EMERGING ISSUES FOR BOARDS OF MUTUALS

Emerging Issues for Boards of Mutual Insurance Companies
KEY ISSUES

1. COVID-19
2. Growth & Structural Alternatives
3. Legislative/Regulatory/Litigation
4. Social Purpose/Social Justice
5. Policyholder Activism

Remember...
What is Corporate Governance?
Governance Roles Are:

• For the board *to give direction*, which it does by granting authority and setting limits and *provide oversight* to the organization

• For management *to execute direction*, which it does by exercising that authority subject to those limits

ONE OF THE THREE BASIC PRINCIPLES OF STATE CORPORATION LAW

1. All authority for
   • *Decision making* as to matters of *policy, direction, strategy* and governance; and
   • *Oversight* as to matters *critical to the health of the organization* for its various stakeholders

   is to be exercised under the *direction* of the organization’s board;
DUTY OF CARE

- Why are we doing it? (i.e., what issues are involved in the action?)
  - What are the risks?
    - Financial
    - Operational
    - Legal
    - Ethical
    - Reputation
    - Strategic

*UNIQUE THAT ALL ARE PRESENT IN OUR OVERSIGHT ROLE DURING COVID-19*
COVID-19 has created unique and interesting challenges
COVID-19 has placed a spotlight on certain risks (new and existing) that Boards should be addressing.

WHAT CAN BOARDS BE DOING?/QUESTIONS TO ASK

1. Logistics: Board Governance/Continuity
   - Is the board positioned/prepared for remote meetings (both full board/committees)?
   - Has the board increased the number of meetings (full board/committee) to address COVID-19 matters?
   - How are board members communicating with each other? Company email? Private email? Text messaging? All are impacted by litigation discovery, document holds, and document retention plans

2. Do you have a risk reporting system/process in place-Does it now include COVID-19 risks that are being reported to the Board?
   - Is the board actively monitoring so it stays informed of material business risks and red flags

3. Consider forming a separate board committee to address COVID-19 issues.
WHAT CAN BOARDS BE DOING?/QUESTIONS TO ASK

4. Enhancing communications with management
   • Consider increasing dialogue with company management on business risks and workplace health safety issues
   • Review legal/regulatory developments regarding COVID-19 at state and federal level
   • Review company’s risk-mitigation policies/protocols- and adjust as necessary
   • Meet frequently to discuss updates
   • Board should be clear with management as to Board’s expectations with respect to management responsibility to report to the Board regarding COVID-19 matters

5. Confirming/Reassessing feasibility of disaster plan / remote working plan
   • Is your current plan working?
   • Where are the gaps/issues? And have they been addressed?
   • Where can we get better?

6. Evaluating potential disruptions to operations and business relationships
   • Changes in travel policies- will it impact operations
   • Potential for increased cybercrime due to a remote access workforce (data breach through remote access devices)
   • System capacity and integrity for new model

7. Health & Safety of workforce
   • Safety of employees
   • HIPPA obligations to notify employees of positive results

8. Business Continuity
   • Employee/Workforce disruption
   • Product Disruption: State regulations creating moratorium on policy terminations
   • Financial Impact/Liquidity
WHAT CAN BOARDS BE DOING?/QUESTIONS TO ASK

9. Reviewing board and management succession plans (both short-term/long-term, temporary/permanent)

10. Reviewing / Reassessing long-term corporate strategy
   • How will this impact our strategic plans?
   • Are there new strategic opportunities?

11. Reviewing / Assessing Executive Compensation
   • Due incentives need to be reworked to ensure appropriate behaviors are encouraged
   • Delaying incentive plan goals or structure flexibility in plans

WHAT’S NEXT: POST-COVID

1. What are the anticipated lasting effects/changes in behavior that may continue—will our short term COVID plans stand with time? Will additional investment be needed?

2. Look back - were we prepared for this “black swan” event?

3. What are our “lessons learned”?
Key issues today that boards need to be aware of have grown out of COVID-19:

- Premium Relief
- Cancellations
- Business Interruption
GROWTH & STRUCTURAL ALTERNATIVES

1. Mutual Insurance Holding Companies
2. Mergers
3. Affiliations
4. Alternative Investments/Insurtech
MUTUAL INSURANCE HOLDING COMPANY – WHERE DID IT COME FROM?

- Began it the late 90s as an alternative to currently available structures for mutuals
- Allows mutuals to address differences between mutual and stock insurers
- Primarily utilized, at first, by mutual life insurers
- Few early adopted P&C companies (Liberty Mutual, Maine Mutual Group)

MUTUAL INSURANCE HOLDING COMPANY – WHAT IS IT?

- A method for mutual insurance companies to re-organize and create a multi-level insurance holding company system
- Creates two new entities:
  (i) a Mutual Insurance Holding Company (MHC), a non-stock corporation which is the holding company system parent; and
  (ii) a Intermediate Stock Holding Company (SHC), a subsidiary of the MHC.
- AND... the original mutual insurance company is converted into a stock insurance company (which is controlled by its new shareholder, the SHC)
- At all times, 51% or more of the ownership rights (the majority) in the SHC must be held by the MHC
**MUTUAL INSURANCE HOLDING COMPANY – WHAT IS IT?**

- In a MHC reorganization, the governance/membership rights and the contractual rights of policyholders are separated
  - The contractual rights remain with the writing company (the converted mutual)
    - All policy terms and contractual obligations are unchanged as a result of the reorganization
  - The membership rights are transferred to the new MHC

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**MEMBERS’ RIGHTS**

- **Contractual/Financial Rights**
  - Contractual right to have valid claims paid when due
  - Receive premium refund when policy cancelled
- **Governance/Membership Rights**
  - To have a say in how the entity is managed/election of directors
  - To approve conversions/mergers/amendments to Articles (and other governing documents potentially)
  - Right to receive dividend if declared by the board
  - Right to equitable portion of surplus upon certain events (liquidation/demutualization)
MUTUAL INSURANCE HOLDING COMPANY:
PRIOR TO REORGANIZATION

Policyholders

Mutual Insurance Company

Subsidiaries

MUTUAL INSURANCE HOLDING COMPANY:
AFTER REORGANIZATION

Policyholders

Mutual Insurance Holding Company

Intermediate Stock Holding Company

Converted Mutual Insurance Company

Outside Shareholders (hold minority of voting stock, if any)

New Subsidiaries
**MUTUAL INSURANCE HOLDING COMPANY**

Key Benefits / Why Are Mutuals Converting?:

1. Creates a structure for mutual insurance companies to **retain mutuality benefits but also raise capital** (through the Intermediate Stock Company) - if desired. Accessing the capital markets is not part of the majority of MHC conversions.
2. Creates flexibility for mergers/acquisitions
3. Allows mutuals to **diversify their operations while retaining the mutual aspect of policyholder membership – invest in InsurTech and/or other non-insurance ancillary businesses**
4. Can **extend mutuality benefits** to future downstream subsidiaries
5. Other benefits: **Clean-up governance structure** (e.g. one-true board, **create legal insurance group, maintain membership interests** for those policyholder that move between companies, and accounting and expense issues (including longer amortization period for system replacements))

**MHC: RAISING CAPITAL**

- Mutual Insurance Companies have limited ways to raise capital:
  - Issue surplus notes
  - Obtain bank loan
- As a MHC, the entity could still do the above AND would be able to:
  - Engage in a public or private offering (through the downstream stock company) of equity, debt or convertible notes
  - The sale of stock could be done in conjunction with the reorganization or at a later date
  - Reorganizing as a MHC- **does not require your company to issue stock or become a publicly traded company**
MHC: FLEXIBILITY FOR M&A

- Allows the group to maintain separate legal entities of insurance companies that comprise the group
- Preserves the existing name and brand of each entity
  - Allows other mutuals to merge into the MHC (separating their membership/contractual rights)
  - Can get same benefits of affiliation without using affiliation model but merging into the MHC
- Allows for non-insurance operations in separate entity and flow of funds from those operations upstream

MHC: ANCILLARY/NON-INSURANCE OPERATIONS

- Allows the group to invest in ancillary non-insurance businesses
- Act outside current regulatory restraints
  - Investments are restricted by state law—under this structure the group could make investments in Insurtech, other financial services companies, and other entities that benefit members via the SHC and not be constrained by state law restrictions of investments by insurance companies
MHC: EXTENDING MUTUALITY BENEFITS

- Permits converting mutual insurance companies to extend mutuality benefits to all or select downstream subsidiaries in the future (if created)

MHC: OTHER BENEFITS

- Clean-up governance structure (e.g. one-true board, create legal insurance group)
- Maintain membership interests for those policyholder that move between companies (or future subsidiary writing companies)
- Accounting and expense issues (including longer amortization period for system replacements)
RECENT P&C CONVERSIONS

Key components for Approval of MHC Reorganization:
  • Preparing Plan of Reorganization/MHC Conversion agreement
  • Approval by the boards of directors
  • Regulatory approval by Department of Insurance and approval by the members
  • Acceptance by Secretary of State of reorganization filings

Other considerations:
  • Messaging of the rationale for the reorganization to (i) employees; (ii) agents; (iii) members/policyholder; (iv) community
CONSIDERATIONS GOING FORWARD THAT COULD IMPACT DECISION

- Timing considerations
  - Regulator review/Regulator tenure
- PR/Reaction from members
- Cost
- Time consuming
- Re-branding
- Impact to tolerance metrics and rating impact

MUTUAL HOLDING COMPANY

- Timing:
  - Conversions may take one year (maybe more if raising capital) to complete (plan for at a minimum 9 months from Board approval to “move forward” (likely a few more))
  - Timing is dependent on:
    - Department of Insurance
    - Market/policyholder reaction to the announcement of the conversion
    - Complexity of the conversion (does it include a public offering, how many states are involved, are there other transactions connected with the reorganization)
MERGERS & AFFILIATIONS

1. Important to understand options available
2. Important to understand the differences between Mergers & Affiliations

ALTERNATIVE INVESTMENTS/INSURTECH

1. Not your typical investment for insurance companies
2. Important to understand how to best protect your investment as it is a risky investment
SOCIAL PURPOSE & SOCIAL JUSTICE

- Boards need to address recent social unrest/racial tension sparked by the death of George Floyd
- Remember certain states have “constituency statutes” that allow board members to take into account other factors in their decision making/oversight role, including: employees, communities and other stakeholders
- Some companies have demonstrated commitment to social purpose to communities and employees by keeping employees on payroll, extending benefits post-termination or during furlough, self imposing premium relief, or donating to local charities
- Some have chosen not to do so or did not believe they could for the best interests of its members
- Decision focuses on brand and reputational risk of engaging or not engaging in such practices
POLICYHOLDER ACTIVISM

PAST QUESTIONS

• Can we be acquired?
• Can we be the subject of a “hostile takeover”?
• Can we be forced by a third party to take some action?
IS ACTIVISM REALLY HAPPENING & WHAT DOES IT LOOK LIKE & WHAT DO YOU DO?

Economical Mutual Insurance Company
RECOGNIZE THE DIFFERENCE

• There is a difference between:
  – a member participating in the governance of the organization pursuant to their membership rights; and
  – a member trying to force a change for his / her sole benefit

IS THIS REALLY HAPPENING & WHAT DO YOU DO?

Either directly, or indirectly, you receive word that a member is:

1. Requesting a copy of the mutual’s governing documents?
   • What do you do?
   • Why?
   • Are they already publicly available? On the company’s website?
2. Requesting a copy of the investment committee charter and investment policy statement?

- What do you do?
- Why?
- Are either of these publicly available? Should they be? Are these documents proprietary, confidential, subject to policyholder/member review?

3. Requesting a copy of the membership list?

- What do you do?
- Why?
- Should this be available for review?
4. Requesting answers to specific questions about the board composition, nomination process, nominating & governance committee?

- What would you do?
- Why?
- Should this information be discussed?

WHAT IF...

In each of the prior examples-what if:
1. The requests were not isolated requests but a series of requests from the same member
2. The requests come from an agent with a significant book on behalf of “several unknown policyholders”
3. It was not just one policyholder but multiple policyholders?

- Would your response be different?
- Should it be?
WHAT IF...

• In each of the prior examples – what if:
  1. You find out that the member is requesting the same information from another mutual that he/she (or their company) is also member
  2. You learn (separate from your communications with the member) that the member is also meeting with members of the state legislature to “discuss” insurance regulations related to mutual insurance companies
  3. You learn (separate from your communications with the member) that the member has engaged a lobbyist in connection with his/her meetings with state legislature regarding insurance regulations related to mutual insurance companies, primarily your state's demutualization statute
  4. You learn (separate from your communications with the member) that the member has met with representatives from your state’s Department of Insurance to discuss “acquiring/taking over” a mutual
  5. You learn (separate from your communications with the member) that the member’s engagement of the lobbyist was “funded” by a third party that is interested in changing the demutualization statute
  6. You learn (separate from your communications with the member) that the member has approached at least one employee and offered the employee a job once the member “takes over the company” in exchange for executing a non-disclosure agreement and sharing information

IS THIS REALLY HAPPENING?

• Of the scenarios described on the last page—
  • Do you think has happened or is happening to at least one mutual?
  • What about to more than one mutual?
  • What about mutuals in different states?
IS IT REALLY HAPPENING?

• YES- it is real
• YES- it is on-going
• YES- you should be prepared

• Note: this is different from a policyholder(s) participating at the annual meeting in person. These are concerted efforts to change the structure of company, the board or both.

WHAT CAN YOU DO?

1. Begin considering the issue today—being proactive is better than reactive in such situations
2. Amend / Restate Governing Documents to add specific protective provisions
3. Create meeting procedures and requirements that will eliminate any surprises—you need time to investigate what is actually happening
4. Review current process for receipt/response of member requests (do not want to trip up early in the process)
5. Review proxy practice-
   1. Is it working?
   2. Is it sufficient?
   3. What options are available to increase number of proxies held by the company to prevent any unsolicited / unwarranted action
6. Depending on membership composition – consider potential structural change (e.g. MHC conversion)
   *you may be limited by state law in how much you can do related to each of the above
RECOMMENDED RESOURCES

Emerging Issues for Boards of Mutuals

Mutual Holding Company: Structure, Issues & Accounting: