J

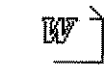
Brooks, Bryan

From: Rose, Laura
Sent: Sunday, April 22, 2001 5:53 PM
To: Brooks, Bryan
Subject: budget motions

Bryan,

Attached are the four budget motions you requested for Senator Moen's committee. Please check them over to see if they reflect what you want. I think I will be modifying motion 1 on the WIC program - I would like to call the Fiscal Bureau for some more detail, which I will do on Monday. Also, motion 4, on the newborn hearing aids, is kind of vague - let me know if you want me to put anything else in there.

Here you go - call me if you have any questions.


meyermotion1.doc


meyermotion2.doc


meyermotion3.doc


meyermotion4.doc

Laura Rose
Deputy Director
Wisconsin Legislative Council Staff
One East Main St., Suite 401
PO Box 2536
Madison, WI 53701-2536
(608) 266-9791; fax (608) 266-3830
laura.rose@legis.state.wi.us

From BC/BS

Copy for chairman Moen

MANAGEMENT CONTRACTS IN THE INSURANCE INDUSTRY: A WISCONSIN STUDY

GORDON SINYKIN*
SHIRLEY S. ABRAHAMSON**

As a business with a public interest, the insurance industry is subject to extensive regulation. Yet, by use of the management contract, business entities, which are not themselves regulated, control the internal management and management decisions of insurance companies. Management contracts can be used to siphon profits out of insurance companies; they create problems of conflicts of interest and subsequent violations of the fiduciary responsibility of corporate officers and directors; they can jeopardize the security of policyholders. In 1962, Mr. Sinykin and Professor Abrahamson were appointed by the Governor of Wisconsin to study the problems arising from the use of management contracts in the Wisconsin insurance industry and to suggest solutions to these problems. This article is based on that study. The authors conclude that because of the great dangers of abuse the most realistic and constructive alternative is to prohibit completely management contracts with insurance companies.

I. INTRODUCTION

The insurance industry sells security against loss. Obviously the insured obtains this security only if—and only as long as—the insurer is economically sound. More than ever, insurance is a major industry in our economy and an important factor in the financial planning of many citizens. Consequently, the law has sought to control insurance management "to prevent wasteful or venal handling of the insurance fund, without depriving society of the benefit of wide dispersion of decision making."[1] Historically,

* Partner, LaFollette, Sinykin, Anderson, Davis & Abrahamson, Madison, Wisconsin. A.B., 1931, L.L.B., 1933, University of Wisconsin.
** Professor, University of Wisconsin, School of Law; Partner, LaFollette, Sinykin, Anderson, Davis & Abrahamson, Madison, Wisconsin. A.B., 1953, New York University; J.D., 1956, Indiana University; S.J.D., 1962, University of Wisconsin.

The authors wish to thank Robert D. Hasse, Commissioner of Insurance and Charles D. Manson, past Commissioner of Insurance, and their staffs, particularly Deputy Commissioner Stanley C. DuRose, Jr., and Martin F. Raynoha, Chief of the Examiners Division, for invaluable assistance in the investigatory work reported here.

1 S. KIMBALL, INSURANCE AND PUBLIC POLICY 149 (1960). *See also* KIMBALL at 149-74, for a discussion of the various methods used in Wisconsin for the control of management practices to protect the integrity of the insurance fund, including control of agents' commissions and control of management salaries.

however, internal management and management decisions have not generally been subject to regulation.

The propriety of internal management of Wisconsin insurance companies came to the fore in the period 1960-62 when four domestic mutual companies went into liquidation.[2] They had "management contracts" or similar agreements at, or prior to, the time of their insolvency.

Although management contracts with insurance companies have existed in Wisconsin and in other states for many years, very little attention has been paid to their development and operation. In June 1962 the Insurance Commissioner of Wisconsin requested the Governor to appoint special counsel to analyze the use of management contracts in the state's insurance industry and determine the need for legislative or administrative action in this area. The authors were appointed and from 1962-1965 conducted an investigation of management contracts.[3] This article is based on that study.

---

2 Federal Mutual Casualty Company (1960), Superior Mutual Insurance Company (1961), Market Mens Mutual Insurance Company (1962), Shawano Mutual Insurance Company (1962).

Obviously, it is of significance to determine what effect the contracts had on these insolvent companies. Unfortunately, information as to these companies was limited because of the difficulty of obtaining adequate records of the management companies and explanations of various transactions from the managers. Unlike the data from other companies supplied by their existing officers, the information came mainly from the Insurance Department and the persons in charge of the liquidation proceedings. While these sources are sufficient with respect to the insurance companies involved, the data they could furnish about the corporate entities managing the companies were often meager. Chapter IX of the 1965 MANAGEMENT REPORT discusses these companies. *See* note 3, *infra*.

3 In December 1965 a report prepared by the authors of this article, entitled REPORT ON THE STUDY OF MANAGEMENT CONTRACTS OF WISCONSIN INSURANCE COMPANIES [hereinafter cited as 1965 MANAGEMENT REPORT], was issued to Robert D. Haase, Commissioner of Insurance, and was distributed by him.

We recognize that our investigation has been subject to several limitations. It would have been desirable to analyze carefully the complete history of management contracts in Wisconsin, but this was not feasible because of the lack of available information. However, the history of existing contracts in Wisconsin companies was studied wherever possible.

The study was conceived as one of contracts in use by domestic insurance companies in Wisconsin. Attempts were also made to examine the practices of foreign insurance companies doing business in Wisconsin and the insurance laws and practices of other states, but this investigation does not purport to be a survey of management contracts in the insurance industry throughout the nation or the insurance laws of the 50 states. Attention has been focused on questions regarding management contracts in Wisconsin. However, our research indicates that there is reason to believe that the Wisconsin experience is similar to that of other states.

For a prior summary of the Wisconsin experience, see WISCONSIN INSURANCE COMM'R REPORT, MANAGEMENT CONTRACTS IN WISCONSIN 86-124 (1958).

A management contract, as the term is used here, is an agreement between an insurance company and a person, partnership or corporation (which we shall call the management entity) in which the management entity agrees to manage all or most aspects of the insurer's business, for a fee usually based on a percentage of the insurance company's premium volume.[4]

The arrangements we characterize as management contracts—or ones similar to them—exist under other names, such as general agency contract, for example.[5] However, the name of the entity or the title given to the agreement is not significant. That there exists an interlocking device by which the management of the insurance company is delegated to another entity and by which earnings of the company may be passed through to this entity is the important point.

The management contract raises several basic problems: (1) delegation of managerial functions by the insurer's board of directors to another entity in violation of the board's duty to policyholders or stockholders; (2) the apparent divided loyalties arising from the typical arrangement under which the insurer's activities are performed by an affiliated management entity in which the officers and directors of the insurer have substantial financial interests; and (3) the control of the insurer by an entity not licensed to transact insurance business.

Management contracts and the problems they present are not limited to the insurance industry. Similar arrangements exist in other fields. Indeed, perhaps the best known example is found in the mutual fund industry. Analysis of management oriented industries and empirical studies of corporate management are needed to evaluate and regulate corporate management of industries affected with a public interest.[6]

As early as 1943, a resolution was introduced in the Wisconsin legislature to investigate management contracts in the mutual insurance companies. *See* Res. 62A, Wis. Leg., 1943 WIS. ASSEM. J. 1477 (June 14, 1943).

[4] Management contracts should be distinguished from and compared with employment contracts in which an insurance company employs an individual to manage certain aspects of the insurance company's business and agrees to pay the employee a salary which may be based in whole or in part on a percentage of premiums of the company. However, the employee does not bear any expenses incurred by the insurance company.

[5] The functions of a manager, of an executive employee, and of a general agent, overlap. It is interesting to note that all the management entities studied had the authority to appoint and to supervise agents for their insurance companies. In some instances the management entity was in fact the exclusive general agent for the company. A so-called agency contract—especially an exclusive one—with interlocking personnel amounts to a management contract in fact, and those studied and found to be of such nature have been treated as management contracts.

[6] For a study of the mutual fund industry, see WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. No. 2274, 87th Cong., 2d Sess. (1962); SEC, PUBLIC POLICY IMPLICATIONS OF INVEST-

A. *Procedure for the Study*

Information for the study was obtained initially by questionnaires mailed late in 1962 to domestic insurance companies, licensed foreign and alien insurance companies, and management entities. The answers were analyzed with the help of staff members of the Insurance Department. Follow-up letters were sent to obtain additional information, where necessary, and to clarify matters raised by responses received. Various files of the Insurance Department were made available, and informal interviews with persons in the insurance business were conducted. We were unable to consult personally with all insurance companies, but discussions were held with all insurers operating under a management contract. All companies were extremely cooperative in furnishing the information requested for this study.

B. *Insurance Companies Studied*

Table 1[7] shows the number of stock and mutual insurance companies, foreign as well as domestic, which were included in our study, and the number and percent of companies which had management contracts. All domestic companies and substantially all licensed foreign companies listed in the 1962 Wisconsin Insurance Commissioner's Report are included in the table.[8]

The table indicates that management contracts are found predominantly in domestic mutual companies. Although it indicates that domestic companies are more likely to use management contracts than foreign companies doing business in the state, the underlying factor is size. Foreign companies writing insurance in Wisconsin are larger than the domestic insurers, and our study indicates that the management contract is used most often by the smaller companies.

C. *Mutual Insurance Companies: Their Nature, Structure, and Limitiations*

Because most of the insurers with management contracts were mutuals, it is important to understand some basic factors about their structure and operation.

MENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. (1966).

A criticism of the SEC study of the mutual funds has been that the commission failed to relate the problems it found in the mutual fund industry to conditions in other management-controlled enterprises. *See* Note, 3 COLUM. J.L. & SOC. PROB. 66 (1967).

[7] For all Tables referred to in this article, see Appendix.

[8] Some foreign companies are excluded for various reasons, such as those doing no business or writing less than $1,500 of premium volume in Wisconsin, and those in the process of domestication, merger, dissolution, reinsurance, and withdrawal.

The policyholder in a mutual insurance company occupies a dual position; he is both an insured and an insurer. The Wisconsin Supreme Court has described him as a quasi-stockholder who owns the corporate property and whose property interest will be protected by the courts.[9] The equitable owners of the mutual's assets are the policyholders; they create the surplus through premiums or assessments, and it belongs to them.[10]

---

[9] The Wisconsin Supreme Court has stated that "those who at any given moment hold policies in such a [mutual] company are the only members of the corporation and that membership and insurance are coterminus." Duel v. State Farm Mutual Ins. Co., 240 Wis. 161, 178, 1 N.W.2d 887, 894, *motion for rehearing denied*, 240 Wis. 188a, 2 N.W.2d 871 (1942). In Huber v. Martin, 127 Wis. 412, 105 N.W. 1031 (1906), the court described the interest of a policyholder of a mutual as follows:

> "The principle which lies at the foundation of mutual insurance, and gives it its name, is mutuality; in other words, the intervention of each person insured in the management of the affairs of the company, and the participation of each member in the profits and losses of the business, in proportion to his interest." . . . "Each person insured becomes a member of the body corporate, clothed with the rights and subject to the liabilities of a shareholder." . . . "Although the members of a mutual company are not usually denominated stockholders, and are not stockholders in the usual sense of the word, yet they are in point of fact shareholders." . . . "The property of the corporation belongs to its members." . . .
>
> In the general sense, every member of a mutual corporation is a stockholder and is the equal of any other member similarly situated, or any member of any corporation having an equal interest, proportionally, as to holding the beneficiary title to the corporate assets. For corporate purposes only the corporate entity owns the property; otherwise it belongs to the members. No principle of law is more firmly founded in reason, and none more important to be kept in bold relief by courts so as to challenge the attention of those who have to do with corporate affairs, especially corporations dealing with the subject of insurance. The officers of such a concern have no greater authority over its assets, as regards appropriating the same to their private use, than those in other corporations. Neither does legislative power legitimately extend to interfering with property rights more in one case than in the other. False notions of this matter, which may be, perhaps, attributed in part to courts, has led to the erroneous idea that the members of a mutual insurance company have no rights save those expressed on the face of their policies; that otherwise they have no interest in the corporate assets which the courts will protect. That is a very erroneous and very dangerous doctrine. Nothing will be more productive of good administration of such concerns as the one under discussion, than to have it definitely proclaimed by the courts, as we do now, that, while the corporate property belongs to the corporation for corporate purposes, the corporation itself belongs to the members thereof, and that any such member, however small his interest, may knock successfully at the judicial doors to prevent the use of the corporate assets in any other way than in strict harmony with what has been said. If such were not the case, wrongs of a serious nature would quite likely go without redress and rights without protection.

127 Wis. at 431-34, 105 N.W. at 1037-38. *Cf.* Ohio State Life Ins. Co. v. Clark, 274 F.2d 771, 775 (6th Cir. 1960).

[10] The essential characteristic of a mutual is the common equitable ownership by the members of the assets of the company, subject to any rights of the common school fund upon dissolution. WIS. STAT. § 201.13 (1967). The policyholders create the surplus through the payment of pre-

In reality, however, the policyholder of a mutual does not ordinarily consider himself an owner of the enterprise, but merely a buyer of insurance. He does not invest funds in the mutual for profit like the shareholders of a stock corporation. His position is more analogous to that of a member of a cooperative, a nonstock corporation or an association.

In Wisconsin mutual insurance corporations may be either assessable or nonassessable, or the assessments may be limited to a specific number of times the annual premium.[11] When a mutual issues nonassessable policies so that, in effect, the policyholders have not combined together as self-insureds, the mutual company looks more like a stock insurance corporation, and the policyholders tend to think of themselves merely as the insured. Nevertheless, the mere fact that there are cash premiums rather than assessments does not destroy the feature of mutuality. Each member legally retains an interest in the surplus premium fund re-

---

miums or assessments, and it belongs to them. It has often been said that the surplus of an insurance company merely reflects an overpayment by its policyholders. WISCONSIN INSURANCE LAWS REVISION COMMITTEE, LEGIS. COUNCIL, DOMESTIC INSURANCE CORPORATIONS (STOCK & MUTUAL), (3d Draft, Feb. 10, 1969), at 7-8 [hereinafter cited as WIS. INS. LAW REV. COMM. (3d Draft)].

The 1965 Wisconsin legislature established an interim committee of the legislative council to study the existing insurance laws and make recommendations for their revision and codification. WIS. STAT. § 13.354 (1965). The Wisconsin Insurance Laws Revision Committee consists of legislators, the Commissioner of Insurance, the Attorney General, the President of the State Bar of Wisconsin, a member of the legislative council and three public members. The Committee is assisted and advised by an advisory committee representing the insurance industry. Spencer L. Kimball, Dean of the University of Wisconsin Law School, is Project Director.

[11] Each policyholder of a mutual has "one vote and shall be liable for a pro rata share of losses and expenses incurred during the time the member has been a policyholder of the company, unless the liability of all members is limited according to law." WIS. STAT. § 201.02(3)(d)(5) (1967).

A mutual may not issue both assessable and nonassessable policies at the same time. WIS. ADM. CODE, § INS. 4.02(4). Under a nonassessable policy, once the premium is paid there is no further obligation on the part of the insured to contribute to losses. The premium is the amount paid to the company as consideration for insurance, and is generally fixed as to the amount and time of payment. Under the mutual assessable plan, the policyholder becomes liable for assessments. An assessment is not a fixed amount but rather becomes payable by the policyholder only in such amount and at such a time as may be necessary to meet losses that arise. It is a call made on the membership of the mutual for definite contributions on account of losses sustained by particular members.

To issue nonassessable contracts, the mutual company must set aside and maintain a specified guaranty fund which varies in accordance with the kinds of insurance transacted. WIS. STAT. § 201.07 (1967). Any profits accruing from good management or favorable underwriting of the company flow to the policyholders in the form of reduced premiums or dividends on policies.

maining after losses and expenses, a right not possessed by policyholders in a stock company.

The nonassessable policy has been adopted by many mutuals in order to meet the competition of stock companies. However, a mutual operating on such a basis has different financial needs than one issuing assessable policies, and may encounter considerable difficulty in acquiring funds to meet heavy losses or to support new or expanding business. Unlike a stock corporation it cannot raise capital by selling shares. It may borrow money on its own notes and may pledge assets to secure these loans.[12] This borrowing power may give the mutual needed cash, but does not provide a method for furnishing additional surplus. Adequate surplus, of course, is all-important to the operation of insurers.

A mutual may issue contribution notes to obtain the minimum fund needed to organize.[13] It must retire these notes five years from the date of organization or as soon thereafter as the earned surplus of the company remaining after deducting such contributions is at least equal to the minimum fund. These notes may be paid only with the approval of the Commissioner and on a pro-rata basis to all contributors.[14]

A mutual may also issue surplus notes[15] to increase its surplus. Such indebtedness is not listed as a liability or claim against the assets of the company. The principal and interest of the notes are payable only from the surplus remaining after all other liabilities.

Since the holders of these notes cannot be paid unless there are sufficient funds for all other creditors, the notes are not attractive investments. Certainly they do not provide a practical solution to the problem of raising needed capital for mutuals. It has been suggested that perhaps some voting rights, such as preferred stockholders have in the event of default,[16] should be given to the note

---

[12] WIS. STAT. § 201.17(3) (1967).

[13] *Id.* § 201.03(1)(a) (1967).

[14] *Id.* § 201.03(2) (1967).

[15] *Id.* § 201.17(2) (1967). Prior to a 1961 amendment, mutuals could exchange surplus notes and increase their surplus without any real change in their assets. For example, Mutual A could purchase $100,000 of surplus notes from Mutual B, and the latter would then purchase $100,000 of surplus notes from Mutual A. The end result of the transaction would be that each mutual would have surplus notes in the amount of $100,000, and its balance sheet would show an additional $100,000 as surplus.

[16] Under Minnesota law, holders of guaranty fund certificates (which are similar to Wisconsin's contribution notes) are

> . . . entitled to one vote in person or by proxy in any meeting of the members of the company for each $10 investment by him in the guaranty fund certificates.
>
> In mutual fire insurance companies with a guaranty fund, the certificate holders shall be entitled to choose and elect from among their own number or from among the policyholders at least one-half the total number of directors.

MINN. STAT. § 66.08 (1965).

holders. Management contracts have also been used to give note holders a form of security and a larger return on their investment.[17] In 1963 the Wisconsin legislature devised a different alternative for mutuals by permitting them to reorganize as stock companies.[18] Previously any such conversion was prohibited by statute.[19] An additional source of capital for mutuals in Wisconsin has recently been proposed by the staff of the Insurance Laws Revision Committee of the Wisconsin Legislative Council. It would permit mutual bonds, which would have priority over contribution or surplus notes in the event of liquidation,[20] to be issued.

Mutuals were conceived as a cooperative means of insuring risks, with individuals banding together to assume and spread the losses among themselves. The development of non-assessable insurance has wrought a change in the mutual character and has pointed up the difficulties under the law in financing a mutual. Moreover, there is the real problem of control of the mutual. Although theoretical control rests with the policyholders through their power to elect directors, the policyholders generally view themselves merely as purchasers of insurance, and few, if any, go to the annual policyholders' meeting. Practical control, therefore, rests with the managers of the mutual, who often regard themselves as its rightful owners, especially if they have started the company or loaned it substantial sums. Unlike a shareholder in a stock company, who is able to register his dissatisfaction with management by selling his shares, the policyholder is locked into the mutual company. He can get out only by cancelling his policy or failing to pay his next premium. In either event, he loses his protection and realizes

---

[17] Over the years the Wisconsin Insurance Department acquiesced in the use of the management contract largely because of the financing problems encountered by mutual companies. For example, one company reported that when surplus funds were needed after the company suffered a large operating deficit in 1949 due to severe windstorms, the Department suggested the management contract as a vehicle for obtaining surplus funds. However, the managers are loathe to give up the contract after the notes are paid.

[18] WIS. STAT. § 201.14 (1967). The board of directors of a mutual formulates a plan of reorganization, and the policyholders are notified and given an opportunity to vote on the plan. An appraisal committee is appointed by the Insurance Commissioner to determine the value of the mutual, following which a hearing is held by the Commissioner. Each policyholder is entitled to shares of stock in the new company (or cash for fractional shares) in an amount equal to his equitable share of the value of the mutual and is given the right to subscribe to additional shares of the new company. As of June 1, 1969, five mutuals had reorganized or were in the process of reorganizing into stock companies pursuant to this statute.

[19] Conversion of a mutual into a stock company was prohibited by WIS. STAT. §§ 201.02(4), 201.13(4) (1961) because conversion was used as a scheme for raiding a prosperous mutual for personal gain. For a detailed discussion of such raids, see S. KIMBALL, *supra* note 1, at 84-91.

[20] WIS. INS. LAW REV. COMM. (3d draft), § 19(2)(a), (b), (d).

no return comparable to that realized by the shareholder upon the sale of his stock.

II. THE MANAGEMENT CONTRACT—CONTRACTUAL PROVISIONS

A. Formal Clauses: Duration, Renewal, Termination and Assignability Provisions

Table 2 lists each insurance company studied and its management entity; the effective date of the management contract; the duration of the agreement; and provisions relating to renewal, termination, modification, and assignability of the contract.

The duration of the contracts ranged from an annual to a 25 year term. Seven had terms of five or six years. Several had substantially longer terms.[21]

Extension or perpetuation of the contract life was made quite easy by the renewal provisions. Generally, renewal was automatic without action by either side. Termination usually required affirmative action, sometimes made difficult by the notice provisions.[22]

The power to extend or terminate a contract necessarily carries with it the duty to determine whether the extension or termination is in the best interests of the company. A truly independent, unaffiliated board of directors reviewing a management contract would seek the best terms for the insurance company, bearing in mind the possibility of having the services performed by its own staff. It would investigate other available management services and compare prices. Such actions are more difficult, and often not even contemplated, when the contract provides automatically for extension and has unduly long notice requirements for termination. The difficulty is compounded when there is interlocking control of both parties to the contract.

Most contracts did not specify any consideration to be paid for termination of the contract. Some merely required that all sums due the management entity at the time of termination be paid.[23]

---

[21] Personal Indemnity (25 years), Badger State (15 years), Wisconsin State Mutual (14 years) and Great Lakes Mutual (10 years).

[22] The Home Mutual and Homestead Mutual contracts stated that they were automatically extended on each anniversary date so that on such date a full contract term of 6 years remained. To terminate the contract and prevent its automatic extension, notice had to be given 5 years in advance of the termination date and between 30 and 60 days prior to the annual anniversary date. Accordingly, if either of the mutuals wanted new management, it would have been in the quite impossible position of arranging for new personnel 5 years in advance and of having to operate with the old managers during that long interim.

[23] The termination provision of the contract between Mutual Indemnity and Mutual Agency, Inc. called for the payment of renewal commissions of 15% to Mutual Agency. The Wisconsin Insurance Department's

Yet, our early exploratory conferences with management groups indicated that they invariably expected some remuneration for terminating a profitable contract.[24]

Some contracts contained a contract clause binding the successors and assigns of the parties; others did not. Although the provision might be binding on a successor to the insurance company, it is doubtful the management entity could sell the contract and assign its obligations.[25] However, management groups have, on the whole, viewed their contracts as a salable item, and a very valuable one at that.[26] Of course, whenever there has been a sale of the management contract or the stock of the management corporation, there has been a change in the officers and directors of the insurance company as well as of the management company.[27]

On the other hand, a few management contracts have recognized that the insurance company is purchasing the services of a particular individual or group who own the management entity, and have made the contract's term dependent upon the continuation of the services of that individual or group.[28]

Examination Report of Mutual Indemnity, dated November 29, 1963 (page 7a), concluded that the contingent liability of the company in the event of termination of the general agency contract "is such as to seriously affect the solvency of the company and its ability to continue in operation."

[24] The management group, as directors and officers of the insurance company and the management entity, did not contemplate the prospect of ending the arrangement without monetary consideration. Nevertheless, they did agree ultimately to termination without consideration; and the management executives generally were constructive in their understanding of the problem. In one instance a contract in operation for less than a year was considered as vitiated, as if it never existed, with the parties left to restoration of their status quo before the contract.

[25] A contract which contemplates the performance of personal services involving the exercise of special knowledge, judgment, skill, and ability is not assignable by the party under obligation to make such performance without the consent of the other party to the contract. 6 C.J.S. *Assignments* § 26 (1936); 4 A. CORBIN, CONTRACTS § 865 (1951). Of course, with the same persons in charge of the insurance company and management entity, such consent undoubtedly could be obtained.

[26] Madison American Guaranty informed the Department that its management corporation had several opportunities to sell its management contract.

[27] In 1943, Auto Insurance Agency, Inc. purchased a contract for the management of Great Lakes Mutual Fire and Marine Insurance Company. Also in 1943, George Stewart purchased the management contract for the Marshfield Mutual Plate Glass Insurance Co., the predecessor of Mutual Indemnity. Market Mens Management Agency, Inc., organized in 1958, entered into a management contract with Market Mens Mutual Insurance Company. The stock of the management company changed hands in 1960 and again in 1962.

The 1940 Investment Company Act provides that if control of the investment advisor is transferred, the advisory contract is terminated. *See* Note, 63 COLUM. L. REV. 153 (1963).

[28] The Dairyland Mutual contract had the following provision:

Sale of Management Company. It is contemplated that the

B. *Compensation of the Management Entity*

Typically, the management contracts did not provide a dollar amount as compensation to the management entity for their services.[29] Most did not fix any minimum or maximum compensation.[30] All provided for a straight or flat percentage fee.

In all except two cases, the management fee was a percentage of premium volume.[31] The percentages under the various contracts ranged in most cases between 33 and 45 percent; but the percentage rate is not of significance itself without considering the services performed and the expenses borne by the management entity.[32] In various instances changes were made in the rate from time to time. Some contracts stated that the management entity could accept a lesser fee or waive part of its fee.

---

majority of stock eligible to vote of the [Dairyland] MANAGEMENT COMPANY be owned by Stuart H. Struck. No sale of such voting stock which has the effect of divesting Stuart H. Struck of such control shall be valid unless prior written consent has been given by the Board of Directors of the [Dairyland Mutual] INSURANCE COMPANY. Such consent is deemed granted if no written objection is filed by the Board of Directors of the INSURANCE COMPANY with Stuart H. Struck within thirty (30) days after written notification to the INSURANCE COMPANY, but such consent cannot be unreasonably withheld. In case of death of Stuart H. Struck, no new manager of the MANAGEMENT COMPANY shall be employed without the consent of the Board of Directors of the INSURANCE COMPANY. Such consent is deemed granted if no written objection is filed by the Board of Directors of the INSURANCE COMPANY with the MANAGEMENT COMPANY within thirty (30) days after written notification to the INSURANCE COMPANY, but such consent cannot be unreasonably withheld.

Hallmark could terminate its contract on 5 days' written notice to Federal Underwriters, Inc. if both Messrs. Bruce and Six died or terminated their employment with Federal Underwriters.

[29] See Table 3 for the contract provisions as to compensation of the management entities during the period 1957-61.

[30] The 1962 Home Mutual contract, in addition to the percentage formula for compensation, provided a minimum guarantee of actual expenses plus $62,500 per annum, but we have been informed that the management entity did not invoke the guarantee.

[31] A different base was used in the Personal Indemnity contract. The insurance company was to bear all expenses of its operation and pay the management entity 55% of its annual net income before payment of the management fee. Net income was defined as the increase in the surplus of the company each year, excluding investment income and gain or loss from the sale of assets. Accordingly, in the absence of an increase in surplus, the managers were entitled to no compensation. Good years were expected to make up for the poor ones.

[32] In 1962 the Home Mutual contract was amended to provide for a management fee of 17½% of the direct premiums written. The rate of compensation prior to this time was 42% of such premiums. The substantial decrease in compensation of the management company in 1962 can be explained by the fact that, beginning in 1962, the insurance company, rather than the management company, paid the commissions and expenses of agents.

C. *Duties of the Management Entity*

All management entities were charged with supervising the acquisition of business. Some also were the sole general agents of their insurance companies. This latter duty gave the management entity the power of life or death over the insurers because they were the only source of business.[33]

Several of the contracts expressly required the manager to pay all agents' commissions and acquisition costs incidental to the procuring of business.[34] While other contracts merely provided that the management company pay all management and operating expenses of the insurance company, the size of the management fee indicated that the manager was expected to pay the agents' commissions.[35] Although the contract would indicate that the management entity bore the expense of the agents' commissions, often the insurance company would pay the agents' commissions and then deduct this sum from the amount due the management entity. In most instances, the agents—although hired by and under the control of the management entity—had agency contracts directly with the insurance company.

The manager under most management contracts was to hire, supervise, and pay the salary of all clerks, stenographers, bookkeepers, and other employees of the company.[36] Generally the managers furnished necessary furniture, equipment, printing, and supplies, and paid postage, telegraph, telephone, and similar expenses.[37] Under several contracts the management entity was responsible for selecting and providing home office space for the insurance company. At times the contract specifically stated that these expenses were to be borne by the insurance company, but in

---

[33] The Merrill Agency was precluded from writing insurance on behalf of anyone except Milwaukee Mutual upon any risks covered by policies issued by Milwaukee Mutual. Likewise, the insurance company agreed not to permit anyone to sell its insurance except subagents appointed by the Merrill Agency, and not to issue policies except through the Merrill Agency. The contract went on to say, "it being understood that . . . [Merrill Agency] is to receive the sole and exclusive general agency for the writing and procuring of all policies of insurance for" Milwaukee Mutual.

[34] Badger State, Great Lakes Mutual, Hallmark, Home Mutual, and Integrity Mutual.

[35] Central Farm, Dairyland Mutual, Madison American Guaranty, and Mutual Indemnity.

[36] Badger State, Great Lakes Mutual, Home Mutual, Homestead Mutual, Integrity Mutual, and Wisconsin State Mutual.

The Badger State contract carefully stated that this provision was not to be construed to create the relationship of employer and employee as between the manager and the employees of the insurance company. Sometimes the company would pay the salaries and deduct the amount from the fees due the management entity.

[37] Badger State, Great Lakes Mutual, Home Mutual, Homestead Mutual, Integrity Mutual, and Wisconsin State Mutual.

other cases it was not clear who would pay for such facilities.[38] In other contracts, the insurance company provided space and facilities to enable the manager to fulfill its duties.[39]

The management entity generally prepared and filed the reports required by public agencies;[40] kept all the records and accounts of the insurance company other than the corporate minutes of the board of directors;[41] made annual reports or those required by the board of the insurance company;[42] and furnished necessary actuarial, accounting, and expert insurance services.[43]

In addition to specifying duties of the manager, the contract sometimes would contain a catch-all clause granting all-inclusive functions to the manager: management shall be responsible for performance of

> . . . all other services usual to the office of corporate manager and incidental and necessary to the management of the business of the insurance company, including full power and authority to employ and direct accounting and legal services.[44]

---

[38] Under the Home Mutual and Homestead Mutual contracts the management entity provided and paid for suitable rooms for the insurance company, with light, heat, and other services ordinarily furnished to office tenants. However, if the insurance company acquired its own home office building or district office facility, the management entity was merely to furnish heating, fuel, light, and other services ordinarily furnished for office tenants. In 1960, when Home Mutual and Insurance Associates reduced the management fee from 45% to 42%, the amendment to the contract stated that the reduction was in contemplation of the insurance company furnishing its own buildings for the district office at Minneapolis and eventually for other district offices, as well as for its home office, but that such reduction was not contingent upon the insurance company furnishing any buildings for office purposes other than the district office at Minneapolis.

[39] The Badger State contract, as amended, specifically provided that the company should pay all taxes on the real estate of the company which may be occupied by the management entity and all rentals for space and facilities for the management group.

[40] Central Farm, Great Lakes Mutual, Home Mutual, and Homestead Mutual.

[41] Central Farm and Madison American Guaranty.

[42] Badger State, Central Farm, Great Lakes Mutual, Home Mutual, Homestead Mutual, and Madison American Guaranty.

[43] Badger State, Great Lakes Mutual, and Home Mutual.

[44] Dairyland Mutual. *See also* Central Farm, Home Mutual, and Madison American Guaranty.

The Dairyland Mutual and Madison American Guaranty contracts authorized the management entity to employ an active manager who would be responsible to the management entity but who, with the officers of the management entity, would report to the officers and board of directors of the insurance company. The Integrity Mutual contract provided that the manager might hire and provide, at its expense, sufficient and capable management personnel and other required executives to conduct the business of the company.

D. *Duties of the Insurance Company*

One may well ask what functions remained under the control of the insurance company. Little was left for it to do. Generally the contracts did not speak of the functions to be performed by the insurance company; they just listed the expenses to be paid by it.[45]

In nearly all contracts the expenses of claims adjustment and payment were borne by the insurance company. However, the contracts did not always specify which entity was to run the claims department.[46] Although under the terms of some contracts

[45] Some expenses generally paid by the insurance company under contract are:

1. Expenses and disbursements incurred for legal services for the insurance company. (Badger State, Central Farm, Dairyland Mutual, Home Mutual, Homestead Mutual, Madison American Guaranty, Milwaukee Mutual, and Wisconsin State Mutual.)
2. Taxes, license fees and assessments levied or assessed against the insurance company. (Badger State, Central Farm, Dairyland Mutual, Home Mutual, Homestead Mutual, Integrity Mutual, Madison American Guaranty, Milwaukee Mutual, and Wisconsin State Mutual.)
3. Insurance premiums on insurance carried to protect the property of the insurance company. (Badger State, Central Farm, Dairyland Mutual, Madison American Guaranty, and Milwaukee Mutual.)
4. Fees, expenses, and compensation of the members of the board of directors or executive committees of the insurance company. (Badger State, Central Farm, Dairyland Mutual, Home Mutual, Homestead Mutual, Integrity Mutual, Madison American Guaranty, Milwaukee Mutual, and Wisconsin State Mutual.)
5. Inspection reports. (Central Farm, Dairyland Mutual, Madison American Guaranty, and Milwaukee Mutual.)
6. Safety inspection and engineering services. (Badger State, Central Farm, Dairyland Mutual, Madison American Guaranty, and Milwaukee Mutual.)
7. Fidelity bonds on officers and employees of the insurance company. (Badger State, Central Farm, Dairyland Mutual, and Madison American Guaranty.)
8. Investment expenses. (Badger State, Central Farm, Dairyland Mutual, Home Mutual, Homestead Mutual, Integrity Mutual, Madison American Guaranty, and Milwaukee Mutual.)
9. Premiums on reinsurance paid to reinsurers of the company. (Central Farm, Dairyland Mutual, Home Mutual, Homestead Mutual, Integrity Mutual, and Madison American Guaranty.)

[46] The Dairyland Mutual contract provided that the management entity shall "have charge of, direct, and carry on all administrative work connected with . . . loss or claim adjustment . . . ." The Wisconsin State Mutual contract authorized the manager "to supervise the investigation and settlement of all claims against the Company. The Managers are to have the right to refer claims to adjusters for investigation and settlement at the expense of the Company and the right and duty to determine the validity of all claims and the amount to be paid in settlement, subject to any specific instructions given by the Company."

In the Hallmark contract, claims adjustment was performed by the management entity, which was also the agent. Hallmark's problem was understandable. It was a new company and did not have sufficient volume to warrant employing a full-time claims adjuster. However, in 1965 the insurance company assumed all claims adjustment duties and management functions, and the interlocking officer-director relationship between it and the agency was ended.

the claims department was not under the aegis of the management company, in actual operation it was conducted by the management entity. For example, Milwaukee Mutual Insurance Company had a large claims department and under the contract bore the expenses incurred for the payment, settlement, or adjustment of claims. Actually, one of the partners of the Merrill Agency (the management entity) was in charge of this department.

That insurers delegated broad powers to run their insurance business was obvious. Yet, according to Wisconsin law, "the business and affairs of a corporation shall be managed by a board of directors,"[47] and although the directors may delegate day-to-day operational duties, they cannot delegate basic supervision and control of the corporate entity. Several courts have struck down management contracts—some involving insurance companies—as an invalid delegation of managerial powers.[48]

To avoid this problem some contracts in our study attempted explicitly to reserve to the board of the insurance company powers of supervision over the management entity.[49] The articles of incorporation or by-laws of some insurers specifically allowed their directors to contract with a competent corporation, individual, or individuals to carry out the active management of the company as manager.[50] Yet such clauses can hardly save the agreement from an attack that the directors of the insurance company have abdicated their authority, especially in view of the other terms of the contract, the circumstances surrounding its creation, and the actual practice of the management entity in performing the functions of the insurer's board.

---

[47] WIS. STAT. § 180.30 (1967). *See also id.* §§ 181.18, 185.31. Sections 180.36 and 181.23 (1967), permit the directors, if authorized by the articles of incorporation or by-laws, to create committees of directors which may exercise limited powers of the board when the board is not in session. *See* Perfex Radiator Co. v. Goetz, 179 Wis. 338, 191 N.W. 755 (1923).

[48] Sherman & Ellis, Inc. v. Indiana Mut. Cas. Co., 41 F.2d 588 (7th Cir. 1930), *cert. denied* 282 U.S. 893; Royal Theater Corp. v. U.S., 66 F. Supp. 301 (D.C. Kan. 1946); Kennerson v. Burbank Amusement Co., 120 Cal. App. 2d 157, 160 P.2d 823 (1953); Shaw v. Bankers' Nat'l Life Ins. Co., 61 Ind. App. 346, 112 N.E. 16 (1916); Long Park, Inc. v. Trentor-New Brunswick Theaters Co., 297 N.Y. 174, 77 N.E.2d 633 (1948).

Professor Ballantine in his work on corporations warns: "Care should be taken in drafting a management contract to reserve substantial powers of supervision and termination to the board of directors and avoid provisions entirely abdicating their authority." H. BALLANTINE, CORPORATIONS § 48, at 136 (rev. ed. 1946).

[49] The Wisconsin State Mutual contract provided that the services by the management company shall be performed in such manner as directed by the mutual, and nothing in the contract shall be construed as interfering with the direction of the business and affairs of the mutual by its board. The Badger Mutual and Great Lakes Mutual contracts noted that all of the management entity's powers and duties set forth in the contract were subject to the control and supervision of the board of the mutual.

[50] Homestead Mutual, Home Mutual, and Dairyland Mutual.

E. Looseness of Contractual Relations

Most of the contracts were loosely drawn. Often there were departures in practice from the terms of the contract. The examination reports, prepared by the Wisconsin Insurance Department, and our conferences disclosed that individual companies evolved their own pattern for handling functions and expenses, not always carefully allocating expenses to each entity.[51] In many cases the distinction between the management entity and the insurance company was legal only; in fact, the two were one and the same. The management entity and insurer usually occupied the same offices and operated with the same staff. In some instances all the books were kept by the insurance company, and periodically there was merely a transfer of an "overwrite" fee to the management entity (the management fee less various expenses considered chargeable to the management entity).

There was much legal informality about the whole arrangement. Perhaps no more was needed because the same persons made the decisions for both parties.

III. THE MANAGEMENT CONTRACT: REASONS FOR ADOPTION AND USE

Typically, the formation of the insurance company and the management entity went hand in hand. Usually the management contract was drafted and accepted by the promoters of the insurance company and by directors of their choosing at the organization of the insurer, in a transaction in which no one actually represented the prospective policyholders or stockholders.[52] In a few cases the contract was made when the insurer got into financial trouble.

To determine the insurance company's views as to the advantages of operating with a management contract, we asked the companies why they initially entered these agreements and why they continued the relationship. Unfortunately many responses were not particularly helpful. For example, although they often cited gains achieved under the management contracts, they usually failed to indicate the characteristics of the management operation responsi-

---

[51] The Wharton study of mutual funds found that the 1940 Federal Investment Company Act did not "require a precise statement of services to be rendered in exchange for the precisely defined compensation, and in a number of cases the contracted obligations of the adviser are vague." WHARTON SCHOOL OF FINANCE AND COMMERCE, *supra* note 6, at 476 n.33.

[52] Badger State, Central Farm, Dairyland Mutual, Great Lakes Mutual, Hallmark, Madison American Guaranty, and Wisconsin State Mutual. *See also* note 72, *infra*, and Table 4. For a discussion of conflict of interest and the management contract, see text at 712-22.

A similar situation exists in the investment fund. *See* Jaretski, *The Investment Company Act: Problems Relating to Investment Advisory Contracts*, 45 VA. L. REV. 1023 (1959); Note, 71 YALE L.J. 137 (1961); WHARTON SCHOOL OF FINANCE AND COMMERCE, *supra* note 6, at 463.

ble for these gains. Many consistently failed to explain why, of all the possible alternatives, a management company was the most desirable method for achieving these gains.

The principal, recurring explanations offered for using the management contract were that it (1) provides continuity and efficiency in management; (2) limits expenses of the insurance company; and (3) is useful in acquiring needed funds. These explanations are not mutually exclusive, and at times all three were given by the company.

More effective and efficient management, the companies claimed, could be acquired because the management contract offered security of position. The managers were assured a long-term contract, and the contract was viewed as a deterrent to proxy fights. Thus more capable men were attracted to and remained with the company. This continuity of management made long-range planning possible.[53]

Some companies noted that the persons involved in the management company had the expertise necessary for the profitable operation of the insurance business.[54] In a number of companies the management entity was composed of persons who were insurance agents or who had other contacts which could produce business for the insurer.[55]

Some companies stated that the percentage fee formula of the management contracts induced the management entities to increase efficiency and reduce expenditures.[56] The manager's profit was

---

[53] Our reasons for presently operating under this management contract is to insure stability of management, to facilitate success of expansion programs, and discourage attempts of proxy fights and mercenary interests of outsiders, which we felt can be disastrous to a small mutual insurance company.

It is our opinion that a small mutual insurance company can grow successfully over a period of time by sound and stable management who are not fighting amongst themselves or with outsiders for control to the detriment of the interests of the company and its policyholders.

Personal Indemnity.

[54] "The directors and management company provided the services for the development of the company. The company by itself was helpless to do this. The management company built the company. The company did not build the management company." Badger State.

[55] Hallmark, and Wisconsin State Mutual.

In the initial stages of the company's development the company would not have survived except by means of a management contract. . . . Each director was an established individual in the insurance business and contributed business and services to the company.

Badger State.

At that time (the early days of the insurance company) the insurance company had no means of establishing agencies except through contacts which its officers had, which officers were individuals engaged in the insurance business either as individuals or as managers of agencies corporate or otherwise.

Badger State Underwriters, Inc.

[56] Badger State.

inversely related to the expenses borne by the entity—the lower the expenses, the higher the profits. Although the management entity might expect to lose money in the early years (when salary and other expenses would be greater than management fees), they could expect large profits in the not too distant future.[57]

In several instances the insurance companies reported that in their early years they could not afford to pay salaries that would attract men of high caliber. Under a management contract, the management entity would bear the salary expense while the insurer would realize a profit from its operations, or at least not so large a loss.[58] Furthermore, since the manager also bore the expenses of operation other than claims, the management contract protected the insurance company from incurring large nonclaim expenses. The insurer thus was cushioned against incurring expenses beyond the management fee.[59]

Some companies noted that the management entity had in one manner or another provided the necessary capital and surplus required to keep the insurer in some financial operating condition.[60] In several instances the stockholders of the management corporation contributed money to establish the insurance company, to permit the company to write a new line of business, or to help a company in financial difficulty.[61] Contributions to mutuals meant

---

[57] Note that the insurance company does not benefit directly from the manager's greater efficiency. If there were a reduction in the manager's expenses, the manager takes the saving in increased profits. The percentage of premiums paid as compensation to the manager by the insurance company remains constant. *But see* note 58, *infra*, and accompanying text.

[58] Badger State, Central Farm, Dairyland Mutual, and Hallmark.

> [T]he insurance company must be strengthened financially as it grows, and with retained earnings as its only real source of such strengthening. By retaining earnings, little could be expended for personnel and physical plant needed to encourage successful growth. The management company was the tool through which competent personnel and adequate plant were furnished, and at the same time permitting the insurance company to strengthen itself. Without such corporate manager to finance and stabilize the organization and growth of the insurance company, it is doubtful if Dairyland Mutual Insurance Company would ever have been started. Dairyland Mutual.

[59] Milwaukee Mutual reported: "One of the principal and most important reasons for operating under a general agency arrangement and assigning to the general agency certain specific duties for a certain fee is that the insurance company knows in advance its acquisition and administrative costs and can better plan and stabilize its entire operations."

[60] Great Lakes Mutual and Home Mutual.

[61] "Such management contracts were entered into primarily because the companies needed financing to carry on the work of organization, promotion, growth, and expansion, and such need existed for many years after organization of the companies." Farmers Mutual.

When Great Lakes Mutual decided to write automobile liability insurance, it borrowed $200,000 from the management company and issued surplus notes therefor.

investing in contribution or surplus notes, but this type of investment was very insecure.[62] In order to get persons interested in investing in such contribution notes, competence and stability of management had to be shown.[63] The management contract was thought to provide these qualities.[64]

In 1948 a management corporation was formed which sold stock and debentures and donated the capital raised to a newly-formed casualty company. The management contract was simply a means to give the corporation "an opportunity to earn back from the insurance company an amount sufficient to pay off the debts it, Great Lakes Agency, created in order to make the gift of $150,000 to the insurance company and provide a reasonable return for an entrepreneur's risk."[65]

In the fall of 1958 Market Mens Mutual was in poor financial condition. A group of individuals arranged for the sale of 300,000 dollars of surplus notes to a management corporation. A management agreement was entered into as a measure of protection for the investment made by the stockholders of the management company. It was rumored that there were agents interested in gaining control of the mutual because of its strengthened financial condition, and the investors were fearful that they might lose control.

Of the mutuals with management contracts, three had outstanding surplus or contribution notes in the 1957-1967 period of the study.[66] In one company all the surplus notes were held by the management entity,[67] and in another the sole stockholder of the management entity held these notes.[68] In the third company, about one-third of all the noteholders were affiliated with the management entity.[69] There were, of course, domestic mutuals without management contracts which had outstanding contribution and surplus notes during the period studied. These were held principally by "insiders" or other mutuals.

In our opinion, efficiency of management, obtaining qualified executives more cheaply, limiting the insurance company's expenses, and economy of operation were not the real reasons for the use of the management contract. We think the actual motivating reason for the contract was the need or desire felt by the managers for protection, security, and incentive. Some of the insurance

---

[62] *See* text at notes 13-17, *supra*.
[63] Dairyland Mutual.
[64] Note that the Dairyland Mutual management contract continued in existence after the contribution notes were paid off.
[65] Integrity Mutual.
[66] Central Farm, Great Lakes Mutual, and Homestead Mutual.
[67] Great Lakes Mutual.
[68] Central Farm.
[69] Homestead Mutual.

companies were starting from scratch, and others were in difficult financial straits when their management contracts were made. Those who organized a new insurance company or took over the management of an existing one wanted to be certain of continued control. Likewise, those who loaned substantial sums to the insurance company on contribution or surplus notes wanted to maintain control as a measure of security. The managers saw themselves as entrepreneurs taking large risks and therefore entitled to commensurate profits. Willing to take over and assist a company in its crises, they felt entitled to the fruits of the good years for their sacrifices in the bad ones.[70] Naturally, they did not relish the idea of others wresting control from them in the process of developing the company's business or in the better days that would follow. The management contract was a means of providing such protection and security for the managers.

IV. THE MANAGEMENT CONTRACT: DISADVANTAGS, DANGERS, AND ABUSES

A. *The Management Contract: A Study of Conflict of Interest*

Management contracts present the issue of self-dealing and consequent violation of fiduciary responsibility of corporate officers and directors.

1. THE CONTRACTING PARTIES—INSIDE DIRECTORS

The contracting parties to a management contract are, of course, the insurance company and the management entity.[71] The officers and directors of each act on behalf of their principals. But an analysis of such officials of the two organizations in our study shows that the same individuals often occupied the key positions in both organizations and, in effect, the same persons were on both sides of the contract—they were negotiating and contracting with themselves.[72] At times this fact appeared on the very face of the

[70] A similar situation exists in the mutual funds. Investment advisors often justify high profits by pointing to the very lean years. *See*, Note, *Mutual Funds and the Investment Advisory Contract*, 50 VA. L. REV. 141, 173 n.165 (1964). Also, the mutual fund managers are the promoters and contribute the initiative and capital necessary to start the enterprise. The costs to the promoters of managing the fund in its infancy may even exceed the charges against the fund. Unable to acquire an inexpensive equity interest in the fund, the promoter looks to management fees to recover original expenses and an additional reward for his risks and talents. Note, 3 COLUM. J.L. & SOC. PROB. 66, 67-68 (1967).

[71] All the management entities but one (the Merrill Agency) were corporations. All the insurance companies were mutuals, except Hallmark and Madison American Guaranty, which were stock companies with shares widely held under a public issue of stock.

[72] Table 4 indicates the numbers of officers, directors, and stockholders or partners of the management entities who were also officers and directors of the insurance companies. From this table, it is clear tha

contract, when the same individuals signed for both parties.

In addition to identical, interlocking personnel, other directors and officers were often related to the interlocking personnel, either directly or indirectly. Some had family ties to the interlocking officers and directors; others had special business relationships, such as agents, lawyers, and accountants. For example, Mutual Indemnity had a management contract with George Stewart. It also had a general agency agreement with Mutual Agency, Inc., which was wholly owned by Stewart. The three-member board and the officers of the agency consisted of Stewart, his son, and his accountant. They were also members of the insurance company board; two were officers of the insurance company; and the other four directors of the seven-member board of the insurance company were related to the manager-agency-insurance company group by professional or business ties.

There are, of course, other forms of control. An insurance company becomes dependent upon the management entity once the management contract is made. Policyholder apathy and proxies allow the managers to maintain a firm hand on the insurance company at annual meetings. In addition, the managers are in a strong position of control when they own property leased to the insurance company, when the insurance company is indebted on obligations to them, or when there is some other affiliation between them.

The factors usually operating in contract negotiations between independent representatives of separate legal entities were not present in negotiationg the management contract. There was no competitive bidding by management entities. Interlocking personnel and control of the proxy machinery of the company generally assured the management entity approval and renewal of the contract on its own terms. Arm's-length bargaining was conspicuous by its absence.

---

there was a close interlocking relationship between the management entities and the insurance companies they managed. A few examples may be pointed out. The directors of Integrity Mutual were the same persons as the directors of its management company, Great Lakes Agency, Inc., each company having a board of 13 directors. Of the 13 directors, 4 were also officers and held the same offices in each corporation. In addition, the common directors included the principal and controlling stockholders of the management entity.

All the officers and directors of Badger State Underwriters, Inc. were directors of the mutual insurance company. Of the 7 board members of Badger State Mutual, 4 were officers, directors, or stockholders of the management corporation.

The officers of Dairyland Mutual and Dairyland Managers, Inc. were the same. The 3 directors of the management entity and its vice president and its secretary-treasurer were also directors of the 10-member board of the insurance company. All of the stock of the management company was owned by 2 of the common directors.

See also note 52, *supra*.

2. CONFLICT OF INTEREST AND THE LAW—THE JUDICIAL DEVELOPMENT OF THE FIDUCIARY DUTY OF OFFICERS AND DIRECTORS

The Wisconsin Supreme Court has often stated that directors have wide discretion in corporate management. Questions of policy are for the judgment of the directors, and courts are reluctant to interfere in the internal management of corporate affairs and substitute their business judgment for that of the board of directors.[73] Nevertheless, the officers and directors occupy a fiduciary position which demands loyalty, care, vigilance, and good faith. If they violate their duty,[74] they become liable for their acts or omissions.[75]

a. Fiduciary duty of officers and directors dependent upon nature of the corporation

Courts have held that the officers and directors of mutuals have at least the same fiduciary obligation as such persons in other

---

[73] For the court to intervene, the allegation must disclose abuse of power or the exercise of power for a purpose injurious to the corporation or to the interests of the stockholders or members. Steven v. Hale-Haas Corp., 249 Wis. 205, 221, 23 N.W.2d 620, 627 (1946); Thauer v. Gaebler, 202 Wis. 296, 301-02, 232 N.W. 561 (1930); Fleischer v. Pelton Steel Co., 183 Wis. 451, 455-56, 198 N.W. 444 (1924).

In Steven v. Hale-Haas Corp., *supra*, the court stated that when the transaction is "so obviously injurious to the corporation as to compel a finding that no consideration of its interests was in the minds of its officers and directors and that they must have been motivated by self-interest or by concern with the interests of outside parties," the transaction may be enjoined. "Damage to the corporation and the obvious improvidence of the scheme viewed in the light of the needs of the corporation constitutes proof of improper motives and of the failure to exercise the judgment and good faith required of officers and directors." 249 Wis. at 221, 23 N.W.2d at 627.

[74] Directors have a three-fold duty to the corporation: they must be obedient, diligent and loyal.

> As to obedience, they, of course, owe a duty to keep within the powers of the corporation as well as within those of the board of directors. . . . With regard to diligence, the directors owe a duty to exercise reasonable care and prudence . . . . In no event is the idea to be tolerated that directors serve merely as brightly gilded ornaments of the corporate institution . . . . The third duty owing by directors is that of undivided loyalty.

H. BALLANTINE, *supra* note 48, at 156. *See also* Jaretzki, *Duties and Responsibilities of Directors of Mutual Funds*, 29 L. & CONTEMP. PROB. 777 (1964); Israels, *A New Look at Corporate Directorship*, 24 BUS. LAW. 727 (1969); Symposium, *Duties and Liabilities of Corporate Directors*, 22 BUS. LAW. 29 (1966), *esp.* Garrett, Jr., *Introduction—General Survey*, 22 BUS. LAW. 29, and Marsh, *Are Directors Trustees?*, 22 BUS. LAW. 35 (1966); Nielsen, *Directors' Duties Under Anglo-American Corporation Law*, 43 U. DET. L.J. 605 (1966); Hetherington, *Fact and Legal Theory: Shareholders, Managers, and Corporate Social Responsibility*, 21 STAN. L. REV. 248 (1969).

[75] Koelbel v. Tecktonius, 228 Wis. 317, 280 N.W. 305 (1938); Boyd v. Mutual Fire Ass'n, 116 Wis. 155, 90 N.W. 1086, *rehearing* 116 Wis. 166, 94 N.W. 171 (1903).

business enterprises.[76] The character of the corporation ought to be considered in determining the responsibility of directors, and there is some indication that directors of mutual companies and of financial institutions should be held to a higher standard than directors of a conventional business corporation.[77] In fact, there is good reason for saying that directors of insurance companies in general—companies affected with a public interest—like directors of banks, should be held to a stricter accountability than other directors.

Some analysts of mutual funds have argued that the courts have mistakenly tended to apply garden-variety rules to the question of the obligation of directors of the funds. Purchasers of shares of a mutual fund are not looking to the directors of the fund but are depending on a management entity. The investors are buying a package sold by a management group. Application of the rules of corporate fiduciary responsibility to mutual funds may thus distort basic understandings and expectations of fund operations.[78] The contrary position has been stated with equal vigor.[79]

---

[76] Boyd v. Mutual Fire Ass'n, 116 Wis. 155, 90 N.W. 1086 (1903). *Cf.* Napier v. Graw, 156 F. Supp. 30 (N.D. Ohio 1957).

[77] Moulton v. Field, 179 F. 673 (7th Cir. 1910), *cert. denied sub. nom.* Gray v. Field, 219 U.S. 586 (1911), involved a suit brought by the policyholders of a mutual life insurance company against Gray, Rosenfeld and Moulton as officers of the company to recover for the benefit of the company the sum of $200,000 alleged to have been wrongfully taken by such officers from the company's treasury. Gray, who had organized the mutual and secured a management contract for himself for 25 years, sold the management contract to Rosenfeld. Moulton, president of the company, assented to the sale. The board of directors approved the assignment and installed Rosenfeld as general manager. Gray held sufficient proxies to control the election of new directors and had in effect autocratic power. The court held that a management contract was an unassignable contract for personal services. The approval of the assignment by the directors was invalid because Gray had nothing legally salable. The court recognized that the directors were not independent parties but were under Gray's power. It noted that "mutual life insurance companies differ radically from ordinary industrial enterprises. Every customer by the act of purchasing what the company has to sell becomes an owner of the business. Because the policyholders are necessarily numerous, widely scattered, unacquainted with one another, each owning too small an interest in the business to justify the expense of long travel to the owners' annual meeting, the proxy system seems inevitable." 179 F. at 675. It concluded that when one person or group of persons held the decision-making power, there was the highest obligation of good faith and the burden of establishing very clearly the fairness and honesty of any challenged benefit to that person or group.

See generally H. BALLANTINE, *supra* note 48, § 63 at 158-61; R. BAKER & W. CARY, CORPORATIONS § 2(a) (3d ed. 1959).

[78] *See* Lobell, *Rights and Responsibilities in the Mutual Fund*, 70 YALE L.J. 1258 (1961); Lobell, *The Mutual Fund: A Structural Analysis*, 47 VA. L. REV. 181 (1961).

[79] Herman, *Lobell on the Wharton School Study of Mutual Funds: A Rebuttal*, 49 VA. L. REV. 938 (1963).

In any event, a distinction must be made between the mutual investment fund business and the mutual insurance field. The Federal Investment Company Act, unlike the Wisconsin insurance laws, requires that investors receive full factual data. If one assumes adequate investor knowledge, an investor who then purchases fund shares apparently would not regard the potential conflict of interest as a dangerous threat, and would consider further legal regulation unnecessary. In contrast, the policyholders in the mutual have little or no knowledge of the management contract arrangement and cannot be regarded as approving it. Indeed, if they had full knowledge, it is unlikely they would give approval.

Moreover, the mutual fund shareholder is solely an investor, whereas the member of a mutual insurance company has a dual interest. Under the mutual concept as distinguished from the stock company, the policyholders are both the insured and the insurers. Any profits accruing from able management or favorable business of the company flow to the policyholders in the form of reduced premiums or dividends on policies.

Legally the policyholders are the owners of the mutual, but the managers tend to regard them only as insured parties looking for insurance protection. It is apparent that most policyholders have the same view of themselves; at least they are not as aware of their legally-protected proprietary interest in the company as are the shareholders of a stock company. Regardless of the policyholders' disinterest, the law explicitly recognizes that the mutual belongs to them—not to the managers, officers, or directors—and that the latter have a basic fiduciary responsibility of undivided loyalty to the policyholders and the insurance company.

b. The fiduciary duty of officers and directors: a director or officer contracting with his corporation

As indicated above, officers and directors who assume control of the property of others have a fiduciary obligation demanding care, vigilance, and good faith. They must subordinate their personal interests to those of the corporation. They must act for its benefit. They cannot use corporate property or their relationship to it for personal gain; they cannot profit as individuals by virtue of their position.[80] Any profits they receive from the company's business or property inure to the company and must be held by them in trust for the corporation. Yet, they can have contractual relations with their corporation.

The adverse interest of a director or officer may arise where the corporation enters into a transaction with him personally, or with a partnership in which he is a partner, or with a corporation

[80] For statutory restrictions, see WIS. STAT. § 201.24(4) (1967), the history of which dates back to 1937, and WIS. STAT. § 201.105 (1967).

in which he is an officer, director, or stockholder. His personal interest or his interest as a partner or stockholder may induce him to favor himself or another entity at the expense of the corporation whose interests are entrusted to his care.

The rules of the cases involving the fiduciary obligation make certain distinctions. One set of rules applies to an officer or director dealing with his corporation. A different and somewhat more lenient set of principles governs the transactions between two corporations having interlocking directors.[81]

When an officer or director deals with his corporation in a transaction in which he has a personal interest, the Wisconsin Supreme Court looks to see whether he has also been representing or acting on behalf of the corporation in the matter. If he has not acted for the corporation, the transaction is voidable where the company has been imposed upon; and the transaction will be closely scrutinized to see that no advantage has been taken of the corporation.[82] On the other hand, when the officer or director has represented both himself and the corporation in a transaction, the contract "is voidable on the part of the corporation simply because of the dual interest of the director."[83] In such cases the corporation can vitiate the transaction regardless of the fairness of the contract; it is absolutely void at the option of the company. This result is reached on two grounds: (1) such a contract lacks two parties, an essential ingredient to a contract; and (2) since the officers and directors have a personal interest adverse to the company, the corporation is not adequately represented in the transaction and should be able to nullify the deal.[84]

It is sometimes difficult to determine whether the officer or director is representing the corporation in the transaction. If the director's presence is necessary to constitute a quorum and he votes on the transaction, it is clear that he is acting on behalf of the corporation. Even if his presence is not necessary for a quorum and he does not vote, but he is present at the meeting, or has control of a majority of the directors, it may be found that he is representing the corporation in the transaction.[85]

In Wisconsin, as in other states, a different rule prevails where the contract or transaction is between two corporations having

[81] The only possible distinction lies in the impracticality of applying the same rule in the business world.
[82] Davies v. Meisenheimer, 254 Wis. 419, 37 N.W.2d 93 (1949).
[83] Federal Mortgage Co. v. Simes, 210 Wis. 139, 245 N.W. 169 (1932).
[84] *See* 3 W. FLETCHER, CYCLOPEDIA CORPORATIONS §§ 922-31 (rev. ed. 1965).
[85] *Id.* at §§ 932-40. The Wisconsin Insurance Law Revision Committee suggested that when the insurance company is contracting business in which a director is interested, the director may be counted in determining a quorum for a board meeting approving a transaction, but may not vote. Approval shall require affirmative vote of a majority of those present. WIS. LAW REV. COMM. (3d Draft), *supra* note 10, § 32(2) at 106.

common directors or officers. In such a case, the transaction is voidable only if it is unfair or inequitable, even if the interested director represents the corporation in the transaction.[86]

When an individual is a director of two corporations which are dealing with each other, the director has a divided allegiance. He owes a duty not to manage either company in his own interest or in the interest of some other group which he represents. Although it is questionable whether there is a justifiable difference between the director dealing with his own corporation and two corporations with similar directors dealing with each other, modern law so far has found it impractical to forbid common directors from participating in inter-company dealings. The Wisconsin Supreme Court has held that contracts between corporations in which some, a majority, or all of the directors are common to both are not voidable merely at the election of either corporation, but only if either corporation has been imposed upon.[87] The court will scrutinize the contract with utmost care, and if such imposition appears, it will permit the rescission of the contract on the part of the suffering corporation. Even under this rule of common directors, it appears to be the general principle that where a majority of the directors are common to both corporations the transaction is presumptively fraudulent. It will be examined closely by the court, and the burden of proof is on the party supporting the validity of the transaction to establish its fairness.[88]

As noted before, where there is a management contract, there is an interlocking relationship between the directors and officers of the insurance company and those of the management entity. In addition, the officers and directors of the insurance company generally own a substantial percentage of the stock of the management corporation. Under such circumstances the insurance company should be able to set aside the management contract without showing that it has been imposed upon. The rule of conditional voidability of transactions between corporations with interlocking directorates makes sense only where the directors have no substantial personal financial investment in either corporation. It seems illogical to permit a director or officer to escape the rule of unconditional voidability applicable when representing both himself and the corporation by interposing between himself and the insurer a corporation in which he is the major shareholder.[89]

---

[86] Gauger v. Hintz, 262 Wis. 333, 55 N.W.2d 426 (1952); Roberts v. Saukville Canning Co., 250 Wis. 112, 26 N.W.2d 145 (1947); Shinners v. Grossman, 213 Wis. 135, 250 N.W. 832 (1933). *See also* H. BALLANTINE, *supra* note 48, § 72 at 180-83; 3 W. FLETCHER, *supra* note 84, § 961.

[87] *See* cases cited in note 86, *supra*.

[88] H. BALLANTINE, *supra* note 48, § 72 at 183-84.

[89] However, in Gauger v. Hintz, 262 Wis. 333, 55 N.W.2d 426 (1952), the Wisconsin Supreme Court did not make this distinction. In that case a second corporation was wholly owned by the directors and stockholders of

Regardless of which of the above rules is applied, management contracts entered into under the circumstances described above are subject to attacks upon their validity. Some may be absolutely voidable by the insurance company; others may be voidable unless it is shown that the contract is fair and beneficial to the insurance company. The burden of proof is on the party asserting the contract to be valid. The fairness of the contracts studied and their benefit to the respective insurers would be difficult to prove in light of the fee based on business volume regardless of expenses; substantial management company profits even after waiver of fees; duplication of expenses resulting from the contract; the duration of the contracts and the practical difficulty of termination. Moreover, the contracts are open to challenge on the separate issue of unlawful delegation of power to an outside entity. Such delegation, together with the locked-in nature of the whole arrangement, leaves the insurance company in an impotent state as to the control and conduct of its business.

3. CONFLICT OF INTEREST AND THE LAW—ADMINISTRATIVE DEVELOPMENTS: "OUTSIDE DIRECTORS"

In an effort to develop independent boards of directors, the Wisconsin Insurance Department in recent years has suggested to insurance companies that a majority of the membership of their boards be outside directors, that is, directors who are not directly or indirectly connected with the management or operation of the company. Some insurance companies have complied with this recommendation, and one finds in recent years that management personnel has become the minority group on some insurance company boards. An effort to restrict the number of insiders who may be directors has also been made in New York.[90]

Beginning in 1961, annual financial statements filed with the Wisconsin Insurance Commissioner included a question asking whether the insurance company had any procedure to ferret out conflicts of interest between the company and its officers, directors, and employees. Several companies reported to us that their boards adopted an official statement of company policy prohibiting conflicts of interest and sent out questionnaires to their employees, officers, and directors to determine possible and po-

the first corporation. The court, applying the rule relating to interlocking directorates, upheld a contract between the two corporations which was attacked by a minority of the shareholders of the first corporation. It may have reached this result in the case because it was clear that the contract was beneficial to the first corporation. *See also* Old Settlers Club v. Haun, 245 Wis. 213, 13 N.W.2d 913 (1944).

For a discussion of the cases involving transactions between corporate officers as such and another corporation in which they are shareholders, see 3 W. FLETCHER, *supra* note 84, § 944.

[90] N.Y. INS. LAW § 56(3) (1966), applying to mutuals.

tential sources of such conflict.[91]

In some instances directors resigned because of their affiliation with other companies. In others the conclusion was that no conflict of interest could arise, and that it was in the best interests of the insurance company that certain directors remain on the board. In such cases the insurance company continued its business relations with the financial institutions with which the directors were affiliated.

The Wisconsin Insurance Laws Revision Committee's draft of the code on domestic insurance companies requires that "employees and agents of a domestic insurance corporation shall not constitute a majority of its board . . . ."[92] The Commentary explains that the purpose of the large outside board requirement is to foster a board made up of persons of varied business experience and to require management to submit its proposals to a board it does not dominate. The draft suggests that a truly independent board can provide a constructive check and balance system and strengthen protection of the interests of the insurance company and its policyholders. Formulation and review of company policy by independ-

---

91 One questionnaire asked: "Do you or any immediate member of your family directly or indirectly own a substantial interest in any partnership or business corporation, association or organization which is, or is likely to be, seeking to enter into any type of financial transaction with our companies . . . ?"

The value of general questionnaires may be limited, since many persons will respond that they have no conflict of interest, thinking they can deal fairly with all sides.

Corporate officers and directors seem to be unaware of the common law rules relating to their fiduciary duties. A July 10, 1968 (p. 1) article in the *Wall Street Journal* quoted numerous executives, serving two or more corporations, who indicated that they saw no problem and that they did not think they were breaking any law. The insurance executives we interviewed were similarly taken aback when we raised the conflicts of interest question. The *Wall Street Journal* reported that guidelines on conflict of interest are being tightened for corporate managers; the regulatory agencies and the courts are forcing "a sterner interpretation of guidelines governing the conduct of influential executives. They reason that such guidelines are needed to protect stockholders and the public and to insure free competition." The *Wall Street Journal* also reported that "executives are feeling pressure for high standards of ethics from within and without business." Professor Louis Loss of Harvard Law School commented that the general level of morality expected of corporate officials has been steadily rising in recent years.

92 WIS. INS. LAW REV. COMM. (3d Draft), *supra* note 10, § 25(2) at 84. Commentators on the ineffectiveness of the 1940 Investment Company Act requirement as to non-affiliated directors suggest that the best solution for this lack of effective independent supervision of mutual fund management is involvement of the SEC. Note, 50 VA. L. REV. 141, 172-73 (1964). The Revision Committee's staff recommended that some directors of the mutual be "public members," that is, appointed by public authority. This suggestion was not acceptable to the Committee. *See* WIS. INS. LAW REV. COMM. (3d Draft), at 10.

ent, disinterested directors is a step in the right direction, but it should be apparent that one cannot rely solely on outside directors to protect against self-dealing by officers and directors. The selection of the independent directors may all too often be left wholly in the hands of the insiders who may be able to arrange for a board they can control.[93]

The 1940 Investment Company Act required that 40 percent of the directors of mutual funds not be affiliated with the management company. The evidence indicates, however, that these impartial watchdog directors did not perform their intended role.[94] Instead, they tended to follow the suggestions and wishes of the insiders who knew more about the business. Thus, the Investment Company Act merely created a "mirage of independence."[95] Nevertheless, outside directors, together with full disclosure of transactions with, and compensation of, affiliated persons can pro-

---

[93] *See, e.g.*, Acampora v. Birkland, 220 F. Supp. 527 (Colo. 1963), where one of the principals of the management company selected almost all the directors of the mutual fund.

[94] Note, *supra* note 92, at 171-73. *See also* SEC, *supra* note 6, at 148; U. of Pa. Conference on Mutual Funds, *The Mutual Fund Management Fee*, 115 PA. L. REV. 726, 738-40, 756-60 (1967).

[95] The following appear in Note, *Management Compensation: The SEC Mutual Fund Report*, 3 COLUM. J. LAW & SOC. PROB. 66, 74 (1967). They are reputedly typical responses of three unaffiliated directors:

> Question: Was it a matter of any concern or interest or relevancy to you as a director of the Fund whether the cost of rendering the advisory service by the Management Company was $50,000 or $500,000?
> Answer: I would say none.[59]
> Question: Did you make inquiry of the investment advisor as to whether it would consider rendering the same service for a lower rate?
> Answer: No.[60]
> Question: Did you ever read the investment advisory contract between the Fund and the Management Company?
> Answer: I don't believe so.
> Question: Did you ever vote to renew the contract?
> Answer: Yes.[61]

59. Simonson v. Cooley, Del. Ch. No. 1327 (1961) (dispute over fee size; settled), Deposition of Matthew W. Powers, at 41.
60. *Id.*, Deposition of William Spencer, at 177.
61. *Id.*, Deposition of Gardner H. Stern, at 47.

Dr. Vannevar Bush, a trustee of a mutual fund, described the qualifications and duties of an "independent trustee of a mutual fund." He described such a trustee as one who (1) has no active association with any entity doing business with the fund; (2) has business experience; (3) is capable of studying matters before the fund and is able to form his own opinions; and (4) has an intimate knowledge of the capability and qualifications of the management team. *See* Jaretski, *supra* note 74: "Standards such as those enumerated are not only unrealistic but would seriously curtail the availability of competent and desirable persons to serve on mutual fund boards. It suggests that the compensation of such director would more nearly approach that of a full-time associate than what is normally paid to a non-affiliated director." *Id.* at 793-94. *See also* Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 PA. L. REV. 1058 (1967).

vide some measure of protection for the interests of the insurance company.

B. *Effective Management Services and Tenure without the Management Contract*

Defenders of the management contract say that it provides the insurance company with expert, efficient services which the insurance company otherwise could not obtain. But we have already noted that the people who own and operate the management entity are also officers or directors of the insurance company, and thus, the same services could be furnished directly instead of through the management entity. This was demonstrated by the affirmative answers given by insurers having management contracts in response to the following question: Could the management services now being rendered by your management company be performed reasonably as well by personnel employed or employable by your insurance company?

Adequate tenure can be provided for management without the management company device. Employment contracts for key personnel are common in other fields of business. They likewise can be used effectively by insurance companies, with reasonable provisions for duration and compensation. An incentive pay plan also is proper, provided it avoids problems peculiar to the insurance business. An insurance company must balance its drive for premium volume with discrimination as to the underwriting risks assumed, and its profit motive with the duty to pay the full, fair value of claims. These factors must be taken into account in devising incentive compensation plans.

The tenure of management is probably more secure in mutuals than in stock companies regardless of a management contract. The insiders of the mutual insurance company—the officers, directors, and employees—are secure in their position because the policyholders have little interest in the insurance company except as the insured, and are probably unaware of their right to vote. Even if they are aware of it, they do not exercise it. The very concept of policyholder control through the exercise of voting rights is contrary to the realities of the situation.

The statute[96] giving theoretical control to policyholders merely requires ten members to be present in person to constitute a quorom for a meeting, unless a greater number is required by the articles or by-laws.[97] We found in our study that attendance at policyholder meetings is very small. The usual number attending ranged between ten and twenty-five. In most instances all

[96] WIS. STAT. § 201.02(3)(d) (1967) provides for one vote per policyholder.

[97] WIS. STAT. § 201.03(7) (1967).

the persons present, or the great majority of them, were affiliated, directly or indirectly, with the insurance company as officers, directors, employees, or agents.[98] Many companies made no attempt to solicit proxies but provided them on request. The officers and directors seemed to rely solely on the control resulting from the fact that they alone were present at the meetings. Even companies with management contracts and surplus or contribution notes of the insurance company found no need to secure proxies. Others solicited proxies, which were generally held by insiders.

A story of a lawyer-policyholder who appeared at the annual meeting of a mutual illustrates the situation. The surprised officers held a hurried conference, trying to figure out what the outsider was up to, and what they should do under the circumstances. Finally the president decided on a direct approach and asked the policyholder why he was there. He replied that he was passing through the city on business, had nothing else to do at the moment, and came to the meeting simply out of curiosity.

Although many officials of management companies stated that the management contract was needed as security for their jobs, the realities of the situation indicated that there was little likelihood of entrenched management being removed.[99] In any event, loss of position is a risk of business life. Absolute security of management tenure should not be expected, nor is it in the best interests of the insurance company. Continuity of management should depend upon the quality of performance. If management is good, it is most likely that it will be retained; otherwise it should be changed. The hands of the company should not be tied by a contract made and controlled by interlocking interests.

The argument has been made that more efficient and thus less costly management is obtained under a management contract. If it is true that management is more efficient under a management contract because of the incentive to keep expenses at a minimum, the insurance company is not the primary beneficiary of these savings. The savings go to the management entity. The insurance company pays a fixed percentage to the management company; if management cuts expenses, the resulting profit goes to it. A decrease in expenses does not necessarily mean increased efficiency. It may means less in quantity or quality of services rendered. If efficient personnel and continuity of their services were the real justification for management contracts, it would seem that

[98] V. NUTT, INVESTIGATION REPORT ON THE INSURANCE INDUSTRY OF THE STATE OF SOUTH DAKOTA 35 (1964) also reported that very few policyholders other than officers, directors or employees attended policyholders' meetings in person and that actual control of the company was in a few individuals.

[99] We were not able to uncover a single instance in recent years where there was actually a proxy fight for control of a mutual, although we have found in a few companies references to the possibility of such a fight.

more insurance companies would use them. However, most companies did not.[100]

C. *Compensation under the Management Contract*

1. PROBLEMS WITH THE FEE FORMULA

If the management contract is valid, the managers should be entitled thereunder to reasonable compensation for their services. That general standard is what other businessmen seek when dealing at arm's length, especially in the open competition of the market place.[101]

The management contracts generally provided a fee based on premium or business volume.[102] The fee was a single, stated percentage, in the range of 33 percent to 45 percent of premium income under most of the contracts. The fee supposedly was intended to cover the costs and expenses of the managers, including remuneration for their own services. However, there was no

---

100 Only about 11% of the domestic companies operated under a management contract when this study was undertaken, and less than 105 of the foreign companies doing business in Wisconsin had management contracts. Some of them operated with such contracts in the past but saw fit to terminate them.

101 The general rule relating to compensation is that the board of directors may determine compensation. WIS. STAT. § 180.31 (1967). Where management compensation is determined in good faith by disinterested directors or approved by an informed majority of the shareholders, the courts will intervene only if the compensation paid bears no relation to the services rendered and thus constitutes a waste of corporate assets. Rogers v. Hill, 289 U.S. 582 (1932).

102 Under the Personal Indemnity contract the management fee was tied to a percentage of the annual increase of the insurance company's surplus.

A management fee geared wholly to an increase in surplus is unrealistic, as demonstrated by the experience of Personal Indemnity. Moreover, surplus figures are susceptible to juggling. Also, a surplus-based fee may be an incentive to underpayment of claims in derogation of the insurance company's responsibility to its policyholders. The Insurance Department's Examination Report of Personal Indemnity dated January 12, 1962, dwelt at length upon the claims practices of the company. The report pointed out:

> In the last examination report reference was made to the recommendation made in 1953 by the National Association of Insurance Commissioners that a "bench mark" be established for determining if benefits under accident and health policies are unreasonable in relation to premiums charged. Using these recommendations and considering the portion of the company's business which is on a monthly premium basis, the company should develop an overall loss ratio of at least 48.5% in order that their premiums should be considered as reasonable in relation to benefits.
>
> Reference to the above schedule (of loss ratios of Personal Indemnity from 1956 through 1960) shows that in every year until 1960 the company's loss ratio was less than 48.5%. It is hoped that future operations will result in a reasonable return of benefits to insureds.

Id. at 12-13.

recognition of the difference between various categories of expenses, such as agents' commissions, which may bear a fairly direct ratio to premium volume and those expenses that do not. The static percentage used assumed that the ratio of all expenses to premium income always remains the same. Yet everyone knows that such is not the case and that such ratio is subject to fluctuation.

The amount of business written is not necessarily a measure of the amount and quality of the management entity's services. The management company performs important functions in addition to sales. Paying commissions to an agent on premiums written is one thing; basing the compensation of management solely on gross sales is quite another matter. Particularly in the insurance field, changes in sales volume do not bring the same corresponding changes in net income. The amount of gross sales is neither an accurate nor an adequate gauge of the performance of management.

Also, when the management fee is a percentage of premium income there may be less than proper caution in the eagerness to write new business. Under such a compensation arrangement, there is a potential danger of increasing underwriting without due regard for the risks assumed by the insurance company.[103]

---

[103] The United States District Court of Utah recognized that danger and held invalid a contract granting overriding commissions to a partnership composed of officers of the insurance company, saying:

> Allowing the officers of the company to receive commissions on all of the insurance premiums received by the company obviously impaired their ability to distinguish between good and bad risk policies. And it is alleged by defendants that because of heavy losses on its policies the company came into early financial difficulty.

Bergeson v. Life Ins. Corp of America, 170 F. Supp. 15, 16 (D. Utah 1958).

The court also held the contract contravened the Utah law which prohibits a company from paying ". . . any person who has the power to decide which applications to the insurer for insurance are to be accepted or rejected, any compensation related to income upon risks so accepted, except upon the net profits therefrom." UTAH CODE ANN. § 11-7-10(3) (1953). The court found that the fact that a partnership was an intermediary between the company and the officers as individuals did not alter the realities of the situation. The contract was exactly what the statute was designed to prevent.

Michigan now provides that the compensation of an officer or director of an insurer "shall not be calculated, directly or indirectly, as a percentage of premiums collected or insurance written by the insurer without the approval of the commissioner" of insurance. No. 343, [1965] Mich. Laws 418.

The Wisconsin Insurance Laws Revision Committee provided that compensation shall not be measured in whole or in part "by any criteria that would create a financial inducement for any director, officer or employe to act contrary to the best interests of the corporation." WIS. INS. LAW REV. COMM. (3d Draft) § 35(4)(1) at 115.

The purpose of this prohibition

> is to prevent growth-oriented incentive compensation schemes that may lead to unsound management practices. Incentive compensation arrangements are often desirable, but unwise ones may be disas-

2. THE WAIVER OF MANAGEMENT FEES AS A TEST OF THEIR REASONABLENESS

The managers insisted that their management fees were fair an reasonable. Yet there was a widespread practice among most c the management entities to waive a part of the fees earned unde their contracts.[104] In several contracts there was a specific pro vision in which the manager might agree to accept a lesser sur than that stipulated.[105]

At times the amount waived was necessary to enable the in surance company to stay in business and have a better ratio o premiums to surplus. The managers pointed to these frequen waivers as a demonstration of their benevolent concern for th insurance company and its welfare. On the other hand, it may b said that the waivers indicate that something was wrong abou the entire arrangement.

The waiver provisions in the contracts, and the frequent sur render of part of the fees by waiver, whether pursuant to a con tract provison or not, indicate a loose way of doing business be tween the parties. It is a phenomenon one rarely finds in othe business transactions. If the parties to the management contrac had been truly independent of one another, it is unlikely that an fees would have been waived. Moreover, if the percentage fee ha been calculated on a fair basis in the first place, there would hav been no need to make adjustments later. The fee was fixed at high level with the all-important power in the managers t take it or to reduce it as they saw fit. Such power is bound t be a vital form of control over the insurance company.

---

trous. For example, underwriting officials should not have thei compensation tied solely to premium volume. This subsection pro hibits such arrangements. A specific list of forbidden compensatio arrangements could be worked out. Mass. ch. 175, § 75 has a spe cific prohibition, forbidding an "officer or other person whose dut it is to determine the character of the risks . . . [to] receive as an part of his compensation a commission upon the premiums. . . ." Such specification is possible but seems unnecessarily limiting, an this draft leaves the prohibition in general terms, to cover any new ones that are invented.

Id. at 120.

[104] In the 5 year period 1957-1961, Insurance Associates, Inc., th management entity of Home Mutual and Homestead Mutual, earne $16,361,499 in fees and waived $2,592,940 thereof. In the same period Dairyland Managers, Inc., earned fees of $8,418,999 and waived $1,198,904 Others waived lesser amounts, and some waived nothing in those years A complete tabulation of the fees earned and waived by the managemen entities is shown in Table 5.

[105] Home Mutual, Homestead Mutual, and Integrity Mutual.

Homestead Mutual also foresaw the possibility of increased compensa tion. The management contract provided: "Such compensation may b increased for such time and from time to time as shall be mutually agree upon by the Manager and Windstorm Company."

3. PROFITS OF THE MANAGEMENT ENTITIES AS A TEST OF THE REASONABLENESS OF FEES

Almost all the management entities made substantial profits, even after the waiver of part of their management fees. The profits must be considered, of course, in relation to the size and nature of the business, the investment of the managers, the salaries and other forms of compensation received by them, and the true worth of their services. All that can be done here is to give a broad picture of the situation.

Table 6 is a tabulation of the profits, before and after income taxes, earned by the management entities for 1957-1961. The income taxes paid are significant because, as shown later,[106] substantial tax savings could have been effected if the mutual insurance companies had operated without a management contract.

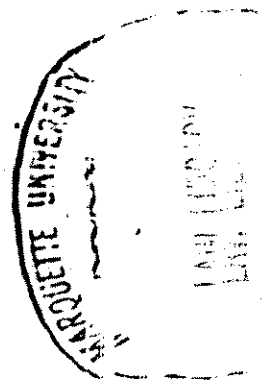
Further analysis of the profits of some of the management entities, as examples, is in order. The net profits of Dairyland Managers, Inc. during the five year period ranged from a low of 428 dollars to a high of 886,318 dollars before taxes. The management entity and Dairyland Mutual commenced business in 1953, and the growth of both corporations was striking, as the figures indicate.

The capital stock of Dairyland Managers, Inc. at the time of its organization in 1953 was only 600 dollars. In 1960 the stated capital was increased from 600 dollars to 300,600 dollars by transferring 300,000 dollars from surplus to capital. A management contract was entered into in 1953 calling for a fee of 40 percent of net premiums after reinsurance, and in 1959 the rate was reduced to 33-1/3 percent. Dairyland Mutual had no outstanding contributon or surplus notes during the 1957-1961 period. It originally had issued 50,000 dollars of contribution notes, but all of these had been paid.

After payment of salaries and other expenses, and the waiver of substantial fees, the management entity was left with the profits shown on Table 6. In the eight years from 1953 to 1961 its net worth had grown from starting capital of 600 dollars to 842,620 dollars. Its balance sheet for 1961 showed heavy investments in common stocks, land, buildings, and equipment. The financial strength of the management entity undoubtedly was used to expand the operations of Dairyland Mutual into other states, but the management entity prospered at the same time. In fact, its surplus at the end of 1961 was more than one-third of the surplus of the insurance company, and counting the 300,000 dollars which was transferred from surplus to capital, it would have had a surplus well over one-half of that of Dairyland Mutual. With all the problems of growth and expansion, the insurance company needed more surplus and could well have used at least part of that which inured to its management entity.

[106] *See* text at 732-33, *infra*.

There is no question but that the insurance compan
ous and enterprising management that built the compa
ground up. From 1957 to 1961 the net total premium v
company rose from 1,671,711 dollars to 7,661,339 d
issue is whether the total compensation taken by the m
reasonable, and as to that the figures speak for themselv



[107] Integrity Mutual is the example of a smaller con
managers received more modest compensation. Its manag
Great Lakes Agency, Inc., was formed in 1948. Integrity Mut
writing fire insurance. At the same time, Integrity Mut
Company was organized as an affiliate of the fire compa
nonassessable automobile insurance. Stock ($61,600) and
($109,000) were issued by the management entity, and $150,00
ceeds was contributed to the new insurance company to mee
requirement. The contribution was made without condition o
—as a gift and not as a loan. The two insurance companies
in 1955.

The management contract was made originally with the
company in 1948, and upon the merger in 1955 was rewritten
sulting company, Integrity Mutual. It provided for a fee of
the net direct premiums written.

The net total premium volume of Integrity Mutual
$1,392,351 to $1,631,852 during 1957-1961. After waiver of po
fee, the net profit (before taxes) of the management entity w
1957, $20,000 in each of the next three years and $15,000 in
were earnings after payment of compensation in all forms to
directors of the management entity, who were the same pe
officers and directors of the insurance company, and to emp
holders of the management entity as well as other employees the

For example, in the year 1961 those who were officers, d
employee-stockholders of the management entity of Integrity
ceived a total of $54,096 in directors' fees and officers' salari
management entity, of which $47,831 went to persons who were
officers or directors of the management entity and the insuran
In addition, nine of the common officers and directors receive
agents' commissions from the management entity which totale
1961. Compensation was also paid by the insurance company
having an interlocking interest in both companies. In 1961,
officers and directors received a total of $12,395 in directors' fe
cers' salaries; an employee-stockholder of the management ent
a salary of $7,155 as vice president of the insurance company;
vice president of the company was paid $12,329. Total compens
key executive that year from the mutual and its managemer
including salaries, directors' fees and agents' commissions a
approximately $20,000.

The common officers and directors constituted the majo
holders of the Great Lakes Agency, Inc., the management en
tegrity Mutual. At the end of 1961 its capital consisted of 61
sued at a stated value of $100 per share, or $61,600, less 56 shar
ury stock at a cost of $7,198.44, or net capital of $54,401.56.
were distributed during the 1957-1961 period as follows:

1957 — $4,536
1958 — $4,520
1959 — $4,520
1960 — $4,520
1961 — $3,955

From 1948 to 1961 the management entity paid a total of $83

Other management groups fared well too. An ultimate question, in each case, is whether inordinate compensation paid to the managers after the insurance company had passed its bad years can be justified by the sacrifices made in those years. If so, for how long and to what limit?

Normally such issues would be decided by parties dealing at arm's length.[108] But there is no independent voice to speak on behalf of the insurance companies. Consequently, the decisions are left to the managers, who have large financial stakes in the management contract and control the actions of the insurer.[109]

---

dends on each share of stock ($100 par value) for an average return of approximately 6 percent.

In terminating its management contract at the end of 1962, Integrity Mutual advised the Insurance Department "that release from the contract would save the insurance company at least $30,000 per year."

Wisconsin State Mutual is one of the smallest companies in the management contract category. It started with such a contract in 1945. The three officers and directors of the management entity are officers and directors of the mutual, and the other six directors of the mutual are insurance agents. The management entity had $5,000 of capital stock, which it increased in 1958 and 1962 by declaring a stock dividend to its three stockholders of $5,000 each time. Its net profits for the 5 year period of April 1, 1957 to March 31, 1962 totaled $41,788 before taxes. It paid cash dividends during this period as follows:

Fiscal year ending March 31 of		Cash Dividend
1959	-	$1,500
1960	-	1,000
1961	-	1,000
1962	-	1,500
		$5,000

Thus, the cash dividends during these years equalled the cash investment in capital stock. The net worth of the management entity on March 31, 1962 was $26,094.

The key officer of the mutual and management company, who was the president, treasurer and director of both companies and also owned 78% of the stock of the management company, received a salary as an officer of the latter amounting to $13,700 in 1961.

Wisconsin State Mutual has a limited operation. The net premiums earned totaled $87,237 in 1957 and $120,839 in 1961. Management fees for those years were $38,154 and $51,391 respectively—approximately 43 percent of the premiums earned. The above financial record of the management entity and its profit figures shown by years in Table 6 indicate that even a miniature management company can do well.

[108] Rogers v. Hill, 289 U.S. 582 (1932).

[109] In the 1960's, when the mutual fund assets of the management fee were increased greatly, fund investors brought suits against mutual fund directors alleging that they abused their fiduciary duty to the fund in negotiating management contracts that provided excessive compensation for the services performed. The leading case was Brown v. Bullock, 194 F. Supp. 207 (S.D.N.Y. 1961). Most of the cases were settled out of court before a trial on the merits. The usual settlement was an adjustment of the management fees by establishing a sliding fee scale. *See* Note, *Legislating Honesty: The 1966 Mutual Fund Report Proposals on Management Fees*, 28 U. PITT. L. REV. 705, 712 (1967). *See also*, Eisenberg

4. OTHER INCOME OF THE MANAGERS

In addition to salaries from their insurance company or management entity, and profits from the latter, various members of the management team have had other forms of income from these or other insurance sources.

As mentioned previously, some of the interlocking personnel also received agents' commissions. Although complete figures were not obtained because of the difficulty of tracing commissions through the different agency entities, the following are several examples of this form of income.

In the case of Insurance Associates, Inc., a management entity, a stockholder, who was also a director of Home Mutual and Homestead Mutual, received commissions totaling 34,232 dollars for the period 1957-1961. Commissions totaling 41,407 dollars for those years were also paid to a corporate agency in which a stockholder of the management entity had a one-third stock interest, and 19,166 dollars to another stockholder of the management entity. In addition, agents' commissions were paid to officers and directors of the two mutuals who were also officers, directors, or stockholders of the management entity, totaling approximately 24,000 dollars for the five year period.

Badger State Mutual had agency agreements with various persons (or agencies in which they had an interest) who were officers or directors of the insurance company and officers, directors or stockholders (or related thereto) of the management entity. A total of 102,859 dollars was paid in commissions to them or their agencies in the 1957-61 period. Another agent—a stockholder of the management company—received 38,490 dollars in commissions during these years. In addition, the management company paid commissions during that period to similarly related personnel, or their agencies, totaling 14,368 dollars.

We take it for granted that these commissions were paid on insurance actually sold. Also, it cannot be denied that it may be good business to have agency representation on a company's board. The foregoing merely points out agency commissions as a source of income for some of the interrelated personnel of the insurance company and its management entity.

Another form of income found in several cases is rent paid to the managers. The most significant instance of this involved the substantial rents paid by Mutual Indemnity Company (19,200 dollars per year) and Mutual Agency, Inc. (24,000 dollars per year for

---

and Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940*, 20 RUTGERS L. REV. 181 (1966); Mondesitt, *The Mutual Fund—A Corporate Anomoly*, 14 U.C.L.A. L. REV. 1252, 1260-64 (1967).

about 3800 square feet) to a corporation wholly owned by the key manager.

In addition to salaries, pension plans were adopted by a number of the companies. Some of the plans were contributory; others were funded wholly by the companies.[110]

It may be noted, too, that in various instances the officers were engaged in other business activities, devoting part-time services to their insurance company or management entity. One should not have the impression that all members of the management entity were full-time or active managers of the insurance company.[111] In fact, in some of the smaller companies active management was carried on by one or two persons.

D. Increased and Duplicated Expenses Under Management Contracts

Additional layers of corporate organization invariably involve additional expenses. The management company as a separate, legal entity incurs expenses, such as organizational expenses, directors' fees, taxes, or added accounting and legal fees, which would not arise if the insurance company performed its own management functions. Insurance company and management personnel were well aware of the existence of these expenses. Indeed, they were carefully and graphically called to our attention by Integrity Mutual.

---

[110] Homestead Mutual, Home Mutual and Insurance Associates, Inc. (the management entity) share the cost of a pension plan for officers and employees, the companies paying the entire cost of the program. In 1961 life insurance provided under the plan for the three key officers of all companies ranged from $99,000 to $49,000, and retirement benefits from $990 to $490 per month.

Dairyland Mutual and its management company are participants in the Wisconsin Mutual Insurance Alliance Pension Trust. The Dairyland plan provides monthly benefits (10 years certain and for life thereafter) at age 65 equal to 35% of the salary at age 60. The plan is contributory, with the companies paying 75% of the cost. Badger State Mutual and its managerial entity also have a pension plan under the Wisconsin Mutual Insurance Alliance Pension Trust, with the employees contributing part of the cost and with monthly benefits equal to 30% of the base salary.

Integrity Mutual and its management entity have a pension plan financed entirely by the companies, providing for monthly retirement benefits and death benefits. The normal retirement benefits approximate 25% of compensation at retirement but not exceeding $150 per month. In addition to the above pension benefits, two of the officers have deferred compensation contracts calling for monthly income to them of $65.44 and $60.43 respectively for 20 years after age 65.

[111] Personal Indemnity reported that its president devoted 40% of his time to that company and its management entity and 60% to other insurance companies. In Great Lakes Mutual the president gave 5 to 10% (20% in 1960) of his time to the mutual and 5 to 10% to the management company. There were, of course, officers in companies who were full-time executives, but others were figureheads or on a part-time basis, with outside business interests related or unrelated to insurance.

In 1962 Integrity Mutual analyzed operations under its management contract and computed for the previous five years the expenses which would not have been incurred if the insurance company had carried on all its functions itself. These "duplicate and additional expenses" ranged from $32,229.66 to $43,079.18 per year and represented between 1.83 percent to 2.78 percent of the premium volume of the insurer. The company stated that there were also extra expenses which could not easily be computed and reduced to dollars and cents. "In addition, there is expense in keeping two sets of books, dividing expenses under the contract and perhaps dual thinking on the part of management," it said.[112]

One of the largest avoidable expenses incurred by reason of the management contract was taxes—both federal and state. If the insurance companies had performed their own functions, these could have been avoided because of the difference in taxation between insurance companies, particularly mutuals, and conventional business corporations (such as management companies)—both under federal and state laws.

As to federal income taxes—since 1941 mutual fire and casualty companies were taxed under alternative tax formulae under which they paid either (1) regular corporate rates on the excess of their gross investment income (*not* underwriting income) over specified deductions (*not* management fees), or (2) a one percent tax on gross income (net premium income plus gross investment income), whichever formula resulted in a higher tax. The effect of these special rules was that mutuals paid only about one-half the tax they would have paid under a tax on total income at regular corporate rates.

Net income from underwriting business was not a factor in the federal scheme of taxing these mutuals until the changes made by the Revenue Act of 1962. Beginning in 1963, mutuals have been taxed on a modified total income formula on both underwriting and investment net income. Beginning in 1963, mutuals have been taxed on the same basis as stock fire and casualty insurance companies, which have always been subject to ordinary corporate tax rates on both investment and underwriting income.[113]

Under the Wisconsin system of taxation, domestic mutual insurance companies are exempt from taxation except for payment of certain charges and dues.[114] Domestic stock insurance companies, with some exceptions, pay a tax on gross premiums received on direct insurance.[115] Insurance companies are not subject

---

112 *See* 1965 MANAGEMENT REPORT, *supra* note 3, Table 13, at 178.

113 For a brief discussion of mutual insurance companies, see Cate, *1962 Act: Most Mutual Insurance Companies Not Adversely Affected By New Provisions*, 17 J. OF TAXATION 371 (1962).

114 WIS. STAT. §§ 71.01(3)(a), 76.305, 200.04(4), 200.13, 200.17 (1967).

115 *Id.* §§ 76.30 to -.32.

to the general corporate income tax.

On the other hand, all the management entities during 1957-1961, except a partnership and an individual proprietorship, were conventional business corporations, and as such were taxable on net income under the regular federal and state corporate rates.

The corporate income tax is, of course, an expense of doing business. In the case of the management corporation, it is an expense that comes out of the fee received from the insurance company. It is an item that must be considered in arriving at the rate of fee, or in determining whether the fee or the profit accruing therefrom is reasonable.

The managers show profits after income taxes as the end pecuniary result of the entity's operations. However, in the case of the management company serving a mutual, the fact is that such federal and state taxes on the corporate profits would have been saved if the mutual had operated without a management contract and performed its own functions because (1) the mutual insurance company was not subject to the regular income tax, (2) it would have paid the same taxes under the tax laws applicable to it, whether or not it had a management contract, and (3) therefore the income of the management corporation, if retained by the insurance company, would have entailed no additional taxes for the latter. In short, the insurance company would not have had to pay the income taxes required of the management entity, and the savings would have inured to the company and its policyholders. In the case of stock insurance companies, there would have been a saving of the state income tax by operating without management contracts.

Another avoidable tax expense incurred under the management contract was local property taxes. Personal property of insurance companies necessary in the operation of their business is exempt from tax by special statute in Wisconsin.[116] Management entities having such property pay local taxes on it.

The additional and duplicated items of expense add up to significant amounts. They could have been avoided, or savings effectuated, if the managers in control of their insurance companies had conducted their insurance business without a separate management entity.

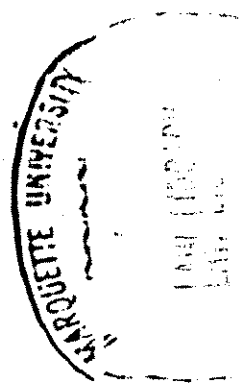
E. "Shell" Insurance Companies Under the Management Contract System

Earlier we reviewed the management contract provisions distributing functions between the insurance company and the management entity.[117] Upon analysis of the contracts and operations

[116] *Id.* § 70.112(2).
[117] *See* text at 704-07.

of the companies, it was clear that the contracts conferred broad powers on the management entity to run the insurance business, and that in actual operation the management entity had complete control over the functions of the insurance company. Management contracts thus present the question of the unlawful delegation of authority by the board of directors of the insurance company.

Directors are general managers and may delegate certain duties to others. Under the modern rule their authority has been held to include the power to appoint officers and agents and assign them discretionary powers in the conduct of the ordinary business operations of the company. But there are limits to the power of directors to delegate their authority. They cannot transfer entire supervision and control of the corporation. Nor can the board delegate the exercise of discretionary powers which by the statutes, charter, or by-laws are vested exclusively in the board.[118]



Under the original Hallmark Insurance Co.-Federal Underwriters, Inc. contract, Federal was the exclusive agent for Hallmark. It was not only the sole agent and the claims adjuster—two key insurance functions—but also furnished to Hallmark office space, utilities, telephone service, furniture, and fixtures. Under the American agency system and the management contract, the agents procured by Federal, and the expiration and renewals obtained through such agents, were the business of Federal. Hallmark was locked up in an arrangement whereby one agency wrote all its business and, in fact, controlled and performed all its functions.[119]

However, the fact that an outside corporation operated the insur-

---

[118] *See* text at 707.

[119] In an effort to avoid "shell insurance companies," the Wisconsin Insurance Laws Revision Committee outlawed (with some exceptions) exclusive agency contracts, that is,

> any contract whereby any person is granted or obtains directly or indirectly the exclusive right or privilege of soliciting, producing or receiving a fee or commission on all or substantially all of the insurance business of the corporation in this state.

WIS. INS. LAW REV. COMM. (3d Draft), § 36(1) at 121-22.

The staff's comment on this prohibition is as follows:

> Exclusive agency contracts are in all ordinary cases objectionable *per se*, irrespective of their terms, because they prevent the insurance corporation from developing. In effect, the corporation remains vestigial—a mere name—and the exclusive agent *is* the corporation for practical purposes. For this reason, whatever may be done with management contracts, exclusive agency contracts for the entire business should be completely outlawed. With little less reason, this is also true for exclusive agency contracts applicable only to the domiciliary state. In its own state the company should begin at once to develop muscle and a separate identity, even if exclusive state agencies may be permitted for a time in other states. The fear that this will weaken a corporation's bargaining position, *vis-a-vis* potential agents, is an exaggerated one. The agent's bargaining position is equally weakened by the illegality of the arrangement he may wish to establish.

Id. at 122.

ance company was not unique to Hallmark. By the very nature of the management contract, the insurance company is chained to an arrangement in which a management entity controls the business and performs basic functions of the insurance company. The company becomes nothing more than a paper organization which has abdicated its responsibilities to the management entity.

With important duties delegated to an outside entity, the financial figures of the total insurance operation are split between two organizations and obscured in the process. The insurance company is left with little or nothing to say about the salaries or the hiring of management personnel. Those directors of the insurance company who are outsiders (not involved in the management entity) may not even know the salaries or other compensation paid. The books of the insurance company show only the fee paid the management entity; the operating figures of expenses and net profits are on the books of the management entity.

The surrender of control and basic functions to another entity is open to even more serious challenge in the case of an insurance company than an ordinary corporation. Only companies licensed by the Commissioner of Insurance can transact business, and then only as regulated under the law.

It is the insurance company which is licensed by the state to transact business and is accountable for its conduct in accordance with the laws of Wisconsin. It should stand on its own feet, manage its own affairs, and function in practice and not on paper. It —not a different, unlicensed organization—should be expected to discharge the important responsibilities for which a license was granted.

V. CONCLUSION—REGULATION VS. PROHIBITION OF MANAGEMENT CONTRACTS

As stated earlier, we have not attempted a 50-state survey of management contracts. Our study of the insurance industry outside of Wisconsin was limited, but it indicated that other state insurance departments have recognized the problem of conflict of interest in management contracts and their potential use as a means of siphoning profits out of the insurance companies.

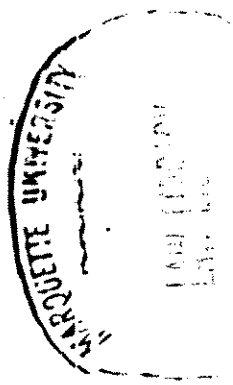
In 1957 the Wisconsin Insurance Department sent a questionnaire to each state department of insurance requesting information on its regulation of management contracts. The results indicated that about half of the states regulate or prohibit management contracts by statute, by departmental rules and regulations, or by informal conferences with the insurance companies involved.

Seven states,[120] and the District of Columbia,[121] have specifi-

[120] ARIZ. REV. STAT. ANN. § 20-727 (1956); IDAHO CODE § 41-2838 (1961); MONT. REV. CODES ANN. § 40-4724 (1961); OKLA. STAT. tit. 36, § 2127 (Supp.

cally regulated management contracts by statute, and each has enacted substantially the same statute. It provides that no stock or mutual insurance company incorporated under the laws of that state may enter into certain contracts unless the contract is submitted to the commissioner of insurance for approval. Basically, the statute covers two types of contracts: (1) contracts delegating management responsibility; and (2) exclusive general agency contracts. A contract is deemed approved unless the commissioner disapproves it within a fixed time after it has been filed. The statute directs the commissioner to disapprove any contract which provides for excessive charges, does not contain fair and adequate standards of performance, extends for an unreasonable length of time, or contains other provisions which are inequitable or may jeopardize the security of policyholders.[122] In addition, Idaho's statute requires the manager or general agent, at the end of each year, to furnish the insurance company's board of directors a written statement of amounts received and expended under the contract, including payments made to directors, officers, and other key personnel of the management or agency entity. It also provides that the commissioner may withdraw his approval of the contract after a hearing.[123]

We wrote to the insurance commissioners of a number of these states regarding their experience with such legislation and their general observations about management contracts. All pointed out the difficulties posed by the contracts and discouraged their use.



1959); VA. CODE ANN. § 38.1-29.1 (Supp. 1968); WASH. REV. CODE ANN. § 48.07.090 (1961); and W. VA. CODE § 33-5-21 (1966).

121 D.C. CODE ANN. § 35-1322 (1961).

122 For example, the Washington statute is as follows:

> (1) No incorporated domestic insurer shall enter into any contract the effect of which would be to grant or surrender the control and management of the insurer to any person.
>
> (2) No incorporated domestic insurer shall make any contract whereby any person is granted or is to enjoy in fact the control and management, or the controlling or preemptive right to produce substantially all insurance business for the insurer, unless such contract is filed with and approved by the commissioner. The contract shall be deemed approved unless disapproved by the commissioner within thirty days after date of filing. Any disapproval shall be delivered to the insurer in writing, stating the grounds therefor.
>
> (3) The commissioner shall not approve any contract referred to in subsection (1) which:
>
> (a) Subjects the insurer to excessive charges for expenses or commissions; or
>
> (b) vests in any person any control over the general affairs of the insurer tantamount to the exclusion of control by its board of directors or officers; or
>
> (c) is to extend for an unreasonable length of time; or
>
> (d) contains other inequitable provisions or provisions which may jeopardize the security of policyholders.

WASH. REV. CODE § 48.07.090 (1951). Arizona, Montana, Oklahoma, Virginia, and West Virginia have adopted essentially the same statute.

123 IDAHO CODE ANN. § 41-2838 (1961).

Although regulation provides some measure of control, it is probably more realistic and constructive to prohibit the contracts altogether. This would eliminate the dangers inherent in the typical management contract because of conflicts of interest and excessive delegation of authority to another entity. Good management can be achieved by methods less susceptible to abuse.

During the course of our study, numerous conferences were held by the Insurance Department and by us with representatives of Wisconsin companies and their management entities, concerning their management contracts. As a result, all such contracts were terminated.[124] In order to avoid any temptation to use them again, the Wisconsin Insurance Laws Revision Committee has recommended, in its chapter on domestic insurance corporations, that management contracts be prohibited.[125]

---

[124] In order to prevent the creation of additional management contracts during the pendency of the 1962-1965 study, it was the Insurance Department's policy not to permit domestic companies to enter into new management contracts. Any foreign company seeking to do business in Wisconsin and having a management entity or comparable arrangement was scrutinized, and changes in operation were required, where necessary, before issuance of a license. In addition, on August 15, 1962, the Commissioner notified all insurance companies with management contracts that they must give him 30 days written notice before any amendment, termination, or other disposition of their contract was made.

No domestic company sought to enter into a management contract between June 1962 and December 1965, but other plans, such as organizing affiliated companies, sometimes raised questions similar to those of the management contract or were tied in with existing management contracts. The Commissioner consulted with us in dealing with these matters, which were carefully studied before any Department approval was given.

The original goal of the study of the management contract was to publish a report setting forth our findings with respect to management contracts and to suggest appropriate action which might be taken, if necessary, to protect policyholders and the public.

As the study progressed, the data demonstrated that management contracts were potential sources of abuse and should be eliminated. Although various factors in the history of some companies indicated mitigating reasons for the creation of the management contract, on careful consideration the advantages of continuing to operate under the contract, if any, appeared to be outweighed by the problems inherent in the management contract concept. These problems were discussed with the representatives of several insurance companies and management entities, and we found they were interested in exploring the question of terminating their contracts.

Accordingly, it was decided to hold conferences with all companies and entities having management contracts and to put off completion of the report until the subject of termination was thoroughly discussed with each of them. Much time was devoted by the Department and us to plans and details for termination. The time proved well spent, for as of December 31, 1965, all such contracts between domestic insurance companies and their management entitles had been terminated or were in the process of termination.

[125] WIS. INS. LAW REV. COMM. (3d Draft) § 37 at 123. A previous draft permitted management contracts under stringent regulation, but recognized

This still leaves the problem of dealing with foreign compan operating under the typical management contract. There are ve few such companies licensed in Wisconsin. We suggest that th be given a reasonable time to terminate the arrangement, a foreign companies seeking admission should be required to comp with the same contract prohibition applicable to domestic co panies. Retaliation by the home states against Wisconsin co panies should pose no difficulty because the domestic compan no longer use the contract.

The progress made in eliminating management contracts shou not be lost by permitting the use of other forms or of circumventi devices. Nor should other conflict of interest arrangements ignored. Several important proposals dealing with such matte are before the Insurance Laws Revision Committee. One wou prohibit exclusive agency agreements under which an agency granted the exclusive right to solicit all, or substantially all, t insurance business of a company. Another would regulate oth dealings between an insurance company and any of its directo or officers, or between the insurance company and an entity which a director or officer of the insurer or a person controlli it has a material interest. Such transactions would be voidab unless the following conditions are met:

> (1) The transaction at the time it is entered into is reasonable and fair to the interests of the corporation; and
> (2) The transaction has, with full knowledge of its terms and of the interests involved, been approved in advance by the board of directors or by the shareholders; and
> (3) The transaction has been reported to the commissioner immediately after such approval.[126]

In addition, the Commissioner of Insurance would be empowered require by rule that any classes of transactions which by the nature "tend especially to be unreasonable or unfair to the i terests of the corporation" be submitted to him in advance f approval.[127]

Another significant proposal of the Committee is a bill to reg late insurance holding companies and intercorporate transactior

---

that a tough regulatory provision can in fact be a prohibition:

> The original section permitted management contracts, but subject them to such close control that they would no longer be convenie or likely instruments for the abuses that plagued them in t past. Perhaps they would no longer have been attractive at all.

Id. at 124.

However, the staff concluded that an ideal insurance code might w permit management contracts subject to controls. In view of the Wiscons history and absence of management contracts presently, the staff stat that outright prohibition for domestic corporations can cause no harm in t domestic market. *Id.* at 125.

[126] *Id.* § 32(1)(a), (b), (c) at 105-06.

[127] *Id.* § 32(3) at 106.

In addition to the reporting required of affiliates, and certain regulatory powers given the Insurance Commissioner, the measure would impose liability upon controlling persons for "milking" or draining the surplus of an insurer by corporate distributions.

These and other recommendations, including proposals for full disclosure and for a board majority of outside, independent directors, should help in protecting the interests of the insurer and the public.

Transactions with affiliated personnel cannot, of course, be wholly eliminated. However, they require constant scrutiny and objective appraisal if the abuses of self-dealing are to be avoided. The increasing litigation against corporate officers and directors in recent years should make such personnel more keenly aware of the fiduciary requirements of undivided loyalty, especially in a business affected with a public interest.

APPENDIX

TABLE 1

Insurance Companies—Number and Percent With Management Contracts in 1961

Insurance Companies	Total No. In the Study	No. With Management Contracts	% With Management Contracts
Wisconsin Domestic			
Mutual	67	11	16.4%
Stock	31	2	6.5%
Accident and Health Associations	6	0	0
Fraternal Societies	11	0	0
Total	115	13	11.2%
Foreign and Alien			
Mutual	119	4*	3.4%
Stock	306	35*	11.4%
Fraternal Societies	32	0	0
Total	457	39*	8.5%

* The term management contract, as used in reference to foreign and alien companies, includes "management contracts", "service contracts" and "agency contracts". *See* 1965 MANAGEMENT REPORT Ch. 8.

TABLE 2

Duration Renewal, Termination and Assignability Provisions of Management Contracts (1957-1961)

Names of Parties	Effective Date	Term of Agreement	Renewal Provisions	Modification and Termination Provisions	Provisions for Assignability
Badger State Mutual Casualty Company & Badger State Underwriters, Inc.	Jan. 1, 1950 (Replaces contract dated Jan. 31, 1946)	15 years	Mutual agreement of parties.	None	Yes
Central Farm Mutual Insurance Company & Central Farm Mutual Management, Inc.	Sept. 8, 1960	5 years	Automatically renewed for successive 5-year terms.	Termination by 6 months' written notice prior to end of term; modified or terminated by mutual consent.	None
Dairyland Mutual Insurance Company & Dairyland Managers, Inc.	Jan. 1, 1960	5 years	Automatically renewed for successive 5-year terms.	Termination by 6 months' written notice prior to end of term.	Parties agree. S. Struck owns majority stock of Dairyland Managers; Struck not to divest self of control of management corporation without insurance company's consent; in the event of Struck's death no new manager of the management corporation shall be employed without consent of insurance company.

Great Lakes Mutual Insurance Company & Great Lakes Management Company, Inc.	April 1, 1957	10 years	Renewable for 10-year period by agreement of parties.	None	Yes
Hallmark Insurance Company, Inc. & Federal Underwriters, Inc.	Dec. 15, 1961 (Insurance company licensed)	5 years	Automatically renewed for succesive 5-year periods.	(1) Termination by 12 months' notice prior to end of term. (2) Insurance company may terminate on 5 days' written notice if management corporation breaches agreement or both Messrs. Six & Bruce die or terminate employment. (3) Terminates if Hallmark unable to issue insurance policies or if Federal insolvent or unable to write policies or procure agents.	Not assignable by either party.
Home Mutual Insurance Company & Insurance Associates, Incorporated	Dec. 19, 1949	6 years	Each year contract automatically extended to run for another 6 years unless parties elect to terminate.	(1) Termination by 30-60 days' notice prior to annual anniversary date for contract to terminate at end of 5 years. (2) Modified or revoked by mutual consent. (3) Insurance company may terminate at any time after 5 years from time management corporation has funds on hand in excess of capital stock plus indebtedness.	Yes