Demutualization Innovations

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Two recent transactions represent significant innovations in the demutualization of mutual insurance companies.

The first, the formation by Nodak Mutual Insurance Company of a mutual holding company, the sale of a 45% interest in an intermediate holding company, and a related distribution of cash to Nodak policyholders, represents a fundamental development in the subscription rights demutualization model. The second, the full conversion of Illinois Casualty Company to stock form with the assistance of minority standby investors, while not as transformative, may open up even more opportunity for mutuals seeking capital without loss of control.

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Insurance demutualizations come in two forms. The first is a so-called distribution rights conversion in which policyholder members are given stock or cash for free in an amount typically equal to the converting company's statutory surplus, and the converted company then seeks additional capital from investors. In theory, this model protects the latent economic interest of members in the mutual's surplus. But this model creates an enormous barrier to demutualization for all but the largest companies (e.g., The Principal, Met Life, Prudential). Few mutuals can raise meaningful capital after first giving away their entire surplus to members. As a result, this type of demutualization rarely occurs. The castle wall that the distribution rights model erects to protect mutual members is so high that whatever latent economic interest mutual members do have is illusory—the value is never realized.

The second form of demutualization is the subscription rights model. In this model mutual members are given the first right to purchase stock at a steep discount to book value, but they do not receive anything for free. This method—modeled after federal law governing thrift conversions—is the law in fewer jurisdictions (about 11) and is possible in several more with insurance department approval. Use of the subscription rights model has been successful each time it has been tried, but it too presents challenges that mutuals sometimes see as an impediment. These challenges include the following:

- Full demutualization frequently results in such a large amount of capital that it cannot be prudently deployed in a reasonable amount of time.
- Despite the fact that the investment is generally attractive, policyholder participation is typically low, which exposes management to the criticism that the transaction is an insiders' game whose goal is management enrichment.
- Full demutualization represents the end of the mutual form that many companies legitimately cherish for historical, governance and other reasons. Conversely, as a stock company, the specter of shareholder activism and possible loss of control looms.

The Nodak transaction addresses each of these concerns by using a 2015 North Dakota subscription rights law that makes two changes to the subscription rights model. The first and biggest change requires the valuation of subscription rights. Like other subscription rights laws, the law lays out a detailed path for a full or mutual holding company conversion through the grant of subscription rights to policyholder members. But in a groundbreaking change to the model, the law then requires payment of compensation to policyholder members who do not exercise their subscription rights. Those policyholder members are deemed to have elected to redeem their subscription rights for cash. The value of the rights is determined using a Black-Scholes option pricing model. This modification to the model solves the policyholder participation issue. Under this model all policyholders participate, either by purchasing stock or redeeming their rights for cash.

The second change addresses explicitly what other laws do, at best, implicitly. The law addresses the remaining interest of policyholder members in the surplus of a mutual holding company that makes a minority stock offering. The insurance landscape is dotted with numerous mutual holding companies, but almost none have used the structure as a capital formation device. Why? Because in distribution rights states the ability to raise capital is severely constrained since investors get no interest in the underlying equity, which still "belongs" to the policyholder members. The North Dakota legislation provides policyholder members with the right to purchase stock or redeem their rights for cash. However, once given the right to purchase stock or redeem their rights, the policyholder members have no further right to the surplus of the converting company. In a full conversion, they relinquish their right to the entire surplus. The North Dakota law makes it clear that in a mutual holding company conversion they also relinquish their right to the extent of the percentage of the company they were offered. Thus, if a mutual holding company completes a minority stock offering of a 45% interest in the company to policyholder members and the public, the policyholder members thereafter have a 55% interest in the underlying equity. If the mutual holding company ever does a so-called "second step" conversion and becomes a full stock company, policyholder members must be offered 55% of the company—not 100%. By selling stock to policyholder members or redeeming their subscription rights for cash in the initial minority offering, the mutual holding company has forever demutualized 45% of the company.

In Nodak, the compay first had to choose whether to fully demutualize or form a mutual holding company and conduct a minority offering. Nodak concluded that a full conversion would yield too much capital to deploy in a reasonable amount of time. It chose a mutual holding company structure and conducted a minority stock offering. By choosing the mutual holding company structure Nodak also preserved mutuality and control. In the offering 10,350,000 shares were issued to policyholders and the public at $10 per share, which represented 45% of the company. Policyholder members who purchased stock did so at approximately 60% of book value. Those who elected to redeem their subscription rights received cash distributions totaling $5.7 million.

The Nodak transaction represents the first subscription rights conversion by an insurance mutual holding company and the first conversion of any kind in which mutual members could redeem their subscription rights for cash. This innovative structure allowed Nodak to preserve mutuality and control, raise the right amount of capital, and provide value to all policyholder members—not just those who elected to purchase stock.

The second transaction, the Illinois Casualty demutualization, had as its principal objective the formation of capital in a manner that insures continued independence for the company. Management is relatively young and believes the company has substantial growth opportunities in its commercial niche. The company needed capital to fund this strategic growth plan, but it did not want to face unreasonable shareholder demands that could derail its strategy. The solution was the use of minority standby investors. Illinois Casualty conducted a typical subscription rights conversion in which stock was offered and sold to policyholders, an employee stock ownership plan and directors, officers and employees. But then, rather than sell all remaining stock to the public, which injects the risk of activist investors, a portion of the remaining shares was sold to investors who agreed to sign a "standstill agreement." These investors were identified and the standstill agreement was in place prior to the commencement of the offering. Under the standstill agreement these standby investors agreed not to buy or sell any shares for three years, and for the ensuing four years they could sell stock, but only if they first offered their stock back to the company. This gives the company or its ESOP the ability to repurchase shares and accrete the ownership position of management and other long term shareholders, thereby retaining control.

The offering was closed at $35.0 million, and $14 million (40%) of the stock was placed with three standby investors who signed the standstill agreement. This transaction represents the first ever subscription rights conversion in which the standby investor structure was used to insure control remained in friendly hands. Illinois Casualty now has the capital it needs to fund organic growth and the time it needs to implement its strategy.

Taken together, these two transactions have the potential to reshape the demutualization landscape by addressing key impediments to the use of the subscription rights model. The distribution model, as evidenced by its lack of use, has proven to be a barrier both to capital formation for companies and value creation for the policyholders it supposedly protects. States that have the distribution model would do well to consider replacing it with the new and improved subscription rights model. This would provide companies with capital flexibility and policyholders with the potential to receive value rather than possess an illusion of value.