 20%, earnings per share increased 23%, and book value per share grew to $7.37. Yet Allied Mutual's board, spearheaded by John Evans and rife with conflicts of interest, now decided that Allied Mutual should sell a huge chunk of its Allied Group stock at an adjusted price only slightly higher than the dirt-cheap price Allied Group paid to repurchase its shares a year earlier.

Today, the shares of Allied Group that Allied Mutual traded away are worth $273 million, while Allied Life, which it received in return, is worth about $50 million.

Six individuals who served as directors of both Allied Mutual and Allied Group owned shares or options in Allied Group and would stand to profit from the mother lode Allied Group would mine at Allied Mutual's expense. They were James Hoak, Jr., chairman of Heritage Communications; James Callison, president of Midwest Wheel and a director of Heritage Communications; William Hancock, a retired senior vice president of Allied Mutual; Mark Putney, CEO of Iowa Power and Light; Harold Evans, group vice president of Aluminum Company of America, younger brother of John Evans, and recipient of $75,000 in "management consulting services"; and John Evans himself, the supreme commander of the Allied companies.

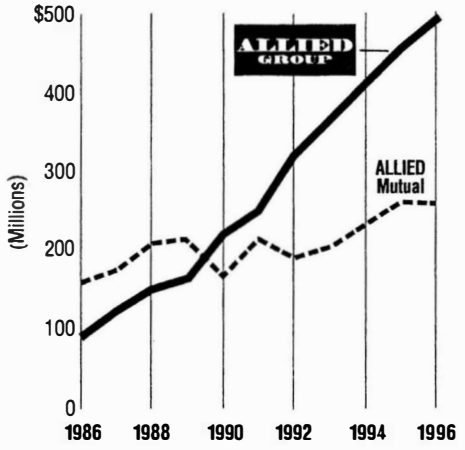
We tried to contact each director (Mr. Hancock is deceased) but only one, James Hoak, returned our call. "I haven't thought about Allied for seven or eight years," he said during a cordial but uninformative conversation. "I don't really know the insurance business. I remember that there was a mutual and a stock company but I didn't even remember being on both boards." As for his stock options, Hoak, who told us he serves on "five or six other boards," said he thought he'd forfeited them when he ceased being a director.

Three other Allied Group directors—B. Rees Jones, a lifelong Allied Mutual employee; Donald Willis, president of Willis & Moore, a general insurance agency; and Harold Carpenter, president of George A. Rolfe Co., a manufacturer of agricultural equipment—had previously served on Allied Mutual's board but no longer owed allegiance to Allied Mutual.

Did Evans know that selling the property/casualty company below book value and buying the life company above book value might not be a good deal for the mutual? "Management believes that the future long-term profitability of property-casualty operations will be greater than the profitability of life operations," said Allied Group's proxy statement. *Continued*

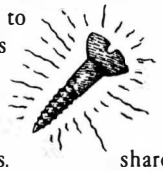
One Always Grows, The Other Doesn't

Premium Volume:
ALLIED Group has left ALLIED Mutual in the dust.



Allied Group sold its life-insurance company to Allied Mutual for 17% more than its book value and repurchased its own shares from Allied Mutual at an 18% discount to book.

As chairman, CEO, and largest individual shareholder of Allied Group, Evans would benefit from the swell deal Allied Group was getting. The proxy made that clear: "[Allied Group] expect[s] higher long-term profits...as a result of the Allied Life sale...[and] will realize an increase in book value per share, from $7.27 to $8.60." Conversely, Allied Mutual's tangible net worth would decline because of the deal.



The next two pieces of the restructuring were equally dexterous.

Allied Mutual's board of directors concluded that a leveraged ESOP would be a more "cost-effective means of providing benefits" to employees than the defined-benefit retirement plan in place. Of course Allied Mutual, the employer of virtually all personnel at both companies, could not, as a mutual, issue stock. So on January 1, 1990, its 1,600 employees were transferred to Allied Group, which then became the direct employer of all persons working for the Allied companies. After 61 years in business, Allied Mutual was bereft of employees.

Prior to this transfer, personnel expenses for Allied Mutual and Allied Group had been "allocated either according to the pooling agreement" noted Allied Group's proxy, "or on the basis of annual time and cost studies." Allied Mutual did not make a profit by providing Allied Group the use of its employees. This arrangement would supposedly continue once all the employees had been shifted to Allied Group: "[Allied Group] anticipates that similar cost allocation methods will be utilized in the future," said the company's proxy. (Three years later, that would change.)

Once the employees had been transferred, the leveraged ESOP was instituted. In granting stock to the employees, the percentage of Allied Group owned by Allied Mutual would decrease. If the ESOP paid full value for its stock, however, Allied Mutual would suffer no diminution. But if the ESOP got a bargain, Allied Mutual would, again, end up with the smaller "half" of the pie.

Bear in mind that in the preceding Allied Life swap, Allied Mutual's Allied Group stock had been valued at $6.01 per share—a price befitting a Kmart blue-light special. Once that exchange was completed, Allied Group's book value rose from $7.27 to $8.60 per share (because it had repurchased shares below book value and sold its life company above book value). Based on this increase in book value, Allied Group's intrinsic value was probably $10 to $11 per share. As you may have guessed, the ESOP (of which John Evans was a participant) didn't pay anywhere near that for its stock.

The deal worked like this: Allied Group contributed $1 million to the ESOP, which then borrowed $35 million (guaranteed by Allied Group) to buy, at $6.66 per share, 5.4 million shares of Allied Group 8% Convertible Preferred stock. Each share paid an 8% annual dividend and was convertible into one share of Allied Group common stock. Thus, the ESOP was paying just 77% of book value to buy convertible preferred stock that was far better than the common: it had a liquidation preference and paid a 53¢ annual dividend versus 21¢ for the common. Assuming that a convertible preferred with such terms is worth a 25% premium to common stock, the ESOP was, in effect, buying common stock at $5.33 per share—about half its true value. Allied Group's proxy stated the following:

> The size of the ESOP was approved by the Compensation Committee of the Board of Directors of Allied Mutual...pursuant to the advice of Hewitt Associates and management. ["Management," of course, meant John Evans and company.] Under assumptions made by management...it was determined that the ESOP could result in a cost-effective means of providing employee benefits [and is] in the best interests of Allied Mutual...The projected present value of the required employer contributions to the ESOP over 15 years is approximately $23,260,000. This is compared with the estimated present value of the required contributions to the existing defined benefit pensions plan over the next 15-year period, which is approximately $28,229,000.

Allied concluded that the ESOP would save it a whopping $5 million (present value) over the following 15 years. Immediately prior to the formation of the ESOP, Allied Mutual owned 66% of Allied Group. Immediately afterwards its interest was reduced to 38%. Today the 5.4 million shares the ESOP bought for $36 million are worth $243 million. Some savings!

As a result of the ESOP, Allied Mutual's interest in Allied Group was diluted and it missed out on about $130 million of stock-market profits.

There was another justification for the ESOP (and, for that matter, the entire restructuring): to "*generate additional surplus capital* [emphasis added] to increase the business of Allied Group's property/casualty subsidiaries to take advantage of perceived opportunities." As we shall see, the restructuring was not necessary to generate—and Allied Mutual did not benefit from—this additional capital. But the ESOP participants, including John Evans, did.

On January 1, 1990, the final piece of the restructuring was enacted: Allied Group's percentage of the Allied pool was raised from 41% to 53%. In its annual report Allied Group boasted that this pooling increase "gave [it] all the advantages of an acquisition without any of the drawbacks." Here's why. Allied's pool is a clean personal-lines business with better-than-average experience. Allied Group was taking on a big chunk of seasoned premiums without any of the risks that writing new business usually entails. As a result, in 1990 its premiums grew from $163 million to $219 million. This gain was Allied Mutual's loss. Its percentage of the pool dropped from 59% to 47%, and its premiums fell from $213 million to $168 million.

Allied Group benefited from the pooling change in another way: it assumed $47.5 million of reserves from Allied Mutual and received $47.5 million in assets on which it would earn investment income until those reserves were paid out. Evans proudly told Allied Group's shareholders that "our performance was enhanced by the transfer of assets accompanying the change in our pooling agreement."

Evans explained Allied Group's increase in the pool by noting that $28 million from the ESOP stock sale had been contributed to Allied Group's property/casualty subsidiaries. This "infusion of capital," as he called it, allowed Allied Group to take on a larger share of the pool.

Evans' statement was baffling. The $36 million generated from the sale of stock to the ESOP was an *infusion of debt* (because Allied Group guaranteed the ESOP's borrowings), not an infusion of equity. Had the Allied companies needed capital, Allied Mutual could have issued surplus notes, then used that additional capital to justify *shrinking* Allied Group's percentage of the pool. But Allied Mutual had no apparent need for additional capital. It's 1989 premium-to-surplus ratio was a modest 1.6-to-1. And Evans would not profit if Allied Mutual's share of the pool increased.

Jamie Shaffer, senior vice president and CFO of Allied Mutual and Allied Group, insisted that the pooling change was justified because Allied Group's insurance com-

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panies were growing faster than Allied Mutual's and that the Allied Group companies were contributing a greater share of premiums to the pool.

Perhaps; but how is it that Allied Group ended up with the fast-growing insurance companies while Allied Mutual ended up with the slow-growing ones? In 1984 Allied Group had instituted the AIDCO program, which gave agents who wrote exclusively for Allied access to low-cost personal-lines products written through an Allied Group subsidiary, Allied Property and Casualty Insurance Company. According to agents and Allied Group employees, Allied Mutual policies are pricier than those issued through the AIDCO program and through another Allied Group subsidiary, Depositors Insurance Company, which bypasses agents entirely, soliciting business via direct mail and telemarketing. (On one occasion, when we called the Allied home office and asked if we could be referred to an agent, we were told that Allied could handle our needs directly, without one.) Since the market is competitive, it's not surprising that business would flow to the Allied companies with the lowest priced product. By 1996, AIDCO agents were responsible for 26.5% of the total premiums in the Allied pool.

Once the restructuring was complete, the relationship between Allied Group and Allied Mutual had been altered radically: Allied Mutual owned 37.1% of Allied Group and the ESOP owned 36.7%. Although Allied Mutual's surplus was 40% greater than Allied Group's, its premiums were now 25% less. Allied Group had all the property/casualty employees, and it had profited from the way its life-insurance company had been sold to Allied Mutual.

Evans would make millions of dollars (through his options and stock) as a result of these transactions. In his "chairman's letter" to Allied Group's shareholders in early 1990, he downplayed his cleverness. "Just because you're smart doesn't mean you can't be lucky," he wrote. (His invocation of "luck" reminds us of the scene from *Night After Night* in which an older woman, admiring Mae West's necklace, blurts out, "Goodness! What lovely diamonds," and West responds, "Goodness had nothing to do with it.") Evans' closing comments to Allied Group's shareholders were more telling: "The restructuring itself will yield immediate advantages and boost long-term profit potential. I don't know whether we'll be lucky throughout the 1990s, but I expect us to be smart."

One might have thought that Evans, having created a situation that had enriched himself and his fellow employees so greatly, would allow the battered Allied Mutual the dignity of a standing eight-count. Indeed, Allied Group's 1989 annual report hinted that the carnage might be curtailed: "The proposed restructuring...is expected to provide the capital resources necessary for the growth of the property-casualty subsidiaries for the foreseeable future." Allied Mutual, however, was punch drunk and bloodied, and Evans, as relentless as Jake LaMotta, would, over the next few years, deliver a combination of body blows that would knock it clear out of the ring.

The following year, 1991, was a relatively good one for Allied Mutual—Evans didn't make it enter into any new transactions with Allied Group. The good times, unfortunately, would not last forever.

In February 1992 Allied Group completed a public offering in which it issued 3,881,250 new shares at $8.22 per share. In one sense this was a strange deal: Allied Group was issuing stock at a 10% discount to book value, which, of course, diluted Allied's Mutual's interests. But it was also dilutive to Evans—who has crowed that he's a "serious investor who watch[es] the stock price."

But Allied Group would make up for issuing shares on the cheap by assuming a bigger portion of the Allied pool. To do

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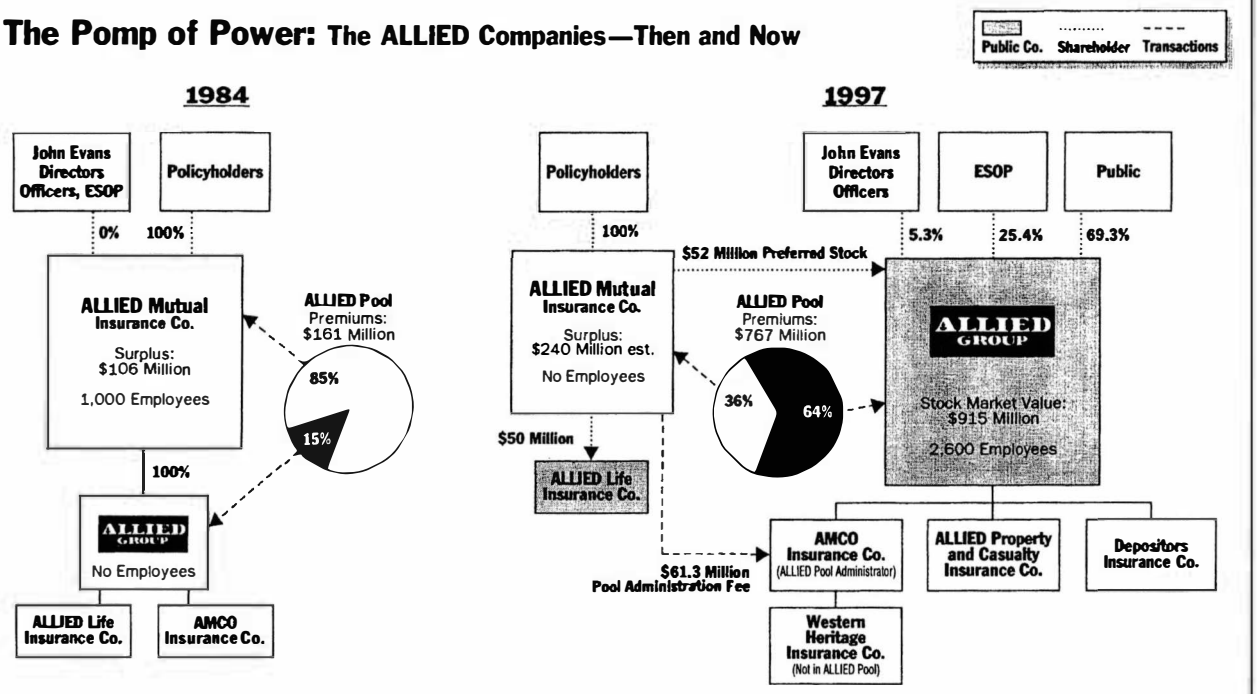
The Pomp of Power: The ALLIED Companies—Then and Now



that, however, it needed more statutory surplus. ("What we needed was capacity," it told shareholders.) The $30 million raised in the offering hit the spot—it was contributed to Allied Group's insurance companies, allowing them to "increase [their] participation in the Allied pool" from 53% to 60%.

Why, one wonders, did Allied Mutual permit its share of the pool to be reduced? One "objective" of the restructuring two years earlier had been to "fully utilize [Allied Mutual's] capital resources." Writing less business seems contrary to that goal. In fact, Allied Mutual could have bought the shares that Allied Group was issuing and still have had the bucks to increase its percentage of the Allied pool.

Because of the pooling change, Allied Mutual's premiums declined 10% in 1992, to $191 million, a figure only 9% higher than 1987's premiums. By comparison, Allied Group's premiums had soared from $121 million to $320 million over five years.

Allied Group has always taken a cautious approach to new business. "We've never been so driven by growth," Evans told Allied Group's shareholders with a straight face, "that we entered territories blindly." He didn't mention that when you can assume premiums from a mature pool like Allied's, growth is not much of a concern. After all, why stretch for new business—with all the risks that entails—when the pool's profitable renewal business was, apparently, theirs for the asking?

Between November 1992 and February 1993, Evans, who floats like a butterfly and stings like a bee, would execute four deft moves in rapid succession. By March, the once proud Allied Mutual would be reduced to little more than a spectral shell, done in by its doppelgänger, Allied Group.

The first transaction occurred in November, when Allied Group issued to Allied Mutual 1,827,222 shares of perpetual nonconvertible 6 3/4% preferred stock, valued at $28.50 per share—an implied worth of $52 million. In return Allied Mutual relinquished 4,111,250 Allied Group shares then trading at about 12 7/8. Allied Group's 1992 annual report said that this "exchange helped Allied Mutual increase its investment income and met one of our priorities by providing long-term capital at a fixed cost." Let's examine those statements.

Since the preferred-stock dividend was $1.92 per share, Allied Mutual would receive $3.5 million a year in perpetuity. By contrast, Allied Group's common stock paid out 34¢ in 1993, which would have yielded Allied Mutual $1.4 million. Thus it was factually correct to say, as Allied Group did, that Allied Mutual's "investment income" would "increase."

On the other hand, Allied Mutual's "look-through" earnings plummeted. Allied Group earned $37 million in 1993. The 4,111,250 shares that Allied Mutual traded away represented a 23.9% stake in those earnings, so Allied Mutual was essentially foregoing $8.8 million ($37 million in earnings times 23.9%) to pick up an extra $2.1 million in dividends ($3.5 million from the preferred minus the $1.4 million common dividend).

Allied Group's 1992 annual report noted the obvious—that the preferred-for-common swap "will increase earnings per share for the holders of the common stock if [Allied Group's] fully diluted earnings per share exceed the cost of the [preferred stock's] dividend of $1.92 per share." (Allied Group's earnings, not surprisingly, exceeded the cost of the preferred stock dividend.)

Jamie Shaffer, Allied Group's chief financial officer, defended the preferred-for-common swap by noting that both companies had obtained fairness opinions. He also told us that at that time Allied Mutual had been "criticized for having too great an investment in subsidiaries." In the 1996 Allied Group annual report, however, Shaffer pointed out what a good deal Allied Group had made. He called the preferred—

in which Allied Mutual was bagged—a "source of low-cost capital."

The whole transaction seemed strange from the start. Why would Allied Mutual want to own $52 million of unregistered, illiquid Allied Group preferred stock that paid 6¾%—and not a basis point more—until the end of time? Allied Group, apparently, wouldn't have touched such a piece of paper. Its $608-million investment portfolio contained no preferred stock, and the average maturity of its bonds was six years. By contrast, the $52-million slug of Allied Group preferred on Allied Mutual's books represented 12.7% of its $394 million in investments and 22.4% of its policyholders' surplus. To make matters worse, long duration assets such as perpetual preferred stock are an inherent mismatch with the short duration of Allied Mutual's liabilities (reserves).

Today the 4,111,250 shares Allied Mutual traded away are worth $185 million; the preferred stock, however, is still worth about $52 million. Some deal.

On January 1, 1993, Allied Group's participation in the Allied pool increased from 60% to 64%, while Allied Mutual's decreased to 36%. More significantly, the pooling agreement between the two companies was amended: AMCO Insurance Company, an Allied Group subsidiary, replaced Allied Mutual as the "pool administrator."

During the years that Allied Mutual had been the pool administrator, expenses had been allocated based upon each company's participation in the pool (e.g., a 25% participant picked up 25% of the expenses). But under the amended agreement, AMCO charged the other pool members fees greater than its actual expenses: 12.85% of written premiums for underwriting services, 7.25% of earned premiums for unallocated loss-settlement expenses, and .75% for premium collection services—20.85% total. Since Allied Group's expense for these services was about 18.85% in 1993, it immediately made a 2% profit on Allied Mutual's share of the pool (which contributed $4.65 million to Allied Group's earnings that year).

The amended pooling agreement was contrary to the spirit of Allied Mutual's 1990 transfer of employees to Allied Group, the purpose of which had been to "provide for employee incentives and benefits in light of statutorily-required amendments" to Allied Mutual's defined benefit plan. The ESOP, as you recall, was supposed to be a cost-effective way for the Allied companies to provide employee benefits—not a means for Allied Group to profit from Allied Mutual. In fact, Allied Group said at that time that it "anticipate[d]" that personnel expenses for it and Allied Mutual would continue to be allocated the way they always had been. The amended pooling agreement altered that allocation significantly.

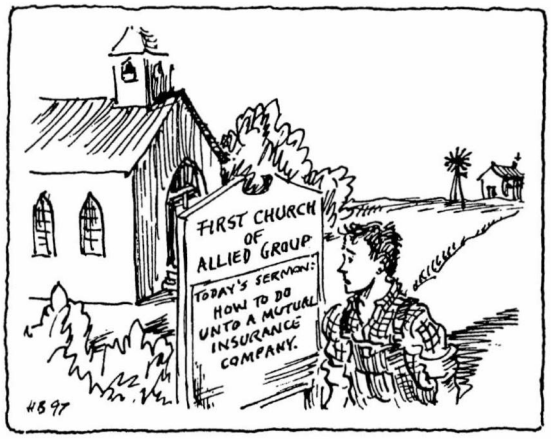
In 1993, Evans told Allied Group's shareholders that "property-casualty is a nickel and dime business," and that one must pay attention to "every penny." Evans is an expert at doing just that—especially when the pennies belong to Allied Group, in which he owns stock and options. "Having [AMCO] named administrator of the Allied pool," he boasted, "is an opportunity to flow every dollar of savings straight to the bottom line"—Allied Group's bottom line.

Jamie Shaffer was more ebullient, *levelling* that he felt "a sense of pride in the growth plan" he'd helped to structure. "AMCO has new opportunities to profit from increased efficiencies," he said of the amended agreement, "and other participants have more predictable expense levels." Shaffer was right on the money: Allied Group did have new opportunities to profit, and Allied Mutual's expenses were more predictable—*more predictably higher.*

"If we didn't already have our current financial structure," Shaffer blabbed in Allied Group's 1993 annual report, "I'd be lying awake nights trying to invent it. Our relationship with Allied Mutual through the pooling agreement is such a plus. The mutual company can concentrate on building surplus to assure policyholders of its continued solvency; our property-casualty segment can run lean enough to earn an attractive return on equity for you." At that moment, Allied Mutual's surplus was $209 million—approximately the same as Allied Group's—yet its premium-to-surplus ratio was an ultraconservative 1-to-1, versus 1.72-to-1 for Allied Group. It seems that Allied Mutual's policyholders were already *more* assured of their company's solvency than were Allied Group's policyholders.

Shaffer's comments raised many questions: Why was "earn[ing] an attractive return on equity" good for Allied Group but not for Allied Mutual? How did taking a smaller portion of the pool and paying AMCO fees allow Allied Mutual to "concentrate on building surplus?" And why, if Allied Mutual has concentrated on building its surplus, has its surplus plodded along at a marginal rate during the greatest bull market in history? Between January 1, 1993 and December 31, 1996, Allied Mutual's surplus grew from $175.5 million to $231.5 million, a 7.17% annual rate. During the same time Allied Group's earnings per share and stock grew at annual rates of 15.7% and 25.5%, respectively. (Since Allied Group's books are kept according to GAAP, policyholders' surplus—a statutory accounting concept—is a less meaningful measure of its success than earnings per share or stock price.) Finally, why are slow growth and paltry profits a better way for Allied Mutual to "assure" its "continued solvency" than the strong growth and hefty profits that Allied Group has racked up?

Six years earlier, in its 1987 annual report, Allied Group extolled the virtues of the *shared-expenses* pooling agreement then in place: "Participating in the pooling agreement *produces more stable underwriting results for all companies in the pool* [emphasis added] and reduces the risk of loss for any one participant by spreading the risk among all the participating companies." By 1996, Allied Group was singing out of a different hymn book: "The [amended] pooling arrangement provides [the Allied companies] more predictable expense levels," said the company's 10-K, and "AMCO has opportunities to profit from the efficient administration of underwriting, loss adjusting, and



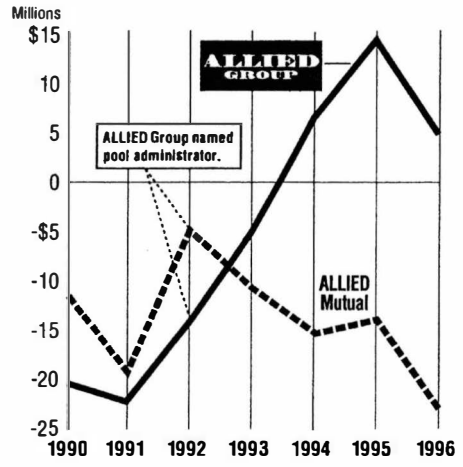
premium collection activities..."

To see the effect the amended pooling agreement has had on the fortunes of Allied Mutual and Allied Group, one need only compare the two company's underwriting results. In the three years preceding the amendment, Allied Group, whose share of the pool ranged from 53% to 60%, experienced a cumulative underwriting loss of $56.7 million; Allied Mutual's underwriting loss was $36.2 million. (Both companies still made money due to investment income.)

Once the amended pooling agreement took effect, however, Allied Group began showing underwriting profits while Allied Mutual's underwriting losses increased. Over the next four years Allied Group earned $21.4 million from underwriting. Allied Mutual, burdened by the amended pooling agreement, lost $63 million from underwriting. (See chart at right.)

Dirty Pool? Underwriting Results

Allied Mutual and Allied Group were once equal participants in the Allied pool. That changed in January 1, 1993, when AMCO (an Allied Group subsidiary) was named pool administrator. Since then Allied Group has recorded underwriting profits from the pool while Allied Mutual has reported increasing losses.



Source: A. M. Best

Since premiums and claims are pooled, all members of the Allied pool have virtually the same "pure loss ratio" (62.5% in 1996). So how did Allied Mutual lose money while Allied Group made money? The answer lies in the "pennies" Evans was counting. Last year Allied Mutual's underwriting expenses and loss-adjustment expenses equaled 45.3% of premiums earned. By comparison, AMCO's expenses totaled 32.5%.

Let's take a closer look at the effect the amended agreement had on both companies' results. In 1996, the four members of the Allied pool—Allied Mutual (36%), AMCO (46%), Allied Property & Casualty (12%), and Depositors (6%)—had a combined underwriting loss of $17.7 million. Had expenses been allocated pari passu, Allied Mutual, with its 36% share, would have lost $6.4 million (36% of $17.7 million). Instead, with its higher expenses, it lost $23 million. Conversely, Allied Group's $5.3-million underwriting profit would have been an $11.4-million loss, but for the amended pooling agreement that allowed it to charge fees to, and earn profits from, Allied Mutual. The result: Allied Group's income was boosted by $16.7 million (and Allied Mutual's loss was deepened by the same amount). That meant that after taxes, Allied Group's 1996 earnings got a positive jolt of $11.9 million, or 58¢ per share. (Thus, without the amended pooling agreement, Allied Group's 1996 earnings per share of $2.31 would have been $1.73 per share—25% less.) Earnings were boosted in 1993, 1994, and 1995, in the same manner.

If Allied Mutual's directors hadn't approved the amendment to the pooling agreement, Allied Group wouldn't have achieved such rapid earnings growth, and its stock wouldn't have reached such lofty levels. At a recent price of 45, it is trading at 16 times the last 12 months' earnings of $2.83 per share. If one were to adjust Allied Group's earnings downward by 25% (factoring out the underwriting differential between Allied Group and Allied Mutual), Allied Group's trailing 12 months' earnings per share would be only $2.12. Assuming a multiple of 12 times earnings (slower growth, lower multiple) the stock would be changing hands somewhere around 25½.

"Alfred and I plan to demutualize."

In June and July, Evans sold 100,000 Allied Group shares at prices ranging from $38.81 per share to $44.77. During the same months his wife Jane registered 100,000 shares. (Shares are generally registered prior to their sale.)

Unlike Evans, Allied Mutual never got to profit from the spectacular rise in Allied Group's stock over the last few years. Just seven weeks after the amended pooling agreement took effect, Allied Mutual, under Evans' direction, sold the last of its holdings—1,462,500 shares at $16.44. In its annual report, Allied Group noted with self-serving arrogance that "the sale of the mutual's shares served all stockholders by increasing the float without diluting earnings or book value."

Thus, when the dust settled, Allied Mutual had sold its entire interest in Allied Group, given up 64% of the Allied pool, parted with all its employees, and—worse—was stuck paying fees to Allied Group for various services. Today Allied Group is worth about $915 million. And what did Allied Mutual receive for parting with everything? Not much: $24 million in cash, $52 million of Allied Group preferred stock, and Allied Life, worth about $50 million. The grand total: $126 million.

After the whirlwind of activity that led to riches for Allied Group and emasculation for Allied Mutual, Evans could have rested on his laurels. He was now quite wealthy and, when you get right down to it, there's not much you can spend your money on in Des Moines, anyway. But he was eager to replay the success he'd had with Allied Group, this time using Allied Life, of which he was chairman, as the medium. (As you may recall, Allied Mutual had repurchased Allied Life from Allied Group in an unusual 1990 restructuring, giving up Allied Group stock that would later be worth $273 million.)

In November 1993 Evans arranged for Allied Life to go public. As in the past, the offering was no bonanza for Allied Mutual. It sold shares at $11.16 each (about book value) and received $19 million in cash. Engineering this small public offering must have consumed a great deal of Evans' time;

otherwise why would Allied Life's "compensation committee"—Harold Evans and James Callison, who were also directors of Allied Mutual and Allied Group—have granted Evans ten-year options on 26,650 shares?

There's an old saw that a hooker has the best product in the world: *she sells it but still owns it.* The same might be said of Evans. As chairman of Allied Group he'd sold Allied Life back to Allied Mutual, profiting handsomely from the deal. Now he would profit once again from the sale of Allied Life, through options granted to him. (Douglas Andersen and Jamie Shaffer, Allied Group's current CEO and CFO, respectively—both of whom have been at Allied for ages and made a bundle as a result of the previous deals—each got options on 13,325 Allied Life shares.)

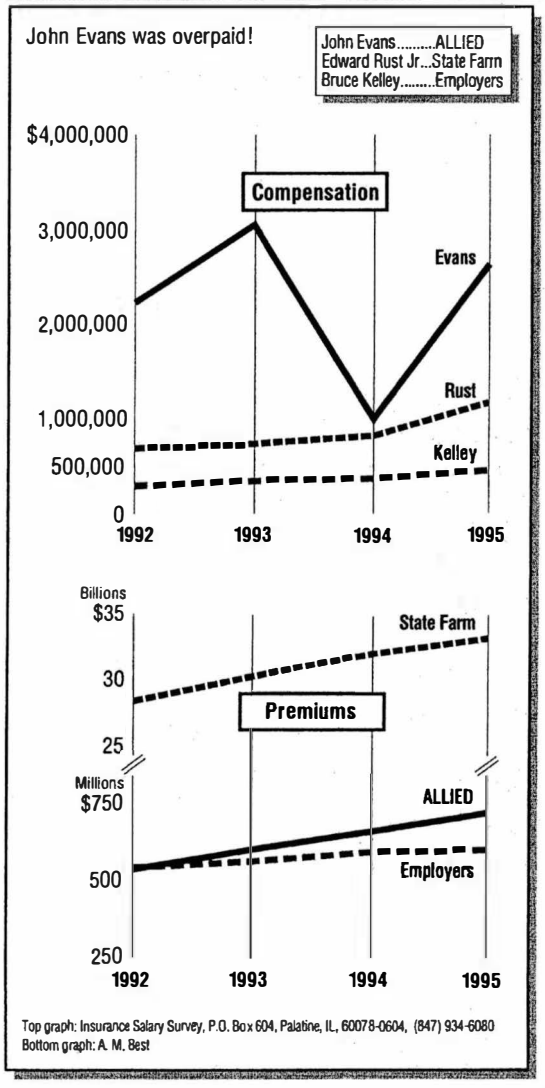
The Allied Life options were a relatively minor deal, even for a penny-pinching potentate like Evans—he'll probably make less than $750,000 from them over time. That's because Allied Life is a small company ($80.7 million in revenues, $46.5 million of statutory capital) with no mutual affiliate from which to siphon premiums and fees. In fact, it had to *pay* Allied Group $4.7 million in fees for "human resources," "joint marketing," and computer services over the last three years.

Evans made his *big* money from Allied Group and Allied Mutual. According to the ever-handy *Insurance Salary Survey* (P.O. Box 604, Palatine, IL 60078, [847] 934-6080), his cumulative compensation for the four years ending in 1995 was $8.9 million, making him, as far as we can tell, the highest paid mutual property/casualty executive in the country. Edward Rust, for example, chairman and president of State Farm (which is 50 times larger than Allied) got $3.5 million during the same period, and Bruce Kelley, president and CEO of Employers Mutual and EMC Insurance Companies (a Des Moines company the same size as Allied) got $1.4 million.

Despite their lower pay, Rust and Kelley did much better jobs for their mutuals than Evans did for his. From the end of 1985 (when Allied Mutual took Allied Group public) to the end of 1996, Allied Mutual's surplus grew from $102.8 million to $231.5 million—an annual rate of 7.66%. During the same period State Farm's surplus grew from $10.12 billion to $30 billion and Employers Mutual's surplus grew from $98.2 million to $410.8 million—annual rates of 10.38% and 13.89%, respectively.

So why did Evans get paid so much? That question is best put to the interlocking boards of Allied Mutual and Allied Group. But while we're on the subject of Evans' compensation, why did *Allied Mutual* own something called Allied Jet Center, Inc., which was, apparently, the corporate moniker for a Learjet? Did Allied Group share the cost of maintaining the Learjet, and did Evans use it to fly to his homes in California? Why, if it was once necessary, did Allied Mutual, as Jamie Shaffer informed us, get rid of the jet a couple of years ago? Did that decision have anything to do with Evans' stepping down as CEO at the end of 1994 and spending more time in California?

Small Insurance Company, Big Salary



Although Evans relinquished the titles of CEO and president, he remained chairman of all the Allied companies, and his imprimatur was everywhere. A photo accompanying Allied Group's 1996 "message to shareholders" shows Evans in a standing pose while Douglas Andersen and Jamie Shaffer sit at a table in front of him.

Celebrating its tenth year as a public company, Allied Group used the opportunity to rewrite history: "We achieved growth the same way we achieved greater profitability: by implementing strategies that reflected...*our Iowa-rooted conservatism* [emphasis added]."

Implying that a regional brand of conservatism had something to do with Allied's success was vintage Evans bunkum. Conservatism is a disposition to preserve that which is established, a tendency towards gradual change rather than sudden shifts. Evans' contorted stratagems—from thimblerigging the Allied pool to deracinating Allied Mutual's labor force—cannot, by any stretch of the imagination, be labeled conservative. And that label is too simplistic for Iowa, with its intriguing contradictions, as well.

Iowa has always had a predilection for moderation, as well as, in the words of historian Dorothy Schweider, "a strong impulse toward social reform": before the Civil War it passed prohibition laws, and abolitionist feelings ran strong. Iowa embraced the Republican party (the party of Lincoln), granted constitutional rights to black men, and was home to the first state university that admitted women. Iowa, as John Gunther noted, is "the heart of agrarian America," yet the Populist party, which swept through neighboring western states like a prairie fire, never took hold there; but native-son Henry Wallace was the country's vice president from 1941 to 1945 and ran for president in 1948 under the Progressive ticket. Iowa voted for Dukakis in 1988 and Clinton in 1992 and 1996.

In short, "the Iowa-rooted conser-

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vatism" to which Evans refers is misleading. But Iowa *is* filled with well-educated, hard-working, churchgoing, temperate folks who eschew ostentation and would be repulsed by Evans' feculent business dealings—if they only knew.

"We'll take a calculated risk," Evans told Allied Group's shareholders in 1996, echoing the basic principles of insurance, "but we won't trust to chance." That sums up Allied Group's interaction with Allied Mutual: it seems that little was left to chance. Allied Mutual was incapable of making a good deal. Allied Group (in which Evans had a big stake) could do no wrong, acquiring through a variety of maneuvers: the Allied insurance companies that grew the fastest, loans from Allied Mutual, a quadrupling of its share of the Allied pool, Allied Mutual's employees, and fees for computer- and investment-management services from Allied Mutual. Allied Group relieved itself (at Allied Mutual's expense) of its overvalued capital-intensive life-insurance company in exchange for undervalued shares of the reliable property/casualty company, bought back its shares in exchange for a pungent perpetual preferred stock, and garnered a lucrative contract to "administer" the Allied pool.

It's hard to discern any risk in these transactions, much less a *calculated one*. (Actually, Evans' greatest risk was that Allied Mutual's policyholders would notice what was going on and string him up from the highest tree.)

Although one of the purposes, ostensibly, for taking Allied Group public was to generate additional capital for Allied Mutual and its subsidiaries, Allied Mutual didn't *need* additional capital, much less need it so badly that it should have sold its birthright: Allied Mutual's cash proceeds from the sale of its Allied Group shares totaled $24 million.

As for Allied Group, over the years it raised $86 million from various public stock offerings, but spent $83 million repurchasing its shares—$31 million in cash and $52 million in preferred stock—approximately what it took in from the public.

The open-market repurchases bring up the familiar issue of Evans' dichotomous behavior. In February 1993, for example, Allied Mutual had, under Evans' direction, blown out the last of its Allied Group stock, receiving $16.44 per share. What was the purpose of this sale (other than to "serve" Allied Group)? Allied Mutual had no pressing need for capital and its balance sheet was better than Allied Group's.

Within a year Evans would do an about-face and oversee Allied Group's *repurchase* of shares at a *higher* price—$16.96 per share. This would prove to be as good a buy as Allied Mutual's sale was bad: over the next three years Allied Group's stock tripled. Once again, Evans profited from Allied Group's propitious repurchase but lost nothing as a result of Allied Mutual's untimely sale.

The sale of Allied Mutual's final block of Allied Group stock is even more puzzling in light of recent changes in Allied Mutual's asset mix. For quite a while Evans avoided common stocks, investing primarily in high-grade bonds. At year-end 1992, Allied Mutual had $175 million of surplus and $397 million in assets, but just $2.2 million in stocks—0.6% of assets. In 1996, Allied Mutual finally caught a touch of bull-market fever and raised its stock portfolio to 4.4% of assets, or $23 million (which is $1 million less than it received from its last sale of Allied Group shares). Had Allied Mutual simply held these Allied Group shares it would have made an additional $42 million.

Although Allied Mutual hasn't had an equity interest in Allied Group since 1993, the preferred stock it owns allows it to "nominate for election" (read *appoint*) two of the ten directors on Allied Group's board. Given the inherent conflicts of interest between the two companies, these directors should play the role of Allied Mutual's champion and protector. To do this, however, they would need to be independent of Allied Group and its management. (It goes without saying that they shouldn't have any financial interest in Allied Group.)

Were it not such a brazen disregard for propriety, Allied Mutual's selection of Evans and his brother Harold to represent the company's interests on Allied Group's board would be farcical, because it's difficult to imagine two directors more ill-suited than these. On the other hand, Allied Group's shareholders had every reason to fancy Evans: he'd masterminded the intricate chain of events that had made them a fortune—at Allied Mutual's expense.

Whether Evans' dismal record at Allied Mutual (compared to his splendid record at Allied Group) is attributable to bad luck, ineptitude, or conflict of interest doesn't matter; he has done a miserable job for Allied Mutual's policyholders and shouldn't be their nominee for Allied Group's board.

In fact, if an outraged-and-determined New York journalist has his way, Evans won't be on Allied Mutual's board, either: he'll be booted out, along with all the other board members. This journalist, one David Schiff, is now an outside, independent nominee for the board, and has submitted a plan to liberate the company from Evans and Allied Group and return at least $385 million to policyholders. (For more on this, see the following article.)

Evans and his pals will, undoubtedly, defend their orchestration of the Allied Mutual and Allied Group intercompany transactions. They will assert that these deals were reviewed and approved by boards of directors, coordinating committees, investment bankers, lawyers, and, in some instances, the Iowa Insurance Department. They will declare that advisors were hired and fairness opinions were issued; that certain matters were voted for by Allied Group's shareholders. They will state that Allied Mutual's policyholders duly elected every director. They will note that financial statements were gone over by independent auditors and that the insurance companies were examined by state insurance departments. They will aver that Allied received high ratings from Best and Standard & Poor's, and that documents were filed with the SEC, Nasdaq, and the New York Stock Exchange. And they will protest that our analysis has been made with the benefit of hindsight—that no one could have foreseen that each and every deal would be a boon for Allied Group and a bust for Allied Mutual. They may even say that they are shocked—shocked that things turned out so badly for Allied Mutual. (Or perhaps they'll take a different tack and maintain that Allied Mutual has done...admirably!)

But so what if sumptuously rewarded investment bankers and lawyers—surprise!—signed off on transactions? Big deal if low-paid bureaucrats and overworked regulators approved, but missed the ramifications of, intricate pooling arrangements and stock transactions. Allied Mutual's directors—the last line of defense—were charged with the responsibility of watching out for the policyholders. John Evans may have been their friend, colleague, or brother, but their allegiance rightfully belonged to Allied Mutual. Whether the directors' poor decisions were due to negligence, ignorance, or bad luck—the disembowelment of Allied Mutual Insurance Company happened on their watch.

We'll be the first to admit that calling attention to directors' disposition to be rubber-stamping yes-men is a bit like complaining that an outhouse stinks. Unfortunately, insurance-company directors often serve the same function as Calvin Coolidge, who, according to Will Rogers, "didn't do anything, but that's what the people wanted done."

Although complacency is not a desirable

trait in a mutual-insurance-company board, it may not be too damaging a quality when a company is run by people like Bruce Kelley or Ed Rust. On the other hand, giving John Evans a pliable board is like giving a two-year-old a chainsaw—something bad is likely to happen.

There's an investment angle to this story, and it is the sale of Allied Group stock. (For the record, we are neither long nor short and don't intend to take a financial position.) Allied Group has profited by riding—no, by *taking*—Allied Mutual's coattails. From 1985 to 1993 it grew rapidly by increasing its share of the Allied pool from 38% to 64%, and its earnings were boosted by outsmarting Allied Mutual in a variety of ways. Since 1991, however, Allied Group's annual premium-growth rate has slowed to 14.75% (10.3% since 1994). Earnings per share have grown much faster, though—23.6% compounded annually—in part because of fees charged to Allied Mutual (which accounted for 25% of Allied Group's 1996 earnings). But Allied Group's relationship with Allied Mutual is approaching a state of entropy—there isn't as much left to reap as there once was (Allied Mutual made $12 million in 1995 and $6.8 million in 1996), and whatever is reaped now will be less meaningful to Allied Group. (Allied Group made $52.3 million in 1995 and $51 million in 1996.)

Although its earnings were up almost 50% in the first half of 1997 due to improved experience in personal auto and homeowners, Allied Group may be sitting on the equivalent of a toxic waste dump: the *manner* in which it has achieved much of its growth over the years. If Allied Mutual's policyholders decide that they're mad as hell and aren't going to take it anymore, they might stage a revolt that culminates in the overthrow of Evans and the board, the elimination of excess fees paid to Allied Group, and the reversing of a decade's worth of cheap-jack maneuvers and gossamer transactions. Such an occurrence would have a devastating effect on Allied Group's earnings, balance sheet, and stock price (and a correspondingly beneficial effect for Allied Mutual's policyholders).

It is possible, of course, that this apocalyptic scenario is no more than the fanciful dream of a quixotic muckraker. Evans may be many things, but he is not stupid; Allied Mutual and Allied Group are intertwined through a variety of long-term contracts and agreements that were designed by well-paid lawyers.

Yet we sense a turning of the tide, a move towards reform. Not so long ago, shareholders of public companies were disenfranchised too, but activists—at first a few small individuals, then corporate raiders, public pension funds, and mutual funds—demanded accountability. This simple truth is often forgotten: mutual insurance companies are not the property of their directors or employees—they belong to their policyholders.

Policyholders' long period of quiescence may be coming to an end. And if it does, that may cause a few sleepless nights for John Evans, Allied Mutual's directors, and Allied Group's shareholders. ■■

ALLIED Mutual Chronology

1929

Allied Mutual formed in Iowa. Amended articles of incorporation later state that "the purpose and object of the corporation shall be to engage in the business of insurance...upon the mutual plan."

1964

John Evans, 36, succeeds his father as head of Allied Mutual.

1974

Allied Mutual forms a downstream holding company, Allied Group.

1985

Allied Group goes public, raising $16.8 million by issuing shares at a price approximating book value. Allied Mutual's ownership decreases to 79%. Allied Mutual's 1,000 employees provide all services for Allied Group and administer the Allied pool.

Stock options granted, including 234,516 to John Evans. Douglas Andersen and Jamie Shaffer each get 43,268.

1986

Allied Group forms Western Heritage Insurance Co., which doesn't cede business to the Allied pool even though it markets through a "readily available distribution system"—Allied Mutual agents.

1987

Allied Group forms Allied Group Information Systems (AGIS) and begins charging fees to Allied Mutual. Allied Group increases its share of the Allied pool to 41%.

1988

Evans receives 10-year options to purchase Allied Group stock for 44¢ per share. (Book value is $6.38 per share.) Other employees receive similar options. Allied Group directors (many of whom also serve on Allied Mutual's board) are offered Allied Group stock options.

1990

Big restructuring plan: Allied Group sells Allied Life to Allied Mutual for 17% premium to book value and repurchases its own shares from Allied Mutual at an 18% discount to book value. (By 1997 Allied Life is worth $50 million and Allied Group's repurchased shares are worth $273 million.)

Allied Group's percentage of the Allied pool is raised to 53%. "[Increasing the pool] gave us all the advantages of an acquisition without any of the drawbacks," says Allied Group.

All Allied Mutual employees are transferred to Allied Group.

Allied Group's ESOP borrows $35 million (guaranteed by Allied Group) to buy Allied Group convertible preferred stock at a bargain-basement price, thereby diluting Allied Mutual. Allied Group employees will make $243 million as a result.

Allied Mutual's ownership of Allied Group is now reduced from 78% to 40%. Allied Group's employees own 37%.

1992

Allied Group's share of the Allied pool increases again—to 60%.

Allied Group issues $52 million of 6¾% nonconvertible preferred stock to Allied Mutual in exchange for 4,111,250 shares of Allied Group owned by Allied Mutual. Allied Group later refers to this preferred stock as "a source of low-cost capital." Today, the preferred stock is worth $52 million, but the shares Allied Mutual parted with are worth $185 million.

1993

Allied Group's share of the Allied pool increases to 64%. AMCO (an Allied Group subsidiary) replaces Allied Mutual as the administrator of the Allied pool. Breaks tradition and begins charging fees to make a profit. Evans calls this deal "an opportunity to flow every dollar of savings straight to the bottom line"—Allied Group's bottom line. As a result, Allied Group earns $21.4 million from underwriting over the next four years while Allied Mutual loses $63 million.

Under Evans' direction, Allied Mutual sells the last of its Allied Group stock at $16.44. Says Allied Group: "The sale of the mutual's shares served all stockholders by increasing the float without diluting earnings or book value."

Allied Life goes public. Evans, Andersen, and Shaffer get stock options.

1994

Allied Group repurchases stock at a higher price than that at which Allied Mutual sold out. Allied Group's stock triples in next three years.

Allied Mutual's executives apparently dislike traveling on scheduled flights: the company owns a Learjet.

1995

Evans receives $8.9 million in compensation between 1992 and 1995. He is now *Allied Mutual's* nominee for Allied Group's board.

1997

Allied Mutual is worth $240 million. Allied Group is worth $915 million. Evans is still chairman of Allied Mutual, Allied Group, and Allied Life. His shares are now worth $15.5 million.

David Schiff is nominated for Allied Mutual's board by dissident policyholder. Will attempt to gain seat held by James Callison. Also seeks to boot out the current board, reverse previous transactions with Allied Group, and return at least $385 million to Allied Mutual's policyholders.

Power to the policyholders!

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The Liberation of Allied Mutual

How I Plan to Seize Control of Allied Mutual

by David Schiff

I'm a fan of mutual insurance; it's worked for a long time. I'm also a fan of stock insurance companies. Many have done well for their policyholders *and* their shareholders.

The concept of mutuality, however, is under attack. In New York, which is noted for its conservative insurance regulation, Governor Pataki has proposed a nasty mutual-holding-company law that would allow mutuals to put their insurance companies into holding companies and sell stock in these holding companies to—who else?—the public.

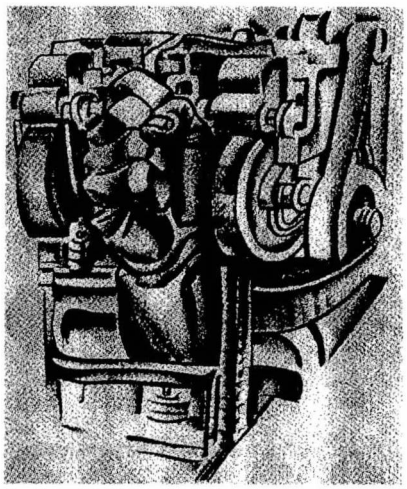
In theory this may not *always* be bad; in practice it stinks. Nonetheless, many mutual-insurance-company executives embrace demutualization because it's a way for them to expand their companies' capital and engage in that great American pastime—making acquisitions. Whether that's good for the policyholders is, apparently, beside the point. Once a mutual is partially converted to a stock company, its executives can wrap their hands around the stuff that dreams are made of—stock options—and, with a little "luck," make a bundle, like John Evans. Although Allied Mutual isn't the only mutual insurance company to have taken a beating from its stock-company affiliate, it's the most egregious example I've ever come across.

Last year I traveled through Iowa, which has 149 domestic mutuals, and visited several of the largest, some of which have publicly-held affiliates and some of which don't. (Iowa is on the front lines of the demutualization business, and Allied was one of the earliest to leave the trenches and go over the top.) I didn't meet with Allied—neither Evans nor Andersen was available—but I'd seen Evans do his shtick at insurance conferences over the years and was vaguely familiar with the success of Allied Group's stock.

When I delved deeper into the Allied Insurance companies this summer I became appalled—not just by the clever deals and asset shuffling, but by the shameless way Evans and his fellow executives boasted of their exploits to Allied Group's shareholders (e.g. "Having [AMCO] named administrator of the Allied pool is an opportunity to flow every dollar of savings straight to [Allied Group's] bottom line"). Evans' hubris left me aghast. How, I wondered, was it possible to preside over the transfer of more than $500 million of value from Allied Mutual to Allied Group without someone—a regulator, a consumer activist, a strike-suit lawyer—screaming bloody murder? Didn't *anyone* care about the policyholders? After all, Allied Mutual—*all mutuals*—are supposed to be run for the benefit of their policyholders.

When Kent Forney, a partner at Bradshaw, Fowler, Proctor & Fairgrave, in Des Moines, taught law, he used to make this analogy: "A policyholder's interest in the surplus of a mutual insurance company is roughly akin to a spouse's dower right, which is an inchoate right that can't be enforced until there's a dissolution of the marriage by divorce or death. Similarly, a policyholder's interest in the surplus can't be enforced until there's dissolution of the insurance company." But, notes Forney, unlike a spouse's dower right, the value in a mutual insurance company belongs to the policyholders—they just don't have the individual right to compel the mutual to pay it out to them.

Somewhere along the way Allied Mutual seems to have forgot that its purpose was not to provide stock-market profits for Evans and his fellow employees. "The purpose and object of [Allied Mutual]," states the company's amended and restated articles of incorporation, "shall be to engage in the business of insurance...upon the mutual plan." Evans and the other Allied Mutual directors were fiduciaries; they were supposed to watch out for Allied Mutual, not worry—as those who were on both boards had to—about earning a high return on equity for Allied Group.



Policyholders of Allied Mutual, unite!

Hugo Gellert, "Machinery and Large-Scale Industry 44." Courtesy Mary Ryan Gallery

As I researched the Allied article—reviewing financials, reading documents, pondering transactions—I came to the conclusion that I wouldn't entrust Evans with the screw-off cap of an empty bottle of muscatel, much less the directorship of a large mutual insurance company. I was reminded of Alexander Woollcott's quip that a stockbroker is a man who takes your fortune and runs it into a shoestring. Woollcott apparently never met the chairman of a mutual insurance company who owned stock in its publicly-held affiliate.

I imagined that Evans had some convoluted rationalization for the disparate results experienced by Allied Mutual and Allied Group—something along the lines of the 1968 Associated Press dispatch from Vietnam quoting a U.S. Army Major saying "It became necessary to destroy the town to save it."

But Evans didn't return my calls, nor did any of the other directors besides Hoak, who displayed a curious inability to recall details concerning his tenure on both boards.

It was around this time that I decided to do what anyone in the world is entitled to do: run for Allied Mutual's board, take control of the company, and set things straight. You see, I have as much right to be on Allied Mutual's board as John Evans does. "Directors need not be residents of Iowa," states Allied Mutual's articles of incorporation, "and need not be Members [policyholders] to qualify for election to office." In fact, the requirements are surprisingly simple: "Nominations for membership on the board of directors...[must be] presented in writing, signed by the Member...at least 60 days prior to" the annual meeting. That's it.

Since Allied Mutual has about 100,000 policyholders, I knew it wouldn't be difficult to find someone to nominate me. But I wanted to keep my intentions under wraps—this was a sensitive subject, after all—so I asked my ex-wife, the writer Joyce Walter (whose novel, *The Hallie Lawrence Story*, is one of the funniest books I've ever read), if she had any objections to becoming an Allied Mutual policyholder. Joyce knows as much about insurance as I know about

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Schiaparelli cocktail dresses, but she's always been a champion of the masses and was glad to help. So I located an Allied agent, took care of the arrangements, and paid a $200 premium. Her policy arrived in the mail three weeks later, along with a document signed by Douglas Andersen, Allied Mutual's president, stating that she "is a member of the company and is entitled to vote...at all meetings."

In compliance with Allied Mutual's requirements, Joyce formally nominated me in a letter addressed to Evans and Andersen. (I drafted the letter and she signed it.) To ensure that the nomination would arrive promptly, I personally took it to Federal Express.

I also enclosed a letter outlining my reasons for seeking election to Allied Mutual's board, and suggested that it would make matters easier for me (and better for the policyholders) if the current board would, in accordance with Article 9, Section G, resign *en masse* immediately after appointing me (and my slate of first-class fiduciaries) as directors of Allied Mutual. To show that there were no hard feelings, I offered to send each Allied Mutual director a bottle of Dom Perignon upon his resignation.

Assuming that the directors reject my offer—as I expect them to—I'll wage a proxy fight and get elected at Allied Mutual's annual policyholders meeting, which is scheduled for one o'clock on Tuesday March 3, 1998, at the home office in Des Moines. Since Allied Mutual has a staggered board, only one seat, that held by James Callison, will be up for grabs this year.

Before I get into the details of my plan, I'll pose a rhetorical question: Can a lone muckraker, armed with a Power Macintosh 6500/250 and a budget that can barely buy a round-lot of Allied Group stock, walk through the mean streets of Des Moines, seize a seat on the board of a large mutual, and wrest control from an entrenched chairman and his obliging understrappers?

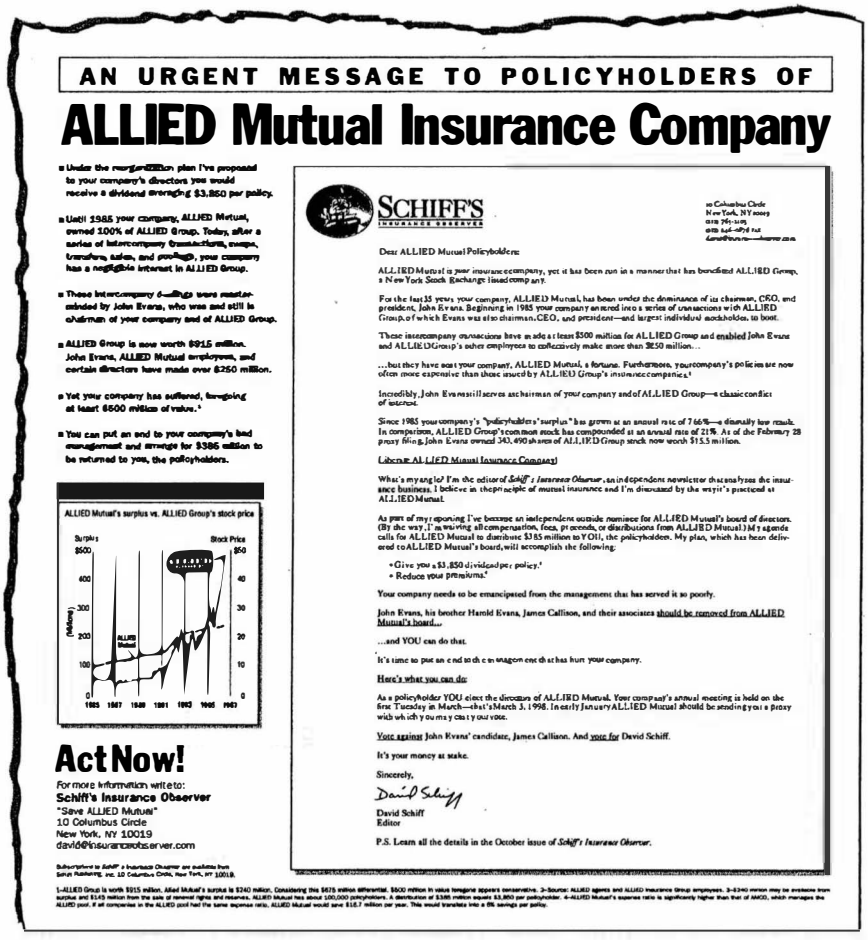
Ordinarily that would be unthinkable. But Allied is no ordinary mutual: it is a vassal bound in feudal service to a tyrannical lord. It has seen its assets sold for *bupkis*, its employees taken, and its premiums diverted. It is encumbered by administrative fees levied by Allied Group, and, not surprisingly, is only marginally profitable. The final insult: Allied Mutual's policyholders generally pay higher premiums than Allied Group's policyholders do for essentially the same coverage.

In short, Allied Mutual is like a pile of oily rags (the hazard we were warned of in Insurance 101): it's an explosion waiting to happen. That's why I can overthrow the board. Ultimately, people will not allow such an inequitable situation to continue. That Evans has, for so long, pressed down upon the brow of Allied Mutual a crown of thorns is a testament to policyholders' ignorance, regulatory folly, a lack of scrutiny, and a general sense of complacency. But that's coming to an end.

Because Allied Mutual's policies tend to be more expensive than Allied Group's, Allied Mutual's policyholders are not benefiting from their company's surplus; they'd actually be better off with Allied Group policies. Allied Mutual's *real* beneficiary is Allied Group; it receives administrative fees and, through the Allied pool, the *use* of Allied Mutual's surplus, which enables the Allied companies to write more premiums, thereby allowing AMCO to earn more from its administrative fees.

There's a good solution to this situation, and it's the backbone of my campaign for the board. Allied Mutual should reverse the myriad transactions in which it was bested by Allied Group: the pooling changes, the stock swaps, the administrative fees—everything. Since that may involve technical difficulties (and since Allied Group won't immediately agree to this), Allied Mutual might have to hire lawyers and consider seeking some kind of compensation for at least a decades' worth of sniggering schlock-house transactions. Although Allied Mutual was once much larger than Allied Group, its $240 million of surplus is now about one-quarter of Allied Group's $915 million market cap. Perhaps the two companies could simply split the difference—$675 million—and do away with legal bickering.

Even if it receives a large payment from Allied Group, Allied Mutual won't have the wherewithal to administer its book of business (after all, it has no employees). There-



An ad that *Schiff's Insurance Observer* is running in *The Des Moines Register.*

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fore, it should sell its $300 million in premiums (which had a 62.5% pure loss ratio last year) to the highest bidder. Investment bankers (not the ones who did the fairness opinions) can handle this, and I wouldn't be surprised if Allied Mutual gets $125 million, maybe more. As a matter of fact, Allied Mutual's book of business would fit quite nicely with Allied Group's operations.

What will Allied Mutual be worth when this has been accomplished? Well, it started with $240 million in surplus. Add $125 million from the sale of its book of business, plus whatever is received in settlement from Allied Group (half of $675 million?). Throw in $20 million or so for the equity in its loss reserves and the total is somewhere between $385 million and $725 million.

Whatever the final figure turns out to be, it belongs to the policyholders. Since there are approximately 100,000 of them, that's $3,850 to $7,250 apiece. Whether the best way to distribute this is by declaring a dividend, by liquidating Allied Mutual, or by some other means, is a matter that will require the assistance of accountants and lawyers (doesn't everything?). We'll hire the best when I'm Allied Mutual's chairman, and get the money back to the policyholders as soon as possible. (By the way, I'm waiving all compensation and director's fees, and Joyce will waive any proceeds or distributions that would ordinarily be due her as a policyholder.)

To kick off my campaign for Allied Mutual's board I've placed an ad in *The Des Moines Register* (see previous page), briefly explaining the situation and seeking the support of policyholders. Although the election is five months away, I have a feeling that it will turn out to be an uneven battle: Evans and the other Allied Mutual directors won't stand much of a chance. Through their actions they have demonstrated that they aren't fit to be on Allied Mutual's board, and their agenda—whatever it is—has not served the policyholders.

I have a suspicion that once Allied Mutual's gimcrackery gyrations, chop-shop poolings, and irreconcilable conflicts of interest are exposed to the light of day, the policyholders, the regulators, the press, and the public will demand change. The time is right, and I hope my actions will serve as an inspiration for mutual policyholders, as a wake-up call for regulators and legislators, and, at long last, as deliverance for the true owners of Allied Mutual.

Power to the policyholders! ■

3/24/15 #4

15.0450.03001
Title.

Prepared by the Legislative Council staff for
Senator Klein
March 23, 2015

PROPOSED AMENDMENTS TO ENGROSSED HOUSE BILL NO. 1313

Page 4, line 1, replace "a majority" with "two-thirds"

Page 4, line 4, replace "a majority" with "two-thirds"

Page 4, line 23, after the underscored period insert "This application fee is in addition to other direct costs incurred by the commissioner in reviewing the proposed plan of conversion."

Page 5, line 3, remove "Immediately, the commissioner shall give written notice to the converting mutual"

Page 5, remove line 4

Page 5, line 5, remove "reasons for the decision."

Page 5, line 8, after "b." insert "The plan is fair and equitable to the converting mutual company and the converting mutual company's members;

c."

Page 5, line 8, remove "and"

Page 5, line 9, replace "c." with "d."

Page 5, line 9, replace the underscored period with "; and

e. The converted stock company will have the amount of capital and surplus the commissioner deems reasonable for the converted stock company's future solvency."

Page 5, line 14, replace "may" with "shall"

Page 5, line 18, replace "All" with "The commissioner shall give written notice to the converting mutual company of any decision, and in the event of disapproval, a statement in detail of the reasons for the decision.

8. No later than forty-five days before the meeting, the converting mutual company shall send"

Page 5, line 18, remove "must be sent"

Page 5, line 19, remove "briefly but fairly"

Page 5, line 20, after the underscored comma insert "must inform the member that the proposed plan of conversion will extinguish the member's membership rights,"

Page 5, line 22, after the underscored period insert "Such notice must provide instructions on how the member can obtain, either by mail or electronically, a full copy of the proposed plan of conversion."

Page 5, line 25, replace "8." with "9."

Page 5, line 26, replace "a majority" with "two-thirds"

#4

Page 6, line 1, replace "9." with "10."

Page 6, line 3, replace "a majority" with "two-thirds"

Page 6, line 5, replace "10." with "11."

Page 6, line 9, after "approved" insert ", which must include the record of total votes cast in favor of the plan"

Page 8, line 13, replace "clear and convincing" with "a preponderance of the"

Page 9, line 10, after "5." insert "The dollar value of a subscription right based on the application of a generally accepted option pricing model. In connection with the determination of stock price volatility or other valuation inputs used in option pricing models, the qualified independent expert may assume that the attributes of the converted stock company will be substantially similar to the attributes of the stock of the peer companies used to determine the estimated pro forma market value of the converted stock company. Solely for the purpose of determining the value of a subscription right, the term of a subscription right is deemed to be a minimum of ninety days.

6. The plan must provide that each eligible member must be given the right to require the mutual company to redeem the subscription rights, in lieu of the exercise of subscription rights allocated to that eligible member, at a price equal to the number of such subscription rights allocated to the eligible member multiplied by the dollar value of a subscription right as determined by the qualified independent expert under subsection 4. The obligation of the mutual company to redeem the subscription rights does not arise until the effective date of the plan. Within thirty days of the effective date of the plan, the redemption price payable to each eligible member must be paid to the eligible member. Alternatively, the converted stock company may offer each eligible member the option of receiving the redemption amount in cash or having the redemption amount credited against future premium payments. An eligible member that does not exercise that eligible member's subscription rights and also fails to affirmatively request redemption of the subscription rights before the expiration of the subscription offering, nevertheless is deemed to have requested redemption of that eligible member's subscription rights and shall receive the redemption amount in cash in the manner otherwise provided in this subsection.

7."

Page 9, line 17, replace "6." with "8."

Page 9, line 30, replace "7." with "9."

Page 10, line 13, replace "8." with "10."

Page 10, line 23, replace "9." with "11."

Page 10, line 25, replace "10." with "12."

Page 11, line 9, remove "The plan of conversion may provide the directors, officers, and employees of the"

Page 11, remove lines 10 through 29

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Page 11, line 30, remove "3."

Page 12, line 13, replace "4." with "2."

Page 12, line 14, remove ", without payment,"

Page 12, remove lines 22 through 24

Page 12, line 25, replace "c." with "b."

Page 12, line 28, replace "d." with "c."

Page 15, line 24, replace "Except as provided for in a plan of conversion approved by the commissioner, a" with "A"

Renumber accordingly

4/1/15 #1

15.0450.03004
Title.

Prepared by the Legislative Council staff for
Senator Klein
March 31, 2015

PROPOSED AMENDMENTS TO ENGROSSED HOUSE BILL NO. 1313

Page 3, line 22, replace "twenty or more than thirty-five" with "forty-five"

Page 3, line 23, after "proposed" insert "subsidiary"

Page 3, line 24, after "the" insert "stock of the"

Page 3, line 24, remove "through"

Page 3, line 25, remove "the purchase of all the stock of the converted stock company"

Page 4, line 1, replace "a majority" with "two-thirds"

Page 4, line 4, replace "a majority" with "two-thirds"

Page 4, line 23, after the underscored period insert "The application fee is in addition to other direct costs incurred by the commissioner in reviewing the proposed plan of conversion."

Page 5, line 3, remove "Immediately, the commissioner shall give written notice to the converting mutual"

Page 5, remove line 4

Page 5, line 5, remove "reasons for the decision."

Page 5, line 8, after "b." insert "The plan is fair and equitable to the converting mutual company, the members of the converting mutual company, and the eligible members of the converting mutual company;

c."

Page 5, line 8, remove the second "and"

Page 5, line 9, replace "c." with "d."

Page 5, line 9, replace the underscored period with "; and

e. The converted stock company will have the amount of capital and surplus deemed by the commissioner to be reasonable for its future solvency."

Page 5, line 14, replace "may" with "shall"

Page 5, line 18, after "7." insert "The commissioner shall give written notice of any decision to the converting mutual company and, in the event of disapproval, a detailed statement of the reasons for the decision.

8."

Page 5, line 19, after "conversion" insert "no later than forty-five days before the meeting"

Page 5, line 19, remove "briefly but fairly"

Page 5, line 20, after the underscored comma insert "must inform the member how the proposed plan of conversion will affect the member's membership rights,"

Page 5, line 22, after the underscored period insert "The notice must provide instructions on how the member can obtain, either by mail or electronically, a full copy of the proposed plan of conversion."

Page 5, line 25, replace "8." with "9."

Page 5, line 26, replace "a majority" with "two-thirds"

Page 6, line 1, replace "9." with "10."

Page 6, line 3, replace "a majority" with "two-thirds"

Page 6, line 5, replace "10." with "11."

Page 6, line 9, after "approved" insert ", which must include the record of total votes cast in favor of the plan"

Page 7, line 8, after "proposed" insert "subsidiary"

Page 7, line 9, remove "all"

Page 7, line 21, replace "total price" with "pro-forma market value"

Page 8, line 2, remove "all"

Page 9, line 2, replace "amount" with "value"

Page 9, line 10, after "5." insert "The dollar value of a subscription right based upon the application of the Black-Scholes option pricing model or another generally accepted option pricing model. In connection with the determination of stock price volatility or other valuation inputs used in option pricing models, the qualified independent expert may assume that the attributes of the converted stock company will be substantially similar to the attributes of the stock of the peer companies used to determine the estimated pro-forma market value of the converted stock company. The term of a subscription right is a minimum of ninety days for the sole purpose of determining the value of a subscription right.

6. The plan must provide that each eligible member has the right to require the mutual company to redeem such subscription rights, in lieu of exercising the subscription rights allocated to each eligible member, at a price equal to the number of subscription rights allocated to each eligible member multiplied by the dollar value of the subscription right as determined by the qualified independent exert pursuant to subsection 4. The obligation of the mutual company to redeem subscription rights arises only upon the effective date of the plan. The redemption price payable to each eligible member must be paid to the member within thirty days of the effective date of the plan. Alternatively, the converted stock company may offer each eligible member the option of receiving the redemption amount in cash or having the redemption amount credited against future premium payments. An eligible member that does not exercise their subscription rights, and which also fails to affirmatively request redemption of the member's subscription rights before the expiration of the subscription offering, nevertheless is deemed to have requested redemption of the member's subscription rights and shall receive the redemption amount in cash in the manner otherwise provided in this subsection.

7."

Page 9, line 17, replace "6." with "8."

Page 9, line 30, replace "7." with "9."

Page 10, line 13, replace "8." with "10."

Page 10, line 23, replace "9." with "11."

Page 10, line 25, replace "10." with "12."

Page 10, line 26, replace "three" with "two"

Page 11, remove lines 9 through 29

Page 11, line 30, replace "3." with "1."

Page 12, line 13, replace "4." with "2."

Page 12, line 13, replace the first "the" with "that"

Page 12, line 14, remove ", without payment,"

Page 12, remove lines 22 through 24

Page 12, line 25, replace "c." with "b."

Page 12, line 28, replace "d." with "c."

Page 15, line 24, replace "Except as provided for in a plan of conversion approved by the commissioner, a" with "A"

Renumber accordingly

4/1/15 #2

15.0450.03004

Sixty-fourth
Legislative Assembly
of North Dakota

FIRST ENGROSSMENT

ENGROSSED HOUSE BILL NO. 1313

Introduced by

Representatives Keiser, Kasper, Klemin

A BILL for an Act to create and enact chapter 26.1-12.2 of the North Dakota Century Code, relating to conversion of a mutual property and casualty insurance company to a stock insurance company; to amend and reenact section 26.1-12.1-10 and subdivision b of subsection 12 of section 26.1-17-33.1 of the North Dakota Century Code, relating to references to demutualization of domestic mutual insurance companies; and to repeal section 26.1-12-32 of the North Dakota Century Code, relating to demutualization of domestic mutual insurance companies.

BE IT ENACTED BY THE LEGISLATIVE ASSEMBLY OF NORTH DAKOTA:

SECTION 1. AMENDMENT. Section 26.1-12.1-10 of the North Dakota Century Code is amended and reenacted as follows:

26.1-12.1-10. Applicability of certain provisions.

A mutual insurance holding company is deemed to be an insurer subject to chapter 26.1-06.1 and is automatically a mandatory party to any proceeding under that chapter involving an insurance company that, as a result of a reorganization according to section 26.1-12.1-02 or 26.1-12.1-03, is a subsidiary of the mutual insurance holding company. In any proceeding under chapter 26.1-06.1 involving the reorganized insurance company, the assets of the mutual insurance holding company are considered to be the assets of the estate of the reorganized insurance company for purposes of satisfying the claims of the reorganized insurance company's policyholders. A mutual insurance holding company may not dissolve or liquidate without the approval of the commissioner or as ordered by the district court according to chapter 26.1-06.1. ~~Section 26.1-12-32~~Chapter 26.1-12.2 is not applicable to a reorganization or merger accomplished under this chapter.

SECTION 2. AMENDMENT. Subdivision b of subsection 12 of section 26.1-17-33.1 of the North Dakota Century Code is amended and reenacted as follows:

b. The restructured company must be treated as a mutual insurance company subject to the provisions of chapter 26.1-12, except for sections 26.1-12-01, 26.1-12-02, 26.1-12-03, 26.1-12-05, 26.1-12-06, 26.1-12-07, 26.1-12-08, 26.1-12-09, 26.1-12-10, 26.1-12-14, 26.1-12-16, 26.1-12-18, 26.1-12-19, 26.1-12-23, 26.1-12-24, 26.1-12-25, 26.1-12-26, 26.1-12-29, and 26.1-12-30~~, and 26.1-12-32~~.

SECTION 3. Chapter 26.1-12.2 of the North Dakota Century Code is created and enacted as follows:

26.1-12.2-01. Definitions.

As used in this chapter:

1. "Capital stock" means common or preferred stock or any hybrid security or other equity security issued by a converted stock company or other company or entity pursuant to the exercise of subscription rights granted pursuant to the provisions of subdivision c of subsection 1 of section 26.1-12.2-03.
2. "Converted stock company" means a mutual company or mutual holding company that has converted to a stock company under this chapter.
3. "Converting mutual company" means a mutual company or mutual holding company that has adopted a plan of conversion under this chapter.
4. "Eligible member" means a member of a converting mutual company whose policy is in force on the date the governing body of the converting mutual company adopts a plan of conversion or such earlier date as the converting mutual company may establish with the consent of the commissioner. A person insured under a group policy is not an eligible member. A person whose policy becomes effective after the governing body adopts the plan of conversion but before the effective date of the plan of conversion is not an eligible member but has those rights established under section 26.1-12.2-09.
5. "Issued minority shares" means the number of shares issued by a subsidiary insurance company or subsidiary holding company of a mutual holding company in all minority stock offerings.
6. "Minority stock offering" means an offering of capital stock by a subsidiary insurance company or subsidiary holding company controlled by a mutual holding company in

which less than fifty percent of the voting stock of the subsidiary insurance company or subsidiary holding company is offered and sold under this chapter or chapter 26.1-12.1.

7. "Mutual company" means a mutual property and casualty insurance company domiciled in this state.

8. "Mutual holding company" means:

   a. A corporation resulting from a reorganization of a mutual company under chapter 26.1-12.1; or

   b. A domestic corporation surviving or resulting from a merger or consolidation with a corporation that resulted from a reorganization of a mutual insurer under the laws of any other jurisdiction as provided by section 26.1-12.1-03.

9. "Participating policy" means a policy that grants a holder the right to receive dividends if, as, and when declared by the mutual company.

10. "Plan of conversion" or "plan" means a plan adopted by the governing body of a mutual company or mutual holding company to convert into a stock company or stock insurance holding company in accordance with the requirements of this chapter.

11. "Policy" means an insurance policy.

12. "Standby investor" means any person that has agreed in writing to purchase all or a portion of the capital stock to be sold in a conversion which is not subscribed by eligible members.

13. "Subscription right" means the nontransferable right to purchase, for a period of not less than ~~twenty or more than thirty-five~~forty-five days, the stock of the converted stock company, its proposed subsidiary holding company, or an unaffiliated stock insurance company or other corporation or entity that will acquire the stock of the converted stock company ~~through the purchase of all the stock of the converted stock company~~.

14. "Voting member" means a member who is an eligible member and is also a member of the converting mutual company as of a date not more than ninety days before the date of the meeting at which the plan of conversion must be voted upon by members.

26.1-12.2-02. Adoption of plan of conversion.

1. A plan of conversion does not become effective unless the converting mutual company seeking to become a converted stock company adopted, by the affirmative vote of not

less than ~~a majority~~two-thirds of its governing body, a plan of conversion consistent with the requirements of sections 26.1-12.2-03 and 26.1-12.2-04, or of section 26.1-12.2-05. At any time before approval of a plan of conversion by the commissioner, the converting mutual company, by the affirmative vote of not less than ~~a majority~~two-thirds of its governing body, may amend or withdraw the plan.

2. Before the eligible members of a converting mutual company may vote on approval of a plan of conversion, a converting mutual company whose governing body has adopted a plan shall file all of the following documents with the commissioner within ninety days after adoption of the plan of conversion together with the application fee:

   a. The plan of conversion, including the independent evaluation required by subsection 4 of section 26.1-12.2-03.

   b. The form of notice and proxy required by subsection 7 of section 26.1-12.2-02.

   c. The form of notice required by section 26.1-12.2-09 to persons whose policies are issued after adoption of the plan of conversion but before the plan of conversion's effective date.

   d. The proposed certificate of incorporation and bylaws of the converted stock company.

   e. The acquisition of control statement, as required by section 26.1-10-03.

   f. The application fee, equal to the greater of ten thousand dollars or an amount equal to one-tenth of one percent of the estimated pro forma market value of the converted stock company as determined in accordance with subsection 4 of section 26.1-12.2-03. If such value is expressed as a range of values, the application fee must be based upon the midpoint of the range. The application fee is in addition to other direct costs incurred by the commissioner in reviewing the proposed plan of conversion. For good cause shown, the commissioner may waive the application fee in whole or in part, or permit a portion of the application fee to be deferred until completion of the conversion.

   g. Such other information as the commissioner may request.

3. Upon filing with the commissioner the documents required under subsection 2, the converting mutual company shall send to eligible members a notice advising eligible members of the adoption and filing of the plan of conversion, the ability of the eligible

members to provide the commissioner and the converting mutual company with comments on the plan of conversion within thirty days of the date of such notice, and the procedure of providing such comments.

4. ~~Immediately, the commissioner shall give written notice to the converting mutual company of any decision and, in the event of disapproval, a statement in detail of the reasons for the decision.~~ The commissioner shall approve the plan if the commissioner finds:

   a. The plan complies with this chapter;

   b. The plan is fair and equitable to the converting mutual company, the members of the converting mutual company, and the eligible members of the converting mutual company;

   c. The plan's method of allocating subscription rights is fair and equitable; ~~and~~

   ~~c.~~d. The plan will not otherwise prejudice the interests of the members~~.~~; and

   e. The converted stock company will have the amount of capital and surplus deemed by the commissioner to be reasonable for its future solvency.

5. At the expense of the converting mutual company, the commissioner may retain any qualified expert not otherwise a part of the commissioner's staff, including counsel and financial advisors, to assist in reviewing the plan of conversion and the independent valuation required under subsection 4 of section 26.1-12.2-03.

6. The commissioner ~~may~~shall order a hearing on whether the terms of the plan of conversion comply with this chapter after giving written notice by mail or publication to the converting mutual company and other interested persons, all of whom have the right to appear at the hearing.

7. The commissioner shall give written notice of any decision to the converting mutual company and, in the event of disapproval, a detailed statement of the reasons for the decision.

8. All voting members must be sent notice of the members' meeting to vote on the plan of conversion no later than forty-five days before the meeting. The notice must ~~briefly but fairly~~ describe the proposed plan of conversion, must inform the member how the proposed plan of conversion will affect the member's membership rights, must inform the voting member of the voting member's right to vote upon the plan of conversion,

and must be sent to each voting member's last-known address, as shown on the records of the converting mutual company. The notice must provide instructions on how the member can obtain, either by mail or electronically, a full copy of the proposed plan of conversion. If the meeting to vote upon the plan of conversion is held during the annual meeting of policyholders, only a combined notice of meeting is required.

~~8.~~9. The plan of conversion must be voted upon by voting members and must be adopted upon receiving the affirmative vote of at least ~~a majority~~two-thirds of the votes cast by voting members at the meeting. Voting members entitled to vote upon the proposed plan of conversion may vote in person or by proxy. The number of votes each voting member may cast must be determined by the bylaws of the converting mutual company. If the bylaws are silent, each voting member may cast one vote.

~~9.~~10. The certificate of incorporation of the converted stock company must be considered at the meeting of the voting members called for the purpose of adopting the plan of conversion and must require for adoption the affirmative vote of at least ~~a majority~~two-thirds of the votes cast by voting members.

~~10.~~11. Within thirty days after the voting members have approved the plan of conversion in accordance with the requirements of this section, the converted stock company shall file with the commissioner:

a. The minutes of the meeting of the voting members at which the plan of conversion was approved, which must include the record of total votes cast in favor of the plan; and

b. The certificate of incorporation and bylaws of the converted stock company.

26.1-12.2-03. Required provisions of plan of conversion.

1. The following provisions must be included in the plan of conversion:

a. The reasons for proposed conversion.

b. The effect of conversion on existing policies, including all of the following:

(1) A provision that all policies in force on the effective date of conversion continue to remain in force under the terms of the policies, except that the following rights, to the extent the rights existed in the converting mutual company, must be extinguished on the effective date of the conversion:

(a) Any voting rights of the policyholders provided under the policies.

(b) Except as provided under paragraph 2, any right to share in the surplus of the converting mutual company, unless such right is expressly provided for under the provisions of the existing policy.

(c) Any assessment provisions provided for under certain types of policies.

(2) A provision that holders of participating policies in effect on the date of conversion continue to have a right to receive dividends as provided in the participating policies, if any.

c. The grant of subscription rights to eligible members.

(1) For purposes of any plan, the transfer of subscription rights from any of the following may not be deemed an unpermitted transfer for purposes of this chapter:

(a) An individual to such individual and the individual's spouse or children or to a trust or other estate or wealth planning entity established for the benefit of such individual or the individual's spouse or children;

(b) An individual to such individual's individual or joint individual retirement account or other tax-qualified retirement plan;

(c) An entity to the shareholders, partners, or members of such entity; or

(d) The holder of such rights back to the converting mutual company, its proposed subsidiary holding company, or an unaffiliated corporation or entity that will purchase ~~all~~ the stock of the converted stock company as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1.

(2) The grant of subscription rights to eligible members must include:

(a) A provision that each eligible member is to receive, without payment, nontransferable subscription rights to purchase the capital stock of the converted stock company and that, in the aggregate, all eligible members have the right, before the right of any other party, to purchase one hundred percent of the capital stock of the converted stock company, exclusive of any shares of capital stock required to be sold or distributed to the holders of surplus notes, if any, and any

capital stock purchased by the company's tax-qualified employee stock benefit plan which is in excess of the ~~total price~~pro-forma market value of the capital stock established under subsection 4, as permitted by subsection 3 of section 26.1-12.2-04. As an alternative to subscription rights in the converting mutual company, the plan of conversion may provide each eligible member is to receive, without payment, nontransferable subscription rights to purchase a portion of the capital stock of one of the following:

[1] A corporation or entity organized for the purpose of becoming a holding company for the converted stock company;

[2] A stock insurance company owned by the mutual company into which the mutual company will be merged; or

[3] An unaffiliated stock insurer or other corporation or entity that will purchase ~~all~~ the stock of the converted stock company.

(b) A provision that subscription rights must be allocated in whole shares among the eligible members using a fair and equitable formula. The formula need not allocate subscription rights to eligible members on a pro rata basis based on premium payments or contributions to surplus, but may take into account how the different classes of policies of the eligible members contributed to the surplus of the mutual company or any other factors that may be fair or equitable. Allocation of subscription rights on a per capita basis are entitled to a presumption that such method is fair, subject to a rebuttal of fairness by clear and convincing evidence. In accordance with subsection 5 of section 26.1-12.2-02, the commissioner may retain an independent consultant to assist in the determination that the allocation of subscription rights is fair and equitable.

2. The plan must provide a fair and equitable means for allocating shares of capital stock in the event of an oversubscription to shares by eligible members exercising subscription rights received under subdivision c of subsection 1.

3. The plan must provide any shares of capital stock not subscribed to by eligible members exercising subscription rights received under subdivision c of subsection 1 or any other individuals or entities granted subscription rights pursuant to section 26.1-12.2-04 must be sold:

   a. In a public offering; however, if the number of shares of capital stock not subscribed by eligible members is so small in number or other factors exist that do not warrant the time or expense of a public offering, the plan of conversion may provide for sale of the unsubscribed shares through a private placement or other alternative method approved by the commissioner which is fair and equitable to eligible members; or

   b. To a standby investor or to another corporation or entity that is participating in the plan of conversion, as provided in paragraph 2 of subdivision c of subsection 1.

4. The plan must provide for the preparation of a valuation by a qualified independent expert which establishes the dollar ~~amount~~value of the capital stock for which subscription rights must be granted pursuant to subdivision c of subsection 1 which must be equal to the estimated pro forma market value of the converted stock company. The qualified independent expert may, to the extent feasible, determine the pro forma market value by reference to a peer group of stock companies and the application of generally accepted valuation techniques; state the pro forma market value of the converted stock company as a range of value; and establish the value as the value estimated to be necessary to attract full subscription for the shares.

5. The dollar value of a subscription right based upon the application of the Black-Scholes option pricing model or another generally accepted option pricing model. In connection with the determination of stock price volatility or other valuation inputs used in option pricing models, the qualified independent expert may assume that the attributes of the converted stock company will be substantially similar to the attributes of the stock of the peer companies used to determine the estimated pro-forma market value of the converted stock company. The term of a subscription right is a minimum of ninety days for the sole purpose of determining the value of a subscription right.

6. The plan must provide that each eligible member has the right to require the mutual company to redeem such subscription rights, in lieu of exercising the subscription rights allocated to each eligible member, at a price equal to the number of subscription rights allocated to each eligible member multiplied by the dollar value of the subscription right as determined by the qualified independent exert pursuant to subsection 4. The obligation of the mutual company to redeem subscription rights arises only upon the effective date of the plan. The redemption price payable to each eligible member must be paid to the member within thirty days of the effective date of the plan. Alternatively, the converted stock company may offer each eligible member the option of receiving the redemption amount in cash or having the redemption amount credited against future premium payments. An eligible member that does not exercise the member's subscription rights, and which also fails to affirmatively request redemption of the member's subscription rights before the expiration of the subscription offering, nevertheless is deemed to have requested redemption of the member's subscription rights and shallreceive the redemption amount in cash in the manner otherwise provided in this subsection.

7. The plan must set the purchase price per share of capital stock equal to any reasonable amount. However, the minimum subscription amount required of any eligible member may not exceed five hundred dollars, but the plan may provide that the minimum number of shares any person may purchase pursuant to the plan is twenty-five shares. The purchase price per share at which capital stock is offered to persons that are not eligible members may be greater than but not less than the purchase price per share at which capital stock is offered to eligible members.

~~6.~~8. The plan must provide that any person or group of persons acting in concert may not acquire, in the public offering or pursuant to the exercise of subscription rights, more than five percent of the capital stock of the converted stock company or the stock of another corporation that is participating in the plan of conversion, as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1, except with the approval of the commissioner. This limitation does not apply to any entity that is to purchase one hundred percent of the capital stock of the converted stock company as part of the plan of conversion approved by the commissioner or to any person that

acts as a standby investor for the capital stock of the converted stock company for an amount equal to ten percent or more of the capital stock of the converted stock company, if in each case such purchase is approved by the commissioner in accordance with the provisions of North Dakota law following the filing of an acquisition of control statement under section 26.1-10-03.

~~7.~~9. The plan must provide that a director or officer or person acting in concert with a director or officer of the mutual company may not acquire any capital stock of the converted stock company or the stock of another corporation that is participating in the plan of conversion, as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1, for three years after the effective date of the plan of conversion, except through a broker-dealer, without the permission of the commissioner. This provision does not prohibit the directors and officers from:

a. Making block purchases of one percent or more of the outstanding common stock other than through a broker-dealer if approved in writing by the insurance department;

b. Exercising subscription rights received under the plan; or

c. Participating in a stock benefit plan permitted by subsection 3 of section 26.1-12.2-04 or approved by shareholders pursuant to subsection 2 of section 26.1-12.2-11.

~~8.~~10. The plan must provide that a director or officer may not sell stock purchased pursuant to this section or subsection 1 of section 26.1-12.2-04 within one year after the effective date of the conversion, except that nothing contained in this section may be deemed to restrict a transfer of stock by such director or officer if the stock is the stock of an unaffiliated corporation that is participating in the plan of conversion as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1 and has a class of stock registered under the federal Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.], or if the transfer is to the spouse or minor children of such director or officer, or to a trust or other estate or wealth planning entity established for the benefit of such director or officer, or the spouse or minor children of such director or officer.

~~9.~~11. The plan of conversion must provide the rights, if any, of a holder of a surplus note to participate in the conversion are governed by the terms of the surplus note.

~~10.~~12. The plan of conversion must provide that without the prior approval of the commissioner, for a period of ~~three~~two years from the date of the completion of the conversion, a converted stock company or any corporation participating in the plan of conversion pursuant to item 1 of subparagraph a of paragraph 2 of subdivision c of subsection 1 or item 2 of subparagraph a of paragraph 2 of subdivision c of subsection 1, may not repurchase any of its capital stock from any person. However, this restriction does not apply to a:

a. Repurchase on a pro rata basis pursuant to an offer made to all shareholders of the converted stock company or any corporation participating in the plan of conversion pursuant to, or item 1 of subparagraph a of paragraph 2 of subdivision c of subsection 1, or item 2 of subparagraph a of paragraph 2 of subdivision c of subsection 1; or

b. Purchase in the open market by a tax-qualified or nontax-qualified employee stock benefit plan in an amount reasonable and appropriate to fund the plan.

26.1-12.2-04. Optional provisions of plan of conversion.

~~1. The plan of conversion may provide the directors, officers, and employees of the mutual company shall receive, without payment, nontransferable subscription rights to purchase capital stock of the converted stock company or the stock of another corporation that is participating in the plan of conversion, as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03. These subscription rights must be allocated among the directors, officers, and employees by a fair and equitable formula and are subordinate to the subscription rights of eligible members. This chapter does not require the subordination of subscription rights received by directors, officers, and employees in their capacity as eligible members.~~

~~2. Unless otherwise approved by the commissioner, the aggregate total number of shares that may be purchased by directors and officers of the converting mutual company, both in their capacity as directors and officers and in their capacity as eligible members under item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03, may not exceed thirty-five percent of the total number of shares to be issued if total assets of the converting mutual company are~~

~~less than fifty million dollars or twenty-five percent of the total number of shares to be issued if total assets of the converting mutual company are more than five hundred million dollars. For converting companies with total assets between fifty million dollars and five hundred million dollars, the percentage of the total number of shares that may be purchased by directors and officers must be interpolated.~~

~~3.~~1. The plan of conversion may allocate to a tax-qualified employee benefit plan nontransferable subscription rights to purchase up to ten percent of the capital stock of the converting mutual company or the stock of another corporation that is participating in the plan of conversion, as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03. A tax-qualified employee benefit plan may exercise subscription rights granted under this subsection regardless of the total number of shares purchased by eligible members. If eligible members purchase shares sufficient to yield gross proceeds equal to the maximum of the valuation range established by subsection 4 of section 26.1-12.2-03, then the tax-qualified employee benefit plan may purchase additional shares of capital stock of the converting mutual company or the stock of another corporation that is participating in the plan of conversion, as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03 in an amount sufficient to equal ten percent of the total shares of capital stock of the converted stock company outstanding.

~~4.~~2. The plan may provide ~~the~~that other classes of subscribers approved by the commissioner shall receive~~, without payment,~~ nontransferable subscription rights to purchase capital stock of the converting stock company or the stock of another corporation that is participating in the plan of conversion, as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03 provided that such subscription rights are subordinate to the subscription rights of eligible members. Other classes of subscribers that may be approved by the commissioner include:

a. Members of the converting mutual company which became members after the date fixed for establishing eligible members;

~~b. Brokers, agents, or other producers or their directors, officers, or employees that represent the mutual company or the insurance company subsidiary of the mutual holding company;~~

~~c.~~b. The shareholders of another corporation that is participating in the plan of conversion, as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03; or

~~d.~~c. The shareholders of another corporation that is a party to an acquisition, merger, consolidation, or other similar transaction with the converting mutual company.

26.1-12.2-05. Alternative plan of conversion.

The governing body of the converting mutual company may adopt a plan of conversion that does not rely in whole or in part upon issuing nontransferable subscription rights to members to purchase stock of the converting stock company if the commissioner finds the plan of conversion does not prejudice the interests of the members, is fair and equitable, and is not inconsistent with the purpose and intent of this chapter. Subject to a finding of the commissioner that an alternative plan of conversion is fair and equitable and is not inconsistent with the purpose and intent of this chapter, an alternative plan of conversion may:

1. Include the merger of a domestic mutual insurance company into a domestic or foreign stock insurance company.
2. Provide for the issuance of transferable or redeemable subscription rights.
3. Provide for issuing stock, cash, policyholder credits, or other consideration, or any combination of the foregoing, to policyholders instead of subscription rights.
4. Set forth another plan of conversion containing any other provisions approved by the commissioner.

26.1-12.2-06. Minority stock offering by a mutual holding company.

A mutual holding company may make a minority stock offering in accordance with the provisions of chapter 26.1-12.1 or this chapter. A minority stock offering pursuant to chapter 26.1-12.1 may not include the grant of subscription rights to policyholders. Except as otherwise provided in section 26.1-12.2-05 concerning an alternative plan of conversion, a minority stock offering pursuant to this chapter must include the grant of subscription rights to policyholders.

26.1-12.2-07. Conversion of a mutual holding company.

1. If a mutual holding company converts from a mutual to stock form, the conversion must comply with the provisions of this chapter.
2. If a mutual holding company seeks to convert to stock form under this chapter and it has previously completed one or more minority stock offerings in which policyholders were granted subscription rights pursuant to this chapter, the valuation required by subsection 4 of section 26.1-12.2-03 must take into account the existence of this minority interest as provided in this section. The amount of capital stock required to be offered by the mutual holding company or another corporation that is participating in the plan of conversion as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03 may be expressed as a range of value and must equal: the pro forma fair market value of the mutual holding company, multiplied by one minus a quotient equal to the number of issued minority shares, divided by the sum of the issued minority shares and the number of shares held by the mutual holding company.
3. The plan of conversion of a mutual holding company must provide that any outstanding issued minority shares must be exchanged for stock issued by the converting mutual company or the stock of any corporation participating in the conversion of the mutual holding company pursuant to subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03. The mutual holding company shall demonstrate to the satisfaction of the commissioner that the basis for the exchange is fair and reasonable. An exchange in which the holders of outstanding issued minority shares retain approximately the same percentage ownership in the resulting company as the quotient of the number of issued minority shares, divided by the sum of issued minority shares and the number of shares held by the mutual holding company, is presumed to be fair and reasonable.
4. If a mutual holding company seeking to convert under this chapter previously completed one or more minority stock offerings, the conversion of the mutual holding company to stock form may not be consummated unless a majority of the shares issued and outstanding to persons other than the mutual holding company vote in

favor of the conversion. This vote requirement is in addition to the required policyholder vote.

26.1-12.2-08. Effective date of plan of conversion.

A plan of conversion is effective when the commissioner has approved the plan of conversion, the voting members have approved the plan of conversion and adopted the certificate of incorporation of the converted stock company, and the certificate of incorporation is filed in the office of the secretary of state of this state.

26.1-12.2-09. Rights of members whose policies are issued after adoption of the plan of conversion and before effective date.

1. All members whose policies are issued after the proposed plan of conversion has been adopted by the governing body and before the effective date of the plan of conversion must be sent a written notice regarding the plan of conversion upon issuance of such policy.
2. Except as provided in subsection 3, each member of a property or casualty insurance company entitled to receive the notice provided for in subsection 1 must be advised of the member's right of cancellation and to a pro rata refund of unearned premiums.
3. A member of a property or casualty insurance company who has made or filed a claim under such member's insurance policy is not entitled to any right to receive any refund under subsection 2. A person that has exercised the rights provided by subsection 2 is not entitled to make or file any claim under such person's insurance policy.

26.1-12.2-10. Corporate existence.

1. On the effective date of the conversion, the corporate existence of the converting mutual company continues in the converted stock company. On the effective date of the conversion, all the assets, rights, franchises, and interests of the converting mutual company in and to every species of property, real, personal, and mixed, and any accompanying things in action, are vested in the converted stock company without any deed or transfer and the converted stock company assumes all the obligations and liabilities of the converting mutual company.
2. Unless otherwise specified in the plan of conversion, the individuals who are directors and officers of the converting mutual company on the effective date of the conversion shall serve as directors and officers of the converted stock company until new

directors and officers of the converted stock company are elected pursuant to the certificate of incorporation and bylaws of the converted stock company.

26.1-12.2-11. Conflict of interest.

1. ~~Except as provided for in a plan of conversion approved by the commissioner, a~~A director, officer, agent, or employee of the converting mutual company may not receive any fee, commission, or other valuable consideration, other than such person's usual regular salary or compensation, for aiding, promoting, or assisting in a conversion under this chapter. This provision does not prohibit the payment of reasonable fees and compensation to attorneys, accountants, financial advisors, and actuaries for services performed in the independent practice of their professions, even if the attorney, accountant, financial advisor, or actuary is also a director or officer of the converting mutual company.
2. For a period of two years after the effective date of the conversion, a converted stock company may not implement any nontax-qualified stock benefit plan unless the plan is approved by a majority of votes cast at a duly convened meeting of shareholders held not less than six months after the effective date of the conversion.
3. All the costs and expenses connected with a plan of conversion must be paid for or reimbursed by the converting mutual company or the converted stock company. However, if the plan of conversion provides for participation by another entity in the plan pursuant to subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03, such entity may pay for or reimburse all or a portion of the costs and expenses connected with the plan of conversion.

26.1-12.2-12. Failure to give notice.

If the converting mutual company complies substantially and in good faith with the notice requirements of this chapter, the failure of the converting mutual company to send a member the required notice does not impair the validity of any action taken under this chapter.

26.1-12.2-13. Limitation on actions.

Any action challenging the validity of or arising out of acts taken or proposed to be taken under this chapter must be commenced on or before the later of:

1. Sixty days after the approval of the plan of conversion by the commissioner; or

2. Thirty days after notice of the meeting of voting members to approve the plan of conversion is first mailed or delivered to voting members or posted on the website of the converting mutual company.

26.1-12.2-14. Converting mutual company insolvent or in hazardous financial condition.

1. If a converting mutual company seeking to convert under this chapter is insolvent or is in hazardous financial condition according to information supplied in the mutual company's most recent annual or quarterly statement filed with the insurance department or as determined by a financial examination performed by the insurance department, the requirements of this chapter, including notice to and policyholder approval of the plan of conversion, may be waived at the discretion of the commissioner. If a waiver under this section is ordered by the commissioner, the converting mutual company shall specify in the mutual company's plan of conversion:
   a. The method and basis for the issuance of the converted stock company's shares of its capital stock to an independent party in connection with an investment by the independent party in an amount sufficient to restore the converted stock company to a sound financial condition.
   b. That the conversion must be accomplished without granting subscription rights or other consideration to policyholders.
2. This section does not alter or limit the authority of the commissioner under any other provisions of law, including receivership and liquidation provisions applicable to insurance companies.

26.1-12.2-15. Rules.

The commissioner may adopt rules to administer and enforce this chapter.

26.1-12.2-16. Laws applicable to converted stock company.

1. A converting mutual company is not permitted to convert under this chapter if, as a direct result of the conversion, any person or any affiliate thereof acquires control of the converted stock company, unless that person and such person's affiliates comply with the provisions of North Dakota law regarding the acquisition of control of an insurance company.

2. Except as otherwise specified in this chapter, a converted stock company has and may exercise all the rights and privileges and is subject to all of the requirements and regulations imposed on stock insurance companies under the laws of North Dakota relating to the regulation and supervision of insurance companies, but the converting stock company may not exercise rights or privileges that other stock insurance companies may not exercise.

26.1-12.2-17. Commencement of business as a stock insurance company.

A converting mutual company may not engage in the business of insurance as a stock company until the converting stock company complies with all provisions of this chapter.

26.1-12.2-18. Amendment of policies.

A mutual company, by endorsement or rider approved by the commissioner and sent to the policyholder, may simultaneously with or at any time after the effective date of the conversion amend any outstanding insurance policy for the purpose of extinguishing the membership rights of such policyholder.

26.1-12.2-19. Prohibition on acquisitions of control.

Except as otherwise specifically provided in section 26.1-12.2-03, from the date a plan of conversion is adopted by the governing body of a converting mutual company until three years after the effective date of the plan of conversion, a person may not directly or indirectly offer to acquire, make any announcement to acquire, or acquire in any manner, including making a filing with the insurance department for such acquisition under a statute or regulation of this state, the beneficial ownership of ten percent or more of a class of a voting security of the converted stock company or of a person that controls the voting securities of the converted stock company, unless the converted stock company or a person that controls the voting securities of the converted stock company consents to such acquisition and such acquisition is otherwise approved by the commissioner.

SECTION 4. REPEAL. Section 26.1-12-32 of the North Dakota Century Code is repealed.

Apr 10, 2015 1

How Senate Amendments to HB 1313
Enhance Policyholder Protections

NAMIC proposed several amendments to House Bill 1313 to enhance the protection of policyholder interests under the bill. DOI also liked these additional protections and Nodak did agree that these would be acceptable. The proposed changes, in a nutshell, do the following things:

- Require a two-thirds majority vote (as opposed to just a majority) of the company's board to approve a conversion plan, as well as a two-thirds majority vote of policyholders to approve the transaction.

- Require that the commissioner hold a hearing on any proposed conversion (as opposed to allowing the commissioner to hold a hearing or not).

- Require a finding by the commissioner that the conversion plan is fair and equitable to the converting company and policyholders.

- Require a finding by the commissioner that the converted stock company will have the amount of capital and surplus deemed by the commissioner to be reasonable for its future solvency.

- Provide ample time (45 days) for policyholders to receive notice of a planned conversion.

- Require that the notice inform the policyholders that the conversion would extinguish the policyholders' membership rights and that the notice provides a way in which a policyholder can receive a full copy of the conversion plan (as opposed to merely a summary).

- Require that the minutes of the meeting at which a policyholder vote is taken include the total number of votes in favor of the plan.

- Provide a means for policyholders to be compensated in lieu of receiving stock subscription rights. It provides for use of the Black-Scholes method of valuation which is a generally accepted valuation model. Those members who choose not to purchase stock will be compensated for the value of their membership.

- Remove provisions that would allow for the potential enrichment of various parties at the expense of policyholders.

- I hope the House can agree to concur in these amendments and move this bill forward.

2

15.0450.03004
Title.

Prepared by the Legislative Council staff for
Senator Klein
~~March 31, 2015~~ Apr. 10, 2015

PROPOSED AMENDMENTS TO ENGROSSED HOUSE BILL NO. 1313

Page 3, line 22, replace "twenty or more than thirty-five" with "forty-five"

Page 3, line 23, after "proposed" insert "subsidiary"

Page 3, line 24, after "the" insert "stock of the"

Page 3, line 24, remove "through"

Page 3, line 25, remove "the purchase of all the stock of the converted stock company"

Page 4, line 1, replace "a majority" with "two-thirds"

Page 4, line 4, replace "a majority" with "two-thirds"

Page 4, line 23, after the underscored period insert "The application fee is in addition to other direct costs incurred by the commissioner in reviewing the proposed plan of conversion."

Page 5, line 3, remove "Immediately, the commissioner shall give written notice to the converting mutual"

Page 5, remove line 4

Page 5, line 5, remove "reasons for the decision."

Page 5, line 8, after "b." insert "The plan is fair and equitable to the converting mutual company, the members of the converting mutual company, and the eligible members of the converting mutual company;

c."

Page 5, line 8, remove the second "and"

Page 5, line 9, replace "c." with "d."

Page 5, line 9, replace the underscored period with "; and

e. The converted stock company will have the amount of capital and surplus deemed by the commissioner to be reasonable for its future solvency."

Page 5, line 14, replace "may" with "shall" making sure there will be a hearing on the conversion plan

Page 5, line 18, after "7." insert "The commissioner shall give written notice of any decision to the converting mutual company and, in the event of disapproval, a detailed statement of the reasons for the decision.

8."

Page 5, line 19, after "conversion" insert "no later than forty-five days before the meeting"

Page 5, line 19, remove "briefly but fairly" giving policyholders more time to understand the conversion

Page 5, line 20, after the underscored comma insert "must inform the member how the proposed plan of conversion will affect the member's membership rights."

Page 5, line 22, after the underscored period insert "The notice must provide instructions on how the member can obtain, either by mail or electronically, a full copy of the proposed plan of conversion."

Page 5, line 25, replace "8." with "9."

Page 5, line 26, replace "a majority" with "two-thirds"

Page 6, line 1, replace "9." with "10."

Page 6, line 3, replace "a majority" with "two-thirds"

Page 6, line 5, replace "10." with "11."

Page 6, line 9, after "approved" insert ", which must include the record of total votes cast in favor of the plan"

Page 7, line 8, after "proposed" insert "subsidiary"

Page 7, line 9, remove "all"

Page 7, line 21, replace "total price" with "pro-forma market value"

Page 8, line 2, remove "all"

Page 9, line 2, replace "amount" with "value"

Page 9, line 10, after "5." insert "The dollar value of a subscription right based upon the application of the Black-Scholes option pricing model or another generally accepted option pricing model. In connection with the determination of stock price volatility or other valuation inputs used in option pricing models, the qualified independent expert may assume that the attributes of the converted stock company will be substantially similar to the attributes of the stock of the peer companies used to determine the estimated pro-forma market value of the converted stock company. The term of a subscription right is a minimum of ninety days for the sole purpose of determining the value of a subscription right.

Black-Scholes

6. The plan must provide that each eligible member has the right to require the mutual company to redeem such subscription rights, in lieu of exercising the subscription rights allocated to each eligible member, at a price equal to the number of subscription rights allocated to each eligible member multiplied by the dollar value of the subscription right as determined by the qualified independent exert pursuant to subsection 4. The obligation of the mutual company to redeem subscription rights arises only upon the effective date of the plan. The redemption price payable to each eligible member must be paid to the member within thirty days of the effective date of the plan. Alternatively, the converted stock company may offer each eligible member the option of receiving the redemption amount in cash or having the redemption amount credited against future premium payments. An eligible member that does not exercise their subscription rights, and which also fails to affirmatively request redemption of the member's subscription rights before the expiration of the subscription offering, nevertheless is deemed to have requested redemption of the member's subscription rights and shall receive the redemption amount in cash in the manner otherwise provided in this subsection.

7."

Page 9, line 17, replace "6." with "8."

Page 9, line 30, replace "7." with "9."

Page 10, line 13, replace "8." with "10."

Page 10, line 23, replace "9." with "11."

Page 10, line 25, replace "10." with "12."

Page 10, line 26, replace "three" with "two"

Page 11, remove lines 9 through 29

Page 11, line 30, replace "3." with "1."

Page 12, line 13, replace "4." with "2."

Page 12, line 13, replace the first "the" with "that"

Page 12, line 14, remove ", without payment."

Page 12, remove lines 22 through 24

Page 12, line 25, replace "c." with "b."

Page 12, line 28, replace "d." with "c."

Page 15, line 24, replace "Except as provided for in a plan of conversion approved by the commissioner, a" with "A" this takes out some concerns

Renumber accordingly

which less than fifty percent of the voting stock of the subsidiary insurance company or subsidiary holding company is offered and sold under this chapter or chapter 26.1-12.1.

7. "Mutual company" means a mutual property and casualty insurance company domiciled in this state.

8. "Mutual holding company" means:

   a. A corporation resulting from a reorganization of a mutual company under chapter 26.1-12.1; or

   b. A domestic corporation surviving or resulting from a merger or consolidation with a corporation that resulted from a reorganization of a mutual insurer under the laws of any other jurisdiction as provided by section 26.1-12.1-03.

9. "Participating policy" means a policy that grants a holder the right to receive dividends if, as, and when declared by the mutual company.

10. "Plan of conversion" or "plan" means a plan adopted by the governing body of a mutual company or mutual holding company to convert into a stock company or stock insurance holding company in accordance with the requirements of this chapter.

11. "Policy" means an insurance policy.

12. "Standby investor" means any person that has agreed in writing to purchase all or a portion of the capital stock to be sold in a conversion which is not subscribed by eligible members.

13. "Subscription right" means the nontransferable right to purchase, for a period of not less than ~~twenty or more than thirty-five~~forty-five days, the stock of the converted stock company, its proposed subsidiary holding company, or an unaffiliated stock insurance company or other corporation or entity that will acquire the stock of the converted stock company ~~through the purchase of all the stock of the converted stock company~~.

14. "Voting member" means a member who is an eligible member and is also a member of the converting mutual company as of a date not more than ninety days before the date of the meeting at which the plan of conversion must be voted upon by members.

26.1-12.2-02. Adoption of plan of conversion.

1. A plan of conversion does not become effective unless the converting mutual company seeking to become a converted stock company adopted, by the affirmative vote of not

less than ~~a majority~~two-thirds of its governing body, a plan of conversion consistent with the requirements of sections 26.1-12.2-03 and 26.1-12.2-04, or of section 26.1-12.2-05. At any time before approval of a plan of conversion by the commissioner, the converting mutual company, by the affirmative vote of not less than ~~a majority~~two-thirds of its governing body, may amend or withdraw the plan.

2. Before the eligible members of a converting mutual company may vote on approval of a plan of conversion, a converting mutual company whose governing body has adopted a plan shall file all of the following documents with the commissioner within ninety days after adoption of the plan of conversion together with the application fee:

   a. The plan of conversion, including the independent evaluation required by subsection 4 of section 26.1-12.2-03.

   b. The form of notice and proxy required by subsection 7 of section 26.1-12.2-02.

   c. The form of notice required by section 26.1-12.2-09 to persons whose policies are issued after adoption of the plan of conversion but before the plan of conversion's effective date.

   d. The proposed certificate of incorporation and bylaws of the converted stock company.

   e. The acquisition of control statement, as required by section 26.1-10-03.

   f. The application fee, equal to the greater of ten thousand dollars or an amount equal to one-tenth of one percent of the estimated pro forma market value of the converted stock company as determined in accordance with subsection 4 of section 26.1-12.2-03. If such value is expressed as a range of values, the application fee must be based upon the midpoint of the range. The application fee is in addition to other direct costs incurred by the commissioner in reviewing the proposed plan of conversion. For good cause shown, the commissioner may waive the application fee in whole or in part, or permit a portion of the application fee to be deferred until completion of the conversion.

   g. Such other information as the commissioner may request.

3. Upon filing with the commissioner the documents required under subsection 2, the converting mutual company shall send to eligible members a notice advising eligible members of the adoption and filing of the plan of conversion, the ability of the eligible

members to provide the commissioner and the converting mutual company with comments on the plan of conversion within thirty days of the date of such notice, and the procedure of providing such comments.

4. ~~Immediately, the commissioner shall give written notice to the converting mutual company of any decision and, in the event of disapproval, a statement in detail of the reasons for the decision.~~ The commissioner shall approve the plan if the commissioner finds:

a. The plan complies with this chapter;

b. The plan is fair and equitable to the converting mutual company, the members of the converting mutual company, and the eligible members of the converting mutual company;

c. The plan's method of allocating subscription rights is fair and equitable; ~~and~~

~~c.~~d. The plan will not otherwise prejudice the interests of the members~~.~~; and

e. The converted stock company will have the amount of capital and surplus deemed by the commissioner to be reasonable for its future solvency.

5. At the expense of the converting mutual company, the commissioner may retain any qualified expert not otherwise a part of the commissioner's staff, including counsel and financial advisors, to assist in reviewing the plan of conversion and the independent valuation required under subsection 4 of section 26.1-12.2-03.

6. The commissioner ~~may~~shall order a hearing on whether the terms of the plan of conversion comply with this chapter after giving written notice by mail or publication to the converting mutual company and other interested persons, all of whom have the right to appear at the hearing.

7. The commissioner shall give written notice of any decision to the converting mutual company and, in the event of disapproval, a detailed statement of the reasons for the decision.

8. All voting members must be sent notice of the members' meeting to vote on the plan of conversion no later than forty-five days before the meeting. The notice must ~~briefly but fairly~~ describe the proposed plan of conversion, must inform the member how the proposed plan of conversion will affect the member's membership rights, must inform the voting member of the voting member's right to vote upon the plan of conversion,

and must be sent to each voting member's last-known address, as shown on the records of the converting mutual company. The notice must provide instructions on how the member can obtain, either by mail or electronically, a full copy of the proposed plan of conversion. If the meeting to vote upon the plan of conversion is held during the annual meeting of policyholders, only a combined notice of meeting is required.

~~8.~~9. The plan of conversion must be voted upon by voting members and must be adopted upon receiving the affirmative vote of at least ~~a majority~~two-thirds of the votes cast by voting members at the meeting. Voting members entitled to vote upon the proposed plan of conversion may vote in person or by proxy. The number of votes each voting member may cast must be determined by the bylaws of the converting mutual company. If the bylaws are silent, each voting member may cast one vote.

~~9.~~10. The certificate of incorporation of the converted stock company must be considered at the meeting of the voting members called for the purpose of adopting the plan of conversion and must require for adoption the affirmative vote of at least ~~a majority~~two-thirds of the votes cast by voting members.

~~10.~~11. Within thirty days after the voting members have approved the plan of conversion in accordance with the requirements of this section, the converted stock company shall file with the commissioner:

a. The minutes of the meeting of the voting members at which the plan of conversion was approved, which must include the record of total votes cast in favor of the plan; and

b. The certificate of incorporation and bylaws of the converted stock company.

26.1-12.2-03. Required provisions of plan of conversion.

1. The following provisions must be included in the plan of conversion:

a. The reasons for proposed conversion.

b. The effect of conversion on existing policies, including all of the following:

(1) A provision that all policies in force on the effective date of conversion continue to remain in force under the terms of the policies, except that the following rights, to the extent the rights existed in the converting mutual company, must be extinguished on the effective date of the conversion:

(a) Any voting rights of the policyholders provided under the policies.

(b) Except as provided under paragraph 2, any right to share in the surplus of the converting mutual company, unless such right is expressly provided for under the provisions of the existing policy.

(c) Any assessment provisions provided for under certain types of policies.

(2) A provision that holders of participating policies in effect on the date of conversion continue to have a right to receive dividends as provided in the participating policies, if any.

c. The grant of subscription rights to eligible members.

(1) For purposes of any plan, the transfer of subscription rights from any of the following may not be deemed an unpermitted transfer for purposes of this chapter:

(a) An individual to such individual and the individual's spouse or children or to a trust or other estate or wealth planning entity established for the benefit of such individual or the individual's spouse or children;

(b) An individual to such individual's individual or joint individual retirement account or other tax-qualified retirement plan;

(c) An entity to the shareholders, partners, or members of such entity; or

(d) The holder of such rights back to the converting mutual company, its proposed subsidiary holding company, or an unaffiliated corporation or entity that will purchase ~~all~~ the stock of the converted stock company as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1.

(2) The grant of subscription rights to eligible members must include:

(a) A provision that each eligible member is to receive, without payment, nontransferable subscription rights to purchase the capital stock of the converted stock company and that, in the aggregate, all eligible members have the right, before the right of any other party, to purchase one hundred percent of the capital stock of the converted stock company, exclusive of any shares of capital stock required to be sold or distributed to the holders of surplus notes, if any, and any

capital stock purchased by the company's tax-qualified employee stock benefit plan which is in excess of the ~~total price~~pro-forma market value of the capital stock established under subsection 4, as permitted by subsection 3 of section 26.1-12.2-04. As an alternative to subscription rights in the converting mutual company, the plan of conversion may provide each eligible member is to receive, without payment, nontransferable subscription rights to purchase a portion of the capital stock of one of the following:

[1] A corporation or entity organized for the purpose of becoming a holding company for the converted stock company;

[2] A stock insurance company owned by the mutual company into which the mutual company will be merged; or

[3] An unaffiliated stock insurer or other corporation or entity that will purchase ~~all~~ the stock of the converted stock company.

(b) A provision that subscription rights must be allocated in whole shares among the eligible members using a fair and equitable formula. The formula need not allocate subscription rights to eligible members on a pro rata basis based on premium payments or contributions to surplus, but may take into account how the different classes of policies of the eligible members contributed to the surplus of the mutual company or any other factors that may be fair or equitable. Allocation of subscription rights on a per capita basis are entitled to a presumption that such method is fair, subject to a rebuttal of fairness by clear and convincing evidence. In accordance with subsection 5 of section 26.1-12.2-02, the commissioner may retain an independent consultant to assist in the determination that the allocation of subscription rights is fair and equitable.

2. The plan must provide a fair and equitable means for allocating shares of capital stock in the event of an oversubscription to shares by eligible members exercising subscription rights received under subdivision c of subsection 1.

3. The plan must provide any shares of capital stock not subscribed to by eligible members exercising subscription rights received under subdivision c of subsection 1 or any other individuals or entities granted subscription rights pursuant to section 26.1-12.2-04 must be sold:

   a. In a public offering; however, if the number of shares of capital stock not subscribed by eligible members is so small in number or other factors exist that do not warrant the time or expense of a public offering, the plan of conversion may provide for sale of the unsubscribed shares through a private placement or other alternative method approved by the commissioner which is fair and equitable to eligible members; or

   b. To a standby investor or to another corporation or entity that is participating in the plan of conversion, as provided in paragraph 2 of subdivision c of subsection 1.

4. The plan must provide for the preparation of a valuation by a qualified independent expert which establishes the dollar ~~amount~~value of the capital stock for which subscription rights must be granted pursuant to subdivision c of subsection 1 which must be equal to the estimated pro forma market value of the converted stock company. The qualified independent expert may, to the extent feasible, determine the pro forma market value by reference to a peer group of stock companies and the application of generally accepted valuation techniques; state the pro forma market value of the converted stock company as a range of value; and establish the value as the value estimated to be necessary to attract full subscription for the shares.

5. The dollar value of a subscription right based upon the application of the Black-Scholes option pricing model or another generally accepted option pricing model. In connection with the determination of stock price volatility or other valuation

Based on Peer Companies Come up with value Volatility Weighted

#5 – Specifies how the subscriptions rights that may be issued by a converting mutual insurance company will be valued. The Black-Scholes option pricing model is the financial industry standard to valuing options which is what a subscription right is.

Subscription rights, if used in the conversion, will be offered to the members without cost and if other groups are offered subordinate subscription rights, those rights must be purchased for the value of the rights as determined by applying the Black-Scholes option pricing model to the specifics of the rights offering.

6. The plan must provide that each eligible member has the right to require the mutual company to redeem such subscription rights, in lieu of exercising the subscription rights allocated to each eligible member, at a price equal to the number of subscription rights allocated to each eligible member multiplied by the dollar value of the subscription right as determined by the qualified independent exert pursuant to amount credited against future premium payments. An eligible member that does not exercise the member's subscription rights, and which also fails to affirmatively request redemption of the member's subscription rights before the expiration of the subscription offering, nevertheless is deemed to have requested redemption of the member's subscription rights and shallreceive the redemption amount in cash in the manner otherwise provided in this subsection.

#6 – Specifies that the converting mutual company is required to redeem the subscription rights for their cash value if the member elects not to participate in the stock offering. The Company may also credit the member's future premiums for the value of the rights in lieu of a cash payment. Regardless of whether the member elects the cash option, if they do not exercise their subscription rights to purchase the stock, they are automatically deemed to have requested the cash option and will be paid the cash value of the options.

7. The plan must set the purchase price per share of capital stock equal to any reasonable amount. However, the minimum subscription amount required of any eligible member may not exceed five hundred dollars, but the plan may provide that the minimum number of shares any person may purchase pursuant to the plan is twenty-five shares. The purchase price per share at which capital stock is offered to persons that are not eligible members may be greater than but not less than the purchase price per share at which capital stock is offered to eligible members.

~~6.~~8. The plan must provide that any person or group of persons acting in concert may not acquire, in the public offering or pursuant to the exercise of subscription rights, more than five percent of the capital stock of the converted stock company or the stock of another corporation that is participating in the plan of conversion, as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1, except with the approval of the commissioner. This limitation does not apply to any entity that is to purchase one hundred percent of the capital stock of the converted stock company as part of the plan of conversion approved by the commissioner or to any person that

acts as a standby investor for the capital stock of the converted stock company for an amount equal to ten percent or more of the capital stock of the converted stock company, if in each case such purchase is approved by the commissioner in accordance with the provisions of North Dakota law following the filing of an acquisition of control statement under section 26.1-10-03.

~~7.~~9. The plan must provide that a director or officer or person acting in concert with a director or officer of the mutual company may not acquire any capital stock of the converted stock company or the stock of another corporation that is participating in the plan of conversion, as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1, for three years after the effective date of the plan of conversion, except through a broker-dealer, without the permission of the commissioner. This provision does not prohibit the directors and officers from:

a. Making block purchases of one percent or more of the outstanding common stock other than through a broker-dealer if approved in writing by the insurance department;

b. Exercising subscription rights received under the plan; or

c. Participating in a stock benefit plan permitted by subsection 3 of section 26.1-12.2-04 or approved by shareholders pursuant to subsection 2 of section 26.1-12.2-11.

~~8.~~10. The plan must provide that a director or officer may not sell stock purchased pursuant to this section or subsection 1 of section 26.1-12.2-04 within one year after the effective date of the conversion, except that nothing contained in this section may be deemed to restrict a transfer of stock by such director or officer if the stock is the stock of an unaffiliated corporation that is participating in the plan of conversion as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1 and has a class of stock registered under the federal Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.], or if the transfer is to the spouse or minor children of such director or officer, or to a trust or other estate or wealth planning entity established for the benefit of such director or officer, or the spouse or minor children of such director or officer.

~~9.~~11. The plan of conversion must provide the rights, if any, of a holder of a surplus note to participate in the conversion are governed by the terms of the surplus note.

~~10.~~12. The plan of conversion must provide that without the prior approval of the commissioner, for a period of ~~three~~two years from the date of the completion of the conversion, a converted stock company or any corporation participating in the plan of conversion pursuant to item 1 of subparagraph a of paragraph 2 of subdivision c of subsection 1 or item 2 of subparagraph a of paragraph 2 of subdivision c of subsection 1, may not repurchase any of its capital stock from any person. However, this restriction does not apply to a:

a. Repurchase on a pro rata basis pursuant to an offer made to all shareholders of the converted stock company or any corporation participating in the plan of conversion pursuant to, or item 1 of subparagraph a of paragraph 2 of subdivision c of subsection 1, or item 2 of subparagraph a of paragraph 2 of subdivision c of subsection 1; or

b. Purchase in the open market by a tax-qualified or nontax-qualified employee stock benefit plan in an amount reasonable and appropriate to fund the plan.

26.1-12.2-04. Optional provisions of plan of conversion.

~~1. The plan of conversion may provide the directors, officers, and employees of the mutual company shall receive, without payment, nontransferable subscription rights to purchase capital stock of the converted stock company or the stock of another corporation that is participating in the plan of conversion, as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03. These subscription rights must be allocated among the directors, officers, and employees by a fair and equitable formula and are subordinate to the subscription rights of eligible members. This chapter does not require the subordination of subscription~~

I like subordinate subscriptions but they should have to pay

The section of the bill offering subordinate subscriptions rights to officers, directors and brokers was struck from the bill as these subordinate rights were to be offered at no cost to those parties. Under The optional provisions of the conversion plan, the converting mutual company may offer subordinate subscription rights to other classes of subscribers but those subscribers must pay for those rights.

~~company, both in their capacity as directors and officers and in their capacity as eligible members under item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03, may not exceed thirty-five percent of the total number of shares to be issued if total assets of the converting mutual company are~~

~~less than fifty million dollars or twenty-five percent of the total number of shares to be issued if total assets of the converting mutual company are more than five hundred million dollars. For converting companies with total assets between fifty million dollars and five hundred million dollars, the percentage of the total number of shares that may be purchased by directors and officers must be interpolated.~~

~~3.~~1. The plan of conversion may allocate to a tax-qualified employee benefit plan nontransferable subscription rights to purchase up to ten percent of the capital stock of the converting mutual company or the stock of another corporation that is participating in the plan of conversion, as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03. A tax-qualified employee benefit plan may exercise subscription rights granted under this subsection regardless of the total number of shares purchased by eligible members. If eligible members purchase shares sufficient to yield gross proceeds equal to the maximum of the valuation range established by subsection 4 of section 26.1-12.2-03, then the tax-qualified employee benefit plan may purchase additional shares of capital stock of the converting mutual company or the stock of another corporation that is participating in the plan of conversion, as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03 in an amount sufficient to equal ten percent of the total shares of capital stock of the converted stock company outstanding.

~~4.~~2. The plan may provide ~~the~~that other classes of subscribers approved by the commissioner shall receive~~, without payment,~~ nontransferable subscription rights to purchase capital stock of the converting stock company or the stock of another corporation that is participating in the plan of conversion, as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03 provided that such subscription rights are subordinate to the subscription rights of eligible members. Other classes of subscribers that may be approved by the commissioner include:

a. Members of the converting mutual company which became members after the date fixed for establishing eligible members;

~~b. Brokers, agents, or other producers or their directors, officers, or employees that represent the mutual company or the insurance company subsidiary of the mutual holding company;~~

~~c.~~b. The shareholders of another corporation that is participating in the plan of conversion, as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03; or

~~d.~~c. The shareholders of another corporation that is a party to an acquisition, merger, consolidation, or other similar transaction with the converting mutual company.

26.1-12.2-05. Alternative plan of conversion.

The governing body of the converting mutual company may adopt a plan of conversion that does not rely in whole or in part upon issuing nontransferable subscription rights to members to purchase stock of the converting stock company if the commissioner finds the plan of conversion does not prejudice the interests of the members, is fair and equitable, and is not inconsistent with the purpose and intent of this chapter. Subject to a finding of the commissioner that an alternative plan of conversion is fair and equitable and is not inconsistent with the purpose and intent of this chapter, an alternative plan of conversion may:

1. Include the merger of a domestic mutual insurance company into a domestic or foreign stock insurance company.
2. Provide for the issuance of transferable or redeemable subscription rights.
3. Provide for issuing stock, cash, policyholder credits, or other consideration, or any combination of the foregoing, to policyholders instead of subscription rights.
4. Set forth another plan of conversion containing any other provisions approved by the commissioner.

26.1-12.2-06. Minority stock offering by a mutual holding company.

A mutual holding company may make a minority stock offering in accordance with the provisions of chapter 26.1-12.1 or this chapter. A minority stock offering pursuant to chapter 26.1-12.1 may not include the grant of subscription rights to policyholders. Except as otherwise provided in section 26.1-12.2-05 concerning an alternative plan of conversion, a minority stock offering pursuant to this chapter must include the grant of subscription rights to policyholders.

26.1-12.2-07. Conversion of a mutual holding company.

1. If a mutual holding company converts from a mutual to stock form, the conversion must comply with the provisions of this chapter.
2. If a mutual holding company seeks to convert to stock form under this chapter and it has previously completed one or more minority stock offerings in which policyholders were granted subscription rights pursuant to this chapter, the valuation required by subsection 4 of section 26.1-12.2-03 must take into account the existence of this minority interest as provided in this section. The amount of capital stock required to be offered by the mutual holding company or another corporation that is participating in the plan of conversion as provided in item 3 of subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03 may be expressed as a range of value and must equal: the pro forma fair market value of the mutual holding company, multiplied by one minus a quotient equal to the number of issued minority shares, divided by the sum of the issued minority shares and the number of shares held by the mutual holding company.
3. The plan of conversion of a mutual holding company must provide that any outstanding issued minority shares must be exchanged for stock issued by the converting mutual company or the stock of any corporation participating in the conversion of the mutual holding company pursuant to subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03. The mutual holding company shall demonstrate to the satisfaction of the commissioner that the basis for the exchange is fair and reasonable. An exchange in which the holders of outstanding issued minority shares retain approximately the same percentage ownership in the resulting company as the quotient of the number of issued minority shares, divided by the sum of issued minority shares and the number of shares held by the mutual holding company, is presumed to be fair and reasonable.
4. If a mutual holding company seeking to convert under this chapter previously completed one or more minority stock offerings, the conversion of the mutual holding company to stock form may not be consummated unless a majority of the shares issued and outstanding to persons other than the mutual holding company vote in

favor of the conversion. This vote requirement is in addition to the required policyholder vote.

26.1-12.2-08. Effective date of plan of conversion.

A plan of conversion is effective when the commissioner has approved the plan of conversion, the voting members have approved the plan of conversion and adopted the certificate of incorporation of the converted stock company, and the certificate of incorporation is filed in the office of the secretary of state of this state.

26.1-12.2-09. Rights of members whose policies are issued after adoption of the plan of conversion and before effective date.

1. All members whose policies are issued after the proposed plan of conversion has been adopted by the governing body and before the effective date of the plan of conversion must be sent a written notice regarding the plan of conversion upon issuance of such policy.
2. Except as provided in subsection 3, each member of a property or casualty insurance company entitled to receive the notice provided for in subsection 1 must be advised of the member's right of cancellation and to a pro rata refund of unearned premiums.
3. A member of a property or casualty insurance company who has made or filed a claim under such member's insurance policy is not entitled to any right to receive any refund under subsection 2. A person that has exercised the rights provided by subsection 2 is not entitled to make or file any claim under such person's insurance policy.

26.1-12.2-10. Corporate existence.

1. On the effective date of the conversion, the corporate existence of the converting mutual company continues in the converted stock company. On the effective date of the conversion, all the assets, rights, franchises, and interests of the converting mutual company in and to every species of property, real, personal, and mixed, and any accompanying things in action, are vested in the converted stock company without any deed or transfer and the converted stock company assumes all the obligations and liabilities of the converting mutual company.
2. Unless otherwise specified in the plan of conversion, the individuals who are directors and officers of the converting mutual company on the effective date of the conversion shall serve as directors and officers of the converted stock company until new

directors and officers of the converted stock company are elected pursuant to the certificate of incorporation and bylaws of the converted stock company.

26.1-12.2-11. Conflict of interest.

Eliminate anyone collecting a fee

1. ~~Except as provided for in a plan of conversion approved by the commissioner, a~~A director, officer, agent, or employee of the converting mutual company may not receive any fee, commission, or other valuable consideration, other than such person's usual regular salary or compensation, for aiding, promoting, or assisting in a conversion under this chapter. This provision does not prohibit the payment of reasonable fees and compensation to attorneys, accountants, financial advisors, and actuaries for services performed in the independent practice of their professions, even if the attorney, accountant, financial advisor, or actuary is also a director or officer of the converting mutual company.
2. For a period of two years after the effective date of the conversion, a converted stock company may not implement any nontax-qualified stock benefit plan unless the plan is approved by a majority of votes cast at a duly convened meeting of shareholders held not less than six months after the effective date of the conversion.
3. All the costs and expenses connected with a plan of conversion must be paid for or reimbursed by the converting mutual company or the converted stock company. However, if the plan of conversion provides for participation by another entity in the plan pursuant to subparagraph a of paragraph 2 of subdivision c of subsection 1 of section 26.1-12.2-03, such entity may pay for or reimburse all or a portion of the costs and expenses connected with the plan of conversion.

26.1-12.2-12. Failure to give notice.

If the converting mutual company complies substantially and in good faith with the notice requirements of this chapter, the failure of the converting mutual company to send a member the required notice does not impair the validity of any action taken under this chapter.

26.1-12.2-13. Limitation on actions.

Any action challenging the validity of or arising out of acts taken or proposed to be taken under this chapter must be commenced on or before the later of:

1. Sixty days after the approval of the plan of conversion by the commissioner; or

2. Thirty days after notice of the meeting of voting members to approve the plan of conversion is first mailed or delivered to voting members or posted on the website of the converting mutual company.

26.1-12.2-14. Converting mutual company insolvent or in hazardous financial condition.

1. If a converting mutual company seeking to convert under this chapter is insolvent or is in hazardous financial condition according to information supplied in the mutual company's most recent annual or quarterly statement filed with the insurance department or as determined by a financial examination performed by the insurance department, the requirements of this chapter, including notice to and policyholder approval of the plan of conversion, may be waived at the discretion of the commissioner. If a waiver under this section is ordered by the commissioner, the converting mutual company shall specify in the mutual company's plan of conversion:
   a. The method and basis for the issuance of the converted stock company's shares of its capital stock to an independent party in connection with an investment by the independent party in an amount sufficient to restore the converted stock company to a sound financial condition.
   b. That the conversion must be accomplished without granting subscription rights or other consideration to policyholders.
2. This section does not alter or limit the authority of the commissioner under any other provisions of law, including receivership and liquidation provisions applicable to insurance companies.

26.1-12.2-15. Rules.

The commissioner may adopt rules to administer and enforce this chapter.

26.1-12.2-16. Laws applicable to converted stock company.

1. A converting mutual company is not permitted to convert under this chapter if, as a direct result of the conversion, any person or any affiliate thereof acquires control of the converted stock company, unless that person and such person's affiliates comply with the provisions of North Dakota law regarding the acquisition of control of an insurance company.

2. Except as otherwise specified in this chapter, a converted stock company has and may exercise all the rights and privileges and is subject to all of the requirements and regulations imposed on stock insurance companies under the laws of North Dakota relating to the regulation and supervision of insurance companies, but the converting stock company may not exercise rights or privileges that other stock insurance companies may not exercise.

26.1-12.2-17. Commencement of business as a stock insurance company.

A converting mutual company may not engage in the business of insurance as a stock company until the converting stock company complies with all provisions of this chapter.

26.1-12.2-18. Amendment of policies.

A mutual company, by endorsement or rider approved by the commissioner and sent to the policyholder, may simultaneously with or at any time after the effective date of the conversion amend any outstanding insurance policy for the purpose of extinguishing the membership rights of such policyholder.

26.1-12.2-19. Prohibition on acquisitions of control.

Except as otherwise specifically provided in section 26.1-12.2-03, from the date a plan of conversion is adopted by the governing body of a converting mutual company until three years after the effective date of the plan of conversion, a person may not directly or indirectly offer to acquire, make any announcement to acquire, or acquire in any manner, including making a filing with the insurance department for such acquisition under a statute or regulation of this state, the beneficial ownership of ten percent or more of a class of a voting security of the converted stock company or of a person that controls the voting securities of the converted stock company, unless the converted stock company or a person that controls the voting securities of the converted stock company consents to such acquisition and such acquisition is otherwise approved by the commissioner.

SECTION 4. REPEAL. Section 26.1-12-32 of the North Dakota Century Code is repealed.

Senator Klein,

This repeals the rules established for demutualization. As an important note, the bill has the same language as the rul being repealed relating to the Commissioner's ability to the ensure that the "Plan is fair and equitable to the converti mutual company, its members and its eligible members."

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7."

Page 9, line 17, replace "6." with "8."

Page 9, line 30, replace "7." with "9."

Page 10, line 13, replace "8." with "10."

Page 10, line 23, replace "9." with "11."

Page 10, line 25, replace "10." with "12."

Page 10, line 26, replace "three" with "two"

Page 11, remove lines 9 through 29

Page 11, line 30, replace "3." with "1."

Page 12, line 13, replace "4." with "2."

Page 12, line 13, replace the first "the" with "that"

Page 12, line 14, remove ", without payment,"

Page 12, remove lines 22 through 24

Page 12, line 25, replace "c." with "b."

Page 12, line 28, replace "d." with "c."

Page 15, line 24, replace "Except as provided for in a plan of conversion approved by the commissioner, a" with "A"

Renumber accordingly

Eliminate Anyone collecting a fee (I.E. directors officers, Agents, of the converting mutual) other than their usual compensation

30 days after hearings (findings)

Company sets meetings

Information 45 days before meetings