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Sponsored Demutualization Comes to Canada

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The Independent Order of Foresters ("Foresters") and Unity Life of Canada ("Unity") recently completed the first sponsored demutualization in Canadian history. Effective April 2, 2008, Unity converted from a mutual life insurance company into a life insurance company with common shares, all of which are owned by Foresters.

This article provides an overview of sponsored demutualization and highlights noteworthy issues that may arise in this type of transaction with a view to providing helpful information to companies that may be contemplating becoming involved in a sponsored demutualization as a converting company or a sponsor. Some of these issues relate to demutualizations generally and others are unique to sponsored demutualizations.

What is a Sponsored Demutualization?

Demutualization is the process by which a mutual insurance company, which is owned and controlled by participating policyholders, converts into an insurance company with common shares, which is owned by its shareholders. Demutualization is, of course, nothing new to Canada. Between 1999 and 2000, the Mutual Life Assurance Company of Canada, the Manufacturers Life Insurance Company, the Canada Life Insurance Company, Industrial-Alliance Life Insurance Company and Sun Life Assurance Company of Canada all demutualized. In those cases, the converted companies became public companies and common shares in the converted companies were issued to eligible policyholders as conversion benefits. Since that initial wave, there have been no demutualizations in Canada. While there had not been any sponsored demutualizations in Canada prior to Unity's demutualization, sponsored demutualizations have taken place in other jurisdictions, including the United States and the United Kingdom.

The process of converting from a federal mutual insurance company into a federal insurance company with common shares is governed by the *Insurance Companies Act* (Canada) (the "Act") and the *Mutual Company (Life Insurance) Conversion Regulations* (the "Regulations") and overseen by the Office of the Superintendent of Financial Institutions ("OSFI"). The key steps in a demutualization are: (1) preparing the Policyholder Guide and Conversion Proposal; (2) mailing notice of the

special meeting of eligible policyholders to eligible policyholders along with the Policyholder Guide, Conversion Proposal and certain other material; (3) holding the special meeting of eligible policyholders at which they vote on the Conversion Proposal (the approval of 2/3 of policyholders present in person or by proxy at the special meeting is required); and (4) the Minister of Finance (the "Minister") approving the Conversion Proposal and issuing Letters Patent of Conversion. Like all demutualizations, a sponsored demutualization involves each of these steps, but has also certain unique aspects.

What is unique about a sponsored demutualization is, as the name suggests, the involvement of a sponsor. In a sponsored demutualization, all of the common shares of the converted company are issued to the sponsor. Consequently, the conversion benefits provided to eligible policyholders in exchange for their ownership rights and voting control must be in a form other than common shares. In Unity's case, conversion benefits were in the form of cash. Upon the issuance to Unity of Letters Patent of Conversion, Foresters subscribed for common shares of Unity and paid a subscription price of $50 million to Unity. Unity used these proceeds to pay cash conversion benefits to eligible policyholders.

The Subscription Agreement — Where the Interests of the Converting Company and the Sponsor Differ

The first step in a sponsored demutualization is to negotiate and settle an agreement between the sponsor and the mutual insurance company pursuant to which the sponsor agrees to subscribe for the common shares of the mutual insurance company upon conversion. This agreement should also address the role of each party in the demutualization process.

A subscription agreement in the context of a sponsored demutualization presents some challenging issues, particularly relating to how the sponsor can protect itself.

In a typical share acquisition transaction, the acquisition agreement contains protections for the purchaser involving representations and warranties, covenants, indemnities and closing conditions.

Generally, if the seller's representations and warranties prove to be untrue following the closing, a purchaser is entitled to be indemnified by the seller for the resulting loss (typically subject to specified limitations). In the case of a sponsored demutualization, there is no seller against whom the purchaser may have recourse — the other party to the agreement is the company that will be acquired and owned by the sponsor. In this sense, a sponsored demutualization is similar to a going-private transaction where the purchaser generally has no rights of indemnification following the closing. However, at least in a going-private transaction the company has been subject to full, true and plain and other continuous disclosure obligations under securities laws.

Notionally, the eligible policyholders are the sellers. Accordingly, one way for the sponsor to protect itself would be to have some of the subscription price held in escrow to satisfy indemnification entitlements that the sponsor may have and not paid to eligible policyholders as conversion benefits until the escrow period had expired. However, the converting company, the eligible policyholders and, probably, OSFI would resist this. There would also be practical issues, including administrative challenges in distributing the balance of the escrow amount when the escrow period ended. In theory, a purchaser could consider some kind of remedy vis-à-vis the senior officers of the company given that they have the most knowledge about the company

and the sponsor is relying on them. However, this is not realistic for several reasons, including that these officers would be extremely resistant to this — they are not the sellers and, notwithstanding that they may want to be part of the sponsor group and have greater growth opportunities; there is not enough in the deal for them to accept this potential liability. Additionally, as some or all of these people will continue to be officers after the closing, the sponsor would likely be hesitant about suing the officers of its new subsidiary.

Similarly, since in a sponsored demutualization the converting company will have announced its intention to demutualize well before the closing date (and will also mail material to eligible policyholders and hold a special meeting of eligible policyholders to vote on the demutualization before the closing date), the converting company will be very concerned about the sponsor's right to withdraw from the transaction. It would be extremely disruptive to business to announce such a fundamental change and have it not proceed. Thus, the converting company will have an interest in resisting closing conditions. The sponsor will have an opposite concern — it will want to ensure that it can withdraw from the transaction in appropriate circumstances (e.g., if representations and warranties are materially untrue at closing or there is a material adverse change), particularly since, as discussed above, the sponsor will probably not be entitled to indemnification following the closing. As public awareness of the sponsored demutualization increases, the downside to the mutual company of the transaction not closing (in terms of reputational loss and market confusion) increases. Accordingly, the parties should consider a mechanism that would allow the sponsor to terminate the transaction before material is mailed to eligible policyholders in certain circumstances (this would be in addition to any right the sponsor has to terminate the agreement if conditions are not satisfied at closing). If, for example, there has been a material adverse change and the sponsor would be entitled to terminate the agreement at closing, it would be preferable if the sponsor exercised its right to terminate the agreement before the mailing to eligible policyholders.

The fact that indemnification and closing conditions may not provide as much protection as a sponsor may want means the sponsor should conduct extensive due diligence before signing the subscription agreement. Ideally, this due diligence would enable the sponsor to assess the risk in the investment and build an appropriate margin into the subscription price.

Another issue that needs to be considered in connection with the subscription agreement is the price to be paid for the common shares. Since a valuation report must be prepared and provided to eligible policyholders to assist them in deciding whether to approve the Conversion Proposal, both the sponsor and the converting company will want the subscription price to be greater than the bottom end of the valuation range (otherwise, there would be an increased risk that policyholders would reject the Conversion Proposal). The subscription agreement, which will presumably address the subscription price, is likely to be settled before the valuation is finalized; therefore, the parties will need to consider how to deal with this issue. One solution is to include a mechanism for adjusting the subscription price based on the valuation in the agreement. For example, the agreement could provide that if the subscription price is lower than the bottom end of the valuation range, the sponsor has the option of increasing the subscription price. Conversely, the agreement could also provide that if the subscription price is above the top end of the valuation range, the sponsor has the option of reducing the subscription price. Another way of addressing this issue is to obtain a preliminary valuation so the parties have some comfort that the agreed upon price is within the valuation range

(although this valuation would later be updated, and may of course change).

Given the unique challenges of a sponsored demutualization, the subscription agreement can entail complex negotiations and demand creative solutions. Accordingly, these matters require consideration at an early stage of a sponsored demutualization.

Finally, the question of whether the converting company should be permitted to accept a superior offer from a third party prior to closing should be considered. The directors of the mutual company owe fiduciary duties to eligible policyholders and will be reluctant to bind themselves to a deal if it is possible that a superior offer may be forthcoming (e.g., once the sponsored demutualization has been announced and it is clear to other potential acquirers that the company is in play). The sponsor will obviously want to protect itself against this, and so a break-fee may be appropriate. This is another aspect in which a sponsored demutualization is similar to a public deal.

Key Documents and Issues Relating to the Demutualization — Where the Interests of the Converting Company and the Sponsor are Aligned

The major document to be prepared in connection with a demutualization is the Policyholder Guide, which includes the converting company's Conversion Proposal. The purpose of these documents is to set out the basis for how the demutualization will occur and to provide eligible policyholders with sufficient information to enable them to make an informed decision on whether to approve the Conversion Proposal.

The Regulations require the Policyholder Guide and Conversion Proposal to set out prescribed information including the following:

- a valuation of the converting company;
- which policyholders are eligible to share in the conversion benefits;
- the form, amount and aggregate value of the conversion benefits to be provided;
- the basis upon which conversion benefits are to be allocated among eligible policyholders;
- the structure and operating rules for the converting company's restructured participating account;
- the advantages and disadvantages of demutualizing;
- the tax treatment accorded the conversion benefits in certain jurisdictions; and
- financial information regarding the converting company.

Other major documents that need to be prepared include the opinion and report of both the Appointed Actuary and the Independent Actuary and an opinion and valuation report from the valuation expert.

The sponsor should lead the process of preparing this material, working with the converting company. Preparing and settling these documents is a significant undertaking and requires significant expertise and work on the part of the sponsor and its legal counsel and the valuation expert and input from the converting company, its legal counsel and actuaries. OSFI will be keenly interested in each of these documents and will review and comment on them.

Eligible Policyholders

One of the key issues facing a mutual company that seeks to demutualize is determining which policyholders are eligible policyholders and are thus

entitled to receive conversion benefits; in other words, deciding who gets the money. As a practical matter, this will need to be settled between the converting company, the sponsor and OSFI. In simple terms, the Regulations provide that eligible policyholders are those entitled to vote. Under the Act, policyholders entitled to vote are holders of participating policies, which are policies "issued" by a company that entitle their holders to participate in the profits of the company. There can be practical issues in determining which policyholders are eligible, including how participating policyholders whose policies were assumed by the converting mutual company in an assumption reinsurance transaction are to be treated; since these policies were assumed, they can only be said to have been "issued" by the company if they have been properly novated. OSFI's view is that only those policies issued by the company and which carry voting rights make the policyholder eligible to receive conversion benefits, as was the case in the sponsored demutualization of Unity.

Regulatory Approvals

Sponsored demutualizations are regulatory intensive transactions. Accordingly, it is important to have a team that has demutualization experience and is very familiar dealing with OSFI. A sponsored demutualization requires two sets of regulatory approvals under the Act – one relating to the demutualization and another relating to the subscription for shares of the converted company.

Under s. 237 of the Act, the approval of the Minister of the Conversion Proposal and the issuance of Letters Patent of Conversion is required. Section 6 of the Regulations requires the authorization of the Superintendent of Financial Institutions to send notice of the special meeting to vote on the Conversion Proposal to eligible policyholders (this notice is accompanied by the Policyholder Guide and the Conversion Proposal). Since the approval of the Superintendent is required to send the Policyholder Guide and Conversion Proposal to eligible policyholders, OSFI will need to sign-off on these documents. These are complex documents relating to numerous areas of concern to OSFI (including capital, actuarial, supervisory and approvals). The process of settling these documents with OSFI is iterative as OSFI seeks to ensure that its concerns are addressed.

The Act also requires several ministerial approvals in relation to the share subscription by the sponsor, namely, the Minister's approval to acquire a significant interest in a class of shares (s. 407(1)) and control of the converted company (s. 407.1) and, where the sponsor is another federally regulated financial institution (as was the case with Foresters), approval for the sponsor to acquire a substantial investment in the converted company (s. 554(5)).

Sponsored demutualizations, like any other acquisition, may also require approval under the Competition Act and the Investment Canada Act.

Relationship between the Sponsor and the Converting Company

Although it is the mutual company that is demutualizing, the sponsor will want to lead the process since, as the future shareholder, it has the greatest risk and, therefore, a strong interest in ensuring that the demutualization is done properly and in a manner that it approves of. If, for example, the demutualization failed to receive regulatory approval or was rejected by eligible policyholders, the sponsor would be deprived of the opportunity to complete the transaction (while having incurred significant transaction costs). If the demutualization and share subscription occurred, any problems or liabilities that arose in the course of the demutualization would indirectly be for the account of the sponsor. Consequently, the sponsor will want to play a key role in leading the demutualization and will want to participate in decision-making. This

involves a high degree of co-operation between the sponsor and the converting company (and their respective advisors). While different parties may of course have different views on a given matter, the interests of the sponsor and the demutualizing company regarding the demutualization should generally be aligned (i.e., both seek to complete the demutualization efficiently and to avoid any problems) and so a consensus-based decision-making process should be possible. That being said, the sponsor will generally want the lead on significant documents. As indicated above, it is important to establish the role of each party at the outset, preferably in the subscription agreement, to ensure a smooth and co-operative process.

In the case of Foresters and Unity, the fact that two parties had input into the demutualization process did not lead to a cumbersome process. This is reflected in the fact that the time between announcement of the intention to demutualize and the effective date of demutualization was approximately eight months, which is far shorter than time taken in any of the prior demutualizations. The fact that Unity's sponsored demutualization was done so efficiently also reflects the fact that it did not have to simultaneously deal with an initial public offering, that OSFI committed significant resources to efficiently reviewing the transaction and working with the parties to finalize material to be sent to policyholders and that all parties had the benefit of looking to the prior demutualizations for guidance.

Final Observations

Effectively competing in the Canadian insurance industry requires growth; without sufficient scale, it is difficult to remain competitive in a consolidating industry. The two ways to grow are through acquisitions and organic growth. Potential sponsors should take note that there is now a Canadian precedent for acquiring a mutual company. For their part, mutual companies should be interested in the possibility of sponsored demutualization as it provides a way of choosing their owner and increasing their access to the capital necessary for both acquisitions and organic growth. While a sponsored demutualization is more involved than an average acquisition (particularly with respect to regulatory considerations) and raises some unique questions, potential sponsors and converting companies alike should be encouraged by the fact that it has been demonstrated that the sponsored demutualization process can be quite efficient.

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