NO LONGER YOUR PIECE OF THE ROCK: THE SILENT REORGANIZATION OF MUTUAL LIFE INSURANCE FIRMS

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When you buy life insurance from a mutual insurance company, the salesperson tells you that you are paying for more than merely a life insurance policy. Rather, you are buying into the firm's future. As the famous advertising slogan goes, you "get a piece of the Rock."

Caveat Emptor.

INTRODUCTION

It is unusual for an issue of central concern to market regulation to go almost wholly ignored. That is precisely the case, however, with the rights of policyholders of mutual life insurance firms (mutuals).[1] Do those who own policies in such firms merit similar protections as shareholders in stock companies? Or do policyholders deserve fewer safeguards given the hybrid status of mutual life insurance firms?

Ever since Ben Franklin started a mutual insurance company,[2] policyholders generally have enjoyed a basic level of ownership rights.[3] Within the past few years, however, and with little debate,

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1 A Westlaw search turned up only one law review article, written six years ago, that directly addresses the rights of policyholders. See Edward X. Clinton, The Rights of Policyholders in an Insurance Demutualization, 41 Drake L. Rev. 657 (1992). That article, however, predates the mutual holding company laws and thus does not analyze how the new laws affect policyholders' rights—the subject of this Note.

2 See Anne Colden, Some Insurers Going Public Draw Fire, Wall St. J., Apr. 7, 1997, at A9A (noting that Benjamin Franklin created Philadelphia Contributionship for Insurance of Houses From Loss by Fire in 1752, which was first mutual insurer in North America).

3 Under state law, current policyholders have the right to elect directors, see, e.g., Wash. Rev. Code Ann. § 48.09.120(2) (West 1984) (providing that each policyholder is entitled to one vote), and the right to receive dividends from the company's net income, see, e.g., id. § 48.09.300(1) (providing that directors may pay dividends to members out of surplus funds that are in excess of required minimum surplus and that represent mutual's net earnings). Policyholders also may have certain rights if the mutual dissolves or converts into a stock corporation. See, e.g., id. § 48.09.360 (West Supp. 1998) (providing policyholders right to proportionate share of company's assets upon liquidation). The first right, to elect directors, is not as valuable as the latter two, however, because policyholders receive only one vote, regardless of the size of their life insurance policies, and thus are disen-

many states have passed mutual holding company laws.[4] The new laws make it easier for mutuals to convert to stock companies and sell stock to the public, but in the process they radically alter policyholders' rights. Industry proponents praise the new laws as tickets to financial strength.[5] Critics demonize the laws as a corporate shell game that will strip policyholders of long-standing protections and work a wealth transfer from policyholders to managers.[6] Some opponents of the new laws even argue that the laws may be unconstitutional.[7] Despite these concerns, more and more states are bowing to industry lobbying and are considering passing such laws.[8]

The fate of this legislation matters because the stakes are enormous: The rights to billions of dollars turn on these new and untested laws. And the uncertainty is exacerbated by the fact that many financial experts consider insurance regulation—one of the few financial markets supervised by the states[9]—the weakest link in the market reg-

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franchised to some extent. For more on mutual policyholder disenfranchisement, see infra note 25.

4 The mutual holding company laws involve a kind of demutualization. Demutualization typically refers to the process by which a mutual, owned by policyholders, converts to a stock company, owned by shareholders. Under the traditional demutualization laws, mutuals typically convert fully so that after the demutualization and issuance of stock, stockholders own 100% of both the voting rights and the equity of the company. Under the new laws, mutuals convert only in part so that after the process, policyholders generally own a minimum of 50.1% of the voting rights of the company, and stockholders own a maximum of 49.9% of the voting rights and up to 100% of the equity of the company. For a more detailed description of the traditional demutualization and mutual holding company laws, see infra Part I. For a list of states that have adopted the new demutualization laws, see infra note 20.

5 See infra Part II.B. for a more detailed analysis of the benefits of the new laws.

6 See infra Part II.A. for a more detailed analysis of the drawbacks of the new laws.

7 See Telephone Interview with David Schiff, Editor of Schiff's Insurance Observer (Mar. 28, 1998); see also infra note 53 (describing lawsuits filed to test constitutionality of mutual conversions that do not compensate policyholders). Even arguably neutral observers of the new laws have raised constitutional concerns. See National Association of Insurance Commissioners (NAIC), Draft of White Paper at 30 (Mar. 1998) (stating that any mutual holding company proposal that does not preserve policyholders' rights and legal expectations takes valuable property rights) (on file with the *New York University Law Review*) [hereinafter NAIC Draft of White Paper].

8 See infra Part III.C. (noting that so-called "race to the bottom" may have already begun); see also infra text accompanying note 21 (noting that IRS recently declared first conversion under new laws tax-free event). The push to pass the new laws may have stalled, however. As of this writing, Massachusetts and New York, two bellwether states with large mutuals, have not passed mutual holding company laws, and Vermont is considering rewriting or repealing its mutual holding company law.

9 See 15 U.S.C. §§ 1011-1015 (1994) (prescribing that federal government will not regulate insurance).

ulation system.[10] The near total absence of critical scholarly analysis of the new laws leaves courts, as well as regulators, mutual companies, and policyholders, with little guidance. This Note begins to address this gap. Part I highlights the main features of the mutual holding company laws. Part II outlines the risks and potential rewards common to the new laws. Part III reviews the deleterious aspects of the new laws and suggests changes that might promote increased access to capital markets—the ostensible goal of demutualization—but neither punish current policyholders nor unduly reward managers in the process. This Note concludes, however, that the mutual holding company laws contain inherent and unremediable flaws.

I
The Mutual Holding Company Laws

Mutuals have a relatively simple corporate framework. In exchange for cash premiums, policyholders receive life insurance policies and a qualified ownership interest in the firm. Once the mutual pays its claims and operating expenses, the profits belong to the policyholders.[11] Typically, part of the profits are paid out to policyholders in dividends,[12] reducing the cost of the premiums, and the rest of the profits flow into the company's "surplus," where they accumulate year after year.[13] Although self-perpetuating boards essentially run most mutuals, thereby limiting policyholders' role in mutuals' corporate governance,[14] the mutual structure has proven quite popular. Mutual life insurance companies underwrite almost one-half of the country's total amount of life insurance.[15]

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10 See, e.g., Jonathan R. Macey & Geoffrey P. Miller, The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation, 68 N.Y.U. L. Rev. 13 (1993).

11 See Clinton, supra note 1, at 659 & n.9 (noting policyholders' rights to profits).

12 Mutuals are not obliged to pay dividends. See, e.g., Wash. Rev. Code Ann. § 48.09.300(1) (West 1984) (providing that directors may pay dividends to members out of surplus funds that are in excess of required minimum surplus and that represent mutual's net earnings). However, dividend payments have been significant. In 1996, for example, Prudential paid $2.5 billion in dividends to its policyholders. See Joseph B. Treaster, A $12 Billion Carrot for Prudential Policyholders, N.Y. Times, Feb. 13, 1998, at A1.

13 See Treaster, supra note 12 (noting that some profits are accumulated but large portion of profits beyond operating expenses is given back to policyholders as dividends); see also Clinton, supra note 1, at 662 (noting that policyholders receive dividends from mutuals' earned surplus or accumulated profits).

14 See Clinton, supra note 1, at 663 (discussing governance structure of mutuals); see also Henry Hansmann, The Ownership of Enterprise 273 (1996) (stating that since their first appearance in 1840s, mutuals have been founded and controlled by officers and directors who are essentially self-appointed).

15 See Note, Developing a Demutualization Acquisition Strategy for Private Equity Firms, 110 Harv. L. Rev. 1904, 1906 (1997).

The traditional mutual form is under pressure, however. Mutuals across the country have been waging a breakneck, but little-noticed, push for new state laws that threaten policyholders' ownership stake in mutuals. In Massachusetts, for example, the insurance industry's main state lobbying group increased its spending by sixty-five percent in 1997, to $689,000, as it advocated a pending mutual holding company bill.[16] Tactics include standard information dissemination and veiled warnings to legislatures to pass the new law or risk watching mutuals take their business (and jobs and taxes) out of the state.[17] These lobbying efforts,[18] and others,[19] have been somewhat successful. In the past few years, fifteen states and the District of Columbia have adopted mutual holding company laws, and bills are pending in at least a half dozen other states.[20] The pace may quicken given that the IRS, in its first ruling on the issue, took the position that a conversion under the new laws is a tax-free event.[21]

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[16] See Steve Bailey & Steven Syre, Mutual Insurers Divided on How Best to Go Public, Boston Globe, Jan. 28, 1998, at C1 (detailing insurance companies' lobbying efforts).

[17] See, e.g., Stephen L. Brown, Opinion, Insurers Need Access to Capital, Boston Globe, Nov. 18, 1997, at C4 (providing John Hancock Mutual Life Insurance Company CEO's description of competitive advantage denied to mutuals in Massachusetts and importance of mutuals' 20,000 jobs and millions of dollars of investment in local development and local charities).

[18] Last year, the Massachusetts House passed a mutual holding company bill, and as of this writing, the Massachusetts Senate is debating the bill. See Steve Bailey & Steven Syre, Senate Seen Near on Insurance Bill, Boston Globe, Jan. 22, 1998, at C1 (describing Massachusetts House and Senate deliberations on mutual holding company legislation).

[19] See Bailey & Syre, supra note 16 (noting that John Hancock Mutual Life Insurance Co.'s 1997 lobbying expenses increased six-fold over prior year to $297,000); see also Treaster, supra note 12 (noting mutual lobbying efforts).

[20] See, e.g., Cal. Ins. Code §§ 11535-11548 (West Supp. 1998); Fla. Stat. ch. 628.441 (1993); Iowa Code Ann. § 521A.14 (West Supp. 1997); Kan. Stat. Ann. §§ 40-4001 to 4014 (Supp. 1997); La. Rev. Stat. Ann. §§ 820-821 (West Supp. 1998); Minn. Stat. Ann. § 60A.077 (West Supp. 1998); Mo. Rev. Stat. §§ 379.980-.988 (Supp. 1997); Neb. Rev. Stat. §§ 44-6101 to 6142 (Supp. 1997); N.D. Cent. Code §§ 26.1-12.1-01 to 14 (Supp. 1997); Ohio Rev. Code Ann. §§ 3913.25-.40 (Banks-Baldwin Supp. 1997); Or. Rev. Stat. §§ 732.600-.630 (1997); 40 Pa. Cons. Stat. Ann. §§ 914-A to 915-A (West Supp. 1997); R.I. Gen. Laws § 27-1-40.1 (Supp. 1997); Tex. Ins. Code Ann. art. 15.22 (West 1997); Vt. Stat. Ann. tit. 8, §§ 3441-3446 (Supp. 1997). The District of Columbia also passed a mutual holding company law. See D.C. Code Ann. § 35-4201 (1997). Three states, Connecticut, Mississippi, and North Carolina, do not have statutes that explicitly authorize demutualization. Hawaii has a statute that bars demutualization. See Haw. Rev. Stat. Ann. § 431:4-503 (Michie 1993). States in which bills are pending include Delaware, Indiana, Maryland, Massachusetts, New Jersey, New York, and Wisconsin.

[21] See Priv. Ltr. Rul. 97-45-013 (Aug. 7, 1997); see also IRS Rules Mutual Holding Conversion Is Tax Free, Best's Ins. News, Nov. 17, 1997, available in 1997 WL 7079195.

The new laws significantly alter the way a mutual may convert to a stock company[22]—a change that involves much more than mere technical fiddling. Under the traditional laws, when a mutual life insurance company converts and sells stock to the public, two things typically happen. First, a portion of the surplus accumulated over the years is distributed to the policyholders in stock, cash, or policy enhancements.[23] For example, when the State Mutual Life Insurance Co. of Massachusetts converted in 1995, policyholders received a median payout of $2,500 in stock in the new company.[24] Second, in exchange for the surplus, the policyholders tender their ownership rights in the mutual.[25] The firm sheds its mutual status and becomes a stock company, owned by the new holders of the company's stock.

The new laws do not create a full-fledged stock company. Rather, they work by fashioning what is called a mutual holding company, which in turn controls a subsidiary with the firm's main operating business. The policyholders, who become members of the mutual holding company, generally own 100% of the holding company, which in turn owns 50.1% of the voting rights of a stock-company subsidiary. The insurers can then sell stock with as much as 49.9% of the voting rights and up to 100% of the equity in the stock-company subsidiary without any payment—in stock, cash, or policy enhancements—to

[22] Perhaps the key traditional difference between mutual life insurers and stock life insurers is that mutuals cannot sell shares of stock on the equity markets. See Clinton, supra note 1, at 659 (discussing this limitation on mutuals).

[23] See Joseph B. Treaster, Insurers' Plan to Sell Stock Riles Consumer Advocates, N.Y. Times, Oct. 9, 1997, at D2 (stating that when mutuals want to sell stock they must divide up much of their accumulated profits, or surplus, among policyholders). A separate issue, one beyond the scope of this Note, is whether policyholders are entitled to the surplus or the enterprise value (i.e., the surplus and intangibles).

[24] See Bailey & Syre, supra note 16. In early 1998, Prudential expressed its desire to demutualize under the traditional full demutualization process, and it is estimated that policyholders would receive an average payout of $1100. See Treaster, supra note 12, at A1. Some experts believe the average payout figure might be much larger, perhaps two or three times the $1100 estimate. See Telephone Interview with David Schiff, Editor of Schiff's Insurance Observer (Mar. 28, 1998). As of this writing, New Jersey lacked a demutualization statute of any kind. However, legislators were considering passing some kind of demutualization law. See id.

[25] See Treaster, supra note 23. For a more detailed analysis of policyholders' role in the demutualization process, see Clinton, supra note 1, at 660-61, 685-86. Policyholders must approve major board decisions, including the decision to demutualize, usually by at least a majority of those voting. See id. at 685-86. However, since policyholders receive only one vote regardless of the size of their policies, policyholders lack incentives to vote against management. See id. at 685 n.210. For example, there appears to be no instance of policyholders defeating management nominees for election to a board. See id. at 663. This disenfranchisement, which occurs for other reasons as well, also applies in the demutualization context. Once the board decides to demutualize, therefore, and assuming the insurance regulators approve the conversion, getting policyholders' approval is not likely a significant hurdle. See id. at 685 n.210.

policyholders.[26] Although they retain their life insurance contracts with the company, policyholders are no longer the exclusive recipients of future profits. Instead, profits belong in part to the new stockholders[27] and thus may not be available for distribution as dividends to help policyholders pay their premiums. Although policyholders sometimes are permitted to buy a limited amount of such stock, they must pay for it out of pocket.[28]

Proponents in the insurance industry say the new laws are needed to shore up mutuals' financial condition.[29] The companies argue that they need to issue stock to gain access to equity markets—to raise money in order to buy other companies so that they can continue to grow.[30] Such growth ostensibly will lead to better-capitalized, more diversified institutions, which in turn will lower policyholders' risks, even if it does not raise policyholders' dividends. The companies also promote the new laws as enhancing mutuals' structural flexibility for expanding operations.

On at least one point, the industry position is plausible. Growth and access to capital may be vital, especially in the increasingly competitive financial services industry. Mutuals are already losing market share to stock insurers, and further erosion is possible in light of the wave of recent mergers and acquisitions between rivals.[31] At the same time, changing demographics have resulted in higher consumer demand for products that provide retirement income and benefits,

26 See Leslie Scism, Principal Mutual Conversion Opposed, Wall St. J., Jan. 16, 1998, at A9A (describing conversion under new laws). In brief, the argument for not compensating policyholders for their lost voting rights is that policyholders have not lost anything (they remain the formal owners) so they do not merit any compensation due to the change in form. See infra Part II.A.1 for a more detailed analysis of the justifications for withholding compensation from policyholders.

27 See Treaster, supra note 23, at D2 (stating that under mutual holding company structure, future profits no longer are reserved exclusively for policyholders but are shared with new stockholders).

28 See id.

29 See Life Insurance Association of Massachusetts (LIAM), Lobbying Material for Proposed Mutual Holding Company Legislation (on file with the *New York University Law Review*) [hereinafter LIAM Lobbying Material].

30 See id.

31 See Leslie Scism, More Mutual-Life Insurers Mull Bringing Their Shares to Market, Wall St. J. (Eur.), Dec. 10, 1997, at 13, available in 1997 WL-WSJE 12217091. Recent mergers include Lincoln National Corp.'s acquisition of CIGNA's individual life insurance and annuities business, and Conseco's acquisition of Capital American Financial Corp., Pioneer Financial Services, The Colonial Penn Group, and the Washington National Group. See Merger Activity to Gather Speed in 1998, Ins. Acct., Jan. 5, 1998, at 1, available in 1998 WL 5099846; see also William Gruber, Bank, Insurance Firm Mergers Boosting Stock Prices, Chi. Trib., Dec. 25, 1997, § 3, at 1 (noting that 410 insurance-related deals were announced in 1997 through mid-December, up from 382 for all of 1996). This Note does not address whether alternative explanations for mutuals' loss of market share exist.

and lower demand for products that provide benefits after death. This is evident in the relatively low premium and asset growth experienced by life insurers in recent years. Mutuals in particular are negatively affected by this trend as they depend heavily on internally generated earnings to provide additional capital for growth plans.[32] Increased access to capital via a stock issue might therefore allow mutuals to grow and stay competitive.

At the same time, however, it is important to note that many mutuals are hardly at risk. Seven of the ten largest United States life insurers are mutuals.[33] New York Life, the fourth largest life insurer, ended 1996 with $62 billion in assets.[34] Prudential ended 1996 with $178 billion in assets, the most of any United States life insurer.[35] Furthermore, new laws are not needed to enable mutuals to access capital markets. Laws already exist that permit conversion from mutual to stock companies.[36]

Why, then, is there this rush to create a new way to sell stock? Certainly, the mutual holding company laws may offer a faster, simpler, and more expansive way for insurers to convert and access the markets.[37] The traditional full demutualization process takes up to two years and often requires a complex determination of the allocable share value of policyholders' interest.[38] The time and expense of the old conversion process, as a practical matter, may bar small or poorly capitalized insurers from demutualizing. The new mutual holding company conversion process is simpler, in part because it does not require compensating policyholders, and likely takes less time to complete, which may help explain its popularity.[39]

The sudden embrace of these laws, however, also may be linked to the various ways the new laws benefit insiders. The traditional demutualization laws, apparently disliked by many mutual execu-

32 See NAIC Draft of White Paper, supra note 7, at 9.

33 See Treaster, supra note 12 (listing United States life insurers by asset totals).

34 See id.

35 See id.

36 Almost every state has an old demutualization statute. See, e.g., Mass. Gen. Laws Ann. ch. 175, § 19E (West 1997) (permitting conversion).

37 Legal challenges to the new laws generally and to specific conversions in particular might delay the conversion process, however, which would minimize some of the potential benefits of the new laws.

38 See Susan Yellin, The Pleasure is "Demutual": Mutual Insurers See Benefits of Becoming Conventional Companies, Fin. Post, Dec. 12, 1997, at 19 (describing demutualization under traditional laws).

39 Indeed, one of the first mutuals to convert using the new laws was a small to midsize Iowa life insurer, AmerUs. See Mark P. Couch, AmerUs Life's Restructuring Faulted, Des Moines Sunday Reg., Sept. 7, 1997, at G1.

tives,[40] severely limited the timing and quantity of stock purchases by mutual executives during a conversion.[41] In contrast, the new laws typically allow executives both to buy large amounts of new stock prior to the start of trading and to receive generous stock option grants.[42] Executives also get more than just a financial windfall. Unlike conversions under the traditional laws, which subject managers to the threat and discipline of the takeover market, conversions under the new laws will insulate managers from external oversight and hostile takeovers.[43] Not surprisingly, many mutual executives have been lobbying aggressively for the new laws.[44]

Given that a way to convert and sell stock already exists, the core issue is whether the risks of the new laws outweigh their potential benefits. Will these laws ensure that policyholders retain their companies' value? Or will they only enrich and insulate insiders? Will policyholders be able to afford insurance premiums if they no longer receive as generous dividends to help offset the costs? What kind of process is due policyholders? And do the laws create an inherent conflict of interest between policyholders and stockholders? Part II addresses these issues.

II
The Risks and Potential Rewards of the Mutual Holding Company Laws

The mutual holding company laws are difficult to evaluate. On the one hand, they contain a number of troubling aspects. As Part II.A. illustrates, the new laws potentially strip policyholders of assets, weaken policyholders' due process protections, and work a windfall for managers while simultaneously insulating management from the market for corporate control. On the other hand, the new laws also offer potential benefits. As Part II.B. describes, the new laws may increase converting mutuals' access to capital, helping such insurers to grow and shareholders to profit.

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[40] See Note, Developing a Demutualization Acquisition Strategy for Private Equity Firms, supra note 15, at 1910.

[41] See Clinton, supra note 1, at 689.

[42] See Center for Insurance Research, Insurance Companies on Fast Attack—Alert! (on file with the *New York University Law Review*) (arguing that new laws permit executives to obtain stocks at discount value and contain limited or no prohibitions on options); see also Treaster, supra note 23, at D2 (explaining that shares can be used as bonuses for executives).

[43] See Note, Developing a Demutualization Acquisition Strategy for Private Equity Firms, supra note 15, at 1913 (noting that firms converting under mutual holding company laws retain certain aspects of mutual form, such as insulation from external oversight).

[44] See, e.g., Brown, supra note 17.

A. *Risks*

1. *Stripping Policyholders of Assets and Creating Conflicts of Interest*

Cases and statutes clearly establish that policyholders at least nominally own a mutual company.[45] Even the insurance industry seems to agree.[46] The real debate, therefore, involves how much of a mutual's surplus policyholders should receive in a conversion. The traditional laws generally resolve this debate in a Solomonic fashion. While few of the traditional laws give policyholders the entire surplus, most ensure that policyholders receive a significant portion.[47] The standards, while imprecise, generally have rewarded policyholders with cash or stock in the new company ranging from hundreds to thousands of dollars.[48]

The new laws break with this tradition. When mutuals convert to mutual holding companies, there is typically no statutory requirement that policyholders receive cash, stock, or other tangible value such as policy enhancements.[49] In one of the first conversions under the new laws, AmerUs, an Iowa mutual, converted and retained its entire surplus.[50]

While there are various justifications for this change in treatment, none is particularly persuasive. One such justification is that conversions under the new laws work only a partial demutualization; policy owners retain 50.1% of the voting rights of the mutual holding company, which controls the subsidiary with the company's operating business. It is unclear, however, how valuable this 50.1% control of

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45 See Clinton, supra note 1, at 659 nn.7-10, 662 n.28 (listing such cases and statutes); see also Note, Developing a Demutualization Acquisition Strategy for Private Equity Firms, supra note 15, at 1905 (describing policyholders' ownership rights).

46 See LIAM Lobbying Material, supra note 29 (explaining that mutual insurance companies are "owned" by their policyholders). Prudential's website, for example, heralds the date in its history when it became "a truly mutual company, owned by and serving its policyholders." See Prudential Ins. Co. of America, History of Prudential (visited Mar. 22, 1998) <http://www.prudential.com/corporate/cozzz1001_content.html#1926>.

47 See, e.g., N.Y. Ins. Law § 7307(e)(3) (Consol. 1985) (providing share based on proportion of total premiums policyholder received over past three years); Wash. Rev. Code Ann. § 48.09.360(3) (West Supp. 1998) (same).

48 See Note, Developing a Demutualization Acquisition Strategy for Private Equity Firms, supra note 16, at 1914 n.96 ("Recent major demutualizations have involved substantial cash, stock, or policy credit payments to policyholders: The Equitable ($67 million), Maccabees Mutual Life ($97.7 million), Northwestern National Life ($180 million), and Union Mutual Life (UNUM) ($250 million).").

49 See, e.g., Vt. Stat. Ann. tit. 8, §§ 3441-3446 (Supp. 1997).

50 See Couch, supra note 39; see also Jeff Gelles, Sale Question: Who Owns Insurance Group?, Phila. Inquirer, Feb. 11, 1997, at A1 (describing conversion of Old Guard Insurance Group and discussing controversy over ownership of company).

the voting rights actually is.[51] Policyholders cannot sell or transfer their stakes in the company. Nor can they vote in proportion to the value of their policies, a condition that decreases policyholders' already weak ability to challenge management.[52] Thus, under the new laws, policyholders may enjoy control of the company in theory, but not in practice.[53]

A second justification for not compensating policyholders is that policyholders can sometimes buy stock in the newly-formed firm. But this ability to purchase, which is not available in every mutual holding company law, may be hollow consolation. Many policyholders will not buy shares either because they are risk averse (which may be why they chose a mutual over a stock insurer in the first place) or because they lack the free capital necessary to invest.[54] Furthermore, policyholders may not understand that they can likely buy stock at a discount to its trading price,[55] or why they should pay for something that they thought they already owned. As one critic of the purchase option said: "That's like someone walking up your driveway, selling your car, and then giving you a chance to buy it back."[56]

The last justification for not compensating policyholders is that policyholders never really expect that their ownership stakes will grow and thus have no claim to any portion of the surplus.[57] This argument ignores two rights historically enjoyed by policyholders. Under the traditional full demutualization laws, as discussed above,[58] policyholders generally possess the right to at least a portion of the surplus when

[51] See Note, Developing a Demutualization Acquisition Strategy for Private Equity Firms, supra note 16, at 1915 (questioning value of policyholders' ownership rights after conversion under new laws).

[52] For more on mutual policyholder disenfranchisement, see supra note 25.

[53] It is also unclear whether the new laws, which essentially strip policyholders of a significant share of their voting rights, can do so constitutionally. Challenges based on the Fourteenth Amendment have been launched against conversions that do not provide policyholders with stock or cash, and more suits are likely as mutuals convert under the new laws. See Note, Developing a Demutualization Acquisition Strategy for Private Equity Firms, supra note 15, at 1914-15 & n.99 (noting suits filed in Pennsylvania raising Fourteenth Amendment challenges); see also Colden, supra note 2 (discussing suits against mutual insurance laws); Gelles, supra note 50 (describing suits against new Pennsylvania law).

[54] See Diane West, Mutual Policyholder Rights Under Review, Nat'l Underwriter Prop. & Casualty/Risk & Benefits Mgmt., Dec. 1, 1997, at 45.

[55] See Mercer to Demutualize Through Rights Offering, Ins. Fin. & Inv., Nov. 17, 1997, available in 1997 WL 12176162.

[56] Betsy McCaughey Ross, Op-Ed, Who is Going to Protect You?, Manhattan Spirit, Nov. 20, 1997, at 5. Indeed, in one of the first conversions under the new laws, only 1,800 of the company's 323,000 policyholders bought shares. See Couch, supra note 39, at G1.

[57] See Gelles, supra note 50 (citing view of Columbia University finance professor Charles Calomiris).

[58] See supra Part II.A.

a mutual dissolves or changes its corporate structure.[59] Policyholders also retain the right to receive dividends.[60] Indeed, in 1996, Prudential paid its policyholders more than $2.5 billion in dividends.[61]

However, the dividend argument also cuts the other way. If policyholders still retain the right to receive dividends under the new laws, it may not be obvious why they deserve anything else. One possible explanation is that the new laws create an inherent conflict between policyholders, who traditionally want dividends to reduce the cost of their policies, and shareholders, who prefer that profits be used for further growth, which in turn will boost share prices.[62] To whom will managers owe their ultimate fiduciary duty: policyholders or shareholders? The new laws do not resolve this question, but managers, if they own stock or options, will obviously have a self-interest to favor stockholders. Furthermore, given the apparent trend away from dividends,[63] it may be unrealistic to expect the new, growth-oriented firms to issue significant dividends.

There is a real risk, therefore, that the conversions under the mutual holding company laws will leave policyholders worse off. If they do not receive any of the accumulated surplus and do not buy stock, policyholders obtain nothing from the demutualization. Their voting stake may drop from 100% to 50.1%. And they face further losses if dividends fail to reduce their premiums, as is likely.

2. *Enriching and Insulating Management*

Another problem with the new laws involves their kid glove treatment of management. Unlike policyholders, executives almost certainly will benefit from conversions under the mutual holding company laws. Provisions in the traditional full demutualization laws severely limit both the amounts and timing of insider stock purchases.

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59 See, e.g., N.Y. Ins. Law § 7307(e)(3) (Consol. 1985) (determining share paid to policyholder based on premiums received over past three years); Wash. Rev. Code Ann. § 48.09.360(3) (West Supp. 1998); see also Clinton, supra note 1, at 659 & n.10; Note, Developing a Demutualization Acquisition Strategy for Private Equity Firms, supra note 15, at 1911-12; Colden, supra note 2.

60 See, e.g., Wash. Rev. Code Ann. § 48.09.300(1) (West 1984) (providing that dividends may be paid out to members); see also Clinton, supra note 1, at 659 & n.9 (noting that policyholders have right to receive dividends).

61 See Treaster, supra note 12 (listing Prudential's dividend payouts).

62 See Scism, supra note 26 (noting conflict between shareholders and policyholders); see also Albert B. Crenshaw, Looking for Stock Answers, D.C. Insurer Finds Questions, Wash. Post, Mar. 30, 1997, at H1 (noting need to divide earnings between policyholders and shareholders).

63 The current dividend ratio is the lowest in seven decades. See Robert O'Brien, Fewer Companies Raise Dividends Even at Time of Healthy Profits, Wall St. J., Jan. 20, 1998, at C2 (noting decline in dividend payouts).

Typically, executives can buy a maximum of five percent of the stock, at least initially, and some laws even require a waiting period of up to five years.[64]

Some of the new laws relax these restrictions. The law pending in New York, for example, contemplates insider ownership of up to eighteen percent of the voting stock.[65] Additionally, many of the new laws include no restrictions on managers' rights to receive stock options or other forms of equity.[66]

Increasing managers' ownership stake has significant benefits, of course. First, stock and stock options better align management's incentives with those of shareholders, rewarding managers for increasing share price. Because stock and stock options help ameliorate conflict between manager and shareholder preferences,[67] they have become standard practice in the past two decades.[68] Second, stock and stock options provide popular and relatively simple ways to increase compensation for mutual executives, who sometimes receive lower salaries than executives at comparable stock insurers.[69] As mutuals face increased competition from stock insurers and banks, it may be vital for them to be able to raise management compensation to competitive levels to ensure future profitability.

But stock and stock options may not be necessary, let alone panaceas, because other methods exist to motivate managers. For example, firms can offer performance-related bonuses. Executives at mutuals also benefit from job security not enjoyed by executives at stock insurers,[70] undercutting the need for equal pay to attract quality management. Furthermore, faith in the beneficence of options has weakened recently. Stockholders increasingly worry that, at a certain level, insider stock option grants can depress earnings, hurting rather than helping owners' interests.[71]

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64 See, e.g., N.Y. Ins. Law § 7312(w)(1)(A)-(B) (Consol. Supp. 1997) (restricting beneficial ownership within first five years); Wis. Stat. § 611.76(4)(f) (1993-94) (providing that directors and officers shall, in the aggregate, acquire no more than five percent of stock for first five years after conversion); see also Clinton, supra note 1, at 689.

65 See Treaster, supra note 23.

66 See, e.g., Vt. Stat. Ann. tit. 8, § 3441 (Supp. 1997) (providing no express restriction on number of stock option grants).

67 Options may be a less effective alignment tool than stock ownership, however, especially when companies permit option repricing.

68 See Abby Shultz, Mutual Funds Report, N.Y. Times, April 5, 1998, § 3, at 46.

69 See Clinton, supra note 1, at 672.

70 See Note, Developing a Demutualization Acquisition Strategy for Private Equity Firms, supra note 15, at 1905-06 & n.21 (stating that mutual insurance managers are not subject to threat of hostile takeovers or proxy contests).

71 See Roger Lowenstein, Microsoft and Its Two Constituencies, Wall St. J., Dec. 4, 1997, at C1 (stating that stock option costs reduced Microsoft's earnings during past four quarters to $2.05 per share from $2.65 per share); see also Lucette Lagnado & Joann S.

Critics also express fear that the new laws will allow the reprise of abuses that occurred when mutual savings and loans converted to stock form. Earlier in the decade, when hundreds of thrifts demutualized, insiders allegedly profited at the expense of the depositors/owners by underpricing the stock or by acquiring more shares than the number to which they were entitled.[72] The evidence is fairly strong that, at least during the heyday of mutual-to-stock thrift conversions, the stock was undervalued: The average first-week price appreciation for the shares issued in more than 100 thrift conversions between January 1, 1992 and April 20, 1994, was 27.7 %.[73] There have not been enough mutual insurer conversions, however, to measure the actual risks of underpricing.

Finally, the new laws protect management from hostile takeovers. Not only is this inefficient, as discussed below,[74] but it also may prove to be an unfair advantage. If some insurers that can sell stock are takeoverproof (making de facto control in those firms extremely valuable), the value of rival stock insurers that remain susceptible to takeovers may drop.[75] These and other concerns recently moved ten large stock-owned insurers to form a lobbying group to oppose the new laws across the country.[76]

Lublin, Columbia/HCA Sets $71 Million Accord With IRS to Settle Compensation Dispute, Wall St. J., Dec. 4, 1997, at B8 (noting IRS's growing interest in reviewing compensation deals).

72 See Jonathan R. Macey & Geoffrey P. Miller, Banking Law and Regulation 327-28 (2d ed. 1997). Managers can buy large amounts of stock at the conversion price and then, once the subscription period is completed, take advantage of the likely increase in value that will occur due to the underpricing. See id.

73 See id. at 328. In some ways, the thrift IPOs were not unique, as most IPOs are underpriced, at least in the short run. See Jonathan A. Shayne & Larry D. Soderquist, Inefficiency in the Market for Initial Public Offerings, 48 Vand. L. Rev. 965, 965 ("On average, the price of IPO stock closes the first day of trading more than ten percent higher than the price at which underwriters began selling it that morning."). Even if the thrift IPOs were not more underpriced than the average IPO, and even if converting mutuals' IPOs are not more underpriced than average, underpricing in converting mutuals remains problematic. In nonmutual IPOs, the underpricing affects all pre-IPO owners equally. In mutual IPOs, executives and others who buy stock, which will likely be sold at a discount to initial trading prices, will benefit from the underpricing, but policyholders who do not buy stock will not.

74 See infra Part III.B.

75 See Stock-Owned Insurers Join Mutual Holding Battles, Best's Ins. News, Jan. 29, 1998, at *3-*4, available in 1998 WL 6566205. An insurer that cannot be acquired incurs fewer costs. For example, such an insurer does not need to hire attorneys and bankers to help put in place defenses against potential hostile acquisitions. The lower costs boost returns. In contrast, insurers that are vulnerable to acquisitions must incur such costs, which decrease returns and hence the value of such a firm.

76 See id. at *1.

3. *Weakening Due Process Protections*

The new laws also dilute due process protections enjoyed by the policyholders. First, some of the new laws alter the standard of approval required by insurance regulators. Under the traditional laws, states typically require insurance commissioners to find that conversions treat the policyholders fairly and equitably before approving a demutualization.[77] Some states require an even higher standard, mandating that demutualizations serve the best interests of the policyholders.[78] In contrast, some of the new laws require merely that mutual holding company conversions not be prejudicial to policyholders.[79] This lower standard likely will ensure that conversions under mutual holding company laws receive easier approval. Although policyholders also must approve any conversion, whether under the traditional or new laws, this requirement is typically pro forma.[80]

Second, the new laws alter policyholders' rights to receive notice and an opportunity to be heard. The traditional laws generally require that commissioners hold public hearings to assess proposed conversions.[81] While many of the new laws continue this requirement, some make a hearing optional.[82] Because the new laws typically do not spell out what rights, if any, policyholders have in hearings that are convened, insurance commissioners have a great deal of discretion.

As the passage of the new laws changes policyholders' role in mutuals, ensuring due process rights is essential. Because the traditional demutualization laws guarantee policyholders certain financial benefits and severely restrict insiders' stock rights, policyholders have

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77 See, e.g., Fla. Stat. § 628.441(2)(a) (1993) (requiring that plan must be "equitable to the insurer's members" before approval); Wash. Rev. Code Ann. § 48.09.350(3) (West Supp. 1998) (providing for reasonable compensation).

78 See, e.g., N.Y. Ins. Law § 7312(j) (Consol. Supp. 1997) (providing that reorganization must be fair and equitable to policyholders).

79 See, e.g., 215 Ill. Comp. Stat. Ann. 5/59.1 (West Supp. 1997) (allowing approval of plan if it "will not prejudice the interests of the members").

80 See Clinton, supra note 1, at 685 (describing shareholder disenfranchisement in these matters); see also Hearing Gets Heated on Principal Conversion Plan, Best's Ins. News, Jan. 26, 1998, available in 1998 WL 6566158 (noting that conversion was approved despite fact that only 150,000 of 700,000 policyholders voted in favor of it). For a fuller discussion of policyholder disenfranchisement, see supra note 25; see also Note, Developing a Demutualization Acquisition Strategy for Private Equity Firms, supra note 15, at 1916 (noting that winning policyholder approval "should not be difficult to achieve").

81 See, e.g., Ark. Code Ann. § 23-69-141(a) (Michie 1994) (requiring hearing before conversion).

82 See, e.g., Vt. Stat. Ann. tit. 8, § 3441 (Supp. 1997) (permitting insurance commissioner to approve conversion without hearing). Even if hearings are held, the laws do not detail policyholders' participation rights.

not had incentives to take an active monitoring role.[83] The new laws do not make these same guarantees, and thus there is an increased need for public participation in the decision process. The growing concern about states' abilities to regulate insurance further argues against decreased due process for policyholders.[84] With tiny staffs and budgets, state regulators cannot be relied on to protect policyholders' interests. The state regulators are especially mismatched against the large mutuals, which have proved adept at influencing legislation and minimizing the impact of watchdog groups.[85]

B. *Potential Benefits of the New Laws*

Although there are clear dangers inherent in the new laws, there are also potential benefits. As discussed above, the new laws may simplify and shorten the conversion process.[86]

Perhaps more importantly, however, the new laws may increase converting mutuals' access to capital by allowing an alternative way for mutuals to convert to stock companies and to sell stock. Such access to the capital markets is vital to any business, but it may be even more crucial in an industry changing as rapidly as insurance. Companies are under intense competitive pressure from two fronts: from their peers in the industry, who can sell stock and are better equipped to raise capital; and from banks and other financial institutions, who are newly allowed to sell insurance products.[87] As the business lines between banks, financial services companies, and mutuals continue to blur, mutual insurance companies may find themselves competing at a disadvantage.[88] If the mutuals are to remain strong in such a competitive market, and compete with giants such as the proposed Citigroup with $700 billion in assets,[89] they need capital to expand their busi-

[83] This may help explain why policyholders seldom participate in hearings and routinely vote in lockstep with management. See Clinton, supra note 1, at 685 (discussing shareholder disenfranchisement problem); see also supra note 25 (same).

[84] See Scott J. Paltrow, The Converted: How Insurance Firms Beat Back an Effort for Stricter Controls, Wall St. J., Feb. 5, 1998, at A1 (noting concerns about states' ability to regulate insurance).

[85] See id. (describing how insurance industry uses various tactics to influence state regulation); see also Melody Petersen, Prudential's Leader Knows His Way Around New Jersey, N.Y. Times, Feb. 13, 1998, at D1 (describing Prudential CEO's success at influencing state regulators).

[86] See supra Part I. Legal challenges to the new laws and to individual conversions may minimize the time-saving aspects of the new laws.

[87] See LIAM Lobbying Material, supra note 29.

[88] See id.; see also 12 C.F.R. § 5.34 (1995) (authorizing national banks to conduct greater insurance activities in nonbank subsidiaries).

[89] Timothy L. O'Brien & Joseph B. Treaster, A $70 Billion Pact, N.Y. Times, Apr. 7, 1998, at A1.

nesses and make strategic acquisitions.[90] Only the financially strong firms will be well-positioned to provide a broad range of conveniently packaged, competitively priced products and services.[91]

The increased access to capital largely will benefit shareholders in the revamped insurance firms. It is also possible, however, that the new laws will benefit some if not all of the policyholders. Policyholders who buy stock will gain if the stock appreciates (and lose if the stock depreciates). But policyholders who do not buy stock might also benefit from the mutual holding company structure, at least in the long run. For example, if the company grows, policyholders may retain life insurance in a better-capitalized, more diversified, and thus safer, firm. And if the company issues generous dividends to policyholders, the policyholders' out-of-pocket life insurance costs will decrease. Of course, this everybody-is-a-winner forecast relies on a number of optimistic assumptions: The company must do well in an increasingly competitive industry; the company must buck current market trends by raising or maintaining dividends at a time when many companies are lowering them; and the company's directors must somehow navigate the conflicting interests of shareholders and policyholders.

Given their inherent risks—stripping policyholders of assets, enriching and insulating insiders, and weakening due process protections—and their potential reward—increasing growth in a fiercely competitive market—what is the proper response to these new laws? Part III offers a brief answer to this question.

III
The Desirable Legal Framework

In assessing the mutual holding company laws, two standards are relevant. The first is whether the new laws protect the rights of the owners—the policyholders. This inquiry is important to the extent that the new laws threaten to strip policyholders of rights or legitimate expectations without adequate compensation.[92] The second is

90 See LIAM Lobbying Material, supra note 29.

91 See id.

92 Conversions under the new laws threaten policyholders' rights and upset policyholders' legitimate expectations in a number of ways: first, by diluting policyholders' voting rights and due process protections; second, by making it less likely that converting mutuals will issue generous dividends, thus increasing policyholders' out-of-pocket insurance costs; and third, by turning companies with a single constituency (policyholders) into firms with multiple constituencies (policyholders and stockholders) with competing interests. This last point is particularly troublesome given that managers, who likely will own stock, will have an obvious self-interest to favor stockholders. See supra Part II.A.2. The new laws also might allow managers unilaterally to opt out of an implied contract with policyholders.

whether the mutual holding company laws are efficient. This question is important to the extent that, all else being equal, legal rules should promote efficiency.[93] This Part assumes that protecting policyholders' rights from inadequate compensation is the paramount concern but notes that the best legal rules will serve both ends. Against this background, Parts III.A. and III.B. analyze the traditional demutualization and mutual holding company laws respectively. Part III.C. suggests an optimal legal framework.

A. The Traditional Full Demutualization Laws

How do the traditional full demutualization laws fare under these two standards? As discussed above, the traditional laws appear to protect policyholder interests adequately compared to the new laws.[94] First, during most conversions, policyholders typically receive a fair distribution in exchange for tendering their ownership rights.[95] Second, conversions under the traditional laws must treat policyholders fairly and equitably, at a minimum, in order to win regulatory approval.[96] As a result, policyholders receive either cash or stock and retain their policies.

It is harder to ascertain whether conversions under the traditional laws are economically efficient. Some experts have argued that mutu-

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One reason for a mutual form is that it permits both the firm and the policyholder to share nondiversifiable risks, such as the risk of broad securities market fluctuations or the risk of interest rate changes. Allowing converting mutuals to sell stock impinges on this risk-sharing benefit and allows the firm to opt out of a deal that also reduced policyholder risk. Another reason for a mutual form is that it permits the firm to take a long-term view. The firm does not have to answer to shareholders and concern itself with quarterly earnings expectations. Allowing converting mutuals to sell stock may undermine the firm's ability to take a long-term view and thus permit the firm to opt out of another implied deal with policyholders.

93 See generally Frank H. Easterbrook, The Supreme Court, 1983 Term—Foreword: The Court and the Economic System, 98 Harv. L. Rev. 4 (1984) (arguing that judges who appreciate economics of legislation will be good agents); Richard A. Epstein, Law and Economics: Its Glorious Past and Cloudy Future, 64 U. Chi. L. Rev. 1167 (1997) (arguing that one point of legal rules is to create incentives to minimize any divergence between private and social costs); Richard A. Posner, An Economic Theory of the Criminal Law, 85 Colum. L. Rev. 1193 (1985) (arguing that substantive doctrines of criminal law, as of common law in general, can be given economic meaning and be shown to promote efficiency). The two standards—protecting policyholders' rights from inadequate compensation and promoting efficiency—are related. If the new laws allow mutual managers to convert without adequately compensating policyholders for their rights, managers will have an incentive to act inefficiently. If, on the other hand, the new laws require adequate compensation, managers will have an incentive to act efficiently.

94 See supra Part II.A.1.

95 See Note, Developing a Demutualization Acquisition Strategy for Private Equity Firms, supra note 15, at 1914 n.96 (listing payouts in recent conversions).

96 See supra Part II.A.3.

als are not competitive, in part because mutuals are not subject to the constraints of the market for corporate control and because mutuals lack easy access to capital.[97] Over time, mutuals may not be able to keep up with their more growth-oriented, better-capitalized stock peers. Although inconclusive, the evidence tends to support this thesis. For many years, the assets of stock companies have grown more rapidly than those of mutuals, and the number of mutuals has declined steadily since 1954.[98] Few mutuals have formed since 1954, and many have converted or merged.[99] During this period, few stock companies have become mutuals.[100] To the extent the traditional laws encourage conversions, they probably benefit society.[101]

At the same time, the traditional laws require that mutuals endure a lengthy demutualization process, which includes determining the allocable share value of policyholders' interest. To the degree that the traditional laws discourage demutualization because of their cumbersome processes, or to the degree they foreclose demutualization by smaller mutuals, they may be inefficient.[102]

B. *The Mutual Holding Company Laws*

The mutual holding company laws do not appear to protect policyholders adequately. On the one hand, as discussed above, the new laws threaten policyholders' exclusive ownership rights to a portion of the surplus and to dividends, weaken policyholders' due process protections, enrich and insulate management, and create a conflict of interest between policyholders and stockholders.[103] On the other hand, the new laws may better align present mutual executives' incentives with those of policyholders who own stock. In spite of the countervailing factors cited above, this change may benefit policyholders who own stock (if optimistic growth projections are realized) and may even benefit policyholders who do not own stock (if generous dividends are paid). Although there may not be enough data to conclude with certainty whether policyholders will be better or worse off, it seems more likely that the new laws leave policyholders worse off, at least in the

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97 See Clinton, supra note 1, at 673.

98 See Frederick S. Townsend, Mutual Life Insurers Earning Dividend Scales, Nat'l Underwriter Life & Health/Fin. Servs. Edition, Nov. 17, 1997, at 4 (noting decline in number of mutual life insurers from 171 in 1953 to 91 in 1996); see also Note, Developing a Demutualization Acquisition Strategy for Private Equity Firms, supra note 15, at 1906.

99 See Clinton, supra note 1, at 674.

100 See id.

101 See id. (arguing that demutualization "probably benefits society" because stock corporations are more performance driven than mutuals).

102 See supra Parts II.A.1. & II.A.3.

103 See supra Part II.A.

short run. The traditional laws generally guarantee policyholders more procedural safeguards and either cash or stock up front. In contrast, the new laws offer fewer procedural safeguards and only the promise of potential profits or dividends down the road. Even a CEO of a converting mutual company stated that converting under the traditional laws is "clearly . . . in the best interests of policyholders."[104]

It is also doubtful that the new laws are efficient. To be sure, the new laws provide an alternative way to access the capital markets.[105] The new laws may also provide this access more simply and quickly than the traditional laws do,[106] which may help mutuals stay competitive. At the same time, however, conversions under the new laws do not expose managers to the takeover market. Since it is the very threat of a hostile bidder that helps discipline managers and focus them on performance,[107] in this respect the new laws encourage less efficient outcomes than the traditional demutualization laws.

Moreover, with generous stock and stock option purchase rules for insiders, the new laws may promote further inefficiencies. Specifically, the new laws simplify the conversion process and increase managers' rewards for conversion, thus giving managers a significant personal incentive to convert and issue stock, regardless of whether such conversions are really worthwhile. Indeed, because managers will not have to pay policyholders anything, managers may be encouraged to take property rights without paying the market value, risking too many conversions from an efficiency perspective.

C. The Desirable Legal Framework

1. Just Say No

The previous sections demonstrate that the traditional laws are preferable because they better protect policyholders and promote efficiency than do the new laws.[108] Ideally, then, legislators should repeal any mutual holding company laws already passed, vote against mutual holding company legislation in states where it is pending, and work to improve the traditional demutualization process.

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104 See Bailey & Syre, supra note 16 (quoting Ronald E. Timpe, CEO of Standard Insurance).

105 See supra note 90 and accompanying text.

106 See supra notes 38-39 and accompanying text.

107 See Note, Developing a Demutualization Acquisition Strategy for Private Equity Firms, supra note 15, at 1905 & n.20 (noting importance of exposure to takeover market).

108 See supra Parts III.A. and III.B. The new laws might better promote efficiency if the time required to demutualize under the traditional laws significantly deters conversions. This seems unlikely, however, given the steady pace of conversions over the years. In any event, only conversions under the traditional laws subject managers to the efficiency-enhancing market for corporate control.

2. *Second Best: Improve the New Laws Incrementally*

However, given the industry preference for the new laws and the strength of the insurance lobby, mutual holding company legislation already on the books may be hard to remove. Whether or not more states will pass the new laws remains more difficult to predict. New York and Massachusetts, two bellwether states with large mutuals, have not yet passed mutual holding company laws, and the National Association of Insurance Commissioners is working on a white paper that, as of this writing, raises significant concerns about the new laws.[109] At the same time, many states that have not yet passed the new laws may believe it is necessary to do so to avoid placing mutuals in their states at a competitive disadvantage. A race to the bottom may be underway, undermining opposition to the new laws.[110] Assuming, therefore, that more states ignore the inherent flaws in the mutual holding company structure and pass the new laws, this section proposes a variety of ways to improve such legislation.

First, the mutual holding company laws should be changed to better protect policyholders. As a general rule, any mutual holding company law should include a number of basic protections. Insurance regulators should be required to hold hearings to aid them in determining whether to approve a particular conversion. Policyholders should receive adequate notice, including a detailed plan of reorganization from the board of directors, and an opportunity to be heard at such hearings, if not an opportunity to communicate with other policyholders prior to such hearings. Also, insurance commissioners should be required to approve conversion plans only if policyholder interests are protected, the plan is in the best interests of policyholders, and the newly converted stock insurer will satisfy the requirements for issuance of a license to write insurance. Furthermore, given the impact of demutualization on policyholders' rights, states should consider raising the necessary level of policyholder participation in the approval process by requiring at least a majority, if not two-thirds of all policyholders, not merely those voting, to vote in favor of converting. At a minimum, these changes to the process will provide insurance com-

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109 See NAIC Draft of White Paper, supra note 7, at 31 (stating that proponents of new laws appear unable to suggest statutory language that does not diminish or dilute either contractual or ownership rights of policyholders).

110 "Race to the bottom" is a shorthand term for the idea that since some states now permit the new-style demutualization, other states may follow. This result is possible because many mutuals may want the opportunity to convert under the new laws, and will use the availability of such an opportunity in other states as leverage in an attempt to push new laws in their home states. The threat of losing mutuals' jobs and tax revenues, however unrealistic, may persuade states to adopt the new laws, as is already happening.

missioners with more information and expose the conversion process to greater scrutiny.

Separately, in an effort to prevent insiders from turning the new laws into get-rich-quick schemes, the new laws should require waiting periods before managers can buy stock or receive options, and tighter appraisals of initial stock prices.[111] These safeguards will decrease the possibility that executives will wind up exponentially increasing their salaries without providing value in return to policyholders and shareholders. The new laws should also raise the required capital base to lessen the risk that firms will become insolvent.[112]

Finally, a number of options exist to funnel portions of the surplus to policyholders. The new laws could require that some amount of stock in the newly-formed company be automatically distributed to policyholders.[113] As a second best option, the new laws could lengthen the purchase period. Some policyholders might wish to buy shares in mutual holding company conversions but lack the needed capital at the initial offering. Giving policyholders more time would ensure that more policyholders who want to buy stock could do so.

To be sure, problems remain. First, even the above measures will not necessarily ensure that policyholders are appropriately compensated. Second, the new laws continue to shield managers from the market for corporate control, perpetuating undesirable inefficiencies. Third, the mutual holding company structure creates an inherent conflict of interest between the policyholders and stockholders.

These problems are difficult, if not impossible, to solve. The mutual holding company laws simply do not allow for the comprehensive safeguards available under the traditional demutualization process. Accordingly, states should hesitate before passing mutual holding company legislation.

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111 This safeguard has been implemented through federal regulation as a response to the same insider scheming problem in the analogous context of thrift demutualizations. See Macey & Miller, supra note 72, at 329.

112 See Bailey & Syre, supra note 19, at C1 (describing addition to proposed state mutual holding law increasing capital base by 50%).

113 One potential way to ensure that policyholders get the highest price of such shares involves holding an auction. This idea was advocated by one commentator six years ago. See Clinton, supra note 1, at 700-04 (discussing implications of auction system). Under this proposal, a market valuation procedure would require a converting company to auction itself via a public offering or by offering an equity interest to third parties. This might help protect policyholders because a market auction would presumably return the highest price to policyholders. The auction, however, would not necessarily improve the cumbersome nature of traditional demutualization.

3. *Improve the Regulatory Process*

Regardless of how states resolve the mutual holding company debate, the present state-by-state insurance system needs to be reevaluated. Generally, state insurance regulators have tiny staffs and budgets compared with the enormous companies that they oversee.[114] Moreover, there is sometimes a clubhouse relationship between many regulators and the industry; regulators are often from the industry and often return to insurance jobs after a stint in government.[115] As Neil Levin, the New York Insurance Commissioner, says: "[U]nless the state-by-state system of insurance regulation becomes much more 'effective, efficient and coordinated,' the creation of a federal insurance regulator 'is going to start to look pretty compelling.'"[116] For similar reasons, the federal government already dominates regulation of most financial services and markets.

While creating a superregulator for insurance and other financial markets may or may not be the best solution—that issue is beyond the scope of this Note—it will probably not happen soon, if at all. The insurance industry likely will oppose such a major change to the present system, as it has in the past.[117] The insurance industry, said one insurance commissioner, would "rather be regulated by 50 monkeys than one big gorilla."[118]

Moreover, there is no reason to assume that one superregulator would be a step in the right direction. Rather, the better response to concerns about insurance regulation may be for state insurance commissioners to work together through the National Association of Insurance Commissioners to perform better, more comprehensive scrutiny of conversions and demutualization laws. Such a move presumably would make full demutualizations easier and more likely. More conversions under the traditional laws likely will boost efficiencies and better protect policyholders' interests, especially if the insurance industry's influence over its own regulation is weakened simultaneously.

Of course, improvements to the regulatory process will not address the problems inherent in the mutual holding company laws. These problems are ones that only a full demutualization under the traditional laws can address.

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114 See Joseph B. Treaster, Financial Services Consolidate, But Regulation Is Still Fragmented, N.Y. Times, Jan. 2, 1998, at D1.

115 See id.

116 Id.

117 See supra notes 84-85 and accompanying text.

118 Paltrow, supra note 84 (quoting Missouri Insurance Commissioner Jay Angoff).

CONCLUSION

Mutual life insurers write almost half of the life insurance policies in the United States. Until recently, policyholders in mutuals generally enjoyed a basic level of ownership rights and protections. However, in the past few years, and with little public debate, fifteen states and the District of Columbia have passed mutual holding company laws. The new laws provide mutuals with an alternative way to convert to stock companies and sell stock to the public, but in the process they radically alter mutual policyholders' rights.

Three major problems beset the new laws. First, under the new laws, mutuals may convert and sell stock without compensating policyholders and with less due process than under the traditional full demutualization laws. Second, the new laws will enrich mutual executives without subjecting them to the threat and discipline of market forces. Third, the mutual holding company structure creates an inherent conflict of interest between policyholders and stockholders, and gives managers, who will own stock and options, an obvious self-interest to favor stockholders. At the same time, however, the new laws provide potential benefits. The new laws might increase growth, reward shareholders in the new companies, and create more diverse, stronger institutions, making life insurance policies in such firms less risky.

Against this background, this Note concludes that the new laws neither adequately protect policyholders' interests nor promote efficiency. Despite their potential benefits, the new laws contain some inherent and unremediable flaws. As a result, mutual holding company legislation should be repealed, where already the law, and opposed where bills are pending. The best way to protect policyholders' interests and promote efficiency is to improve the traditional full demutualization and regulatory process and promote conversions under the traditional laws. Absent such improvements, however, it seems possible that more states will pass the mutual holding company laws, leading to the slow but certain reorganization of mutual life insurance firms.