



State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

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Date	<u>11/7/08</u>
Case	<u>08-C31480</u>
Ins. Comm.	

DATE: November 5, 2008

TO: Guenther Ruch
Roger A. Peterson
Peter Medley

FROM: Tim Vande Hey

SUBJECT: In the Matter of the Conversion of Sheboygan Falls Mutual Insurance Company (SFMIC or Sheboygan Falls) to a Wisconsin Stock Insurance Corporation under the provisions of s. 611.76 (4m), Wis. Stat. (Case No. 08-C31480)

This memorandum is regarding the proposed Conversion of Sheboygan Falls Mutual Insurance Company, a Wisconsin domiciled property and casualty mutual insurance company, to a Wisconsin domiciled stock insurer.

History of SFMIC

Sheboygan Falls was organized in May 1899 as The Village of Sheboygan Falls Mutual Fire Insurance Company and commenced business on August 18, 1899. In 1934, the present name of the company was adopted. The Manitowoc Mutual Fire Insurance Company and the Mutual Fire Insurance Company of Bloomington were merged into the company on July 1, 1962, and November 1, 1966, respectively. Additionally, the business of German Mutual Fire Insurance Company was reinsured as of November 1, 1964.

Sheboygan Falls is a mutual fire and casualty insurer, which is licensed and writes business only in Wisconsin. The company currently operates on a mutual plan, issuing nonassessable policies, with business acquired through 671 independent agents in 146 agencies.

The major products marketed by the company include homeowner's, private passenger auto liability, auto physical damage, and commercial multiple peril. The company also writes worker's compensation. The company's certificate of authority was amended to include auto as of May 1990. In 2007, the company wrote direct premium of \$9,238,231 with a mix of business that is 91% personal and 9% commercial. Sheboygan Falls reported statutory surplus of \$7,144,246 as of December 31, 2007 and \$6,138,409 as of June 30, 2008 (both surplus amounts reduced by the \$3.5 million surplus note held by Donegal Mutual Insurance Company).

On December 27, 2006, the company entered into an affiliation agreement with Donegal Mutual Insurance Company (Donegal Mutual), a property and casualty insurer headquartered in Marietta, Pennsylvania.

The Office of the Commissioner of Insurance (OCI) approved the affiliation agreement in June 2007. Donegal Mutual acquired control of the company on June 7, 2007, when six of the ten board of directors' positions of the company were allocated to current directors of Donegal Mutual through amendments to its bylaws. Also on that date, Donegal Mutual purchased a \$3,500,000 contribution note issued by the company.

OBSERVATIONS BASED ON REVIEW OF DOCUMENTS AND ON INQUIRIES

Resolutions by SFMIC Board and the Demutualization Committee

In October 2007, SFMIC retained the law firm of Foley & Lardner LLP to serve as independent company counsel in connection with the analysis of a conversion.

Also in October 2007, the Board of Directors of SFMIC established a Demutualization Committee to analyze the potential conversion. The committee is composed entirely of the non-Donegal board members to avoid any appearance of a conflict of interest. The Demutualization Committee retained the law firm of Parrett & O'Connell, LLP to serve as the Demutualization Committee's independent counsel in connection with the Committee's analysis of a Conversion. The Demutualization Committee is comprised of four members including: James H. Fasse, Kenneth F. Maurer, Thomas A. Scribner and Lee F. Wilcox.

On April 21, 2008, the Demutualization Committee unanimously determined that the demutualization is in the best interest of the policyholders of SFMIC. Factors considered included: the fact that such policyholders will receive cash consideration in an amount determined by an independent expert Appraisal Committee appointed by OCI to be equal to the value of their equitable shares in SFMIC, shares which are otherwise illiquid; simultaneously as the policyholders of SFMIC will be insured by a much stronger company that maintains higher levels of technology, has access to public sources of capital and can achieve a significantly lower expense ratio, that will give SFMIC a more assured future. Based upon their assessment, the committee recommended that the board of directors of SFMIC proceed with a proposed Conversion.

On April 30, 2008, the Board of SFMIC adopted resolutions setting forth its determination that the conversion of SFMIC would be in the best interests of the company and its policyholders, and filed those resolutions with OCI pursuant to s. 611.76(3)(a), Wis. Stat.

On October 14, 2008, the Demutualization Committee, after review of the drafts of the conversion plan (Plan), the Articles and the Bylaws changes, the valuation determination of the OCI Appraisal Committee, the valuation material and fairness opinion prepared by StoneRidge Advisors, LLC., and consideration of such other matters as it considered relevant under the circumstances recommended that the Board of Directors of SFMIC approve and adopt the Plan.

On October 14, 2008, the Board of SFMIC approved the Plan and the changes to the Articles and Bylaws, and authorized the President and Secretary of SFMIC, each acting singly, to take all such actions, necessary or convenient to consummate the matters contemplated by the Plan and the Filings required.

Appraisal Committee Valuation

On June 16, 2008, the OCI appointed Randy Blumer, Brian Hogan and Richard Keintz to serve as members of the Appraisal Committee pursuant to s. 611.76 (3) (c), Wisconsin Statutes. The Appraisal Committee was chartered with the responsibility to determine the value of Sheboygan Falls in its proposed conversion.

On July 31, 2008, StoneRidge Advisors, LLC. (StoneRidge) was engaged to assist the Appraisal Committee in the valuation of Sheboygan Falls.

As part of the due diligence and review of the value of Sheboygan Falls the following industry-accepted valuation methodologies were considered:

- Public Market Multiples – this methodology considered current trading multiples of publicly traded companies
- M&A Transaction Multiples – this methodology reviewed valuation multiples paid for similar insurance company transactions
- Sum of Parts – this methodology attempts to approximate the fair market value of the entity including estimated value of marketing organization and the book of business
- Discounted Cash Flow – this methodology attempts to approximate the value of the company based on the discounted future cash flows expected to be generated by the operations of the entity

Due to several factors, including the relative size of SFMIC in relation to other industry comparables noted above and that the geographic service area is limited to the State of Wisconsin, the Appraisal Committee and StoneRidge concurred that, in this specific case, the Sum of Parts methodology most closely followed the intent of the Wisconsin demutualization statutes. This analysis implied a valuation based on currently available data of between \$6.3 and \$7.0 million (or approximately 1.03x to 1.14x 6/30/08 surplus)

On September 30, 2008, at the Appraisal Committee's final open meeting, a unanimous vote has established SFMIC's value at \$7,200,000 as of the date of conversion. This selection is above the indicated range of the Sum of Parts methodology, or any other methodology, contained in StoneRidge's report, dated September 30, 2008. In establishing this value, the Appraisal Committee took into consideration the unusual business environment of the 2008 year that has negatively impacted the values of certain assets, the material decline in surplus that the Company experienced during the first six months of 2008 from claims activity above the long term average experience of the Company, the liquidity strength of the Company that offsets any need for sale of assets at their current market value, potential tax benefits the Company may have that were not reflected in its reported June 30, 2008 surplus, and the potential increase in surplus through the latter half of 2008 through recovery of asset values and profits from operations.

On October 13, 2008, StoneRidge issued a fairness opinion stating that based upon and subject to the areas identified in its opinion letter, the aggregate consideration to be received by the policyholders of SFMIC, as a group, in exchange for their aggregate ownership interests, is fair, from a financial point of view, to such policyholders, as a group.

A copy of the Appraisal Committee's findings and deliberations as well as StoneRidge's final report dated September 30, 2008, and its fairness opinion, dated October 13, 2008 are available on the OCI website and maintained in OCI's legal file.

Examination of SFMIC

Pursuant to s. 611.76 (3) (b), Wis. Stat., an examination of SFMIC was performed. The previous examination of SFMIC was conducted in 2006 as of December 31, 2005. The examination covered the intervening period ended December 31, 2007, and included a review of such 2008 transactions as deemed necessary to complete the examination.

Surplus during the examination period has increased from \$5,943,185 at year-end 2005 to \$10,644,246 at year-end 2007. The surplus increase over the past two years is primarily due to \$3,500,000 cash received from the contribution note issued to Donegal Mutual during 2007. The company has had both underwriting gains and investment gains in each of the past five years, though the underwriting gain of \$57,833 was much lower than previous years due to a large catastrophe loss in June 2007.

The examination report has three recommendations – regarding investment reporting, affiliated balances and reinsurance agreement disclosure. There were no adjustments to surplus as a result of the examination. A reclassification of \$7,552 was made from Other Expenses to Payable to Parent, Subsidiaries and Affiliates. Neither the examination recommendations nor the relatively small reclassification were deemed a significant violation of the law that would be a basis for withholding approval of the demutualization plans of SFMIC.

Conversion Expenses

Pursuant to 611.76 (10), Wis. Stat. all expenses of the conversion are borne by SFMIC. I have tracked the expenses since the Plan was filed. Total conversion expenses are expected to be \$421,571.72. Of this total amount, \$65,917.95 has already been recognized in the valuation amount determined by the Appraisal Committee and is therefore not included in the reduction of the distribution to policyholders if the conversion goes forward. Of the remaining \$355,653.77 to be recognized, \$254,974.03 has already been expensed by October 27, 2008, and \$100,679.74 is estimated to have to be recognized to complete the transaction. OCI has been provided invoices in order to authorize payments and will continue to authorize reasonable payments if the transaction proceeds.

Policyholder Notices

Public Hearing

A public hearing to be held before OCI has been scheduled on Friday, November 7, 2008 at 1:00 p.m., Central Standard Time, at the offices of OCI, 125 South Webster Street, Madison, Wisconsin, to consider the fairness and equity of the terms of SFMIC Plan. Notice has been properly served by the Company.

Policyholder Special Meeting

A notice of a special meeting of the voting policyholders has been properly communicated to policyholders along with the notice of hearing described above. The special meeting is scheduled for Monday, November 17, 2008 at 10:00 a.m., Central Standard Time, at the offices of SFMIC, 511 Water Street, Sheboygan Falls, Wisconsin, to consider the approval of the Plan contingent upon approval by OCI following the November 7, 2008 hearing.

Eligible Policyholders

On October 9, 2008, SFMIC provided its methodology for determining the identity of two lists of eligible policyholders.

The first list consisted of eligible voting policyholders as of April 30, 2008 (the date on which SFMIC's Board of Directors adopted the conversion resolution provided for in s. 611.76 (2), Wis. Stat.). It includes the universe of active policyholders with an in-force policy on April 30, 2008 and includes approximately 11,500 policyholders. It was prepared from the data base maintained on SFMIC information systems. This list of eligible voting policyholders was determined to be reasonable and comply with s. 611.76 (4) (8), Wis. Stat.

The second policyholder list consists of policyholders who paid premium to SFMIC during the "five-year look back period" from May 1, 2003 through April 30, 2008, both dates inclusive. It consists of approximately 22,000 policyholders and also was prepared from the data base maintained on SFMIC information systems. This list of policyholders eligible to receive an equitable share of SFMIC value was determined to be reasonable and comply with s. 611.76 (4)(b), Wis. Stat.

Both lists are retained by SFMIC and will be made available to the OCI upon request.

Proof of Mailing

An affidavit of mailing dated October 20, 2008, confirmed that the notice of the public hearing, the policyholder information statement, a copy of the Plan, the proposed amended articles and bylaws of Sheboygan Falls Insurance Company, the fairness opinion of StoneRidge Advisors LLC., the notice of the policyholder special meeting, and a proxy form were sent to 11,490 policyholders.

Contribution Note and Ancillary Agreements

A Contribution Note Purchase Agreement was negotiated between SFMIC and Donegal Mutual as of December 27, 2006, and it was approved by OCI in June 2007. The \$3,500,000 note was issued by SFMIC on June 7, 2007, for cash equal to the principal amount. The Note is issued at a floating rate of interest with a minimum of 5.50% and a maximum of 8.0%. OCI has approved quarterly payments of interest on the Note. As part of the previously discussed affiliation with Donegal Mutual, Donegal Mutual purchased a \$3,500,000 contribution note from SFMIC.

Effective June 5, 2007, Donegal Mutual and SFMIC also entered into several ancillary agreements, including: (1) a Services Agreement to assist SFMIC in reducing its expense ratio by providing "back office" assistance with underwriting, claims, reinsurance, investments, human resources, and financial reporting operations; (2) a Technology License Agreement whereby Donegal Mutual granted SFMIC the right to use certain computer systems and applications licensed to or developed by Donegal Mutual, including systems that provide automated underwriting and policy issuance; and (3) a Retrocessional Reinsurance Agreement, whereby SFMIC ceded 100% of its in-force business to Donegal Mutual, which immediately retroceded all such business to SFMIC, in order to assist SFMIC in obtaining an improved A.M. Best rating (from B++ to A).

Both the Services Agreement and the Technology License Agreement will terminate on December 31, 2010, unless SFMIC provides a written notice of extension to Donegal Mutual not later than 90 days prior to the expiration of the current term, upon which these Agreements may be extended for an additional year. SFMIC has the option to extend the termination of this Agreement for five successive years to December 31, 2015. Additionally, these Agreements may be terminated if the company's Plan to convert to a stock fire and casualty company is denied or the policyholders of the company fail to approve the Plan to convert to a stock fire and casualty company. These later terminations would only become effective 18 months after the date on which written notice of termination is given to SFMIC by Donegal Mutual. The Retrocessional Reinsurance Agreement may be terminated by either party upon 12 months written notice.

On October 14, a Form D, Prior Notice of Transaction, was filed with OCI. The filing indicates that Donegal Group, Inc. (DGI) intends to purchase the Contribution Note from Donegal Mutual; and after SFMIC converts into Sheboygan Falls Insurance Company (SFIC), DGI will exchange the Contribution Note with SFIC for shares of SFIC common stock (whereupon the Contribution Note will be deemed cancelled). It is the intent of SFMIC that the Effective Date be 12:01 a.m., Central Standard Time, on December 1, 2008. Additionally, on the Effective Date, DGI will make an additional capital contribution to SFIC so that SFIC's surplus shall be no less than \$10,500,000 after distribution of cash equal to the net value of the Company to the eligible policyholders.

Summary of Observations

1. The conversion resolutions meet the requirements of s. 611.76(2), Wis. Stat.

2. The application was prepared in a format that complies with s. 611.76 (3) (a), Wis. Stat. The information contained in the filing and its supplements are sufficient to the transaction.
3. Pursuant to s. 611.76 (3) (b), Wis. Stat., an examination of SFMIC was performed to determine its financial condition and whether it is operated in accordance with the law. This examination was officially adopted on October 20, 2008. No adverse findings affecting the conversion to proceed were discovered.
4. An Appraisal Committee, consisting of at least 3 qualified and disinterested persons with differing kinds of training were appointed to determine the value of the Company as of the date of conversion in compliance with s. 611.76 (3) (c), Wis. Stat. The Appraisal Committee considered the assets and liabilities of the corporation, adjusting liabilities to take account of the amounts of any reserves in excess of or below realistic estimates, the value of the marketing organization, the value of goodwill, the going-concern value, and other factors having influence on the value of the corporation.
5. A Plan of Conversion was prepared in a format compliant with s. 611.76 (4m), Wis. Stat. The Plan of Conversion and other informational documents sufficient to explain the Plan appears to have been properly mailed to the policyholders entitled to vote at the Special Policyholder Meeting.
6. The Plan of Conversion, proposed Articles and Bylaws of the new stock corporation, projection of the anticipated financial situation of the new corporation for five years after the conversion, and all other information required pursuant to s. 611.76(5), Wis. Stat. or requested by OCI was submitted for approval.
7. A public hearing has been scheduled for November 7, 2008 at 1:00 pm and properly noticed to policyholders pursuant to s. 611.76 (6), Wis. Stat.
8. Conversion expenses have been properly filed and approved by the OCI pursuant to s. 611.76 (10), Wis. Stat. The OCI noted no compensation of any kind other than regular salaries to existing personnel, in connection with the proposed conversion, other than for clerical and mailing expenses, except that OCI approved for reasonable rates of printing cost and legal and other professional fees for services actually rendered. All expenses of the conversion, including the expenses incurred by the OCI appear to have been borne by SFMIC.

RECOMMENDATION

The Plan of Conversion was filed pursuant to s. 611.76 (4m), Wis. Stat., on the basis that grounds exist under s. 645.41 (2) or (4), Wis. Stats., for rehabilitation or liquidation of a domestic mutual insurer, or are reasonably expected to exist within one year, unless the board of directors adopts a plan of conversion as submitted for consideration by the Commissioner. The basis provided for the filing under the aforementioned statute included, but is not limited to, the antiquated technology systems of SFMIC, the difficulty of accessing capital to address needs to remain competitive in the marketplace, the lack of a clear line of succession for senior management, the significant efficiencies and assistance that the affiliation with Donegal Mutual has provided to address these potential challenges and Donegal's termination of its relationship with SFMIC absent the conversion.

I concur with the SFMIC board that a disaffiliation at this point in time may reasonably be expected to lead to a financially hazardous condition within a year of a potential disaffiliation. It is recommended that the Plan of Conversion of Sheboygan Falls Mutual Insurance Company be approved. I have concluded that the Plan does not appear to be contrary to the law and appears not to be contrary to the interests of policyholders or the public. I further recommend that if after the public hearing, the Commissioner approves the conversion, that the Form D be approved related to the cancellation of the Contribution Note, contingent upon approval of the Plan of Conversion by SFMIC's voting policyholders in the Special Policyholders Meeting to be held on Monday, November 17, 2008.