MARQUETTE LAW REVIEW

Vol. 49 NOVEMBER, 1965 No. 2

LIFE INSURANCE COMPANIES: THEIR PROMOTION AND REGULATION

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I. INTRODUCTION

A. The New Company Phenomenon

In 1964, the number of legal reserve life insurance companies in the United States swelled to a record total of 1,595. The formation of 150 new companies in 39 of the 50 states during the year represented the most activity in new company formation in a single year since 1955. These figures reflect only the more recent data on the tremendous growth in the number of new life companies in the past decade. The total number of companies has increased 72 per cent from the end of 1953 to December 31, 1964.[1] Such figures indicate a continued interest and enthusiasm for new life insurance companies. However, they reveal only part of the story.

From 1950, at which time 611 life insurance companies were domiciled in the United States, to July 1964, 1,570 new companies have been organized and 471 of these have been retired.[2] (The retirement of a life insurance company may take the form of a merger, liquidation, reinsurance, etc.)[3] In other words, 30 per cent of the companies formed in this 14½ year period are no longer in business. It has been suggested, with some force, that the ultimate retirement rate for these companies will be substantially in excess of 30 per cent, perhaps as high as 60 per cent to 70 per cent.[4] With the passing of several years,

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The authors wish to express their appreciation to The Northwestern Mutual Life Insurance Company for the use of its facilities and files. Although employed by the Company (Mr. Farney as a summer employee), the authors were granted complete academic freedom as to the form and substance of the article and the conclusions reached. The authors also wish to thank Acting Securities Commissioner Thomas J. Hawekotte (Ill.), Securities Commissioner William M. King (Texas), and Superintendent of Securities Robert L. Walters (Iowa) for their cooperation in providing background material, and Professor Spencer L. Kimball, University of Michigan Law School, for reviewing an early draft of the article. However, they, as well as the Company, should be absolved of all responsibility for the views expressed, which are solely those of the authors.

[1] Best's Weekly News Digest (Life Ed.), Feb. 1, 1965.

[2] Institute of Life Insurance, Report on Life Insurance Company Formation and Dissolution—1950 Through Mid-Year 1964, at 1, 18 (Dec. 1964). An additional 160 companies formed prior to 1950 were retired in the same period bringing the total to 631 for the 14½ years. *Id.* at 35. A further breakdown of the 471 companies shows that 38 or 8% were mutuals at the time of retirement, whereas 433 or 92% were stock companies, Letter from William E. Kingsley (Institute of Life Insurance) to Allen P. McCartney, August 26, 1965.

[3] Reinsurance, as a form of company retirement and as distinguished from merger, is essentially a sale of all the insurance in force plus assets held as reserve and possibly other assets, with the reinsurer assuming some or all of the liabilities. Subsequently, the ceding company is usually dissolved. Typically, as consideration, the ceding company receives stock of the reinsurer which is passed on to the stockholders in the liquidation.

[4] Probe, Jan. 25, 1965, made the following analysis: It isolated the significant characteristics common to the 471 companies comprising the 30% which did not survive.

(1) 89% of the retired companies possessed assets of less than $5 million.
(2) 89% possessed under $50 million of insurance in force.
(3) 79% had been in business less than ten years.

Of the [still existing] new companies formed between 1950 and 1962, 900 have assets of less than $5 million, 813 have less than $50 million in force,

it is likely that many of the newly organized companies will be unable to withstand the rigors of the insurance business. This expectation is supported by Appendix A which illustrates the percentages of surviving companies by years of experience.

B. Purpose

The new company phenomenon, therefore, possesses two outstanding characteristics: a high birth rate and a high mortality rate. These have been the subject of numerous comments and discussions by financial analysts, insurance company executives, regulatory authorities and insurance trade papers.

The purpose of this article is to (1) consolidate in one place and in condensed form the vast amount of literature on this subject; (2) explore the reasons behind the high rate of formation and termination of new life insurance companies; (3) discuss the effect of this phenomenon on the insurance buying public, the holders of insurance company stock and the industry itself; (4) outline the problems which these new companies have posed for regulatory agencies, both Federal and State; and (5) analyze some possible solutions. Because of the scope of this article the authors have not attempted to make a state by state analysis of statutes, regulations, etc., preferring to use selected statutes and regulations to illustrate the points which are made.

One thing should be made clear at the outset. The majority of life insurance company agents and officers are competent, sincere and honest in conducting their business. Their companies may be new or old, large or small, regional or national, stock or mutual. Regardless of the classification, most of these companies and the men who operate them are quite cognizant of the legal and moral obligations which they have undertaken. This is *not* the group toward which this article is primarily directed. On the other hand, there are those life insurance companies whose promoters seem to be motivated by the opportunity for stock speculation; whose achievements are measured not in terms of policyholder benefits, but in terms of stock appreciation; whose sales

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and 870 are less than 10 years old. Even though it is obviously true that at one time every presently established company had these same characteristics, it appears reasonable to us to say that between 800 and 900 new companies have a long way to go before they can get out of the woods. Our point is that the 30% termination figure may be exceeded considerably. *Ibid.*

Furthermore,

> The National Underwriter, in its annual listings of companies on the basis of in force, carries only 725 listings—less than 50% of the life insurance companies doing business in the country. Even some of these may be marginal operations. But of the remaining 50%, more than half are probably marginal operations. I would estimate that there are perhaps as many as 500 companies that need help. Address by Phillip J. Goldberg, Chicago Conference on Acquisitions and Mergers, Oct. 28-29, 1964, p. 4.

This appraisal—which has not been challenged—coupled with the figures developed by Probe suggests that the termination rate of new companies may be nearer to two out of three rather than one out of three.

techniques seem designed to confuse or mislead their prospective policyholders; and whose activities have been a source of grave concern both to state and federal regulatory agencies and to the established companies who fear irreparable damage to the industry's hard won reputation for financial stability, integrity, and continuity of management. For the most part, the article discusses this limited group.

New stock life insurance companies organized during the period 1950-1963 and still operating at year-end 1963 possessed approximately 2.3 per cent(or $3.2 billion) of the 1963 total industry assets of $141 billion. These companies held 6.6 per cent (or $51 billion) of the total insurance in force, approximately $775 billion.[5] Some perspective is gained by noting that in 1963 the eighth largest life insurance company (by assets) had assets greater than the total amount possessed by all new companies organized in this period. Similarly, the largest company (by assets) in 1963 had ordinary insurance in force of approximately $4 billion more than the total insurance in force of these same companies.[6] Many of the new companies are soundly conceived and competently managed. But some—whose assets and insurance in force are but a small fraction of the industry total—are not. It is this minority which causes concern.

As to most companies, special legislation is not needed to ensure sound and honorable business practice. Thus, we are confronted with the problem of preventing the abuses of a few while refraining from imposing burdensome and unneeded restraints on the many. The authors will attempt to tread this narrow path. To the extent possible, remedies will be suggested within the framework of existing legislation so as to facilitate corrective action.

II. THE WHY'S AND HOW'S OF THE PROMOTION ORIENTED COMPANIES

A. Motivation

1. *Organizers of New Companies*

Who are organizing new life insurance companies today? What are the motives that prompt them to do so? (1) Finance companies are organizing credit life insurance companies to capitalize on the life insurance needs of borrowers. (2) Fire and casualty companies are organizing life insurance affiliates to broaden their insurance coverage —and in some cases hoping to offset underwriting losses in other lines of business. (3) Several of America's large corporations are seeking to diversify their activities by entering the life insurance business. (4) Many companies have been organized by an individual or group

[5] Institute of Life Insurance, 1964 Life Insurance Fact Book 15, 65, and Letter, *supra* note 2.
[6] Flitcraft Courant, April 1964, p. 36.

of individuals. Of these, some appear to have been organized by promoters primarily for personal gain. The latter group is the primary concern of this article.

2. *The Promoters*

Recently, an investment research firm published a study on small life insurance companies in which promoters were asked about their motivation.

> The answer to our query was, in the last analysis, nearly always "Why, of course, to make money for ourselves. . . ." Such is the current faith of an uninformed public that just about anyone can make money in the life insurance business.[7]

The California Department of Insurance found it necessary to promulgate a set of guidelines for new insurers "to discourage the organization of new life insurers for the primary purpose of profiting on transactions in the stock of the insurer" as distinguished from establishing and maintaining the company as an insurance operation.[8] Various commentators have described some new companies as "fast buck" operations or "speculator type life insurance companies."[9]

There is ample evidence that the formation of stock promotion oriented companies is not an uncommon occurrence. The Report of the Special Study of Securities Markets conducted by the staff of the SEC recognized the proliferation of this type of company.

> Many of the new insurance companies which emerged during this period [1951-1961] were inevitably promotional to some degree and their operations have presented problems of investor protection.[10]

Similarly, the National Association of Insurance Commissioners (NAIC) demonstrated cognizance of this problem as early as 1957 when a subcommittee of the Laws and Legislation Committee concluded that it was necessary to study "the control and possible elimination of the formation of insurance companies for purely promotional purposes . . ."[11] The fact that a solution has yet to be found is evidenced by the January 1965 appointment of an NAIC Subcommittee

[7] Equity Research Associates, The Hazards and Rewards of Investing in Small Life Insurance Companies, Oct. 15, 1964, p. 3. (investment analysis)

[8] Statement by California Insurance Commissioner Grady as quoted in The National Underwriter, Jan. 9, 1965, p. 1.

[9] Address by James F. Oates, Jr., Institute of Life Insurance Annual Meeting as reported in Journal of Commerce, Dec. 14, 1964, p. 8, and Probe, Oct. 19, 1964. The new company situation is reaching "scandalous proportions. Although there are a lot of well intentioned people involved, it is a pretty cynical operation these days." Address by Levering Cartwright, 15th Conference of Public Actuaries in Private Practice, Oct. 1964, as reported in The National Underwriter, Nov. 14, 1964, p. 4. See Pfeffer, *Measuring the Profit Potential of a New Life Insurance Company*, Journal of Risk and Insurance, Sept. 1965, pp. 413, 415.

[10] H. R. Doc. No. 95, Pt. 3, 88th Cong., 1st Sess. 42 (1963).

[11] 2 PROCEEDINGS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 511 (1959).

"To Study Proper Control of the Formation, Ownership and Licensing of New Life Insurance Companies."[12] From this brief survey the authors conclude that the subject of stock promotion companies warrants further exploration.

B. The Promoters' Technique

1. *The Speculative Climate*

A prime cause underlying the plethora of new companies is speculation. One executive described the speculative climate in these terms:

> 100 years separated two frantic discoveries, gold in the West in 1849 and gold in the common stock of the life insurance industry in 1949. The rush for the newly discovered gold in an industry that had slept peacefully 150 years created an investment holocaust into which people leaped, casting aside sound habits and setting off an hypnotic era of cliches, platitudes, misunderstandings and half-truths.
>
> . . . The investment world wanted life insurance shares—few were available. If new shares were to be created, new companies would have to be created. And this is exactly what happened.[13]

Recent advertisements, books and other literature suggest that the era of high investor interest continues.[14]

2. *Local Promotion*

In launching a new company, it is a common practice to appoint to the board of directors one or more of the community's prominent citizens upon whom the company's reputation can be projected. (On occasion such persons are actually part of the promoter group.) Some companies have shown a preference for well-known persons in the

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[12] 2 Proceedings of the National Association of Insurance Commissioners (1965) (Report of Subcommittee I2, June 7, 1965)

[13] Address by William O. Sahm, Chicago Conference on Acquisitions and Mergers, Oct. 28-29, 1964, pp. 5-6. "The investment climate of the life insurance common stock market during the decade of the 1950's can best be described by the word 'speculation.'" *Id.* at 6. "One fundamental cause of the formation of so many new companies . . . is outstanding and that is the present speculative environment in which the life insurance business finds itself. The gold rush is really on." Address by Bruce E. Shepherd, 22nd General Agents and Managers Conference, Saratoga Springs, N. Y., Feb. 12, 1965, p. 4. See Pfeffer, *Measuring the Profit Potential of a New Life Insurance Company,* J. of Risk and Insurance, Sept. 1965, pp. 414-15; Timmons, *Dangers in the High Birth Rate of New Life Companies,* Insurance, Oct. 16, 1965, p. 27; Life Insurance Investors, Inc., Life Insurance Stocks, (1961), p. 4 (investment analysis); and Forbes May 1, 1965, p. 21.

[14] E.g., Milton, Life Insurance Stocks: The Modern Gold Rush (1963) refers to the spectacular gains which have been made in life insurance stock. A newspaper advertisement said, "Yes, most investors probably know, in a general way that common stocks of Life Insurance companies are growth stocks. But even so, we believe few individual investors are fully aware of the almost fantastic capital gains it has been possible to realize from modest investment sums . . . Life insurance companies are, in our opinion, on the threshold of a new growth era." N. Y. Times, Jan. 23, 1965, p. 33. These are representative of what one investment firm referred to as alleged offers of "an endless cornucopia of investment riches." McDonnell & Co., The Life Insurance Industry (Industry Review Series), Nov. 1964, p. 1 (investment analysis).

sports or entertainment world, prominent legislators, ex-commissioners, ex-governors, etc.[15] The average investor probably draws the inference that if the well-known individual is willing to lend his name to the venture it *must* be good, and certainly ought to be worthy of his confidence.

A life insurance company is organized and set into operation. Stock is sold to the founders at a low price per share, perhaps at $1 or less.[16] Subsequently, a second issue of stock may be floated at a higher price and sold to the public through an intense promotional campaign. Thereafter, successive public issues may be floated, each at a higher price than the former, if the market will bear them. A secondary market may then develop which would be sufficiently strong to enable the promoters to "unload" their original stock at a substantial profit, perhaps as high as several hundred per cent. At this point, the promoters might elect to leave the company and repeat the cycle elsewhere.[17]

3. *The Role of the Insurance in Force Account*

Rapid growth is normally thought to be indicative of a company's vitality and success. While this may also be true with respect to a life insurance company, rapid growth in the insurance in force account has a negative aspect. In the company's annual statement filed with the state insurance department, acquisition costs (expenses incurred in writing new business) are charged against income in the year incurred rather than amortized over the premium paying period of the policy.[18] Since, in most new companies, acquisition costs exceed the first year premium income, even a well-run company is likely to incur operating losses in its first several years.[19] Such losses deplete surplus and, in some cases, deplete surplus below the amount required by law. A key problem in a stock promotion is to create a market for the stock of a company which is showing or will show substantial operating losses.

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[15] The authors' files contain recent prospectuses listing such persons on the boards of directors. No particular purpose would be served by identifying individuals or companies in this paper. Therefore, while the source material is in the above files, citations which would identify persons or companies are not given. All of the prospectuses used were issued in the period 1960-1965, the great majority in either 1964 or 1965.

[16] See text p. 230.

[17] See Chicago Tribune, Jan. 27, 1960, Section 4, p. 7; Timmons, *supra* note 13; Pfeffer, *supra* note 9, p. 417; Forbes, May 1, 1965, p. 21; and Maynard, *Behind the Scenes with Newcomers in the Life Insurance Business,* Magazine of Wall Street, Jan. 9, 1965, p. 402.

[18] Chenault, *Comments on Accounting for Stock Options Issued by a Life Insurance Company to Its Agents,* The Texas CPA, July 1965, p. 62; and Equity, *supra* note 7 at 5.

[19] As a rule of thumb, it is commonly said that a company will suffer losses during its first six to ten years. See e.g., Chauner, *Fundamentals to Conserving Surplus in New Companies,* Insurance, June 19, 1965, pp. 29, 30; Life Insurance Investors, Inc., Life Insurance Stocks (1961), p. 18 (investment analysis); and Equity, *supra* note 7 at 5-7. But see text, pp. 74-75 and Appendix B.

Various methods have been developed to measure the worth of a life insurance stock.[20] The method commonly favored by investors to offset the impact of the current operating loss is to add to it projected future earnings on the business already written.[21] This is done through the application of the so-called adjusted earnings concept, a technique which is said to "normalize" profits. That is, earnings are adjusted to reflect the investment in the unamortized acquisition costs.[22] Adjusted earnings are calculated by adding to the net loss (or gain) from operations the value of the increase of the insurance in force for that year.[23] A rule of thumb approach in determining adjusted earnings is to value the increase in the insurance in force at, for example, $20 per thousand of ordinary business.[24] Stocks then may be valued in terms of their price-earnings (adjusted) ratio.

Since the size of the increase in the insurance in force account is deemed to be very important in valuing the stock, the promoter attempts to put as much new business on the books as rapidly as possible.[25] Several techniques have been employed in this endeavor.

a. Policyholder Inducements

Specialty Policies. During the past few years, specialty policies such as coupon, charter and profit sharing policies have been in vogue with many new companies. These have been employed "In order to get started with a flourish and put business on the books rapidly. . . ."[26] A recent article explored in detail the nature of these policies, marketing practices associated with them and legal ramifications. It noted two general approaches which have been employed—either separately

[20] Among the methods are (1) market value, (2) adjusted book value, (3) capitalized future earnings value, and (4) adjusted earnings. See addresses by Thomas P. Bowles, Jr., and Robert A. Sjostrom, Chicago Conference on Acquisitions and Mergers, Oct. 28-29, 1964. Occasionally, when stock is being evaluated for the purpose of a merger, if there is an active market for the stock of both companies, the market prices of such shares are used as the means of valuation.

[21] See Sjostrom, *id.* at 8, and Griffith, *Valuation of Life Insurance Stocks,* J. of Risk and Insurance, Mar. 1965, p. 77.

[22] Equity, *supra* note 7 at 5.

[23] Lecture by Donald L. McKibbin, Milwaukee Vocational Technical and Adult Schools, Milwaukee, Wisconsin, Oct. 20, 1964.

[24] This rule of thumb has its hazards. "Some reconciliation of viewpoints is surely needed when the market appraises a company's outstanding business at $20 a thousand and its own actuary, by using the method of asset shares, says it is worth minus $10 a thousand." Address by Bruce E. Shepherd, American Life Convention, Oct. 15, 1964, p. 5.

[25] E.G., Probe, April 6, 1964. "Of course, the trick is to get enough business on the books and then try to sell, or somehow merge the company and get out while the going is good." *Ibid.*

[26] Anreder, *Multiple Risks, New Life Insurance Stocks Deserve a Critical Appraisal.* Barron's National Business and Financial Weekly, Nov. 16, 1964, p. 15. "Some companies, seeking to build sales volume rapidly, offer 'gimmick' policies such as 'founders' or coupon policies . . ." E. F. Hutton & Co., Market and Business Survey, Nov. 1964, p. 9 (investment analysis). See Timmons, *supra* note 13 at 28.

or in combination—to compete in a price conscious life insurance market: (1) orthodox insurance protection is supplemented with investment and other features to create maximum marketing appeal despite admittedly high costs, and (2) orthodox insurance coverages are packaged in a manner precluding cost comparisons with policies of other companies.[27] The merchandising of these policies (at least prior to their widespread curtailment or prohibition by state insurance departments) has been successful enough for one writer to describe specialty policies "as a device for 'instant volume.' "[28]

Profitless Motivated Company. Another technique used to run up the insurance in force account is the sale of policies at a very low cost resulting in an inevitable loss.[29] One actuary noted that

> Since arbitrary weights are applied, why not come out with a loss leader and issue $100,000,000 of this business? At $20 per $1,000 the company has an added value of $2,000,000 even though the business is probably worth less than nothing. This is absurd, yet, unfortunately for the industry, there are some persons promoting companies with this in mind.[30]

In this way a new company may (at least in part) overcome the competitive price advantage enjoyed by some of the more established companies. With the rapid growth in the insurance in force account, the promoter may anticipate a parallel rise in the price of the stock. Aware of the inherent long run unprofitability of the business being written, he can then sell out while the market is high and move on to new opportunities.[31]

b. Agent Incentives

As a part of the process of stimulating sales, in order to run up the insurance in force account, many new companies have made special efforts to recruit and retain agents. This task of acquiring and maintaining a competent agency force is one of the most important, tedious and costly tasks of any confronting the new company. The prob-

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[27] Kimball and Hanson, *The Regulation of Specialty Policies in Life Insurance,* 62 MICH. L. REV. 167, 173 (1963).

[28] Anreder, *supra* note 26 at 16.

[29] The term "loss" here is used in the sense of long term loss as distinguished from losses in the initial years of a new company arising from the accounting prohibition against amortizing first year expenses.

[30] Gold, *Valuing a Life Insurance Company,* 14 TRANSACTIONS: SOCIETY OF ACTUARIES, 139, 150 (1962).

[31] "Some young companies are writing premium volume that will not, could not, and never was intended to create a profit. If they are not seeking a profit, then what is their objective? What type of management will knowingly sell a product without any corporate profit potential? The answer must be: Only that management whose intention is to quickly reap a personal financial gain and then exit from the corporate structure." Sahm, *supra* note 13, at 7. It may be difficult to prove such motives in any particular case. However, several statements in the insurance literature suggest that selling life insurance at inadequate premium rates as a part of a scheme to raise the price of the stock is an existing practice. See e.g., *Ibid;* Goldberg, *supra* note 4 at 8.

lem is difficult enough for established companies;[32] it is monumental for a new company.

Various methods of building an agency force are open to a new company. It may elect to embark on the long hard road of recruiting and developing its own agents. Some companies have attempted the merger route in hopes of combining with a company already possessing an agency force. Others have sought to attract agents by issuing attractive specialty policies which may ease the path of the agent in making a sale. The latter two methods have not proved to be very satisfactory.[33]

Commissions. Commissions are the backbone of agent compensation. Companies licensed in New York are restricted in the amount of commissions which they can pay by that state's expense limitation law.[34] Thus, new companies not licensed in New York can utilize higher commissions in recruitment competition with companies licensed in New York.[35]

Bonuses. Another incentive is the offering of bonuses to agents geared to the amount of their sales. The payment of bonuses had

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[32] For example, the experience of nine companies having an average amount of Ordinary insurance in force of $6 billion is revealing. From 1957 to 1963, they recruited 25,872 new men but at the end of the period increased their total sales manpower by only 2,122 agents, or only 8.2% of the number contracted. Address by Leland J. Kalmbach, 58th Annual Meeting of the Life Insurance Association of America, Dec. 9, 1964, p. 8.

[33] Acquiring an agency force by means of a merger might prove to be the easiest route, however, there are several reasons to conclude that this is not the case. (1) Three presidents whose companies have gone through the merger route spoke on this point. Two (including a president of a company which has merged fifteen times) reported that no agents of the absorbed companies were retained. The third said that a total of three or four new agents resulted from his company's merging experience. (2) An agent under contract to the company to be absorbed is not legally obligated to sell for the surviving company. The uncertainty as to agents' status may cause a disintegration of the agency force of the company to be absorbed. (3) It is not uncommon for a company which is to be absorbed to possess a very poor sales force. This may even be the reason compelling a company to merge in order to survive. (4) Furthermore, a merger may destroy the company's image of uniqueness. Panel discussion, Chicago Conference on Acquisitions and Mergers, Oct. 28-29, 1964. The specialty policy route also has its pitfalls. ". . . at some time in the company's future there must be a change to the orthodox plans of insurance. This may come as a very drastic change and affect the agency force to a great extent. Companies have done quite well selling a founders' contract but have found their men woefully untrained and completely inadequate when attempting to sell the orthodox plans." Robinson, *The New Life Insurance Company—Its Problems,* 1956-1957 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 133, 144. "A specialty-type salesman, as a rule, is an individual who will drift from company to company." 1960-1961 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 59.

[34] N. Y. INSURANCE LAW §213. This provision is applicable to the operations of all companies licensed in New York, even though domiciled elsewhere, through the operation of N. Y. INSURANCE LAW §42 (extraterritorial provision).

[35] Address by Robert W. Strain, Chicago Conference for Young Life Insurance Companies, Sept. 1-2, 1965, p. 5.

developed to the point of being an abuse in the life insurance business at the turn of the century. New York's famous Armstrong Investigation wrote *finis* to this practice by prohibiting bonuses and by outlawing prizes and awards having more than nominal or insignificant value.[36] Wisconsin imposes a ceiling of $150 per agent per year.[37] However, many states do not have similar requirements. In several states flamboyant merchandising methods have been introduced. Companies have offered Cadillacs to their agents as prizes. Others have offered mink stoles and diamond lavalieres to agents' wives. Some have offered trips to such places as Hawaii at company expense.

Stock Options. Recently, another development has emerged, namely the granting of stock options to agents paid in addition to the traditional forms of compensation.[38] Stock options are especially alluring in the life insurance industry because of its unprecedented growth and prosperity in recent years. It is not surprising, therefore, that new companies have utilized stock options as a means of attracting agents. Such options have been said to be used by promoters "to steal hot agents and get rapid growth of insurance in force just to run up the price of their stock."[39]

The essence of a typical stock option plan for agents is quite simple. An agent is afforded the opportunity to purchase shares in the life insurance company through the mechanism of a stock option.[40] The number of options which an agent will be given may vary in accordance with the amount and types of insurance which he places with the company and with the persistency of such business.[41] For example, an agent may receive an option to purchase four shares of the company stock for every $1,000 of ordinary insurance written. Some companies provide that the stock options can be purchased at a specified price, for example, $1.00 per share, whereas other companies may provide that the options can be exercised at the market value existing at the time the options are granted.[42] Usually, options are nontransferable and nonassignable with the single exception that they may pass through the agent's estate upon his death.[43] Furthermore, if the agent fails to meet

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[36] N. Y. INSURANCE LAW §213(7).

[37] WIS. INSURANCE LAWS §206.32.

[38] Address by William R. Robertson, Research Agencies Group, Williamsburg, Va., May 13-14, 1965, p. 5.

[39] Forbes, April 15, 1964, p. 26. The sale of stock to life insurance agents is being used as a "lure to attract agents of other life companies, thus resulting in a continual raiding of sales forces by recently organized companies." ONE HUNDRED AND SIXTH ANNUAL REPORT OF THE SUPERINTENDENT OF INSURANCE TO THE NEW YORK LEGISLATURE COVERING THE CALENDAR YEAR *1964*, p. 24.

[40] In addition to or in lieu of stock options agents may be offered a chance to subscribe to shares of the initial offering. See Robertson, *supra* note 38 at 4-5.

[41] Strain, *Stock Option Incentives in Newly Formed Life Insurance Companies*, J. of Amer. Society of C.L.U. (Winter 1965) p. 8.

[42] *Ibid* at 7.

[43] Robertson, *supra* note 3 at 5.

a minimum production requirement, the company may have an option to repurchase the stock for example at the option price, which the agent has already acquired.[44] Thus, if the market price is increasing, there is a double incentive for an agent to place business with this company: (1) to acquire more stock options, and (2) to avoid losing profitable options already acquired.

Stock options hold two basic appeals to life insurance agents. First, there is the attraction of obtaining an interest in the growth of his own company. The more business he writes, presumably, the higher will be the value of his stock. Through the vehicle of stock options, the agent can reap the gain attributed to the appreciation in the value of his stock due not only to his own efforts and the efforts of his colleagues, but also due to a general rise in the national economy. Second, there is the possibility of favorable tax treatment, i.e., capital gain rather than ordinary income treatment on stock appreciation.

The attraction of stock options, however, may prove to be unwarranted. One insurance executive of an admittedly agent-oriented company expressed some sobering thoughts as to the long term value of the stock option approach. Although a group of agents are in a position to bring in business, the company cannot succeed unless it attracts the services of technicians, specialists and administrative personnel who are capable of handling day to day problems and of designing saleable products.

> Part and parcel of ever-increasing agents' involvement in company ownership are the stock deals which new companies offer. Options, purchase of stock at knock-down prices—these are frequently *pie-in-the-sky arrangements that may produce nothing of value,* either for the company or *for the agent.* From the agent's point of view, he will frequently come up with hard American dollars to buy some scraps of paper. These scraps of paper will come to have value only as he and others like him succeed in their representation of the company.
> [U]nless they are backed up by a sound home office team of underwriters, actuaries and administrators, *their hard work will not translate itself into increased value of their holdings.*[45] (Emphasis supplied)

Furthermore, some agents will want to sell their stock shortly after they exercise the options. Since the market for such stock may be "thin," such sales could significantly depress the market. In turn, future options may be rendered worthless.[46]

There appears to be no question that it is possible for an agent to achieve substantial monetary success via the stock option route. But

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[44] Prospectuses in authors' files.
[45] Goldberg, *supra* note 4, p. 7.
[46] Robertson, *supra* note 38 at 8.

such success is by no means assured. The survival rate of new companies is not encouraging. Furthermore, if life insurance stocks have lost some of their appeal, as some investment firms have suggested,[47] an agent's hard work may be discounted by the vagaries of the market. In short, the monetary rewards may be substantial, but so are the risks.

A prime attraction of stock options stems from the opportunity to obtain capital gain tax treatment. If the option qualifies under §422 of the Internal Revenue Code of 1954, no tax is incurred until the option recipient ultimately sells the stock. At this time the difference between the sale price received and the option price paid is taxed at capital gains rates. As one General Agent said,

> When stock options are mentioned, the thought of capital gains jumps into our minds. Putting together these two factors—the market strength of established life company stocks plus stock options—has made it a relatively easy task to market stocks in these agent-owned life companies to good agents, who are experiencing prosperity these days and who have the urge for some of the tax breaks available to so many of their best customers.[48]

Many agents attracted to stock option companies no doubt anticipate capital gains treatment. Such hopes may prove to be illusory. A stock option must meet certain conditions in order to qualify for favorable tax treatment. For example, the stock acquired pursuant to an option must be held for three years and the option must be issued at 100 per cent of market value.[49] Furthermore, the agent must fall into the category of a statutory employee.[50] An agent is normally considered to be an independent contractor rather than an employee. This is particularly true with respect to the relationship between a stock option company and an agent who retains his primary contract with another company. Thus, stock options to agents would appear not to qualify under §422 because of the absence of the employee relationship.[51] Presumably, this

[47] See *infra* note 301 and accompanying text.

[48] Robertson, *supra* note 38 at 7.

[49] INT. REV. CODE OF *1954* (As amended 1964), §§422(a)(1) and 422(b)(4). Prior to the amendments added by the Revenue Act of 1964, the optionee was required to hold the stock for only six months, and options could be granted from 85% to 100% of market value. INT. REV. CODE OF *1954*, §421.

[50] To be a qualified option, the option must be granted "for any reason connected with his employment by a corporation." INT. REV. CODE OF *1954*, §422(b) (as amended 1964). See *ibid.*, §422(a)(2).

[51] Prop. Reg. §1.421-7(h)(1) suggested that the definition of the employer-employee relationship which applies to qualified stock options is to be drawn from the definitions of employee under the withholding tax provisions of the Code [§3401(c)]. 7 CCH 1965 STAND. FED. TAX REP. ¶8937. "Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the results to be accomplished by the work but also as to the details and means by which that result is accomplished. . . . In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the results, he is not an employee." Reg. §31.3401(c)-1(b).

is one of the reasons why some companies in their prospectuses have indicated that their stock option plans for agents do not qualify.[52] Consequently, these options may have less appeal than originally thought.[53]

4. *Merger*

Another technique which has been employed as a means to run up the price of the stock is to merge two or more companies. Although there are numerous business reasons for merging,[54] one motivation is frequently dominant—namely, to "stimulate the market value for the company's stock and perhaps increase its value."[55] On occasion it seems that a merger almost automatically translates into a higher market for the stock of the surviving company.[56] Sometimes a promoter may merge to enhance the value of the stock through wider distribution and public acceptance of such stock.[57]

III. CAUSES FOR CONCERN FROM THE INVESTOR'S VIEWPOINT AND SOME SPECIFIC REMEDIES

A. Preliminary Remarks

Securities regulatory bodies at both the state and federal levels are charged with the duty of enforcing compliance with securities laws and regulations. Promoters of stock promotion oriented life insurance companies, by definition, conduct much of their activity in areas which are subject to the scrutiny of securities regulators. This fundamental condition is not altered by the fact that the issuer of the stock is a life insurance company. When a promoter or group of promoters engage

[52] None of the prospectuses so doing which the authors examined set out the reasons for this conclusion. In addition to the possibility that many agents might not be considered to be employees within the meaning of the tax provisions is the possibility that the company may be inclined to seek a tax advantage for itself at the expense of the stock optionees. If the plan is nonqualified, the company may be entitled to an expense deduction. See Int. Rev. Code, §§162, 809(d)(12). The deduction is barred where stock is transferred pursuant to the exercise of a qualified stock option. *Ibid.*, §421(a)(2).

[53] See e.g., Robertson, *op cit supra* at 8.

[54] E.g., to gain capital strength, to create an agency force, to diversify the product line, to acquire new territory, to gain additional management personnel, to reduce insurance unit cost, etc.

[55] See Address by Professor John S. Bickley, Chicago Conference on Acquisitions and Mergers, Oct. 28-29, 1964, pp. 3-6. "The considerations that prompt this widespread interest (in mergers) include the following . . . (4) the belief that a purchase or merger will result in an immediate increase in the market value of the company's stock. . . ." Niles, 14 Transactions: Society of Actuaries 166 (1962).

[56] One merger has been described as a "golden dowry" for the stockholders. Milton, *supra* note 14 at 42. See Anreder, *supra* note 26 at 3. Mr. Willard F. Mueller, Director of the F.T.C.'s Bureau of Economics told the Senate Antitrust and Monopoly Subcommittee that a study of mergers shows "a particularly close relationship between merger activity and stock prices (although) it is not entirely clear just how 'conditions' in the stock market encourage mergers." As reported in the N. Y. Times, March 17, 1965, p. 65:

[57] Address by Professor Richard M. Heins, Chicago Conference on Acquisitions and Mergers, Oct. 28-29, 1964, p. 10.

in activities that are diametrically opposed to securities regulations, it can be anticipated that such controls will be applied.

The authors are aware of the intense feeling on the part of many members of the insurance community against federal intervention in the regulation of the insurance business. It is not the purpose of this article to engage in a discussion of the pros and cons of state versus federal regulation. However, it is to be emphasized that reference to remedies available through the SEC does not constitute advocacy of federal intervention. The practices discussed are now and have been within the province of the federal securities laws which were enacted in the early 1930's. What is new is not federal intervention into insurance regulation but rather the rise of questionable practices on the part of some insurance company promoters which fall within, or are on the fringe of, the areas governed by federal securities law.

There are several reasons why persons who are interested in state regulation of insurance would do well to explore the new company problem from a securities viewpoint as well as from an insurance viewpoint. Securities regulation may afford precedents which could be adapted to insurance regulatory problems. Also, it is possible that in some areas the interests of the investor and of the policyholder are sufficiently close that remedial action taken on behalf of the former will redound to the benefit of the latter. Furthermore, since securities administrators are likely to act in this area, informed members of the insurance community may be able to contribute to the decision making process. This would enhance the likelihood that the final results would be adapted to the peculiar characteristics of the life insurance business.

In their research, the authors have received the impression that the insurance fraternity—with a few exceptions—has not been keenly aware of the applicability of federal and state securities acts and of their potential impact upon the industry. As might be expected, insurance people have typically attempted to approach a problem from an insurance viewpoint and have sought solutions through the techniques traditionally used by insurance companies and insurance commissioners. By the same token, securities people look at the problem primarily from their viewpoint. In this article, we have tried to blend the two points of view and call attention to those areas where the cooperative efforts of both groups might effect a satisfactory solution.

B. Securities Laws

Because a general grasp of the securities laws and their underlying philosophies is essential to understand the role of the SEC and of state securities administrators, to recognize potential precedents which could be utilized by individual commissioners or by the NAIC, and to recognize some of the adverse implications in various courses of conduct;

there is set out below a general exposition of the two federal securities acts of primary interest—the Securities Act of 1933 and the Securities Exchange Act of 1934[58]—and of the framework of state securities regulation. No attempt has been made to be exhaustive. In fact, some technical accuracy may have been sacrificed in favor of a simpler exposition of an extremely complex subject.

1. *Securities Act of 1933*

a. The Distribution and Underwriting Mechanism[59]

An issuer of a block of securities seeks to raise dollars through the sale of such securities. The underwriting process plays an essential role in this endeavor. The purpose of underwriting is to assure the issuer of a specified amount of money at a certain time and to shift the risk of the market to the investment bankers.[60]

The most common form of underwriting is "firm commitment" underwriting. In essence, the issuer simply sells the entire issue to a group of securities firms represented by one or more "principal underwriters." They, in turn, sell at a price differential to a larger "selling group" of dealers who in turn sell to the public at another price differential. A rough analogy would have the issuer as the manufacturer, the principal underwriter as the wholesaler, the selling group as the retailers and the investing public as the consumer.

Typically, a single underwriting group is formed by a contractual agreement in which it is agreed that one or more of their number will negotiate with the issuer on behalf of all. Through their representative the underwriters enter into a purchase contract prior to the effective date of the registration statement. Commonly the representative is authorized to allocate various portions of the issue among the underwriters. Some underwriters want a certain proportion of their share for their own retail distribution in which case they become a part of the selling group. Other investment houses participate with a view to making a profit by assuming the investment risk and permitting the representative to sell their participations, for their account, to dealers and institutional investors.

Underwriters and participating dealers, during the life of the group, follow the practice of making concurrent public offerings at a uniform price and at uniform concession discounts given by them to other dealers. Typically, however, the agreement among the purchasers terminates within thirty days after the initial public offering. The representative is entitled to a fee. The underwriter may buy "X" number of

[58] Securities Act of 1933, 1 CCH 1965, FED. SEC. LAW REP. ¶¶501-954. Securities Exchange Act of 1934, 2 CCH 1965, FED. SEC. LAW REP. ¶¶20, 101-120, 621.

[59] The description of the underwriting process is based upon the discussion in 1 Loss, SECURITIES REGULATION 164-72 (2d ed. 1961).

[60] By "investment bankers" we refer to those securities dealers who engage in the distribution process.

shares from the issuer at $23.00 per share with a view to a public offering at $25.00 per share. Those underwriters selling at retail could obtain a full two point spread (less the management fee of the representative). Other underwriters may sell their participation to select dealers at $24 and the select dealer may sell to other dealers at a discount of one-fourth point (i.e., at $24.75).

Companies which are not well established may discover it difficult to find underwriters who will give a "firm commitment" to purchase the issue and assume the investment risk. These companies distribute their securities through firms which merely undertake to use their best efforts. The underwriters, instead of buying the issue from the issuer, sells the securities as an agent for the issuer on a commission rather than profit basis.

b. Statutory Philosophy

When Congress came to the point of legislating in the early 1930's it was confronted with a choice between conflicting philosophies. At one extreme were those who preferred a strict antifraud act. At the other extreme were those favoring the qualification philosophy, that is, the administrator could pass upon the merits of the security and exclude those securities which fail to meet statutory standards. The "middle of the road" approach was the disclosure concept.[61] President Roosevelt successfully urged the latter.[62]

The following statement succinctly describes the Securities Act of 1933.

> The Securities Act is designed simply to afford potential investors an adequate basis upon which to found their judgment as to what new security offerings represent good investments, and to prevent misrepresentation, deceit, and other fraudulent practices in the sale of securities. Fundamental in the Act is the principle of disclosure—all facts which a prudent investor needs

[61] 1 Loss, *op. cit. supra* at 34, 122.

[62] In his message to Congress on March 29, 1933, President Roosevelt said:

> . . . Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.
>
> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.
>
> This proposal adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.
>
> The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.

S. REP. No. 47 at 6-7 and H. R. REP. No. 85 at 1-2, 73d Cong., 1st Sess. (1933).

> for investment analysis are required to be presented by the issuer of the securities. The actual merits of the securities are not reviewable by the Commission or any other Governmental authority under the Act. No guarantee against loss is provided—all that is required is that the facts which the issuer must disclose are truthfully stated and that no facts are concealed. Whether or not a security would be classified as 'speculative' or 'conservative' is no concern of the Commission so long as the true facts with resepect to the issuer are available for the buyer's scrutiny.[63]

These aims were to be achieved by a general antifraud provision, Section 17, and by registration a provision, Section 5. Except for the antifraud and the companion civil liability provisions, the other provisions in the Securities Act serve to implement Section 5.

c. The Registration Process

There are three stages in the registration process; the prefiling stage, the waiting period and the post-effective date stage.

Pre-filing Stage. Section 5 prohibits both offers to sell and sales of securities through interstate facilities or the mails before a registration statement is filed.[64] However, preliminary negotiations or agreements between the issuer and the underwriters may be made. Consequently, the negotiation for financing can proceed during this period but neither the issuer nor the underwriters may offer securities to investors or dealers.[65]

Waiting Period. After the registration statement is filed but before its effective date, offers to sell securities via interstate facilities or the mails are permitted.[66] However, no *written* offer may be made except

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[63] 1 CCH 1965 FED. SEC. LAW REP. ¶109.

[64] "Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
>
> (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale."

Securities Act of 1933, §5(a). 1 CCH 1965 FED. SEC. LAW REP. ¶561. Persons other than the issuer, underwriter or dealer are exempt from the registration requirements of §5. *Ibid.* §4(1). 1 CCH 1965 FED. SEC. LAW REP. ¶552.

[65] Excluded from the definitions of "sale," "offer to sell," etc. are "preliminary negotiations or agreements between an issuer . . . and any underwriter . . . who are or are to be in privity of contract with an issuer." Securities Act of 1933 §2(3), 1 CCH 1965 FED. SEC. LAW REP. ¶514. Publicity about an issuer, its securities or the proposed offer prior to filing many constitute an illegal offer to sell. SEC Reg. §231.4697 (1964) 1 CCH 1965 FED. SEC. LAW REP. ¶3258.

[66] "It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal

by means of a "prospectus."[67] During this waiting period the freedom of the underwriter or dealer, waiting to participate in the distribution, to communicate with his customers is limited by the antifraud provision and by the restriction on written material.[68] With one exception, other than the "Tombstone Ad,"[69] the only written offer permitted during the waiting period is a prospectus meeting the requirements of Section 10(a). However, during the waiting period, a preliminary prospectus may be employed.[70] Such a prospectus must contain "substantially the information required . . . to be included" in the full statutory prospectus.[71] Information with respect to the "offering price, underwriting discounts or commissions, discounts or commissions to dealers, amount of proceeds, conversion rates, call prices or other matters dependent upon the offering price" may be omitted.[72] The preliminary prospectus is used during this period as a source of reliable information in discussing the securities with prospective customers. The principal purpose of the waiting period is to enable dealers, and through others, the investors to become familiar with the information contained in the registration statement and to reach an unhurried decision as to the merits of the securities.[73]

Post-effective Date Period. The effective date of the registration statement is the twentieth day after filing or such earlier date as the

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order or stop order or (prior to the effective date of the registration statement) any public proceeding of examination under section 8."
Securities Act of 1933, §5(c). 1 CCH 1965 FED. SEC. LAW REP. ¶567. See SEC Reg. §231.3844 (1957), 1 CCH 1965 FED. SEC. LAW REP. ¶3252.

67 "It shall be unlawful for any person, directly or indirectly—(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10, . . ."
Securities Act of 1933, §5(b), 1 CCH 1965 FED. SEC. LAW REP. ¶564. The term "prospectus" is defined to mean "any prospectus, notice, circular, advertisement, letter or communication, written or by radio or television, which offers any security for sale . . ." *Ibid.*, §2(10), 1 CCH 1965 FED. SEC. LAW REP. ¶521. However, §2(10(b) excludes from the definition of a "prospectus" (written offer) a notice, circular, etc. if it states from whom a written prospectus meeting the §10 requirement can be obtained and does no more than merely identify the security, the price, who will execute the order and other data deemed appropriate by the SEC. This is commonly known as a "tombstone ad" which is placed in such papers as the Wall Street Journal. It is designed not as a piece of selling literature but rather as a device to ascertain prospective customers who might be sufficiently interested in the security to ask for a prospectus. 1 LOSS, *op. cit. supra* at 226-27, and SEC Reg. §230.134, 1 CCH 1965 FED. SEC. LAW REP. ¶1455.

68 See SEC Reg. §231.4697 (1964), *supra* note 65 at ¶3259.

69 See note 67 *supra.*

70 Securities Act of 1933, §10(a) and (b), 1 CCH 1965 FED. SEC. LAW REP. ¶¶631, 636.

71 SEC Reg. §230.433 (1958), 1 CCH 1965 FED. SEC. LAW REP. ¶4167. For a discussion of the full prospectus required by §10(a) see text, pp. 194-195.

72 SEC Reg. §230.433 *ibid.*

73 SEC Reg. §231.4697, *supra* note 65 at ¶3259.

SEC deems appropriate.[74] When the registration statement becomes effective sales may be made and consummated. It is unlawful to deliver through the mails or in interstate commerce any security for purposes of sale or delivery after sale unless it is accompanied or preceded by a prospectus meeting the requirements of Section 10(a).[75] Subsequent to the effective date, sales literature in addition to the prospectus may be used if the Section 10(a) prospectus precedes or accompanies the supplemental literature.[76] The issuer and the underwriter must employ the complete Section 10(a) prospectus as long as they are offering an unsold allotment. On the other hand, dealers need use the prospectus only during the forty-day period following the effective date or commencement of the public offering, whichever occurs later.[77] In general, after this period of time, the initial distribution stage is deemed to be completed and the 1933 Act no longer applies.

d. The Registration Statement and The Prospectus

The registration statement must contain the information specified in Schedule A of the Securities Act.[78] Amendments to the statement may be filed both before and after the effective date.[79] If the registration statement includes an untrue statement of a material fact or omits a material fact required to make the statements therein not misleading, the Commission may issue a stop order suspending its effectiveness.[80] The prospectus, if it is to meet prospectus requirement, must contain all the information contained in the registration statement save that contained in certain documents.[81] Schedule A sets out the items required for both the registration statement and the prospectus with respect to securities other than those issued by a foreign government. These items include information on the following:[82] issuer's name; state of incorporation; business address; executive personnel and promoters; underwriters; those owners of securities who own 10 per cent or more of one class or 10 per cent of the aggregate amount of stock; amount of issuer's securities held by the executives, promoters, under-

[74] Securities Act of 1933, §8(a), 1 CCH 1965 FED. SEC. LAW REP. ¶601.

[75] "It shall be unlawful for any person directly or indirectly . . . to carry or to cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10."
Securities Act of 1933, §5(b)(2), 1 CCH 1965 FED. SEC. LAW REP. ¶564.

[76] SEC Reg. §231.3844 (1957), 1 CCH 1965 FED. SEC. LAW REP. ¶3253.

[77] Securities Act of 1933, §4(3), 1 CCH 1965 FED. SEC. LAW REP. ¶554; SEC Reg. §231.844 *supra* note 76 at ¶3253; SEC Reg. §230.174 (1965, 1 CCH 1965 FED. SEC. LAW REP. ¶2862. See LOSS, *op. cit. supra* at 256-58.

[78] Securities Act of 1933, §7, 1 CCH 1965 FED. SEC. LAW REP. ¶591.

[79] *Ibid.* §8(b) and (c) at ¶¶602 and 603.

[80] *Ibid.* §8(d) at ¶604.

[81] *Ibid.* §10(a)(1) at ¶632. The documents which need not be included are copies of the underwriting contract, opinions of counsel, organization papers, underlying agreements affecting stock, etc. to be offered. See §10(a)(1).

[82] Schedule A can be found in 1 CCH 1965 FED. SEC. LAW REP. ¶¶901-933.

writers and 10 per cent owners, and amount for which such persons have indicated their intention to subscribe; description of business; capitalization; options; amount of stock to be offered; amount and nature of funded debt; use of proceeds from securities; executive salaries; estimated amount of proceeds; offering price to public; underwriters' commissions and discounts; offering expenses of the issues; information on prior offerings; payments to promoters; information on property acquired or to be acquired; officer, director and stockholder interests in property acquired; counsel; information on material contracts; balance sheets, profit and loss statements; and profit and loss statements for acquired business. In addition to the items set out in Schedule A, the Commission is authorized to require other information to be disclosed in the prospectus if it is necessary or appropriate for investor protection or the public interest.[83]

The registration procedure summarized above reflects the disclosure philosophy. The combination of the registration process and the antifraud provisions is manifestly designed to provide the investing public with complete, timely and accurate information. At the same time, the federal government did not and does not intend to guarantee the merits of a particular issue of securities.[84]

e. Civil Liability and the General Antifraud Provisions

Section 16 provides that the rights and remedies provided under the act are *in addition* to other rights and remedies existing in law or equity. Superimposed upon common law and state law remedies are three specific liability provisions in the 1933 Act. Section 11(a)(1) provides that any person who acquires a security in connection with a registration statement containing an untrue statement of a material fact or omitting to state a material act necessary to make the statements therein not misleading may sue, among others, those who signed the statement, directors and underwriters.[85] Persons, other than the issuer, may avail themselves of statutory defenses.[86] This assault on the concept of privity signifies this section's primary departure from precedent.[87] The number of cases based upon this provision are few, the main deterrent apparently being the Commission's careful examination of the registration statements.[88] Sections 12(1) and (2) respectively, provide that a purchaser of a security offered or sold in violation of Section 5,[89] or offered and sold by means of false or mislead-

[83] Securities Act of 1933, §10(c), 1 CCH 1965 FED. SEC. LAW REP. ¶637.
[84] See *ibid.* §23 at ¶801.
[85] *Ibid.*, §11(a) at ¶¶651-657.
[86] E.g., resignation before effective date, belief on reasonable grounds that the statements are true, statement made on the authority of an expert other than the defendant, etc. *Ibid.* §11(b) at ¶¶658-664.
[87] 3 LOSS, SECURITIES REGULATION 1731 (2d ed. 1961).
[88] *Ibid.*, 1686-87, 1690.
[89] Securities Act of 1933, §12(1), 1 CCH 1965 FED. SEC. LAW REP. ¶681. The

ing prospectus or oral communication may recover damages.[90] However, few cases can be traced to the application of Section 12.[91]

Section 17(a), the general antifraud provision of the Securities Act of 1933, supplements the specific liabilities of Sections 11 and 12. This is discussed subsequently, in connection with the antifraud provision of the Securities Exchange Act of 1934.

f. Exemptions

The Securities Act exempts several securities from its provisions and exempts numerous transactions from the registration requirements of Section 5.[92] In attempting to avoid the applicability of the Act, new insurance companies have tended to rely upon one or more of three exemptions: (1) the intra-state exemption, (2) the private offering exemption, and (3) Regulation A. These will be discussed more fully below.

2. *Securities Exchange Act of 1934*

a. Purposes

Whereas the Securities Act is primarily concerned with the initial distribution process, the Securities Exchange Act of 1934 focuses primarily on post distribution trading. It has four basic purposes:[93] (1) disclosure, (2) prevention of fraud and manipulation, (3) regulation of securities markets, (i.e. securities exchanges[94] and over-the-counter markets)[95] and (4) control of credit in securities markets.[96] We are primarily concerned with the first two.

liability under this section is virtually absolute. The plaintiff need only allege and prove (1) defendant was seller, (2) mails or some interstate commerce facility were used in the offer or sale made to plaintiff, (3) defendant failed to comply with either registration or prospectus requirement, (4) statute of limitations has not run, and (5) adequate tender was made when recission was sought. The defense is to allege and prove that the security or transaction was exempt. 3 Loss, *supra* note 87 at 1693.

[90] Securities Act of 1933, §12(2), 1 CCH 1965 FED. SEC. LAW REP. ¶683. There is some overlap between sections 11 and 12(2), e.g., when the seller is the issuer or underwriter of a registered security. However, since the ordinary dealer is not covered by section 11, section 12(2) is important to the ultimate investor.

[91] See 3 Loss, *supra* note 87, at 165 *et seq.*

[92] Securities Act of 1933, §§, 4, 1 CCH 1965 FED. SEC. LAW REP. ¶¶531-555.

[93] 1 Loss, *supra* note 87 at 130-131.

[94] Since the trading of life insurance stock rarely occurs on exchanges, we need do no more than merely highlight the SEC's control over an exchange. It is unlawful for a broker or a dealer to use the mails or facilities of interstate commerce for the purpose of using any facility of an exchange unless the exchange is registered. Securities Exchange Act of 1934, §5, 2 CCH 1965 FED. SEC. LAW REP. ¶20,171. An exchange may be registered if certain conditions are met. *Ibid.* §6(a) at ¶20,181. Among other things, the exchange must agree to comply with the rules of the SEC and provide specified information. *Ibid.* §§6(a)(1) and (2) at ¶¶20,182 and 20,183.

[95] The over the counter (OTC) market refers to the trading of securities other than on an exchange. It is primarily a negotiated rather than an auction market. For a discussion as to how the OTC market functions, see 2 Loss, *supra* note 87 at pp. 1277-87, and Loomis and Rotberg, *Over the Counter Market Quotations,* 62 MICH. L. REV. 589 (1964). The Exchange Act requires the registration of brokers and dealers (other than those whose busi-

b. Disclosure

The goal of disclosure is sought in four ways: registration, periodic reporting, proxy and insider trading requirements.

Registration Statement. Section 12(a) makes it unlawful for a broker or dealer to effect a transaction in any security on a national securities exchange unless the security is registered.[97] A security may be registered on an exchange by filing an application containing specified information with the exchange and a duplicate with the Commission.[98] Before securities are admitted to trading they must be au-

ness is exclusively intrastate) using the mails or any means of interstate commerce to effect any transaction or to induce the purchase or sale of any security other than on a national exchange. Securities Exchange Act of 1934, §15(a)(1), 2 CCH 1965 FED. SEC. LAW REP. ¶20,351. A broker or dealer registered under the Exchange Act who is not a member of a registered securities association may not engage in the securities business in the OTC market unless he, his firm, its principals and employees meet standards relating to training, experience and other qualifications. *Ibid.* §15(b)(8) at ¶20,360. The SEC can and does require the passage of examinations. *Ibid.* §15(b)(8)(C) at ¶20,360 and SEC Reg. ¶240.15b8-1 (1965), 2 CCH 1965 FED. SEC. LAW REP. ¶25,057A. Associations of brokers and dealers may be formed and registered if certain information is filed and conditions met. Securities Exchange Act of 1934, §15A(a), 2 CCH 1965 FED. SEC. LAW REP. ¶20,371. Only the National Association of Securities Dealers (NASD) is registered. To be eligible for participation, the rules of the association must be designed, among other things, to prevent fraudulent and manipulative practices and to promote investor protection. *Ibid.* §15A(b)(8) at ¶20,383. It is felt that the adequate protection of the investor and the honest dealer from marginal conduct by the fringe elements in the securities industry calls for self-regulation (under government supervision) of the industry's ethics. 2 Loss, *supra* note 87 at 1361. Furthermore, the rules of the association may not permit acceptance of a new member unless he qualifies as to training, experience, etc. *Ibid.* §15A(b)(5) at ¶20,380. However, disciplinary action or denial of membership is subject to review by the SEC. *Ibid.* §15A(g) at ¶20,394. Congress contemplated that effective discipline could be maintained in an association by authorizing economic sanctions against nonmembers. H. R. REP. No. 2307, 75th Cong. 3d Sess. (1938). The association may provide that no member shall deal with any nonmember except at the same prices, commissions, conditions, etc. as are afforded to the general public. Securities Exchange Act of 1934, §15A(i)(1), 2 CCH 1965 FED. SEC. LAW REP. ¶25,711. The rules of the NASD not only require members to treat nonmembers in the same manner as they treat the general public, but they also prohibit members from joining with any nonmember in a group contemplating underwriting the distribution of an issue of securities. NASD Rules of Fair Practice, Art. III, §25 as cited in 2 Loss, *supra* note 87 at 1370 (fn. 43). The antitrust laws are not violated by such practices. "If any provision of this section is in conflict with any provision of any law of the United States in force on the date this section takes effect, the provision of this section shall prevail." Securities Exchange Act of 1934, §15A(n), 2 CCH 1965 FED. SEC. LAW REP. ¶25,821.

[96] To prevent excessive use of credit for the purchase of securities, the Board of Governors of the Federal Reserve System is authorized to regulate the amount of credit which may be extended on a security registered on a national securities exchange. *Ibid.*, §7 at ¶20,201.

[97] *Ibid.*, §12(a) at ¶20,301.

[98] *Ibid.*, §12(b) at ¶20,302. The required information includes such items as organization, financial structure, nature of the business, rights, privileges, etc. of different classes of stock; terms of previous offerings; information on directors, officers and underwriters; remuneration; bonus and profit sharing arrangements; management and service contracts; options, material contracts, balance sheets, profit and loss statements, etc. *Ibid.*, §12(b)(1) at ¶303.

thorized for listing by the Exchange and must be registered under the Exchange Act.[99] The application for original listing serves a dual purpose. It furnishes to the Exchange information essential in determining the suitability of trading such securities on the Exchange and provides information to the investing public as to the merits of the security.[100] If the Exchange authorities certify to the Commission that the security has been accepted for listing by the Exchange, the registration becomes effective in thirty days.[101]

An issuer is not required to list securities on an exchange. The securities may be sold in the over-the-counter market (OTC) that is, otherwise than on an exchange. But, under the 1964 amendments to the Securities Act of 1934, OTC securities, except those meeting certain requirements,[102] must meet substantially the same registration requirements as those securities listed on an exchange.[103] These requirements are not applicable to insurance company securities if certain conditions, to be discussed later, are met.[104]

Periodic Reports. Every issuer of securities registered under Section 12, including OTC securities under the 1964 amendments, must file periodic and other reports as the Commission may require "to keep reasonably current the information and documents" filed pursuant to Section 12.[105] The filing of annual and semi-annual reports may also be required.[106]

Proxy Rules. The SEC is authorized by Section 14(a) to regulate proxy solicitation, made through the use of the mails or by any means of interstate commerce or facility of a national securities exchange, from holders of securities registered pursuant to Section 12. Since the 1964 amendment, OTC securities as well as listed securities are subject to the proxy rules.

Regulation 14A encompasses the proxy rules promulgated by the

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[99] New York Stock Exchange Company Manual, pp. B-5 and B-6, 2 CCH 1965 FED. SEC. LAW REP. ¶23,020.

[100] *Id.* at B-6, 2 CCH 1965 FED. SEC. LAW REP. ¶23,021.

[101] Securities Exchange Act of 1934, §12(d), 2 CCH 1965 FED. SEC. LAW REP. ¶20,307. A request for an acceleration of the effective date may be made. SEC Reg. §240,12d1-2 (1954), 2 CCH 1965 FED. SEC. LAW REP. ¶23,073.

[102] "Every issuer which is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce" and which has total assets exceeding $1 million and a class of equity securities held by 750 or more persons (500 persons after July 1, 1966) must file a registration statement. Securities Exchange Act of 1934, §12(g)(1), 2 CCH 1965 FED. SEC. LAW REP. ¶20,315.

[103] The registration statement must contain such information and documents, as the Commission may specify, which is comparable to that required by §12(b). *Ibid.*

[104] *Ibid.*, §12(g)(2)(G) at ¶30,316. For a discussion of the insurance exemption, see text, p. 309.

[105] *Ibid.*, §13(a)(1) at ¶20,332. See SEC Reg. §240.13a-11 (1949), 2 CCH 1965 FED. SEC. LAW REP. ¶23,512.

[106] SEC Reg. §240.13a-1 (1965), 2 CCH 1965 FED. SEC. LAW REP. ¶23,602.

SEC.[107] It governs every solicitation of a proxy with regard to securities registered under Section 12. The basic philosophy underlying the proxy rules is that of full disclosure. The rules are, in a sense, a little Securities Act. Within this basic framework, the SEC has designed the rules to make the proxy device the nearest practical substitute for shareholder attendance at company meetings. In essence, the proxy rules constitute a three-pronged attack implementing the disclosure philosophy.[108] (1) They require a description of the matter to be voted upon.[109] (2) They compel management to perform certain services for security holders if requested in writing by a security holder entitled to vote. Proposals which security holders want to be voted on (with some exceptions) are required to be included in management's proxy statement.[110] A security holder desiring to communicate with other security holders may require management to furnish him with list of security holders or to mail his communication for him (at management's option).[111] (3) They prohibit materially misleading or false statements.[112]

No proxy solicitation shall be made unless each person solicited is, or has been, furnished with a written proxy statement containing the detailed information specified in Schedule 14A.[113] Section 14(c) provides that unless proxies with respect to securities registered under Section 12 (including OTC securities) are solicited by management in accordance with the proxy rules prior to a security holders meeting, the issuer shall transmit to its security holders information "substantially equivalent" to the information which would be required to be sent if a solicitation was made.[114] This 1964 amendment eliminated a problem under the former Section 14(c) which permitted management to avoid such disclosure by refraining from soliciting proxies.

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[107] SEC Reg. §240.14a, 2 CCH 1965 FED. SEC. LAW REP. ¶¶24,005-24,016.
[108] See 2 LOSS, SECURITIES REGULATION 868-71 (2d. ed. 1961).
[109] SEC Reg. §240.14a-4 (1952), 2 CCH 1965 FED. SEC. LAW REP. ¶24,008.
[110] SEC Reg. §240.14a-8 (1954), *ibid.* at ¶24,012.
[111] SEC Reg. §240.14a-7 (1956), *ibid.* at ¶24,011.
[112] SEC Reg. §240.14a-9 (1956), *ibid.* at ¶24,013.
[113] SEC Reg. §240.14a-3 (1965), *ibid.* at ¶24,007. Schedule 14A requires the inclusion of information on the following items: revocability of proxy, dissenters' rights, solicitors and methods of soliciting, interest of persons in matters to be acted upon, voting securities and principal holders thereof, nominees and directors, remuneration of and other transactions with management, selection of auditors, bonus, profit sharing and other remuneration plans, pension and retirement plans, options, authorization of issuance of securities other than for exchange, mergers, consolidations, acquisitions, financial statements, acquisition or disposition of property, etc. Schedule 14A may be found in 2 CCH 1965 FED. SEC. LAW REP. ¶¶24,031-24,053. If management solicits the proxy with respect to an annual meeting at which directors are to be elected each proxy statement shall be accompanied or preceded by an annual report which contains such financial statements deemed by management to adequately reflect the financial position and operating results of the issuer. SEC Reg. 240.14a-3 (1965), *ibid.* at ¶24,007.
[114] Securities Act of 1934, §14(c), 2 CCH 1965 FED. SEC. LAW REP. ¶20,343.

Insider Trading. Prior to the enactment of the Exchange Act it was common for a director or corporate officer to profit from information not available to or known by outsiders. They used confidential information which came to them by virtue of their positions in personal market activities. Section 16 was enacted to combat such inequitable and improper practices in three ways.

(1) Insider Reports. An officer, director or principal stockholder of an issuer of securities registered under the Act, commonly called an insider, is required to file reports with the SEC as to his holdings of all of the issuer's equity securities. A further report must be filed within ten days after the close of each calendar month in which there has been any change in holdings.[115] The reports are made available to the public both at the Commission and at the Exchange.[116]

(2) Recapture of Short-Swing Profits. Section 16(b) was enacted to prevent an insider from unfairly using information obtained by reason of his relationship to the issuer in a short-swing speculation. Profits realized by an insider from any purchase and sale (or sale and purchase) of the issuer's securities within a six-month period may be recovered by the issuer. Suit to recover short-swing profits may be instituted by the issuer or by any security owner if the issuer refuses to do so. Section 16(b) furnishes an objective standard. Intent is not a factor. On the other hand, if more than six months elapse between purchase and sale, the insider is not liable under Section 16(b) whatever the profit from unfair use of information.

(3) Prohibition of Short Selling. Section 16(c) prohibits an insider from engaging in a short sale.[117]

c. Antifraud Provisions

Currently, there are three *general* antifraud provisions, namely, Section 17(a) of the Securities Act of 1933, Rule 10b-5 under Section 10(b), and Section 15(c)(1) of the Securities Exchange Act of 1934. Section 17(a) creates three separate offenses.

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—(1) to employ any device, scheme or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order

[115] *Ibid.*, §16(a) at ¶20,421. A principal stockholder is one who is the beneficial owner of more than 10% of any class of equity security.

[116] SEC Reg. §240.24b-3 (1951), 2 CCH 1965 FED. SEC. LAW REP. ¶26,464.

[117] *Ibid.*, §16(c) at ¶20,423. A short sale occurs when there is a sale of a security which the seller does not own or a sale which is completed by delivering a security borrowed on behalf of the seller. E.g., stock is selling at 100. Insider thinks it will drop to 80, so he sells shares which he does not own at 100, and buys shares when market drops to 80 to cover his previous sales.

> to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Section 10(b) makes it unlawful for any person through the use of the mails, an instrument of interstate commerce, or facility of any national securities exchange to use in connection with the purchase or sale of any security (whether or not registered) any manipulative or deceptive device in violation of rules prescribed by the Commission as necessary or appropriate in the public interest or for the protection of investors. Under this section, the SEC promulgated Rule 10b-5 which incorporated the substance of Section 17(a) of the Securities Act into Section 10(b) of the Exchange Act.[118] Similarly, Section 15(c)(1) authorizes the Commission to define manipulative and deceptive devices in the sale or purchase of securities in the over-the-counter market.[119]

The courts have repeatedly held that the fraud provisions under the federal securities laws are not limited to circumstances which are necessary to give rise to an action at common law. However, generally speaking, it is doubtful that the statutes have caused a radical departure from what the courts have decided or would come to decide in the absence of such provisions.[120]

Each of these provisions may be the basis of an injunctive, administrative,[121] or a criminal action.[122] Futhermore (as will be discussed

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[118] Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

SEC Reg. §240.10b-5 (1942), 2 CCH 1965 FED. SEC. LAW REP. ¶22,725.

[119] Rule 15c1-2 defines the term "manipulative, deceptive or other fraudulent device or contrivance" as used in §15(c)(1) in language similar to that of clauses (2) and (3) of §17(a) of the Securities Act of 1933. SEC Reg. §240.15c1-2 (1938), *ibid.* at ¶25,067.

[120] See 3 Loss, *supra* note 108 at 1435 and the sources cited therein. For a discussion of the relationship between common law deceit and SEC fraud concepts, see *ibid.* at 1430 *et seq.* For discussion of special SEC fraud concepts applicable to corporate insiders, see *ibid.* pp. 1445 *et seq.* For discussion of special SEC concepts applicable to broker-dealer and management advisors, see *ibid.* 1474 *et seq.*

[121] See Securities Act of 1933, §§20, 21, 1 CCH 1965 FED. SEC. LAW REP. ¶¶771, 781 and Securities Exchange Act of 1934, §§21, 22, 2 CCH 1965 FED. SEC. LAW REP. ¶¶20,481, 20,501.

[122] The Securities Act §24 provides that willful violations may result in a fine up to $5,000 and imprisonment up to 5 years. Securities Act of 1933, §24, 1 CCH 1965 FED. SEC. LAW REP. ¶811. The Securities Exchange Act of 1934 §32(a) provides for a $10,000 maximum fine and 2 years maximum imprison-

below), they may serve as the basis for private actions by sellers and purchasers of securities. These provisions overlap to some extent.[123]

d. Prevention of Manipulation

Market manipulation, although related, is not synonymous with fraud. A classic technique of manipulation may be described as follows. A group or pool of persons select a large block of stock possessing actual or potential market appeal and an easily controllable floating supply as the target for price manipulation. The pool secures an option to purchase the stock at a price somewhat higher than the then prevailing market price. It then attempts to raise the market price above the option price by increasing demand. The pool manager may open a number of accounts with various brokers and enter both buy and sell orders, preponderantly the former. The price rises with the increasing volume of transactions. The operator may engage in "wash" sales in which he is both the buyer and seller of the stock. Or, he may use "matched" orders in which he enters orders to sell knowing that a confederate is entering orders to buy at approximately the same time at approximately the same price. In addition, as the price rises slowly, favorable publicity as to the corporation's prospects may be disseminated. When the market price exceeds the option price, the operator exercises the option and then gradually sells off the acquired stock at a profit. Furthermore, if he is able to distribute the entire holdings of the optioned stock, he may sell short. The stock, which is now selling at an inordinately high level, will decline after the pool's support disappears, thereby enabling the manipulators to profit from both the rise and the fall in the market.[124]

Prior to the enactment of the Exchange Act in 1934, several cases in England and the United States, decided under the common law, reflected both the fraud concept and the free or open market concept. Under the former, it would not be unlawful to trade stock so as to raise or depress prices. Some degree of fraud must be involved. On the other hand, the "free market" concept deems manipulative trading itself to be fraudulent. An outsider is justified in believing that the quoted price is a reasonable appraisal of value in a free and open market.[125] The Exchange Act reflects a blend of these two concepts. The function of the antimanipulation provision is to furnish a greater degree of precision to the concept of manipulation

ment. However, no imprisonment if defendant had no knowledge of such rule or regulation. 2 CCH 1965 FED. SEC. LAW REP. §20, 601.

[123] See 3 Loss, *supra* note 108, pp. 1428-29.

[124] *Id.* at 1529-30.

[125] *Id.*, pp. 1531-4. See U.S. v. Brown, 5 F. Supp. 81, 85 (S.D.N.Y. 1933), *aff'd.* 79 F 2d 321 (2d Cir. 1935), *cert. denied sub nom.* McCarthy v. United States, 296 U.S. 650.

[126] 3 Loss, *supra* note 108 at 1541-2.

and to supply preventive and enforcement mechanisms.[126] Congress attacked the problem of manipulation in several ways: (1) specific prohibitions,[127] (2) vesting the SEC with rule-making authority,[128] and (3) general prohibition against trading for a manipulative purpose.[129]

Section 9(a)(1) of the Exchange Act makes it unlawful for any person to effect "washed" or "matched order" transactions in any security registered on a national exchange by using the mails, instrumentalities of interstate commerce or facilities of an exchange for the purpose of creating a misleading appearance of active trading. Section 9(a)(2) outlaws not only pool operations but every other device employed to persuade the public that the activity in a security reflects a genuine demand.

> It shall be unlawful for any person [via mail, instrument of interstate commerce] . . . To effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.[130]

Thus a violation of this section contains two elements, the requisite series of transactions and a manipulative purpose.

Sections 9(a)(1) and 9(a)(2) are founded primarily on the "free market" concept rather than on prevention of fraud.[131] When securities are sold at manipulated prices without disclosure of the manipulation, both the courts and the SEC have held the antifraud provisions to be violated.[132] Although Secton 9(a) specifically refers to securities listed on a national exchange, consistent with legslative intent, the SEC has used its administrative power to place the regulation of manpiulations in the OTC market, so far as practicable, on the same level as in the exchange market. This is achieved through the antfraud provisions of Section 15(c)(1).[133]

[127] Securities Exchange Act of 1934, §9(a), 2 CCH 1965 FED. SEC. LAW REP. ¶¶20,241-20,247.

[128] *Ibid.*, §§9(b) and (c) at ¶¶20,248, 20,252.

[129] Securities Act of 1933, §17, 1 CCH 1965 FED. SEC. LAW REP. ¶731; Securities Exchange Act of 1934, §§10(b) and 15(c)(1), 2 CCH 1965 FED. SEC. LAW REP. ¶¶20,273, 20,363.

[130] See Securities Exchange Act of 1934, §9(a)(6), 2 CCH 1965 FED. SEC. LAW REP. ¶20,247 which authorizes the SEC to promulgate rules regulating "pegging, fixing or stabilizing the price" which under proper circumstances is a beneficial form of manipulation. For a description of stabilization, its pros and cons, the SEC's approach, etc., see SEC Reg. §241.2446 (1940), 2 CCH 1965 FED. SEC. LAW REP. ¶22,512 *et seq.*

[131] 3 LOSS, *supra* note 108 at 1560. These sections are designed to provide investors with markets where prices are established by free and honest balancing of investment demand and supply. H.R. No. 1383, 73d Cong. 2d Sess.

[132] 3 LOSS, *supra* note 108 at 1561.

[133] See *ibid.*, pp. 1563-68, In the Matter of Halsey, Stuart & Co., 30 SEC 106 (1949) and Opinion of the Director of the Trading and Exchange Division,

3. *State Securities Laws*

Kansas is given credit for having enacted the first comprehensive state securities law in 1911. Since then, virtually all states have adopted some form of securities legislation.[134] In 1917, the Uniied States Supreme Court held that the Michigan, Ohio and South Dakota statutes did not violate the Fourteenth Amendment or unduly burden interstate commerce.[135] When Congress enacted securities legislation in the 1930's, rather than preempting the field, it chose to preserve state legislation and thereby create concurrent systems of regulation.[136]

With the development of state controls, three distinct regulatory devices have emerged. (1) Antifraud provisions authorize the administrator to issue warnings, investigate suspected fraudulent activities, enjoin such activities and punish violators. (2) Licensing requirements pertaining to brokers, dealers, agents and investment advisers afford the administrator a means to prevent unqualified or dishonest persons from entering into or remaining in the securities business. The license can be revoked if conduct falls below statutory requirements. (3) Provisions for the registration of securities were designed to afford the investor a better opportunity to make a good investment. The anti-fraud approach no longer exists in isolation. At least two and frequently all three of the regulatory devices may be found in the same act.[137] The anti-fraud provisions range from broad general prohibitions to none at all. The licensing provisions range from simple to elaborate. The registration of securities requirements range from rudimentary to comprehensive.

SEC Reg. §241.3505 (1943), 2 CCH 1965 FED. SEC. LAW REP. ¶22,551 at ¶22,554.

> We think that there is no reasonable distinction in this respect between manipulation of over-the-counter prices and manipulation of prices on a national securities exchange, and that both are condemned as fraudulent by the Securities Exchange Act and, in fact, were fraudulent at common law. . . . We believe that the Securities Exchange Act contemplates that Section 15(c)(1) affords to the over-the-counter market at least as great a degree of protection against manipulation or attempted control as is afforded to the exchange market by Section 9(a). We find, therefore, that respondents' activities constitute an 'act, practice, or course of business' which operated 'as a fraud or deceit' and that respondents thereby violated Section 15(c)(1) of the Securities Exchange Act and paragraph (a) of Rule (15c1-2) thereunder.

In the Matter of Barrett and Co., 9 SEC 319, 328 (1941). The SEC did not rely solely on the application of §9(a) to the OTC market. Its holding was fortified by applying fraud reasoning as well. *Id.* at 329.

[134] 1 Loss, *supra* note 108 at 27-28.

[135] Hall v. Geiger-Jones Co., 242 U.S. 539 (1917); Caldwell v. Sioux Falls Stock Yards Co., 242 U.S. 559 (1917); and Merrick v. N. W. Halsey & Co., 242 U.S. 568 (1917). See 1 Loss, *supra* note 108 at 28-30.

[136] 1 Loss, *supra* note 108 at 31, 155-7. "Nothing in this title shall affect the jurisdiction of the securities commission . . . of any State . . . over any security or any person." Securities Act of 1933, §18, 1 CCH 1965 FED. SEC. LAW REP. ¶751.

[137] 1 Loss, *supra* note 10 at 33-35.

The registration requirements of different states pose a seemingly infinite amount of variation in detail. In some states only very elementary information need be filed. A few states tie information requirements to broker-dealer registration. The majority of states prohibit sales of securities prior to some affirmative administrative action. Most states which require the filing of information specify standards upon which the denial, suspension or revocation of registration can be based. Although these standards vary considerably, they may be broken down into two basic categories. Some statutes establish relatively simple fraud and disclosure standards. If the statements are not misleading and the required information has been disclosed, the securities are entitled to registration. This is akin to the disclosure philosophy underlying the federal securities acts. Several state securities laws embody the "regulatory" concept. That is, the registration of a security can be denied if it fails to meet broad statutory standards. This type of statute vests a wide range of discretion in the regulator. For example, Section 10 of the Texas Securities Act provides:

> If he [Commissioner] finds that the proposed plan of business of the applicant appears to be fair, just and equitable . . . and that the securities which it proposes to issue and the methods to be used by it in issuing and disposing of the same are not such as will work a fraud upon the purchaser thereof, the Commissioner shall issue to the applicant a permit authorizing it to issue and dispose of such securities. Should the Commissioner find that the proposed plan of business of the applicant appears to be unfair, unjust or inequitable, he shall deny the application for a permit. . . .[138]

The so-called "fair, just and equitable" doctrine enables the administrator to pass upon the merits of the security. He is not restricted to requiring adequate disclosure. This is a more paternalistic approach than that found in the federal acts.

The complex nature of securities regulation, combined with the added complexity stemming from the differences in philosophy and detail from state to state led to the drafting of a model Uniform Securities Act which was adopted in 1956 by the National Conference of Commissioners on Uniform State Laws. This act consists of four basic parts. Part I concerns fraudulent and other prohibited practices. Part II concerns registration of broker-dealers, agents, investment ad-

[138] TEXAS REV. CIVIL STAT. ANN. Art. 581-10 (1964). Other states have similar provisions. E.g., IA. CODE §502.10 (1962); KAN. GEN. STAT. ANN. Ch. 17, Art. 12 §1260 (1959). In Illinois registration may be refused "if there are conditions affecting the soundness of a security so that the sale of such securities would be inequitable, or would work or tend to work a fraud or deceit." ILL. REV. STAT. Ch. 121½, §137.11(B) (1953). The "fair, just and equitable" doctrine has not been incorporated into the Uniform Securities Act. 9C NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, UNIFORM LAWS ANNOTATED 119-20 (1957).

visers. Part III deals with registration of securities. Part IV includes general provisions (e.g., definitions, exemptions, investigation, etc.) which are necessary—in varying degrees—to the three basic philosophies. Each of the first three parts was designed to stand alone or in combination, the hope being that at least substantial uniformity could be achieved among those states adopting a particular philosophy.[139] At least nineteen states have adopted this uniform act in some form.[140]

Several states, including those having the Uniform Securities Act, exempt securities issued by an insurance company.[141] In these states the regulation of the issuance of securities is left to the insurance law. However, insurance statutes were designed primarily for the protection of the policyholder. Consequently, a purchaser of an insurance security may enjoy little or no protection at the state level. On the other hand, some states which exempt insurance securities from their general securities statutes, do provide investor protection through special statutory and regulatory provisions under the insurance law.[142]

C. Specific Problems Pertaining to Investor Protection

The SEC has voiced concern over several aspects of stock promotions of new life insurance companies.[143] When problems pertaining to stock promotions arise in connection with life insurance companies, there is an interplay of interest between the state insurance and securities regulatory officials and the SEC. The primary responsibility for regulating the insurance industry rests with the states.[144] However, insurance regulation is focused mainly on the protection of the policyholder. The federal securities laws were enacted for the protection of the investor, with the responsibility for regulation falling upon the SEC. In an effort to meet their respective responsibilities to both investors and policyholders, and at the same time to avoid eroding the principle of state reg-

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139 Uniform Laws Ann., *ibid.* at 84. See 1 Loss, *supra* note 108 at 96-105.

140 See Uniform Laws Annotated (Supp. 1964), *ibid.* at 60 for citations to individual states.

141 1 Loss, *supra* note 108 at 65; Uniform Securities Act, §402(a)(5).

142 E.g., Calif. Insurance Code, §§820-860; Ill. Insurance Code §157.1 and Ill. Dept. of Ins. Rule 9.13, April 23, 1964.

143 It is obvious from a cursory review of the Commission's News Digest over the past few months, that the public is being deluged with a torrent of securities offerings by life insurance companies. Many of these offerings involve unusual distribution methods not normally encountered in the sale of securities of non-life insurance issuers. Also, many of these offerings are being made by companies that do not have any history of operation or do not have a history of profitable operations. In some cases, the market price for the securities of these companies has been manipulated or the securities have been sold by fraud.

SEC Staff Study as quoted by 2 Proceedings of the National Association of Insurance Commissioners ——— (1965) (Report of Subcomm. I2 To Study Proper Control of the Formation, Ownership and Licensing of New Life Insurance Companies, June 7, 1965, p. 2). See SEC, *Report of Special Study of Securities Markets*, H. Doc. No. 95, Pt. 3 (1963) at 42.

144 See McCarran Act, 59 Stat. 33 (1945) as amended 15 U.S.C. 1011-15 (1958).

ulation, the SEC staff members and representatives of the NAIC have held extended discussions relating to those aspects of the new company phenomenon of mutual inteest. As yet no final conclusions have been reached; but the SEC has noted that, while it hopes to avoid numerous formal actions, it has the power to cope with improper practices. It urges that abuses be curbed promptly to avoid damage to the public confidence in the business.[145] We shall examine some of the problems and comment on remedial action which has been or may be taken.

1. *Failure to Register Under the 1933 Act*

New insurance companies have frequently relied upon the intrastate, the private offering or the Regulation A exemption to avoid compliance with the federal securities laws.[146] In doing so, when the circumstances do not warrant, these companies are depriving investors of the protection which Congress intended them to have. An examination of these exemptions suggests that their availability to new life insurance companies is, in fact, quite limited.

a. Intrastate Exemption

Section 3(a)(11) exempts from the Securities Act

> Any security which is a part of an issue offered and sold only to persons resident within a single State . . . where the issuer of such security is a . . . corporation, incorporated by and doing business within such State. . . .

The exemption applies "only to local financing of such nature that it may be practicably consummated in its entirety" within the state. For the exemption to be effective, the securities must be found in the hands of resident investors when the ultimate distribution is completed. This occurs when the securities are purchased "for investment and not with a view to further distribution or for purposes of resale." On the other hand, after the securities have actually "come to rest" in the hands of a resident investor, who purchased without a view to further distribution, the securities may be sold to a nonresident without affecting the exemption. The entire issue must be distributed to residents. If any part of the issue is offered or sold to a nonresident, the exemption is unavailable to all securities constituting a part of the issue, including those sold to residents. Even a dealer who sells securities only to residents risks civil liability for selling unregistered securities be-

[145] See 2 PROCEEDINGS OF NAIC, *supra* note 143 at 12-1, 2 and Life Insurance Association of America Monthly Report, March, 1965, p. 15.

[146] See e.g., Special Study, *supra* note 143, at 42; In the Matter of Associated Investors Securities, Inc., SEC Securities Exchange Act Release No. 6859 (July 24, 1962), CCH 1961-1964 FED. SEC. LAW REP. ¶76,858; In the Matter of J. H. Goddard & Co., Inc., SEC Securities Exchange Act Release No. 7618, Investment Advisers Act Release No. 189 (June 4, 1965), CCH CURRENT FED. SEC. LAW REP. ¶77,251. For a company contemplating reliance upon an exemption it is important to note that the person claiming an exemption has the burden of proving that he is entitled to it. SEC Reg. §241.6721 (§231.4445) (1962) 2 CCH 1965 FED. SEC. LAW REP. ¶¶22,753, 22,754.

cause of the possibility of another dealer, for example, selling to a non-resident or to a person who has a view to resale and does, in fact resell to a non-resident.[147] Insurers who contemplate invoking this exemption should be cognizant of its stringency.

b. Private Offering Exemption

Section 4(2) exempts from the registration and prospectus requirements of Section 5 those "transactions by an issuer not involving any public offering." However, the statute does not define what constitutes a "public offering." In *SEC v. Ralston Purina Co.*, the United States Supreme Court said that the crucial question is

> whether the particular class of persons affected needs the protection of the Act. The focus of inquiry should be on the need of the offerees for the protections afforded by registration. The employees here were not shown to have access to the kind of information which registration would disclose.[148]

In another case the Second Circuit Court of Appeals said

> . . . the governing fact is whether the persons to whom the offering is made are in such a position with respect to the issuer that they either actually have such information as a registration would have disclosed, or have access to such information.[149]

As the *Ralston* case suggests, the number of offerees is not determinative as to whether the offering is public or private. All relevant factors must be considered.[150]

One consideration is whether the securities offered have come to rest in the hands of the initially informed group of purchasers, or whether this group acts merely as a conduit (having a view to resale) in a wider distribution. Persons acting in this capacity are deemed to be underwriters who constitute one part of the distribution process. Persons to whom they offer to sell the stock may be in need of the information so as to render the private offering exemption unavailable. If the purchasers do in fact acquire the securities with a view to public distribution, the seller assumes the risk of civil liability for noncom-

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[147] See Letter of General Counsel, SEC Reg. §231.1459 (1937), 1 CCH 1965 FED. SEC. LAW REP. ¶¶2260-2262; and SEC Reg. §231.4434 (1961), 1 CCH 1965 FED. SEC. LAW REP. ¶¶2270-2277. If securities are sold a short time after their acquisition, the inference (although not conclusive) would be that they had not been purchased for the purpose of an investment. A similar inference arises if the seller is a dealer rather than a nonprofessional. Letter, *ibid.* at ¶2262. Customarily, sellers obtain assurances from purchasers that the purchase is not made with a view to resale. Reg. §231.4434 (1961); 1 CCH 1965 FED. SEC. LAW REP. ¶2272.

[148] 346 U.S. 119, at 125, 127 (1953).

[149] Gilligan Will & Co. v. SEC, 267 F. 2d 461, 466 (2d Cir. 1959).

[150] E.g., SEC Reg. §231.4434 *supra* note 147 at ¶2272; Letter of General Counsel, SEC Reg. §231.285 (1935), 1 CCH 1965 FED. SEC. LAW REP. ¶2740-44. See In the Matter of Dempsey & Co., CCH 1957-1961 FED. SEC. LAW REP. ¶76,585 (1958). See 1 LOSS, SECURITIES REGULATION 654-55 (2d ed. 1961).

pliance with the registration requirement.[151] Presumably, offers made solely to persons having access to information required in a prospectus are the exception rather than the rule.

c. Regulation A

Section 3(b) authorizes the SEC to exempt a class of securities, subject to such conditions as it may prescribe, if it finds that enforcement of the Act is unnecessary in the public interest or for investor protection by reason of the small amount involved or the limited character of the public offering. Such an exemption is available only where the issue offered to the public is $300,000 or less. The purpose of this section is to facilitate the raising of new capital by small business.[152] Under this section the SEC has promulgated Regulation A.[153]

Following revisions made in 1953, Regulation A, in effect, requires a simplified prospectus for certain issues up to $300,000. No securities may be offered under Regulation A until ten working days after filing of a "notification," which includes certain required information. No written offer of securities may be made under Regulation A unless an offering circular containing specified information has been furnished to the offeree. The exemption can be suspended for, among other things, violating the antifraud provisions.[154]

The $300,000 limitation on the amount which can be raised impairs the utility of Regulation A exemption for life insurance companies. As will be discussed below, this amount may be substantially less than adequate in lauching a new life insurance company. However, in this connection we note that thirty-five states have capital and surplus requirements of $300,000 or less,[155] and forty-nine new companies organized in 1964 had initial capital and surplus of $300,000 or less.[156]

d. State Cooperation

The SEC is in no position to scrutinize closely all new life insurance companies from their incipiency. Individual state insurance departments occupy a more strategic position. New insurers must obtain a license and must renew it in subsequent years. If the department is cognizant of the securities requirements it could, perhaps, refuse to license a company until the insurer registers with the SEC. Or, if the department lacks sufficient discretionary power to refuse a license on this basis, it could suggest that the company file with the SEC. If the company refuses, the department could inform the SEC, which could then compel compliance in appropriate cases.

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[151] SEC Reg. §231.4552 (1962), 1 CCH 1965 FED. SEC. LAW REP. ¶2770 at ¶2777.
[152] See 1 Loss *supra* note 150, at 612.
[153] SEC Reg. §230.251-.263 (1956), 1 CCH FED. SEC. LAW REP. ¶¶2359-71.
[154] See 1 Loss, *supra* note 150 at 610-11, 619-26.
[155] See note 411, *infra*.
[156] Best's Life Insurance News, March 1965, p. 14.

2. *Unorthodox Stock Distribution*

Typically, when a new company organizes and seeks public financing, it contracts with a group of professional underwriters to handle the distribution. The stock is then distributed from the issuing corporation, through the professional underwriters, brokers and dealers to the investing public. However, the promoters of a new life insurance company frequently by-pass the use of a professional by organizing their own captive underwriter. In some instances the underwriter forms and owns the new insurer. For example, the prospectus of one life insurance company stated that an investment corporation

> was established for the sole purpose of underwriting and selling the stock of the Company [insurer]. . . . Its [the investment company's] stock is wholly owned by————————who will thus personally be able to profit from the underwriter's commission payable upon the sale of the stock hereby offered. He is the proposed Chairman of the Board [of the insurer]. . . . [O]fficers of the [insurer] . . . will be licensed as securities salesmen with [the investment company] . . . and thus will personally profit from the sales commissions. . . .

The prospectus also revealed that the commission rates on the sale of stock of this company were 15 per cent.[157] Total commissions and expenses exceeded $1.3 million, the bulk of which went to the organizers as commissions.[158] Consequently, before the company even became a going concern, its organizers garnered a substantial return by having the underwriting commissions paid to themselves rather than to a professional underwriter. This is a common method for distributing the stock of new life insurance.[159]

Both the NAIC and several states have recognized the potential for abuse in the area of promoters' commissions, discounts and expenses.[160] For example, an NAIC subcommittee recommended that organizers be required to disclose to regulatory authorities "all promotional cost spent and to be spent." It was also recommended that the regulatory authority

[157] In some public offerings of stock of new life insurance companies, no underwriting commissions are paid when no professional underwriter is used. Prospectuses in file; see note 15 *supra.*

[158] This information was derived from the company's prospectus and Best's Life Insurance Reports (1964).

[159] E.g., one prospectus stated that the new life insurance company's stock distribution was handled by a newly licensed securities dealer. The underwriter's stock was solely owned by the president of the insurer. Commissions were paid at a rate of 12%. Another prospectus revealed that the underwriters performed such function in connection with the organization's three other life insurance companies but otherwise they have not been involved in the selling of securities.

[160] A hearing before a state securities department (Jan. 1963) revealed that in purchasing a life insurance company, a promoter paid $.50 per share of stock. Within a few days he sold some of his stock at $2.00 per share. He asserted that a promoter should be compensated for his services but admitted that he had not rendered services in this few day period.

> be given the power to determine what are promotional expenses and that such promotional expenses shall not exceed 10% of the selling price of the entire issue of capital stock . . . sold to the public.[161]

California considers options to promoters to be a promotional expense and as such should be justified "by a showing of the nature of the services or other consideration justifying the grant of the options." Furthermore, the total of all expenses (including the value of such options) cannot exceed 10 per cent of the amount actually paid for the capital stock.[162]

When professional underwriters and dealers are bypassed, the likelihood of irregularities in the distribution process may increase since the distribution is being handled by persons with little or no experience in selling securities. Since the enforcement of a law rarely keeps pace with widespread infractions, intentional or inadvertent, the public investor may be adversely affected. [163]

Some new life insurers have attempted not only to distribute stock through its directors and officers, but also through its agents. [164] When the officers and directors distribute the stock (with or without commission) they may be considered "underwriters" as defined by the Securities Act of 1933.[165] An agent selling his companys' stock for the company could also be deemed an "underwriter." As such, the directors, officers and agents would be obligated to deliver prospectuses and comply with the statute's other requirements. They would also be subject to the statute's liabilities. This potential liability should either deter nonprofessionals from acting as securities salesmen or, at least, enhance investor protection by encouraging prospectus distribution. It would not, however, protect the investor from the mistakes attributable to the seller's lack of experience in this area.

[161] 2 PROCEEDINGS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 512 (1959).

[162] Calif. Dept. of Ins. Memorandum, Nov. 25, 1964, as amended Jan. 15, 1965. Other states also impose limitations on promotion and selling expenses. E.g., IOWA CODE §506.4 (Supp. 1963) (15%); TEXAS REV. CIVIL STAT. ANN. Art. 581-9B (1964) (20%). "The terms 'fraud' or 'fraudulent practice' shall include . . . the gaining, directly or indirectly, through the sale of any security, of an underwriting or promotion fee or profit . . . so gross or exorbitant as to be unconscionable." TEXAS REV. CIVIL STAT. ANN. Art. 581-4F (1964).

[163] The SEC has expressed concern over the unorthodox distribution of securities via nonprofessional underwriters. See note 143 *supra* and LIAA Monthly Report, March 1965, p. 15.

[164] Hearings before a state securities department (Jan. 1963).

[165] "The term 'underwriter' means any person who . . . offers or sells for an issuer in connection with the distribution of any security. . . ." Securities Act of 1933, §2(11), 1 CCH 1965 FED. SEC. LAW REP. ¶522. One prospectus noted that "The offering is being made by the Company and its Officers and Directors, without an underwriter. While there is no underwriting commitment and no compensation or commissions will be paid in connection with this offering, such Officers and Directors may be deemed to be 'Underwriters' as that term is defined in the Securities Act of 1933."

The Michigan Corporation and Securities Commission has adopted a direct approach in countering abuses resulting from the nonprofessional broker-dealer technique. According to department policy, a public offering of a new insurance company may not be sold in whole or in part by or through a broker-dealer affiliated with the insurer or persons having affiliations common to both.[166] In addition to obviating the potential abuses described above, the prohibition of the use of captive broker-dealers, compels the use of professionals who are under a higher degree of fiduciary obligation to their clients. This duty, coupled with the fact that their interest in the sale of the stock may not be as strong as that of the promoters, renders the possibility of overselling less likely than if the promoters carried out their own distribution.

3. *Misleading Statements*

One technique employed in the sale of new life insurance company stock has been aptly described as the "shell-game phenomenon." The prospect is induced to concentrate on the favorable results of long established, successful companies while at the same time he is persuaded to speculate in untested securities issued by new insurers.[167] For example, the salesman of Company XYZ may illustrate that $10,000 invested in Company ABC in 1954 would be worth $150,000 in 1964. The phenomenal success of some older companies furnishes the springboard for the sale of stock in new and untried ventures.[168] This type of representation has been held to violate the antifraud provision of the federal securities acts. The failure to point out the material differences between the securities of long-estabished, well-known companies with substantial assets and insurance in force at the beginning of the

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[166] Letter from Michigan Corporation and Securities Commissioner to Author, August 24, 1965. Many states would appear to have sufficient statutory authority to prohibit "captive" underwriters if they have proved to be a problem. Those states under the "fair, just and equitable" doctrine could deny registration. In addition, some states, such as Texas, provide that

> If it appears to the Commissioner at any time that the sale or proposed sale or method of sale of any securities . . . would tend to work a fraud on any purchaser thereof or would not be fair, just or equitable to any purchaser thereof, the Commissioner may . . . (after appropriate notice and opportunity for hearing) issue a written cease and desist order. . . .

TEXAS REV. CIVIL STAT. ANN. Art. 581-23A (1964). Recently, the SEC has brought action against a brokerage firm alleging among other things that sales of a life insurance stock were made without disclosing that the firm and the insurer were under common control. See The National Underwriter, Oct. 30, 1965, p. 10.

[167] Pfeffer, *Measuring the Profit Potential of a New Life Insurance Company*, J. of Risk and Ins., Sept. 1965, p. 413.

[168] Address by Superintendent Stern (N.Y.), Chicago Conference for Young Life Insurance Companies, Sept. 1-2, 1965, p. 7; Ins. L. J., Oct. 1964, p. 613; The National Underwriter, March 27, 1965, p. 4; Changing Times, May 1965, p. 35; and Forbes, May 1, 1965, p. 21. See In the Matter of George J. Mitchell, Jr. Co., Securities Exchange Act Release No. 6433 (1960), CCH 1957-1961 FED. SEC. LAW REP. ¶76,735.

growth period cited, and the securities of new companies is deemed to be materially misleading.[169]

Some sellers of life insurance stock have also seized upon state regulation and the life insurance industry's reputation for safety as a basis for assuring profits in advance. For example, one brochure stated

> Like commercial banks they [life insurance companies] are so closely supervised and protected by government agencies that it is almost impossible for them to lose money on operations.
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>
> Profits can be assured in advance. Life insurance is the only type of business able to assure itself, legally, of a profit each and every year. [170]

Another brochure contained statements to the effect that, because of state laws and regulations, investment in life insurance stock is unusually safe and that the life insurance business is the only business whose profits could be assured of in advance.[171] These representations have also been held to be misleading.[172] Policing the number and variety of deceptive and misleading statements in connection with the sales of securities imposes a staggering burden on both state and federal securities regulators. Nevertheless, vigorous enforcement of antifraud provisions certainly affords some deterrence.

Furthermore, an investor may have a private right of action under the securities statutes' antifraud provisions, although no specific sections in either statute create such a right. Some courts have held that the violation of either Section 17(a) of the Securities Act of 1933 or Section 10(b) of the Securities Exchange Act of 1934 by the use of fraudulent devices impliedly creates a civil liability which may be enforced in the courts.[173] This liability has been predicated on a tort doctrine.

> It is also true that there is no provision in Section 10 or elsewhere expressly allowing civil suits by persons injured as a result of violation of Section 10 or of the Rule. However, 'The violation of a legislative enactment by doing a prohibited act, or

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[169] See Mitchell case, *ibid.* and In the Matter of Whitehall Corp., Exchange Act. Rel. No. 5667 (1958), CCH 1957-1961 FED. SEC. LAW REP. ¶76,573.

[170] See Case Publication Order No. CP-231, Texas State Securities Board, May 28, 1965.

[171] Mitchell case, *supra* note 168. See a similar representation in the Whitehall case, *supra* note 169.

[172] Mitchell case, *supra* note 168 and Texas Securities Board Order *supra* note 170.

[173] Osborne v. Mallory, 86 F. Supp. 869 (S.D. N.Y. 1949). See also Fratt v. Robinson, 203 F. 2d 627 (9 Cir. 1953) (defrauded party has civil cause of action under Rule 10b-5 even though transaction was purely private, having no relation to any securities exchange, stock dealing organization or any person connected with the over-the-counter market). Robinson v. Difford, 92 F. Supp. 145 (E.D. Pa. 1950); Speed v. Transamerica Corp., 71 F. Supp. 457 (D.C. Del. 1947). Additional authority cited in 3 Loss *supra* note 150 at 1763 (f.n. 260, 261).

> by failing to do a required act, makes an actor liable for an invasion of an interest of another if: (a) the intent of the enactment is exclusively or in part to protect an interest of the other as an individual; and (b) the interest invaded is one which the enactment is intended to protect. . . .' Restatement, Torts, Vol. 2, Section 286. This rule is more than merely a canon of statutory interpretation. The disregard of the command of a statute is a wrongful act and a tort.[174]

Until recently, the Supreme Court has not considered the question of an implied private right of action under any section of the federal securities law.[175] However, in 1964, the Court held that such a right does exist on the basis of alleged proxy rule violations.[176] While Section 14(a) provides no specific private right of action, the fact that the rules adopted thereunder are for "the protection of investors" implies the availability of private recourse to the courts. Identical language appears in Section 10(b). This suggests that the Court would reach the same conclusion with respect to a private right of action under the antifraud Rule 10b-5.[177]

4. *Manipulation*

Many of the ingredients of a stock promotion may be inocuous when each is viewed individually. However, a combination of such elements may result in manipulation.

One promotional technique is the creation of the appearance of scarcity when this, in fact, is not the case. This impression may be achieved through limitations, or apparent limitations, on the amount of stock to be distributed. For example, the promoter might say that only 10,000 shares have been allocated to a particular community or geographical area, or, only 1,000 shares will be sold to any one person. The later limitation may be refined by the "center of influence" approach. Here, various persons are contacted and informed that they will receive, for example, 500 shares in return for 25 names of potential purchasers. The "center of influence" may be required to make appointments or actually participate in the meeting with the 25 prospects. Each prospect may be limited to the purchase of 300 shares. Through these limitations, whether alleged or real, the appearance of scarcity

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[174] Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1947). The court also suggested an alternative basis for the decision. Section 29(b) provides that the contracts violating the Act are void. This implies a remedy. The statute would be of little value, otherwise. See POSNER, FEDERAL REGULATION OF SECURITIES 20 BUSINESS LAWYER 595, 604-06 (1965).

[175] Posner, *supra* note 174 at 595.

[176] J. I. Case Co. v. Borak, 377 U.S. 426 (1964).

[177] See POSNER, *supra* note 174 at 613. Although this "same word" analysis is inapplicable to Section 17(a), because of the similarity between Section 17(a) and Rule 10b-5, it is likely that the Court would reach the same conclusion concerning Section 17(a). In this instance, it might resort to the statutory tort theory even though this theory was not used in the *Borak* case.

is created. In addition, affirmative misrepresentations or innuendos may be used in attempting to sell the stock. The combination of pressure selling, glowing representations as to the company and its stock and the apparent scarcity of the stock, all tend to induce prospective investors to purchase the amount offered to them and to enter the open market to acquire additional stock for which their appetite has been whetted. The resulting increased demand in the open market drives up the price of the stock. As a consequence, investors purchase additional shares at a higher price induced by an artificially created demand, not by a genuine demand inspired by the merits of the company and its prospects. Eventually, the market price of the stock may decline to a more realistic level. In the meantime, however, the promoters may have sold their shares, leaving the average investor a victim of their manipulation.

Another manipulative technique, designed to enhance the value of the promoter's stock, involves intentional oversubscription. The promoters limit the offering to an amount significantly less than the anticipated demand. To the extent the offering is oversubscribed, the money is refunded to the prospective investor. The refusal and return of the subscriber's money tends to whet his appetite to a greater degree than when he originally subscribed to purchase the stock. Thus, the "after market" is favorably conditioned. When trading of the stock commences, an initial reservoir of demand has been generated, and tends to drive up the price.

The intentional oversubscription technique may have a direct impact on the policyholder of a new company. Subsequently, it will be shown that new companies frequently find it necessary to resort to repeated stock offerings in their early years to raise additional capital. Second issues may or may not be successful in raising sufficient funds depending upon the vagaries of the market. At least from the standpoint of a sound financial structure (policyholders' safety), it would be advantageous for a new company to obtain as much capital as possible at the outset. To intentionally limit the amount of funds obtained by the company, for the purpose of enhancing the market value of the stock, may be injurious in the long run to both the average investor who is caught up in this manipulation and the policyholder who is depending upon the company's financial stability. The deterrence of this practice would directly benefit both.

The above examples are illustrative, not exhaustive, of the types of manipulative techniques employed by some promoters. It is even conceivable that variations on the classic "washed sales" or "matched orders" methods are utilized despite specific prohibitions at the federal

level.[178] There are undoubtedly other methods which we have not touched upon.

The SEC possesses several legal sanctions which it can bring to bear upon those stock promotions falling within its jurisdiction. In addition to the specific prohibitions found in Section 9 of the Securities Exchange Act, there are the general antifraud and manipulation sections. The primary difficulty appears to be the discovery of abuses rather than the lack of sufficient statutory authority to act. State regulators are closer to the pulse of local stock promotions. Whereas a group of promoters may attempt to avoid federal scrutiny by relying on the exemptions, in most cases the stock issue must be registered at the state level. Furthermore, a new insurer must be licensed by the state insurance department. Here again it is subject to regulatory scrutiny.

In states whose securities laws embody the regulatory approach, the securities commissioner possesses the means to counteract questionable practices in their incipiency. With the ultimate sanction of refusing to register the stock, thereby prohibiting its sale, the commissioner is in an excellent position to bring pressure to bear on the promoters to eliminate objectionable features in the stock offering. Thus, factors which lend themselves to manipulation can be screened out in advance.

5. *State to State Movement*

There is ample evidence that it is not an uncommon practice for a promoter, or group of promoters, to move from state to state organizing new life insurance companies.[179] Some promoters, who could appropriately be called transient promoters, have cut their ties with their earlier promotions, often leaving in their wake a string of failing life insurance companies.[180] Other promoters organize new companies which are related to each other through financial ties (e.g., holding companies) or through service, consulting, management or other types of contracts.[181]

a. Transient Promoters

Transient promoters who terminate association with their former

[178] See Pfeffer, *supra* note 167 at 415. For discussion of "washed sales" see text, p. 202.

[179] BEST'S LIFE INSURANCE REPORTS (1965) lists the names of promoters, principal officers and directors, sometimes indicating prior insurance connections. BEST'S also indicates affiliated groups of companies.

[180] For example, one executive left four companies of which only one had a profit in 1964. One suffered a loss. Two were retired. Nine other executives left one or more companies which either suffered a loss or were retired. These examples were derived from a cursory survey of BEST'S LIFE INSURANCE REPORTS (1965) which sometimes gives the principal officers' prior experience. Where names of former companies are given, such companies can be traced back. An extensive, detailed survey of BEST'S would undoubtedly reveal additional examples. Furthermore, many new and small operations do not appear in BEST'S.

[181] BEST'S LIFE INSURANCE REPORTS (1965) and prospectuses in files.

companies have little interest, from an insurance viewpoint, in the results of their promotions. At least, it is difficult to reach any other conclusion in view of their short-run participation in a venture which is inherently long run in nature. These promoters, who frequently have little experience in the insurance business, have no roots in the community. They profit from local stock promotions by reaping monetary reward in the form of stock commissions and in the form of gains from a rising market. Shortly thereafter they move on to another state repeating the same cycle.[182] The investing public wants life insurance stocks. The promoter seeks to capitalize on this desire.

Both California and Iowa have translated their concern over transient promoters into affirmative action. The California Department of Insurance guidelines provide that the promoters, initial directors and initial officers as a group must purchase a substantial portion of the original issue for cash and on the same terms as offered to other investors. Ordinarily this portion is not to be less than 25 per cent of the first $1,000,000 and not less than 15 per cent of the excess over $1,000,000. Each person investing in the company pursuant to this requirement must execute an agreement for the benefit of the company and its shareholders to the effect that he will not sell, transfer or encumber such shares without the Commissioner's consent unless in accordance with the following schedule: 5 per cent after each of the first and second years, 10 per cent after the third year, 20 per cent after the fourth year, and the remainder after five years.[183] The requirement of a substantial investment coupled with restrictions on the alienability of the stock prevents the promoter from operating in a "hit and run" fashion—i.e., promoting new companies and then selling their holdings in rapid succession—and assures the promoters' continued interest in the company as a going company for a period of several years.

The Iowa Department of Insurance has promulgated several requirements paralleling those of California. The promoters must invest their own funds in at least 20 per cent of the proposed issue, they cannot alienate their holdings for a three year period, they cannot acquire securities at less than the public offering price, and they are limited as to stock options. In addition, the Department requires that the chief executive officer be a bona fide resident of the state.[184]

[182] For description of a typical local stock promotion, see text pp. 180-181.

[183] Calif. Dept. of Ins. Memorandum *supra* note 162. In Illinois, promoters must deposit in escrow enough money to purchase at least 15% of the shares at the public offering price. These shares are to be held in escrow and not disposed or for a period of at least three years. Ill. Dept. of Ins. Rule 9.13 §7, April 23, 1964.

[184] Iowa Dept. of Ins. Ruling T6, Nov. 12, 1963. Similarly, the New York Department requires "[n]on-alienation commitments from insiders and agents that stock sold to them in connection with new or later financing shall be

Both the California and the Iowa substantial investment requirements may indirectly prevent wholesale alienation of the promoters' stock after the specified period of five years and three years respectively. An attempt to "unload" substantial blocks of stock for a "quick profit" could depress the market, thereby discouraging such an attempt.

The SEC can partially fill the gap in investor protection in those states where the regulator lacks the power to promulgate such regulations or is unwilling to do so. The SEC could require promoters to disclose in the prospectus not only prior experience and the companies with which they were associated, but also some concise statement on the financial condition of such companies. The prospective investor in the promoter's new venture is entitled to know whether the promoter's previous endeavors have been successes or failures. Similarly, the SEC could require promoters to disclose attempts to register the securities in other states and whether such attempts were denied. Presumably, prospective investors would be highly interested in knowing about previous denials and the reasons for them. If the transient nature of the promoters is revealed, investors may be less enthusiastic to finance such a venture.

b. Affiliated Groups

Other promoters organize companies in different states, yet retain affiliation with the original companies.[185] For example, the New York Insurance Department, in checking a proposed subscription for stock, found that six of the promoters owned significant amounts of stock in one or more other newly organized companies.[186] Typically, there is a substantial interlocking between the board of directors, management and ownership of the affiliated companies.[187] Sometimes the tie is based upon a service, management or other type of contract.[188] Some persons even act as president of two or more life insurance companies domiciled in the same state.[189] (Iowa applies one antidote to this prac-

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held for a period of not less than two years." 106th ANNUAL REPORT OF THE SUPERINTENDENT OF INSURANCE TO THE NEW YORK LEGISLATURE COVERING 1964, p. 25.

[185] A cursory survey of BEST'S LIFE INSURANCE REPORTS reveals more than 20 affiliated groups of companies. A more extensive inquiry presumably would reveal additional examples. Furthermore, many of the newer companies are not reported in detail in Best's. If figures on these companies were available, the number of affiliated groups, we believe, would be substantially higher.

[186] N.Y. Report *supra* note 184 at 24.

[187] An example from BEST'S LIFE INSURANCE REPORTS (1965) lists an insurance executive as chairman of the board of five companies and as director of a sixth company. Nine other members of management held between two and six positions apiece as officers or directors in these companies. The authors have similar examples in their files.

[188] E.g., one member of an affiliated group contracted with another member to provide the latter with underwriting, accounting, issuing, etc. service in consideration of 12½% of first year premiums and 3% of renewal premiums. Prospectus in authors' file.

[189] For example, a company in BEST'S LIFE INSURANCE REPORTS (1965) lists an

tice by requiring the chief executive officer of the new company to "devote his entire time to such duties. . . .")[190]

This type of operation prompts the question: When a promoter organizes a new company in another state, while at the same time retaining his relationship with the old company, is he involved in a conflict of interest situation? In other words, should the old company alone be entitled to the promoter's efforts in the development of a potential insurance market? This question becomes more acute when an individual is the principal officer of two or more companies which are domiciled in the same state and are competing in the same market. Being a principal officer or director of the old company involves a fiduciary obligation to that company and to its stockholders[191] which may be breached by the promotion of new ventures.[192] In the case of *Guth v. Loft, Inc.,* the Delaware Supreme Court said the obligation is one

> . . . that demands of a corporate officer or director . . . the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which

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individual as Vice President, Chairman of the Board and President, Vice President and Director, and President and Director, of three companies incorporated and licensed only in the same state and one company licensed in four states. Each of four other officers simultaneously hold top management positions in each of the four companies.

190 Ia. Dept. of Insurance Rule T6, Nov. 12, 1963.

191 E.g., McCandless v. Furland, 296 U.S. 140 (1935); Perlman v. Feldmann, 219 F. 2d 173 (2d Cir. 1955), *cert. denied* 349 U.S. 952 (1955); Orlando Orange Groves Co. v. Hale, 107 Fla. 304, 144 So. 674 (1932); Manson v. Curtis, 223 N.Y. 313, 119 N.E. 559 (1918).

192 Possibly on the theory of usurpation of a corporate opportunity. See 19 AM. JUR. 2d *Corporations* §§1311-12 (1965). Such a theory is based upon the duty of a fiduciary to act with undivided loyalty, Raines v. Toney, 228 Ark. 1170, 313 S.W. 2d 802 (1958), and is one manifestation of the general rule that requires the utmost good faith of an officer or director in exercising his corporate duties. Guth v. Loft, Inc., 23 Del. Ch. 255, 5A. 2d 503 (Sup. Ct. 1939). A director or officer who violates his duty by seizing a corporate opportunity is chargeable as a constructive trustee for the benefit of the corporation with all profits and benefits he receives from such transactions. Diedrick v. Helm, 217 Minn. 483, 14 N.W. 2d 913 (1944).

> [T]he true basis of the governing doctrine rests fundamentally on the unfairness in particular circumstances of a director or officer, whose relation is fiduciary, taking advantage of an opportunity for his personal profit when the interest of the corporation justly calls for protection. Some cases support the view that when a corporation is engaged in a certain business, and an opportunity is presented to it embracing an activity as to which it has fundamental knowledge, practical experience, and ability to pursue, which is logically and naturally adaptable to its business, having regard for its financial position, and is consonant with its reasonable needs and aspirations for expansion, the opportunity is in the line of the corporation's business.

19 AM. JUR. 2d *Corporations* §1312 (1965), citing Central Ry. Signal Co. v. Longden, 194 F. 2d 310 (7th Cir. 1952); Durfee v. Durfee & Canning, Inc., 323 Mass. 107, 80 N.E. 2d 522 (1948); Diedrick v. Helm, *supra.*

> his skill and ability might properly bring to it, or enable it to make in the reasonable and lawful exercise of its powers.[193]

Of course, the facts in each individual case determine whether or not the fiduciary obligation is violated.[194] But, in view of the proliferation of affiliated groups and common managements, it appears that at least some boards and managements would be hardpressed to explain away potential conflict of interest situations.

A 1965 prospectus of a new life insurance company revealed a particularly striking situation. The new company is to use the agents of an affiliated company which was licensed to do business in the new company's domiciliary state. That is, competing companies in the same area intend to utilize the same agency force.

Instead of organizing affiliated new companies, why do not the promoters expand the insurance operations of the original company, which possesses at least some experience and reputation, rather than commence a new venture? There are at least two possible reasons. First, the creation of a new local company in another state holds the promise of a successful stock flotation. This is accomplished through the use of influential local personalities in the stock promotional campaign. This motive may or may not be totally divorced from considerations of the company as a life insurance operation.[195] Second, organizing a new company in the state to be entered, in lieu of expanding the old company's operations into that state, may avoid the applicability of the stringent registration and disclosure requirements of the Securities Act of 1933. The frequent, but inappropriate, use of the intra-state exemption by new companies suggest a desire to avoid public disclosure of pertinent information.[196]

The merger technique appears to have been dovetailed with the local promotion technique to achieve a double impetus to the market value of stock held by the promoters of an affiliated group of companies. A promoter (or team of promoters) organizes and operates a life insurer in State A. He then inaugurates a second company in State B, issuing securities by means of a local promotion. The second com-

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[193] 23 Del. Ch. 255, 5A. 2d 503, 510 (Sup. Ct. 1939).

[194] Whether or not a director or officer has appropriated for himself something that in fairness should belong to his corporation is a factual question to be decided by reasonable inference from objective facts. Johnston v. Greene, 35 Del. Ch. 479, 121 A. 2d 919 (Sup. Ct. 1956).

[195] It may be that a locally domiciled company would achieve more ready acceptance by the local insurance buying public.

[196] See e.g., In the Matter of Associated Investors Securities, Inc., Securities Exchange Act Rel. 6859 (1962), CCH 1961-1964 FED. SEC. LAW REP. ¶76,858, in which the SEC found that there had been a willful violation of the Act's registration provisions (in effect saying the respondents knew that the intra-state exemption did not apply). In his oral report, Glendon Johnson of the American Life Convention noted that in conversations with the SEC, the SEC has expressed concern over new insurers' use of the intra-state exemption. ALC Meeting, Milwaukee, Wisconsin, April 26-27, 1965.

pany is typically tied to the first through a management or service contract. After a time, the second company is merged into the first with the expectation of stimulating increased market value in the stock of one or both companies. Both the local promotion and the subsequent merger transaction give impetus to the market value of the company's stock.[197]

Inherent in such an interlocking management situation are potential conflict of interest problems stemming from the fiduciary obligations of directors and officers common to both companies. In the merger negotiations the non-insider stockholders are subject to the risk of having their interests bargained away by a management which is representing both sides. Potential for abuse exists since the negotiator, while owing equal duties to both companies, may be tempted to act in favor of one, in which he has a greater interest, to the detriment of the other.[198]

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[197] Recently, one member of an affiliated group of companies merged into another member while at approximately the same time a new member of the group was being organized in another state. If the merger was prompted by economies of running a life insurance business, some might ask why a new company was formed instead of expanding the operations of one of the existing companies. It could be argued that stock promotion considerations perhaps constitute a part of the answer.

[198] "The most widely accepted view is that transactions between corporations having common directors or officers may be avoided if unfair, and, conversely, may not be avoided if fair." 19 AM. JUR. 2d *Corporations* §1307 (1945). However, the courts scrutinize very closely transactions between two corporations having common directors. Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1921). There is also some possibility that federal law will apply in the future to interlocking directorates in the insurance business. The Clayton Act has long prohibited interlocking directorates in certain situations, but the immunity conferred upon insurance by the McCarran Act, 59 Stat. 34, as amended 15 U.S.C. §1012(b) (1958), has thus far protected insurance company directors from federal action. The Clayton Act provides:

> No person at the same time shall be a director in any two or more corporations, any one of which has capital, surplus, and undivided profits aggregating more than $1,000,000, engaged in whole or in part in commerce . . . if such corporations are or shall have been theretofore, by virtue of their business and location of operation, competitors, so that the elimination of competition by agreement between them would constitute a violation of any of the provisions of any of the antitrust laws.

38 Stat. 732 (1914), as amended 15 U.S.C. §19 (1958). In recent years the federal government has begun systematically to enforce this provision. United States v. W. T. Grant Co., 345 U.S. 629 (1953); United States v. Sears, Roebuck & Co., 111 F. Supp. 614 (S.D.N.Y. 1953). In the latter case the court held that Congress intended "to nip in the bud incipient violations of the antitrust laws by removing the opportunity or temptation to such violations through interlocking directorates." *Id.* at 616.

That McCarran Act immunity for insurance may not be permanent is indicated by a recent House Judiciary Antitrust Subcommittee staff study. The study recommended that consideration be given to supplanting state regulation in the area of vertical management interlocks between insurance companies and companies financed from insurance company investment funds with new federal controls. While admittedly the situation of merging new companies with common directors or officers is a different matter, the study also concluded that state laws with respect to horizontal interlocks of cor-

A stockholder of one of the affiliated companies may bring suit against the company's board of directors and management if he believes that there has been a breach of fiduciary duty stemming from conflict of interests. At best, however, this after-the-fact remedy is an expensive and tedious one. Few stockholders would be willing to shoulder the burden of commencing such litigation. Consequently, reliance on the availability of judicial recourse is unlikely to constitute a strong deterrent to future action by other promoters in similar situations.

In those states having the "fair, just and equitable" doctrine, it would be possible for the regulator to prevent the issuance of securities of a new insurer whose management, promoters or directors are affiliated with another insurer unless it can be shown to the regulator's satisfaction that no conflict of interest exists. For example, in Texas, determination as to whether the proposed plan of business meets this standard involves consideration of "reasonable safeguards against possible conflicts of interest between management and other shareholders."[199] However, not all states have or would be willing to exercise this power. Here, again, the SEC can partially fill a void in investor protection by requiring management connections with other insurance companies to be disclosed, thereby cautioning the investor of potential conflict of interest situations.[200]

6. *Stock Options to Agents*

The use of stock options to agents as a means of developing an agency force raises several regulatory questions as to both investor and policyholder protection. The former will be discussed here and the latter in a subsequent section.

a. Dilution

As the agents exercise their options, shareholders' equity becomes diluted.[201] Agents have an opportunity to offset dilution of their in-

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porate management in the insurance industry are ambiguous and remain to be clarified by judicial interpretation or further state action. See Washington Insurance Newsletter, No. 794, March 22, 1965. On the other hand, New York Superintendent of Insurance, Henry Root Stern, Jr., countered the study insofar as it applied to the State of New York by stating that even the most cursory examination of the official records of New York State by the study group would have disclosed the state insurance department's vigilant interest in interlocking directorates. See The National Underwriter, May 29, 1965, p. 1.

[199] Administrative Interpretation of Section 7C(2) and Section 10A of the Securities Act of Texas (no date given).

[200] The SEC may require "such other information . . . necessary or appropriate in the public interest or for the protection of investors." Securities Act of 1933, §10(c), 1 CCH 1965 FED. SEC. LAW REP. ¶637. Some prospectuses in the authors' file show information on affiliations with other insurance companies.

[201] To earn the option the agent must write some business. To the extent this business has value the company (and its stockholders) receives some quid pro quo. Thus, there may be some hidden value offsetting the dilution of the stockholders' equity. Chenault, *Comments on Accounting for Stock Op-*

terest by earning more shares. On the other hand, non-agent public shareholders, if any, who do not have the opportunity to acquire stock via the option route, cannot offset a dilution of their equity interest. They may provide a substantial portion of risk capital while a select group of option recipients are in a position to receive the greatest gain. However, this situation does not appear to call for additional remedial action, at least with respect to those companies registering under the federal acts, since the SEC apparently requires this characteristic to be explained in the prospectus under the Securities Act of 1933.[202] In these cases an investor recives sufficient warning to enable him to make an informed judgment.

b. Agents Inducing Stock Purchases

A potential problem, if not an already existing one, involves agents proclaiming the virtues of their stock in violation of the federal securities laws. An agent functioning under a stock option program possesses a vital financial interest in the market level of that stock. The greater the demand which can be generated for the stock, the greater will be its value to him. Thus, it is only natural for an agent to extoll the value of such stock (every word of which he may believe) when he meets with his life insurance prospects, friends and business acquaintances. In fact, it appears that some agents, who have retained their affiliation with another company, have "touted the stock of the new company and compared their old 'first line' company unfavorably to the new one . . ."[203] Furthermore, it appears that in addition to the natural inclination of agents to extoll the stock of their company, members of the company's management, who also own shares, may urge the agents to do so. One company executive in a letter to his company's agents discussed not only their life insurance sales but also the importance of keeping "the demand (for the company's stock) high and the supply low." It is a short step from this type of communication to one urging the agents actively to stimulate demand for the stock.[204]

tions Issued by a Life Insurance Company to its Agents, The Texas CPA, July, 1965, 62 at 63. However, if the policy lapses in its early years, it may result in a loss rather than a profit. Since persistency of the business is related to the agent's length of service with the company, Pfeffer, *supra* note 167 at 421, and since agents in stock option companies exhibit a high turnover, *ibid* and see text p. 247 *infra*, there is serious question as to the value of this business to the company. The stockholder or prospective investor would find it almost impossible to determine whether the depletion in book net worth per share is offset by equivalent equity in the increased insurance in force or whether true economic losses have been sustained. See Pfeffer, *supra* note 167 at 421.

[202] Prospectus in authors' files.

[203] Memorandum Meeting of the Advisory Council of the Institute of Life Insurance, Sept. 30 and Oct. 1, 1963, p. 9.

[204] Letter in authors' files dated Jan. 23, 1965. This letter was specifically concerned with the agents' selling their stock and thus increasing supply in relation to demand. But such a communication to the field force on stock matters suggests that a company may not be hesitant to urge its agents to stimulate demand by extolling the stock.

The Securities Act of 1933 was founded on the concept that an investor should be entitled to full and accurate disclosure of information pertinent to the purchase and sale of a security. As a consequence, the registration and prospectus requirements were enacted. To the extent that agents extoll the virtues of stock in their companies without furnishing a full complement of information, a fundamental purpose of the statute is being circumvented. Furthermore, the Securities Exchange Act of 1934, among its other objectives, seeks to prevent a manipulation of the market which results in artificial prices for a security.

Judging from the content of recent prospectuses filed with the SEC, the SEC seems to be quite concerned over the practice of agents touting their stock. The Commission appears to be evolving the following theory to combat the potential harm to persons who might be adversely influenced (inadvertently or otherwise) by the representations of an overly enthusiastic agent. An agent who purchases stock in his company in the original distribution *or pursuant to a stock option* with a view towards further distribution or resale is deemed to be an "underwriter."[205] As an "underwriter," the agent would be subject to the various requirements and liabilities imposed by the Act. For example, the Act requires that an underwriter deliver a prospectus to each person to whom written offers and sales are made. But even if he makes no such offer and merely touts, or praises, such stock he may fall within the prohibition of Rule 10b-6 of the Exchange Act of 1934.

Rule 10b-6 was designed to regulate practices aimed at artificially maintaining the market price of a security during distributions to the public. The rule is a sweeping prohibition from which certain activities and transactions are carved out as exemptions and exceptions to make it viable and feasible.[206] It provides that:

> It shall constitute a 'manipulative or deceptive device or contrivance' . . . for any person, (1) who is an underwriter or prospective underwriter in a particular distribution of securities, . . . [by means of the mails, instrumentality of interstate commerce, or facilities of national exchange] to attempt to *induce* any person to purchase any such security or right until after he has completed his participation in such distribution. (Emphasis supplied)

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[205] The theory seems to have been adopted in the spring of 1965. It may be that this is being done on an experimental basis since the SEC has not come out with a definitive statement on the subject. Prior to that time the prospectuses in the authors' files did not refer to this theory, but the recent ones do. From this the authors surmise that the SEC, having accepted this approach, requires it to be disclosed in the prospectus.

[206] See WHITNEY, *Rule 10b-6:The Special Study's Rediscovered Rule*, 62 MICH. L. REV. 567, 568-69 (1964).

If this rule is applied vigorously by the SEC, the proscription on inducement should severely limit, if not completely curtail, an agent from proclaiming the virtues of his company's stock.[207] This would benefit both investors and policyholders. It would lessen the potential for manipulation in that over-enthusiastic agents would be deterred from inducing prospective investors to purchase stock on limited and biased information. (Such inducement could cause an artificial stimulus of demand for the stock.) Furthermore, an agent, whose prime concern is touting or selling stock in which he has an interest is less likely to perform his insurance function in a professional manner.

c. Disclosure of Tax Consequences

As discussed above, many, if not most, stock option plans for agents will not qualify under the Internal Revenue Code, because of such defects as the absence of the statutory employee relationship. Some prospectuses explicitly reveal this fact; others do not. Nevertheless, it is common for agents to think in terms of capital gains when they are induced to purchase stock from and place business with a company. Section 12(2) of the Securities Act imposes civil liability on,

> . . . any person who . . . offers or sells a security . . . by means of a prospectus or oral communication, which . . . omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading. . . .

It can be argued that failure to indicate in the prospectus the non-qualified nature of the stock options, if such is the case, violates this provision. (The general antifraud provision may also be applicable.) As a preventive measure, the SEC could require that the stock option company at least state in some prominent manner that there is no assurance of favorable tax treatment. Its attorney's opinion could be used to buttress this one way or the other. Such disclosure should impose no undue burden on the issuer and it would provide the agent with information on a question which may be of substantial importance to him.[208]

7. "Cheap" Stock

Another practice causing concern is the issuance of stock to the public at a price higher than that paid by the promoters. To a limited extent this practice can be justified as a means of compensating the promoters for the time and expense spent in connection with formation

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[207] If the agent procures his stock under a stock option plan which is qualified under the Internal Revenue Code, he is exempt from this provision. SEC Reg. §240.10b-6 (1964), 2 CCH 1965 FED. SEC. LAW REP. ¶22,726.

[208] It can be argued that the disclosure of probable tax consequences under the stock options is unnecessary from the public investor's viewpoint. On the other hand, an agent is an investor in the company. As such he should be entitled to full disclosure on matters of importance to him.

of the new company. However, the acquisition of "cheap" stock is subject to abuse. If no restrictions are imposed on this technique, the promoters can obtain substantial equity interest in the company far in excess of the value of their services during the company's formation. The equity interest of other investors would then be significantly diluted. (This may be in addition to the dilution resulting from the use of the stock option technique.) The promoters could obtain and retain voting control of the company despite the fact that public investors have provided substantially more capital. It is not unheard of for the investing public to pay thirty times more than the amount paid by the promoters for an equal amount of stock.[209] Furthermore, the promoters may be in a position to immediately sell their stock thereby reaping a quick profit.[210]

At least in those states having the "fair, just and equitable" doctrine, the regulator possesses sufficient authority to exert control over the use of "cheap" stock. Several states have publicly indicated their awareness of the problems of investor protection stemming from its use.[211] Close scrutiny in individual cases by the regulator with a view towards preventing the promoters from receiving more than fair value for promotional service by means of "cheap" stock may be sufficient to counteract this problem. With the ultimate sanction of no registration, the regulator is in an excellent position to persuade the promoters to eliminate those aspects of their venture which could lead to excesses. In those states which vest less authority in the securities commissioner,

[209] State of Texas, Eightieth Annual Report of the Board of Insurance Commissioners (1955), p. 15, as quoted by Pfeffer, *supra* note 167, p. 416.

[210] The insurance laws in some states prevent an insurer from issuing more than one class of stock. The promoters may lack sufficient funds to be assured of control if they must pay the public offering price. Consequently, they may resort to a holding company device. Two classes of stock could be issued by the holding company, with Class A stock issued to the promoters at e.g., one cent per share, and the Class B stock issued to the public at e.g., $1.00 per share. To justify the difference in price, the Class B stock may be given some extra rights, e.g., with respect to liquidation, dividends, etc. Most of the capital raised by issuing holding company stock can then be invested in the stock of the insurer. Thus, through the holding company technique, the one class of stock limitation may be avoided in some states.

[211] E.g., California disfavors more than one class of stock. Calif. Dept. of Ins. Memorandum, *supra* note 162. Iowa Ins. Rule T6, Nov. 12, 1963 prohibits a promoter from purchasing stock at less than the public offering price. The Texas Securities Act specifically obligates the securities commissioner to ascertain whether the price paid by promoters "is fair, just and equitable when such consideration . . . is less than the proposed offering price to the public. . . ." TEXAS REV. CIVIL STAT. ANN. Art. 581-10A. An administrative interpretation of this section says that ordinarily this standard is met if the price to the promoters is no less than 80% of the offering price. Administrative Interpretation, *supra* note 199. In Illinois, a different approach has been adopted. Issuance of "cheap" stock in amounts which exceed one-third of the total number of shares to be outstanding is presumed to be inequitable and is prohibited. Thus, the promoters must purchase a substantial amount of stock at the public offering price in order to assure themselves of control. Ill. Securities Div. Special Bull. No. 1, Jan. 1965. This rule would apply to the holding company technique described in note 210 *supra*.

perhaps full disclosure in the prospectus as to the drawbacks of "cheap" stock from the public investor's viewpoint could be required.

8. *Coordinating Regulatory Efforts*

In this section we have concentrated, primarily from an investor's viewpoint, on some of the problems generated by promotion-oriented new stock life insurance companies. The SEC and the state securities departments' interests inevitably overlap since both are concerned with the same subject matter, i.e., the investor. Less obvious but no less important is the interest of the state insurance departments whose primary function is to safeguard the interests of the policyholder. Several of the problems in the securities area impinge directly on these interests. Some of these were specifically mentioned above. More important, however, is the likelihood that effective sanctions in the securities area would either prevent or discourage stock promotion artists from entering into the area of life insurance. With their absence many of the questions discussed below, pertaining primarily to policyholder concern, may become moot. Thus, cooperation between the SEC, state securities administrators and state insurance departments should benefit each.

After approximately thirty years of experience, few would deny that the federal securities laws have had a beneficial impact on the securities business. On the other hand, few would assert that these laws are a panacea for all problems. A prime concern with respect to the new insurance company ventures is the quality of management and the competence of its technical staff. The federal disclosure philosophy does not particularly lend itself to resolving problems resulting from low quality personnel. From a regulatory standpoint, state administrators operating under statutes embodying the "regulatory" or "fair, just and equitable" doctrine possess a decided advantage over the SEC. If the truth is disclosed, a stock issue is entitled to be registered under the federal laws no matter how poor the background of the promoter or the merits of the stock. This is not the case in those states embracing the "regulatory" concept. The commissioners in such states have the power to deny registration in the appropriate cases or to promulgate regulations setting out specific guidelines and prohibitions.

Although the SEC lacks the powerful regulatory tool of the "fair, just and equitable" doctrine, nevertheless, it can significantly contribute to remedying some defects in investor protection. First, many state statutes dovetail their registration provisions with those found in the Securities Act of 1933. If a registration statement has been filed with the SEC, registration may be accomplished at the state

level by filing copies of the federal prospectus.[212] This is commonly called registration by coordination. Thus it is possible to meet the state disclosure requirements by complying with the federal provisions. In these cases, to the extent that the SEC strengthens its requirements (e.g., in accordance with some of the above suggestions), disclosure at the state level is also strengthened.[213] Second, several state statutes either require or enable the administrator to require the use of a prospectus. In practice, however, the mere filing of the prospectus is required more commonly than its delivery to potential investors.[214] Dissemination of information through the use of the prospectus is the heart of disclosure. In those states where the use of the prospectus is not made mandatory, a significant weakness exists in the regulators' arsenal. To the extent the SEC can extend its prospectus requirements to those new insurers who improperly rely on one or more exemptions, this void can be filled. Third, several states do not operate under the "regulatory" concept. Some administrators who do have wide discretionary authority are either unwilling to exercise it or are hampered by an inadequate budget and a shortage of personnel.[215] Other states exempt insurance securities from the provisions of the securities acts without affording the insurance department the means to exercise comparable controls. In these states, the absence of federal controls leaves the investor virtually unprotected when judged by federal standards and by the standards of many states.

Federal securities regulation, through its disclosure requirements, can supplement, not usurp, state efforts to achieve effective control in the area of new life insurance companies. Maximum effectiveness could be achieved through a close working relationship between the states and the SEC. This is not something new. A substantial exchange of information is now taking place. For example, at the North American Securities Administrators Association annual meeting, one day is usually devoted to an exchange of information on common problems between the SEC and the state regulators. The Association also has a standing committee known as the SEC Liaison Committee. Furthermore, several state departments contact the SEC on such matters as background material on promoters who come from outside the state.

[212] E.g., IOWA CODE §502.7(2) (1962); TEXAS REV. CIVIL STAT. ANN. Art. 581-7C (1964).

[213] The converse may also occur. If the securities commissioner accepts a federal prospectus in lieu of meeting state registration requirements, in those areas where state disclosure requirements are more stringent the disclosure requirements have been weakened.

[214] 1 LOSS, SECURITIES REGULATION 57-58 (2d. Ed. 1961).

[215] *Id.* at 106. "Unfortunately, the enforcement of state Blue Sky laws remains handicapped by low budgets, small staffs, and local political pressures . . . [T]he effectiveness of state securities regulation . . . is extremely uncertain." Dorosin, Comment, *Current Problems in Securities Regulation,* 62 MICH. L. REV. 680, 693.

Whether or not the existing cooperative mechanism, as it now functions, is adequate is a practical question for the securities regulators to answer. The lines of communication between state insurance departments and securities regulators should also be open and utilized. Here again the free flow of information could educate and assist each group in developing its own administrative policy and regulation and in coordinating efforts on a voluntary basis.

In some states a formal tie-in exists between the state securities department and the state insurance department. For example, in Iowa the administration of the securities laws is vested in the insurance commissioner who appoints a superintendent of securities to perform such duties as the commissioner may direct.[216] The securities and insurance department share the same offices. From the communications viewpoint, this seems ideal. Some insurance commissioners have jurisdiction only over insurance securities while general securities regulation is vested in another department.[217] These commissioners are in an excellent position to oversee the operations of new insurance companies from both the insurance and securities viewpoints. However, the insurance commissioner probably does not enjoy as much experience and expertise in securities matters as does his counterpart in the securities department. An exchange of views and information between the two could be of substantial value, particularly where the regulation of securities is entirely outside the insurance commissioner's jurisdiction. He could contribute information which would enable the securities administrator to more effectively regulate. This, in turn, could alleviate some of the regulatory problems burdening the insurance commissioner.

The intertwining of interests suggests that there may be value in establishing a liaison or joint committee of both the National Association of Insurance Commissioners and the North American Securities Administrators Association. In connection with the 1964 amendments to the Securities Acts of 1964, the NAIC established a liaison committee to work with the SEC. Perhaps these committee members and representatives of the securities administrators could meet on a periodic basis both with each other and as a group with the SEC.

Many, if not most, insurance and securities administrators in the same state maintain close contact.[218] The value of these informal lines of communication is quite substantial. But this does not obviate the need

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[216] IOWA CODE §502.2 (1962).

[217] E.g., California and Illinois, *supra* note 142.

[218] Director Bolton, Illinois Department of Insurance, reported that a close relationship exists between the Illinois insurance and securities departments and that a study is being made toward coordinating the laws and regulations of both agencies for general public and investor protection. Address by Director Bolton, Chicago, Conference for Young Life Insurance Companies, Sept. 1-2, 1965, p. 8.

for a more formal structure on a nationwide basis (such as the suggested periodic committee meetings). The latter can be an effective forum for obtaining additional information and views. Furthermore, where the relationship between the securities and insurance commissioners is something less than satisfactory, the more formal system may become the prime source of information.

D. An Attack on Speculation

Speculation is one of the fundamental causes of the frequent formation of new companies.[219] The intense investor interest in life insurance stock, prompted by the established companies' long records of earnings and dividends, has created a demand for life insurance stock which promoters have sought to fill by organizing new companies.[220]

1. *Minimum Initial Price*

The California Department of Insurance has sought to combat the stock promotion phenomenon in new life insurance company stocks by setting guidelines which must be met before the Department will issue security permits. One guideline provides that, in the initial issue, the selling price may not be less than $50 per share.[221] This requirement strikes at one, emotional rather than logical, attraction of new life insurance stock, namely its low initial selling price.[222] Some investors may feel they have greater leverage when the initial price is at a low level.[223] For example, a $4 per share increase in the value of stock purchased at $1 per share would provide a 400 per cent gain. This same $4 increase would be an 8 per cent gain if the initial price were $50 per share. In short, low initial selling prices may generate buyer appeal, which results in a rapid price increase out of proportion to the true worth of the stock. "This, in turn, tends to lead to speculation and overvaluation of the shares from the outset."[224] Setting the minimum per

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[219] See text p. 180 and note 13 *supra*.

[220] E.g., Address by Superintendent Stern (N.Y.) New York Life Underwriters Sales Conference, March 11, 1965, p. 2.

[221] Calif. Dept. of Ins. Memorandum, *supra* note 162. In New York, the par value of life company shares cannot be less than $2.00. N. Y. Superintendent's Report, *supra* note 184 at 25.

[222] See The National Underwriter, March 27, 1965, p. 4.

[223] "It is well established that it is far easier for a $2.00 stock to reach a value of $8.00 per share [an increase of 400%] than it is for a $30 stock to reach a value of $120 per share [an increase of 400%]." Address by Burton A. Finberg, New York State Association of Life Underwriters, 22nd Annual General Agents and Managers Conference, Saratoga Springs, N.Y., Feb. 12-13, 1965, at 12.

[224] Address by William R. Robertson, Research Agencies Group, Williamsburg, Virginia, May 13-14, 1965, p. 14. Mr. Robertson recommended that: ". . . insurance departments should require that the capital stock of these new companies have a minimum par value, say of $10, $15 or $20. With the need for a substantial paid-in surplus, in addition to the capital, because of the early years operating losses, this would mean that the shares would have to be marketed at $25-$50 per share originally, two or three times the par value. This price level would remove a good deal of the speculative fever from these issues. Also it would remove these securities from the category of

share price at $50 obviates this artificial attraction of the stock, thereby reducing the probability of a "hit and run" promoter success.

2. *The Development of Standards*

a. Need

Proceeding on the assumption that speculation in life insurance stock is not in the best long range interest of the life insurance industry and of those persons which it serves, the comments of one prominent industry spokesman are relevant.

> Speculation is one big attraction for some people and it is easy to understand why. Obviously there are too many different concepts of the potential earning power of a life insurance company. One basic trouble is that there is no general agreement on the principles to be followed in valuing our own business. The insurance commissioners favor one approach, the conservative investors another, and the speculators still another. Some reconciliation of viewpoints is surely needed when the market appraises a company's outstanding business at $20 a thousand and its own actuary, by using the method of asset shares, says it is worth minus $10 a thousand.[225]

Speculation, particularly in the stocks of new companies is likely to continue as long as the companies are "a mystery to the financial community."[226] This suggests a need for the creation of a set of criteria by which the performance of a company can be measured.

> Unrealistic market values—mismanaged companies—find their refuge in the lack of 'standards.' Standards to which internal management can compare its operation—standards by which board members can judge their company's growth—standards to which the investment banker can look for analysis—standards which can guide the investing public. True, there are over 1500 companies in our industry—all building a different way—exact standards would be difficult to create . . . however, we should be able to get some basic bench marks and guideposts. For as Mr. Shepard stated—if you can value a piece of business all the way from $20 a thousand down to a negative $10 a thousand—something is wrong. These standards should be the end result of the efforts of many people.[227]

On the other hand, some doubt has been expressed as to the feasibility of developing such standards.[228]

'penny stocks,' which detracts from the fine reputation of our industry." *Id.* at 17.

[225] Address by Bruce E. Shepherd, Chicago Meeting of the American Life Convention, Oct. 15, 1964, p. 5.

[226] Address by A. H. McAulay, New York Association of Life Underwriters, Feb. 13, 1965, p. 8. See *id.* at 8-9.

[227] Sahm, *supra* note 219 at 9. See Remarks by Ronald F. Dorman, Society of Actuaries, May 27, 1965, p. 4.

[228] See Address by Richard E. Pille, New York State Association of Life Underwriters 22nd General Agents and Managers Conference, Feb. 12-13, 1965, p. 3. "What is this (stock) share worth? No one yet has been able to reduce

b. Existing Practice

Currently, the investment community, in general, appears to rely on the adjusted earnings concept in valuing a life insurance company.[229] Generally, a premium is paid not only in the year of sale, but also for several years thereafter. The life insurance in force may ultimately result in either profit or loss over a period of time. It is not treated as an asset in the annual statement submitted to the insurance departments. Thus, the primary problem confronting the investor is to adjust the operating results revealed in the annual statement so as to reflect the potential profit or loss from the insurance sold during the year.[230] This is typically attempted by attributing some arbitrary value—the rule of thumb approach—to the increases in the insurance in force account. For example, a value of $20 per $1,000 may be used for permanent plans, $7.50 per $1,000 for term, $5 per $1,000 for group.[231]

The following table illustrates a calculation of adjusted earnings.

XYZ LIFE (1964)

Net Loss from Operations			$ 52,000	
Increase in Insurance in Force				
Permanent	$10,000,000 x $20.00 per $1000	=	$200,000	
Term	5,000,000 x $ 7.50 per $1000	=	37,500	
Group	5,000,000 x $ 5.00 per $1000	=	25,000	
Total			252,000	
Adjusted Earnings			$200,000	
Adjusted Earnings per Share (100,000 shares)				$2.00

In addition to adjusting earnings to reflect the income potential of the life insurance in force, this technique can turn a net loss from operations into an anticipated gain. This would appear to enhance the market appeal of the stock; at least, it is more appealing to talk in terms of adjusted earnings rather than in terms of a net loss from operations.

The adjusted earnings—rule of thumb—approach has been subject to severe criticism.

> Any attempt to derive an average yardstick for the value of in-force business, or for the amount which can be allocated to get it, *is usually futile, self-deceiving, and dangerous.* As someone so well said, 'Each $1,000 of business was not created equal.' (Emphasis supplies)[232]

this to a precise present vaue or to a very meaningful future value; and no one ever will because of the unique long-range nature of our business and its dependence on *future* experience in interest rates, mortality, expenses and persistency in the thrift and protective attitude of our people, and even in developments in our social, political, and economic national life." *Ibid.*

[229] See Griffith, *Valuation of Life Insurance Stocks,* Journ. of Risk and Insurance, March 1965, p. 77.

[230] GOLD, *Valuing a Life Insurance Company,* 14 TRANSACTIONS: SOCIETY OF ACTUARIES 139, 145 (1962).

[231] *Ibid.* at 149.

[232] *Ibid.* During the panel discussion at the Chicago Conference on Acquisitions

For example: (1) How can it be said that $1,000 of decreasing, level and increasing term coverages possess equivalent profit potential?[233] (2) How can reinsured business legitimately be valued the same as non-reinsured business? Some, if not all, of the profit on business reinsured will accrue to the reinsurer, yet the rule of thumb approach fails to differentiate between that business which is reinsured and that which is not. This can be very deceptive. For example,

> Suppose that ABC Life writes a $500,000 business insurance policy (not unusual) and its retention is $20,000. (ABC will count the entire one-half million dollars as 'insurance in force,' presumably to be capitalized by investors at stock market multiples.) The $480,000 'excess' is then sent, let us say, to Reinsurer A, whose maximum retention is $200,000. (Reinsurer A adds $480,000 to its insurance in force.) The last $280,000 might wind up with Insurer B. In this manner, $500,000 of insurance at face value shows up as an aggregate of $1,260,000 of business in force on the books of three companies.[234]

This type of situation is particularly important with respect to new companies which reinsure a high proportion of their business. (3) Why is not a different value ascribed to business written in those states which limit the amount of surplus generated by participating policyholders which can accrue to the stockholders' benefit. The rule of thumb approach makes no adjustment for this limitation on stockholders' earnings. (4) Perhaps the greatest indication of the weakness of this approach is the fact that a company can intentionally write business at a loss, so as to run up the insurance in force account, and obtain added illusory value via the adjusted earnings rule of thumb approach. Even though the business may be unprofitable, a $1,000,000 increase in the insurance in force account can serve as the basis for the illusion of an added value of $20,000 (assuming $20 per $1,000 is used).[235] (5) How can the same value per $1,000 be given to business written by companies having different premium structures, commission scales, average policy size, underwriting standards, etc?[236]

This list of objections to the adjusted earnings approach is intended to be illustrative, not exhaustive. In the words of an actuary,

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and Mergers, Oct. 28-29, 1964, one life insurance executive, speaking from the floor, asserted that the adjusted earnings concept which ignores an asset share calculation gives a "dishonest" evaluation. A spokeseman for the investment industry, while recognizing its limitations, defended its use so long as the life insurance industry fails to disclose adequate information upon which better evaluations could be made.

233 Gold, *supra* note 230 at 149.

234 Equity Research Associates, *The Hazards and Rewards of Investment in Small Life Insurance Companies,* Oct. 15, 1964, p. 11 (investment analysis; actual names of companies omitted in the quote). See Gold, *supra* note 230 at 149-50.

235 Gold, *supra* note 230 at 150.

236 Insurance, Aug. 14, 1965 (guest editorial).

> No single standard can be applied indiscriminately. Each company presents its own problems and, therefore, demands individual attention. [237]

Some of the adjustments to earnings may be based upon extensive research and expense by investment firms. Others, however, are based upon "market rumor, hunch and speculation."[238] One executive noted that security analysts "in sheer desperation . . . have arbitrarily arrived at formulas" which assign a value to insurance in force and that these formulas are "highly inaccurate and mislead more often than inform."[239] One team of California professors noted that:

> Many students of the life insurance industry, regulatory officials, and insurance executives reject the concept of adjusting earnings of life insurers. This rejection arises from tradition, from their belief that most techniques are directed toward the sale of insurance securities rather than the evaluation of insurance earnings, from their preoccupation with the long-run nature of the insurance earnings cycle, and from technical reasons. Basically, those who reject the concept believe it is a faulty one, or that it is valid only in a few instances.[240]

c. Federal Securities Law Antifraud Provisions

The Securities Act of 1933 and the Exchange Act of 1934 (and the regulations promulgated thereunder) contain three basic general antifraud provisions. Under the authority vested in it by Section 10(b), the SEC promulgated Rule 10b-5 which makes it "unlawful for any person"

> to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security.

This rule applies to "any person."[241] It speaks in terms of not only affirmative misrepresentation but also in terms of half truths and omissions.[242]

> A statement in a business transaction which, while stating the truth so far as it goes, the maker knows or believes to be mate-

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[237] Gold, *supra* note 230 at 139.

[238] COWEE, GOSHAY AND MORRISSEY, *Taxation of the Life Insurance Industry in California* 109 (1964).

[239] Insurance, Aug. 14, 1965 (guest editorial).

[240] COWEE, *supra* note 238 to 109.

[241] "Person" is broadly defined to include "an individual, a corporation, a partnership, an association, a joint stock company, a business trust, or an unincorporated organization." Securities Exchange Act of 1934, §3(a)(9), 2 CCH 1965 FED. SEC. LAW REP. ¶20,140.

[242] See 3 LOSS, *supra* note 214 at 1433-34, "a statement of a half truth is as much a misrepresentation as if the facts stated were untrue." Equitable Life Ins. Co. of Iowa v. Halsey, Stuart and Co., 312 U.S. 410, 426 (1941).

rially misleading because of his failure to state qualifying matter is a fraudulent misrepresentation.[243]

In view of the numerous misleading aspects associated with the adjusted earnings—rule of thumb—technique, it has been suggested that the use of this technique may constitute a violation of Rule 10b-5, at least, in the absence of a clear delineation as to its limitations and of a sufficient caution as to the validity of the valuations based thereon.[244]

The general antifraud provisions apply with respect to the "purchase and sale of any security." Since the rule of thumb method is used frequently by persons acting in investment adviser capacity, e.g., through investment reports, market letters, etc., rather than in a purchase or sale situation, these antifraud provisions may not apply. However, the antifraud provisions under the Investment Adviser Act of 1940 may be applicable. An investment adviser is defined as any person who for compensation engages in the business of advising others, either directly or through publication or writings as to the value of securities or on the advisability of investing in or purchasing securities. [245] Section 206 of the Investment Advisers Act of 1940 makes it unlawful for an investment adviser via the mails or any instrumentality of interstate commerce to employ any device, scheme or artifice to defraud any client or prospective client; to engage in any transaction, practice, which operates as a fraud or deceit; or to engage in any practice which is fraudulent, deceptive or manipulative.[246] While there has been little litigation under this section,[247] *In the Matter of Spear and Staff, Inc.*, the SEC said,

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[243] Restatement of Torts §529 as quoted in First Trust and Savings Bank v. Fidelity-Philadelphia Trust Co., 214 F. 2d 320, 325, n. 9 (3d Cir. 1954) *cert. denied* 348 U.S. 856. It seems clear from the securities law background that at the very least the most liberal common laws on fraud should be applied under the securities statute. In fact the courts have repeatedly held that the fraud provisions in the SEC Acts are not limited to circumstances giving rise to a common law action for deceit. 3 Loss, *supra* note 214 at 1434-5. Furthermore, scienter does not appear to be a necessary element in a cause of action for omitting those facts necessary to make the statements not misleading (i.e., the half truth situation). *Id.* at 1440-42.

[244] Rule 10b-5(2) and (3) was found to be violated when there were misleading omissions as to assets and prospects of the insurer issuer, the value of the securities, etc. In re Matter of R. D. Bayly and Co., as reported in 2 CCH 1965 FED. SEC. LAW REP. ¶22,781.206. "The determination of value made by applying rule-of-thumb values has no validity except as an indication of what may be a possible range of value." Bowles, *An Approach to the Determination of the Purchase Price of a Block of Life Insurance,* 1961-1962 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 56, 60.

[245] Investment Advisers Act of 1940, §202(a)(11), 3 CCH 1965 FED. SEC. LAW REP. ¶56,155.

[246] *Ibid.* §206(1), (2) and (4) at ¶¶56,365, 56,369, 56,381. Subsections (1) and (2) are patterned after clauses (1) and (3) of §17(a) of the Securities Act of 1933. See 3 Loss, *supra* note 214 at 1515.

[247] "In reaching our decision we took into account that this is one of the first administrative proceedings in which we have dealt with the question of improper investment advisory advertising material . . ." In the Matter of

> In appraising advertisements such as those now before us we do not look only to the effect that they might have had on careful and analytical persons. We look also to their possible impact on those unskilled and unsophisticated in investment matters.
> By the securities acts Congress sought to protect 'those who do not know . . . from the overreachings of those who do.' To attain that objective, *persons engaged in the securities business must be held to rigorous standards of full and fair disclosure in their dealings with investors.* The rendition of investment advice is an integral part of the securities business, and the Act evidences Congressional recognition of that fact and of the need to protect those who seek such advice. *In passing upon the propriety of securities selling techniques we have repeatedly held that lax merchandising standards epitomized by such terms as 'puffing' are antithetical to the antifraud provisions of the securities statutes.*[248] (Emphasis supplied)

Holding Section 206 to have been violated, the Commission said:

> Appraised in the light of the foregoing considerations and standards, registrant's advertisements were clearly deceptive. *They obscured and misleadingly minimized the numerous uncertainties and imponderables inherent in any attempt to forecast security prices.* There were ocasional caveats, but they were unobtrusively worded and placed. . . .[249] (Emphasis supplied)

This suggests that if an investment adviser uses the adjusted earnings —rule of thumb—technique, he should clearly delineate the limitations inherent in this approach, in order to avoid violating Section 206. Rule 206(4)-1 leads to the same conclusion:

> It shall constitute a fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of Section 206(4) of the Act, for any investment adviser, directly or indirectly, to publish, circulate or distribute any advertisement . . . which represents, directly or indirectly, than any graph, chart, formula or other device being offered will assist any person in making his own decisions as to which securities to buy or sell, or when to buy or sell them, *without prominently disclosing in such advertisement the limitations thereof and the difficulties with respect to its use* . . .[250] (Emphasis supplied)

This conclusion is entirely consistent with the fiduciary nature of the investment adviser.[251]

Because of the inherent potential for abuse in the adjusted earnings —rule of thumb—technique, it has been suggested that the SEC should

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Spear and Staff, Inc., Investment Advisers Act Release No. 188, 1965 CCH FED. SEC. LAW REP. ¶77,216. See 3 Loss, *supra* note 214 at 1515.

[248] Spear case, *supra* note 247.

[249] *Ibid.*

[250] SEC Reg. §275.206(4)-1 (1962), 3 CCH 1965 FED. SEC. LAW REP. ¶56,382.

[251] See e.g., SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) revg. 306 F. 2d 606 (2d Cir. 1962); Opinion of Dir. of Trading and Exch. Div., SEC Reg. §276.40 (1945), 3 CCH 1965 FED. SEC. LAW REP. ¶56,374.

promulgate a ruling stringently restricting its use. There are at least two counter arguments to this approach. First, this practice has been and is now commonly employed by the investment community. However, this argument is not an impressive one. If a practice is deceptive and misleading, its widespread use is the more reason for its curtailment.

Second, despite its limitations, the adjusted earnings—rule of thumb approach may be more meaningful in evaluating a company than relying on the earnings figures shown in the annual statement filed with the various state insurance departments.[252] This contention is more persuasive. Nevertheless, there are two possible answers to it. (a) Assuming the validity of this contention, it does not follow that disclosure of the rule of thumb limitations becomes unnecessary or impractical. The securities laws are premised on the concept that an investor is entitled to sufficient information upon which he can make an informed choice.[253] Defects in an analytical tool need to be revealed in order to afford an opportunity for such an informed choice. Whereas this contention is relevant in considering whether or not to prohibit the rule of thumb technique, it in no way detracts from the desirability and need of compelling sufficient disclosure of its limitations. (b) A second possible answer to this argument is that there may be other methods of evaluating a company which do not possess such misleading characteristics. To this question, we shall now turn.

d. Another Approach: The Gross Premium Valuation Method

A vacuum exists with resepect to meaningful standards for investors. (This is true whether or not the adjusted earnings—rule of thumb—approach, with its inherent inadequacies, is deemed violative of the securities laws.) However, there are indications in actuarial literature that this need not be the case.[254] The actual determination as to what standards and methods should be used in valuing a life insurance company is beyond the scope of this article. This is a question for actuaries and financial analysts. However, removal of the mystery from life insurance stocks would tend to arrest widespread speculation. At the same time, soundly conceived and managed new companies could organize and survive. In short, if an effective approach could be found, thereby curtailing speculation, there may be less need to implement other controls. In the following discussion, we do not intend to embark upon a detailed actuarial analysis. We do, however, want to sug-

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[252] See e.g., Bear, Stearns and Co., Monthly Financial Digest, March 1965, p. 2, and Lehman Brothers, Review of the Life Insurance Industry, June 1965, p. 11 (investment analysis).

[253] REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H. DOC. No. 95, Pt. 3 (1963), p. 5.

[254] See Gold, *supra* note 230.

gest that it appears possible to develop meaningful information and criteria.

An investment in a life insurance company, like that in any other company, should be an investment in earning power.[255] However, it may be more difficult to determine earnings in a life insurance company since they are not ultimately ascertainable until a block of policies have terminated after a long period of time. Nevertheless, future earnings may be estimated on a reasonably sound basis. The value of a life insurer—as a going concern—may be calculated as follows:

$$\text{Going Concern Value} = \begin{cases} \text{Capital} \\ \text{Surplus}^{256} \\ \text{Value of the in-force business} \\ \text{Value of future production} \end{cases}$$

The primary problems are determining the value of existing business and of business yet to be written.

Conceptually, ascribing a value to existing insurance in force is quite simple. This may be done by the "gross premium valuation" method (GPV). The GPV method "determines future profits by recognizing as many of those factors affecting profits as is practical."[257] In essence, this requires tabulating insurance in force by plan, issue age and policy duration, and then projecting the experience with *realistic* rates of mortality, expense, interest and persistency assumptions.[258] Annual earnings may then be projected for whatever number of years are selected.[259] In succeeding years actual experience can be compared with the projections. Of course, the GPV method of valuation can be no better than the assumptions which are used. Even a minor variation in assumptions may have significant impact on the calculation of anticipated profit.[260] No single precise value can be said to be the true value. However, by varying the assumptions from favorable to unfavorable, a range of values may be obtained. For comparative pur-

[255] *Id.* at p. 145.

[256] Surplus here means adjusted surplus which involves a recomputation of the surplus shown in the annual statement. This can be done by considering a revaluation of assets and a recalculation of company liabilities taking into account contingency reserves, deficiency reserves, mandatory security valuation reserves, non-admitted assets, untaxed Phase 3 profits, etc. *Id.* at 146.

[257] Address by Thomas P. Bowles, *supra* note 244 at 58. "A more satisfying approach to the determination of price lies in an actuarially elegant gross premium valuation. This technique enables the initiated clairvoyant to predict future earnings. . . . Since the value of a block of business, in the final analysis, is a function of the amount of future earnings, the application of this technique permits the actuary to rest more comfortably in his conclusions than if rules of thumb are blindly applied." *Id.* at 57.

[258] As contrasted to the assumed rates used in determining the legal reserve liability and premium rates. For a new life insurance company there is little credible mortality experience upon which the assumption can be based. At best, there can only be an educated guess. This may be better than nothing.

[259] Gold, *supra* note 230 at 147.

[260] *Id.* at 147-48.

poses, as between companies, perhaps the midpoint of the range of values could be used.[261]

The value of earnings stemming from business yet to be written is dependent upon the competence of management, the quality of the agency force, the company's reputation and its past performance. These are intangible items whose valuation depends upon the subjective judgment of the analyst.[262] Such limitations should be disclosed in any recommendation to an investor based upon this approach.

This approach—Gross Premium Valuation and assignment of values to management, agency organization and goodwill—requires considerable judgment and insight into a company's operations. The availability of information is of prime concern. It is one thing for an insider to make such calculations and quite another for an outsider, whose access to information is somewhat limited, to do the same thing.[263] Thus, the basic problem becomes one of the availability of the essential information.

e. Providing Information

As discussed previously, the basic philosophy underlying the federal securities act is disclosure of sufficient information to enable an investor to make an informed choice in his investment decisions. The adjusted earnings—rule of thumb—approach does not meet this criterion. On the other hand, the GPV method might do so if adequate information were made available.

Disregarding for the moment the insurance exemption under the 1964 amendments, it would seem that the SEC possesses the authority to require the disclosure of the basic information essential to application of the GPV method. It could, for example, require such information to be included in the periodic reports filed with the SEC under Section 13 of the Exchange Act. These reports are public documents. Therefore, the information would be available for those securities analysts and investors who desire it.

But an insurer is generally exempt from the Exchange Act if the enumerated conditions (relating to reporting, proxies and insider trading) are met.[264] As to such companies there is no apparent reason why the NAIC could not require the information to be included either as

[261] Of course, one company may achieve results near those projected on the optimistic assumptions whereas another company may approximate the projections based on pessimistic assumptions.

[262] It has been suggested that at least with respect to valuing the agency force one might make a GPV of a projected sales pattern of new business minus the net development outlay. Gold, *supra* note 230 at 148.

[263] *Id.* at 147. In applying GPV, some of the information needed is level of policy benefits, cash values, premium, age at issue, plan, duration distribution, policy size, cost of reinsurance, commissions and other expenses, mortality, interest earnings and persistency. Bowles, *supra* note 244 at 58.

[264] Securities Exchange Act of 1934, §12(g)(2)(G), 2 CCH 1965 FED. SEC. LAW REP. ¶20,316. See text, pp. 137-38.

a separate schedule in the NAIC annual statement blank or in the Stockholder's Information Supplement. These, too are public documents, open to examination by analysts and investors.

Why should the states compel such disclosure?

(1) It is difficult to argue against disclosure which permits an investor to be better informed, particularly when this is a fundamental concept upon which the federal securities acts are premised.[265]

(2) It may contribute to the curtailment of speculation. If so, the promotion-oriented-company problem could be significantly alleviated without jeopardizing those new companies soundly conceived and managed. The New York Superintendent of Insurance recently said:

> As with gambling, it is often argued that speculation in itself harms no one except the unlucky speculators, who, in each of the risks, knowingly take their chances. It has been further argued that such risk-taking is not a matter of Insurance Department concern. I do not agree with these arguments, if for no other reason than the unfortunate effect which speculation in new life company stock can have upon the image of the entire life insurance industry, and that of state regulation.[266]

However, this approach does not promise to be a panacea. The average investor, who is in a speculative frame of mind, may not concern himself with information which is made available to him. The law cannot protect the speculator from his own folly. Furthermore, some of the speculation in new life insurance company stock occurs before there is a sufficient amount of experience available for analysis.

(3) In essence, the insurance exemption in the 1964 Amendments with its three conditions sought to achieve conformity with the federal disclosure principles in the insurance industry while at the same time preserving state regulation. But, if the states via this exemption permit basic violations of those disclosure principles deemed to be fundamental under the securities law, it may reasonably be anticipated that Congress will eventually cure the defect and further erode the jurisdiction of the states in regulating the insurance business.[267]

While the gross premium valuation method is accepted by some as the ideal method to value a block of insurance business and "could presumably be adapted for use in a going-concern valuation,"[268] mandatory disclosure of the information necessary to make a GPV would undoubtedly pose practical problems for the life insurance companies.

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[265] See text, pp. 16-17.

[266] Address by Superintendent Stern, Chicago Conference for Young Life Insurance Companies, Sept. 1-2, 1965, p. 8.

[267] During the panel discussion at the Chicago Conference on Acquisitions and Mergers, Oct. 28-29, 1964, one panel member commented that if the industry fails to cooperate with the insurance departments in improving disclosure of information, the insurance exemption will eventually be revoked.

[268] Bear, Stearns & Co., Monthly Financial Digest, March 1965, p. 3.

The problems vary, depending on a company's size and its years in the business.

The larger and older companies over several decades have issued numerous policy series each involving many plans sold at varying gross premium levels. A GPV would require a vast array of data. Presumably, in view of the widespread use of electronic data processing, these companies have access to the requisite information. The prime problem would appear to be compressing the information into meaningful form. However, the whole burden of making the GPV need not fall on the company. If the basic information is made available, the actual calculations could be done by the investment houses who are now adapting electronic data processing to their business.[269] Furthermore, an examination of the company's in force business may reveal certain key plan, age, and year of issue combinations as being representative of the company's business as a whole. By using the key combinations projections could be made, thereby reducing an otherwise gargantuan task to more manageable proportions.[270] This is not proposed to minimize such an undertaking. But it does suggest that such an approach is not beyond the realm of possibility.

In one sense, at least, this disclosure approach would impose a lesser burden on new companies. Their insurance in force consists of a relatively few policy series. The magnitude of compiling the necessary information would be substantially less than that of an older company. On the other hand, it may be that the expense burden in maintaining the requisite information would be proportionately higher than that of an older company.

Even though the profit on a block of policies is not known until the last policy is terminated, techniques are available to measure anticipated profits year by year in the future. One such technique is the "asset share" method, which is a fund accounting process. Basically, an asset share is a projected accumulated fund associated with a particular group of policies. Each policy in the group possesses like characteristics with respect to the plan (e.g., whole life), year of issue and age at issue. The asset share (or projected fund) is comprised of gross premiums paid, minus expenses and benefits paid,[271] accumulated at interest. The increase in the fund is computed for each policy year and

[269] See Thomas, *Calculating Risks,* Barron's National Business and Financial Weekly, June 28, 1965, p. 3. Electronic computers make it feasible to consider variations such as premium levels, policy benefits, plans, ages at issue, etc. in analyzing the value of the insurance in force. Bowles, Andrews and Towne, The Key to Sound Management, Aug. 1965, p. 2. The smaller firms may embark on acquiring EDP through some pooling device where several firms could share the use of such equipment.

[270] Gold, *supra* note 230 at 147.

[271] Benefits paid include death benefits, cash values and dividends (if policy is participating) paid.

accumulated to give the total fund. The anticipated accumulated profit by the end of any given year (e.g., twentieth policy year) is sometimes determined by comparing the asset share with the policy reserve for that year.[272] Actual experience can be compared with the projections and adjustments made in the amount of anticipated profit on the group of policies involved. Whereas the GPV relates to valuing the company's insurance in force as a whole, the asset share method relates to valuing homogeneous groups of policies. In essence, it might be said that a GPV is a summing of asset share calculations for the various groups of policies issued by the company.

It has been said that a well managed company should project asset share values on every policy it writes.[273] A company which does this would appear to be in a position to disclose the essential information necessary for a GPV. At least one company appears to have accepted the philosophy that annual financial statements to stockholders should include an estimate of future profits by application of the asset share method. This approach was predicated on the belief that it would provide both management and the stockholders with a more accurate picture of the company's financial progress and with more accurate standards, upon which to base adjusted earnings figures, than would the rule of thumb approach.[274]

Before deciding whether life insurance companies should be required to disclose such information in the annual statement filed with the insurance departments, the value of such reports must be weighed against the disadvantages. The advantages include the following. (a) An investor and his adviser would have recourse to sufficient information upon which an informed choice could be made. (b) To the extent that speculation is encouraged by the absence of such information speculation would be curbed. This in turn would tend to discourage those promoters, who form new companies as stock promotions, from entering the life insurance business, thereby mitigating potential harm to policyholders, stockholders and the industry. Such an effect may render unnecessary some of the more burdensome controls on new company formation and operation which might otherwise be deemed necessary by either the securities or the insurance regulators (e.g., the "needs" test). (c) To the extent that the GPV or asset share method permits sounder management decisions, mandatory disclosure requirements which encourage its use contribute to sounder company operations.[275]

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[272] For a more detailed discussion of the asset share technique, see Address by Bowles, Conference for Young Life Insurance Companies, Sept. 1-2, 1965, p. 7 and Exhibit B.

[273] Insurance, Aug. 14, 1965 (guest editorial). See Bowles, *supra* note 272.

[274] Insurance, Aug. 14, 1965 (guest editorial).

[275] "The organizers of a new company should be required to prepare a detailed plan of its proposed mode of operation, together with an actuarial projec-

One disadvantage is that companies may incur higher administrative costs in compiling such information. (Presumably, however, many companies have already compiled much of this information as a basis for management decisions.) Another disadvantage is the fact that competitors and agents might use this material for competitive purposes in a misleading context. (However, this could be said about any form of disclosure.) It is also possible that some of the reporting services such as *Best's* or *Flitcraft* might publish such data or distillations of it as part of their report on each company. This raises a fundamental question, How much information on the internal operation of a company should management be required to reveal publicly? Whether a detailed disclosure of such information is classified as an advantage or disadvantage depends upon the answer to this question.

Admittedly, this discussion of the GPV method is oversimplified with much detail omitted. A more extensive exploration of the suggested disclosure approach would require consideration of difficult problems relating to its implementation. It is beyond the province of this article to determine whether or not the suggested disclosure approach should be adopted. However, it is felt that the potential benefit accruing from the adoption of the proposed approach warrants its serious consideration.

Furthermore, at least with respect to the newer companies, this approach appears to be promising. Because of the smaller size of the insurance in force account, the magnitude of the administrative problems would be less. Since speculation in life insurance stocks occurs predominately in new company stocks, there may be some justification in applying this requirement to only the new companies if it can be feasibly applied only to them.[276] New York has taken a step in this direction. The Department requires newly organized companies and companies seeking additional public financing to furnish a detailed plan of proposed operations with actuarial projections based upon the proposed plan. There are two main benefits stemming from this requirement (1) It influences management to provide a sound capital and surplus structure, and (2) The actuarial projections serve as a basis for prospectus information furnished to the stockholders as to the likelihood of a need for further financing and the corresponding likelihood of stock-

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tion—it forces some realistic thinking. . . ." Gold, *An Actuary Examines the Rash of New Companies,* Insurance (Goldbook), Sept. 11, 1965, p. 130.

[276] Professor Kimball questions the assumption that all companies must be regulated alike. To subject the large companies to the same kinds of detailed control and examinations as a newly organized company seems "absurd." "The insurance department shall have the same power over all companies. But it is not necessary to exercise this power in the same way with respect to all companies." Kimball, *Sketches from a Comparative Study of American and European Insurance Regulations,* Journal of Risk and Insurance, June 1965, p. 195, 202.

holder dividends in the early years.[277] Perhaps New York (and other states) could build upon this approach so as to furnish investors, regulators and the public with a continuous flow of information of this type.

The GPV method is not the only alternative to the adjusted earnings—rule of thumb—approach in valuing a company's insurance in force. Other methods have been suggested. While lacking some of the refinements of a GPV calculation, they may constitute a significant improvement over the rule of thumb approach.[278] If they do, and if the GPV approach is deemed to be either impractical or outweighed by other considerations, mandatory disclosure requirements could be developed to assure ready accessibility of information necessary for their use. The purpose of this discussion is not to advocate any particular method of valuation but, rather, to suggest at least one possibility and invite the experts to improve upon it or suggest preferable and effective alternatives.

IV. CAUSES FOR CONCERN FROM THE POLICYHOLDER'S VIEWPOINT

Many groups possess an interest in life insurance. However, the importance of the interests of the policyholder exceeds that of the interests of any other group. The policyholders constitute the bedrock upon which the entire institution of life insurance has been built. The long range development and growth of the industry depends upon catering to their needs and concerns. The insurance-buying public seeks three principal qualities in life insurance: safety, service and low cost.[279] The new company phenomenon will be measured against each of these qualities.

A. Policyholder Safety

The purchase of a life insurance policy initiates a transaction whose duration may span the better part of a century. The election of

[277] 106TH ANNUAL REPORT OF THE SUPERINTENDENT OF INSURANCE TO THE NEW YORK LEGISLATURE COVERING 1964 at 27-28. Section 51(2), N.Y. INS. LAW provides that an applicant for a license to sell securities of an insurer must file, among other things, "a statement in detail as to the financial condition and the plans and purposes of the insurer . . ." See Partridge, *The Search for Quality Among New Life Companies,* Insurance, June 26, 1965, p. 24. One actuary suggested that the insurance departments require periodic actuarial projection on the operation of those companies whose drain on surplus exceeds a specified amount, e.g., $7.50 per $1,000 of insurance in force. Gold, *supra* note 275 at 130.

[278] E.g., one method is profit valuation which projects the earnings of a life insurance company as a whole upon the company's past experience. See Gold, *supra* note 230 at 146, 151-54. One investment firm adjusts earnings by amortizing expenses over the mean expected duration of the business and by adjusting reserves to a more realistic basis. See Bear, Stearns & Co., Monthly Financial Digest, March 1965, p. 3. See also Moody's Investor's Service, Inc., *Moody's Insurance Stocks—Adjusting Life Insurance Earnings,* Special Supp. Vol. 2, No. 25, Sept. 8, 1964, p. 277, (This approach is said to be inapplicable to new companies. *Id.* at 278.), and Griffith, *Valuation of Life Insurance Stocks,* Journal of Risk and Insurance, March 1965, p. 77.

[279] SCHWARZSCHILD AND ZUBAY, PRINCIPLES OF LIFE INSURANCE, 17-27 (1964).

a settlement option by the beneficiary can postpone final termination of the transaction for years beyond the death of the insured. Thus, the policyholder needs assurance that, no matter how long a period elapses before the policy matures and the final payments are made, the company will survive and be able to complete the transaction. In short, he relies on the company's permanence. Furthermore, he needs assurance that the company will have sufficient funds to make the payments required by its contract, i.e., he wants security.[280] In view of these needs, state legislatures have required the maintenance of minimum reserves, the filing of annual statements, periodic examination by the insurance departments, etc. Nevertheless, many believe the reputation of the life insurance industry for permanence and stability is being seriously jeopardized. The statistics on the retirement of insurance companies in the past fifteen years do little to enhance the image of stability and financial strength.

1. Why the High Mortality of Life Insurers

The mortality rate, among companies whose function relates to the longevity of the institution and the ability to survive financial crises, has prompted serious concern over the number of new companies organized and terminated. [281] Several causes have contributed to the high mortality rate.

a. Supply Exceeds Demand

It is questionable whether the market for life insurance can support the number of new companies which have been or are now being organized. At the end of 1964, there were 1,595 life insurance companies in the United States. This constitutes one company for each 121,000 persons. In some states the ratio is much lower. The following table provides some examples as of December 31, 1964.[282]

	Number of Companies Licensed	Estimated Population	Persons Per Company	Estimated Households	Households Per Company
United States	1595	193 million	121,000	56.9 million	35,700
Arizona	520	1.6	3,100	.5	1,000
California	297	18.4	62,000	5.8	19,500
New York	89	17.7	198,900	5.5	61,800
Texas	1190	10.5	8,800	3.0	2,500
Wisconsin	213	4.2	19,700	1.2	5,600

[280] Kimball, *The Purpose of Insurance Regulation,* 45 Minn. L. Rev. 471, 478-79 (1961).

[281] Address by Bruce E. Shepherd, 58th Annual Meeting of the Life Insurance Association of America, Dec. 10, 1964, p. 3.

[282] The estimated population figures were derived from Sales Management Survey of Buying Power, June 1965. The number of licensed companies, both domestic and foreign, was derived from correspondence with individual insurance departments. Some of the company figures provided are more cur-

A recent study of insurance operations in Europe compared the relationship between the number of companies licensed and the population in several European countries vis-a-vis individual states and the United States as a whole.[283]

	Inhabitants per Company
Italy	2,000,000
France	750,000
Germany	500,000
Great Britain	400,000
Switzerland	300,000

A sharp contrast exists between the European countries and the United States, particularly when the comparison is made with certain individual states. Some experienced life insurance people question whether such population-company ratios can be sustained over an extended period of time. This concentration may underlie the high termination rate.[284]

b. Quality of Management

Competent and experienced management is a *sine qua non* in any new business enterprise. It is axiomatic that most industries, the life insurance industry included,[285] need additional skilled and effective management personnel. One state regulatory body has noted that most defunct insurance companies in its state "succumbed as a result of mismanagement."[286] The problem seems to be that numerous managements in the life insurance business consist of people with sales experience but with little background in home office administration. An outstanding life insurance producer does not necessarily make an outstanding executive.[287] During a hearing one promoter was asked his occupation.

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rent than year end 1964, but for our purposes the approximate ratios are adequate.

[283] Address by Professor Spencer L. Kimball, the Annual Chartered Property and Casualty Underwriters Seminar, Sept. 25, 1964, pp. 10-12.

[284] See *contra* Address by Burten A. Finberg, New York State Association of Life Underwriters, Saratoga Springs, N.Y., Feb. 12, 1965, pp. 6-7. But see Probe, Feb. 22, 1965.

[285] "There is no new manpower being created in our industry today . . . only a shuffling and reshuffling of that which already exists." Address by Willaim O. Sahm, Chicago Conference on Acquisitions and Mergers, Oct. 28-29, 1964, p. 9. Another source states that "experienced managerial and sales talent is in tight supply." Anreder, *Multiple Risks? New Life Insurance Stocks Deserve a Critical Appraisal,* Barron's National Business and Financial Weekly, Nov. 16, 1964, p. 3.

[286] Texas State Securities Board Memorandum on Insurance Securities Pricing Formula and Analysis (Revised to March 1964), p. 6.

[287] Gold, *supra* note 275 at 130. "Merely to list necessary attributes of superior management—and to interview many companies new and old—is to confirm that only a relatively small number of such concerns exist. The great ma-

"A. Salesman.

Q. Salesman of what?

A. Anything. Anything. Insurance, washing machines."[288]

The same promoter in response to another question answered, "Well, of course, I don't know too much about the insurance business."[289] The rapidly increasing number of new companies undoubtedly has heightened the need for quality management. "Some companies have been launched—and their stock sold—by individuals with only the scantiest notions of how to run them."[290]

c. Acquiring an Agency Force Through Stock Options

The building of a sound, permanent agency force is a long, tedious and expensive task. The stock-options-to-agents concept has been advocated as a means to circumvent some of the problems. However, the soundness of this approach is open to question. Frequently, the agent will remain with the company only until he is able to sell at a profit the stock he acquired under the options.

> From the standpoint of the Company, they frequently buy a pig in a poke. Six months and a day after a stock deal has been made an agent may take his profits and move on to the next new company that is offering what appears to be an even more attractive stock deal. Officers and directors of companies that have made a practice of this have evaluated the results from the company's standpoint and there are very few who come up with the conclusion that stock deals open up to their companies an easy road to success.[291]

Furthermore, if stockholders' equity is not to become extremely diluted, the granting of stock options in lieu of commissions must cease after some period of time. Thereafter the agent may prefer to seek a new stock option "deal" rather than revert to ordinary commissions.[292] Such

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jority of young companies today, formed perhaps by a 'hot' insurance salesman and a few friends, are sadly deficient in one or more crucial areas. . . .

"Most young companies fall short in several areas, and some in all. The question of product is usually given scant attention. A survey of numerous prospecti reveals managements with primarily sales experience but little background in home office administration in positions of high responsibility. To a greater extent than in most manufacturing or merchandising concerns, the learning process for management follows rather than precedes the sale of shares to the general public."

Equity Research Associates, *The Hazards and Rewards of Investing in Small Life Insurance Companies,* Oct. 15, 1964, p. 8 (investment analysis). See United States Investor, June 1, 1964, pp. 31, 34, and Address by Phillip J. Goldberg, Chicago Conference on Acquisitions and Mergers, Oct. 28-29, 1964, p. 6.

288 Hearing before a state securities department (Jan. 1963).

289 *Id.*

290 Anreder, *supra* note 285 at 3. "The scarcity of topnotch insurance executives with a broad understanding of the business is appalling." Gold, *supra* note 275 at 130.

291 Goldberg, *supra* note 287 at 7-8.

292 See Finberg, *supra* note 284 at 10-11. For example, The National Underwriter, Jan. 16, 1965, p. 5, reported that one company, which was organized

transient movement seriously undermines the company's chance of successfully building a permanent agency force.

d. Insufficient Capital and Surplus

As discussed above, a life insurance company must deduct operating costs in the year incurred without the benefit of amortization. When a new policy is issued, the company incurs substantial, initial and non-recurring expenses such as agent first year commissions, medical examination costs, sales promotion and overhead. In most, if not all new companies, the first year premium income is substantially less than the first year acquisition costs. The practical effect of charging off all first year expenses in the year incurred is to delay the reporting of profits for several years (until renewal premiums constitute a significant portion of the company's income). The funds upon which the company is operated must come from the company's surplus. Consequently, in the company's early years, the writing of new business may cause a severe drain on surplus.[293]

The substantial cost of new business is emphatically illustrated by the following table.[294] The figures are based on a $50,000 ordinary life policy purchased at age 35 in an average company.

		First Year	Fifth Year	Seventh Year
(a)	Annual Premium	$1150	$1150	$1150
(b)	Interest earned	0	115	195
(c)	Cash available	1150	1265	1345
(d)	Disbursements (including management and field expenses, premium tax, general expenses, dividends, mortality charge)	1590	430	485
(e)	Plus or Minus	—440	+835	+860
(f)	Increase in Reserve	—800	—860	—880
(g)	Deficit	—1240	—25	—20

in 1959, wrote $2 million of business in 1960, $14 million in 1961, $14 million in 1962, $5 million in 1963, and it was merged in 1964. The year 1962 marked the end of the stock options.

[293] Ratio of new business expense to first year premium has been said to range between 150% to 250% in some companies. See Pfeffer, *Measuring the Profit Potential of a New Life Insurance Company,* Journ. of Risk and Insurance, Sept. 1965, p. 413 at 419. Equity, *supra* note 287 at 5, reports that one small company has a rule of thumb that $1.35 is paid out in the first year for every $1.00 of first year premium income. It has been said that when new business is 25% of the total insurance in force, the company is close to earning a profit. Pfeffer, *supra* at 418. For a discussion on the drain of surplus and operating losses, see e.g., address by Richard E. Pille, N. Y. State Association of Life Underwriters 22nd Annual General Agents and Managers Conference, Feb. 12-13, p. 6 *et seq.* and Equity *supra* at 5-7.

[394] This table is taken from Pille, *id.* at 7-9.

Even in the seventh year a small deficit was incurred. The yearly (not cumulative) deficit figures indicate that a lengthy time span is needed before the company will show a net gain from operations. Additional time is needed before the investment in new business can be recouped. During the deficit years, the source of the company's operating capital is paid-in surplus.

As a rule of thumb, it is said that a new life insurance company will commonly incur operating losses in its first six to ten years.[295] These are inherent in the mandatory accounting system. But, even if a company survives this period, profit is not guaranteed. If the premiums are too low or expenses and lapses are too high, there should be little expectation of ever recovering the initial investment, much less realizing a profit. Losses and drains on surplus in the early years are too often accepted complacently as being the expected thing. While the drain on surplus reflects an accounting technique it may also reflect a dissipation rather than an investment of surplus.[296]

The authors' survey of *Best's Life Insurance Reports* (1965) indicates the limitations of the six to ten year rule of thumb (see Appendix B). This survey covered companies which were organized during the period 1950 to mid-year 1964 and which still existed as of December 31, 1964. Of the companies with six to ten years of experience, the percentage of those showing losses ranged from a low of 34 per cent for those with ten years experience to a high of 53 per cent for those with seven years experience. Of the companies with ten to fourteen years of experience, the percentage of those showing losses ranged from 29 per cent for those with thirteen years experience to 40 per cent for those with eleven years and fourteen years experience.

Many new managements apparently did not correctly foresee, or were not concerned with, the high costs incidental to starting a new life insurance company. Several mergers stem from companies depleting surplus in the push for new production, only to discover that they have sold themselves "out of business."[297]

In 1964, 150 new companies were formed. The *average* capital and surplus was approximately $700,000.[298] This figure is less than 50 per cent of the *minimum* capital and surplus requirement in Michigan.[299]

The need for adequate capital and surplus of many new companies may be illustrated as follows. One publication collected the figures on twenty new companies organized in Indiana in the last ten years.[300]

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[295] See *supra* note 19.
[296] Gold, *supra* note 275 at 130.
[297] Franklin, *Should Agents Form Own Company?* The National Underwriter, Dec. 29, 1962, p. 4. See Pfeffer, *supra* note 293, p. 421.
[298] See Best's Weekly News Digest (Life Ed.), Feb. 1, 1965.
[299] Mich. Act. No. 242, Public Acts of 1965.
[300] Probe, Dec. 14, 1964.

The average new Indiana company in this group had 1963 sales of $11.8 million, compared with $10.7 million for the average agency of a large established company. The average insurance in force of the twenty companies was $32 million, compared with the average insurance in force of each of the established company's agencies of $116.8 million. Thus, many of the new companies had to maintain a home office organization (executives, actuaries, lawyers, underwriter, agency department, etc.) on a total volume substantially less than that of a single agency in a large established company.

If the drain on a company's surplus threatens the impairment of its capital the company, assuming it wishes to continue operations, is confronted with two alternative courses of action: merger or refinancing through a supplemental issue of stock. In its deficient capital and surplus condition, the chances of an advantageous merger are slight.

Before the investing public began to acquire some expertise in life insurance investing, it was relatively easy to raise capital through repeated stock offerings. But recently a number of experienced investment houses and financial magazines have indicated that new offerings of life insurance companies have become less attractive.[301] The potential

[301] The investment houses include Equity Research Associates, Lehman Brothers, First Manhattan Co., McDonnell and Co., and E. F. Hutton and Co. Financial magazines include Barron's and Forbes to name but a few. The following excerpt from a report by Equity Research is typical. "With few exceptions, 'life' stocks in the newer companies do not represent good value today. . . . Only a small number will attain important size and standing." Equity, *supra* note 287 at 2. Several factors, including the following, have led the investment houses to this conclusion.

(1) Due to high price earnings ratios, the growth of many of the new companies has been discounted far into the future, a factor which has contributed to the falling off in stock prices. McDonnell, The Life Insurance Industry, Industry Review Series, Nov. 1964, p. 1. As Equity Research cautioned, an investor should consider current price-earning ratios as "possibly excessive" and that "current prices for most small new life insurers are too high," Equity, *supra* at 2, 7. For example, the Dow Jones industrial average carries an aggregate price-earnings ratio for thirty stocks. (The price-earnings ratio is calculated by dividing the price of the stock by the latest available—or estimated—earnings per share.) For the year ending September 30, 1964, the Dow Jones average shows a price-earnings ratio of 19.7 to 1. In 1961, when the ratio was 22.9 to 1, the price-earnings ratio was considered to be excessive. See New York Times, March 3, 1965, p. 55. In contrast, several life insurance stocks have possessed a P-E ratio in excess of 50 times (adjusted) earnings, and at least one insurer's stock possessed a P-E ratio of nearly 100 times earnings. See Eastman Dillon, Union Securities & Co., Life Insurance Stocks, Feb. 1965. "It will continue so long as young companies can sell at 50, 80, 100, 130 times adjusted earnings and still get investor support." Sahm, *supra* note 285 at 7.

(2) Profit margins (from the stockholders' viewpoint) have been narrowing for two reasons: (a) Mortality has improved steadily for some years. This led to the replacement of the 1941 CSO Mortality Table by the 1958 CSO Mortality Table, which has tighter margins. The improvement in mortality seems to be leveling off. (b) Interest rates have been rising steadily since 1947, but the rate of increase is slowing up. Also, many policies now have higher interest guarantees.

(3) The diminishing profit margins and more intense price competition

lessening of investors' enthusiasm for life insurance stocks may render it more difficult for new companies with continued operating losses to replenish their surplus via new stock offerings.[302] Although to date only incipient signs of slackened investor enthusiasm for new company issues have been observed, this trend may gain momentum.[303] If so, terminations because of the absence of readily available capital may increase.

e. Specialty Policy Regulation

The specialty policy has quite often become the "crutch" to the agency force. Companies which have done well selling specialty contracts have found their agency force untrained and inadequate to sell conventional policies. The restrictive impact of state regulation (referred to above) on this type of policy has tended to force several new companies into some form of retirement.[304]

f. Motivation

Those companies organized by promoters for the sole purpose of creating stock, inflating its price, and then disposing of it quickly for

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as more companies organize suggests that growth in "insurance in force" will not be matched by growth in stockholder profits. E.g., Equity, *supra* at pp. 10 *et seq.*

(4) There is increasing sophistication among some investors in applying the adjusted earnings concept in evaluating the profitability of the life insurance in force account. For example, rather than multiplying the entire insurance in force account by $X per $1,000, different multiples are used for different types of business. Participating policies, as contrasted to nonparticipating policies, are discounted because of the necessity of allocating some profits to the policyholders. In states where there is a limitation on the amount of the participating profits which can be allocated to the stockholder, there is even a greater discount. Reinsured business is discounted since some of the profit goes to the reinsurer. Financed insurance is discounted because of its likelihood of lapse. Similarly, term, group, and accident and health business are discounted because of their short term nature.

[302] "Many fledgling life companies are forced to float new equity at regular intervals. So long as the market for such offerings is buoyant, as it has been in recent years, this process is painless. Should investors' sentiment cool, however, the story inevitably would be different." Anreder, *supra* note 285 at 15.

[303] "(T)he decline in stock prices has chiefly affected the shares of established companies." Forbes, May 1, 1965, p. 20.

[304] See 1960-1961 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 55; Robinson, *The New Life Insurance Company—Its Problems,* 1956-1957; PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 133, 144; Address by James H. Hall, Chicago Conference for Young Life Insurance Companies, Sept. 1-2, 1965, pp. 2-3. One executive commented,

> The same peak in production and falling off occurs when the company uses the other approach—that of a special policy, such as a founders contract.
>
> (He) reviewed the history of another Illinois company which had used this method of business building, noting that as soon as the founders policy was discontinued the sales fell off. Then when an effort was made to revitalize the company with new management, money ran out and a merger resulted. The National Underwriter, Jan. 16, 1965, p. 5.

capital gains have little chance of surviving.[305] Once the promoters have made their exit, little more than a corporate shell remains.

The prospectus of one company reflects the attitude of a group of stock promoters.

> Options [will] provide the organizers, officers and Advisory Committee members with an opportunity to profit from a rise in the market for the stock of the Company (if such should occur) at a minimum of expense and risk. It should also be noted that the granting of options might deprive the Company of favorable opportunities to procure additional equity capital, if it should be needed; and that at a time when the holders of options might be expected to exercise them, the Company would, in all likelihood (were it not for the options), be able to sell the stock by a public offering at a price more favorable than that provided for by the options.

Despite an awareness that the extensive stock option program might very well endanger the company's financial position and that after a period of time most new companies need to obtain additional financing through recourse to the public capital market, this approach afforded the promoters an opportunity for a profit "at a minimum of expense and risk." It might also be noted that the company underwriting this new insurer was wholly owned by the president of the new insurer and that the underwriting commission was 12 per cent of the price paid by the public for the stock.[306]

2. *Protection Via Reinsurance*

The development of sophisticated reinsurance arrangements has contributed to the formation of new companies. Each company, whether large or small, determines the maximum limit of insurance which it will retain at its own risk on an individual life. This limit will depend upon the size of the company and upon the amount of its assets and insurance in force. Small companies commonly tend to have retention

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[305] See Pfeffer, *supra* note 293 at 417. One reason an executive offers for new company failure is "improper motivation or a desire on the part of some promoters of life companies to make their money in stock rather than get into the life insurance business seriously." As reported in The National Underwriter, Jan. 16, 1965, p. 5.

[306] Prospectus in authors' files. In the formation of some new insurers, no underwriting commissions are paid. However, the prospectus of one insurer revealed the underwriting commission to be $.60 per $4.00, or 15%. The stock of the underwriter was owned solely by one of the officers of the new life company.

> The success of recent life insurance stock sales has, I am sure, fanned to fever heat the enthusiasm of promoter groups. The Oregon law allows up to fifteen per cent of stock sale proceeds for selling expense and on, say, a $3,000,000 sale, that would amount to $450,000, a most attractive morsel. Unfortunately, many promoters care little what happens to the company once the stock is sold and the company has obtained its license.

Department Memorandum by Oregon Insurance Commissioner Korlann (1965)

limits from $10,000 to $25,000, while a very large company might be willing to retain up to $500,000 or more at its own risk.[307]

There are basically two types of reinsurance coverage, that on the yearly renewable term (YRT) basis and that on the coinsurance basis. Under the YRT coverage, the company is reinsured on that part of the net amount at risk (i.e., face amount less the reserve thereon) which it wants to reinsure. The ceding company pays the reinsurer a yearly renewable term premium covering the amount of reinsurance. The ceding company, itself, maintains the reserve for the full amount issued. Under a coinsurance plan, the ceding company, in effect, transfers a portion of the policy, both the amount of risk and the reserves, to the insurer which receives a proportionate part of the premium less commission and an agreed upon expense allowance. The reinsurer is liable for a corresponding portion of all payments made under the policy. The smaller companies tend to prefer the YRT plan of reinsurance since it permits them to retain a larger amount of assets.[308]

It has been alleged that because of the use of reinsurance the policyholders will not "get hurt" if a new company fails.[309] The claim is that even if a company is not adequately reinsured, its inability to pay death claims most likely would be rectified through the insurance department prevailing upon some company or group of companies to assume the obligation.[309a] On the other hand, if the company does have an adequate reinsurance contract with a substantial, well-managed reinsurer, the impression may be given that the policyholder is protected in much the same manner as his bank account is protected by the Federal Deposit Insurance Corporation. However, this is an oversimplification which obscures some important facts.

Generally, with few exceptions, no privity of contract exists between the policyholder and reinsurer. The proceeds of the reinsurance are paid to the ceding company. If the ceding company is insolvent, the proceeds are payable to the liquidator and become general assets which are not held for any particular policyholder.[309b]

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[307] See MACLEAN, LIFE INSURANCE 264 (9th ed. 1962).

[308] *Id.* at 264-265. Reinsurance is also issued on a modified coinsurance basis under which the issuing company holds the entire reserve. See *Id.* at 265.

[309] In this connection, see Equity, *supra* note 287 at 3; McDonnell, *supra* note 301 at 11-12; and The National Underwriter, Feb. 27, 1965, p. 2. On occasion, a reinsurer's name is used in advertisements or prospectuses, without the reinsurer's consent, prior to the entering into a reinsurance contract. Oral discussion at the American Life Convention regional meeting in Milwaukee, Wisconsin, April 26-27, 1965.

[309a] N.Y. INS. LAW §224 provides for the creation of a guaranty fund, arising from assessments on domestic companies, to promote stability of domestic life companies and the performance of their contractual obligations. A company needs to transact business for at least six years to be eligible for assistance from the fund.

[309b] See 29A AM. JUR. *Contracts* §1757 (1960).

In many, if not most, cases the reinsurance contract provides yearly renewable term protection only. The reinsurer assumes only the mortality risk. The policyholder must still look to the ceding company for the security of his policy reserves and cash values. There may be liens on the policyholder's cash values. The dividends on participating policies could be drastically cut. The company might assume a "cut-all-expense" attitude towards policyholder service. Such items as these, we submit, certainly fall within the term "getting hurt." Therefore, the financial stability of the ceding company is a very important factor, from the policyholder's viewpoint, even when reinsurance is involved.[310]

From 1950 to mid-year 1964, 35 life insurance companies failed to renew their license, had their licenses revoked, were in receivership, or were inactive; and 63 companies terminated their corporate existence through voluntary dissolution, liquidation or retirement.[311] Apparently, there has been no full scale study of policyholder losses in the last twenty years resulting from such terminations. However, the Institute of Life Insurance Report indicates that some have occurred.[312] This could become an even more serious problem should refinancing become unavailable due to a dampening of the investment climate.

Some observers feel that new companies are being somewhat less than candid when they stress the permanence and stability of life insurance in messages to their policyholders, and, at the same time, disclose the risks involved in the new enterprise in prospectuses to stockholders. For example, one prospectus states the shares "are speculative in nature and involve substantial risks." Many of those factors which make an investment in the stock in a new life insurance company a risky venture, for example, questions regarding the competence of its management and technical staff, its integrity and its investment policy, also relate to policyholder safety. To rationalize or justify the high termination rate of new companies on the basis that the policyholder is fully protected by reinsurance, particularly if the company writes most of its policies for an amount under its retention limits for which no reinsurance is procured, leaves something to be desired.

3. *The Image of Stability*

As the general public becomes cognizant of the mortality rate of new companies, the industry's image of stability could be seriously undermined. This, in turn, could portend grave consequences for all

[310] Changing Times, May 1965, p. 38, reports that two Texas companies were put into receivership in 1960. Liens were placed against the policies up to 70% of the cash values in one company. See The National Underwriter (Editorial), Feb. 20, 1965, p. 22. But see address by A. H. McAulay, N. Y. State Life Underwriters Association, 22nd Annual General Agents and Managers Conference, Saratoga Springs, N.Y., Feb. 12-13, 1965, p. 3.

[311] INSTITUTE OF LIFE INSURANCE, REPORT ON LIFE INSURANCE COMPANY FORMATION AND DISSOLUTION—1950 THROUGH MID-YEAR 1965, 89.

[312] *Id.* at 97.

life insurers and for those members of the public who are dissuaded thereby from purchasing life insurance. An ebbing of confidence in the life insurance industry's stability and reliability "can do incalculable damage to the public interest, and to the insurance industry."[313]

B. Policyholder Cost

1. *Relationship Between Policyholder Costs and Stockholder Profits*

The Two Way Split. In addition to safety, policyholders presumably seek the lowest possible cost (consistent with their other goals such as safety and good service). The cost of life insurance is determined by three basic elements: mortality, expenses and interest. (Interest is used to reduce the policyholder's cost.) Since protection is furnished over a period of years for a level premium, it is necessary to set the premium rate at a sufficiently high level to provide a margin of safety against fluctuations in these three elements. At the end of each year the unneeded safety margins may be allocated to the participating policyholders, to the stockholders, or to both. In a mutual company the unused margins are refunded to the policyholders in the form of dividends. In a stock company which issues only nonparticipating policies, the unused margins, here called "profits," accrue to the benefit of the stockholders.[314] In a stock company which writes participating policies, the "profits" are split between the participating policyholders and the stockholders.

Traditionally, the net cost to the policyholder of a participating life insurance policy has been determined by substracting the dividends and the cash value from the gross premium.[315] The greater the dividends, and the higher the cash value, the lower will be the net cost. On the other hand, the more dividends paid to the policyholders, the less will be available for the stockholders' benefit in the form of increased equity or larger dividends. In this sense, there is a conflict of interest between the policyholder and the stockholder.[316]

A conflict of interest also exists between the promoter (as dis-

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[313] Address by Superintendent Stern (N.Y.), N. Y. Life Underwriters Sales Congress, Mar. 11, 1965, p. 4. "The high national rate of retirement of new life insurance companies by either merger or reinsurance adversely affects the image of life insurance . . ." New York Superintendent's Report, *supra* note 277 at 23.

[314] Stock companies also build profit into their premium structures.

[315] For another way to compute cost, see Belth, *The Cost of Life Insurance to the Policyholder—A Single Year Attained Age System,* Journ. of Insurance, Dec. 1961, p. 23.

[316] "What is good for life insurance policyholders is not necessarily good for the stockholders of insurance companies." Forbes, April 15, 1964, p. 23. Specialty policies sometimes give the policyholder a right to share in the company's earnings. Those states which have the "fair, just and equitable" doctrine embodied in their securities laws may ask whether such a provision is fair to the investors. This question highlights the conflict of interest feature from the investor's viewpoint.

tinguished from the general stockholder) and the policyholder. Because of the drain in surplus when new business is written, "any well trained insurance man ought to be well aware of the danger of writing a new company out of business in the first few years."[317] Therefore, the interest of the promoter in rapidly running up the insurance in force account tends to conflict with the policyholders' interest in a well-run, sound insurance operation.

Investor Anticipation of Profit. The widespread belief that "fantastic" profits are to be made in life insurance stocks has been fostered by some investment advisers and by some elements of the insurance industry itself.[318] It arises from the fact that life insurance stock is highly leveraged. A high ratio of assets to invested capital multiplies the effect of excess interest earnings. For example, assume that a company with a capitalization of $1 million has $10 million in assets. Since shareholders' equity is 10 percent, an increase of one-half of 1 per cent in the company's investment yield can produce a 5 per cent increase in the return on equity.[319]

The following example has been used as an illustration of the profitability of life insurance.[320] A successful agent decided to establish his own company. He was the company's only employee and only agent. The insurance operations were actually conducted through a reinsurer. The agent paid himself regular commissions plus a managerial salary. At the end of a period of a few years, the company had $20 million of insurance in force and a total of $800,000 in capital and surplus. The agent is reported to have sold his company to the reinsurer, received dollar for dollar for the capital and surplus, and received, in addition, $500,000 for the insurance in force. Not including the managerial salary, it was stated that this agent received $1.3 million over and above what he would have earned in ordinary commissions.

The magnetic appeal which the so-called "profitability" of life insurance stock has for investors has affected management because of the continuing pressure from stockholders to allocate the largest possible share of the unneeded margins to the stockholders' benefit. The preoccupation of some managements with the company's stock is illustrated by the following letter written by one chief executive of a small midwestern company, to the company's agency force:

> I receive a daily report from our Stock Transfer Department as to who is selling and who is buying. I would be very disappointed to have any sales of stock by our representatives trigger a lack of confidence in our company. Since supply and demand regulate the price of our stock, *we must keep the de-*

[317] United States Investor, June 1, 1964, p. 34.
[318] E. F. Hutton & Co., Market and Business Survey, Nov. 1964, p. 1.
[319] See Forbes, April 15, 1964, p. 22.
[320] At an organizational meeting of a new life insurance company.

> *mand high and the supply low* or we will have defeated our purpose in having hit our 100 million goal.[321] (Emphasis supplied)

Legal Recognition of Conflict of Interest. The law has recognized that the distribution of unused margins can have a very vital bearing on the policyholders' costs, and that there is a basic conflict between the interests of the policyholders and the stockholders. In Canada and in five American states(New York, NewJersey, Illinois, Wisconsin and Nebraska) laws or regulations have been passed limiting the amount of unused margins from participating policies which the company can allocate to the benefit of the stockholders.[322] In Canada there is a sliding scale ranging from 10 down to 2½ per cent, depending upon the size of the company. The rationale of the limitation on the stockholder charge in Canadian law makes explicit the recognition of the potential conflict.

> By far the greater part of the business in Canada is transacted on the participating plan and in a very real way, therefore, Canadian companies are 'policyholder' companies. Because of this, there are important provisions in Canadian insurance laws *designed to protect participating policyholders against shareholders who might seek to profit unduly at the policyholders' expense.*[323] (Emphasis supplied)

In New York and Wisconsin, the stockholders are limited to 10 per cent of the "profits" on participating business, or fifty cents per year per thousand of insurance in force, whichever is the larger.[324] The amount that the company may allocate to the stockholders has been termed the "stockholder's charge."[325]

One enterprising stock company gave the stockholder's charge regulation a reverse twist. By using appropriately phrased language its agents, in the course of soliciting, attempted to convince their prospects that they were indeed fortunate to be buying insurance with a company which would pay them 90 per cent of the participating profits

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[321] Letter in authors' files dated January 23, 1965.

[322] Canadian and British Insurance Companies Act. §84(2), REV. STAT. OF CAN. 1952, c. 31; ILL. INS. CODE §233; NEB. REV. STAT. (1960) §§44-708; N. J. STAT. ANN. §17.34-12 (1962); N. Y. INS. LAW §216(6); Wis. Adm. Code Sec. Ins. 2.02(3) (1962). The United States and Canadian definition of "participating profits" differ. The Canadian definition permits smaller amounts to be allocated to the benefit of the stockholders. See BELTH, PARTICIPATING LIFE INSURANCE SOLD BY STOCK COMPANIES 57-60 (1965).

[323] 2 REPORT OF THE SUPERINTENDENT OF INSURANCE FOR THE DOMINION OF CANADA (Life and Fraternal) xix (1954).

[324] Illinois uses the 90%-10% rule with no alternatives. Similarly, New Jersey uses solely the $0.50 per $1,000 rule. Nebraska requires that all of the surplus arising from the participating business accrue to the benefit of the participating policyholders.

[325] Belth, *supra* note 322. Of course, surplus which may belong to the stockholders provides additional safety margins for the policyholders in a going company.

—without disclosing the fact that this was not voluntary, but rather a requirement of state law.

Professor Belth reports another interesting example. In 1957, Illinois amended its insurance law so that the stockholder charge limitation is confined only to the Illinois business of Illinois companies. Previously the limitation had applied to all business of domestic companies, wherever written.[326] Following this amendment, one company gradually increased the stockholder's charge from 55 cents per thousand of participating life insurance in force in 1957, to $2.70 per thousand in 1963. In other words, the company levied a stockholder charge of 8.3 per cent of participating profits prior to the amendment as contrasted to 39.7 per cent in 1963.[327]

One approach to avoid a conflict of interest between policyholder and stockholder is well illustrated by Canadian experience. In 1957, the Canadian parliament enacted legislation facilitating the conversion of Canadian stock companies into mutual companies.[328] The primary purpose of the Canadian legislation was to make sure that ownership of Canadian life insurance companies remained in Canada. But another important purpose was to keep out speculators and in this process safeguard the interests of the policyholders.[329]

Another approach to the conflict of interest problem is that followed by New York. Section 213 of the New York Insurance Law imposes expense limitations on companies licensed to do business in New York. Subsection (7) prohibits the payment of

> Any bonus, prize or reward or any increased or additional commissions or compensation of any kind whatsoever based upon the volume of any new business or the aggregate number of policies written or paid for.

Relying on this statutory provision, the New York Department has prohibited the use of stock options as a means of compensating agents.[330]

> The philosophy underlying the law [Section 213] contemplates that the public be in a position to obtain life insurance at the lowest cost possible consistent with sound underwriting principles and management.[331]

The concept of lowest possible cost coupled with the prohibition on stock options appears to be a tacit recognition by the New York De-

[326] Ill. Law 1937, p. 804 §233.
[327] See BELTH, *supra* note 322 at 89 n. 54 and at 97 n. 70.
[328] Canadian and British Insurance Companies Act, §90A, REV. STAT. OF CAN. 1952, c. 31 as amended by 1957-1958, c. 11.
[329] See House of Commons Debates, Dec. 3, 1957, pp. 1810-13. The insurance laws of several states permit the mutualization of a stock company, E.g., WIS. INS. LAW, §201.301.
[330] See New York Superintendent's Report, *supra* note 277 at 24-25.
[331] 5 STAUB, EXAMINATION OF LIFE INSURANCE COMPANIES 341 (1955). See 5 STRAUB at 337, 351, 411.

partment that the profits which might accrue to an agent holding stock options may do so at the expense of the policyholder.

However, this is not necessarily true. Some stock option companies reduce their first year commissions somewhat below the level of some more established companies.[332] In lieu of some commissions, stock options are given at a low, specified price. Part of the agent's compensation is derived from the difference between the option price and the market value. One new company writes some business at a lower gross premium that its own reinsurer, despite the fact that the new company must pay for the reinsurance. This is made possible by partially compensating its agents through stock options.[333]

One consideration should be kept in mind by management contemplating the use of stock options, in lieu of a portion of regular commission, as a means of compensating its field force. At some point in time, the issuance of options for new business needs to be discontinued. Otherwise, the value of each share will become so diluted that stock options no longer will provide adequate incentive to write new business. When the option plan is terminated, regular commissions must be raised to a competitive level if the company is going to retain its agents. Whereas the premium rate structure may have been adequate under the original mode of compensation, it may not support the increased commissions.[334]

In short, companies writing both participating and nonparticipating policies inherently possess some degree of conflict of interest between the policyholders and the stockholders. The pressure on management to emphasize the interest of the stockholders varies in accordance with the stockholders' concept of the profitability of life insurance stock. On occasion the law has recognized the relationship between stockholder profits and policyholder costs and has sought to counterbalance an occasional overemphasis on the former at the expense of the latter.

2. Reinsurance

Reinsurers play a fundamental role in most new life companies. In addition to reinsuring risks which a new company could not otherwise accept, reinsurers may supply invaluable actuarial and underwriting facilities on a continuing basis, or furnish advice to the new company on underwriting practices, rates, policy forms, accounting and reserve methods, investments, agency and personnel problems.[335]

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[332] A typical first year commission paid by an established company licensed in New York, on a Whole Life policy is 55% of the first year premium.

[333] This was developed in a discussion at the American Life Convention regional meeting in Milwaukee, Wisconsin, April 26-27, 1965. Other stock option companies give the option in addition to standard first year commissions. See address by William R. Robertson, Research Agencies Group, Williamsburg, Va., May 13-14, 1965, p. 5.

[334] See Finberg, *supra* note 284 at 10-11.

[335] See 2 SCHWARZSCHILD, *supra* note 279 to 176, and Probe, Nov. 30, 1964. But

During its early years, the new company may reinsure a substantial portion of its business. For example, one company in its prospectus indicated that it intends to cede the first $1,000 of all risks (except policies issued for amounts ranging from $1,000 to $5,000) and all insurance in excess of $20,000 in every case. A reinsurer does not offer its services gratuitously. It charges premiums at a level adequate to cover mortality costs and expenses as well as to generate profits for its stockholders. This, in turn increases the cost to the policyholders of the ceding company. A company with a large retention "picks up a cost advantage" over the smaller companies who must reinsure to a greater extent.[336]

3. Reputation for Low Cost

Starting from the premise that a life insurance company is simply a vehicle to create a pool of lives for insurance protection purposes, one of the main responsibilities of a life insurance company is to furnish such protection at a reasonable cost. In fact, the New York Expense Limitation Law (Section 213) was enacted to secure reasonable economy of operations and to protect policyholders from extravagant expenditures.[337] Wide dissemination of information that life insurance is a "gold mine" for the stockholders carries with it quite a different idea, namely, that life insurance may be overpriced for the policyholder. For example, one investment survey ran an advertisement which stressed the claim that life insurance companies, for a variety of reasons, including the complex laws under which they operate, tend substantially to understate their true earning power. It was asserted that the companies put far more money into policy reserves than were necessary to meet the required future disbursements as claim payments. The advertisement concluded that

> in 1963, the *real* (or adjusted) earnings of leading Life Insurance Stocks . . . were 65% above *reported* earnings.[338]

The constant reiteration of this and similar themes may be stimulating public curiosity as to what are the sources of these stockholder profits.

> Perhaps up to now the investing public and the noninvesting reading public have not related the fantastic growth of new life insurance company stock to the cost of their personal life insur-

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a spokesman for one reinsurer during an oral discussion, at an ALC meting, *supra* note 333, commented that the cost of providing extensive underwriting and management services, to the degree implied by some, would be very great. A reinsurer does not have sufficient margins to provide such extensive service.

[336] See Hutton, *supra* note 318 at 9; Anreder, *supra* note 285 at 4-5; and Pille *supra* note 293 at 12.

[337] Mayerson, *A New Look at the New York Expense Limitation Law,* 8 TRANSACTIONS OF THE SOCIETY OF ACTUARIES 258 (1956).

[338] New York Times, Jan. 23, 1965, p. 34.

> ance. But that relationship will, in time, occur to millions. What makes the value of any common stock rise? Profits, of course. And where do profits in life insurance come from? The public will quite naturally assume that they stem directly from the margin between the actual cost of insurance and the premiums charged. And when life insurance stock is so certain to rise in value, and to rise in predictable leaps and bounds, that margin, many people will ultimately come to believe, is excessive. And when people start to believe that, the life insurance business, including established as well as new companies, will be in trouble.[339]

The Institute of Life Insurance has suggested that the new company stock boom may lead the public to think of the insurance industry as a mechanism for "the creation of legendary personal fortunes through the use of their (policyholders') premium dollars."[340]

C. Policyholder Service

1. *Professional Status*

The third attribute which a policyholder seeks in a life insurance company is service. The national advertising of the Institute of Life Insurance has been designed to foster the professional status of the agent. This, among other things, has led policyholders to expect such service and to rely on their agents to render it.

> The future of the life insurance business, and to a large extent the economy of the country, is closely tied to the confidence and high esteem in which companies and their representatives are held. Any development which could shake this confidence is of grave concern to all.[341]

Efforts have been made by the American College of Life Underwriters, and the National Association of Life Underwriters, to name two, to assure that such service is given.

2. *Stock Options to Agents*

a. Conflict of Interest

An agent who contemplates placing business in a company so as to earn stock options is confronted by two potential conflict of interest situations. First, there may be a conflict of interest between the principal company (assuming the agent retains his contract with his principal company) and the stock-option-to-agent company. Typically, companies offering stock options have no full-time agents of their own. Their avowed target is agency broker business or excess business—i.e., the life insurance business which the agent of another company writes but which his principal company refuses to accept for underwriting or other reasons. But, it is manifest that

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339 Probe, Nov. 16, 1964.
340 Institute of Life Insurance News Letter, Nov. 1964.
341 Strain, *Stock Option Incentives in Newly Formed Life Insurance Companies*, J. of American Society of C.L.U., Winter 1965, p. 10.

> Such a purpose . . . does not end here. Since the new company is not disposed to refuse any business it considers profitable, nor can it afford to, obviously more than brokerage business is at stake in its target.
> Many of the stock promotional companies have been formed by experienced life insurance sales personnel. Normally they have no full-time agents and no plans for acquiring full-time agents. They rely largely for their premium income on full-time agents of other established companies.[342]

In such circumstances each time the agent writes a new policy he is confronted with the question: Into which company should this business be placed? If he elects to give the new company business which his principal company would have been willing to underwrite, he may violate legal principles in at least two respects. First, general principles of agency law impose upon the agent a duty of good faith to his principal which is providing him not only with his commission but also with the usual incidents of such a relationship such as a retirement plan, fringe benefits and social security contributions.[343] Second, an agents' contract customarily contains a provision which gives his company the right of first refusal on all of his business. If the agent places business with the new company, this provision may be violated.[344]

It is only natural that an established company should want to protect its substantial investment in its field force. The problem resulting from agent defections to stock option companies should not be minimized. However, from a regulatory standpoint it is not the prime consideration in evaluating the stock option technique.

More important is the potential conflict of interest between the agent and the policyholder when the agent situates himself in the position where he is confronted with the choice of placing business in a stock option or a non-stock option company. When an agent writes

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[342] Strain, *id.* at 7. See Pfeffer, *supra* note 293 at 416; Timmons, *Dangers in the Hight Birthrate of New Life Companies,* Insurance, Oct. 16, 1965, pp. 27, 28; and Probe, Jan. 25, 1965. This is denied by some stock option companies who claim they are interested in only excess business from agents under contract with another company. See The National Underwriter, Feb. 6, 1965, p. 1.

[343] "An agent is a fiduciary with respect to the matters within the scope of his agency. . . . (T)he agent . . . is bound to the exercise of the utmost good faith, loyalty and honesty toward his principal or employer." 3 AM. JUR. 2d Agency §199 (1962). "For reasons of public policy the law does not permit an agent to assume any relationship antagonistic to his duty to his principal . . . [who] is entitled to the best effort and unbiased judgment of his agent . . ." *Id.* §220. Probe, Nov. 30, 1964 said that these companies "are in their very nature parasitic since they have no sales organizations and no recruiting or training procedures of their own." In short, established companies are subsidizing the stock option companies. See letter from Robert H. Harmon, published in The National Underwriter, Sept. 19, 1964, p. 9.

[344] Strain, *supra* note 341 at 11. One executive of a stock option company commented that established companies accept business from agents affiliated with other companies without concern for conflict of interest. See The National Underwriter, Feb. 6, 1965, p. 1.

business for both his principal company and for the stock option company, a very significant factor may enter into the agent's recommendation, i.e., the current status of the stock market and the agent's appraisal of the same. If the market prospects or the market price of the insurer's stock are favorable, the agent is under personal financial pressure to place the business in the company where he can earn stock options. When the agent's appraisal of the market is unfavorable, he may be more inclined to place the business where he can earn regular commissions. Thus, the market factor, while extraneous from the policyholder's viewpoint, could conceivably become a primary consideration in the agent's recommendation. This potential conflict of interest pressure is inherent in every situation involving an agent's choice of earning straight commissions or earning stock options.

Furthermore, in many stock option to agent plans, if the agent fails to meet a minimum production requirement, the company reserves the right to repurchase, at a specified price per share, the stock already acquired by the agent. If the market price exceeds the repurchase price, the agent is under pressure to place business with the stock option company not only to earn options on present business but also to protect his investment in past business. This requirement makes it doubly difficult to maintain the policyholders' interest as the prime consideration.

Professional groups such as the American Institute of Certified Public Accountants, the American Bar Association, etc., impose stringent limitations in situations where their members have a personal interest.[345] A duty of disclosure is imposed upon securities brokers-dealers as a consequence of the professional nature of their function.[346] A trust officer is a fiduciary, subject to the responsibility described by the classic language of Judge Cardozo in the famous case of *Meinhard v. Salmon.*

> A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. . . . Only

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[345] The Executive Committee of the American Institute of Certified Public Accountants described the C.P.A.'s independence. "It has become a great value to those who rely on financial statements of business enterprises that they be reviewed by persons skilled in accounting, whose judgment is uncolored by any interest in the enterprise, and upon whom the obligation has been imposed to disclose all material facts." As quoted in an address by A. F. Colao, Chicago Conference on Acquisitions and Mergers, Oct. 28-29, 1964, p. 1. "Members should not have any financial interest in, or serve as officers or directors of clients on whose financial statements they express opinions." Rule 1.01, Code of Professional Ethics, American Institute of Certified Public Accountants, as amended March 3, 1964, at 28-29. See e.g., Canons 6 & 10, American Bar Association, Canons of Professional and Judicial Ethics 3, 9 (1957); Canon 10 states: "The lawyer should not purchase any interest in the subject matter of the litigation which he is conducting."

[346] See KNAUSS, *A Reappraisal of the Rule of Disclosure,* 62 MICH. L. REV. 607, 638-39 (1964).

> thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.[347]

Almost sixty years ago, New York's Armstrong Committee, speaking of the responsibility of the officers and trustees of a life insurance company, said,

> The business of the company should be transacted under the direct supervision of the trustees and no opportunity should be afforded for a conflict between their personal interest and their official duty. It is entirely indefensible to permit one to act as the trustee of an insurance corporation in a transaction in which he may benefit . . . by the exercise of his discretion.[348]

To implement concepts comparable to those expressed by the Armstrong Committee, the rules of the National Assocation of Insurance Commissioners require that the company have an established procedure for disclosure to the board of trustees of any material interest or affiliation on the part of any of its officers, directors, trustees or responsible employees which might conflict with their official duties.[349]

The law has not left unrecognized the responsibilty of an agent to his policyholder. For example, *Knox v. Anderson*[350] indicates that where an agent permits his personal interests to take precedence over the best interests of the policyholder, he may be held liable. While the court held the defendant agent liable on the ground that he had made fraudulent misrepresentations to plaintiffs, it indicated that an insurance agent, who has superior knowledge of facts, material to the transaction, may have a possible duty to make full disclosure of them to his customer. The court cited as authority for this proposition a case involving a sale of stock in which the seller omitted to state a material fact which was within his knowledge and of which the buyer was unaware.[351] Arguably, then, the court saw an analogy between the situation of the securities dealer in a sale of stock and an insurance agent in the sale of an insurance policy. One of the facts which a

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[347] 249 N.Y. 458, 164 N.E. 545, 546 (1928).

[348] Report of the Joint Committee of the Senate and Assembly of New York Appointed to Investigate the Affairs of Life Insurance Companies (1906), p. 388.

[349] See NAIC Blanks Committee Report, 2 PROCEEDINGS: NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 447, 457-59 (1961).

[350] Anderson v. Knox, 297 F. 2d 702 (9th Cir. 1961), *cert. denied* 370 U.S. 915 (1962). The trial judge's opinion is reported under the title of Knox v. Anderson, 159 F. Supp. 795, (1958). The judge's formal findings are also reported at 162 F. Supp. 338 (1958). The agent had recommended a certain insurance plan as suitable for one in plaintiff's income bracket. The court held that plaintiff's reliance on this representation was reasonable under the circumstances, that the plan was not suitable and that the agent was or should have been aware of this fact.

Judgment was awarded to plaintiff on the ground that defendant's "expressed opinion of suitability was not an honest one but was made fraudulently and with intent to deceive. . . ." (297 F. 2d at 727).

[351] 297 F. 2d at 727 n. 46a.

securities dealer must disclose in a sale of securities by him is the existence of any conflict of interest "arising because he has a direct interest in the security he is selling."[352] The broker-dealer's duty of disclosure rests upon his professional status and is thought to be a higher standard than that required of an ordinary salesman and

> similar to the obligations long imposed on attorneys, doctors, certified public accountants, and architects in dealing with their customers. Recent cases have applied the same concept to insurance salesmen. . . .[353]

It would seem to be a short step to require disclosure by insurance agents to their customers of the potential conflict of interest situation stemming from their interest in the company's stock and stock options. *Hardt v. Brink* may be a harbinger in this area. In holding an insurance agent liable to his client, the court said,

> This is an age of specialists and as more occupations divide into various specialties and strive towards 'professional' status the law requires an ever higher standard of care in the performance of their duties.[354]

In many sales of insurance there must be a close working relationship between the client, the attorney, the trust officer, the accountant and the insurance agent. Each of these four professionals has fiduciary responsibilities. There should be no double standard in the life insurance business—a high one for management, trust officers, attorneys and accountants, and a lower one for the agents. The policyholder has a right to expect from the officers, trustees and agents of a company that their judgments and recommendations are unaffected by any opportunity for concealed personal gain at the expense of the policyholder. An agent does his client and his industry a disservice if he opens himself up to powerful temptations to put his personal interest above that of his client.[355] In light of the professional standards referred to above, disclosure would appear to be the minimum which should be required of an agent.

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[352] See Knauss, *supra* note 346 at 609. "Other rules require a broker-dealer to make appropriate disclosure to his customer if he is controlled by or in a control position of the issuer of any security in which he is effecting a transaction, and to inform any customer he advises on securities for a fee of any interest he has in any distribution of securities concerning which he is advising." *Id.* at 637. See *Id.* at 638-40.

[353] *Id.* at 638 citing Anderson v. Knox, *supra* note 350 and Hardt v. Brink, 192 F. Supp. 879 (W.D. Wash. 1961).

[354] 192 F. Supp. at 881. The court held that an insurance agent who held himself out to be a highly skilled adviser and who was relied upon by the plaintiff was under a duty to advise the plaintiff as to a potential liability under the lease and to recommend insurance therefor.

[355] See Burridge, *Producer-Owner Insurers With Stock Options Are A New Life Insurance Phenomena,* The National Underwriter, Sept. 7, 1963, p. 1-2. On the other hand, it may be argued that an agent who fails to put the policyholder's interest first would not remain in business for very long. *Id.* at 2.

One spokesman for the stock-option-to-agent companies offered this reply: some established companies also offer inducements, such as office space, expense allowances and pension plans, which may enter into the agent's decision as to where the business should be placed.[356] There may be some truth in this. Where such inducements are used to obtain non-surplus business from agents who are under primary contract with another company, a similar conflict of interest argument may be made. But whether such inducements give rise to a conflict of interest is immaterial for the purpose of this discussion. The propriety of one company offering stock options to agents under full-time contract to another company must still be judged on its own merits.

The situation is significantly altered when an agent opts to go full time with the stock option company. He is no longer confronted with the choice, influenced by the stock market condition, as to which company should be the recipient of his business. To this extent, conflict of interest problems disappear.

b. The Nomad

The quality of service to the policyholder may be impaired not only by agent recommendations influenced by personal considerations, but also by the instability of the agency force prevalent among stock-option-to-agent companies. An agent may find it advantageous to sell his stock and move to the next company which is offering an allegedly better deal. "(T)he temptations made nomads of agents."[357] Furthermore, an agent who moves from company to company may be tempted to replace and even "twist" the policies he sold previously, to his own policyholders' detriment.[358]

Another difficulty which has plagued some new stock option companies in efforts to retain their agents has been the artificial inflation

[356] See The National Underwriter, Feb. 6, 1965, p. 1.

[357] Address by Phillip J. Goldberg, Chicago Conference on Acquisitions and Mergers, Oct. 28-29, 1964, p. 8; STRAIN, *supra* note 341 at 10-11, discusses the negatives of stock option companies from the agent's viewpoint. See Goldberg at 7 and addresses to the N.Y. State Life Underwriters Association 22nd Annual General Agents and Managers Conference, Feb. 12-13, 1965, by A. H. McAulay at 11-12, Richard E. Pille at 21-22 and Joseph N. Desmon at 6-7.

[358] "(A)gents rewrite the business in a constant search for the next capital gains opportunity." Pfeffer, *Measuring the Profit Potential of a New Life Insurance Company,* Journ. of Risk and Insurance, Sept. 1965, p. 413 at 420. A replacement occurs when an agent knows that an existing policy will be surrendered, converted to paid up insurance, subjected to substantial borrowing, etc. in connection with the purchase of new insurance. Replacements are not prohibited as such, although a strong argument may be made that in most cases it is to the policyholder's disadvantage to replace his policy. However, a policyholder may change contracts as he sees fit. On the other hand, "twisting," which is replacement induced by misrepresentation or misleading or incomplete comparisons, is prohibited. For a comprehensive discussion of replacement, see Dineen, Callan and Ninneman, *Replacement: Causes and Control,* June 13, 1962 (presented at a meeting of the Chicago Association of Life Underwriters, Inc.)

of stock prices during the company's early stages. Agents who acquired stock in the company at a low price frequently found that this same stock was selling in the market at a favorable price. They sometimes found it difficult to resist selling their shares for a quick profit.[359]

It can hardly be said that repeated moves on the part of an agent are conducive to rendering policyholders the quality and continuity of service to which they are entitled.[360] This, in turn, tends to offset the industry's efforts to upgrade agents to professional status.

D. Related Matters

1. *Management Contracts and Holding Companies*

a. Role

Management and holding companies have assumed a significant position in the insurance business. In predicting that their role will increase, one executive aptly described their function as follows:

> Such a company, through its ability to provide centralized services to its member companies, can go a long way toward cutting the ordinary high overhead which a young life insurance company, going it alone, would face.
> Such an operation, moreover, is able to develop policies and products for its member companies, design and implement training methods, furnish data processing and machine accounting and generally provide member companies with large company services and facilities which would otherwise be beyond them. Such an operation also has the capacity for attracting producers to the member companies without the need to pay more than the premium dollar in acquisition costs.
> And where the need arises for additional financing, such a company is generally in a position to facilitate the efforts of the member life insurance companies, including increasing the investment of the parent company in the subsidiary. Within the holding company structure, each member company enjoys complete individual identity and autonomy of operation.[361]

On the other hand, from the policyholders' viewpoint serious reservations have developed as to the desirability of the management and holding company concept.

Management companies are merely companies providing manage-

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[359] "Many observers feel that gains achieved by a stock relationship with agents will prove strictly temporary. Any number of agents sitting on a fat profit cannot resist the temptation to sell their shares—and their interest in placing business with the fledgling concern diminishes accordingly." Anreder, *Multiple Risks? New Life Insurance Stocks Deserve Critical Appraisal,* Barron's National Business and Financial Weekly, Nov. 16, 1964, at 16. See Hutton, *supra* note 318 at 8-9; and Burridge, *supra* note 355.

[360] "Are we really doing the public a service to build up a temporary agency force . . . one that is likely to pull out? I do not think so." 1960-1961 Proceedings: Conference of Actuaries in Public Practice 59. "(T)he interruption of continuity in field sales organizations [because of the raiding of agents] handicaps virtually all life insurers." Remarks by Superintendent Stern (N.Y.), N.Y. Life Underwriters Sales Congress, March 11, 1965, p. 9.

[361] Goldberg, *supra* note 357 at 10. See Pfeffer, *supra* note 358 at 421.

ment service to an insurance company, commonly in exchange for a portion of the premium income. The management company may or may not own the controlling interest in the insurer which it manages. However, it is not uncommon for the insurer's officers or directors to own the controlling interest in the management company. A holding company, in essence, is merely one company which owns controlling interest in one or more other companies. It differs from a parent company in a parent-subsidiary relationship in that the holding company's primary function is to control other companies rather than to produce or retail. It may not be a management company.

b. Management Contracts

In one state, fifteen insurance companies (primarily automobile insurers) had to be liquidated. In each case, the companies were managed through management contracts which generated, in the Commissioner's opinion, excessive commissions, expenses and fees.[362] In one investigation, an examiner uncovered a management contract between a small fire and casualty company and a management group. The examiner was highly critical of the arrangement because

> all the profits . . . would be paid to the management corporation thus depriving the policyholders of any equity whatsoever in their corporation.[363]

Although this was a mutual company, participating policyholders and stockholders of a stock company may have reason for similar concern if their company has such an arrangement.

In the wake of the failure of one fire and casualty company, the Wisconsin Department of Insurance retained special counsel to study the problem of management contracts. The study has revealed "that management contracts are of doubtful validity, have an inherent potential for abuse, and should be terminated."[364] While some companies may enjoy sound management under management contracts, this relationship poses several problems. For example, potential conflict of interest situations are created which can erode the fiduciary obligations of the officers and directors to the policyholder or stockholder. The delegation of most functions of the insurer to an unlicensed entity may render the insurer little more than a corporate shell. The management fee, usually based on premium volume, may be excessive. There are added bookkeeping and organizational expenses. The profits of the

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[362] Journal of Commerce, Feb. 11, 1965, p. 8.

[363] Report on the South Dakota Insurance Department by Vinton S. Nutt, Aug. 21, 1964, p. 12.

[364] Statement by the Wis. Ins. Commissioner Manson as reported in the Milwaukee Journal, May 28, 1965, p. 1. While the final study has not yet been published as of this writing, it has already produced some results. Eleven insurance firms in Wisconsin have been persuaded by the Department to drop their management contracts.

management agency are subject to less favorable tax treatment than if they had remained in the insurance company.[365]

Recently, a management company was organized in Indiana to furnish assistance to small life insurance companies. According to one source:

> The company will be in a position to supply management assistance on either a consulting basis or to acquire a majority ownership in small companies where stockholders are dissatisfied with current management.[366]

It may be disquieting to the managements of some companies when they learn that there exists a company which may intervene in the affairs of small life insurance companies on the solicitation of a minority of dissatisfied stockholders. This could have an unstabilizing effect on the continuity of operations and generate undue pressures to acquiesce in the demands of those stockholders who want to withdraw from the company the maximum amount of profit possible. One need not be clairvoyant to discern the adverse impact that operations such as these can have, not only on policyholder dividends (and therefore policyholder cost), but also upon the very financial stability of the company upon which the policyholder has relied.

c. Holding Companies

There are numerous applications of the holding company technique to life insurance company situations. A group of promoters might organize a holding company which issues two classes of stock, one class offered at a low price to the promoters, and one class offered at a higher price to the public. The difference in price may be justified by granting some extra rights (e.g., allegedly preferable dividend or liquidation rights) to the more expensive stock. Through this technique the promoters can acquire voting control of the holding company even though the public investors provide most of the capital. Then one or more insurance companies can be formed with the holding company purchasing controlling interest and the public investors the balance. In this manner, the promoters may acquire control over several life insurance companies even though their capital investment is relatively small in comparison with that provided by others.[367]

The prospectus of one insurance company revealed that the use of the holding company technique vested control of the insurer in a company located in another state outside the direct jurisdiction of the domiciliary insurance commissioner. Nor is it uncommon for a holding company to exist between a parent holding company and the insurer with effective control of the insurer twice removed. The problems of ef-

[365] *Ibid.*
[366] The National Underwriter, Jan. 9, 1965, p. 15.
[367] See Franklin, The National Underwriter, Dec. 29, 1962, p. 2.

fective regulation may be compounded if holding companies, none of which are subject to the commissioner's direct jurisdiction, are located in two or three different states. For example, a new company may be confronted with a substantial minimum par value requirement as a licensing prerequisite in one state. This requirement may be met by organizing a life company in the state with the par value of the stock fixed in accord with that state's requirements. However, a holding company organized in another state may purchase all of the life company's shares. The stock of the holding company may then be offered to the public without regard to the minimum par value requirement, thereby circumventing the intent of the regulation.

According to one prospectus, a company has adapted the holding company technique to a stock-option-to-agents plan. Agents could purchase shares in the life company when the stock was initially issued. A substantial bloc of the original issue, however, was reserved to an out-of-state holding company. The agents could earn stock options in the stock of the holding company by placing business with the life company. It was alleged that since the stock options would be in the holding company shares, not in the life company shares, the profits accruing therefrom to the agents would not be at the expense of the policyholders.[368] However, there may be some question as to the value of the stock options unless the profits of the life insurance company are siphoned off to the holding company. In fact, the New York Department has expressed concern about the use of the holding company technique and about stock options given to the agents in the holding company rather than in the insurer as a means of avoiding Section 213 prohibitions against stock options to agents.[369]

2. *Mergers*

For financial or other reasons, many new insurance companies soon find it necessary to merge with another company. Although the surviving company assumes the liabilities of the contracts issued by the absorbed company,[370] it does not follow that the policyholders of the absorbed company are in no way affected. They have "a vital stake in the integration process."[371] Of course, to the extent, if any, that the surviving company enjoys a sounder financial condition, the policyholders benefit. However, the mere fact that two companies have consummated a merger does not inevitably lead to improvement in the policyholders' position.

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[368] Oral remarks at an organizational meeting of one new life insurance company.

[369] 106TH ANNUAL REPORT OF THE SUPERINTENDENT OF INSURANCE TO THE NEW YORK LEGISLATURE COVERING 1964, pp. 24-25.

[370] See 19 C.J.S. *Corporations*, §1630 (1940) and 44 C.J.S. *Insurance* §115 (1945).

[371] Address by Professor Richard M. Heins, Chicago Conference on Acquisitions and Mergers, Oct. 28-29, 1964, p. 3.

There have been occasions when the participants in a merger transaction paid little attention to the impact of the merger on the policyholders.[372] Some mergers are intended to effectuate a wider distribution and trading of the company's securities. From the policyholders' viewpoint this reason has little consequence. Rather, it is designed by the promoters to enhance the value of their securities through wider distribution and increased public acceptance.[373]

Over a century ago, Elizur Wright, the founder of legal reserve life insurance in America, travelled to England where he was appalled to learn that individual life insurance policies of those days were being sold on the auction block because of the absence of guaranteed nonforfeiture values. The aged and the poor policyholders who could no longer afford the premiums stood before the bidders who bought the contracts for a fraction of their real value.[374] Wright's indignation led him, on his return to America, to sponsor the development of nonforfeiture requirements including guaranteed cash values.

Today, instead of individual policyholders, whole companies seem to be on the block. The contracts of the individual policyholders are traded en masse with the policyholders having little to say in the matter. Sometimes substantial companies have stepped in, almost as a matter of public service, to rescue a company in difficulty. Other times, the transfer simply represents substituting one group of promoters for another. In the latter cases, the insurance commissioner, whose duty it is to pass on all such transactions, may not have much choice except to approve, hoping the new management may prove to be better than its predecessor.

A buyer in this country has traditionally had the right to deal with people of his own choice. A giant advertising industry has been built upon the American predilection for brand names. The policyholder may have been attracted to a new company because of local names and local identification. Yet, overnight the control of his company may be transferred to persons of whom he knows nothing. He does not know whether the new owners have an interest in increasing the dividends on participating policies for his and for other policyholders' benefit or reducing policyholder dividends for the benefit of the new owners. Such transferrals may undermine his confidence in the institution of life insurance from which he had sought security.

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[372] In a recent attempt to merge two life insurance companies, dissenting stockholders of the company to be absorbed raised a strong protest. They formed the "Stockholders Protective Committee" which maintained that over three times as much cash per share could be obtained if their company merged with Company B instead of Company A. Presumably, such a committee is primarily concerned with stockholders' rather than policyholders' interest. See The National Underwriter, Feb. 6, 1965, p. 6.

[373] Heins, *supra* note 371 at 10.

[374] AMERICAN CONSERVATION CO., THE BIBLE OF LIFE INSURANCE 67 (1932).

The argument has been advanced that since a good portion of weak companies are taken over by stronger companies and are protected by reinsurance, the policyholders suffer no loss. This is tantamount to saying that in life insurance, continuity of management and policy are inconsequential. Such a thesis is subject to serious doubt.[375]

Prospective purchasers of ailing companies have been admonished to examine carefully outstanding policy contracts of the company to be absorbed, and to be sure that there are no overgenerous commitments to policyholders which might be a source of future diminution of profits.[376] For example, one company issuing a "founders" policy accumulated up to 40 per cent of the premium and guaranteed 6 per cent interest on the accumulation. Another company, which had contemplated a merger withdrew when it learned that it would have to pay 6 per cent interest on the fund which was invested at 4 per cent.[377] Sometimes the merging company is unaware of such commitments until after the merger has been consummated. In this situation the new company may be tempted to persuade the policyholder to relinquish his old contract and enter into a new one which, in fact, is less favorable to him.

V. CAUSES FOR CONCERN FROM THE INDIVIDUAL COMPANY'S VIEWPOINT

Apart from their concern for the well being of the policyholders, well-intentioned and well-managed new companies as well as the established stock and mutual companies, are vitally interested in the new stock company phenomenon. There is widespread acceptance in this country of the mistaken idea that all life insurance companies are basically the same. This public image of the life insurance industry may be attributable to several factors.

(1) A substantial portion of insurance advertising is institutional in character, and the general public is encouraged to believe that all companies sell similar products.[378] For many years, the Institute of Life Insurance, an organization supported by many of America's substantial life insurance companies, has conducted a national advertising program about life insurance. Without mentioning the name of any particular company, it has "sold" life insurance as an institution. It

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[375] Although in a different context, the New York Department has recognized the value of continuity of management. New York Superintendent's Report, *supra* note 369 at 25-26.

[376] Oral discussion at the Chicago Conference on Acquisitions and Mergers, Oct. 28-29, 1964.

[377] See Frazier, *Do's and Dont's of Mergers,* The National Underwriter, Jan. 23, 1965, p. 2.

[378] Equity Research Associates, *The Hazards and Rewards of Investing in Small Life Insurance Companies,* Oct. 15, 1964, p. 8 (investment analysis).

has fostered the concept of the life insurance agent as a responsible professional serving the best interests of his policyholders.[379]

(2) To the extent that the general public has not been educated in the basic fundamentals of life insurance, it has little basis upon which to distinguish one company from another.

(3) All states lay down minimum capital, surplus, reserve and other requirements which characterize legal reserve life insurance. As a consequence, one might suspect that some companies and agents have asserted that since all companies meet the same legal standards, all are equally deserving of public confidence. Certainly, the insurance buying public

> is notoriously undiscriminating in the life insurance that it buys; it believes all life insurance is safe if the company that sells it is licensed in the state.[380]

Of course, in the life insurance industry, as in any other industry, companies are not alike. Standards laid down by the states are minimum standards which vary from state to state in terms of regulatory strictness. As one commissioner pointed out,

> A company may meet all the statutory requirements as to capital and surplus and still be undesirable.[381]

The quality and performance of a company should not be measured by how close it comes to the minimums but, rather, by how much it exceed the minimums. This, in turn, depends upon the differences among various life insurance companies as to their size, strength, mode of operation, managerial ability, and, most importantly their philosophy and integrity. The figures presented earlier on formations and terminations of life insurance companies furnish ample proof that a marked difference exists. Some companies are strong, some are marginal and some have already passed from the scene.

Further evidence that those companies which have survived are not of uniform quality is provided by the numerous insurance statistical and rating publications such as Best's Life Insurance Reports, Flitcraft, Spectator Year Book, and Little Gem. Best's, for example, provides comparative information relating to numerous facets of company operations. Comments ranging from fair to excellent are made in several important categories, including bonds, stocks, mortgages, real estate, net yield on investments, reserves and expenses. The operating results revealed by such reports not only measure how well a company

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[379] See Franklin, *Should Agents Form Own Company?* The National Underwriter, Dec. 29, 1962, p. 2.

[380] The National Underwriter (editorial), Dec. 14, 1963, p. 28. See e.g., Timmons, *Dangers in the High Birthrate of New Life Companies,* Insurance, Oct. 16, 1965, p. 27. The National Underwriter, Feb. 27, 1965, p. 2.

[381] Department Memorandum by Oregon Insurance Commissioner Korlann (1965).

translates its philosophy into working principles, but they also measure the efficacy of such principles. The differences between companies can be very substantial.

The combination of (1) differences among companies, (2) the industry's public image of "sameness"[382] and (3) the potential harm to the industry's reputation arising from certain aspects of the new company phenomenon suggests that some remedy to the new company problem must be found. Otherwise the adverse public image, current and potential, generated by the activities of the new promoter companies could mar the reputation of the industry as a whole. The confidence which the public now reposes in the life insurance industry may be seriously, if not irreparably, damaged.

> Widely fluctuating values of life insurance stocks can result in loss of public trust in the business. Insurance, as banking, cannot tolerate loss of public faith in its ability to meet obligations, its ability to offer a desirable service at a fair price, or its ability to serve the public well and ethically as an important public institution.[383]

For this reason, the market for life insurance stocks and the activities of those who buy and sell them are sources of legitimate concern for those who regulate the insurance industry.[384]

VI. THE NEW COMPANY POSITION: COMPETITION AND FREE ACCESS TO THE MARKET

The new companies are not without their spokesmen.[385] Many of the new insurers find their justification in the role of competitive stimulant to the industry.[386] Although they concede the existence of some

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[382] This problem is not peculiar to the U.S. life insurance industry. A survey of companies in Great Britain noted "that many people are simply unaware of the very considerable differences in value offered by the 48 principal life assurance offices." Economist, July 24-30, 1965, p. xx.

[383] STRAIN, *supra* note 341 at 9. With respect to stock options to agent companies, the editorial in the Aug. 15, 1964, issue of The National Underwriter had this to say,

> Because if it should eventually turn out that agents had been more swayed by the prospect of capital gains tax treatment than by level-headed, objective comparison of the two companies, the status of life insurance selling could suffer a severe set back. (p. 24)

[384] See address by Superintendent Sterns (N.Y.), N.Y. Life Underwriters Sales Congress, March 11, 1965, pp. 3-4.

[385] See e.g., address by John T. Scott, Chicago Conference for Young Life Insurance Companies, Sept. 1-2, 1965; address by Burton A. Finberg, N.Y. State Ass'n. of Life Underwriters, 22nd Annual General Agents and Managers Conference, Feb. 12-13, 1965, p. 1, The National Underwriter, Feb. 6, 1965, p. 1; Journal of Commerce, Jan. 19, 1965, p. 7; and The National Underwriter, May 1, 1965, p. 1. We do not propose to deal here with each contention advanced. Instead, we do so generally where appropriate throughout this article. On one fundamental point we must agree, that is, that soundly financed, well-managed new companies are beneficial to the industry and that these should not be denied free access to the industry or the right to compete therein. We have emphasized this at the outset and do so again here.

[386] The National Association of Life Companies at its 1962 convention strongly

abuses, many feel that restrictions on or prohibition of the formation and operation of new companies are inconsistent with general principles of competition and free enterprise. One of the basic tenets upon which our economic system is founded is the concept that competition results in the highest quality of goods at the lowest possible prices. An essential element in a competitive economy is the accessibility to the market of new companies which can challenge established concerns with new ideas and fresh talent and stimulate a more progressive attitude in the industry. Furthermore, it is basic to any economy that when established facilities for servicing the market do not adequately satisfy the demand for a product or service, new facilities should be established to serve these demands.

The antitrust laws were based upon this rationale. However, freedom to compete is not absolute. The existence of insurance regulation since the middle 1800's testifies to the long recognized need for some restraint. Freedom to compete is justified only to the extent to which it serves the public interest. Congress did not adopt free enterprise as an absolute value despite its enactment of the antitrust laws. For example, the Robinson-Patman Act was enacted to prevent price discrimination.[387] The states also recognize the role of competition but do not accept competition as an end unto itself.

> The Department welcomes sound and vigorous competition in New York State—fair and competent business rivalry is an important ally to the Department in its regulatory tasks. But the interests of the insuring public, and ultimately the soundness and good repute of the insurance business, demand that the capitalization, management and operation of companies entering New York should not be 'built upon the sand!'[388]

In short, the free enterprise system does not now, nor has it ever, contemplated absolute freedom to compete without restraints.

It should be noted that recent criticisms of the new insurance company phenomenon are not directed at all new insurers or against the continuation of a competitive climate. Contrary to the notions of some, the established companies have not conspired together to regulate out of existence vibrant competition from new companies. It is not uncommon for an established company to open its doors and show how it runs its business to a new company which is sincerely interested in founding a sound life insurance company operation.[389] Furthermore, there are no patents and few secrets in life insurance.

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urged that free enterprise and competition afforded by new small companies should not be regulated out of business. See The National Underwriter, Aug. 11, 1962. See Equity, *supra* note 378 at 3-4 for comments on insurers who do not even attempt to justify their existence.

[387] 38 Stat. 730 (1914), 49 Stat. 1526 (1936), 15 U.S.C. §§13-13b, 21a.

[388] Stern, *supra* note 384 at 1.

[389] See address by A. H. McAulay, N.Y. State Ass'n. of Life Underwriters,

> If an established company discovers a better way of doing things . . . it rushes to a trade association to broadcast its discovery to its competitors. . . .
> This freedom of information and the readiness to assist . . . is one of the peculiarities and perhaps one of the glories of American life insurance. . . .
> The established companies have tremendous economic power and, as far as I can make out, they are very scrupulous in the use of this power. A giant company may bend over backwards lest its great power should destroy a small competitor.[390]

This is not to say that the motives of all established companies are altruistic. However, the preoccupation of some new company spokesmen in trying to limit discussion on the basis of an "old" versus"new" argument does little to cast light on problems which deserve serious consideration by all of those interested in the welfare of the life insurance business.

VII. REMEDIES FROM AN INSURANCE VIEWPOINT

Several remedial approaches have already been adopted, recommended or mentioned by persons both within and without the industry to curb the excesses stemming from new company promotions. This section will be devoted to reviewing those which approach the problem from an insurance oriented viewpoint and to suggesting some additional alternatives.

A. Industry Action

1. *Education*

Widespread ignorance of both investors and policyholders as to the general principles of life insurance company operations affords fertile ground from which speculation can and does grow. To counteract this, an accelerated program of public education has been suggested. Unfortunately, this solution faces nearly insurmountable practical difficulties and can at best be effective only after several years of concentrated effort.[391]

22nd Annual General Agents and Managers Conference, Feb. 12-13, 1965, pp. 15-16. "As a reinsurer I like to claim that we help the new company to grow soundly, but I have to admit that even greater help comes from the regular established companies." *Ibid.* For example, three times in the last ten years one established company was approached by local groups about to organize new life insurance companies. In each case they sought to obtain the benefit of the company's experience and know-how. The company produced actuarial, agency and service personnel to assist these new companies. In one case it consented to the use by a new company of its policy forms which had been developed after long experimentation, study and much expense.

390 McAulay, *supra* note 389 at 16.

391 I think that this is getting at the heart of the problem but just plain public education is a slow process and much damage to the public could talke place before the process had a significant effect. I doubt whether the speculatively inclined organizers of new life insurance companies today would be dissuaded from their plans as long as they thought they could dispose of their stockholdings within five

2. *Pressure on the Reinsurer*

Reinsurers provide several essential services (e.g., organizational, actuarial, underwriting, etc.) which contribute to the birth and survival of new life insurance companies. One commentator suggested that if established companies refuse to deal with reinsurers of companies whose conduct is "antithetical to the best interests of the insuring public and to the life insurance business," most of the problems stemming from new company formations would no longer arise.[392]

An appealing aspect of this approach is the prospect of the industry acting to solve its problems without having to rely upon the state insurance departments. However, it possesses some significant defects. From a practical viewpoint, how can an established company ascertain who is reinsuring whom? What standards should be adopted in determining which new insurers operate in a manner contrary to the interest of both the public and the industry? These are serious questions, but we need not pursue their answers since the antitrust laws would appear to preclude this approach.

While the McCarran Act for the most part preserves state regulation of insurance and renders federal control inapplicable,[393] Section 3(b) provides:

> Nothing contained in this act shall render the said Sherman Act inapplicable to any agreement to boycott, coerce, or intimidate, or act of boycott, coercion or intimidation.

Thus, the McCarran Act would furnish little immunity to an action brought by the Department of Justice against insurers who seek to apply pressure to a reinsurer. It is beyond the province of this paper to explore in detail the federal antitrust laws, or the case law developed to interpret them, but it seems reasonable to assume that this approach is fraught with insurmountable antitrust implications.[394]

> years at a neat profit. It would take more than a brief course in actuarial principles to do that.

Address by Bruce E. Shepherd, N.Y. State Ass'n. of Life Underwriters, 22nd Annual General Agents and Managers Conference, Saratoga Springs, N.Y., Feb. 12-13, 1965, p. 4.

392 Probe, Nov. 30, 1964.

393 See 59 Stat. 33 (1945), as amended, 15 U.S.C. §§1011-15 (1958). For a history of the McCarran Act, see 2 BULEY, AMERICAN LIFE CONVENTION, 938-67 (1953).

394 The term refusal to deal has been used interchangeably with the word boycott. See U.S. v. Waltham Watch Co., 47 F. Supp. 524, 531 (S.D.N.Y. 1942). Under §3(b) of the McCarran Act, the refusal to deal, or boycott, must be judged by the standard established by Section 1 of the Sherman Act which provides that "Every contract, combination . . . or conspiracy in restraint of trade or commerce among the several States . . . is declared to be illegal." 26 Stat. 209 (1890), as amended, 15 U.S.C. §1 (1958). The Supreme Court has condemned a group refusal to deal with anyone as a means of preventing him from dealing with a third person even if the refusals are aimed at curbing abusive or fraudulent business conduct. Fashion Originators Guild v. FTC, 312 U.S. 457 (1941). Although a unilateral refusal to deal may not

Furthermore, the adoption of this approach may have some additional long range consequences. A 1960 Senate Subcommittee Report had serious reservations as to the effectiveness of state regulation of the insurance industry. Members of the Senate antitrust subcommittee have recently indicated that there would be continued investigation of state regulation.[395] If the insurance industry were to adopt the "pressure" approach, thereby inviting wholesale intervention by the Department of Justice, the advocates of federal regulation would find their position strengthened.

B. Organizational and Structural Remedies

As a prerequisite to the effective regulation of insurance, the states need to assert effective control over the market place. Whether such control can be achieved depends basically upon the financial and human resources of the regulator, and the nature of the insurance market. Apart from whether the market is saturated or capable of absorbing more companies, it appears that in some states insurance department staffs may be too limited to effectively regulate the large number of companies already licensed. A possible approach to solving, or at least, to mitigating this problem, is control of access to the market. Stringent control of entrance into the market is more conducive to effective regulation than is unlimited access to the market. On the other hand, controlling access to the market restricts freedom of economic activity. Therefore, the objectives of regulation need to be weighed against the infringement on the freedom of access to the market.[396] While the broad subject of effective regulation is not the prime consideration of this article, it is a factor to be considered when evaluating proposed remedial courses of action.

1. *The "Needs" Test*

The American insurance market does not appear to be in substantial need of new company formations. The large number of companies now operating in the United States, the rapid birth rate of new companies in recent decades, and the relatively high ratio of companies to population suggest that some restriction upon access to the market may do no harm and might possibly be desirable.

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constitute a violation of the Sherman Act, U.S. v. Colgate & Co., 250 U.S. 300 (1919), this doctrine has been severely limited. U.S. v. Parke, Davis & Co., 362 U.S. 29 (1960); U.S. v. Bausch & Lomb Optical Co., 321 U.S. 707 (1944); Eastman Kodak Co. v. Southern Photo Materials Co., 273 U.S. 359 (1927); FTC v. Beech Nut Packing Co., 257 U.S. 441 (1921); U.S. v. Schrader's Sons, Inc., 252 U.S. 85 (1920). Furthermore, such action would have little impact on the new company situation as a whole. In the context of the new insurance company problem, however, action on the part of more than one insurer would most likely be construed as inferentially spelling out concerted action or a group refusal to deal, U.S. v. Schrader's Sons, Inc. 252 U.S. 85 (1920), thereby falling within the Act's proscription.

[395] See The National Underwriter, Feb. 6, 1965, p. 1.

[396] See Kimball, *Sketches From a Comparative Study of American and European Insurance Regulation,* Journ. of Risk and Insurance, June 1965, p. 195.

In some of the European countries, an insurance company cannot be organized without first demonstrating the need to the regulatory authorities[397] for the new company. These countries follow a practice somewhat similar to that followed in this country in the banking and utility fields. Those who seek to organize a bank here must demonstrate the need to the banking supervisory officials in order to obtain a charter, and those in the utility business must obtain a certificate of convenience and necessity from the Public Service Commission.[398]

Evidence that an undue concentration of financial institutions can have an effect on a new institution's ability to survive has recently been demonstrated in the banking area. The Comptroller of the Currency, in announcing what has been called the "freeze," said

> In view of the increase in the number of new banking institutions, both state and national, and the continuing interest which has been displayed by groups seeking to organize additional new banks, it seems appropriate to indicate that, for the time being, a period of digestion is essential in order to provide a reasonable opportunity for recently formed banks to develop, and in order to enable us to assess any public need for additional facilities in the future.
>
> It must have become apparent by now that certain other banking market areas are considered closed to new bank entry.[399]

Some observers may feel that state insurance laws should be amended to authorize state insurance commissioners to employ a "needs" test when an undue concentration of licensed companies has developed or threatens to develop.

One factor which tends to restrain the enactment of insurance legislation of this kind is the inherent danger that Congress might consider such action to be an undue restraint upon trade and contrary to underlying principles of federal antitrust laws. An indication of this appeared in the Senate Antitrust and Monopoly Subcommittee Report of August 10, 1960, which said in part,

> The admission and licensing of foreign insurers [by the states] has not been conducted in as efficient and direct manner as the

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397 Austria, Luxemburg, Norway, Portugal and Sweden. ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, SUPERVISION OF PRIVATE INSURANCE IN EUROPE 18 (1963).

398 E.g., WIS. STAT. §221.01(5) "The commissioner shall thereupon ascertain . . . whether public convenience and advantage will be promoted by allowing such bank to organize . . ." And, e.g., WIS. STAT. §196.50 "Certificate of Necessity. No license, permit or franchise shall be granted to own, operate (etc.) . . . any plant or equipment for the conveyance of telephone messages, or for the production, transmission, delivery or furnishing of heat, light, water or power . . . where there is in operation . . . a public utility engaged in similar service, without first securing from a commission a declaration, after a public hearing . . . that public convenience and necessity require such second utility."

399 As reported and quoted in the New York Times, Feb. 20, 1965, p. 31.

> public interest dictates. In several states, the pending licensing applications which have not been acted upon are quite substantial, *indicating a restraint on possible legitimate competition* within that State and perhaps undue favoritism to the domestic companies. . . .
> [I]nsurance departments with a large number of pending applications or applications denied should reexamine their licensing policy to determine if the matter is being handled expeditiously and *in the public interest.*[400] (Emphasis supplied)

After commenting critically on the number of failures among insurers and the need for high capital and surplus requirements the subcommittee report went on to say:

> At the same time, such requirements should not be too high to restrict competition unnecessarily where there are opportunities for organizing competing companies.[401]

As Senator O'Mahoney said,

> The history of the congressional debate on the bills leading to Public Law 15 [the McCarran Act] makes it abundantly clear that Congress was making a conditional grant of authority to the States, and that if this authority were not exercised in a manner which best served the public interest, Congress would reconsider its action.[402]

If Congress were to become convinced that the states, in applying needs tests as criteria for admission of new companies, had restricted competition in a manner inconsistent with the public interest, it might well amend the McCarran Act and provide federal regulation to supplant that of the states.

Banks and life insurance companies are both savings institutions upon whose long term stability individuals rely. Therefore, it seems anomalous for a Committee of Congress to criticize the states for not opening up enough opportunities for organizing competing companies, while at the same time another organ of the federal government, the Comptroller, "freezes" the formation of new national banks until there is a "period of digestion" and reappraisal of any public need for new banking facilities.[403]

Apart from potential congressional action, however, is a more fundamental question going to the merits of the "needs" test. The advocates of this test turn to the banking law for support. For example,

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[400] Report of the Committee on the Judiciary by Its Subcommittee on Antitrust and Monopoly, S. REP. No. 1834, 86th Cong., 2d Sess. 243 (1960).
[401] *Id.* at 244.
[402] *Id.* at III.
[403] New York Times, Feb. 20, 1965, p. 31. The Missouri Insurance Division imposed a temporary moratorium on the formation of new companies specializing in charter policies until the Department has studied the problem. Wall Street Journal, April 26, 1965, p. 8.

Section 29 of the New York Banking Law provides that the Superintendent must "find upon investigation that the public convenience and advantage will be promoted by the opening of (a proposed) branch office" before applying to the Banking Board for permission to open such office. However, the "needs" test has been subject to severe criticism.[404] According to the report of the United States Attorney General's Committee to study the antitrust laws,

> from the economic point of view, relative freedom of opportunity for entry of new rivals, is the fundamental requisite for effective competition in the long run. . . . The entry and withdrawal of firms . . . is the basic mechanism of the market for achieving its economic results.
> Reasonable opportunity of outsiders with requisite skill to enter the market may appear dispensable, for if there are sufficient number of competitors and they compete vigorously, what purpose would be served by additional numbers? But if energetic and imaginative rivals cannot enter, the boldest and most rewarding innovation may be excluded.

And

> reasonable opportunity for entry is needed if there is to be assurance of a sufficient number of sellers to maintain effective competition and thus prevent markets from evolving gradually into a state of monopolistic stability.[405]

The bank "needs" test is premised on the concept that inadequate markets mean insufficient resources to underpin strong and efficiently operated institutions.[406] This raises the question: Is the "needs" test a condition precedent to the establishment of such institutions in the insurance business or can this be achieved in a manner consistent with the public policy of freedom of access to the market?

The "needs" test appears to suffer from two serious defects. First, there is the practical problem of determining whether the community actually needs a new company.[407] Furthermore,

> one would be reluctant to use a 'needs test,' both because of the reluctance to concede to an official the power to decide on need, and of the fear to leave to him the decision whether insurance company X or Y should receive a license, if it is necessary to make a choice between them.[408]

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[404] See e.g., Phillips, *Competition, Confusion and Commercial Banking,* 19 The Journ. of Finance, March, 1964; and Alhadeff, *A Reconsideration of Restrictions on Bank Entry,* 76 Quarterly Journ. of Economics 246 (1962). See also Motter and Carson, *Bank Entry and the Public Interest, A Case Study,* 1 NATIONAL BANKING REVIEW 469 (1964).

[405] Report of the Attorney General's National Committee to Study the Antitrust Laws, 326-27 (1955).

[406] Alhadeff, *supra* note 404 at 247.

[407] *Id.* at 261. Nevertheless, this approach appears to have worked satisfactorily in Sweden. See Kimball, *supra* note 396 at 199-200.

[408] Kimball, *supra* note 396 at 202.

But, even if a means of objective measurement existed, the test is an indiscriminate approach condemning good—as well as bad—prospective insurance companies. Furthermore, if a "needs" test were adopted, those marginal companies already in the market place might survive solely because of the regulatory fiat limiting competition from possibly more efficient would-be entries.

Since the aim of the needs test is to prevent public injury due to failures, the underlying assumption must be that banks will fail because the market is incapable of absorbing them. While this may be true in some situations, it seems more likely that most failures of new life insurers result from inadequate capitalization, the absence of high quality management, or both. At any rate, the fallibility of the needs test is exposed when it is seen that the premise on which it rests is not necessarily true in every case. The better alternative is to upgrade the standards for entry rather than foreclosing entry to all.

We submit that there are more selective controls which can be employed to resolve problems attendant to the formation of new companies. If these controls should prove to be effective, in addition to being more consistent with the concept of freedom of access, the "needs" test issue will become moot.

2. *Capital and Surplus Requirements*

One factor underlying the termination of many companies has been an inadequate supply of capital and surplus. An insurance executive commented that whereas a few years ago most actuaries felt that $500,000 of capital and surplus would be sufficient for sound, steady growth without refinancing, today the figure has jumped to $1,000,000. And, it is not uncommon even for companies with this amount of capitalization to resort to the market for additional financing almost immediately.[409] Eight of the fifteen domestic life companies organized in New York between 1957 and 1963 have sought additional capital and paid-in surplus through public stock offerings. Six of these did so within the first year. One company found it necessary to make three public stock offerings in its first four years, and three of the eight companies increased their capitalization by four to six times the original amounts.[410] The capital and surplus requirements of the various states are summarized as follows:[411]

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[409] See Partridge, *The Search for Quality Among New Life Insurance Companies,* Insurance, June 26, 1965, p. 24 at 25, and Insurance, June 26, 1965, p. 8.

[410] Address by Supt. Stern (N.Y.), the N.Y. Life Underwriters Sales Congress, March 11, 1965, p. 5.

[411] The following is a list of minimum capital and surplus requirements for new domestic stock life insurance companies at the writing of this article. However, there has been substantial legislative activity in this area and some figures may be in error at the time of publication. The figures are the total capital and surplus required by statute in each state. While Connecticut,

Minimum Capital and Surplus Requirements for Domestic Life Insurance Companies	Number of States
No Statutory Minimum	2
Zero to $200,000	15
$200,001—$300,000	18
$300,001—$600,000	10
More than $600,000	6

Michigan and Massachusetts set the highest minimum requirements, $1.5 million and $1.2 million, respectively.

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and Rhode Island have no express statutory minimum requirements, state authorities must be satisfied that a company is adequately capitalized before granting it a license. The requirements vary widely in some details. For example, some states also require the company to deposit with the appropriate state authority a certain minimum amount in securities, but for purposes of simplicity, such details have been omitted. Requirements for foreign companies sometimes differ from those applicable to domestic companies.

State	*Requirement*	*Statute*
Alabama	$ 500,000	1965 (1)
Alaska	150,000	Ala. Stat. 21.10.090 (1963)
Arizona (a)	37,500(2)	Ariz. Rev. Stat. Title 20-210 & 211 (1964)
Arizona (b)	150,000	Ariz. Rev. Stat. Title 20-210 & 211 (1964)
Arkansas	200,000	Ark. Stat. §§66-2207, 66-2208 (1960)
California	1,000,000	1965 (3)
Colorado	300,000	Colo. Rev. Stat. §72-1-36 (1963)
Connecticut	Created by Legislature	(4)
Delaware	150,000	18 Del. Code §504 (1964)
D.C.	300,000	D.C. Code §§35-508, 35-601 (1964)
Florida	600,000	Fla. Stat. §§624.0206, .0207 (1963)
Georgia	400,000	Ga. Code §§56-306, -307 (1963)
Hawaii	300,000	Hawaii Ins. Law §181-88 (1963)
Idaho	300,000	Idaho Ins. Code §41-313 (1965)
Illinois	600,000	House Bill No. 631, approved by Governor June 28, 1965
Indiana	450,000	Ind. Stat. Ann. §39-3614 (1965)
Iowa	750,000	Ia. Code. §508.5 as amended by House File 211, 61st General Assembly (1965)
Kansas	300,000	Kan. Gen. Stat. §40-401 (1965)
Kentucky	150,000	Ky. Rev. Stat. §304.071, .075 (1963)
Louisiana	200,000	La. Ins. Code §71 (1960)
Maine	100,000	Me. Rev. Stat., c. 60 §68 (1963)
Maryland	500,000	Md. Acts of 1965 c. 704 §48
Massachusetts	1,200,000	Mass. Gen. Laws c. 175 §48, 51 (1962)
Michigan	1,500,000	Mich. Act. No. 242 Public Acts of 1965
Minnesota	200,000	Minn. Stat. §60.29 (1963)
Mississippi	500,000	Miss. Code §5660 (1962)
Missouri	400,000	Mo. Stat. Ann. §376.280 (1964)
Montana	200,000	Mont. Rev. Code §§40-2808 (1965)
Nebraska	300,000	Neb. Legis. Bill 730, approved May 28, 1965
Nevada	300,000	Nev. Rev. Stat. §682.160 (1963)
New Hampshire	500,000	(5)
New Jersey	300,000	N.J. Ins. Laws §25 (1958)
New Mexico	150,000	N.M. Stat. Ann. §58-18-24 (1963)
New York	750,000	N.Y. Ins. Law §191
North Carolina	300,000	N.C. Ins. Laws §58-77 (1961)
North Dakota	225,000	N.D. Rev. Code §26.08-04 (1963)
Ohio	1,000,000	Ohio Rev. Code §3907.05 (1965)

One executive, in recommending that the Massachusetts minimum capital and surplus requirements of $1.2 million be adopted by all states, noted that

> The minimum requirements of many states are totally inadequate for our type of business, and there is no doubt that many companies which have considered it desirable to merge or reinsure in recent years have had insufficient funds to finance their development programs adequately.[412]

His opinion is not an isolated one. From actuarial projections, the New York Department of Insurance estimates that an initial capital and surplus of at least $3,000,000 is required by new companies in New York if they are to avoid dependence upon early additional stock offerings during their formative period.[413] The Department recommended to the legislature that the minimum capital and surplus requirement be raised from $750,000 to $1.5 million, but the bill embodying this recommendation failed to pass the legislature.[414] However,

State	*Requirement*	*Statute*
Oklahoma	150,000	Okla. Ins. Code §§610, 611 (1957)
Oregon	500,000	Ore. Rev. Stat. 736.205 (1964)
Pennsylvania	300,000	40 Pa. Stat. Ann. §386 (1964)
Rhode Island	Created by Legislature	R.I. Gen. Laws §7-1-5 (1956)
South Carolina	200,000	S.C. Code §37-181 (1963)
South Dakota	200,000	S.D. Code §31.1510 (1959)
Tennessee	300,000	Tenn. Code Ann. §§56-303, 305 (1961)
Texas	200,000	Tex. Ins. Code Art. 3.02 (1963)
Utah	300,000	Utah Laws §31-11-1 (1963)
Vermont	100,000	8 Vt. Stat. Ann. §3303 (1959)
Virginia	300,000	Va. Ins. Laws §38.1-88 (1960)
Washington	300,000	Wash. Rev. Code §48.05.340 (1963)
West Virginia	300,000	W.Va. Code Ann. §3312 (1961)
Wisconsin	274,000	Wis. Ins. Code §201.11 (1963)
Wyoming	300,000	Wyo. Ins. Laws §26-19 (1965)

(1) Enacted during the recent session of the Ala. legislature; Letter from Bill Armstrong, Ala. Deputy Superintendent of Insurance, to author, Oct. 19, 1965.
(2) Domestic *limited* stock life and disability companies.
(3) Enacted during the recent session of the Calif. legislature, letter from Ernest Braun, Counsel, Calif. Dept. of Ins., to author, Oct. 20, 1965.
(4) The charter determines the capital and surplus requirements. Letter from John B. Farley, Conn. Ins. Dept., to author, Oct. 13, 1965.
(5) Recently enacted by the N.H. legislature. Letter from Kinsley Batchelder, N.H. Ins. Dept. to author, Oct. 14, 1965.

412 Address by Leland J. Kalmbach, 58th Annual Meeting of the Life Insurance Association of America, Dec. 9, 1964, p. 6.

413 106TH ANNUAL REPORT OF THE SUPERINTENDENT OF INSURANCE TO THE NEW YORK LEGISLATURE COVERING 1964, p. 28. One executive of a newly formed company said that a capital structure of $5 million was needed to sustain his company's operations until they became profitable. Partridge, *supra* note 409 at 25. An actuary commented that $1.5 million is the minimum needed for an exceptionally well run company, $3 million for an average new company. Gold, *An Actuary Examines the Rash of New Companies,* Insurance (Goldbook), Sept. 11, 1965, p. 130.

414 Address by Superintendent Stern (N.Y.), Conference for Young Life Insurance Companies, Chicago, Sept. 1-2, 1965, p. 9. However, the Department administratively requires nearly $3 million initial paid in capital and surplus. *Ibid.*

several legislatures have increased minimum requirements during the 1965 legislative session. To date, no consensus exists as to what constitutes appropriate minimum levels of capital and surplus, but it is quite evident that the standards in most states are too low.[415]

In order to encourage the organizers of a new company to face realistically the operating losses and resulting drains on surplus in its early years, the New York Department, in addition to enforcing the minimum capital and surplus requirements, requires the submission of a detailed plan of operation. This must be supported by actuarial projections meeting Department criteria. Such planning and projections reveal the likelihood of the need for additional financing in the near future.[416]

In addition to statutory minimums for initial capital and surplus, many states require maintenance of capital and surplus at certain minimum levels while the company is a going concern.[417] A bill introduced in the Arkansas legislature, had it passed, would have restricted the insurer in its use of surplus. Only 50 per cent of the required minimum initial surplus could have been used in the normal course of business. If surplus were reduced below the 50 per cent level, the insurer's authority to issue new policies would have been suspended, and if the deficit were not restored within 90 days, the commissioner would have had the power to revoke the company's certificate of authority.[418] Such a restriction on the use of surplus would tend to prevent writing new business too rapidly, and curb the drain of surplus and the potential threat of impaired capital.

Few, if any, claim that strengthened capital and surplus require-

[415] Professor Kimball has distinguished between the primary role and secondary role of capital. The initial capital and surplus requirements serve to afford security to the policyholder in the company's initial phase. Thereafter, theoretically, the law of large numbers will keep the company solvent. Although the primary function of the initial fund is then discharged, there remains for the fund and/or reinsurance the function of cushioning a catastrophe or years of bad experience. This fund and reinsurance should be related to the size and other characteristics of the company's business. In this regard, the inflexible minimum capital and surplus requirements serve little purpose. Some European regulatory departments have attempted discretionary authority in setting minimum capital requirements to provide a realistic relationship between the amount of capital and the size of the anticipated business. See Kimball, *supra* note 396 at 203-204.

[416] N.Y. SUPT. ANN. REP., *supra* note 413 at 27-28. ILL. INSURANCE CODE §155.04(1) provides that the Director of Insurance shall not approve the organization of a company until it has submitted a sound plan of operation. Senate Bill 222, approved Aug. 2, 1965.

[417] E.g., IND. STAT. ANN. §39-3614(e) (1964); MO. STAT. ANN. §376.280 (1964); N. Y. INS. LAW §191.

[418] This was Senate Bill 152 which in addition would have more than doubled minimum capital and surplus requirements by raising each from $100,000 to $250,000, and would have placed limitations on stock sales, required the state securities commissioner's certification of compliance with the securities laws before shares might be issued, and required promoters to deposit their stock for three years in escrow with the securities commissioner. The bill, however, was defeated in its entirety. See Arkansas Gazette, Feb. 20, 1965, p. 6B.

ments constitute a panacea for all of the problems generated by new companies. The speculative climate in which stock promotions thrive would remain. Nevertheless, it is essential to the best interests of the policyholders, investors and general public that an insurer have a reasonable opportunity to succeed and perform its contracts. Therefore, such requirements should have a salutary effect. They would screen out some of the small, unstable promoters, while at the same time, they should prove no handicap for large scale promoters who can attract substantial financial backing in organizing a soundly financed company.[419] The additional funds would allow the company to operate for a longer period of time without having to resort to the vagaries of the market. This, in turn, should afford a better opportunity for the company to survive. The long run effect would not be to stifle competition, but rather to stregnthen it, since fewer new companies would be exposed to the risk of failure because of inadequate financing. Furthermore, the industry image of stability and permanence would be enhanced if there were fewer company terminations.

3. *Review of Qualifications of Management*

A prime problem associated with the formation of stock promotion life companies has been the absence of competent insurance oriented management.[420] This problem received official recognition by a subcommittee of the Laws and Legislation Committee of the NAIC as early as 1959 when it recommended a list of minimum requirements which must be met by any new company. Three of these requirements pertained to the personal characteristics of those associated with the new company.

> The organizers, promoters, backers and incorporators of a new insurance company or a holding company organized with one or more of its purposes being for the sale of stock to finance the organization or establishment of an insurance company shall make a *full disclosure* of who are such organizers, promoters, backers and incorporators, that a short *biographical sketch* of these persons should be given to the regulatory authority in the

[419] "Promoters of new life insurance companies appear to have no difficulty in obtaining from the public the necessary capital funds. Perhaps the most important reason is that in recent years life insurance shares have taken on the aura of 'glamour' stocks. Investors in new life companies are attracted by the long record of earnings and cash and capital stock dividends of already *established* life insurance companies and are led to believe that newly-organized companies have a potential for a similar record of earnings." N.Y. SUPT. ANN. REP., *supra* note 413 at 22-23. The National Underwriter of March 27, 1965, p. 20 (editorial), noted that particularly in New York City promoters have little difficulty in raising funds to float the initial stock issues. New company issues tend to be over-subscribed. The proposed increase in capital and surplus requirements to $1.5 million "is not going to stop the baby boom dead in its tracks. Instead, it might be said that the new minima will serve as sort of selective breeding program for the life insurance business in New York."

[420] See text, p. 246.

> particular state where the said company or companies were being organized. Included in this biographical sketch should be *detailed the business experience* of these persons and *any experience they may have had in the insurance business.* (Emphasis supplied)
>
> The regulatory authority may require a proper hearing on the application for a license to do an insurance business by such a new company. At which time, it may inquire into the *competency, fitness and reputation* of all persons directly or indirectly associated with the formation of such a company. *The regulatory authority shall have a right to review or deny an application upon a showing that any such individual or individuals may be unworthy of public trust.* (Emphasis supplied)
>
> No insurance company is to be licensed until *qualified persons* are employed full time to manage the business of said company.[421] (Emphasis supplied)

The rationale underlying this approach is obvious. By exerting some control over the quality of personnel who organize and manage new companies in the formative years, the insurance departments may be able to foreclose many promotional schemes in their incipiency. An old regulatory axiom holds that initial prohibition is easier and more effective than attempts at continued control and limitation thereafter.

This approach should not be difficult to implement. In addition to the information required to be filed and the availability of a hearing, an insurance department could utilize the services of investigating credit bureaus to provide comprehensive background material on those who propose to form and operate a new life insurance company. Furthermore, either the state or federal securities regulators may have background information. Similarly, state securities departments operating under the "fair, just and equitable" philosophy could implement this approach. For example, they might read into this doctrine authorization comparable to that found in the Iowa securities statute, namely, the securities commissioner's authority to deny, suspend or revoke registration of securities if the issuer "is of bad business repute."[422]

The NAIC's suggestion that control over the quality of the insurer's personnel be exercised by the insurance departments has ample precedent. For example, the New York Insurance Law provides that

> The superintendent may refuse to issue or renew any such license if in his judgment such refusal will best promote the interests of the people of his state.[423]

[421] 2 PROCEEDINGS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 511-12 (1959). One state which has followed through in this respect is Iowa. Iowa Dept. of Ins. Ruling T6, Nov. 12, 1963, requires that the general plan of organization shall include "proposed management personnel with biographical sketches, including state of residence and complete insurance experience of each."

[422] IOWA CODE §502.10(5) (1962).

[423] N. Y. INS. LAW §40(4). "New York carefully scrutinizes the officers and

Furthermore, the Superintendent may refuse to license a corporation if any of the proposed directors or incorporators has been convicted of any crime involving fraud, dishonesty, or like moral turpitude, or is an untrustworthy person."[424] Recently, the Illinois Insurance Code was amended to provide that the Director of Insurance shall not approve the organization of an insurer until he has found that the general character and experience of the insurer's incorporators, directors and principal officers assures reasonable promise of a successful operation. Furthermore, the law requires notification whenever a new director or officer is elected or appointed. The Director is to remove such persons who fail to meet the above standard.[425] Kansas requires the submission of a biographical sketch on each officer and director.[425a] In his 1965 legislative program, the Michigan Commissioner sought a requirement that the commissioner be given notice of a major change in ownership with the right to revoke the company's certificate of authority if the management is deemed to be incompetent or untrustworthy.[426]

The adoption of this regulatory device is not peculiar to the insurance industry. For example, the management of a state bank which seeks the benefit of the Federal Deposit Insurance Corporation must submit its qualifications to regulatory scrutiny.[427] Under the Bank Holding Company Act, in determining whether a merger should be approved, the "character of the management" is considered.[428]

These examples support the NAIC's subcommittee proposal to exercise control over the quality of an insurer's personnel. While this approach seems to have considerable merit, it has yet to be widely adopt-

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directors of the new company. I understand they may fingerprint an important and well known business executive before he can become a director of a new company." Address by A. H. McAulay, N. Y. State Association of Life Underwriters, 22nd Annual General Agents and Managers Conference, Saratoga Springs, N.Y., Feb. 12-13, 1965, p. 4.

[424] N. Y. INS. LAW, §48(8). Also the Superintendent may seek an order to rehabilitate a company if an officer or director has been found to be dishonest or untrustworthy. N. Y. INS. LAW, §511(n).

[425] Senate Bill 222, approved Aug. 2, 1965, ILL. INS. CODE, §155.04 (1965).

[425a] KAN. DEPT. OF INS. REG. 40-1-5 compiled Jan. 1, 1966. See note 421 *supra*.

[426] As reported in The National Underwriter, March 6, 1965, p. 8. The bill is still in committee.

[427] 64 Stat. 873 (1950), 12 U.S.C. §1816 (1952) enumerates factors to be considered including "the general character of its (bank's) management." The Comptroller of the Currency may remove officers or directors of banks where they have "continued unsafe or unsound practices in conducting the business of such bank . . . after having been warned by the Comptroller . . ." 48 Stat. 193 (1933), 49 Stat. 704 (1935), 12 U.S.C. §77 (1958). Comptroller Saxon in connection with recent bank failures felt that his office should have additional tools to bring pressure on banks having undesirable persons or engaging in undesirable practices. New York Times, March 10, 1965, p. 55.

[428] 70 Stat. 134 (1956), 12 U.S.C. §1842(c) (1952). Comptroller of the Currency James J. Saxon, has recently filed amendments to December, 1962 regulations dealing with changes in control of national banks. One amendment would provide that "within ten days following a transfer of control, the purchasing group will be required to file complete biographical information with the controller." As reported in New York Times, March 22, 1965, p. 49.

ed by state legislatures or insurance departments. Of course, the effectiveness of this type of regulation depends upon the forcefulness of its administration by each individual department.

4. *The Right to Vote*

In mutual companies, the policyhloders are the technical owners of the company and they possess the right to vote for the board of directors. In stock companies the stockholders possess the right to vote to the exclusion of the participating as well as the nonparticipating policyholders. Because of the divergence of interest between the policyholders and stockholders, some might feel that the participating policyholders of a stock company should be entitled to vote, while others may place little faith in the concept of shareholder or policyholder democracy.

At least three jurisdictions permit participating policyholders of a stock company to vote. Canada requires that at least one-third of the directors be elected by the participating policyholders.[429] Minnesota gives each participating policyholder of a stock company one vote plus an additional vote for each $1,000 of insurance in excess of the first $1,000, but no policyholder is entitled to more than 100 votes.[430] On the other hand, Missouri permits, but does not require, a company to allow its policyholders to vote.[431]

5. *Limitations on the Admission of Foreign Companies*

A recent regulation promulgated by the Kansas Department of Insurance demonstrated official cognizance of the instability of a new life insurance company.

> [T]o protect the insurance buying public from the inherent risks associated with an insurance company newly organized . . . [n]o foreign insurance company will be considered for admission to Kansas unless it has been in operation at least two (2) years and has been the subject of a state or convention examination other than its organizational examination.[432]

This "seasoning" requirement affords some protection to the residents of the state which a foreign company seeks to enter. The operation of a new company for at least two years followed by an examination of it furnishes some evidence as to the new company's stability. On the other hand, this requirement does not apply to domestic companies. Furthermore, a new company may survive two years primarily on the

[429] The Canadian and British Insurance Companies Act §6(5)(c), REV. STAT. OF CAN., 1952, c. 31 as amended 1960-1961 c. 13.

[430] MINN. STAT. §61.04 (1963).

[431] MO. REV. STAT. §§376.020, 376.150 (1949).

[432] Kans. Dept. of Ins. Reg. 48-1-13 (new), Sept. 1, 1964. In 1959, a subcommittee of the Laws and Legislation Committee of the NAIC recognized this type of regulation. "Any requirement as to the length of time that a company would have to have been in business prior to admission or certification should be discretionary with the regulatory authorities, but under no conditions should a requirement of more than three years' operation be made necessary." NAIC, *supra* note 421 at 513.

basis of refinancing through repeated stock offerings. When this source of funds is depleted, its financial condition may be seriously jeopardized. Thus, while the "seasoning" approach has merit, it does not constitute a comprehensive solution to the new company problem.

6. *Multiple Classes of Stock*

Recently both the California and the New York Departments of Insurance reaffirmed their position against multiple classes of stock.[433] In his report to the legislature, the New York Superintendent concluded that "multiple classes of stock are prejudicial to policyholders" after having considered several factors, including the following.[434]

(1) Different classes of stock may confer preferential treatment on insiders. This may be a deterrent in an attempt to raise needed additional funds through a public offering.

(2) The purchase of a special class of stock at a preferntial price by insiders may result in withholding of dividends from other stockholders and participating policyholders in order to improve the company's surplus position and give insiders the special advantage of converting from the special class of shares to regular common stock after the company has established an earnings record and is on a sound basis. This situation poses a conflict of interest situation for the board of directors.

(3) Multiple classes of stock may serve to facilitate speculation and stock promotion and manipulation by insiders who, with a minimal investment in a preferential class of stock, can exert effective control directly or through a holding compnay. If the operations prove to be unsuccessful the promoters may move on, accepting the loss of their small investment.

(4) Preferential prices to the promoters may facilitate evasion of the Department's control over organization expense and its prohibition against promoter's fees.

(5) A preferential price to a holding company may provide the subsidiary an unfair competitive advantage over other life insurers since the holding company can offer stock options to officers, employees and agents in circumvention of New York's expense limitation law and statutory requirements for stock option plans for officers and employees of insurers.

C. Control of Practices Subsequent to Formation

1. *Specialty Policy Regulation*

The so-called specialty policies, such as the profit sharing, charter

[433] "Complex security structures involving more than one class of stock are disfavored." Memorandum, Calif. Dept. of Ins., Nov. 25, 1964, as amended Jan. 15, 1965. See N. Y. Supt. Ann. Rep., *supra* note 413 at 25-26.

[434] N. Y. Supt. Ann. Rep., *supra* note 413 at 25-26.

and coupon policies, have been employed as one means of rapidly increasing the insurance in force account. Over thirty states have passed or have pending rules or legislation regulating specialty policies in some way. Some of these rules prohibit such policies, some attempt to regulate the type of sales representations, and some require a separate disclosure of the premium charged for coupons or pure endowments.[435] The recently promulgated limitations on specialty policies, those now pending, and the strengthening of original rules, have significantly affected the sales of specialty policies.[436] In turn, they mitigate the usefulness of this technique as a means of increasing the insurance in force account to enhance the value of the stock.

2. *Control of the Stock-Option-to-Agents Technique*

a. Conflict of Interest as Between Companies

The conflict of interest situation was discussed previously in some detail. The stock option to agent mode of operation raises two conflict of interest situations. Some agents retain a contract with their original company and place business in the stock-option company. The original company may have two "after the fact" remedies as a means of protecting their investment in field force development. (a) If the agent's contract is exclusive, the company may sue for breach of it. (b) The company may also sue for breach of the agent-principal relationship.[437] Such remedial action could deter similar conduct by other agents. However, these remedies may be cumbersome and impractical. Moreover, the competition for agents is quite intense. Few, if any, life insurance companies would care to face the adverse criticism which would be generated by litigation with its own agents.

Several older companies have issued rules or statements of policy in an attempt to counteract the stock option technique. For example, one company stated that it would not enter into a full time agent's conract with an individual who is a full time agent of another life insurance company, an officer or director of such company, a major stockholder of such company, or under contract with any life insurance company that offers him stock options in lieu of or in addition to commissions. Those agents who already had a full time contract were given

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[435] See National Association of Life Underwriters Committee on Field Practices, *"Special" Life Insurance Policies: Applicable Statutes and Regulations,* Sept. 1964. Kimball and Hanson, *The Regulation of Specialty Policies in Life Insurance,* 62 MICH. L. REV. 167.

[436] It was reported that speakers at a meeting of the National Association of Life Companies "believe(d) the day of the special policy is ending." The National Underwriter, July 25, 1964, p. 15. See Burridge, *Switch from Founders Policies to Non-Par Life and Mutual Fund Works for Ill. Insurer,* The National Underwriter, Oct. 24, 1964, p. 20.

[437] See note 343 *supra.* "(A) principal whose agent has violated or threatened to violate his duties has an appropriate action or remedy." *Id.* §329.

six months to divest themselves of any of the enumerated conflicting interests, under penalty of termination.[438]

The effectiveness of this approach has been questioned.[439] The principal company possesses no systematic means by which offenders among its agency force may be detected. Such directives will have a salutary effect only to the extent that the agents feel the value of the stock options to be insufficient to warrant assuming the risk of detection and the consequences thereof.

It has been suggested that the insurance departments could afford a systematic means of detection by requiring companies to file periodic statements as to the current ownership of their stock and lists of recipients of their stock options.[440] The stockholder list could be made available to other life insurance companies who would then be in a position to ascertain whether or not their agents violate the companies' rules on conflict of interest. However, the magnitude of the task of checking the stockholder list against a list of the company's own agents may prove to be impractical in some situations. If this method is mechanically feasible, it could constitute a significant deterrance against agents transgressing their obligations to a parent company.

But, is this a desirable remedial approach? Is it appropriate for a state regulatory body to intervene in a matter which is primarily a recruiting battle between insurance companies? The authors think not. The competition between companies for new agents does not raise questions of public interest. (Regulatory intervention of some kind might be required, however, if competition for new agents were to reach the extremes of, for example, the early 1900's.) The aggrieved insurer has recourse to the courts and to company conflict of interest rules which may be partially effective.

Even if state intervention is found to be appropriate, the stockholder list method suffers from serious defects. For example, the stockholder list of a company primarily owned by agents would in effect be an agent list, as would the list of option recipients. The public availability of this information could subject the company to raiding of its agency force by other companies. Furthermore, mutual companies might receive a competitive advantage: Whereas they could use the lists of stock companies in recruiting, they themselves would have no such list which could be used by stock companies. SEC proxy rules require management, if it intends to solicit proxies, to utilize corporate

[438] See The National Underwriter, Oct. 17, 1964, p. 6. For statements made by several of the established companies, see Insurance, Nov. 28, 1964, p. 3.

[439] Probe, Nov. 30, 1964. "To be effective, the directives alone presuppose that full-time agents and *agency heads* will be dissuaded from investments that promise windfall profits, and that those who have already gotten in on the ground floor will voluntarily confess that they have been bad boys. Such a supposition is utterly unrealistic." *Ibid.*

[440] See *Ibid.*

facilities to mail out communications from dissident shareholders to other shareholders if the corporation is unwilling to furnish a shareholder's list containing names and addresses.[441] The adoption of this approach by a disclosure-minded regulatory agency such as the SEC suggests that there is potential for abuse in the publication of stockholder lists. Thus, we doubt whether the requirement of periodic stockholder lists would be an appropriate solution to this particular phase of the conflict of interest problem.

b. Conflict of Interest as Between the Agent and the Policyholder

We have suggested above that an agent who writes business in both stock option and non-stock option companies subjects himself to serious conflict of interest pressures to the detriment of both the industry and his policyholder. Other groups claiming professional status have acquiesced in the concept that disclosure of conflict of interest situations constitutes a minimum standard for the protection of their clients. Various organizations and individual agents are seeking to upgrade the quality of agents and thereby enhance their professional standing. Such standing calls for increased responsibility on the part of the agents. As agents become increasingly involved in the financial plans of their clients, their roles as fiduciaries assume increased importance. The *Knox* and *Hardt* cases indicate judicial awareness of this trend.[442] The parallel developments pertaining to broker-dealers and investment advisers in the securities field may hasten the day when legal liability is imposed on insurance agents who write business in both stock option and non-stock option companies, and who fail to disclose to prospective insurance clients potential conflict of interest situations. At the very least, a policyholder is entitled to this information so that he is in a position to better evaluate the credibility of the agent's recommendation. Such disclosure may even enhance the status of the agent in the eyes of the prospective policyholder.

There is no necessity, however, to await judicial imposition of liability. The state insurance departments can promulgate rulings requiring such disclosure by an agent. This requirement and refinements thereof also could be incorporated in a regulatory code of ethics comparable to that governing lawyers and accountants. Perhaps this could be done through the auspices of the National Association of Life Underwriters and other responsible agency associations. Of course, the mechanics of enforcement would be difficult. An enforcing body possesses no systematic means to determine whether affirmative disclosure has been made. However, the ultimate sanction of license revocation should constitute some deterrence to willful violations. Fur-

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[441] See SEC Reg. §240.14a-7 (1956), 2 CCH 1965 FED. SEC. LAW REP. ¶24,011.
[442] See discussion text, pp. 264-265.

thermore, companies could be made responsible for the conduct of their agents, at least when a pattern of violations indicates that a company sanctions or condones such action.[442a]

New York's approach to this problem is more stringent than most states. Stock options to agents are not permitted in any form. This prohibition is premised on the New York expense limitation law rather than upon conflict of interest considerations. Solely from a conflict of interest viewpoint, this prohibition may go too far, since it applies to agents who act as full time agents with the stock option company as well as to agents who split their business between stock option and non-stock option companies. However, a strong case can be made for prohibiting an agent from acting in such dual capacity and for prohibiting a company from knowingly accepting business from such an agent. This conclusion is supported by the existence of potential conflict of interest between the agent and the policyholder, the evolving standards of responsibility among professional groups, the mechanical limitations in the enforcement of disclosure requirements and the intentional violation of the agent's duty to his principal.

On the other hand, it may be argued that such a prohibition unduly limits an agent's freedom to act both in his own and in his client's best interest. Furthermore, prohibition is a drastic remedy. Finally, it may be argued that the relationship between the agent and his principal company does not involve matters of concern to the insurance department. If the prohibitory approach is rejected, and perhaps it should be until less stringent means of control have been attempted, minimum disclosure requirements would seem to be in order.

c. Nomadic Agent

One of the by-products of the stock option technique has been the nomadic agent who moves from company to company. This tends to reduce the quality of service rendered to his policyholders and to diminish the ability of the company to build the stable agency force so essential to sound development.

Reliance on stock options to develop and maintain an agency force may pose some serious temptations to the company's management. The agents receiving options as part of their compensation have a continuing interest in the market price of the stock. If the market declines, or if the market for the stock in another option company is more favorable, the management may be tempted to stimulate artificially (i.e., manipu-

[442a] New York Superintendent of Insurance Stern has said that management has a responsibility to take the initiative in assuring that its representatives comply with the law. See address to New York Midtown Managers' Association, Oct. 20, 1965, p. 3. The SEC has recently held senior officers of a large brokerage firm responsible for not stopping wrongful activities of other members in the firm in an action described as a "developing campaign to hold senior managements . . . responsible for any wrongdoing to investors by anyone, anywhere, in the firm." See Economist, Nov. 20, 1965, p. 845.

late) demand for its stock in order to retain its agents. Or, the management may feel compelled to adopt some course of action highly favorable to the stockholders and unfavorable to the policyholders which it may not otherwise take, such as funding increased stockholder dividends from participating surplus.

The California Department of Insurance has countered the nomadic tendencies of stock option agents in its guiding principles used in passing upon applications for securities permits.[443] Among other things, stock options may not become fully vested unless the policy persists for at least five years. If the agent fails to render adequate service, the policyholder may allow his policy to lapse, thereby depriving the agent of his stock options. Furthermore, the option price must closely approximate the market price at the time the option is granted. By prohibiting an immediate widespread price differential between the option price and market price, the incentive for immediate exercise of the option followed by a quick resale is eliminated.

To the extent that new companies take remedial action, the problem of the nomadic agent may be self-correcting. Some new company managements have taken specific steps to (a) retain their field force, (b) prevent their agents from "dumping" significant amounts of stock on the market thereby depressing the value of managements' own shares, and (c) avoid losing existing business through replacement by former agents who have joined a new company.[444] On their own volition, these companies condition the receipt of options on a minimum persistency of the insurance sold. They also impose some restraints, for a specified period of time, on the alienability of stock acquired via the option route.

d. Summary

We have seen that in both the securities and insurance areas, stock options may be subject to abuse. On this basis some observers have concluded that their use should be completely prohibited. To this view the authors cannot subscribe, at least with respect to options given to *bona fide* full time agents of a stock option company. Stock options have been widely accepted as an appropriate means of incentive compensation. This acceptance is highlighted by the fact that Congress has accorded certain stock options favorable tax treatment. The appeal of the options may help attract *new* agents to the life insurance business (as distinguished from proselyting agents from other companies). They may, in some cases, result in lower acquisition cost to the policyholders. If the abuses to which their use is subject can be controlled by means other than prohibition, and we think they can, complete prohibition would be an unnecessary restraint.

[443] California Memorandum, *supra* note 433.
[444] See note 358 *supra*.

3. *Remedies Pertaining to Management Contracts and Holding Companies*

At the time of this writing, we are unaware of any published comprehensive study of management contracts and holding companies in the life insurance business. Undoubtedly, some abuses and excesses have occurred in this area. Although a detailed study of remedial action is beyond the scope of this article, perhaps some brief remarks are in order.

a. Management Contract Regulation

A remedial approach was suggested by a subcommittee of the Laws and Legislation Committee of the NAIC, in 1959.

> The regulatory authorities should have the right to review any management contract or exclusive agency contract that may have been made between the new insurance company and some individual, partnership, or corporation. The regulatory authority should have the right to approve or disapprove such management or exclusive agency contract. Certain definite standards should be set up by which to judge any such contract.[445]

Recently, the Illinois Insurance Department unsuccessfully sought statutory authority to have all management contracts submitted to the Director for his approval or disapproval in accordance with specified standards.[446] Nevertheless, the Department has proceeded to deal with the problem on a voluntary basis. Companies are requested to submit their management contracts to the Department for review. If they are found to be illegal or so unfair as to border upon illegality, the companies are advised to abrogate them. When so advised, most companies have cooperated and terminated the contracts. A similar program has been conducted by the Wisconsin Insurance Department.[447] Michigan has recently amended its insurance laws to prohibit unreasonable compensation to management and to prohibit compensation on the basis of a percentage of premiums.[448]

b. Holding Company Regulation

A parallel may be drawn between the adaptation of the holding company technique to the life insurance industry and the use of holding companies in the public utility field prior to the enactment of the Public Utility Holding Company Act of 1935. Professor Loss in reviewing some of the factors which ultimately led to Congresional action during the 1930's included the following:

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[445] NAIC, *supra* note 421 at 512.

[446] See The National Underwriter, March 13, 1965, p. 23.

[447] Milwaukee Journal, May 28, 1965, p. 1. Eleven companies voluntarily terminated management contracts after discussions with the Wisconsin Insurance Department. Perhaps such informal action is all that is needed in this area.

[448] Mich. Act 243 of Public Acts 1965.

> inflationary write-ups on the books of operating companies . . . the financing of expansion by issuing excessive amounts of senior securities and *insufficient common stock capital, which resulted in the abuses of excessive 'leverage'* and *inequitable distribution of voting power;* unduly favorable treatment to investment bankers . . . *preoccupation of management with financial maneuvering rather than efficient production and distribution* . . . extraction of excessive dividends to maintain top heavy holding company structures coupled with *exorbitant* 'service charges' and leading frequently to improper accounting practices . . .[449] (Emphasis supplied)

He went on to point out that:

> This technique afforded a maximum of economic control with a minimum of investment. It also resulted in the highly speculative quality of holding company securities known as 'leverage'. As a result of this leverage, small increases in earnings of the underlying operating companies were magnified into large changes in the earnings applicable to the holding company securities.[450]

Several of these elements have been shown to exist in the new life insurance company phenomenon. For example, one of the attractions of the industry for the promoter is the high degree of "leverage." Also some managements appear to be more concerned with "financial maneuvering" rather than operating an efficient, well run insurance company. Furthermore, management service charges may be excessive.

Although it would be premature for us to suggest a comprehensive scheme of control, some early efforts have been made which bear mentioning. For example, if the situation in the life insurance industry is analogous to the public utility situation three decades ago, the Public Utility Holding Company Act of 1935[451] may afford one possible approach.

Holding companies having subsidiaries engaged in the electric utility business or in the retail distribution of natural gas must register with the SEC. A geographical integration requirement would limit the operation of a holding company system to a single integrated public utility system in a single area or region. A corporate simplification provision is aimed at the elimination of undue and unnecesary corporate complexities and the redistribution of voting power on a fair and equitable basis as between the security holders of the entire holding company structure. In addition, there are a number of regulations pertaining to the issuance of securities, filing of reports, solicitation of proxies, and insider trading.[452]

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[449] 1 Loss, Securities Regulation, 132 (2d ed. 1961).
[450] *Id.* at 134.
[451] 49 Stat. 838 (1935), 15 U.S.C. §79 (1958).
[452] For a more complete discussion, see 1 Loss, *supra* note 449 at 131-43.

The New York Department of Insurance, being concerned over the use of the holding company device to avoid the jurisdiction of New York law, now requires that one-third of the board of directors of a domestic life insurer controlled by a holding company have no association (direct or indirect) with the holding company. Furthermore, the Department is currently preparing legislative recommendations to prevent holding companies from doing for their subsidiary insurers what they could not themselves do under New York law. For example, the holding company would be prevented from selling or optioning stock in the subsidiary in a manner not permitted to the subsidiary itself.[453]

The Iowa Legislature has vested the Insurance Commissioner with broad discretion in this area. The securities of a holding company, whose purposes include the intent to organize, purchase or acquire control of an insurance company, may not be sold or solicited until the promoters have secured from the comissioner a certificate of compliance. Before the commissioner issues this certificate, "he shall first be satisfied with the general plan of such organization . . ."[454] Thus, the comissioner is in a position whereby he can disapprove a holding company scheme which may work adversely to either the interest of the policyholder or the general investor.

A re-examination of the appropriateness of the management contract and the holding company in the quasi-public business of life insurance may lead to some form of limitation on their use. The several limitations discussed above represent neither an exhaustive list of alternatives nor a final recommendation. Rather, they represent initial or tentative ideas suggested by those who have addressed themselves to the problems of management contracts and holding companies in the life insurance industry.

4. *Merger Procedure*

One of the dominant characteristics of the new company phenomenon has been the extraordinary number of mergers. One company has even established a department solely for the purpose of acquisition of companies through merger or direct purchase. Some mergers serve a valuable function by combining the strengths of two companies and thereby eliminating some, if not all, of the weaknesses of each. However, a merger possesses no inherent qualities which compel automatic acceptance of its desirability and worth. Some mergers may be motivated solely for the purpose of enhancing the value of the stock with little regard for its impact upon the policyholders' interest. For example, it is not unheard of for an influential member of the board or management of the merged company to receive extra value for his stock

[453] N. Y. Superintendent Annual Report, *supra* note 413 at 24-25.
[454] IOWA CODE §§506.2, 506.3 (1962), as amended by Ch. 299 by the 60th General Assembly (1963).

unbeknown to other persons in the company. Because of the "under the table incentive" he persuades his colleagues of the desirability of merging on the terms suggested by the surviving company.[455] In these cases, little thought is given to the policyholders' welfare.

Generally, state laws require that a comprehensive plan or agreement to merge be prepared and submitted first to the board of directors of each company for approval and then to the stockholders of each company for ratification. Approval by the insurance commissioner of the domiciliary state is usually required, sometimes with and sometimes without a public hearing on the proposed merger plan. Subsequent to approval by the necessary parties the so-called "articles of merger" are filed with the appropriate state officer and the merger is legally consummated. Typically, the statute permits the commissioner to approve the merger plan only if he finds it to be fair, equitable and free from reasonable objection.[456]

Nevertheless, the federal government has questioned the effectiveness of state insurance department scrutiny of proposed merger plans. A study by the Senate Subcommittee on Antitrust and Monopoly reported that of 187 mergers between insurance companies from 1953 to 1957,

> not in one case did the State insurance departments refuse permission to merge or institute proceedings to prohibit a merger. Also, several states indicated that the merger question was not considered at all by the department, either with respect to approval or denial of permission to merge.[457]

In view of the number of mergers, the relationship between mergers and the new company and stock promotion phenomenon, and the report of the Senate Subcommittee, a study in depth is warranted as to the

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[455] Conversations with members of the industry. See allegations made by the SEC which resulted in its obtaining a temporary restraining order from an Arizona district court to block a merger between two Arizona life insurance companies, as reported in The National Underwriter, April 10, 1965, p. 18. The ruling was reversed on appeal by an Arizona superior court, as reported in The National Underwriter, July 17, 1965, p. 1. Litigation is currently pending in the federal district court. The National Underwriter, Sept. 25, 1965, p. 25. See SEC Litigation Release No. 3180, March 30, 1965.

[456] For a discussion of the merger procedure, see address by Robert D. Williams, Chicago Conference on Acquisitions and Mergers, Oct. 28-29, 1964, pp. 17-20. For an example of the statutory procedure described, see N. Y. INS. LAW, §§480-504.

[457] Senate Report, *supra* note 400 at 216. The WIS. STAT., §201.03(8) authorizes a merger between mutual companies if such a merger is "fair and equitable to the policyholders." Recently the Wisconsin Department has been involved in a controversy as to whether a particular merger between two casualty companies meets this requirement. Without going into the merits of this case, it is quite evident that this department was quite vigorous in contrast to what the Senate subcommittee described as the typical situation. See Cream City Mut. Ins. Co. v. Northwestern Mut. Ins. Co., Order Upon Rehearing, Merger Commission, Jan. 27, 1964; Opinion by Commissioner (acting) DuRose; Memorandum Decision, Case No. 115 262, Wis. Circuit Court (Dane County), Jan. 13, 1965.

impact of a merger on the policyholders' interest (safety, cost, and service), and the merger statutes and their enforcement.

5. *Surprise Audits*

The president of one company advocated surprise audits of insurance companies by the insurance departments, comparable to those experienced by banks.[458] Such a practice would encourage management to exercise continuous care in its management function. Furthermore, an examination could assist the departments in diagnosing financial instability in the incipient stage thereby affording an oportunity for remedial action before the point of no return has been reached. This suggestion possesses considerable merit, yet it has its limitations. Most insurance departments tend to be underbudgeted and understaffed. Consequently, frequent surprise audits, in addition to periodic examinations, would impose a heavy burden on the department staffs. The possibility of a surprise audit might deter at least some questionable practices. However, because of its sporadic nature the remedial impact would probably be limited.

6. *Limitation on Profits*

As mentioned earlier, a few states and Canada have imposed either statutory or regulatory limitations on the profits generated by participating policyholders which may be allocated to the stockholders' benefit. Most of these limitations require that at least a certain percentage of the participating profits (ranging from 90 per cent to 100 per cent) must inure to the benefit of the participating policyholders. Although not enacted for this specific purpose, such limitations may have had a deterrent effect on speculation in new life insurance company stocks.

> Some easily understood limitations on profit making that distinguished between the policyholder's and the stockholder's interest would do much to demonstrate that the life insurance business was not the bonanza that present speculative market conditions would suggest.[459]

Such limitations decrease the value of the stockholder's equity. Similarly, the calculation of the present value of future profits accruing to the stockholders' benefit is affected. That such a limitation on stockholders' profits is a deterrent to speculation is indicated by the cautions offered by some investment analysts to investors contemplating invest-

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[458] Address by John A. Lloyd, Zone 2 Meeting of the NAIC, as reported in The National Underwriter, May 1, 1965, p. 2.

[459] Address by Bruce E. Shepherd, 22d General Agents and Managers Conference, Saratoga Springs, N.Y., Feb. 12-13, 1965, p. 5. Mr. Shepherd was talking in terms of developing some accepted criteria for measuring the value and the earning power of a company. This effect would be assisted if there were easily distinguished limitations on the profit available to stockholders. *Ibid.* This is not to say that Mr. Shepherd is advocating the imposition of statutory profit limitations.

ment in companies doing business in these states.[460] This limitation constitutes an "important consideration in evaluating the stock of a company."[461]

The regulatory authorities of Canada felt that a limitation on the stockholders' charge was appropriate to ensure equitable treatment of participating policyholders.[462] This, in turn, would mitigate the possibility of undue speculation in life insurance stocks. In 1951, the Canadian law was amended to reflect the principle of gradation. The proportion of participating profits which may be allocated for the benefit of stockholders declines as the participating branch of the company grows larger.[463] The sliding scale is based upon the recognition that:

> As a company grows, the ratio of its capital stock to its total assets rapidly decreases, and the share of such profits necessary to pay a reasonable dividend to shareholders likewise decreases.[464]

Similarly, in the United States, one executive of a stock life insurance company said:

> since the higher premium received on participating business furnishes a cushion against adverse experience which practically removes all stockholders' risk on such contracts, a limit on profits . . . seems entirely proper.[465]

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[460] Lehman Brothers, *The Life Insurance Industry,* Nov. 1964, p. 18 (investment analysis). See also Equity Research Associates, *The Hazards and Rewards of Investing in Small Life Insurance Companies,* Oct. 15, 1964, p .12 (investment analysis). Also, "participating insurance in force, where restricted by charter limitation or state law, is valued at 50% of nonpar business." *Id.* at 13.

[461] BELTH, PARTICIPATING LIFE INSURANCE SOLD BY STOCK COMPANIES 141 (1965).

[462] REPORT OF THE SUPERINTENDENT OF INSURANCE FOR CANADA FOR THE YEAR ENDED DECEMBER 31, 1951, (Ottawa, 1953), Vol. II, p. xviii.

[463] See Canadian and British Insurance Companies Act, §84(2), REV. CAN. STAT. 1952, c. 31 which provides the following:

Participating Fund	*Stockholder's Charge Limitation*
Less than $250 million	10 %
$250-$500 million	7½%
$500 million to $1 billion	5 %
In Excess of $1 billion	2½%

[464] REP. OF SUPT. OF INS. FOR CAN., *supra* note 462 at xviii.

"The capital stock of a relatively mature life insurance company is usually quite small in comparison with the total funds of the company and its total liabilities. The capital serves a most important purpose in launching a company and in providing protection to the policyholders during the early years. However, as a company grows, the capital becomes less and less important so far as protection to the policyholders is concerned. That is not to say, of course, that the shareholders are not entitled to the profits resulting from the development of a successful enterprise, or to minimize the value of a proprietary interest in most businesses. In the field of life insurance, both mutual companies and stock companies have their advantages and their disadvantages. Nevertheless, the diminishing role of the capital must be mentioned to point up the fact that the principal strength of a well-established life insurance company lies in the funds accumulated from the premiums paid by its policyholders, especially the participating policyholders, rather than in the capital stock. House of Commons Debates (Canada) 1810-11 (Dec. 3, 1957) (remarks by Donald M. Fleming, Minister of Finance).

[465] Remarks by Howard C. Reeder, Meeting of the New York Society of

Some companies, cognizant of the appropriateness of a limitation on participating profits have voluntarily imposed such a limit on themselves via the company's charter or by a binding resolution of the board of directors.[466]

Widespread adoption of a stockholder's charge limitation in some form has been advocated.[467] In addition to the five states and Canada which already have statutory or regulatory limitations, Zone IV of the NAIC passed a resolution requesting the NAIC to develop model legislation which would limit, in terms of a percentage, the amount of profit on participating business which a stock company could retain for its stockholders.[468]

In summary, proponents of the adoption of some form of stockholder's charge limitation on participating profits justify their position on at least three grounds. (1) As a company grows and matures, the

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Security Analysts, June 29, 1962, as reported in the Eastern Underwriter, July 7, 1962, p. 1. The founder of modern life insurance, Elizur Wright, made a similar observation about a century ago:

> In the experimental stage of a company, which surely ought not to last many years, while the net receipts from interest are little or nothing, it is of course necessary to expend a considerable portion of the receipts from premiums in establishing the means of future business, and securing an attractive nucleus of policyholders. Hence the importance of a guarantee capital at this stage, which may quell every apprehension of a possible want of means to pay losses on the policies. But after this stage is passed, and it probably will be in two or three years, if ever, the guarantee capital becomes perfectly unnecessary, and every cent which it costs more than the earnings of its investment is a bootless extravagance and waste of the policyholders' money.

Massachusetts Reports on Life Insurance 1859-1865, p. 63, as reproduced by AMERICAN CONSERVATION CO., THE BIBLE OF LIFE INSURANCE (1932).

"In all successful life insurance companies the capital stock soon comes to bear an insignificant relation to the resources of the company provided by its policyholders." Report of the Joint Committee of the Senate and Assembly of New York Appointed to Investigate the Affairs of Life Insurance Companies (1906), p. 359.

[466] BELTH, *supra* note 461 at 140. In Sweden there is also a willingness to limit life insurance profits to a percentage of the stockholders' original investment. Kimball, *The Purpose of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law,* 45 MINN. L. REV. 471 at 506 (1961).

[467] "Because of the fundamental nature of participating life insurance, it is the author's opinion that stock companies selling participating life insurance should be required to observe strict limitations on the extent to which the stockholders may benefit from participating operations." BELTH, *supra* note 461 at 141. In his book, Professor Belth discussed possible procedures and theories upon which the ascertainment of the appropriate amount of the stockholders' charge limitation could be based. *Id.* at 125-134.

[468] 1 PROCEEDINGS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 149-50 (1965). An NAIC subcommittee studying this question recommended that its membership be expanded to continue the study. The Laws and Legislation Committee did not adopt this report, in effect, removing this question from the agenda. American Life Convention and Life Insurance Association of America Joint General Bull. No. 1185, June 17, 1965, p. 3. This was a setback, at least temporarily, for the proponents of such limitations. On the other hand, Michigan Senate Bill No. 375 (1965), if enacted, would require that "no profits on participating policies and contracts in excess of 10% shall inure to the benefit of the stockholders."

capital furnished by the stockholders is subject to little risk. Consequently, there should be a reasonable limitation on the profits which can accrue to them. (2) Equitable treatment demands that most of the unneeded margins generated by the participating policyholders should be applied for their benefit. (3) A clearly delineated limitation on profits from participating business might contribute to curbing widespread speculation in life insurance stocks.

On the other hand, profit regulation interjects political considerations. Regulators are selected by the political process and their regulation must meet with the general approval of the consuming public. Profit regulation means, in effect, that the conduct of an important phase of management has been turned over to an outsider. It is a drastic remedy. Historically, it has been imposed on management only after management has demonstrated a lack of public responsibility. Other remedies which impose less onerous burdens on the industry would be more appropriate and, perhaps, even more effective.

To date, only participating profits or surplus are subject to profit limitations. The insurance and investment literature is replete with statements as to how profitable nonparticipating business is to the stockholder.[469] For example, one commentator pointed out:

> Stock companies have still another built-in profit-maker. Their mutual rivals, by definition, write only so-called participating policies. This means they are under a certain obligation to share at least some of whatever operating gains they may achieve with their policyholders in the form of dividends. Stock companies, on the other hand, can issue nonparticipating policies, which they almost always do. Thus, when mortality rates are down, expenses are down and investment yields are up—as has generally been true since World War II—the stockholders are the sole beneficiaries.[470]

Because of the continuous nature of the insurance transaction, it is argued that some form of profit limitation should be imposed on nonparticipating business as well. Such a possibility is not without legislative or regulatory precedents. The history of the insurance business reveals numerous instances of legislative intervention where, in the

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[469] Several investment houses and research groups have made this point. E.g., "Participating Insurance—Ideally, [investment in] this type of insurance should approach zero, from the viewpoint of the stockholder since policyholders share in the earnings. . . . *As a general rule*: [potential purchasers of stock should] question any stock company with more than 5%-to-10% of total policies in nonsegregated participating insurance—this may be a threat to the stockholders' claims on earnings." American Research Council, *Life Insurance Stocks 1965*, ANNUAL INDUSTRY STUDY AND INVESTMENT FORECAST, p. 25. "Generally, non-participating business is more profitable and therefore more desirable than participating business." Maynard, *Behind the Scenes with Newcomers in the Life Insurance Business*, Magazine of Wall Street, Jan. 9, 1965, p. 401.

[470] Forbes, April 15, 1964, p. 21 at 22.

opinion of the solons, the relationship between the premiums charged to the policyholders and profits accruing to the stockholders becomes unbalanced.

Mortality Tables. Between the adoption of the American Experience Mortality Table in the nineteenth century and the 1941 Commissioners' Standard Ordinary Mortality Table by the various states, the life insurance business was subjected to adverse publicity. Many came to believe that the old table did not reflect improved longevity of life and that built-in excessive mortality charges were siphoned off by the companies. In many respects this claim was inaccurate. Dividends paid by stock and mutual companies on participating policies reflected current mortality. The nonparticipating companies reduced their gross premium rates on new contracts. (On the older contracts mortality gains were achieved but these were in part offset by the long decline in interest rates between 1923 and 1947.) Nevertheless, this experience indicates that the life insurance business is not immune to pricing criticism.

Credit Life Insurance. A number of states, either through legislation or regulation, restrict the premium which may be charged to the borrower.[471]

Accident and Health. In some states, pricing restrictions are imposed on accident and health insurance. The Wisconsin Insurance Laws, for example, provide that the commissioner may disapprove an accident and health form "if the benefits provided therein are unreasonable in relation to the premium charged."[472]

Group Life. In New York the Superintendent of Insurance, after consulting with the insurer, may prescribe the minimum group life insurance premium to be charged for the first year of insurance, based on the insurer's experience and reasonable assumptions as to interest, mortality and expense.[473] The effect of this is to establish a price "floor" rather than a "ceiling."

Expenses. The New York expense limitation law provides an elaborate machinery for limiting costs of life insurance companies, including commissions.[474] Its enactment was a direct result of public criticism of the pricing practice of the business.

Stockholders' Charges on Participating Profits. Several states and Canada now have a limitation on the profits generated by the participating business which may be allocated to the benefit of the stockholders.

Whether a limitation should be extended to the profits on nonpar-

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[471] See e.g., N. Y. Dept. of Ins. Reg. No. 27-A, Sept. 27, 1963. Credit life insurance is defined as insurance on the life of a debtor in connection with a loan or credit transaction to provide payment to the creditor in the event of the debtor's death. *Ibid.* See WIS. STAT. §201.04(3c) (1963).

[472] WIS. STAT. §204.31(3)(g)(3) (1963).

[473] N. Y. INS. LAW §204(2).

[474] N. Y. INS. LAW §213.

ticipating business is a much more difficult and controversial question than is the question of limitations on profits of participating business. The life insurance business has traditionally taken the position that life insurance premiums should be determined by competition. The stock companies contend that they are in active price competition with mutuals, which have no profit loading. This, in turn, renders price controls unnecessary. Furthermore, the interjection of political considerations into the rate making structure may not be good for either the life insurance industry or the policyholders. The general feeling of the business seems to be that any form of profit limitation beyond that now in effect would be unduly burdensome. Such a drastic remedy should be considered only after other proposed solutions have failed.

Furthermore, assuming it can be determined when stockholder profits are so excessive as to warrant placing restrictions on them (this is no small assumption), there remains the question: To whom should the profits accrue? The nonparticipating policyholder obtained his coverage at a guaranteed cost. If the company's mortality or interest experience is unfavorable, the company could not increase his premium rate as an offset. If the company's experience is favorable, there seems to be little justification in requiring the gain to be allocated to his benefit since he assumed no risk as to his cost. The participating policyholders, if any, have no justifiable claim to "excess" profits on nonparticipating business. They do not contribute to such profits. In fact, it can be argued that the nonparticipating policyholders who do contribute to the excess profits have a more equitable claim to them than the participating policyholders.

Because of the difficulty in ascertaining whether the nonparticipating business generates "excess" profits, the assumption of no risk as to cost by the nonparticipating policyholders, the pressure of competition to prevent unconscionable profits, and impingement upon management's function by political intervention, the wisdom of governmental restrictions on stockholder profits on nonparticipating business seems questionable.

D. Disclosure

In the federal securities laws, Congress adopted primarily a disclosure, rather than a direct regulatory approach. Although it is not a panacea for all problems, the disclosure philosophy has proven to be quite valuable in providing investor protection. Disclosure is generally considered to be a milder remedy and tends to reduce the need for stronger regulation in other areas. Thus, disclosure is the next subject of our inquiry.

The disclosure concept seems to lend itself particularly well to the

correction of some of the problems discussed above. If full disclosure of operating results to stockholders has proven to be an effective remedy in protecting investors, full disclosure of operating results of new life insurance companies may prove equally effective in protecting the interests of the policyholders. It should be noted moreover that this remedy (as well as other remedies discussed) lends itself to application to all life insurance companies, new and old, stock and mutual. All policyholders and all stockholders have a vital stake in how their company is performing regardless of its age, size or corporate structure. In the following sections, therefore, the authors have discussed the problems and remedies in general terms, with the thought that this is an area where the practices of not only new companies but the industry as a whole might be reviewed and, where necessary, improved.

1. *Separation of Accounts*

When there is no separation of accounts, showing separately the gains and losses from the participating and nonparticipating branches and the distribution of gains between policyholders and stockholders, the concept of the stockholders' charge is inapplicable since the results of participating and nonparticipating operations are automatically merged.[475] Implicit in the adoption of a limitation on participating profits is a corresponding requirement for maintenance of separate accounts. However, the latter requirement may stand alone as a possible remedial course of action.

The proposal for separate gain and loss statements appear to be founded at least in part on the theory that the income received by a life insurance company possesses many of the attributes of trust funds.[476] The life insurer handles other people's money. The law requires that part of this income must be set aside as reserves for future benefit payments. A portion of the income is added to the surplus to guard against future contingencies. The law in most states mandates an equitable refund of unused margins to participating policyholders.[477]

Since a life insurer's income has some of the aspects of a trust fund, many feel that an accounting for these funds should include a full disclosure of pertinent facts to enable policyholders and stockholders to satisfy themselves that the company is being efficiently operated in their best interests. For example, a policyholder in a stock company issuing only nonparticipating business would be primarily interested in safety margins provided by surplus. A participating policyholder need be less concerned about the size of the surplus because the higher

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[475] BELTH, *supra* note 461 at 121.

[476] See e.g., McCahan, *Introduction*, INVESTMENT OF LIFE INSURANCE FUNDS 5 (McCahan ed. 1953).

[477] See BELTH, *supra* note 461 at 151-153, for a summary of laws relating to the frequency of surplus distribution.

gross premium provides an extra cushion in case of adverse experience. Instead, he would be more concerned about the size of dividends which lower his net cost. He has a very real interest in earnings and in the surplus account for both have a direct effect on his cost. If his dividends are reduced so as to increase the surplus for the benefit of the stockholders, he ought to be able to determine this. But whatever the reason for his interest, safety, dividends, etc., a policyholder ought to be afforded the opportunity to make an intelligent determination of the disposition of the premium dollars paid by him from information readily available. And, if these questions are of common interest to policyholders of companies which write only participating or nonparticipating business, they should be of equal interest to policyholders of a company writing both lines.

The Armstrong Committee went beyond the proposal for a separate gain and loss exhibit for each line of business. It recommended that the writing of both lines of business by the same company be prohibited. The New York legislature adopted this recommendation with respect to domestic companies; out-of-state companies were permitted to issue both lines on the condition that separate accounts would be filed. However, in 1955, the New York law was amended so that both domestic and foreign companies can issue participating and nonparticipating business if they file separate accounts.[478]

Other states were not as inclined as New York to actually prohibit dual line operations. Nevertheless, many of them require a separation of accounts.[479] Perhaps it was felt that competition with companies writing participating policies would compel nonparticipating companies to pare their margins. The requirement of separate disclosure of gains and losses on the two lines of business may have been premised on the idea of enabling the competitive system to function more effectively. In addition to those states which already impose this requirement, it is reported that legislation to require separate profit and loss statements for participating and nonparticipating business is being sponsored by the Washington and Michigan insurance departments.[480] Such accounts would also be of value to the private investor. This is evidenced by the Financial Analysts Federation recommendation that there be a

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[478] For a discussion of the evolvement of the New York law, see BELTH, *supra* note 461 at 74-87.

[479] See *id.* at 158-175 for a summary of laws and regulations relating to participating life insurance sold by stock companies.

[480] See Life Insurance Association of America Monthly Report, Jan. 1965, p. 7, and the National Underwriter, March 6, 1965, p. 8. See Michigan Senate Bill No. 375 (1965). The Life Insurance Association of America subcommittee on Participating and Nonparticipating Insurance opposed statutory proposals to require filing of separate accounts. LIAA Monthly Report, June 1965, p. 1.

"segregation of policyholders' and stockholders' surplus" in the balance sheet.[481] Furthermore, if a life insurance company is subject to the federal securities laws, the form and content of the financial statements which must be filed with the SEC are governed by Regulation S-X as amended October 6, 1964. Among other things, the balance sheet must show "the amount of surplus required to be allocated to participating policies and not available for dividends to stockholders" and the profit and loss statement must show "the amount of net income allocated to participating policies."[482]

Professor Belth summarizes the problem in this manner. When a company issues a participating policy, it establishes the premium at a level which management believes to contain an overcharge. The parties to the contract contemplate that periodic reasonable refunds of the overcharge will be made. In handling this money the management of the company acts as a fiduciary. Whether the management's action pertaining to the participating policyholders and stockholders is reasonable must initially be resolved by the management itself, but in the final analysis it is resolved by the informed judgment of outsiders. The preferable manner of apprising outsiders of management's actions is full disclosure of operating results and the disposition of funds. Adequate disclosure requires a separation of accounts.

> At the same time, it would seem that a stock company acting with the utmost good faith toward its stockholders and participating policyholders would have no reason to conceal its actions from public view. Rather, it would seem that such a company would be willing to display its results publicly and defend its actions against any and all criticism.
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> The experience of companies that currently file a complete separation of accounts [because of the requirements of a few states] seems relevant. These companies have been living with the requirement for many years and have not only survived but have prospered. It would appear that any stock company acting with the utmost good faith toward its stockholders and participating policyholders could do the same. And if any companies are acting with something less than the utmost good faith, it is imperative that the questionable practices of such companies be corrected at the earliest possible date, lest such practices achieve a magnitude that would bring discredit upon the entire institution of life insurance.[483]

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[481] The Financial Analysts Federation, 16th Annual Report of the Corporate Information Committee (1963-1964), p. 22.

[482] SEC Reg. §210.7a-03 (1964), 3 CCH 1965 FED. SEC. LAW REP. ¶69,342 and SEC Reg. §210.7a-04 (1964), *ibid.* at ¶69,343.

[483] BELTH, *supra* note 461 at 138-139. For some arguments which have been raised in opposition to separate accounts, see *id.* at 180-185, and for answers to these arguments, see *id.* at 192-195.

2. *Annual Report to the Policyholders*

a. 1964 Amendments to Securities Exchange Act of 1934

The activity in the stock of life insurance companies has led more and more security analysts to examine balance sheets and operating statements of such companies. As a result of this exposure the analysts have become openly critical of life insurance financial reports. In 1960, the Corporate Information Committee of the National Federation of Financial Analysts Societies issued a statement in which it said:

> It is our conclusion that the annual reports [to stockholders] of the life insurance industry are the poorest of any major industry in the United States.[484]

In 1963, the Securities and Exchange Commission in a special study reported that a number of companies failed to furnish profit and loss or surplus statements, and in other cases failed to give statements in adequate detail, including the necessary financial notes. Some of the companies failed to send any financial reports to their stockholders.[485]

In 1964, Congress amended the Securities and Exchange Act of 1934 to extend registration, proxy and insider trading requirements to over-the-counter securities.[486] In the absence of an exemption, this amendment would have brought most stock insurance companies under the sway of the SEC. In exchange for an exemption, the National Association of Insurance Commissioners evolved comparable requirements to be administered by the states. For stock insurers to be exempt from SEC jurisdiction, three conditions must be met:[487]

(1) An annual statement which conforms to the statement prescribed by the NAIC must be filed with the insurance commissioner of the domiciliary state;

(2) The insurer's domiciliary state must regulate proxies in respect to the insurer's securities in conformity with regulations prescribed by the NAIC;

(3) After July 1, 1966, the purchase and sale of the insurer's securities by insiders must be subject to regulation by the domiciliary state substantially in the manner provided by Section 16 of the Securities Exchange Act of 1934.

To meet the first condition, the NAIC developed the Stockholders Information Supplement (SIS) which is attached to the annual state-

[484] The National Federation of Financial Analysts Societies, 12th Annual Report of the Corporate Information Committee (1960), p. 12.

[485] SEC, Report of Special Study of the Securities Markets, H. Doc. No. 95, Pt. 3, 88th Cong. 1st Sess., p. 41 (1963). There has been an improvement in annual reports as contrasted to prior years, but there is still room for substantial improvement. The Financial Analysts Federation, 16th Annual Report of the Corporate Information Committee, pp. 21-23 (1963-1964).

[486] Securities Exchange Act of 1934, §§12(g), 14, 16, 2 CCH 1965 FED. SEC. LAW REP. ¶¶20,315, 20,341-43, 20,421-23.

[487] Securities Exchange Act of 1934, §12(g)(2)(G), 2 CCH 1965 FED. SEC. LAW REP. ¶20,316.

ment filed with the insurance departments.[488] Stock insurance companies are required to answer certain interrogatories in the Supplement. The questions are designed to elicit information as to whether the company had distributed financial reports to its stockholders prior to the company's annual meeting, and whether the report included (a) a statement of assets, liabilities, surplus and other funds, (b) a summary of operations, and (c) a surplus account. Furthermore, information covering management and directors is required. This includes name, principal occupation, length of service, remuneration and retirement benefits. The SIS also requires data bearing on conflicts of interest and stock options, and inquires whether the data has been furnished to stockholders in proxy statements. Additional information pertaining to beneficial ownership of securities in the company and their disposition by certain key officers, directors and owners must be given.[489]

To meet the second condition for exemption from the 1964 amendment, an NAIC subcommittee recommended proxy regulation which closely parallels that of the SEC.[490] In effect, the NAIC proposal requires the insurer to send to its stockholders each year (1) a state-of assets, liabilities, surplus and other funds, (2) a summary of operations, and (3) a surplus account. The insurer must also send a proxy statement which includes information on the personal interests of management; the nominees for directors (including principal occupations in the last five years, stock owned by them, etc.); remuneration and other transactions with management; bonus arrangements; and stock options. If there is a contested election, the policyholder must be furnished additional information on the participants, not just the nominees, in the election.[491]

To meet the third condition, the NAIC subcommittee recommended the adoption of a model insider trading act. Its provisions are quite comparable to those of Section 16 of the Securities Exchange Act.[492]

[488] 2 PROCEEDINGS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 515 (1964).

[489] A copy of the SIS may be found in 1 PROCEEDINGS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 175-78 (1965). The SIS was adopted by the NAIC, Dec. 1963, 1 PROCEEDINGS OF THE NAIC 204-09 (1964) and by the Blanks Committee, April 1964, 2 PROCEEDINGS OF THE NAIC 313, 315 (1964).

[490] A copy of the proposed proxy rules may be found in the 1 PROCEEDINGS OF THE NAIC, 155-170 (1965). The SEC Proxy Regulation, promulgated under §14 of the Securities Exchange Act, may be found in SEC Reg. §240.14a-1 to §240.14a-12, 2 CCH 1965 FED. SEC. LAW REP. ¶¶24,005-24,016.

[491] NAIC proposed proxy regulation, §§5(1), (2), (11) and Schedules A and B. If proxies are not solicited "substantially equivalent information must be sent." *Id.* at §3.

[492] Copy of the NAIC model legislation on insider trading may be found in 1 PROCEEDINGS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 171-173 (1965). Most states have enacted the Model Insider Trading Statute and have authorized or promulgated proxy regulation. Review of 1965 Legis-

b. The Anomaly

An anomaly now exists. As a result of the 1964 securities legislation, most insurance companies will be required to furnish their stockholders with a gain and loss exhibit, a balance sheet, and a surplus reconciliation account. These same companies are under no compulsion to treat similarly their policyholders. This anomaly can be highlighted by the following illustration.

Two individuals have $2,500. The first decides to buy 2,500 shares in a life insurance company at $1 per share. The second decides to buy a single premium life insurance policy with a premium of $2,500 from the same company. Under the federal securities law, the investor is entitled, among other things, to be warned in writing (via the prospectus) that the venture is speculative, there is no assurance that it will succeed, and that if the company does survive it is likely to show substantial operating losses in its early years. Furthermore, each time his vote is solicited in corporate elections (typically on an annual basis), the investor will receive a financial statement which adequately reflects the financial position and operations of the issuer.[493] Both the pluses and the minuses in the company's operations are revealed. The policyholder, although expending the same number of dollars (perhaps at less risk) receives no warning that the new company may not make the grade. On the contrary, the policyholder is given to understand that since the new company has met the minimum state licensing requirements it is entitled to public confidence. The law does not require the company to communicate to him either the pluses or the minuses in the company's operating results. In fact, a competing agent who calls attention to the minuses runs the risk of prosecution for disparaging the company.[494]

Of course, the policyholder (prospective or otherwise) has not been left unprotected. One tenet upon which the insurance laws are based is that the commissioner and his staff, being experts, are in a better

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lation pp. 3-4 attached to Life Insurance Association of America Monthly Report, Aug. 1965.

[493] SEC Reg. §240.14a-3 (1965), 2 CCH 1965 FED. SEC. LAW REP. ¶24,007 (1965).

[494] If the individual agent obtains a copy of BEST's and points out the thin financial margins of some new company or its dubious operating record, he may be accused of disparaging the financial condition of the company. In many states this may violate the insurance law. A typical statute reads as follows: "Unfair methods of competition and unfair or deceptive acts or practices defined. (1) The following are hereby defined as unfair methods of competition and unfair and deceptive acts or practices in the business of insurance: . . . (c) *Defamation.* Making, publishing, disseminating or circulating, directly or indirectly, or aiding, abetting or encouraging the making, publishing, disseminating or circulating of any oral or written statement or any pamphlet, circular, article or literature which is false, or maliciously critical of or derogatory to the financial condition of an insurer, and which is calculated to injure any person engaged in the business of insurance." WIS. STAT. §207.04(1)(c) (1963).

position to protect the policyholder's interest than the policyholder himself. Thus, the information is filed with the insurance commissioner rather than furnished to the policyholder. But this does not mean that the policyholder should not be entitled to information comparable to that furnished to a securities holder. The proposition that an individual must rely solely on a government regulatory body without the opportunity to act on his own behalf has received little, if any, acceptance.

If it were otherwise, an individual would have no recourse if the regulator's competence is less than adequate, or if the regulator is overburdened with work and has little time for or interest in the individual's problem. Furthermore, the regulator can protect the policyholder only to the extent of the minimum standards set out in the statute. Thus, few would argue that a policyholder should not be entitled to seek information upon which he can make an informed decision. If he is so entitled, then it is incumbent upon someone to make such information available.[494a]

c. Need and Propriety of Annual Accounting

With respect to participating mutual insurance it can be said that the policyholder is an insurer as well as an insured. This point may be illustrated by the following hypothetical example: In 1964, the policyholders in Company XYZ paid $200 million in premiums. They received back in dividends $75 million. At year end the company's surplus, built up by policyholder contributions over the years, stood at $120 million. This means that during 1964, the company's safety margins, over and above the policy reserves, totaled $195 million, or roughly the equivalent of one full year's premiums. These figures highlight the dual status of the participating policyholder as both an insurer and an insured. They make plain the obligation of the company to render him an annual report showing the sources and dispositions of the funds which he has entrusted to the company. If this is true of a mutual company writing participating insurance, it should be equally true of a stock company writing participating insurance.

It can be argued with some justification that a nonparticipating policyholder has less need for information in an annual report than

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[494a] With respect to private employee retirement plans, a Presidential Committee said:

> Full disclosure of relevant facts is a prerequisite for self help and for the enforcement of statutory measures for the protection of the individual's rights. No one can enforce his rights if he is unaware his rights have been injured. Nor can employers, trustees, or fund administrators be held to standards of fiducial responsibility unless there is adequate disclosure of their financial and investment activities. Other public interests also require knowledge of the facts.

President's Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs, Public Policy and Private Pension Programs, A Report to the President on Private Employee Retirement Plans, Jan. 1965, p .77.

does his participating counterpart. His annual cost is fixed. It is not dependent upon the yearly earning results of the company. Therefore, it may be asked, why raise questions in his mind if the information serves no useful purpose? Even in a stock company writing nonparticipating insurance, where the relationship between the company and the policyholder is contractual and the legal title to the surplus rests in the company as the alter ego of the stockholders, the dividends, additions to surplus, and the surplus itself may have been largely contributed by the policyholders. Since the surplus funds are held for the protection of the nonparticipating policyholders, they, too, are entitled to a comparable accounting on this basis alone. Furthermore, if the policyholder is insurable, he may wish to acquire coverage elsewhere, either in lieu of or in addition to that written by the original company, if he is dissatisfied with its performance. However, for him to judge this performance, he must have the relevant information on its operating results.

d. Disclosure: Filing vs. Dissemination

The famous Armstrong Committee officially recognized the importance of disclosure of information when it said:

> Of all the reforms suggested by the Committee nothing, it is believed, is more imperatively demanded than that the companies should be compelled to exhibit the results of their management by annual accounting. If details of management are to be left, as they should be, to the discretion of the directors, they should be compelled each year to state the results of their administration and to come under definite liabilities to the policyholders for the amounts to which the latter are entitled.[495]

Disclosure may assume one or both of two forms: (1) filing the required information with an official body where it is available for public inspection, and (2) delivering the information directly to the policyholders. The drafters of the federal securities law were also cognizant of the importance of both forms of disclosure. They required both (i.e., registration statement and prospectus). The Report of Special Study of Securities Markets of the Securities and Exchange Commission emphasized the latter when it said:

> If disclosure of information is fundamental . . . the widest possible dissemination and use of filed information will obviously best serve the purposes of disclosure. In light of modern techniques for duplicating and communicating the printed word, it would seem that dissemination and not mere filing should be required in many instances.[496]

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[495] Report to the N. Y. Legislature, *supra* note 465 at 425.
[496] Special Study of the Securities Markets, *supra* note 485 at 64.

Similarly, it would appear that the direct receipt of information is a highly desirable and necessary element in the regulatory structure for policyholder protection.

e. Recommendation

The insurance departments possess a wealth of information on individual companies licensed to do business in their states. However, they have no organized machinery for disseminating such information directly to the individual policyholders, and it is difficult to conceive of a practical means for them to do so. Thus, the responsibility, if any, for distributing such information must rest with the individual companies.

To date, although many companies, stock and mutual, send annual reports to their policyholders, some companies have evinced little interest in assuming this responsibility. In this connection, notice should be taken of the complaints of the securities analysts and the SEC that many companies, anxious to play down (and in some cases even to conceal) adverse factors in their operating results, resorted to issuing financial statements which contained a balance sheet but no operating or surplus statement. In some cases the companies did not even send abbreviated statements to their stockholders. The 1964 securities amendments may be expected to cause a fundamental change in reports to life insurance securities holders. If companies were disinclined to present the whole story to their stockholders, despite outside pressure and criticism, they would have been less inclined to do so to their policyholders.

A life insurance company serves three primary functions: (1) it provides risk protection, (2) it operates as a savings medium, and (3) it functions as a trustee in distributing the proceeds. Manifestly, insurance companies act as fiduciaries. Since they deal with trust money, those who have entrusted their money to them have the right to expect the kind of reports that trustees would issue to their beneficiaries, particularly in light of the congressional mandate in the securities area. Therefore, the authors suggest that a comparable realignment of thinking should occur with respect to the policyholders. Each life insurance company, stock or mutual, new or old, should be required by law (a) to send an annual report to each of its policyholders, as well as its stockholders, and (b) to deliver its most recent annual report to a prospective policyholder, preferably before the sale is consummated (akin to the federal prospectus requirement), but not later than the time of delivery of the policy.

The annual report should include the following information:

Operating Results. The annual report should include (a) a balance sheet, (b) an operating statement (gain and loss statement),

(c) a surplus statement, (d) appropriate notes where required, (e) biographical data on its chief officers and directors. The current report should also contain results of the previous year so as to facilitate comparisons.

Statistical Data. The report should contain appropriate data, statistics and ratios such as (a) the net yield on investments, (b) character and quality of the investments, (c) lapse rate, (d) mortality experience, (e) expense information and other relevant data. This information should be provided on a basis designed to facilitate comparison with the results of other companies. However, such information should be presented in a manner which does not facilitate misleading comparisons. For example, a new company should have proportionately fewer death claims than an established company since its insureds generally (a) tend to be of lower age, and (b) have been subject to more recent underwriting including, possibly, a medical examination. To avoid misleading mortality comparisons, mortality figures should be related to the distribution of business by plan, age, etc. By the same token an explanation of the higher lapse rates generally expected on new business might be included.

Separate Gain and Loss Exhibit. Where the company writes both participating and nonparticipating business, the report should contain a separate gain and loss exhibit for each branch. In the case of participating insurance the statement should plainly show the dollar split of the earnings between stockholders and policyholders. A supplemental breakdown might show the split both as a percentage of earnings and as an average per thousand of insurance in force. This would provide a ready comparison as to how the split compared with the various state laws which limit the amount of participating profits allocable to the stockholders. Companies which operate in states requiring such a breakdown may already provide much of this data to their stockholders.

Reinsurance Information. Most, if not all companies (whether new or old) reinsure a portion of their business. Most new companies reinsure a substantial proportion of their business. The Financial Analyst Federation suggested that the annual report to the stockholder show the amount reinsured.[497] This is required in the annual statement filed with the state insurance departments.[498] The investor is interested in the amount reinsured for at least two reasons: (a) the reinsurer siphons off some of the profits on reinsured business, and (b) if the investor uses the rule of thumb—adjusted earnings technique (e.g., $20 per $1,000 of permanent insurance in force) in valuing a company, a downward adjustment should be made on the reinsured

[497] Financial Analysts Report, *supra* note 485 at 22.
[498] Annual Statement, Schedule S Pt. 3 (Data on Reinsurance Ceded).

business. A more realistic evaluation of a new company's profit potential should contribute to a lessening of the speculative environment for life insurance stocks.

The policyholder is interested in the amount of reinsurance because of policyholder safety and policyholder cost.

Furthermore, the type of reinsurance should be disclosed and the basic limitations highlighted. For example, under a yearly renewable term contract, the reinsurer reinsures the company only to the extent of a portion of the net amount at risk on each policy. Since the reinsurer assumes no obligation as to policy reserves, as it would do if co-insurance were employed, the policyholder must look solely to the writing company for the adequacy and safety of the policy reserves underlying his contract. Very few investors or policyholders understand this distinction. Mandatory discussion of this point in the annual report would obviate criticism for failing to disclose this pertinent information.

Stockholders. Stock companies should also provide (a) a list of key stockholders and their holdings, similar to the data which appears in prospectuses and proxy statements, and (b) a summary of significant insider trading in the stock of the company for an appropriate period. The policyholder is entitled to know with whom he is doing business and the continuity of the company's ownership. It can be argued that the policyholder should be entitled to receive, not only the information set out above, but also any other information submitted to investors. This would tend to prevent the company from having the best of two worlds, namely, proclaiming to the investors the gold mine to be had, while at the same time congratulating the policyholders on the good bargain they have purchased. Once information is fairly and timely conveyed to both policyholders and stockholders, each group is in the position to make an informed evaluation of the company's operations.

Every life insurance company is in direct contact with its new policyholders when it receives the application, collects the first premium and delivers the policy. Thereafter it is in touch with its policyholders at least annually, and commonly more often, when it sends out premium notices. Virtually all companies have elaborate mailing facilities. The enclosing of "advertising stuffers" along with the premium notice as a means of conveying information to policyholders is common. It is possible that the necessary information can be compiled in a condensed form enabling it to be sent with or in lieu of such stuffers at little extra expense. If the dissemination of the annual reports necessitates an expansion of mailing facilities, the cost should not be as great as might otherwise be expected since the basic facilities already

exist. Furthermore, a mandatory disclosure requirement might exempt the company from mailing a report to holders of small policies except upon request.

f. Objections

There has always been genuine disagreement in the life insurance business about the value of sending annual reports to stockholders and policyholders. First, there is the question of expense; the cost of mass mailings may run into sizable amounts. However, if this is handled in conjunction with the mailings of premium notices, the additional cost should be minimized. With the advent of time and cost saving mechanical processes, this task does not pose the difficulties of a manual operation.

Second, a sizable percentage of the recipients of such reports may not read them or many of those who do may not fully understand them. Similar arguments were raised by people in the securities business when the federal securities acts were under consideration. For example, Mr. Justice Douglas, who was then a professor at Yale Law School, wrote a monograph dealing with the efficacy, or lack of efficacy, of proposals to give adequate warning to prospective securities purchasers.[499] He questioned the ability of the average investor to understand and assimilate information required to be disclosed. In spite of these arguments, Congress adopted the disclosure technique and passed the Securities Act of 1933 and the Securities Exchange Act of 1934. Its actions were, in part, based upon the belief that the disclosure would benefit the investor in two ways: (a) disclosure, itself, would deter those practices which could not withstand the light of publicity, and (b) the judgment of those who did understand would be reflected in the market price of the stock and thus, indirectly, benefit the less sophisticated investor.[500] At least (a) is applicable to an annual report to policyholders.

Furthermore, the argument that stockholders and policyholders would not read financial statements, or if they did they would be too poorly informed to understand them, has lost some of its force. There has been a substantial upgrading in the education of our populace over the past thirty years, and a substantial increase in its financial alertness. The editor of a financial magazine predicted that even mutual insurance companies would feel policyholder pressure in respect to

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[499] Douglas, *Protecting the Investor,* 23 YALE REV. (N.S.) 521 (1934).

[500] See 1 Loss, *Securities Regulation* 125, 2d ed. (1961) and Special Study of Securities Markets, *supra* note 485 at 9-10. Years after the passage of the federal acts many of the persons in the securities business, who had opposed the disclosure concept for reasons similar to those set out above, came forward to say that the disclosure provision had a salutary effect. 1 Loss at n. 17, pp. 127-128.

their reporting procedures. Many policyholders are buying securities as well as life insurance.

> Americans are becoming more and more sophisticated regarding their investment and savings programs. In the past decade twelve million persons purchased common stocks for the first time.[501]

As a consequence, many persons have not only been exposed to periodic corporate reports, they are coming to expect such reports.

There may be some reservations about the wide distribution of operating statements of insurance companies. For example, agents might use differences in financial reports unfairly or improperly for sales purposes in competitive cases, or policyholders might misinterpret the information given to them. One aspect of new life insurance company financial reporting is said to be particulary vulnerable, that is, the requirement that the first year costs of selling new business be charged off in the year of sale. As a consequence, the company may show an operating loss for several years, even though it is capably managed and has a sound future.

The argument that disclosure should not be required because agents may misuse or policyholders may misinterpret financial information disclosed to them is subject to several flaws.

First, a new company's operating losses and the severe drain on capital and surplus may stem solely from the accounting requirements. But, as one professor noted:

> The undercapitalized companies also use the argument . . . that their business growth has been so rapid that they are subject to extremely heavy drains on surplus. But, in many cases, this line of argument may be misleading in that while the company may be writing a large volume of business, it also has a high lapse ratio, or overly generous commission schedules or excessive salaries for key employees. The capital shortage may be due then to *inept management and too fast living by the capital deficient company*. . . .[502] (Emphasis supplied)

Second, much of this information has already been disseminated to stockholders by security houses and analysts. Furthermore, governmental pressure is causing even wider dissemination of such information to stockholders. Thus, such information is becoming a matter of public knowledge.

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[501] Plenty, *Tenth Annual Report Contest,* Spectator, June 1963, p. 26. "Policy owners today have a continuing interest in their life insurance. They want to know what happens to the premiums they pay; they want advice; they want assurance that the policies they own will do what they want them to do and to be able to meet varying conditions as they arise" Slater, *Shaping the Working Team For Change and Action,* Insurance (Goldbook) Sept. 11, 1965, p. 32.

[502] Address by Professor Richard M. Heins, Chicago Conference on Acquisitions and Mergers, Oct. 28-29, 1964, pp. 9-10.

Third, company reports to stockholders often stress the success of the management in generating earnings, the source of dividends to stockholders and of additions to stockholders' surplus. But the principal source of a company's earnings is the premiums paid by policyholders and the interest on their policy reserves. It seems anomalous that management should be required to give data on the distribution of earnings to stockholders without providing the policyholders with corresponding data as to the impact of these distributions on their interests. Management must give substantial data to the stockholders through a proxy statement when it seeks their votes. Why should it not give comparable data to the policyholders when it is seeking their premium money? Is the policyholder, who gives the company stability, by paying his premium year after year, entitled to less information than the stockholders, many of whom are in the venture for capital gains on a short term basis?

Fourth, the amount of operating losses and surplus shrinkage are the direct result of management decisions. If management prefers the kind of a statement that will inspire greater confidence on the part of the policyholders, it could, for example, slow down the rate of growth somewhat. This would improve the image of the company as well as that of the industry. The venture might have less attraction for speculators, but that can hardly be said to be a shortcoming.

Fifth, the company could include in its policyholder statement an explanation, similar to that now embodied in stock prospectuses, as to why new companies often show operating losses. After all, this is the truth and truth has a place in statements designed for the information of people who have entrusted their savings to the company. In this connection, it is significant to note the view of the SEC:

> The brochure on . . . Life, while commenting favorably on the company's performance in the writing of new insurance and its future prospects, failed to disclose the fact that it had sustained operating losses in its four years of operation . . . It was stipulated that it is usual for new insurance companies to show an operating loss for the first few years in view of the fact that the cost of writing new insurance is greater than the income derived therefrom during the first year after it is written. *This fact did not however relieve registrant [broker-dealer] of the obligation to disclose the losses in view of registrant's recommendation of the company.*[503] (Emphasis supplied)

Although this case involved a broker-dealer revocation proceeding before the SEC, the obligation to disclose here is quite analogous to the obligation of an insurer to its policyholders (prospective or otherwise).

[503] In the Matter of G. J. Mitchell, Jr., Co., Exch. Act Rel. No. 6433, Dec. 13, 1960, CCH 1957-1961 FED. SEC. LAW REP. ¶76,735.

g. Agent's Liability: Need for Meaningful Disclosure

A number of insurance departments have imposed certain duties on brokers who place fire and casualty risks with unauthorized alien insurers when coverage is not available in the domestic market.[504] For one thing, the broker must ascertain the financial stability of such insurers. Failure to place the business with a responsible insurer may expose the broker to liability for damages. It seems inconsistent that in establishing standards to protect the public, the law has imposed sanctions in an area where there have been relatively few company failures, and yet has failed to impose such sanctions in the authorized domestic market where there have been numerous retirements of life companies. The anomaly is compounded by the fact that most of the unauthorized insurance transactions (fire and casualty business) are relatively short time coverages, whereas in the life insurance field the coverage may extend for decades and the policyholder may be locked into the transaction because of health considerations or surrender deductions.

If an agent informs the prospective policyholder that the new company is on a par with the finest of the established firms, the buyer has the right to rely on such representations. But the agent's liability might be extended even beyond a case of affirmative misrepresentation. The *Knox v. Anderson* case[505] involving "suitability" of a recommendation made by an agent, has opened new vistas of potential liability for an agent. More recently the SEC has required that an agent selling an "equity funding" program must deliver to the buyer a written statement as to its "suitability" in view of the buyer's circumstances.[505a] Thus it is not beyond the realm of probability that the "suitability" standard could apply to the financial soundness of the insurer.[506]

The report on the claims handled under the professional and association liability coverage developed for agents indicates a disposition on the part of policyholders to hold the agent responsible when things do not turn out as anticipated. For example, a company which had replaced group life coverage denied a claim on the grounds that the

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[504] E.g., see N. Y. Dept. of Ins. Reg. 41, Aug. 1, 1962.

[505] 297 F. 2d 702 (9th Cir. 1961), *cert. denied* 370 U.S. 915 (1962).

[505a] SEC Reg. §240.15c2-5 (1962), 2 CCH 1965 FED. SEC. LAW REP. ¶26,919. See SEC Reg. §231.4491 (1962), 1 CCH 1965 FED. SEC. LAW REP. ¶1043. A typical case of "equity funding" involves the sale of securities, particularly mutual funds, to customers and loans collateralized by the securities are used to pay premiums on a life insurance policy sold at approximately the same time. *Ibid.* See also The National Underwriter (editorial), July 28, 1962.

[506] See Annot. 29 ALR 2d 171 (1953) and supplements (dealing with the duties of an insurance broker or agent). Where agent procures policy in company known by him to be insolvent, agent is liable for resulting loss. Hancock v. Wilson, 173 S.W. 1171 (Tex. Civ. App. 1915). See Eastham v. Stumbo, 212 Ky. 685, 279 S.W. 1109 (1926); Gerald V. Universal Agency, Inc., 56 N.J. Super 362, 153 A2d 359 (1959).

decedent was ineligible. The beneficiaries filed a suit against the agent on the ground that the decedent had been assured that the coverage would continue without lapse. In commenting on this claim, one editorial noted:

> It seems like a small jump from that sort of situation to holding an agent liable for the stability and general soundness of the company he recommends—especially if he concealed anything at all unfavorable about the company.[507]

This prognostication is reinforced by the developments in the unauthorized alien insurer area referred to above, the *Knox* case, and the increasing need for professional liability coverage,

> if agents are to be held responsible for the quality of the companies they recommend to buyers, the agents are going to be in a tough spot unless they have some better basis for judgment than now exists.[508]

Thus, it becomes important to make meaningful financial information readily available not only to the policyholders but also to the agents.

h. Implementation

If the proposal requiring an annual report to policyholders has merit, the next question is, how may it be implemented? The preferable approach would be to act through the NAIC. It might adopt a Model Bill, leaving its enactment to the individual states. A simpler approach might be to require an annual report to policyholders, containing the specified information, to be filed as part of the annual statement.[509] However, attempts to reach a consensus on this controversial issue may prove to be very time consuming. An alternative (taken concurrently with efforts to work through the NAIC) would be the adoption of this requirement by commissioners of individual states through the exercise of their discretionary rule making power. If several key states made annual reports to all policyholders mandatory for both the domestic and foreign companies operating in the state, most companies would probably fall within the scope of this requirement.[510] Public relations and competitve considerations may sub-

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[507] The National Underwriter, Jan. 30, 1965, p. 16.

[508] *Ibid.*

[509] There could also be a question in the interrogatories, inquiring whether a copy of the annual report had been mailed to all policyholders and stockholders. Precedent for this requirement may be found in the use of the Stockholders Information Supplement, and the interrogatory regarding conflict of interest. This approach would not require additional legislation on the part of individual state legislatures.

[510] Enforcing this rule to a foreign company's out of state business may raise extra-territorial questions. N.Y. INS. LAW §42(5) provides that no foreign insurer shall be authorized to do business in New York "if it fails to comply substantially" with New York law. New York Superintendent Stern said in another connection, that "[a]dequate insurance regulation by the leading states is no dependable shield for state supervision. Advocates of federal regulation

sequently compel the remaining companies to voluntarily issue such reports.

CONCLUSION

Few persons, either within or without the industry, would claim that the life insurance needs of the general public have been fully met. It is believed that most persons are either uninsured or underinsured. In the absence of a convincing demonstration that existing insurance facilities meet this need, soundly managed and insurance oriented new companies hold the promise of being able to contribute significantly to the economic well-being of this nation's expanding population. Condemnation of the new company phenomenon in its entirety overlooks this fundamental fact.

There are two primary forms of insurance company organization, stock and mutual. The proponents of the mutual form of organization contend that the policyholders receive their insurance coverage at cost, and that all other things being equal, insurance costs more in a stock company because the stockholders share in the company's earnings. The proponents of the stock form of organization point to the safety provided by guaranty capital and, in the case of nonparticipating insurance, to the guaranteed cost feature. In this article we do not intend to debate the advantages and disadvantages of mutual versus stock companies. It is enough to recognize that (a) there is little incentive for a promoter to organize and develop a mutual company, and (b) the laws of some states render it impractical, if not nearly impossible, to do so.[511]

Keeping all these considerations in mind, the important role of stock life insurance companies becomes quite evident. However, inherent in the stock form of organization is a degree of conflict between the interests of the stockholders and those of the policyholders. In resolving this conflict a reasonable balance must be maintained if the company is to become and remain a viable institution. If promoters and investors are inadequately rewarded the company may be unable to attract sufficient capital (initially or thereafter) and competent management. Conversely, inadequate attention to the policyholders' concerns (safety, cost and service) reduces the likelihood of attracting and retaining the number of policyholders essential to a successful operation.

Most of the older and established companies have apparently solved the problem of appropriately balancing the interests of the stockholders and policyholders. On the other hand, many of the problems of new companies seem to stem from overemphasis on the interests of the

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look to the weak spots. Address to the N.Y. Society of Security Analysts, N.Y. City, Nov. 23, 1965, p. 7.

[511] See e.g., N. Y. INS. LAW §196.

stockholders to the detriment of the policyholders. The "hit and run" or transient stock promoters provide the clearest example. Not far behind are those persons who retain their connection with the insurance company and utilize it in a manner devoted to enhancing the value of the securities holdings of the insiders. Further down the line are those new companies which have achieved reasonable balance between the interests of the various groups concerned. These are the companies which hold the most promise of joining the distinguished roster of fine insurance companies.

The authors have attempted to shed some additional light in an area which has been the subject of some "heated" discussion. A variety of sources have been drawn upon in an attempt to present a balanced picture of the new company phenomenon. However, the authors are under no illusion that this discussion will receive enthusiastic response from all segments of the business and appreciate that several readers will be able to point to some ideas with which they strongly disagree.

As time goes on new abuses will be uncovered, new remedies and new ideas will be brought forward. It is likely that there will be other papers on this general subject. The authors will be satisfied if this paper is regarded as a starting point for discussion and if it stimulates industry and regulatory people to give further thought to the industry's problems and their possible solutions. It is also hoped that this discussion will serve as a primer for those who may have limited exposure to this subject but may have to make policy decisions in this area.

Because of the length of this paper it may help the reader to have a brief summary of the problems which have been discussed. In broad categories they include: failure to register with the SEC; unorthodox distribution of securities; misleading statements in the sale of insurance securities; manipulation; state to state movement of promoters; defects in the stock option to agent technique; issuance of cheap stock to promoters; low initial public offering price of insurance securities; the absence of meaningful information from both the policyholders' and investors' viewpoints; a speculative investment climate for insurance securities; the high mortality rate of new companies as related to policyholder safety; policyholder cost; the relationship between stock options to agents and service rendered to the policyholder; conflicts of interest; and the impact of management contracts, holding companies and mergers on the policyholder.

Many remedies have been proposed. Some may be impractical, ineffective or impolitic. Others may possess considerable merit and provide workable solutions to some of the problems. Only time will tell in which category the following suggestions ought to be placed. At this juncture we would divide the proposed remedies into three broad

categories; those deemed inappropriate, those whose anticipated effectiveness is limited, and those which may provide effective workable solutions.

A few remedies seem to be either inappropriate or too stringent in view of other feasible alternatives. These include:

(1) pressure on the reinsurer,
(2) prohibition of stock options to full time agents of stock option companies,
(3) publication of stockholder lists,
(4) limitations on stockholder profits on nonparticipating business,
(5) the "needs" test.

Other suggestions, possessing some merit, but promising either limited or questionable effect, include:

(1) granting participating policyholders in a stock life insurance company the right to vote,
(2) a "seasoning" period before a foreign company can be admitted to the state,
(3) surprise audits.

The proposed solutions which may significantly contribute to the solution of one or more problems include:

(1) notification to the SEC by state insurance and securities departments as to those new insurers which do not appear entitled to claim an exemption from the federal securities registration requirements;
(2) classification of promoters and agents as "underwriters" under the federal securities laws when they, rather than professional underwriters, handle the distribution of the securities;
(3) state prohibition of "captive" underwriters;
(4) limitation of promotional expenses in the organization of new companies;
(5) scrutiny of and prohibition against those aspects of a securities distribution which lend themselves to fraudulent or manipulative practices;
(6) vigorous enforcement of the antifraud and antimanipulative provisions at both the state and federal levels;
(7) exercise of the private right of action for violation of the federal securities laws;
(8) requirement that promoters invest in a substantial portion of a new company's stock offering and limitation on options to them;
(9) limitation on alienability of promoters' stock for a specified period of time;

(10) review of the quality and integrity of the promoters, board of directors and management of a new insurance company;
(11) imposition of a residence requirement for the chief executive officer;
(12) disclosure in the prospectus of information pertaining to the experience of management, the financial condition of companies with which the promoters and management were formerly affiliated, previous attempts to register the stock, potential conflict of interest situations, potential dilution in equity when stock options are granted, probable tax consequences to agent recipients of stock options;
(13) requirement that actuarial and financial projections of new companies be approved in advance;
(14) SEC prohibition against an insurance agent inducing the purchase of his company's stock;
(15) limitations on the issuance of "cheap" stock to promoters;
(16) requirement that initial offering price of insurance stocks exceed stated minimum;
(17) limitations on the use of the adjusted earnings-rule of thumb approach;
(18) publication of information necessary to make a gross premium valuation calculation;
(19) better education of investors and policyholders;
(20) increased minimum capital and surplus requirements;
(21) restriction on complex securities structures;
(22) prohibition against agents writing non surplus business in both stock option and nonstock option companies, or, in the alternative, requiring affirmative disclosure to the policyholder of potential conflicts of interest;
(23) limitation on the alienability of stock acquired under stock options to agents for a specified period of time;
(24) tying stock options to agents to the persistency of the business;
(25) requirement that the stock option price be substantially equivalent to the market price at the time the option is given;
(26) limitation on amount of stock subject to options;
(27) regulation of or prohibition against management contracts;
(28) regulation of or prohibition against the use of holding companies;
(29) study of possible changes in merger statutes;
(30) limitation on stockholder profits on participating business;
(31) requirement that separate gain and loss exhibits for both participating and nonparticipating business be provided;

(32) requirement that an annual report be distributed to each policyholder and to each prospective policyholder, either prior to the time of sale or at the time the policy is delivered.

In attempting to find solutions to the numerous and varied problems generated by new life insurance companies, certain fundamentals should be kept in mind.

(1) The majority of life insurance companies, including new companies, are operated by persons of integrity and competence. Many of the practices described in this article are attributable to a small minority. Nevrtheless, some form of regulatory intervention seems necessary if the interests of policyholders, investors and the life insurance industry as a whole are to be adequately safeguarded. Thus, the ultimate goal is to deal effectively with the irresponsible minority without imposing onerous and excessive burdens on the responsible majority.

(2) A concerted attack on misleading, deceptive and manipulative practices in the securities market at both the state and federal level would be consistent with this goal. Such an approach directly affects only those companies engaged in questionable activities. Being selective, rather than indiscriminate in its application, the reputable companies would not be impeded in their operations. However, inherent in most "after the fact" remedies are certain defects including ascertaining the existence of an abuse (many are never discovered), and obtaining enforcement capabilities (in terms of number and quality of regulatory personnel and in terms of the adequacy of the regulatory budget). Few would claim that this approach alone provide a comprehensive remedy. Nevertheless, vigorous action in this area would remedy some abuses and should deter others.

(3) In this article full and accurate disclosure has been discussed in various contexts as a solution to specific and general problems. It is difficult to argue against the assertion that the public interest requires full disclosure. The antiquated doctrine of *caveat emptor* has given away to an emerging national pattern of full disclosure.

The adoption of the disclosure technique possesses several advantages over other forms of remedial action.

(a) It affords policyholders and investors the opportunity to make an informed choice. Those companies whose practices cannot withstand close scrutiny are screened out of the market by virtue of purchaser choice rather than by legislative or regulatory fiat.

(b) Adequate disclosure enables investors to invest their money in more worthy investment situations. This redounds not only to their benefit but also to the benefit of the economy as a whole.

(c) Both new and established companies ought to welcome the opportunity to convey information to their policyholders and stockholders about their operating results. Only those whose performance compares unfavorably with the industry may be reluctant to do so. Yet, these are probably the cases where disclosure is the most important.

(d) Full disclosure should inspire greater confidence in the investing community which has long been accustomed to it in other lines of business. If disclosure eliminates competition for capital funds from less worthy enterprises, those companies which are worthy of confidence should find it easier to obtain funds.

(e) A legal requirement of full disclosure to stockholders and policyholders would eliminate any competitive disadvantages which might otherwise result if some companies voluntarily disclosed their operating results to both groups while others did not.

(f) Mandatory disclosure would not impinge upon management's decision making functions (except indirectly in those cases where disclosure is an inhibiting factor with respect to some course of conduct.)

(g) A life insurance company in handling other people's money assumes a fiduciary character which becomes particularly important in view of the complexity of the product which it sells. This, coupled with the fact that the life insurance business is "affected with the public interest"[512] may lead to the suggestion that the business should be subject either to rate regulation or to a statutory ceiling on profits as an appropriate means of control. An analogy could be drawn to rate regulation of public utilities and railroads. But in these areas rate regulation may be essential because of the monopolistic nature of the enterprise. Since life insurance companies compete with each other by the hundreds, it should be possible to maintain policyholder costs at a reasonable level by simply increasing the effectiveness of competition, rather than by direct governmental intervention. Full disclosure to policyholders (prospective and otherwise) might serve as a mechanism to bring about effective competition. Thus, full disclosure may render less necessary more stringent and onerous remedial actions.

(h) As the House Committee on Interstate and Foreign Commerce stated in 1934:

> There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the marketplace thrive upon mystery and secrecy. The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security

[512] E.g., Smith v. Penn Mut. Life Ins. Co., 244 Ala. 610, 14 So. 2d 690, 693 (1943); McWilliam v. Central States Life Ins. Co., 137 S.W. 2d 641, 646 (Mo. App. 1940).

> values truth does find relatively quick acceptance in the market.... Delayed, inaccurate, and misleading reports are the tools of the unconscionable market operator and the recreant corporate official who speculates on inside information.[513]

We belive that a comprehensive approach to the problems generated by the new company phenomenon should be built upon the foundation of full and accurate disclosure. Where this, in itself, is insufficient to meet a particular problem, specific additional remedies may be required.

A profound change has taken place in the regulation of the life insurance business. Until recently, the province of the state insurance departments was generally conceived to be limited mainly to the protection of the policyholders. The federal and state securities acts were considered adequate to protect the public against abuses by those issuing and selling life insurance securities. But the enactment of the 1964 amendments to the Securities Exchange Act of 1934 has overturned previous conceptions as to the sharp demarcation between securities and insurance regulation. State insurance departments are now charged with the responsibility of reviewing annual reports to the stockholders and administering both the proxy rules and the insider trading requirements. Functions heretofore considered to be within the primary domain of the securities regulators have been transferred to the state insurance departments.

The vesting of this jurisdiction in the state insurance departments should not be viewed solely as the result of a successful attempt to stave off federal regulation. Rather, it should be viewed as an opportunity for the states to adapt some securities regulatory techniques to the solution of problems affecting the life insurance industry. Furthermore, it has become apparent that excesses in the issuance and sale of securities can adversely affect a company's policyholders. Therefore, joint and cooperative efforts between the SEC and state insurance and securities regulatory officials assume increasing relevance and importance in the continuing effort to effectively regulate the life insurance industry.[514]

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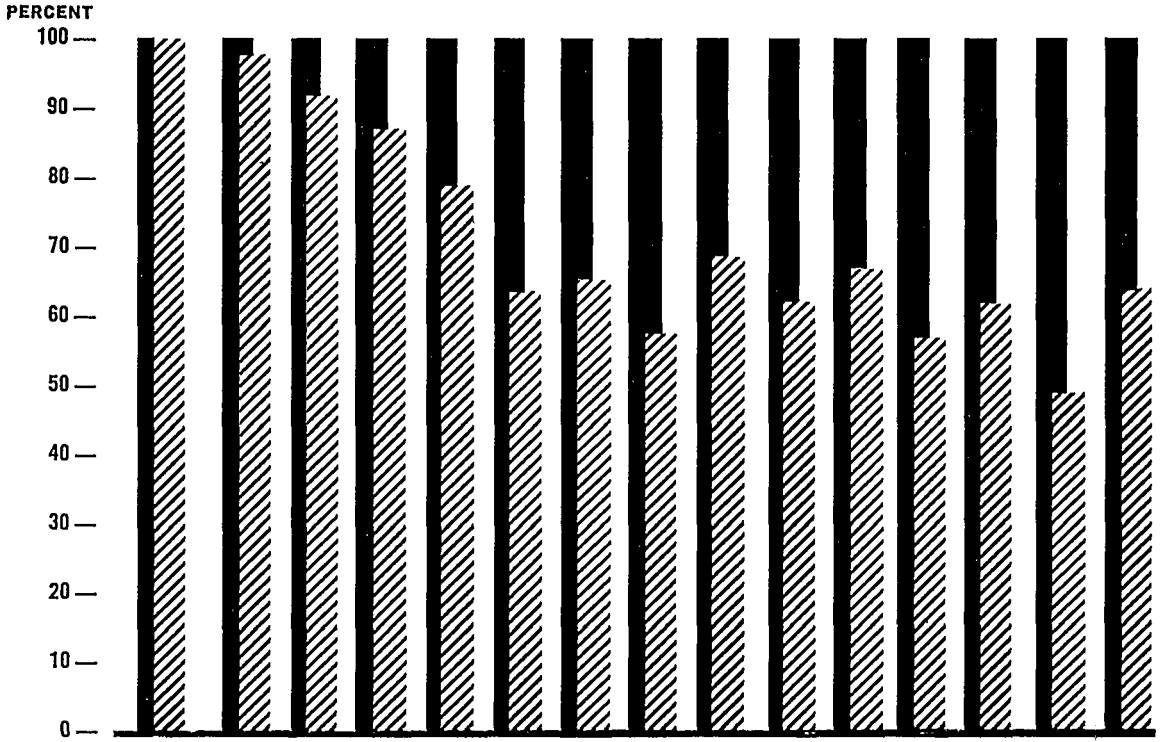
[513] H. REP. No. 1383, 73d Cong., 2d Sess., p. 11 (1934).

[514] In late October 1965, the General Agents Management Conference released its report on new life insurance company formations. This report suggested minimum statutory or regulatory requirements which the NAIC might want to consider. Among the suggested requirements are the following: (1) investigate background of promoters, management and directors of a new company, (2) impose an experience requirement, (3) $1 million minimum capital and surplus requirement, (4) prohibit low price per share, (5) prohibit more than one class of stock, (6) require promoters to purchase a substantial portion of the original issue and prohibit its sale for ten years, (7) plans to issue stock options should need both the commissioner's and the stockholders' approval, (8) promoters should receive no more than 10% of the original issue as compensation for their efforts, (9) original option should not be exercisable for two years, and (10) option price should be no less than 95% of market value at time of issuance.

APPENDIX A

LIFE INSURANCE COMPANIES FORMED AND SURVIVING



←Total Companies Formed 1950 Thru Midyear 1964

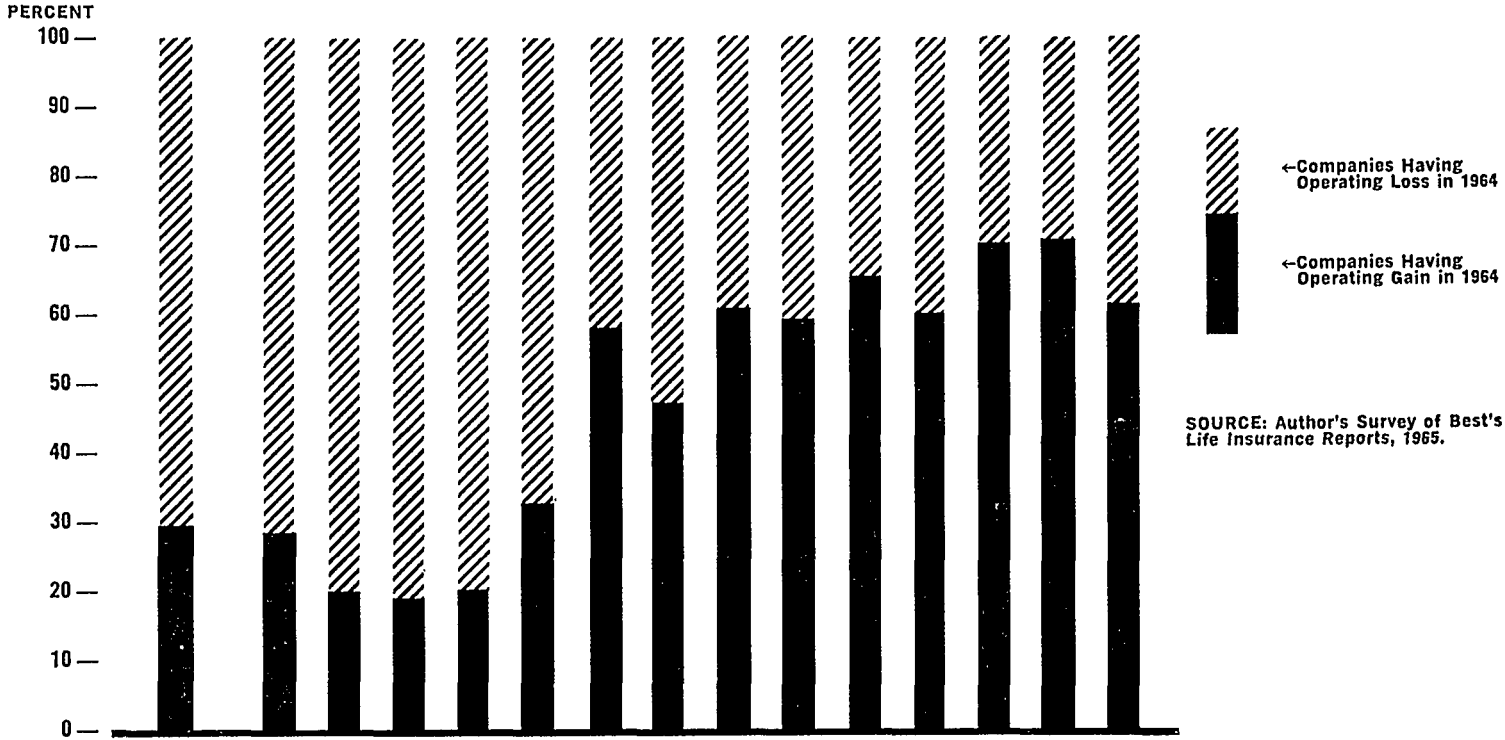
←Companies Surviving Midyear 1964

SOURCE:
Institute of Life Insurance Report of Life Insurance Company Formation and Dissolution 1950 - Midyear 1964 (1964, p. 36).

Years of Experience to Nearest Full Year	Less Than One Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	
Year of Incorporation ..	1964	1963	1962	1961	1960	1959	1958	1957	1956	1955	1954	1953	1952	1951	1950	
No. of Companies Formed	72	90	99	89	95	125	142	120	133	217	115	117	62	50	44	Total Formed: 1,570
No. of Companies Surviving	72	88	92	78	75	79	93	69	90	134	76	65	37	24	27	Total Surviving: 1,099

APPENDIX B

1964 OPERATING RESULTS OF DOMESTIC STOCK LIFE INSURANCE COMPANIES (1)



SOURCE: Author's Survey of Best's Life Insurance Reports, 1965.

Years of Experience Excluding Partial Years..	Less Than One Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	
Year of Incorporation ..	1964 (Jan. 1-June 30)	1963	1962	1961	1960	1959	1958	1957	1956	1955	1954	1953	1952	1951	1950	
No. of Domestic Stock Companies with Operating Results Shown in Best's	23	34	55	43	35	52	39	43	45	75	53	43	23	14	15	Total: 592

(1) Of all legal reserve companies for which operating results are shown in Best's, Hawaiian, Puerto Rican, Canadian, Mutual, and Fraternal Companies have been excluded; Best's does not list financial information for all companies formed from 1950 through midyear 1964 surviving through 1964 (See Appendix A)