

**FORC QUARTERLY JOURNAL
OF
INSURANCE LAW AND REGULATION**

Fall 1998 September 12, 1998 Vol. X, Edition III

THE AVAILABILITY OF DISSENTERS' RIGHTS IN MUTUAL INSURANCE COMPANY TRANSACTIONS,

James M. Kennedy, Esq.
(503) 226-6555

A policyholder of a mutual insurance company has a membership interest as well as contract rights as an insured. A policyholder's membership interest consists of rights that arise under the charter documents of the mutual insurance company and under applicable law. In general, such membership rights 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, after provision for liabilities, upon liquidation. The membership interest is separate from the policyholder's contractual rights arising under the insurance policy.

Although both shareholders and mutual policyholders have voting rights and the right to receive the net assets of the corporation upon dissolution, there are fundamental differences between share ownership and a policyholder's membership interest. Many state insurance codes apply provisions of state corporation statutes to mutual insurance companies, but unfortunately the differences between ownership of shares and a membership interest are not always clearly delineated. Although all state corporation statutes afford dissenting shareholders the right to withdraw their investments at a fair value in certain types of transactions, the law in many states is confused with respect to whether a nonconsenting policyholder of a mutual insurance company has the same right as a shareholder to assert dissenters' rights. In some cases, because of the absence or paucity of mutual insurer transactions, the applicable statutory frameworks have not been interpreted by state insurance departments. This article will examine whether statutory dissenters' rights provisions should be available to the policyholders of a mutual insurance company and will review Oregon's recent legislation which clarified the nonapplicability of dissenters' rights in mutual insurer transactions.

Dissenters' Rights Statutes

All state corporation statutes recognize dissenters' rights for specified types of corporate transactions.¹ Under these statutory provisions, a shareholder who does not vote in favor of the transaction and who follows applicable procedures is entitled to receive the fair value of his or her shares, plus accrued interest. Although corporation statutes differ in the types of corporate transactions that give rise to dissenters' rights, a significant majority of the statutes in the United States conform to the Revised Model Business Corporation Act ("RMBCA") in extending dissenters' rights to a shareholder in any of the following transactions:²

1. A merger to which the corporation is a party, if the shareholder is entitled to vote on the merger;
2. A share exchange to which the corporation is a party as the corporation whose shares will be acquired, if the shareholder is entitled to vote on the share exchange;
3. A sale or exchange of all or substantially all of the assets of the corporation other than in the usual and regular course of its business if the shareholder is entitled to vote on the sale or exchange, but excluding (a) a sale pursuant to a court order and (b) a sale for cash pursuant to a plan of liquidation by which all or substantially all of the net sales proceeds will be distributed to the shareholders within one year after the date of sale; or
4. An amendment of the articles of incorporation that materially and adversely affects the rights with respect to a dissenter's shares because it (a) alters or abolishes a preferential right of the shares, (b) creates, alters or abolishes a right of redemption, (c) alters or abolishes a pre-emptive right to acquire shares or other securities, (d) excludes or limits the right to vote on any matter or to cumulate votes, or (e) reduces the number of shares owned by the shareholder to a fraction of a share if the fractional share so created is to be acquired for cash.

shareholder to a fraction of a share if the fractional share so created is to be acquired for cash.

In general, dissenters' rights may be asserted only by shareholders who are entitled to vote on the transaction. Many corporation statutes have so-called "market provisions" that deny dissenters' rights if the shares are listed on a national securities exchange or quoted on NASDAQ as a National Market System issue.³ Consistent with the RMBCA framework, many statutes provide that the exercise of dissenters' rights constitutes a shareholder's exclusive remedy unless the transaction is "unlawful" or "fraudulent."⁴ This exclusivity principle recognizes that the holders of a majority of the shares should be permitted to proceed with a significant corporate change, even if a minority considers it disadvantageous, because the minority has the statutory right to withdraw their investments and obtain the fair value of their shares.

The RMBCA requires that if proposed corporate action creating dissenters' rights is submitted to a vote at a shareholders' meeting, the meeting notice must state that the shareholders are or may be entitled to assert dissenters' rights and must include a copy of the statutory provisions.⁵ The RMBCA commentary states that notice of the existence of dissenters' rights is required because "many shareholders have no idea what rights of dissent they may have or how to assert them."⁶ The RMBCA is silent on the effect of failing to give the required notice, but it would appear that dissenters' rights are not lost until the notice is given and the dissenting shareholder has a reasonable opportunity to respond.⁷

The RMBCA emphasizes private settlement rather than judicial resolution. If proposed corporate action creating dissenters' rights is submitted to a vote at a shareholders' meeting, a shareholder who wishes to assert dissenters' rights (a) must deliver to the corporation before the vote is taken a written notice of intent to demand payment for his or her shares if the proposed corporate action is consummated and (b) must not vote his or her shares in favor of the proposed action.⁸ Within ten days after the corporate action giving rise to dissenters' rights, the RMBCA requires that the corporation deliver a written notice to all dissenting shareholders that states when and where a payment demand must be sent and supplies a form for the purpose of demanding payment.⁹ After receiving a payment demand, the corporation must pay the amount that the corporation estimates to be the fair value of the shares, plus interest.¹⁰ If the corporation fails to pay the dissenting shareholder within 60 days after the date set for demanding payment or if the dissenting shareholder disagrees with the corporation's estimate, the dissenting shareholder may demand payment of the shareholder's estimate of the fair value of the shares and accrued interest.¹¹ The corporation then must either commence a judicial appraisal proceeding within 60 days or pay the dissenting shareholder's estimate of fair value and accrued interest.¹² If a judicial proceeding is timely initiated by the corporation, the court will enter judgment on the amount, if any, by which the court finds the "fair value" of the shares, plus interest, exceeds the amount paid by the corporation.¹³

Dissenters' rights statutes have been criticized for their inconsistency. Not only are there significant differences among the statutes in the types of transactions that trigger dissenters' rights, but also corporations are given considerable flexibility in structuring transactions to circumvent the availability of dissenters' rights. For example, triangular mergers are commonly used to avoid giving dissenters' rights to the shareholders of the acquiring corporation (i.e., Acquiring Corp intending to acquire Target Corp sets up a subsidiary, Acquisition Sub, and then has Acquisition Sub merge with Target Corp; dissenters' rights apply to Acquiring Corp as the shareholder of Acquisition Sub, but not to the shareholders of Acquiring Corp). Further inconsistency exists as a result of the absence of dissenters' rights for nonconsenting shareholders of the acquiring corporation in a share exchange or purchase of assets even though their interests may be materially affected by the transaction. From the corporation's perspective, the existence of dissenters' rights can create significant uncertainty with respect to a proposed transaction. For example, a corporation entertaining a merger transaction does not know what proportion of its shareholders will demand payment for their shares or what value ultimately will be placed on the shares.¹⁴

Should Policyholders Be Entitled to Dissenters' Rights?

It is the author's opinion that a mutual policyholder should not be entitled to assert dissenters' rights because the policyholder's membership interest fundamentally differs from the interest of a shareholder in a business corporation. A shareholder's interest in a business corporation revolves around the shareholder's economic rights. Share ownership entitles the shareholder to participate in future corporate income streams and to protect this economic interest with voting rights. A mutual policyholder, on the other hand, does not make the same type of investment as a shareholder. A policyholder seeks financial protection through the insurance policy, and the policyholder's expectations under the insurance policy are protected as a contract and by regulation. A mutual policyholder's decision to buy insurance is not motivated by a desire to purchase an ownership interest in the residual assets of the mutual insurance company. Moreover, the premiums paid by the mutual policyholder for the insurance policy are not based on the policyholder's interest in the surplus of the mutual insurance company.

insurance company.

Membership rights exist for mutual policyholders not by reason of an investment, but because there are no other stakeholders having a higher claim to the voting rights or the residual assets of the mutual insurance company. In contrast to stock which is freely transferable, membership rights are nontransferable apart from the underlying insurance policy. Furthermore, membership rights are extinguished, without compensation, by the lapse, termination or maturation of the insurance policy. A policyholder's membership interest is tethered to an existing policy of insurance and ends when the insurance policy lapses, terminates or matures. Because membership rights exist by default, the law affords no protection to the extinguishment of a membership interest under these circumstances, and the policyholder is not entitled to be compensated for the policy's contributions to surplus or any appreciation in the mutual insurer's residual assets during the period of the policyholder's membership interest.¹⁵

Nevertheless, a policyholder's membership interest can become a valuable economic right upon the occurrence of a significant transaction. A policyholder who happens to be in the right place at the right time can receive considerable compensation (in the form of stock, cash, policy credits or benefits or other compensation) for relinquishing the policyholder's membership interest. This result, however, is fortuitous. Moreover, it is often highly inequitable because the policyholder may have contributed little to surplus and is really benefitting from the contributions to surplus of former policyholders.¹⁶

One rationale for dissenters' rights in the corporate context is to provide an alternative to shareholders who otherwise would be compelled to accept a fundamental change in the risk of their investments.¹⁷ Because a shareholder purchases stock essentially to participate in future corporate income streams, a higher risk may influence the risk-return calculus of the shareholder. In circumstances where the majority chooses to accept a material change in risk, nonconsenting shareholders are given the opportunity to withdraw their investments at a fair value.

The change of risk rationale, however, is not tenable in a mutual policyholder context because the policyholder's claim on future residual assets is too illusory for the reasons described above. Furthermore, a mutual insurance company transaction will be subject to regulatory approval which is designed to protect against risks that might jeopardize the financial stability of the insurer or prejudice the interests of the policyholders. In transactions in which the policyholders will achieve liquidity (e.g., a cash merger or a conversion of the mutual insurer to a stock insurer), the regulatory approval process is designed to assure that consideration is allocated with respect to membership interests in a fair and equitable manner. Where liquidity is received in the transaction, there is generally no continuing economic interest in non-policy income streams that needs to be protected.

Dissenters' rights also exist in the corporate context to protect against self-dealing or overreaching by the majority. The availability of dissenters' rights protects minority shareholders against the tyranny of the majority who might profit at the minority's expense.¹⁸ This benefit, however, is largely immaterial in mutual insurance company transactions that are subject to regulatory approval. Whether or not the transaction involves liquidity, the regulator is empowered to achieve fairness and equity for and among the policyholders.

Under the RMBCA, a shareholder is not entitled to dissenters' rights with respect to a sale of all or substantially all of the corporation's assets if the sale is pursuant to a court order.¹⁹ The RMBCA commentary explains that court-ordered sales are excluded because "court review and approval ensures that an independent appraisal of the fairness of the transaction has been made."²⁰ By analogy, policyholders should not be afforded dissenters' rights because regulatory approval assures an independent assessment of the fairness of the mutual insurance company transaction.

Oregon Legislation

Like many other state insurance codes, the Oregon Insurance Code applies provisions of the Oregon Business Corporation Act to domestic stock, mutual and reciprocal insurers.²¹ The application of corporate statutory provisions to Oregon insurers, however, must satisfy two requirements. First, certain enumerated statutory sections are not applied to insurers (e.g., filing provisions with the Secretary of State's office, organizational provisions, corporate names, shareholder list for meetings, election of directors by certain classes of shareholders, provisions relating to mergers, share exchanges and sales of assets, foreign corporation provisions, annual reports and other miscellaneous provisions). The enumeration of these inapposite statutory provisions is not deemed to be exclusive. Second, the remaining corporate statutory provisions are applicable to

statutory provisions is not deemed to be exclusive. Second, the remaining corporate statutory provisions are applicable to domestic insurers "except where inconsistent with the express provisions of the Insurance Code...."²² The Oregon Insurance Code goes on to state that references in corporate statutory provisions to "shareholders" will be deemed references to "policyholders" in the case of mutual insurance companies and "subscribers" in the case of reciprocal insurers.²³

Prior to 1997, the application of corporate statutory provisions to Oregon mutual insurers created the possibility that dissenters' rights could be asserted by nonconsenting policyholders in a merger involving a mutual insurance company for the following reasons:

1. The dissenters' rights provisions of the Oregon Business Corporation Act²⁴, which closely follow the RMBCA, are not included in the enumerated corporate statutes that expressly do not apply to domestic insurance companies.
2. It is difficult to argue that dissenters' rights are "inconsistent with the express provisions of the Insurance Code" if they are not referenced in the Oregon Insurance Code.
3. By substituting the word "policyholder" for "shareholder" as mandated by the Oregon Insurance Code, the corporation statute, if read literally, triggers dissenters' rights in a merger in which policyholder approval is required.

A tortured interpretation of the interplay between the corporation statute and the Oregon Insurance Code also created the possibility that a conversion transaction (i.e., the conversion of a mutual insurer to a stock insurer), which is not structured as a merger, could trigger dissenters' rights if the conversion was characterized as the "consummation of a plan of share exchange to which the corporation is a party as the corporation whose shares will be acquired, if the shareholder is entitled to vote on the plan."²⁵ That is, the exchange of a "membership interest" for shares perhaps might be characterized as a "share exchange" if references to "shareholders" are considered references to "policyholders." This construction, however, suffers from the fact that the Oregon Insurance Code does not deem references to "shares" to be references to "membership interests." Furthermore, the share exchange provisions contemplate two corporations (i.e., an acquired corporation and an acquiring corporation), and that circumstance exists in a conversion transaction only if the transaction involves the simultaneous formation of a holding company.

Similar issues arose regarding the sale of substantially all of a mutual insurer's assets. However, it could be argued that a bulk reinsurance transaction did not trigger dissenters' rights as a result of Oregon's adoption of a version of the NAIC Model Assumption Reinsurance Act. In view of a policyholder's option to accept or reject the transfer of the policyholder's insurance policy,²⁶ dissenters' rights provided little additional protection for the policyholder and therefore could be found to be "inconsistent with the express provisions of the Insurance Code."

The uncertain status of dissenters' rights in Oregon mutual insurance company transactions ended in 1997 with Oregon's enactment of Senate Bill 92 (1997 Oregon Laws, chapter 771), a comprehensive bill addressing the procedures for conversion of domestic mutual insurance companies and authorizing domestic mutual insurance companies to merge with stock and reciprocal insurers. As a result of the enactment of Senate Bill 92, ORS 732.630(1) now provides that dissenters' rights are not available to policyholders in a conversion transaction. In addition, the existing Oregon holding company provisions were augmented by ORS 732.529(5), which provides:

Dissenters' rights provided in ORS 60.551 to 60.594 are not available to any member of a domestic mutual insurer or any subscriber of a domestic reciprocal insurer with respect to an activity that is subject to the approval of the director.²⁷

By linking the elimination of dissenters' rights to transactions subject to regulatory approval, the opportunity still exists for a dissenting policyholder to assert dissenters' rights in a transaction that is not subject to regulatory approval. This prospect is highly unlikely, however, because all mergers, conversions, and bulk reinsurance transactions are subject to the approval of the director and the types of amendments to the articles of incorporation that would trigger dissenters' rights (i.e., the elimination of pre-emptive rights or creation of fractional shares) are not germane to mutual insurers. Nevertheless, dissenters' rights could exist in a mutual insurance company transaction if the articles of incorporation or by-laws of the

dissenters' rights could exist in a mutual insurance company transaction if the articles of incorporation or by-laws of the mutual insurer or a resolution of the board of directors expressly provides that the policyholders are entitled to assert dissenters' rights.²⁸

Availability of Dissenters' Rights in Other States

Among U.S. jurisdictions, there is varying treatment of dissenters' rights in mutual insurance company transactions. Because space precludes an overview of all statutes, several regulatory frameworks will be analyzed below.

Like Oregon, many states apply their corporation statutes to domestic mutual insurance companies. For example, Alabama, Alaska, Arizona, Georgia, Idaho, Kentucky, Montana and South Dakota apply their respective corporation statutes to domestic mutual insurance companies "except where in conflict of the express provisions of [the state insurance code] and the reasonable implications of the provisions."²⁹ Because the insurance codes in these states do not negate dissenters' rights, an issue exists whether the dissenters' rights statute conflicts with the "reasonable implications" of the insurance code. Because it can be argued that dissenters' rights should not be afforded to mutual policyholders as a matter of policy, there is perhaps a conflict with the "reasonable implications" of the insurance code. Nevertheless, the existence of dissenters' rights remains unclear under these statutory frameworks. It appears that a stronger argument for the availability of dissenters' rights can be made under insurance codes of Florida, Hawaii, New Hampshire and Washington where the "reasonable implications" language is omitted and the sole test of applicability is based on whether the dissenters' rights statutes are inconsistent with the provisions of the insurance code.³⁰

Many of the foregoing statutes extend "applicable" state corporation laws to mutual insurance companies.³¹ Use of the word "applicable" becomes somewhat circular because none of the state corporation statutes would apply but for a state insurance code provision establishing linkage to the corporation statute. The RMBCA provides that "a corporation engaging in a business that is subject to regulation under another statute of this state may incorporate under this Act only if permitted by, and subject to all limitations of, the other statute."³² According to the RMBCA commentary, this provision extends to insurance companies and contemplates that state insurance codes may "refer back to or incorporate by reference portions of the general business corporation statute."³³ Nevertheless, even though the Michigan insurance code made insurers "subject to all of the provisions of law in relation to corporations so far as they are applicable,"¹²³⁴ the Michigan Court of Appeals in *Wiltse v. Standard Accident Insurance Company*, 135 NW2d 592 (Mich. Ct. App. 1965), held that dissenters' rights were not available to shareholders of Michigan stock insurance companies based on the express exclusion of insurance companies from the Michigan corporation statute.

In several states, the applicability of dissenters' rights in mutual insurance company transactions may be buttressed by statutory comparisons between the rights of policyholders and shareholders. For example, the insurance codes of Arizona, Hawaii, Idaho, Kentucky and Washington provide in substantially similar language that "with respect to the management, records and affairs of the insurer, a member of a domestic mutual insurer shall have the same character of rights and relationship as a stockholder has toward a domestic stock insurer."³⁵ Broadly reading the term "affairs" as used in these statutes, it would appear that a dissenting policyholder would have the same entitlement to dissenters' rights that a dissenting shareholder would have in a stock insurance company transaction.

Many state insurance codes also incorporate applicable provisions of state corporation statutes with respect to mergers or consolidations. For example, the insurance codes of Alabama, Alaska, Arizona, Florida, Georgia, Idaho, Montana, and South Dakota provide that a domestic mutual insurance company may merge or consolidate with another insurer (in some states limited to another mutual insurer) under the "applicable procedures" or "procedures" of the corporation statute.³⁶ The use of the word "procedures" in these statutes may be intended only to reference procedures for mergers rather than substantive provisions regarding the rights of shareholders in connection with such mergers. However, it can be argued that the requirements for notifying shareholders of the existence of dissenters' rights as well as the manner for settling a shareholder's payment demand are merger procedures. Perhaps, a stronger claim of entitlement to dissenters' rights might be made by policyholders under slightly different insurance code provisions that provide for mergers involving a mutual insurer under the "general laws" (Hawaii and Washington) or "statutes" (Kentucky) governing mergers of business corporations.³⁷

The foregoing examples, as well as Oregon's prior statute, illustrate considerable statutory imprecision regarding a policyholder's entitlement to dissenters' rights in mutual insurance company transactions. Some states have opted to eliminate this uncertainty. For example, Delaware and Maine expressly disallow the assertion of dissenters' rights by mutual policyholders.³⁸ Arkansas eliminates dissenters' rights for policyholders by not applying its corporate statutes to mutual

policyholders.³⁸ Arkansas eliminates dissenters' rights for policyholders by not applying its corporate statutes to mutual insurance companies and by expressly extending dissenters' rights only to nonconsenting shareholders.³⁹ Kansas, on the other hand, authorizes any policyholder who is a resident of Kansas and who voted against a merger or consolidation of a mutual insurance company to petition the court in the county in which the policyholder resides to appoint three qualified persons to appraise the policyholder's interest in the mutual insurance company, which then becomes the obligation of the surviving insurer.⁴⁰ In Illinois and Indiana, if at least five percent of the policyholders vote against the merger of a mutual insurance company, they may request another hearing on the merger, at which the Insurance Commissioner may revoke the prior regulatory approval upon a finding that the interests of the policyholders are not properly protected.⁴¹

Conclusion

The imprecise linkage between the Oregon Insurance Code and the Oregon Business Corporation Act induced the Oregon Legislature to clarify that policyholders are not entitled to assert dissenters' rights in mutual insurance company transactions that are subject to regulatory approval. With the encouragement of Oregon's mutual insurers and the Oregon Insurance Division, the Oregon Legislature acted because the uncertainty fostered by Oregon's prior statutory framework imposed a significant burden on mutual insurers. The uncertainty that existed in Oregon's statutory framework is present in the statutes of other states. In a period of increasing consolidation, conversion, and change, mutual insurance companies should be provided with a clear regulatory or statutory response to whether dissenters' rights are available to mutual policyholders.

Endnotes

The author wishes to thank Robert C. Art (Professor of Law, Willamette University), Lewis C. Littlehales (Oregon Department of Consumer and Business Services) and Rhonda W. Kennedy (Kennedy & Kennedy LLP) for their assistance in reviewing this article.

1. Rev. Mod. Bus. Corp. Act Annotated (3rd ed.) 13.02, Annotation; Cavitch, Business Organizations with Tax Planning, 112.01[2]. Dissenters' rights have sometimes been characterized as "appraisal rights" in recognition of the right to a judicial appraisal.

2. Rev. Mod. Bus. Corp. Act 13.02.

3. Rev. Mod. Bus. Corp. Act 13.02, Annotation.

4. *Id.*

5. Rev. Mod. Bus. Corp. Act 13.20.

6. Rev. Mod. Bus. Corp. Act 13.20, Official Comment.

7. See *Meadows v. Bicrodyne Corp.*, 573 F. Supp. 1030 (N.D. Cal. 1983), holding that properly addressed notices deposited in the mail satisfied the corporation's statutory notice obligation, and the failure of shareholders to receive the notice did not excuse the noncompliance of the shareholders with the statutory dissenters' rights requirements; *Hilligoss v. Associated Companies, Inc.*, 589 NE 2d 1202 (Ind. App. 1 Dist. 1992), holding that the corporation gave timely notice of a special shareholders' meeting at which a vote on a plan of merger was taken, and thus the plan of merger was not invalid.

