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The Changing Status of Participating Policyholders

Claude Gingras

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Article abstract

La présente réflexion concerne les droits administratifs des détenteurs de polices participantes des compagnies mutuelles d'assurance sur la vie au Canada. L'auteur décrit sommairement les lacunes actuelles et le lent développement des corporations mutuelles depuis la Confédération. Dans un second temps, il tente de dégager les aspects essentiels qui devraient être encadrés dans les réformes proposées, fédérale et provinciale, notamment la reconnaissance pleine et entière des détenteurs de polices participantes en tant que propriétaires des compagnies mutuelles, incluant tous les droits et privilèges que ce statut leur confère, notamment en matière de droits politiques, économiques et judiciaires.

The Changing Status of Participating Policyholders [1]

by

Claude Gingras [2]

La présente réflexion concerne les droits administratifs des détenteurs de polices participantes des compagnies mutuelles d'assurance sur la vie au Canada. L'auteur décrit sommairement les lacunes actuelles et le lent développement des corporations mutuelles depuis la Confédération. Dans un second temps, il tente de dégager les aspects essentiels qui devraient être encadrés dans les réformes proposées, fédérale et provinciale, notamment la reconnaissance pleine et entière des détenteurs de polices participantes en tant que propriétaires des compagnies mutuelles, incluant tous les droits et privilèges que ce statut leur confère, notamment en matière de droits politiques, économiques et judiciaires.

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I will confine the bulk of my remarks to the corporate status of par policyholders in Canadian mutual life insurance companies. Par policyholders in stock companies certainly constitute an interesting case but they have very limited access to corporate mutuality.

Contractual mutuality is well known to us all. Reform of federal insurance legislation is coming. It seems to me that the real challenge is to invent (I don't think the word is too strong) a viable legal framework for corporate mutuality. Success would mean that the mutual corporate structure would be given its own identity, with distinctive attributes and modus operandi. A good start would be to recognize that the primary purpose of a mutual structure is not to provide a widely held ownership nor a Canadian, or for that matter, a Quebec, ownership; rather, the primary purpose is to provide insurance at the lowest cost consistent with the solvency and the viability of the organization. This can be contrasted with the

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[1]Remarks of Claude Gingras, C.I.A. General Meeting, November 15, 1990.

[2]Vice President and General Counsel, The Mutual Group.

primary purpose of a stock company which, in our economic system, is to provide the best return to its owners, the shareholders, under the same constraints.

Before I pursue further this subject, I want to provide some personal background. I started to develop a strong interest in the governance of a mutual when my company embarked on a program of diversification in the early 80's. I was convinced — like our CEO — that the way to gain more management discretion and greater diversification powers was enhanced accountability to our policyholders. This was seen as a necessary quid pro quo for the removal of the very rigid supervisory controls then in effect.

From a professional point of view, I was also intrigued by the existence of very different structures — mutual and stock companies — which in practice produced identical results for policyholders, through contractual mutuality [3]. In my view, if stock and mutual life insurance companies could not be ascribed different purposes and functions, the presence of their different structures constituted a waste of legal and supervisory resources. I thus made the issue of governance of mutual companies the subject of my "major paper" for my master's degree in business law at York University in 1984. The text was published in the 1985 annual meeting proceedings of the Legal Section of CLHIA.

Today I want to share with you some of the conclusions I then reached, as well as several other considerations resulting from six more years of reflection on this topic, taking also in account recent developments. Outstanding among these developments was the announcement last September by Mr. Loiselle, Minister of State for Finance, that the corporate rights of participating policyholders will be enhanced along the lines of the provisions applying to shareholders under modern corporate law.

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[3]After extensive study of the matter, the Select Committee on Company Law of the Ontario Legislature concluded in 1980: "[...] the Committee has seen no evidence to indicate that there are any significant differences in the methods of operation of mutual and stock life insurers in Ontario... Aside from some legal distinctions such as the mechanics of electing Boards of Directors, there is, in the Committee's view, little by way of underlying techniques and philosophies of management of mutual and stock companies to differentiate their operating practices." (*Fourth Report on Life Insurance*, June 1980, page 430).

The Old System of Governance

To understand the magnitude of the transformation that will soon be coming to us, it is first necessary to review briefly the elements and circumstances of the regulatory regime which prevailed for more than a century.

Immediately after Confederation, the federal government occupied the field of insurance for the declared purpose of safeguarding the public interest. By 1876, less than 10 years after Confederation, all the major elements of the federal system of supervision were in place: the office of the federal Superintendent of Insurance had been created, which was to be occupied by a succession of strong-minded incumbents; detailed reports were required together with segregation of assets and proper reserving for liabilities. Finally regular inspections were carried out. Such a strict supervision system, with the main purpose of ensuring solvency and fair treatment, left very little room for participation by policyholders in the corporate affairs of their companies.

Although this was the main factor, other historical factors contributed to the very slow development of corporate mutuality:

- The jurisdictional dispute over insurance is one. It is not well known that for some 20 years at the beginning of this century, par policyholders had a legal recourse to force their companies to distribute excess surplus. But when in 1931 the federal authorities lost the battle over jurisdiction on insurance, this legal recourse disappeared in the following federal insurance statute of 1932. This judicial right to force an accounting was dropped from the federal act because it was considered to be too closely related to contractual matters, I have been told. The provinces never picked up the ball with the result that an important instrument of control for par policyholders over their companies was definitively lost.
- Another factor for the slow development of corporate mutuality was the failure of the English judiciary — after a promising start, I must say — to clearly articulate the principles that would have recognized the distinctive nature of mutuals. Instead, on the basis of the *Salomon* v. *Salomon* case, the independent fictitious corporate personality was made absolute,

without any attention being paid to the desires and motivation of the mutualists in establishing their companies.

- Finally, it can be said that the tradition of mutuality in its corporate form was a marginal phenomenon in Canada for a long time. Mutual Life of Canada had been the only federal mutual for some sixty years when North American Life mutualized in 1931. The other large mutuals adopted this structure very recently, some 30 years ago, not because of the virtues of corporate mutuality but rather for very practical reasons — to avoid the discipline of the stock market and foreign takeovers.

So much for the difficult past of corporate mutuality. The future appears more promising for this form of corporate structure.

The Emerging System of Governance

In the long overdue federal reform, we are told that companies will be given a system of increased accountability to their stakeholders to counter-balance greater freedom in investment and business powers.

For a mutual company a system of governance conforming with modern corporate law requirements would call for three fundamental determinations:

1. The recognition of par policyholders as owners of their company;
2. The determination of the privileges attached to their ownership status; and
3. The establishment of mechanisms by which their ownership rights can be exercised.

That par policyholders should be recognized as owners of their company is a direct, and I might say, natural consequence of their voting power. Various theories have been advanced to deny to par policyholders their ownership status. The prevailing one is that a mutual company stands in a fiduciary position to society at large for the benefit of not only present but future generations of policyholders. Not only does such an approach fail under general trust law because of uncertainty of subject-matter and beneficiaries but this view will no longer be defendable once the present generation of

voting policyholders is possessed of effective means to change the management of the company and intervene in its affairs in order to chart its course.

It has also been said that par policyholders deserve no special recognition because there is practically no difference between a par policy and an adjustable premium non-par policy. That may be the case when mutuality is viewed only as a pricing mechanism. Under corporate mutuality what counts is the voting power and the right to share in the divisible surplus of the company. That a mutual company be allowed to sell par and non-par contracts is not the issue. What is important is that the life insurance purchasers be informed of their rights at the time of purchase, i.e., whether they are acquiring par policies, with resulting corporate rights, or non-par policies with only customer rights.

Another claim I have heard within our industry is that par policyholders cannot be owners of their company because their situation is dissimilar to that of shareholders. But there is no need for ownership of companies to conform to this model. One should perhaps read the *History of Ownership* by Jacques Attali to realize how the ownership concept has taken an almost infinite number of forms in different societies and through the ages.

Par policyholders will never be shareholders and par policyholder democracy will never be shareholder democracy. For one thing there is no such thing as shareholder democracy, only shareholding democracy. Par policyholders do not have a negotiable title but rather purchase a service. Yet in practice, and at law, so long as they alone have effective means of controlling company affairs and are solely capable of giving legitimacy to management decisions, they should be recognized as owners.

In looking at par policyholders as owners of mutual companies the argument to the contrary is also valid: if they don't own the company, who does? [4]

[4]The legitimacy of the par policyholders' claim to the ownership of their companies is also supported by the purpose of mutuals. Par policyholders, among all possible contenders, are the ones best situated to make sure that insurance is provided at the lowest cost consistent with solvency and viability, if given the means to effectively control management.

The scope of their ownership extends to the entire enterprise and, consequently, to the totality of surplus whether derived from the par or non-par business, investments in assets or in subsidiaries, and any other business pursuits of the company.

Under a modem system of governance and effective accountability the permanent contribution to surplus theory will not be able to hold its ground for long! Nor would the argument that most of the surplus, having been contributed by past generations of policyholders, should escape accountability to the present voting generation.

Old ways of thinking are tough to discard, however. For instance one can read in the *Brender Report* prepared last year for the Office of the Superintendent of Financial Institutions, the following:

> "In some cases, mutual companies have large and rather profitable blocks of non-participating business which were written before the companies mutualized. To the extent that those blocks of business were never supported by the participating fund, given the historical circumstances, it is difficult to insist that the emerging profits should accrue directly to the current participating policyholders, even if they do accrue to the mutual company."

This argument is not only alarming, it is also wrong. If the par policyholders of the Canadian stock companies which mutualized did not buy the rights to the non-par business, then the mutualizations of the early 60's were major swindles!

The rights of par policyholders as owners of their companies are numerous. Jack Masterman, CEO of the first Canadian mutual life insurance company, in his address to the 1989 annual meeting described as follows the rights of mutualists:

> "In a mutual company, final authority is vested collectively in its policyholders as owners... Policyholders of a mutual have certain fundamental rights. These include the right to order the affairs of the company, the right to information, the right to an accounting of the financial results and, in the case of participating policyholders, the right to share in earnings." [*meaning earnings from all sources, of course.*]

As owners of their companies, par policyholders should, in my opinion, have three sets of rights:

1. *Political rights*

   These include the right to information and the rights to elect the board, make proposals and approve major changes. (It was announced that the dividend policy of a company should be available to par policyholders. The annual statements are also another important source of information for them).

2. *Economic rights*

   These extend beyond experience or pricing dividends to all parts of consolidated surplus, to what my company has recently named ownership dividends.

3. *Judicial rights*

   These include the right to derivative actions and rights stemming from the higher duties and standards of conduct to be imposed by legislation on directors and officer of insurance companies.

To know in detail how these rights could be exercised by par policyholders we will have to wait for the text of the Federal insurance legislation which I hope will be tabled in early 1991.

In Lieu of a Conclusion

I am aware that I have barely scratched the surface of this important topic. Given the space limitations I want to conclude with some comments related to the forthcoming change in status of par policyholders.

1. I maintain that the new governance of mutual companies will be the most original part in the legislative package promised by Ottawa. It has been often said that Quebec is by far the leading jurisdiction in the modernization of financial institutions legislation. However, in the recent *Quinquennal Report* on the Application of Quebec's Bill 75 of 1984, beyond good intentions stated in the introduction, no concrete measure is in fact being proposed to improve par policyholders' rights as owners of their companies.

As Tom Courchêne, a keen observer of the Canadian political scene, said, Quebec is pursuing a different agenda in its financial institutions reform, which is inspired by what he called "market nationalism." Ottawa will be the first jurisdiction in Canada that will promote consumer protection in insurance by enhancing par policyholders' rights.

2. In 1979, Robin Leckie, who was then chief actuary of Manufacturers Life, said: "In a way, there is little fundamental difference in ownership rights between a participating policyholder of a mutual company and a non-participating policyholder of a stock company. The actual difference in the contracts is that the former is entitled to insurance at cost as measured retrospectively by the actuary, while the latter receives his insurance at cost estimated prospectively. Both should pay something for the use of someone else's capital and for the right to participate in a going concern enterprise [5]." I suggest that once our legislation is modernized, such thinking will clearly appear to be from another age and, perhaps, from a different world!

3. A word should be said about par policyholders in stock companies. I have always thought that they would be better protected by legislative provisions similar to former section 84 of the CBIC Act rather than by extending to them a system of governance based on shareholder democracy. Clearly they will always be in a minority position and their economic interest will continue to be confined to the par fund: If elements of shareholders' rights are to be given to them, perhaps they should have an oppression remedy, as do minority shareholders under modern corporate law.

4. The enhancement of policyholders' rights would seem to make even more artificial, if that is possible, the hastily introduced provision in 1987 in the CBIC Act, which deemed a mutual company with its head office in Canada and at least 75% of its directors residing in this country to be controlled in Canada regardless of where the majority of voting policyholders live [6].

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[5] "Some Actuarial Considerations for Mutual Companies" (1979) 31 Transaction 187, at page 190.

[6] It is said that this deeming provision was put in the Act to allow large Canadian mutuals with a majority of voting policyholders outside Canada to avoid restrictions applicable to non-residents under Canadian laws. In my view there are better ways of doing that than deeming

5. The implementation of enhanced accountability to par policyholders will certainly create new issues and require changes in other legislation. For instance, under corporate mutuality what justification is there for the punitive tax treatment applicable when dividends exceed earnings of the par fund? Why should ownership dividends be reported in financial statements as coming out of present year earnings when in fact they flow from a reappraisal of necessary surplus from all sources held for solvency and growth or constitute a distribution of excess surplus which may be triggered by other factors than yearly earnings [7].

6. Finally, to finish on a very positive note, I will say this: until recently the offices of the chief actuary and of the general counsel in our companies have functioned quite independently with few business contacts. In my opinion, this is bound to change with the legislative reform. Equity of treatment of policyholders will take on new dimensions, political and legal ones. I certainly welcome this "rapprochement." It will be a delight to witness the disappearance of at least these two solitudes in my lifetime!

In conclusion, I think we are entering a fascinating period for the Canadian life insurance industry, one in which the Canadian insurance consumers will be given the opportunity not only to buy par policies from mutual insurance companies but to actually control their companies.

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these companies to be Canadian controlled on the basis of the location of their head office and residency of a portion of their directors. After all, these companies have not in the past refrained from using out-of-Canada votes and proxies to support management decisions. The dubiousness of this fiction will be exacerbated by the proposed enhancement of par policyholders' rights.

[7]For instance, should an effective cure for AIDS be discovered, a reassessment of the surplus needs could lead to a release of that portion which has been appropriated by many companies to protect themselves against the effects of this dreaded desease. A distribution of that excess in the form of an ownership dividend would then have no relations whatever to the earnings of the year.