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BILL ANALYSIS

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House Bill 4521 (Substitute H-1 as reported without amendment)
Sponsor: Representative John Llewellan
House Committee: Insurance
Senate Committee: Financial Services

Date Completed: 10-17-95

RATIONALE

Chapter 59 of the Insurance Code provides for a procedure under which a mutual insurer (an insurer that is owned by the policyholders and does not have stock available on the stock exchange) may convert to a stock insurer (one that is owned by the stockholders), or may be acquired by a stockholder-owned insurance company. The current process of "demutualization" was established by Public Act 22 of 1987, which replaced a conversion procedure that had required a mutual insurance company to reincorporate. Essentially, under Chapter 59, a mutual insurer must submit a petition and a conversion plan to the Insurance Commissioner; receive approval of the plan from two-thirds of the policyholders; and resubmit the plan, along with proof of the policyholders' approval, to the Commissioner for final approval.

Typically, a mutual insurer converting under Chapter 59 is a financially troubled company that needs to obtain fresh capital. When the company converts, however, cash or stock is distributed to the policyholders, which apparently makes the capital-raising process less than effective, and gives the insurer's management little incentive to convert; instead, the officers and directors might attempt to keep a troubled company going in order to save their jobs. It has been suggested that a new procedure be instituted to extend the conversion option to healthy companies wanting to increase their surplus, and require a converting company to issue subscription rights (rights to purchase stock) to officers and directors, as well as policyholders. Reportedly, this approach has been adopted in Illinois, is being considered by a number of other jurisdictions, and is patterned after a model designed for savings and loan institutions.

CONTENT

The bill would amend the Insurance Code to replace the process by which a mutual insurer may convert to, or be acquired by, a stock company. The bill would do the following:

- **Require a mutual company to adopt a plan of conversion by the affirmative vote of at least two-thirds of its board of directors.**
- **Require the Insurance Commissioner to approve or disapprove a plan of conversion.**
- **Provide that a plan would be adopted upon the affirmative vote of at least two-thirds of the votes cast by eligible members (members whose policies were in force when the board adopted the plan).**
- **Require a conversion plan to contain certain provisions, including the subscription rights to eligible members, and a provision that shares not subscribed to would be sold in a public offering.**
- **Require the total price of the capital stock to equal the estimated pro forma market value of the converted stock company or the stock of another participating corporation.**
- **Limit the percentage of capital stock that a person or group of persons could acquire through public offering or subscription rights.**
- **Specify that a conversion plan could provide that the directors and officers would receive subscription rights to purchase capital stock of the converted company.**

- **-- Limit the number of shares that could be purchased by directors and officers.**
- **-- Allow a plan to allocate to an employee benefit plan subscription rights to purchase up to 10% of the capital stock.**
- **-- Provide for the right of members to rescind or cancel their policies.**
- **-- Allow the Commissioner to waive notice and policyholder approval requirements in the case of an insolvent mutual insurer.**

Plan of Conversion: Approval and Adoption

Under the bill, a mutual company seeking to convert to a stock company would have to adopt, by the affirmative vote of at least two-thirds of its board of directors, a plan of conversion consistent with the requirements described below. At any time before approval of a plan by the Commissioner, the mutual company, by the affirmative vote of at least two-thirds of its board, could amend or withdraw the plan.

Before a mutual company's eligible members could vote on approval of a plan, a company whose board had adopted a plan would have to submit all of the following documents to the Commissioner:

- -- The plan of conversion, including the independent evaluation of pro forma market value required by the bill.
- -- The form of notice required by the bill.
- -- Any proxies to be solicited from eligible members under the bill.
- -- The form of notice required by the bill to persons whose policies were issued after the plan was adopted but before it took effect.
- -- The proposed articles of incorporation and bylaws of the converted stock company.

Within 60 days after these documents were filed, the Commissioner would have to approve or disapprove the plan. The Commissioner would have to approve the plan if he or she found that it complied with Chapter 59; the plan would not prejudice the interests of the members; and the plan's method of allocating subscription rights was fair and equitable. At the mutual company's expense, the Commissioner could retain any qualified expert not otherwise a part of his or her staff to assist in reviewing the plan and the independent evaluation of the pro forma market value required by the bill.

All eligible members would have to be given notice of the members' meeting to vote upon the plan. ("Eligible member" would mean a member whose policy was in force on the date the mutual company's board of directors adopted a plan of conversion. A person insured under a group policy would not be an eligible member. A person whose policy became effective after the board adopted the plan but before it took effect would not be an eligible member but would have the rights to receive notice and rescind the policy, as established under the bill.) The notice would have to describe the proposed conversion plan briefly but fairly, inform the members of their right to vote upon the plan, and be mailed to each member's last known address at least 21 days before the meeting. If the meeting to vote on the plan were held during the mutual company's annual meeting of policyholders, only one combined notice of meeting would be required.

The plan would be adopted upon receiving the affirmative vote of at least two-thirds of the votes cast by eligible members. Members could vote in person or by proxy. Any proxies to be solicited from eligible members would have to be filed with and approved by the Commissioner. The number of votes each eligible member could cast would be determined by the company's bylaws. If the bylaws were silent, each eligible member could cast one vote.

The revised articles would have to be considered at the meeting of the policyholders called for the purpose of adopting the plan of conversion, and would require for adoption the affirmative vote of at least two-thirds of the votes cast by eligible members.

After the eligible members had approved the plan, the converted stock company would have to file with the Commissioner the minutes of the meeting of the members at which the plan was voted upon, and the revised articles of incorporation and bylaws of the converted stock company.

The plan would be effective when the Commissioner and the eligible members had approved it and the revised articles of incorporation had been adopted.

Plan of Conversion: Provisions

A plan of conversion would have to include the reasons for the proposed conversion, and the effect of the conversion on existing policies, including all of the following:

- -- A provision that all policies in force on the effective date of conversion would continue to remain in force under the terms of the policies, except that any voting rights of the policyholders provided for under the policies or under Chapter 59 would be extinguished on the effective date of the conversion.

-- A provision that holders of participating policies in effect on the conversion date would continue to have the right to receive dividends as provided in the participating policies, if any.

-- A provision that (except for the mutual company's life policies, guaranteed renewable accident and health policies, and guaranteed renewable, noncancelable accident and health policies) upon the renewal date of a participating policy, the converted stock company could issue the insured a nonparticipating policy as a substitute for the participating policy.

A plan of conversion also would have to include the subscription rights to eligible members, including a provision that each eligible member was to receive, without payment, nontransferable subscription rights to purchase a portion of the capital stock of the converted company. As an alternative to subscription rights in the converted company, the plan could provide that each eligible member was to receive, without payment, nontransferable subscription rights to purchase a portion of the capital stock of one of the following: 1) a corporation organized for the purpose of purchasing and holding all of the stock of the converted company; 2) an unaffiliated corporation that would purchase all of the stock of the converted company; or 3) a stock insurance company into which the mutual company would be merged. In addition, the plan would have to provide that the subscription rights would be allocated in whole shares among the eligible members using a fair and equitable formula. The formula could, but would not have to, 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 could be fair or equitable. The plan also would have to 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.

The plan of conversion would have to provide that any shares of capital stock not subscribed to by persons exercising subscription rights would be sold in a public offering through an underwriter. If the number of shares of capital stock not subscribed to by eligible members were so small that it did not warrant the expense of a public offering, the plan could provide for purchasing unsubscribed shares by a private placement or other alternative method approved by the Commissioner that was fair and equitable to eligible members.

The plan of conversion would have to set the total price of the capital stock equal to the estimated pro forma market value of the converted stock company or the stock of another corporation that was participating in the conversion plan, based upon an independent evaluation by a qualified expert. This pro forma market value could be that value that was estimated to be necessary to attract full subscription for the shares, as indicated by the independent evaluation. The plan would have to set the purchase price per share of capital stock equal to any reasonable amount.

The plan would have to provide for notice and a clear explanation to eligible members of their right to subscribe to stock of the converted stock company or the stock of another corporation that was participating in the conversion plan.

<u>Plan of Conversion: Life Insurance</u>

The following provisions would apply only to mutual life insurance companies.

A plan of conversion would have to provide that a mutual life insurance company's participating life policies in force on the conversion date would be operated by the converted stock company for dividend purposes as a closed block of participating business, except that any and all classes of group participating policies could be excluded from the closed block.

The plan would have to establish one or more segregated accounts for the benefit of the closed block of business, and would have to allocate to those accounts enough assets of the mutual company so that the assets together with the revenue from the closed block of business were sufficient to support the closed block, including at least the payment of claims, expenses, taxes, and any dividends provided for under the terms of the participating policies, with appropriate adjustments in the dividends for experience changes. The assets allocated to the closed block of business at its establishment would have to be at least equal to the amount of reserves then held in connection with the closed block of business or the minimum reserve permitted by statute or regulation for the closed block, whichever was greater. The amount of assets allocated to the segregated accounts of the closed block would have to be based upon the mutual life insurance company's last annual statement, updated to the effective date of the conversion.

The converted stock company would have to keep a separate accounting for the closed block and make and include in the statement to be filed with the Commissioner each year a separate statement showing the gains, losses, and expenses properly attributable to the closed block.

The Commissioner could waive the requirement for establishing a closed block of business if it were in the best interests of policyholders to do so. The Commissioner could permit the discontinuation of a segregated account if its size did not warrant the expense of maintaining the account.

Stock Acquisition

A plan of conversion would have to provide that any person or group of persons acting in concert could not acquire, through public offering or subscription rights, more than 5% of the capital stock of the converted stock company or the stock of another corporation that was participating in the conversion plan, for five years from the plan's effective date, except with the approval of the Commissioner. This limitation would not apply to any entity that was to purchase 100% of the capital stock of the converted company as part of the plan of conversion approved by the Commissioner.

The plan would have to provide that no director or officer or person acting in convert with a director or officer of the mutual company could acquire any capital stock of the converted stock company or the stock of another participating corporation, for three years after the plan's effective date, except through a broker/dealer, without the Commissioner's permission. This provision would not prohibit the directors and officers from purchasing stock through subscription rights received in the plan or from participating in a tax qualified stock benefit plan (described below).

Stock options for the converted stock insurance company or the stock of another corporation that was participating in the conversion plan could not be made available to the directors or officers of the company for two years after the plan's effective date if the aggregate stock holdings of directors and officers exceeded, or would exceed if the options were exercised, 25% of the total number of shares issued by the converted company if total assets of the company were less than $50 million, or 15% if total assets were more than $500 million. For converted companies with total assets of or between $50 million and $500 million, the company size threshold for limiting stock options would have to be interpolated.

Directors' and Officers' Subscription Rights

A plan of conversion could provide that the directors and officers of the mutual company would receive, without payment, nontransferable subscription rights to purchase capital stock of the converted stock company or the stock of another corporation participating in the conversion plan. These rights would have to be allocated among the directors and officers by a fair and equitable formula.

The total number of shares that could be purchased under these provisions could not exceed 25% of the total number of shares to be issued for a mutual company if total assets of the company were less than $50 million, or 15% if total assets were more than $500 million. For mutual companies with total assets of or between $50 million and $500 million, the percentage of the total number of shares that could be purchased would have to be interpolated.

Stock purchased by a director or officer under these provisions could not be sold within one year after the effective date of the conversion.

Other Provisions

Employee Benefit Plan. A plan of conversion could allocate to a tax-qualified employee benefit plan nontransferable subscription rights to purchase up to 10% of the capital stock of the converted stock company or the stock of another participating corporation. The employee benefit plan would be entitled to exercise its subscription rights regardless of the total number of shares purchased by other persons.

Alternative Plan. A board of directors could adopt a plan of conversion that did not rely in whole or in part upon issuing nontransferable subscription rights to members to purchase stock of the converted company if the Commissioner found that the plan did not prejudice the members' interests, was fair and equitable, and was not inconsistent with the purpose and intent of Chapter 59. An alternative plan could include the merger of a domestic mutual insurer into a domestic or foreign stock insurer, the issuance of stock or cash to policyholders instead of subscription rights, or another plan approved by the Commissioner. The Commissioner could retain, at the mutual company's expense, any qualified expert not otherwise a part of his or her staff to assist in reviewing whether the plan could be approved.

Recision Rights. All members whose policies became effective after the proposed plan had been adopted by the board of directors and before the plan's effective date would have to be given written notice of the plan of conversion by the 45th day after its effective date. The notice would have to specify a member's right to rescind or cancel the member's policy, as described below. A copy of the description of the plan provided to members would have to accompany the notice. The form of the notice would have to be filed with and approved by the Commissioner.

A member of a life or health insurance company entitled to receive this notice could rescind his or her policy and receive a full refund of any amounts paid for the policy or contract within 10 days after he or she had received the notice. Each member of a property or casualty insurance company entitled to receive the notice would have to be advised of his or her right to cancel and to receive a pro rata refund of unearned premiums.

Corporate Existence. Upon the conversion of a mutual company to a converted stock company, the corporate existence of the mutual company would be continued in the converted stock company. All of the rights, franchises, and interests of the mutual company in and to every species of property, and any accompanying things in action, would be transferred to and vested in the converted company, without any deed or transfer. In addition, the converted company would assume all of the obligations and liabilities of the mutual company.

Unless otherwise specified in the plan of conversion, the directors and officers of the mutual company would serve as directors and officers of the converted company until new directors and officers were duly elected pursuant to the articles of incorporation and bylaws of the converted company.

Conversion Fee/Costs. A director, officer, agent, or employee of a mutual company or any other person could not receive any fee, commission, or other valuable consideration, other than his or her usual salary or compensation, for aiding, promoting, or assisting in a conversion under Chapter 59, except as provided for in the plan approved by the Commissioner.

All of the costs and expenses connected with a plan of conversion would have to be paid for or reimbursed by the mutual company or the converted stock company. If the plan provided, however, either for an unaffiliated corporation to purchase and hold all of the stock of the converted company or for the merger of the mutual company into a stock company, the unaffiliated corporation or stock company would have to pay for or reimburse all of the costs and expenses connected with the plan.

Validity. If a mutual company complied substantially and in good faith with the notice requirements of Chapter 59, the company's failure to give a member the required notice would not impair the validity of any action taken under the chapter.

Any action challenging the validity of or arising out of acts taken or proposed to be taken under Chapter 59 would have to be commenced within 30 days after the plan's effective date.

Insolvency. If a mutual insurer became insolvent, its board of directors by a majority vote could request in its petition that the Commissioner waive the requirements imposing notice to and policyholder approval of the planned conversion. The petition would have to specify the method and basis for the issuance of the converted insurer's shares of its capital stock to an independent party in connection with an investment by that party in an amount sufficient to restore the insurer to a sound financial condition. The petition also would have to specify that the conversion would be accomplished without consideration to the past, present, or future policyholders, if the Commissioner found that the insurer's value, due to the insolvency, was insufficient to warrant consideration.

If the Commissioner, upon review of the conversion plan and after a financial examination, found that the mutual insurer no longer met statutory requirements with respect to capital, surplus, deposits, and assets, the Commissioner could waive, by a written order, the requirement that a plan be adopted upon the affirmative vote of at least two-thirds of the votes cast by eligible members.

MCL 500.5901 et al.

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

Although the mutual form of an insurance company is considered antiquated and is no longer being used for new companies, Michigan's existing conversion process is said to be ineffective for purposes of raising capital and is unattractive to management. By providing for a new conversion process that would give directors and officers, as well as policyholders, subscription rights to purchase stock, the bill would provide an incentive for both financially troubled and fiscally robust companies to convert. While a troubled insurer would be able to raise needed capital that the company could keep--instead of it giving away to policyholders--a healthy insurer could realize a significant increase in its net worth. The proposed changes also would create liability protection for members of management who received stock options; currently, a converting company must distribute cash or stock representing its surplus to the policyholders, and the insurer and management could be sued for making distributions to directors and officers. Under the bill, however, a plan of conversion could provide that directors and officers would receive nontransferable subscription rights to purchase stock of the company. At the same time, the bill would prevent a single individual or group of individuals from acquiring control of the company. In addition, under the bill, a converting company could allocate up to 10% of its capital stock in nontransferable subscription rights to an employee benefit plan.

These provisions would make conversion more attractive to and feasible for mutual insurance companies struggling with insolvency as well as for companies with a clear future. It would be in the State's interest to enable these insurers to survive and grow.

Opposing Argument

The bill clearly would create a tremendous financial incentive for strong mutual insurers to convert to stock companies. Rather than retaining these businesses, the State actually could lose them, since the stock could be purchased by anyone. The conversion process should be limited to financially troubled companies.

Opposing Argument

Since the policyholders of a mutual insurer are considered to *own* the company, it is questionable whether they should have to *buy into* the new stock company.

Response: Policyholders who have done little or nothing to keep a company going or help it grow should not receive a windfall upon the company's conversion, especially if the capital is needed to ensure the company's survival.

Legislative Analyst: S. Margules

FISCAL IMPACT

This bill would not affect the regulatory workload of the Insurance Bureau, Michigan Department of Commerce or have a fiscal impact on the State or on local governmental units.

Fiscal Analyst: K. Lindquist

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