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Mutuals: An Area of Legal Climate Change

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MUTUALS: AN AREA OF LEGAL CLIMATE CHANGE

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ABSTRACT

Underappreciated in its importance and often-misunderstood in its implications, the choice between a company limited by shares and a company organized as a mutual is an important decision in sectors ranging from agriculture to banking to insurance. Adding gravity to this particular decision is the difficulty and enormous cost of corporate metamorphosis between company types later in the company's life. The authors examine the history of the mutual form, its popularity's rise and fall during the twentieth century, and its advantages and disadvantages in today's environment.

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INTRODUCTION

The corporation limited by shares is among the most common corporate form in the Western world,[1] and the one familiar to most attorneys, entrepreneurs, and investors.[2]

In that type of entity, a company is owned and controlled by the shareholders,[3] who are permitted to buy shares from one another, or from others, or from the company itself. The owners of these shares have certain rights,[4] such as the right to receive dividends,[5] the right to vote on certain matters that affect the company,[6] and the right to sell shares as they please to whom they please at a time of their choosing.[7] But other corporate forms exist to serve other purposes.[8]

This Article discusses an ownership model not often discussed at law firms, in law schools, or even among law professors: the type of cooperative known as a "mutually held" company, or a "mutual."[9]

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[1] *See generally* DAVID KERSHAW, COMPANY LAW IN CONTEXT (Oxford University Press, 2d ed. 2012).

[2] As of this writing, the vast majority of corporations in America are either corporations limited by shares or corporations of a limited liability type (LLCs and their progeny) with member stakeholders; mutuals, the form discussed here, represent a minority of corporations and are often unfamiliar to laypeople. Conor Clarke & Wojciech Kopczuk, *Business Income and Business Taxation in the United States Since the 1950s*, 31 TAX POL'Y & ECON. 121, 129 (2017).

[3] *See* 2 WILLIAM MEADE FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 848 (Callaghan & Co. 1917).

[4] *See* Alexander Hamilton Frey, *The Distribution of Corporate Dividends*, 89 U. PA. L. REV. 735, 738 (1941).

[5] *See, e.g.*, Minstar Acquiring Corp. v. AMF Inc., 621 F. Supp. 1252, 1256, 1258 (S.D.N.Y. 1985).

[6] Press Release, SEC, SEC Votes to Seek Public Comment on U.S. Proxy System (Sept 14, 2010), https://www.sec.gov/news/press/2010/2010-122.htm [https://perma.cc/3N78-EK2N] ("The U.S. proxy system governs the way in which investors vote their shares in a public company regardless of whether they attend shareholder meetings.").

[7] For an interesting commentary on how and when such rights are subject to restriction, see Allen v. Biltmore Tissue Corp., 141 N.E.2d 812, 814 (N.Y. 1957). *See generally* UNIFORM LAWS, ANNOTATED, BOOK 6: UNIFORM STOCK TRANSFER ACT § 15 (H. Noyes Greene ed., 1922); *accord.* Costello v. Farrell, 48 N.W.2d 557, 560 (Minn. 1951).

[8] *See* Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 260, 278 (1967).

[9] "Mutual Company" *in* JOHN DOWNES & JORDAN GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS (Barrons 2014) (A mutual company is a "corporation whose ownership and profits are distributed among members in proportion to the amount of business they do with the company.").

The goal of this corporate form is to align the economic interests of the company with the pecuniary interests of its customers and to remove incentives for the company to generate excess profits;[10] this is achieved by returning excess profits to the customers according to their contributions to those profits.[11] Early examples of cooperatives include associations that owned or controlled infrastructure and enjoyed natural monopolies, such as places to store agricultural commodities, docks used for commercial vessels, and so on.[12] The form's pedigree is Commonwealth British, and examples of mutuals exist in America as early as the pre-Constitutional Eighteenth Century.[13] Its dominance as a form for life insurance companies in particular is likely Dutch[14] or British[15] in origin.

It is important to note that all corporate models are templates. In other words, the partnership, the corporation limited by shares, and the mutual are all organizations that groups of mercantile actors could establish from whole cloth of their own accord beginning with a pencil and a blank sheet of parchment.[16]

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[10] Henry Hansmann, *The Organization of Insurance Companies: Mutual Versus Stock*, 1 J.L. ECON. & ORG. 125, 126–27 (1985).

[11] For an exploration of why one might choose one form for a business entity rather than another, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, chs. 1, 5 (1991).

[12] Peter Normark, *A Role for Cooperatives in the Market Economy*, 67 ANNALS PUB. & COOPERATIVE ECON. 429, 430 (1996).

[13] For an interesting case of a mutual undergoing demutualization in an overseas context, see *Old Mutual*, Harvard Business School, Case No. 9-701-026 (Harvard 2001) (on file with the authors). The oldest domestic mutual company was The Friendly Society for Mutual Insurance of Houses Against Fire in Charleston, S.C., founded in 1736; it was inadequately capitalized and diversified to survive a catastrophic loss and hence bankrupted by a wave of claims from The Great Fire of 1740 in its eponymous year. Matthew Mulcahy, *The "Great Fire" of 1740 and the Politics of Disaster Relief in Colonial Charleston*, 99 S.C. HIST. MAG. 135–57 (1998).

[14] The Dutch contemplation of life insurance firms, or levensverzekeringsmaatschappij, often simultaneously contemplates the mutual form as the form of these firms. Regulatory frameworks for life insurance in the Netherlands are also seemingly made with mutual forms in mind, though this form is not mandated by current law. *See, e.g.*, Art. 7:975 BW (Neth.).

[15] *See Old Mutual*, *supra* note 13, at 5 ("The mutual life assurance structure was developed in the U.K. during the eighteenth century and was exported abroad during the nineteenth century.").

[16] *See* Charles Baden-Fuller & Mary S. Morgan, *Business Models as Models*, 43 LONG RANGE PLAN. 156, 159 (2010).

Corporate forms, including those discussed here, are types of enterprises that like-minded entrepreneurs might create if they could bargain with each other indefinitely at zero cost and engineer every minute aspect of the business. Because people do not have this luxury in real life, corporate forms represent useful models with reasonable default rules that parties might arrive at after negotiation; these include provisions related to distribution of dividends, representation and governance, mechanisms for dissolution, and others.[17] In the case of cooperatives and mutuals, we see a template for a company that is engineered with equality of stakeholders and fairness towards consumers as core values.[18]

In the cooperative model, often referred to as a "co-op," a group of people voluntarily agree to form an organization for the purpose of providing a service while, at the same time (through formal or informal governance mechanisms), ensuring the service is operated for the benefit of its users (i.e., customers).[19] Excess profits are distributed to users in a payment that may be characterized in a number of ways, such as dividends or credit.[20] It is important to note that, while customers in other areas of the economy may also be stakeholders (a buyer of a Ford car may or may not own Ford Motor Co. shares), the co-op is unusual in that the transaction itself creates the ownership interest.[21] Co-ops have been

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[17] *See* Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155, 1156, 1158 (1985).

[18] For an explanation of why self-interested, rational economic actors might participate in such a structure, see Johnston Birchall & Richard Simmons, *What Motivates Members to Participate in Co-operative and Mutual Businesses?: A Theoretical Model and Some Findings*, 75 ANNALS PUB. & COOPERATIVE ECON. 465, 470–71 (2004).

[19] Jim Crandall, *Using the Cooperative Business Model as an Economic Development Tool*, CORNHUSKER ECON. (Aug. 28, 2014), https://agecon.unl.edu/cornhusker-economics/2014/using-the-cooperative-business-model-as-an-economic-development-tool [https://perma.cc/S32D-PHLH].

[20] *See* Margaret Lund, *Cooperatives Equity and Ownership: An Introduction,* U. WIS. CTR. COOPERATIVES at 7, 26–27 (Apr. 2013). It is neither particularly important, nor legally dispositive, whether the amount involved is called an "excess," a "dividend," a "benefit," or a "membership payment." Other terms are also used and, in some cases, charges pending in the current period (for instance, insurance premia) are simply adjusted to account for the amount.

[21] *Id.* at 6–7.

formed to serve a diverse set of community needs from residential property management companies to taxicab associations, to burial and funeral societies, to grocery stores.[22] In an era before Airbnb, Uber, Zipcar, and other startups now familiar to us, co-ops of various sorts were the primary structure through which assets or resources would be shared among a group of otherwise unacquainted consumers.[23]

A mutual is a specific kind of cooperative model. While a co-op may simply favor its customers, the favoritism need not be in proportion to the customer's economic activity with the company.[24] For instance, it is not unusual for a co-op feed store in a rural community to only allow members to shop there.[25] A membership might cost $1,000 and come with one share in the company, but this policy might be waived for farmers who spend at least $750 in a transaction, live in the county, and receive two shares; a further rule might specify that only members with even numbers of shares can run for the board of the co-op in annual elections.[26] These kinds of arbitrary rules are especially common in rural cooperative settings where certain characteristics (local ownership or local governance, for instance) are valued more than revenue maximization.[27]

Mutual companies typically have more precise rules than traditional cooperatives; these govern in what proportion and through what mechanisms the customers own and control the company.[28] For instance, in the case of an insurer, the amount of premium (often determined by a customer lifetime value calculation)

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[22] *See* Sonja Novkovic, *Defining the Co-operative Difference*, 37 J. SOCIO-ECONS. 2168, 2175 (2008).

[23] *Id.* at 2174.

[24] University of California Small Farm Program, *What is a Cooperative?* (last updated May 22, 2012), http://sfp.ucdavis.edu/cooperatives/what_is/ [https://perma.cc/2YBQ-UVNN].

[25] *Id.*

[26] *See, e.g.*, Bylaws of Cooperative Corporation Mohawk Harvest Cooperative Market, MOHAWK HARVEST, arts. 2.1–2.2, 5.6, 6.1–6.6, http://www.mohawkharvest.org/assets/Mohawk_Harvest%20_ByLaws.pdf [http://perma.cc/5875-JL6Z].

[27] *See, e.g.*, *id.* at art. 1.2.

[28] This is in part due to the regulatory environment in which mutuals operate. *See*, *e.g.*, Penn Mutual Life Ins. Co. v. Lederer, 252 U.S. 523, 526 (1920)

is often used to determine a mutual customer's "stake" in the company.[29] Whereas ownership and associated rights in stock companies are determined based on the purchase, vesting, or grant of a set of units, ownership and attendant rights in mutual companies are determined by other measures having to do with the consumption of the company's services (e.g., premium paid, grain stored, trades completed, etc.).[30]

Mutual companies are particularly common in the insurance industry and were more common historically in the savings-and-loan industry (pre-1980s) and among community banks (pre-1970s).[31] Many familiar institutions that today take different forms (e.g., stock and commodities exchanges in the US are less likely than ever before to be organized as mutual companies) were once mutually owned, while farm cooperatives, town granaries, rural pharmacies,[32] regional life insurers, and community health systems have been the least interested in transforming into other types of entities.[33]

(referencing Revenue Act of October 3, 1913, c. 16, 38 Stat. 114, 172, 173 as to the way in which premium returned as a dividend might be treated or not treated as income).

[29] "Policy holders are the nominal owners of mutual insurance companies, and mutual insurers that change to ownership by equity investors offer stock to policyholders as part of the process; free or discounted stock cashes out the value of the policyholders' ownership interest in the insurer's ... assets." RLJCS Enters. v. Prof. Benefit Tr., 487 F.3d 494, 495 (7th Cir. 2007) (Easterbrook, C.J.).

[30] *See* Lund, *supra* note 20, at 6–7.

[31] Hansmann, *supra* note 10, at 135.

[32] Pharmacies are a rare case where some argue the incentive alignment produced by the mutual form is both modern and desirable, especially in a time of rising healthcare and pharmaceutical costs. Mutual Drug Company of North Carolina is an example of a pharmaceutical wholesale business owned by its customers. Colorado was among the first states to recognize pharmacies as a valid use for the mutual form, with Schlotz Mutual Drug Co. appearing in the Colorado State Board of Pharmacy directory in 1922; few mutual pharmacies survived the post-WWII consolidation trend in pharmacies and the growth of national brands. *See* COLORADO STATE BOARD OF PHARMACY, TWENTY-NINTH ANNUAL REPORT OF THE STATE BOARD OF PHARMACY OF COLORADO FOR THE YEAR ENDING JULY 2, 1922, ST. BOARD PHARMACY 39 (1922) (showing Schlotz Mutual Drug Co.'s presence in nine locations in and around Denver).

[33] "[D]emutualization [is] [t]he conversion of a mutual society into a corporate entity." PETER MOLES & NICHOLAS TERRY, THE HANDBOOK OF INTERNATIONAL FINANCIAL TERMS 156 (1997).

Above: Tobacco storage for farmers in Viroqua, Wisconsin owned by a traditional mutual company.[34]

Mutual companies are further divided into two types: traditional mutuals and mutual holding companies.[35] Traditional mutuals are designed for high levels of service with optimal incentive alignment between consumers and the company; this comes at the expense of access to capital and strategic or managerial

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[34] *See* U.S. Dep't of Interior, National Park Service, National Register of Historic Places, Registration Form for Northern Wisconsin Co-op Tobacco Pool Warehouse (Sept. 30, 2003); *see also* Kelly Slentz, *Into the Driftless—Growing Tobacco (Part Two)*, ROOTSTOCK (Jan. 5, 2015), https://www.rootstock.coop/cropp-culture/into-the-driftless-growing-tobacco-part-two-3/ [https://perma.cc/3AVP-RR2K]. Photo taken in 2017 by the author, K. Muth.

[35] Fabio R. Chaddad & Michael L. Cook, *Understanding New Cooperative Models: An Ownership-Control Rights Typology*, 26 REV. AGRIC. ECON. 348, 351 (2004).

flexibility.[36] However, members of the mutual are willing to subject the company to these constraints, as they enjoy both the increased performance of the company (in terms of customer service or product innovation, for instance) and economic benefits.[37] Mutual holding companies were designed to have many of the benefits of a traditional mutual while also allowing the company a greater degree of flexibility to engage in mergers-and-acquisitions activity outside the firm's traditional industry or to access capital more easily (and on better terms).[38] When a mutual wishes to abandon the mutual form, it engages in a process known as "demutualization."[39] Demutualization can (confusingly) refer to either the conversion of a traditional mutual into a mutual holding company or the transformation of a traditional mutual into a stock company limited by shares;[40] both transitions are discussed here. In the post-WWII era, demutualization has become something of a trend among traditional mutual companies seeking to restructure themselves away from the traditional mutual model.[41]

This Article examines which changes in the understanding of firm incentives and economics, changes in legislation or regulation,

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[36] It is difficult for a mutual to explore entering a new line of business, for instance, because these customers will upset the balance of revenues that produce the stakeholdership calculation for the mutual. Consider, for instance, a mutually owned health insurer that opens a hospital; while the revenues and stakes in the insurance business are relatively predictable (customers are known, premium amounts are predictable), the mutual stakeholdership implications from hospital revenues are much less obvious and very unpredictable. *See* John Haydon & Robin Swindell, *Special Report—Diversification Challenges and Opportunities for Mutuals,* WILLIS RE, http://www.willisre.com/documents/Media_Room/Publication/Diversification_Challenges_and_Opportunities_for_Mutuals.pdf [https://perma.cc/VLB4-RN4M].

[37] Kimberly M. Inman, Comment, *The Mutual Holding Company: A New Opportunity For Mutual Insurance Companies?,* 42 ST. LOUIS U.L.J. 677, 679 (1998).

[38] *Id.* at 682, 692 n.172.

[39] *See* RLJCS Enters. v. Prof. Benefit Tr., 487 F.3d 494, 495–97 (7th Cir. 2007) (Easterbrook, C.J.).

[40] *See In re* MetLife Demutualization Litig., 495 F. Supp. 2d 310, 311 (E.D.N.Y. 2007); *see also In re* MetLife Demutualization Litig., 322 F. Supp. 2d 267, 268 (E.D.N.Y. 2004); *In re* MetLife Demutualization Litig., 156 F. Supp. 2d 254, 258–60 (E.D.N.Y. 2001) (detailing the underlying fact pattern).

[41] Note, *Developing a Demutualization Acquisition Strategy for Private Equity Firms,* 110 HARV. L. REV. 1904, 1906, 1910 (1997).

and changes in market expectations may have caused the mutual form to fall out of favor during the past several decades.[42]

To better understand which corporations this Article's analysis addresses, see Figure 1 below.

Fig. 1: A Simplified Taxonomy of Companies by Ownership or Control Mechanism[43]

- Companies
  - Corporations
    - Companies Established by Participating Members
      - Traditional LLCs
      - Member-Managed Corporations of Various Types
      - Merchant Companies (Commonwealth)
    - Companies Limited By Shares
      - Companies with Public Offerings
      - Companies with Limited Offerings
        - Companies with Equity Traded on Coupons/Tickets
        - Companies with Equity Traded on Ledger
    - Companies Limited By Guarantee (No Shares or Dividends)
      - Universities
      - Public Charities
      - Municipalities
      - Professional Partnership Forms
      - Companies Established by Royal Charter (Commonwealth)
  - Partnerships
    - Traditional (at Common Law) Partnerships
    - De Facto Partnerships Among Proprietors
    - LLPs and Limited-Liability Forms
      - Professional Partnership Forms
      - Special-Purpose Investment Vehicles
    - Other Partnership Models

[42] Gregory N. Racz, Note, *No Longer Your Piece of the Rock: The Silent Reorganization of Mutual Life Insurance Firms,* 73 N.Y.U. L. REV. 999, 1002–03 (1998).

[43] This is an intentionally incomplete taxonomy. It is not meant to be exhaustive; instead, it is meant to portray the space mutual companies and mutual benefit organizations occupy relative to other types of companies. *See Standard Taxonomies,* SEC, https://www.sec.gov/info/edgar/edgartaxonomies.shtml [https://perma.cc/HCB5-QH95] (listing numerous examples of complete taxonomies).

- Cooperative Models
  - Traditional Cooperatives
    - Customer-Owned Grocery Stores
    - Granaries and Foodstuffs Storage
    - Farm Implement Lend-Lease Associations
  - Mutual Companies
    - Traditional Mutuals
      - Stock Exchanges
      - Commodity Brokerage Associations
      - Savings-and-Loan Associations
      - Insurers of Various Types (Life, Property & Casualty, etc.)
    - Mutual Holding Companies
      - Insurance Companies
      - Banks and Investment Management Companies
      - Diversified Holding Companies of Various Kinds

I. To Mutual or Not To Mutual: That Is the Question

Assuming, *ceteris paribus*, actors prefer structures that are expected to maximize operational efficiency, access to capital, and returns to stakeholders,[44] the mutual form is not an obvious choice when creating an entity. It is less appealing in terms of flexibility than stock companies when considering that the process of demutualization is financially demanding and procedurally nontrivial.[45] The mutual form, with the exception of some industries where special protections exist, is not particularly tax-efficient either, and accounting for small stakes held by a large number of customers can be administratively burdensome.[46]

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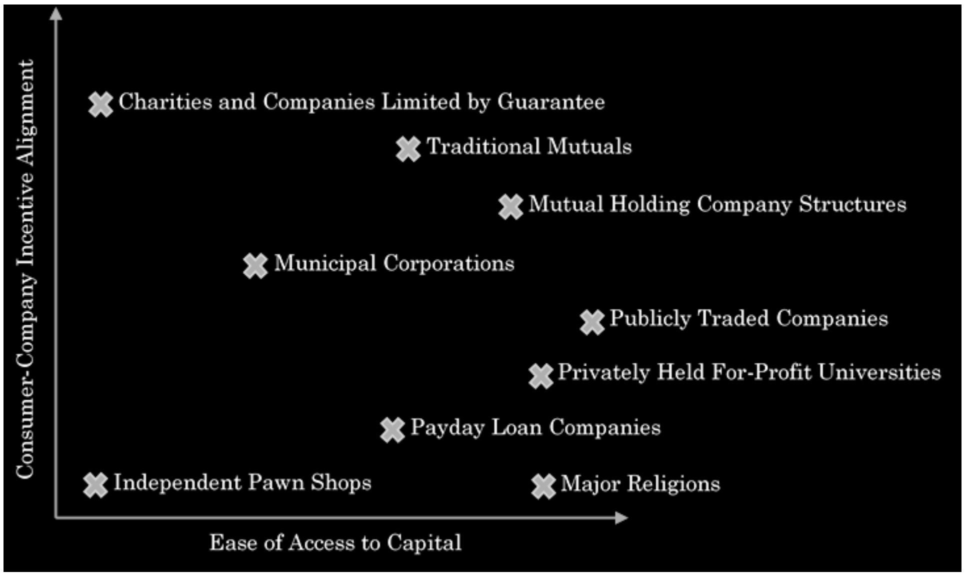
[44] *See generally* Eugene F. Fama & Michael C. Jensen, *Organizational Forms and Investment Decisions*, 14 J. Fin. Econ. 101 (1985).

[45] *See* Racz, *supra* note 42, at 1005.

[46] For an example of how complex these calculations can be, consider the following:

> When the companies demutualized, policyholders [ ] therefore retained their policies and continued to pay the same premiums. They no longer, however, held mutual rights, and therefore could not vote on corporate decisions and had no interest in the surpluses of the new companies. In exchange for the lost

Fig. 2: Comparison of Interest Alignment, Access to Capital Among Example Corporation Types



So why are there any mutuals at all? The popularity of mutuals persisted, with varying levels of enthusiasm, from 1870 to 1970.[47] This was followed by a trend away from mutuals, which can be thought of as the prevailing trend in the period from 1970 to present. Understanding these two opposite phenomena requires understanding how incentives affect corporate structural decisions.[48]

> mutual rights, the companies provided policyholders with the option of receiving stock in the new companies or receiving a cash payment in lieu of stock. When determining how much stock to give policyholders, the companies calculated a "fixed" component to correspond to policyholders' loss of voting rights, and a "variable" component designed to measure "the policyholders' contribution to the surplus of the company." Although the companies used slightly different methods to measure their policyholders' contribution to the company's surplus, all obtained independent actuarial opinions that the methods were "fair and equitable."

Dorrance v. U.S., 877 F. Supp. 2d 827, 830 (D. Ariz. 2012) (internal citations omitted).

[47] *See* Lisa L. Broome & Jerry W. Markham, *Banking and Insurance: Before and After Gramm-Leach-Bliley Act*, 25 J. CORP. L. 723, 727–38 (2000).

[48] *Update on Mutual Holding Companies*, New York Annual Meeting, SOC'Y ACTUARIES, 24 RECORD 1, 10–11 (Oct. 1998).

General America, an insurer, is one example of a company that has followed these major trends. General America began as a stock company and continued that way until 1946, when it became a mutual.[49] In 1997, the company began the demutualization process and eventually (in that same year) became a mutual holding company (GenAmerica Corporation is the intermediate stock holding company that may be familiar to readers of this Article).[50]

More than a matter of fashion, firms gravitate toward certain corporate forms and not others for a variety of reasons and, in this case, these forces are chiefly economic rather than regulatory.[51]

The decision to create a mutual company is a hefty one and normally made with significant planning and discussion of alternatives. Similarly, the conversion from a mutual company to a mutual holding company or traditional stock company should be viewed as a serious decision that is difficult, though not impossible, to reverse.[52] As one contemplates the waves of demutualization experienced in various industries, considering the prevalence of these transformations during historical periods is informative.[53]

In 1975, more than two thirds of savings-and-loan (S&L) assets in the United States were held and managed by cooperative organizations of some type, the vast majority of those having been organized as mutual companies.[54] Between 1975 and 1989, over 750 mutuals converted to stock associations, and by 1990 less than a quarter of S&L assets[55] were held by mutuals.[56] A generation later, the insurance industry is witnessing a similar shift.[57]

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[49] *Id.* at 10.

[50] *Id.* at 11.

[51] *Id.* at 10.

[52] *Id.* at 6–7.

[53] Stephanie O. Crofton, Luis G. Dopico & James A. Wilcox, *Conversions and Capital of Mutual Thrifts: Connections, Problems, and Proposals for Credit Unions*, 30 ESSAYS ECON. & BUS. HIST. 31, 34, 36–37 (2012).

[54] *See* U.S. Census Bureau, U.S. Dep't of Commerce, *Statistical Abstract of the United States*, Table 788 (97th ed. 1976).

[55] Among other things, this was influenced by Federal Home Loan Bank Board rules that protected post-conversion companies from hostile takeover, one of many examples of the legislative or regulatory environment's effect on the desirability of conversion. *See* Crofton, Dopico & Wilcox, *supra* note 53, at 34, 36–37.

[56] *See A Unified Federal Charter for Banks and Saving Associations: A Staff Study,* 10 FDIC: BANKING REV. 1, 11 (1997).

[57] Mutual life insurance juggernauts John Hancock, MetLife, and Prudential demutualized and converted into stock companies with IPOs greater than

The prime rationale (theoretically and practically) for mutual enterprises to demutualize (either becoming a mutual holding company or a stock company) is to gain access to capital on better terms.[58] However, other considerations contribute to the decision to demutualize and the subsequent increased firm performance that often results.[59] For instance, the mutual structure and the mutual form is generally tax-inefficient, which has been considered a constraint to growth.[60] In particular, because mutuals cannot generally merge successfully with traditional stock companies without compromising their structures, mutuals have traditionally only had very limited opportunities to pursue mergers-and-acquisitions transactions and have been even less attractive as targets.[61] This may explain why, in the case of insurers, companies tend to acquire or enter riskier lines of business (or noninsurance businesses) following a demutualization but have difficulty finding allies or partners with whom to make similar maneuvers prior to demutualization.[62]

II. TWO FLAVORS OF MUTUALS

The traditional mutual company and the mutual holding company are similar yet different. While both are very different from a traditional company limited by shares, legal scholars, in-house counsel, and the customers of mutually held companies often underestimate the difference between the two forms.[63]

$1 billion in the 1990s, having substantial market effects on how the life insurance industry is organized. While over half of life insurance policies by policy value were represented by mutual companies in 1986, that portion had decreased to only 15 percent fifteen years later (2001). *See* Lorraine Gorski, *Life in the Public Eye: Newly Demutualized Life Insurers Adjust to the Glare of Shareholder Scrutiny*, BEST'S REV. 22–29 (Nov. 2002).

[58] *See Update on Mutual Holding Companies*, *supra* note 48, at 12.

[59] *See* Gordon O. Pehrson, Jr., David R. Woodward, & James H. Mann, *Demutualization of Insurance Companies: A Comparative Analysis of Issues and Techniques,* 27 TORT & INS. L.J. 709, 736–37 (1991–92).

[60] James M. Carson, Mark D. Forster, & Michael J. McNamara, *Changes in Ownership Structure: Theory and Evidence from Life Insurer Demutualizations*, 21 J. INS. ISSUES 1, 15 (1998).

[61] *See* James A. Smallenberger, *Restructuring Mutual Life Insurance Companies: A Practical Guide Through the Process*, 49 DRAKE L. REV. 513, 519–20 (2001).

[62] *Id.* at 519.

[63] *See generally* Marianne Bonner, *Stock Insurer Versus Mutual Insurer*, BALANCE (Sept. 29, 2017), https://www.thebalance.com/stock-insurer-versus-mutual-insurer-462504 [https://perma.cc/FPB7-4699].

First, it is important to establish that not all states allow, and even fewer encourage, both mutual forms.[64] States like Wisconsin have traditionally had both kinds of mutual companies.[65] The state has an especially rich history of dairy and other agricultural cooperatives using these forms.[66] Meanwhile, states in New England (like Massachusetts) have regulatory frameworks that clearly favor traditional mutuals while allowing, but not favoring, mutual holding company forms.[67] Western states, like California and Montana, also have regulatory postures that allow mutuals, but tend to be less specific as to mutual holding companies.[68] Nebraska is the most restrictive of the states that allow mutual holding companies, mandating that each mutual holding company have only one subsidiary.[69] Other states have special rules regarding demutualization, but these go beyond the scope of this Article.[70]

The advantage of a mutual holding company over a traditional mutual relates to the mutual holding company's access to capital markets and its ability to raise capital from outside parties on better terms.[71] This is accomplished by setting up a holding

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[64] As of this writing, mutual holding company forms, or other forms that behave and are structured like mutual holding companies, are allowed by statute in California, Florida, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Massachusetts, Michigan, Missouri, Minnesota, Montana, North Dakota, Nebraska, Ohio, Oregon, Pennsylvania, Rhode Island, Texas, Vermont, and Wisconsin. The District of Columbia also offers a mutual holding company form. *See Update on Mutual Holding Companies*, *supra* note 48, at 4–5; *see also* Inman, *supra* note 37, at 684, 684 n.68.

[65] *See* Wisconsin Office of the Commissioner of Insurance, *Comparison of Wisconsin and Iowa Insurance Regulation*, WISCONSIN.GOV, https://oci.wi.gov/Documents/Companies/FinCunaCMISCompIAWI-200701.pdf [https://perma.cc/Z29T-6W2P].

[66] *See* Greg Lawless, *Humble Beginnings*, U. WIS. CTR. COOPERATIVES, Bulletin No. 2, at 1–3 (Aug. 2002), http://www.uwcc.wisc.edu/pdf/Bulletins/bulletin_08_02.pdf [https://perma.cc/B6DA-FJVX].

[67] *See* Worcester Bus. J., *Depositor-owned banks in Mass. angling to go public*, WBJOURNAL (Mar. 31, 2014), http://www.wbjournal.com/article/20140331/PRINTEDITION/303279998/depositor-owned-banks-in-mass-angling-to-go-public [https://perma.cc/QP33-FEL2].

[68] *See* CAL. INS. CODE § 4097.01(m)(1)–(3) (1998); *see also* MONT. CODE ANN. § 33-3-216 (2009).

[69] *See Update on Mutual Holding Companies*, *supra* note 48, at 9.

[70] Iowa, for instance, has special rules that distinguish mutuals that will have an initial public offering of a stock company (an "IPO") from ones that will not. *See Update on Mutual Holding Companies*, *supra* note 48, at 4.

[71] *Id.* at 6.

company (as the name suggests) which owns fifty-one percent[72] (or more) of the equity in the operating company. The remainder of the equity can be used as consideration in public or private transactions involving noncustomer investors (these include the sale of equity, the use of equity as collateral in transactions, or the use of equity to purchase other entities).[73] The company can also, of course, simply sell stock to noncustomers either in an IPO or through private auctions.[74] Following the demutualization of American Family Insurance, the company released press materials explaining this new possibility: "While a mutual holding company structure would allow American Family to consider the sale of stock to raise capital, it has no plans do so."[75] By contrast, a traditional mutual cannot raise money in this way because its equity is "locked up" and owned by its customers, whose shares are tied to the consumption of the company's goods and services and who do not have the right to buy or sell their shares[76] (in the case of an agricultural mutual, the farmers transacting in commodities; in the case of an insurance company, the policyholders enjoying the protection of the insurance products the company offers).[77] Central documents of a traditional mutual generally not only avoid granting equity to noncustomers, but also prohibit noncustomer ownership of equity.[78] It is important to recognize that the holding company layer of the mutual holding company is not in the

[72] In some states, 50.1 percent. *Id.* at 3.

[73] *See id.* at 12.

[74] The direct sale of shares is somewhat uncommon in the case of a mutual holding company conversion, but a substantially more common feature of full demutualizations. Sales of voting stock to noncustomers (non-policyholders in the insurance context) after a mutual holding company conversion generally require approval of the mutual holding company board and may also require approval of the relevant regulatory bodies. *See id.* at 3.

[75] *Policyholders approve American Family's Plan for organizational structure change*, AM. FAM. INS. (Dec. 7, 2016), http://newsroom.amfam.com/12-7-16-mhc-conversion-vote/ [https://perma.cc/B3RC-SHBF].

[76] *Capital Markets Special Report*, NAT'L ASS'N. INS. COMMISSIONERS, http://www.naic.org/capital_markets_archive/150428.htm [https://perma.cc/E9UZ-5B2F].

[77] *See* Andrew Beattie, *A Primer for Investing in Agriculture*, INVESTOPEDIA, https://www.investopedia.com/articles/basics/12/agriculture-primer.asp [https://perma.cc/FD5Y-E26X] (showing that a farmer's produce is his commodity); *see also Capital Markets Special Report*, *supra* note 76.

[78] *See* Lund, *supra* note 20, at 4. Note that this does not include past customers. In other words, if Company A is a traditional mutual life insurer and a customer was, for a time but not currently, a customer of Company A, that customer may have

business of its subsidiaries or partner companies; it is a holding company, not an insurance company, for instance.[79]

From a legal perspective, the best way to think about the difference between a traditional mutual and a mutual holding company is to think of a shareholder's bundle of rights.[80] These rights fall into two groups: governance rights and operating rights.[81] The governance rights relate to how the stakeholder gives his or her input on how the company is run, such as voting in board elections. The operating rights pertain to how the stakeholder interacts with the company as a customer, such as access to a grain shed to store excess grain produced on one's farm[82] or ability to force the mutual to pay beneficiaries upon the death of an insured.[83] Figure 3 shows examples of differentiated rights.

Fig. 3: A List[84] of Rights Mutual Stakeholders Enjoy, Segregated into Two Categories

- Governance Rights
  - The right to cast a vote for who is a director of the mutual
  - The right to cast a vote for demutualization
  - The right to cast a vote approving or disapproving of a merger

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remaining equity (and even voting) rights as to the mutual company despite not having a current policyholder relationship to Company A. *See id.* at 31–33.

[79] In many states, including California, Illinois, New York, and others, the holding company layer, though a general-purpose separate entity, is regulated as an insurance company and subject to the inquiries and decisions of insurance regulators. This is not true in all states. Stephen J. Olsen, *Chuck vs. Goliath: Basis of Stock Received in Demutualization of Mutual Insurance Companies*, 9 HOUS. BUS. & TAX J. 360, 366 (2009).

[80] *See Update on Mutual Holding Companies*, *supra* note 48, at 3.

[81] *See id.*

[82] In the case of an agricultural cooperative structured as a mutual. *See* Marc Schneiberg, *Toward an Organizationally Diverse American Capitalism? Cooperative, Mutual, and Local, State-Owned Enterprise*, 34 SEATTLE U.L. REV. 1409, 1423 (2011).

[83] In the case of a mutual life insurance company. *See Update on Mutual Holding Companies*, *supra* note 48, at 3.

[84] This list is incomplete and for illustrative purposes only. In the case of a commodities exchange, for instance, a stakeholder customer might have hundreds of transactional operating rights. *See* Smallenberger, *supra* note 61, at 584–85; *see also Update on Mutual Holding Companies*, *supra* note 48, at 3.

- Operating Rights
    - The right to make a claim as the holder of an insurance policy
    - The right to cause a redemption or pay-on-demand event in a commodity market
    - The right to force a clear-or-fail decision as to a trade on a stock market

In a traditional mutual, the customer stakeholder holds the whole bundle of rights; the governance and operating rights run together.[85] In fact, even if the stakeholder desires it, the stakeholder cannot split the rights and sell them separately or dispose of them as he or she pleases.[86]

Conversely, in the case of a mutual holding company, the rights exist separately. The governance rights sit in the mutual holding company, while the operating rights are enjoyed by the stakeholder.[87] In other words, the mutual holding company holds the majority of votes at all times in its subsidiary operating company, but customers still enjoy the operating rights they would have enjoyed in a traditional mutual relationship, whether the company is an exchange operating company, an insurer, or something else.[88]

III. THE LAW AND ECONOMICS OF THE DECISION

Once a company establishes that the mutual form it desires to take is legally viable in the jurisdiction of its incorporation, the company customarily engages in some form of economic analysis to determine the impact of such a decision.[89]

In the case of a mutual holding company, the economics are often as much related to the time involved as to the money involved. Mutual holding company conversions, now that they are a well-understood transformation and can be planned to a great extent ahead of time, can be completed in as little as nine or ten months.[90] The costs of a mutual holding company transformation

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[85] U.N. CONF. TRADE & DEV., DEVELOPMENT IMPACTS OF COMMODITY EXCHANGES IN EMERGING MARKETS 21, 195 (2009).

[86] *See* Smallenberger, *supra* note 61, at 585.

[87] *Id.* at 580.

[88] *Id.* at 586.

[89] *See generally Update on Mutual Holding Companies*, *supra* note 48.

[90] *Id.* at 5, 12.

are lower not only because of savings on professional fees in the (much) shorter transformation period, but also because the interim accounting is far less complex.[91] In a traditional demutualization, the company must do (in some cases decades of) comprehensive accounting of all revenues, their sources, and the equivalent shareholder positions represented by these contributions to firm revenue.[92] Unsurprisingly, in some cases these records are not well kept or not up-to-date or are kept in a variety of analog and digital forms.

A firm transitioning to the mutual holding company form also needs less spare capital during the transaction period because there is no threat of a hostile takeover (since the mutual holding company always owns a majority of shares) during what would otherwise be a period of transition, cash scarcity, and managerial transition; an ideal time for a takeover to occur.[93] On the other hand, a company undertaking a traditional demutualization and becoming a stock company has all of these disadvantages from an economic perspective; it absorbs tremendous costs during a lengthy transition period and is vulnerable to hostile parties accumulating substantial or even majority (in the case of an IPO, in particular) positions and forcing decisions that are unpopular among management, customers, or both.[94]

The economics of switching between the forms can be intimidating, even for well-managed companies with substantial cash reserves.[95] While some of the costs of a full demutualization are offset by the proceeds of an IPO and some of the costs of the mutual holding company's reorganization are offset by the ability to issue up to forty-nine percent of the voting stock in the enterprise to other parties (through private or public sales), these are downstream sources of capital not available at the time the demutualization begins.[96]

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[91] *Id.* at 5, 13.

[92] *See* Smallenberger, *supra* note 61, at 542.

[93] *See Update on Mutual Holding Companies*, *supra* note 48, at 12.

[94] Glenn S. Daily, *Mutual Life Insurance Company Reorganizations: An Overview*, GLENNDAILY, http://www.glenndaily.com/mhcoverview.htm#Q10 [https://perma.cc/HNP2-HK9W].

[95] *See* Olsen, *supra* note 79, at 368–69.

[96] *See* Smallenberger, *supra* note 61, at 526, 530; *Update on Mutual Holding Companies*, *supra* note 48, at 12.

While some argue the tax savings of changing between structures may represent a substantial savings (the Section 809 advantages of a life insurance mutual becoming a stock company, for instance, or the accounting for tax-exempt interest in that same case),[97] these savings generally are not—at least in any one year—significant when compared to the cost of reorganizing a company of substantial size.[98] In general, only companies with strong affiliations with private equity firms or outside investors will be able to raise the cash for a mutualization, which is essentially a wholesale buyback and looks very much like a take-private transaction.[99] In a mutualization, one of two things happens: a mutual holding company reverts (along with its subsidiaries) to being a traditional mutual, or the equity of a company limited by shares is gathered and surrendered into a container having the mutual form.[100]

Companies with an interest in protecting themselves from takeover and owning operating companies that are not in their traditional industries (an insurance company interested in owning financial services companies, for instance) will choose the mutual holding company structure.[101] The economic incentives to engage in a traditional, full demutualization and become a stock company will be compelling for many reasons: substantial financial rewards to management and increased flexibility in future capital is raised.[102] However, the consequences of the restructuring transaction itself are material and the company may be cash-poor or

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[97] *See* IRS Rev. Rul. 99-3, 1999-3 I.R.B. 313 (affecting interpretation and implications of Internal Rev. Code §§ 808(c)(2), 809).

[98] *See* Daily, *supra* note 94.

[99] Mutualization is dramatically harder to fund than demutualization, as it requires a mop-up of outstanding equity and front-loaded equity buyback costs may be hundreds of millions, or even billions, of dollars. There will often be pressure from stakeholders to not engage in such a buyback-like transaction, unless current holders of equity see little upside to holding the stock and interest rates are predictably and persistently low. *See* Marvin Dumon, *Why Public Companies Go Private*, INVESTOPEDIA, https://www.investopedia.com/articles/stocks/08/public-companies-privatize-go-private.asp [https://perma.cc/9Y9W-L266] (explaining that mutualization requires large amounts of cash which is similar to the type of financing needed for a privatization transaction).

[100] *See* Olsen, *supra* note 79, at 367–68.

[101] *See Update on Mutual Holding Companies*, *supra* note 48, at 12, 13.

[102] *See* Daily, *supra* note 94.

may undergo a managerial transition for several fiscal quarters while being unable to defend itself from takeover during that time.

CONCLUSION

The reasons for demutualization's popularity are relatively clear—capital is substantially more plentiful and affordable for companies with stock company or stock-company-like forms.[103] Companies like mutuals, not-for-profit companies (which by law cannot pay dividends), and other more unusual forms generally are penalized with a cost of capital that exceeds, sometimes by a multiple, that of stock company and mutual holding company peers.[104]

At the same time as this difference in cost of capital is stark as ever, the capital requirements of businesses have increased markedly.[105] Running a large-scale commodities trading floor or stock exchange in the modern age costs billions of dollars per year.[106] A single hailstorm in Colorado can cost a property and casualty insurer a billion dollars.[107] It is not unusual for a hospital system to have an operating budget in the hundreds of millions or billions of dollars.[108] These are all businesses that have, at different points in history, been predominantly organized as mutuals.

We suggest the trend toward demutualization will continue as capital markets will continue to favor entities with stock company or stock-company-like forms that are familiar to analysts, are seen as more transparent and orthodox in their reporting, and

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[103] *See* Smallenberger, *supra* note 61, at 521.

[104] *Id.*

[105] Yalman Onaran, *Capital Requirements*, BLOOMBERG (Jan. 9, 2017, 1:48 PM), https://www.bloomberg.com/quicktake/banks-leverage-capital-ratios [https://perma.cc/CDA7-7SDQ].

[106] *See, e.g.*, *What is the New York Mercantile Exchange (NYMEX)?*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/new-york-mercantile-exchange-nymex/ [https://perma.cc/L4NP-3738].

[107] *May 8 Hail Storm Breaks Records At $1.4 Billion in Damage*, CBS DENVER (May 23, 2017, 11:14 AM), http://denver.cbslocal.com/2017/05/23/hail-storm-may-8-insurance/ [https://perma.cc/9RZK-QMTY].

[108] *See, e.g.*, *A Look at Our Books: Fiscal Year 2015 Capital Budget and Annual Operating Plan*, JOHNS HOPKINS MED., https://www.hopkinsmedicine.org/news/publications/_docs/operating_capital_budget_infographic.pdf [https://perma.cc/4H7W-WJZV].

can move quickly to acquire rivals or expand into adjacent market spaces.[109] We further predict that mutuals will not perish, but will only persist in areas like insurance, farm cooperatives, niche exchanges, and community banking where the demutualization transaction itself is seen as too risky, too costly, or subjects the enterprise to unbearable takeover risk.[110]

[109] *See Update on Mutual Holding Companies*, *supra* note 48, at 2.
[110] *See* Daily, *supra* note 94.