

# STATE SECURITIES LAW ISSUES REGARDING MUTUAL INSURANCE COMPANIES AND MUTUAL HOLDING COMPANIES

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A policyholder of a mutual insurance company has a membership interest in the mutual insurance company as well as contract rights as a policyholder. The membership interest is separate from the contractual rights that arise under the insurance policy. The membership rights of a policyholder include (a) voting on matters submitted to a vote of the policyholders and (b) sharing in the distribution of the residual assets of the mutual insurance company upon liquidation. Members of a mutual holding company have essentially the same voting rights and distribution rights as members of mutual insurance companies. While these rights bear some resemblance to a shareholder's right to vote and to receive the net assets of a business corporation upon dissolution, membership interests and stock are treated differently under the federal and state securities laws. This article will examine the applicability of federal and state securities laws to membership interests in mutual insurance companies and mutual holding companies, focusing primarily on the treatment of membership interests under state securities laws.

## *Federal Securities Laws*

The Securities Act of 1933, as amended (the "1933 Act") regulates the sale of securities in the United States. A security must either be registered with the Securities and Exchange Commission (the "SEC") or qualify for an exemption from registration. Section 2(a)(1) of the 1933 Act defines the term "security" as follows:

... any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, ... any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest thereon or based on the value thereof), ... or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.<sup>1</sup>

While a membership interest in a mutual insurance company or mutual holding company is not specifically referenced in the 1933 Act definition of a "security," it may be considered a "security" if it falls within the category of an "investment contract" or an "instrument commonly known as a 'security'."<sup>2</sup> In *Securities and Exchange Commission v. W.J. Howey Co.*,<sup>3</sup> the Supreme Court first articulated the test that is now used to interpret both of these categories.<sup>4</sup> The four elements of the *Howey* test are (1) an investment (2) in a common enterprise (3) with an expectation of profit (4) to be derived primarily from the efforts of others. In applying the *Howey* test, the Supreme Court has emphasized the need to consider "the substance [and] the economic realities of the transaction."<sup>5</sup>

A membership interest in a mutual insurance company or mutual holding company does not satisfy the first and third elements of the *Howey* test (*i.e.*, an investment that is made with an expectation of profit). The first element of the test requires an "investment." The Supreme Court in *Howey* defined investment to mean "... the placing of capital or laying out of money in a way intended to secure income or profit from its employment." The SEC staff have granted no-action relief in a number of membership interest cases where the analysis focused on the first and third elements of the *Howey* test.<sup>6</sup> As to the first element, the analysis in such no-action letters focused on the fact that a membership interest arises from the purchase of an insurance policy and such policyholders automatically become members of a mutual insurance company or mutual holding company by operation of law, without the payment of cash or other property. In addition, it was argued that any monies paid by policyholders were in the form of premiums paid with the intent of obtaining insurance coverage, and not with any profit-making, profit sharing or

investment intent with respect to membership.

The third element, “expectation of profit,” has been defined by the Supreme Court in *Forman* as (i) capital appreciation resulting from the development of the initial investment or (ii) participation in earnings resulting from the use of investors’ funds. By contrast, however, when a purchaser is motivated by a desire to use or consume the item purchased, the securities laws do not apply. A member of a mutual insurance company or mutual holding company is not motivated by profit, but rather by a desire to purchase an insurance policy resulting in a membership interest falling outside the definition of a “security” for purposes of the 1933 Act under *Forman*. This conclusion is supported by a long line of no-action letters issued by the Division of Corporation Finance of the SEC.<sup>7</sup>

It should be noted that not all transactions involving membership interests in a mutual insurance company or mutual holding company will fall outside of the definition of a “security” under the 1933 Act. For example, as a method of providing initial or additional capitalization, some mutual insurance companies have required their policyholders to make loans to the company that are evidenced by surplus notes. A surplus note is generally considered a “security” under the 1933 Act.<sup>8</sup> Careful analysis therefore should be conducted with respect to each transaction involving membership interests.

### *State Securities Laws*

In addition to application of the 1933 Act, a sale of a security either must be registered or exempt from registration in all applicable states, *i.e.*, states in which members or potential members are offered or sold the securities, or that have sufficient contacts with the sales process. The definition of a “security” under most state securities laws is very similar to the 1933 Act definition, including the category of “investment contracts.”<sup>9</sup> In California, however, a “security” also includes a membership in an incorporated or unincorporated association.<sup>10</sup> Furthermore, Section 821.5 of the California Insurance Code defines a security to include a “certificate evidencing a contribution, certificate of interest or participation, or ... beneficial interest in title to property, contract or earnings.” Statutory definitions of the types set forth in the California statutes require careful analysis of the applicability of state securities laws to mutual insurance company and mutual holding company transactions.

The similarity between the definition of “security” in the 1933 Act and state securities laws, however, does not necessarily mean that there are consistent interpretations regarding the applicability of federal and state securities laws to membership interests in mutual insurance companies and mutual holding companies. As remedial statutes, state securities laws are often liberally construed to afford broad protection to state residents. Accordingly, state policies can differ regarding the perceived need to protect members of mutual insurance companies and mutual holding companies. In the absence of clear statutory or case law, a no-action letter from a state securities administrator often is desirable.

There are significant differences among the states on the application of state securities laws to membership interests under the category of “investment contracts.” Some states interpret “investment contracts” using the *Howey* criteria, other states apply a risk-capital test, and yet other states apply a hybrid *Howey*/risk-capital test.

The risk-capital test was initially applied in *Silver Hills Country Club v. Sobieski*,<sup>11</sup> where promoters attempted to develop a country club by selling club memberships to finance the purchase of property and construct a golf course. The California Supreme Court held that the club memberships were “securities” under the California securities laws on the basis that only because the purchaser of a club membership “risks his capital along with other purchasers can there be any chance that the benefits of club membership will materialize.” As other state courts applied the risk-capital test following the *Silver Hills* case, it became increasingly difficult to clearly articulate the elements of the test.

The Hawaii Supreme Court decision in *State Commissioner of Securities v. Hawaii Market Center, Inc.*<sup>12</sup> introduced the combined *Howey*/risk-capital test, articulating the four elements of this test as follows:

- (a) An offeree furnishes initial value to an offeror; and

- (b) A portion of this initial value is subjected to the risks of the enterprise; and
- (c) The furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise; and
- (d) The offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

In those states that have adopted a risk-capital analysis, the solicitation of organizational capital from prospective policyholders may constitute the offer and sale of a "security" that is subject to the registration requirements of the state securities statute, absent an exemption. Under the *Silver Hills* and *Hawaii Market Center* decisions, the provision of value in the form of a non-interest bearing certificate of contribution that is subject to the risks of the enterprise may constitute a "security" even though the only benefit which the prospective policyholder seeks to derive is the ability to purchase insurance.<sup>13</sup>

In several states, the risk-capital test has been supplemented by statutory modifications to the definition of a "security." For example, in Washington, a "security" includes any "investment of money or other consideration in the risk-capital of a venture with the expectation of some valuable benefit to the investor where the investor does not receive the right to exercise practical and actual control over the managerial decisions of the venture."<sup>14</sup> Under this formulation, Washington adopts the basic elements of the combined *Howey*/risk-capital test.

If a membership interest in a mutual insurance company or mutual holding company is characterized as a "security" under state securities statutes, one or more exemptions from state registration requirements may be available.

- (a) **Exempt Insurance Company Securities.** Many state statutes exempt the securities issued by insurance companies. For example, Washington exempts "any security issued by and representing an interest in or a debt of, or insured or guaranteed by, any insurance company authorized to do business in this state."<sup>15</sup> While this exemption broadly exempts membership interests in mutual insurance companies, it does not appear to encompass mutual holding companies.

- (b) **Exempt Transactions with Existing Security Holders of Issuer.** State securities statutes often exempt transactions with existing security holders of the issuer. For example, Idaho<sup>16</sup> exempts:

"any transaction pursuant to an offer to existing security holders of the issuer ... if (i) no commission or other remuneration other than a standby commission is paid or given directly or indirectly for soliciting any security holder in this state, or (ii) the issuer files a notice in the form prescribed by the director not less than thirty (30) days before making the offer."<sup>17</sup>

This type of exemption encompasses transactions by mutual insurance companies and mutual holding companies with their existing members, such as transactions designed to increase the company's capital and surplus. Because there are no "existing security holders," this exemption does not apply, however, to efforts to raise organizational capital from prospective policyholders (*i.e.*, the type of transaction which is most susceptible to the risk-capital test). Furthermore, some states limit the exemption to "pro rata offerings" to existing security holders, which is problematical in the context of mutual insurance companies and mutual holding companies.<sup>18</sup>

- (c) **Transactions by Mutual or Cooperative Associations.** Some state securities statutes exempt transactions by mutual or cooperative associations, which may encompass mutual insurance companies or mutual holding companies.<sup>19</sup> Since there are a wide variety of cooperative economic arrangements, this type of transaction exemption needs to be reviewed carefully with respect to its scope and requirements.
- (d) **Membership Interests in Mutual Holding Companies.** Some state statutes specifically provide that membership interests in mutual holding companies are not "securities."<sup>20</sup> State insurance codes in the

domiciliary state and securities laws should be reviewed to determine whether the state Securities Commissioner and/or the state Insurance Commissioner have jurisdiction with respect to any issuance of membership interests. In some circumstances, dual, single or no jurisdiction may exist.

### *Conclusion*

Generally accepted interpretations of the federal securities laws provide relative assurance that a membership interest is not a “security” because members intend to purchase insurance rather than make an investment. In terms of the economic realities test articulated by the Supreme Court in *Forman, supra*, there is no expectation of profit, but only a desire to use or consume the insurance that is purchased.

In contrast, mutual insurance companies and mutual holding companies face a high degree of uncertainty regarding the applicability of registration requirements under state securities laws with respect to transactions with members and prospective members. Compliance with a patchwork of state law “security” definitions, exemptive frameworks and registration requirements can be costly and burdensome to mutual insurance companies. In general, mutual insurance companies lack access to capital, which places them at distinct competitive disadvantage to insurers that can access the capital markets. The primary source of financing for many mutual insurance companies and mutual holding companies is their members. Yet, this capital source can be limited by the burdensome and inconsistent requirements of state securities laws.

As a matter of public policy, there is minimal benefit in subjecting mutual insurance companies and mutual holding companies to regulation under state securities laws. State securities laws are ill suited to regulate mutual companies and their membership interests where there is no investment and merely the motivation to purchase insurance. The members’ relationship with the mutual insurance company or mutual holding company is subject to pervasive regulation by state insurance departments, and the additional regulatory framework imposed by state securities laws adds no meaningful protection to members. The “mutual concept” can be an effective mechanism for meeting the insurance needs of policyholders by aligning policyholder interests with insurer objectives. The elimination of inconsistent and burdensome state securities law requirements on mutual insurance companies and mutual holding companies would mitigate one of many structural impediments and competitive disadvantages facing mutual companies.

### *Endnotes*

1. Section 3(a)(10) of the Securities Exchange Act of 1934 (the “1934 Act”) sets forth a definition of “security” which closely parallels the 1933 Act definition. This article will not discuss the 1934 Act.
2. Section 3(a)(8) of the 1933 Act exempts traditional insurance products and annuity contracts from the registration requirements of the 1933 Act. Some insurance products, however, may be deemed securities if they possess some of the hallmark characteristics of a security, including substantial investment risk and an expectation of profit *Securities and Exchange Commission v. Variable Annuity Life Insurance Company of America*, 359 US 65, 71-73 (1959). This article will not address membership interests in mutual insurance companies and in mutual holding companies that arise from insurance products that are considered securities.
3. *See Securities and Exchange Commission v. W.J. Howey Co.*, 328 US 293 (1946).
4. *See, Landreth Timber Co. v. Landreth*, 471 US 681 (1985) (concluding that, although *Howey* addressed only investment contracts, the *Howey* test applied to instruments commonly known as a security).
5. *See United Housing Foundation, Inc. v. Forman*, 421 US 837, 852 (1975).
6. *See* endnote 7.
7. *See* the following mutual insurance company no-action letters: *Attorney’s Liability Assurance Society, Ltd.*, SEC

No-Action Letter (February 12, 1979); *Global Van Lines, Inc.*, SEC No-Action Letter (October 2, 1979); *Medical Device Mutual Assurance and Reinsurance Co., Ltd.*, SEC No-Action Letter (August 31, 1979); *Norcal Bowling Proprietors Mutual Insurance Co., Ltd.*, SEC No-Action Letter (December 5, 1983); *Podiatric Assurance Co.*, SEC No-Action Letter (February 19, 1985); *Medmarc Insurance Company Risk Retention Group*, SEC No-Action Letter (October 2, 1987); *National Transport Assurance Alliance, Inc.*, SEC No-Action Letter (February 22, 1989); *Construction Trade Purchasing Group, Inc. and Construction Trades Insurance Company*, SEC No-Action Letter (October 1, 1993).

See the following mutual holding company no-action letters: *The Woodmen Accident and Life Company* (December 28, 1999); *National Travelers Life Company* (December 29, 1999); *The Baltimore Life Insurance Company* (December 11, 2000); *Milwaukee Mutual Insurance Company* (January 30, 2003).

8. See, *Reves v. Ernst & Young*, 494 US 56 (1990). If the note is a “security” under the 1933 Act, the issuance of the note will be subject to the registration requirements of the 1933 Act unless an exemption from registration is otherwise available. A discussion of registration exemptions under the 1933 Act is beyond the scope of this article.
9. State securities laws usually exclude from the definition of a “security” insurance or endowment policies or annuity contracts under which an insurance company promises to pay money in a lump sum or periodically for life or some other specified period. A membership interest in a mutual insurance company or mutual holding company does not fall within these exclusions.
10. Cal. Corp. Code §25109.
11. See *Silver Hills Country Club v. Sobieski*, 55 Cal 2d 811 (1961).
12. See *State Commissioner of Securities v. Hawaii Market Center, Inc.*, 52 Haw 642 (1971).
13. The analysis differs if the organizational financing is evidenced by surplus notes that accrue interest. In that case, the interest feature constitutes an “expectation of profit,” and the surplus notes could be found to be securities by virtue of their characterization as “notes” or “investment contracts.”
14. RCW §21.20.005(12)(a).
15. RCW §21.20.310(5).
16. Idaho Code §30-1435(1)(k).
17. See also Alaska Statutes §45.55.900(b)(7) and Revised Code of Washington §21.20.320(11).
18. See, Oregon Revised Statutes §59.035(3).
19. For example, see Revised Code of Washington §21.20.320(16), which exempts transactions by a mutual or cooperative association meeting certain requirements.
20. See, Oregon Revised Statutes §732.620(6) and Idaho Code §41-3821(6). 