

# STATE OF ILLINOIS

## DEPARTMENT OF INSURANCE



IN THE MATTER OF:

HEARING NO. 15-HR-0542

FEDERAL LIFE INSURANCE COMPANY'S  
APPLICATION OF APPROVAL OF A PLAN  
FOR MUTUAL HOLDING COMPANY  
CONVERSION

### ORDER

I, Anne Melissa Dowling, Acting Director of the Illinois Department of Insurance, hereby certify that I have read the Record in this matter and the hereto attached Findings of Fact, Conclusions of Law and Recommendations of the Hearing Officer, Anne Marie Skallerup, appointed and designated pursuant to Section 402 of the Illinois Insurance Code (215 ILCS 5/402) to conduct a Hearing in the above-captioned matter and that I have carefully considered the Record of the Hearing and the Findings of Fact, Conclusions of Law and Recommendations of the Hearing Officer attached hereto and made a part hereof.

I, Anne Melissa Dowling, Acting Director of the Illinois Department of Insurance, being duly advised in the premises, do hereby adopt the Findings of Fact, Conclusions of Law and Recommendations of the Hearing Officer as my own, and based upon said Findings, Conclusions and Recommendations enter the following Order under the authority granted to me by Article III, and Article XXIV of the Illinois Insurance Code (215 ILCS 5/36 *et seq.* and 215 ILCS 5/401 *et seq.*) and Article X of the Illinois Administrative Procedure Act (5 ILCS 100/10-5 *et seq.*).

This Order is a Final Decision pursuant to the Illinois Administrative Procedure Act (5 ILCS 100/1 *et seq.*). Parties to the proceeding may petition the Director of Insurance for a Rehearing or to Reopen the Hearing pursuant to 50 Ill. Adm. Code 2402.280. Appeal of this Order is governed by the Illinois Administrative Review Law (735 ILCS 5/3-101 *et seq.*).

**NOW IT IS THEREFORE ORDERED THAT:**

- 1) In addition to any other provisions of the Illinois Insurance Code governing the operation of an Illinois domestic insurance company, the approval of the Plan of Conversion of Federal Life Insurance Company is subject to the following conditions:
  - a) The Director's approval of the trust agreement in accordance with 215 ILCS 5/59.2(11)(d); and
  - b) All of the following actions are subject to prior approval of the Director in accordance with the standards set forth in 215 ILCS 5/59.2(5)(c):
    - i) any acquisition or formation of an affiliated entity of Federal Life Mutual Holding Company;
    - ii) any changes to the articles of incorporation, bylaws, or capital structure of any intermediate holding company;
    - iii) any initial public offering or other issuance of equity or debt securities of any intermediate holding company or Federal Life Insurance Company in a private sale or public offering. The term "issuance of equity" includes, but is not limited to, any proposed sale, exchange, subscription, award, or transfer of stock, warrants, options, voting rights, or other ownership rights or interests in the issuer or of any securities directly or indirectly convertible or exchangeable into any of the foregoing;
    - iv) any change or expansion of the converted company into lines of business, industries, or operations not presented at the time of the conversion;
    - v) any changes to the dividend principles, with respect to the determination of divisible surplus or the allocation of divisible surplus of, or the calculation, declaration, or payment of dividends or distributions from Federal Life Insurance Company or any intermediate holding company;
    - vi) any dividend distributions from the converted stock company and any intermediate holding company and any waiver by the mutual holding company of any dividends or distributions payable to the mutual holding company;

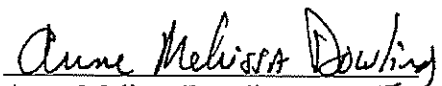
- vii) the pledge, encumbrance, or transfer of stock of the converted company;
- viii) any changes to the trust agreement; and
- ix) the distribution or employment of excess accumulated earnings of the mutual holding company, which shall inure to the exclusive benefit of the members of the mutual holding company.

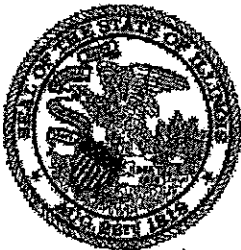
All of the foregoing actions must be approved by the Federal Life Mutual Holding Company Board of Directors prior to submission to the Director.

- 2) The requirement for the converted company to operate its participating policies for dividend purposes as a closed block of business pursuant to 215 ILCS 5/59.2(8)(b)(iv) is hereby waived. The converted company shall comply with the requirements of 215 ILCS 5/233.
- 3) The minimum surplus requirements of 215 ILCS 5/43(1) and the statutory deposit requirements of 215 ILCS 5/53 shall be required of the mutual holding company.
- 4) Pursuant to the provisions of 215 ILCS 5/408(5), the court reporter fee and expenses in the amount of \$355.25 be paid by Federal Life Insurance Company.

DEPARTMENT OF INSURANCE  
of the State of Illinois

Date: December 2, 2015

  
Anne Melissa Dowling JAS  
Acting Director



# STATE OF ILLINOIS

## DEPARTMENT OF INSURANCE



IN THE MATTER OF:

HEARING NO. 15-HR-0542

FEDERAL LIFE INSURANCE COMPANY'S  
APPLICATION OF APPROVAL OF A PLAN  
FOR MUTUAL HOLDING COMPANY  
CONVERSION

**FINDINGS OF FACT, CONCLUSIONS OF LAW  
AND RECOMMENDATIONS OF THE  
HEARING OFFICER**

Now comes Anne Marie Skallerup, Hearing Officer, in the above captioned matter and hereby offers her Findings of Fact, Conclusions of Law and Recommendations to the Acting Director of Insurance, Anne Melissa Dowling, (hereinafter the "Director").

**FINDINGS OF FACT**

**PROCEDURAL DOCUMENTS AND THE EVIDENCE**

- 1) On July 9, 2015, the Director issued a Notice of Public Hearing ("Notice") in this matter setting a Hearing date and location of the hearing, August 26, 2015 at 10:00 am in the Department's Offices in Springfield, Illinois. The Notice set forth that any interested person may appear or otherwise be heard at the public hearing and contained instructions for the submission of written statements and questions and to make an oral statement during the hearing. (Hearing Officer Exhibit #2)
- 2) On July 9, 2015, the Director issued an Authority to Conduct Hearing appointing Anne Marie Skallerup as Hearing Officer in this matter. (Hearing Officer Exhibit #1)
- 3) On July 9, 2015, James C. Rundblom filed a Notice of Appearance as Counsel for the Department. (Hearing Officer Exhibit #3)

- 4) On August 5, 2015, Mark R. Goodman filed a Notice of Appearance as Counsel for Federal Life Insurance Company (“Federal Life”). (Hearing Officer Exhibit #4)
- 5) On August 7, 2015, the Hearing Officer entered an Order granting Federal Life’s Motion for a pre-hearing conference, which was conducted August 18, 2015. (Hearing Officer Exhibit #5)
- 6) Hearing Officer Exhibits 1 – 5 were entered into the Record without objection. (R.11). It was stipulated that the closed block requirement was waived in the conversion of Mutual Trust Life Insurance Company and Trustmark Insurance Company’s conversions. (R.83)
- 7) The Hearing in this matter was convened on August 26, 2015, at the Department’s Offices in Springfield, Illinois. Those present included: Anne Marie Skallerup, Hearing Officer; Mark R. Goodman Counsel for Federal Life; Jim Rundblom, Counsel for the Department; William Austin, President and Chief Operating Officer of Federal Life Insurance Company; Marcy Savage, Acting Assistant Deputy Director of the Department Corporate Regulatory Unit; Susan Lamb, Associate Actuary of the Department. (R.6-7). Paul R. Murphy, an actuary of Federal Life, was not present at the Hearing, but testified by phone. (R. 49)
- 8) This hearing was held pursuant to the Director’s authority set forth in Sections 59.2(5), 401, 402 and 403 of the Illinois Insurance Code (“Code”) (215 ILCS 5/59.2(5), 401, 402, 403). The purpose of this proceeding was to receive testimony and other forms of evidence at the hearing regarding issues relevant to whether the Director should approve or disapprove Federal Life’s Plan for Mutual Holding Company Conversion (“Plan”) and, if the Plan is approved, whether the Director should impose conditions on such approval. Specifically, the Hearing Officer was authorized to hear testimony and receive and review evidence regarding (i) whether the Plan complies with the provisions of Section 59.2 of the Code (215 ILCS 5/59.2), (ii) whether the Plan is fair and equitable as it relates to the interests of the policyholders of Federal Life, (iii) whether the Director’s approval of the Plan should be subject to any conditions reasonably necessary to protect policyholder interests, including but not limited to any of the conditions provided in Section 59.2(5)(c) of the Code (215 ILCS 5/59.2(5)(c)), (iv) whether the Director should waive the requirement for the establishment of a “closed block” (as contemplated by Section 59.2(8)(b)(iv) of the Code (215 ILCS 5/59.2(8)(b)(iv)) because it is in the best interests of the participating policyholders of Federal Life to do so, and (v) whether the resulting mutual holding company formed pursuant to the Plan, if approved, should be required to comply with the statutory deposit requirement of Section 53 of the Code (215 ILCS 5/53).
- 9) William Austin, President & Chief Operating Officer (“COO”) of Federal Life, testified in this matter as follows (R. 15-35):
  - a) He has been with Federal Life since 1990. He was elected to the Board of Directors in 1992 and has served as the Chairman of the investment committee since that time. As President and COO, he is responsible for the operations of the insurance company, including both the financial and administrative and marketing areas.

- b) Federal Life was incorporated in 1899 as a stock company in Chicago. It became a mutual company in 1962. Federal Life is currently headquartered in Riverwoods, Illinois in Lake County, Illinois.
- c) Federal Life sells insurance and annuities. It sells single premium life insurance, interest sensitive whole life, universal life, final expense whole life, term life, and fixed annuities. It also administers a variable annuity with a partnership that it has with Vanguard. It also administers disability plans on the accident and health side.
- d) The amount Federal Life has inforce of life insurance is \$2.4 billion. Its total assets are \$230 million as of December 31, 2014. That number is from Federal Life's last audited financial statements. Its total adjusted capital under the Risk Based Capital ("RBC") rules as of August 26, 2015 is \$20.4 million.
- e) Federal Life is pursuing a mutual holding company conversion because it would like the flexibility in its operations to raise capital by issuing stock or entering relationships with other mutual holding companies or other mutual companies if it desires. Such partnerships will provide Federal Life with opportunities for growth which could lead to efficiencies in its operations, as well as allow it to diversify its offerings.
- f) There is no current plan to demutualize the mutual holding company following the conversion.
- g) There are no plans for merger or issuance of stock from either the intermediate holding company or the Federal Life Insurance Company following the conversion.<sup>1</sup>
- h) Federal Life policyholders will have the same contractual rights they have now and will continue to have the same contractual rights with the [stock] insurance company. The policyholders will have the same contractual rights with an insurer that will be in the same financial position it was in before the conversion. The policyholders will become members of the mutual holding company and have the same rights as members of the mutual holding company that they had with the insurance company previously.
- i) Membership rights will include the right to vote on any matters that come before the members, including the right to elect directors of the company.
- j) The Federal Life Board of Directors elected to adopt the Plan on November 20, 2014 by unanimous vote. At that time, the Board of Directors authorized the Federal Life Chief Executive Officer ("CEO") to take further actions as required in pursuant of the Plan, including making immaterial changes to the Plan as requested by the Department.
- k) The items required by Section 59.2(5)(b)(i) of the Code (215 ILCS 5/59.2(5)(b)(i)) were submitted to the Department following the Board of Directors' adoption of the Plan, including the Plan, the form of notice to the policyholders, a proposed proxy form, the

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<sup>1</sup> Federal Life Insurance Company will be the stock company post conversion. (R.14)

proposed articles and bylaws of the mutual holding company, of the intermediate holding company, and the converted insurance company.

- l) Federal Life Exhibit #4 is a letter dated December 12, 2014 from him to former Director Boron submitting an application for approval of a mutual holding company conversion, including the Plan and articles and bylaws of the three companies, a proxy form, and a form of policyholder statement.
- m) The Department requested revisions to the Plan and exhibits to the Plan over the past six months and the revisions were made.
- n) Federal Life Exhibit #1, which is the Plan with attachments labeled 'A' through 'G', which are articles of incorporation and bylaws of Federal Life Insurance Company, revised bylaws of Federal Life Insurance Company, articles of incorporation of Federal Life Mutual Holding Company, bylaws of Federal Life Mutual Holding Company, a certificate of incorporation of FEDHO Holding Company, the intermediate holding company, and the bylaws of FEDHO Holding Company, and, Attachment G to Federal Life Exhibit #1, the actuarial opinion from Federal Life's actuary, reflect the form of the Plan and exhibits thereto approved by the Federal Life Board of Directors and modified following comments from the Department.
- o) Federal Life Exhibit #2 is the notice of special meeting of policyholders, which includes a proxy statement. Federal Life Exhibit #3 is a policyholder information statement. Both of the documents were reviewed by the Board of Directors ("Board") and accurately reflect what was approved by the Board as modified following conversations with the Department of Insurance.
- p) Submission of Federal Life Exhibit #1, and the exhibits thereto, and Federal Life Exhibits #2 and 3 to the Department are required by Section 59.2(5)(b)(i) [215 ILCS 5/59.2(5)(b)(i)] as part of the application for approval of a Plan of Conversion.
- q) Page 4 of the Plan, the second to last "whereas" clause states the reasons for conversion as required by Section 59.2(8)(a) [215 ILCS 5/59.2(8)(a)]. The clause states that the Board believes the conversion will enhance the insurance company's strategic and financial flexibility by creating a corporate structure that will enable it to more easily raise capital and enter into business relations with other mutual insurance companies and mutual holding companies. It will also provide an avenue for expansion and efficiencies of increased size and diversification through a mutual holding company structure.
- r) Section 7.5 of the Plan provides that all policies of the converted company in force on the effective date shall continue to remain in force under the terms of those policies, except for any voting or other member rights of the policyholders as provided for under its articles of incorporation or under the Code shall be extinguished with respect to the insurance company as of the effective time.

- s) Article 8, Section 8.1 of the Plan, provides that holders of participating policies on the effective date shall continue to have the right to receive dividends as provided in those participating policies. The first sentence of that Section states that all policies of the insurance company in effect on the effective date that according to their terms are participating policies, shall continue in force in accordance with their terms, and policyholders of such policies shall continue to be eligible to receive dividends in accordance with the policy terms, consistent with the company's dividend principles and practices prior to the effective date.
- t) The Plan provides that except for life policies, guaranteed renewable accident and health policies, and non-cancelable accident and health policies, that after the conversion, Federal Life may issue an insured a nonparticipating policy as a substitute for a participating policy upon renewal of the participating policy.
- u) Section 8.1, 8.2 and Exhibit G to the Plan set forth the reasons why establishment of a closed block for participating policies should be waived.
- v) The company believes that the establishment of a closed block is not necessary to protect the policyholders and is not in the best interest of the company or policyholders because the company has not issued dividend-paying policies since 1988. So, the size of the block is insignificant. The dividend paying policies represent 1.2 percent of the in-force policies of the company and 1.5 percent of the annualized premium. The total dividends paid out are less than \$300,000 a year and decreasing every year. The reserves that the company has put up on those dividend paying policies are actually in excess of requirements from cash flow testing that the company actuary has prepared. The company believes that the cost and expense of actually setting up a formal closed block are not necessary.
- w) The \$300,000 threshold is significant because the company's accountants have told them that they consider \$350,000 to be a material item. Whenever they discuss any audit issues, \$350,000 is what the company has historically been told is a material item. So, the \$300,000 amount the company pays out in dividends is less than the material threshold they have from an auditing standpoint.
- x) Discussions with the Department regarding approval of the Company's request to waive the establishment of a closed block as permitted by Section 59.2 over the last six months resulted in changes to Article 8 of the Plan. The changes have included adding a provision to the Plan that the company may modify its dividend principles and policies in effect on the approval date only with the approval of the Director. The changes have also included a provision that the company will annually submit to the Director a report on the book of dividend-paying policies, including the number of such policies, the aggregate face amount of the policies, and the total dividend paid on the policies.
- y) Section 7.1 of Article 7 sets forth the requirements for granting membership interests to future policyholders of the converted company. The first sentence of Section 7.1 states that as of the effective time, each member of the insurance company shall become a



member of the mutual holding company, and after the effective time, any person who becomes a policyholder of the Federal Life Insurance Company shall simultaneously become a member of the mutual holding company.

- z) Section 9.15 under Article 9 of the Plan provides information to demonstrate that the financial condition of the converted insurance company will not be diminished by the Plan or by the mutual holding company conversion. It states that the costs and expenses of the conversion will not be material to the financial condition of the insurance company.
- aa) There will be no material financial impact on the company from the conversion.
- bb) Article 9, Section 9.6 of the Plan provides that there are not present plans for the sale of stock of Federal Life Insurance Company or of FEDHO, the intermediate holding company, following the mutual holding company conversion.
- cc) Article 9, Section 9.2(a) states that upon conversion, the directors and officers of Federal Life Insurance Company serving immediately prior to the effective time shall continue to serve Federal Life Insurance Company until their successors have been duly elected. It also states that those directors and officers of the mutual holding company and FEDHO shall be persons serving as directors and officers of the insurance company immediately prior to the effective time.
- dd) The Director, the Department, or its staff has not requested that the plan contain any other provisions to be included in the Plan that are not already included in the Plan.
- ee) The company has had discussions with Wells Fargo Bank, which is the current custodian of the company, to have them also act as trustees for the assets of the Federal Life Mutual Holding Company as required by Section 59.2(11)(d) [215 ILCS 5/59.2(11)(d)]. A draft agreement has tentatively been agreed to and it is pending Department comments. The agreement has been submitted to the Department. Upon receiving direction from the Department, they will proceed to finalize that agreement.
- ff) Pursuant to the trust all assets of the mutual holding company will be held in trust for the benefit of the policyholders of Federal Life Insurance Company.
- gg) No director, officer, agent, or employee of Federal Life Insurance Company, or any other person, will receive any fee, commission, or other valuable consideration, other than her usual salary and compensation, for in any manner aiding, promoting, or assisting in the conversion of Federal Life, in violation of Section 59.2(14) [215 ILCS 5/59.2(14)].
- hh) In his view, this Plan and the conversion pursuant to the Plan is fair and equitable as it relates to the interests of the members of Federal Life.

10) On Examination by the Department, Mr. Austin testified as follows (R.36-42):

- a) No decisions have been made regarding at what level stock would be issued, assuming the company were to later decide that it would be advisable to issue stock. It could be stock in the intermediate holding company, FEDHO or it could be stock in the insurance company, Federal Life Insurance Company.
- b) If the Director grants the conversion, the members would control the mutual holding company as they control Federal Life as it exists now.
- c) If the company decides to issue stock, the stock may have voting rights. However, members would maintain a majority of the voting shares of stock that will be held. There is a provision in the Plan that provides members will always maintain a majority.<sup>2</sup>
- d) A participating policy would be a policy which was issued which would have rights to dividends which would be paid out depending upon the profitability of the underlying product that was being performed.<sup>3</sup>
- e) Even though upon renewal the company may substitute a nonparticipating policy for a participating policy, the policyholders would not have fewer rights by virtue of having a nonparticipating policy substituted. The Statute [215 ILCS 5/59.2] provides that except for life policies, guaranteed renewable accident and health and non-cancelable accident and life policies, after the conversion, the company may issue a nonparticipating policy. All of the policies the company has now, that have membership rights, would be included in the exception. There is very specific wording in Section 8.1 of the Plan regarding membership rights. The language comes right out of the Statute, 59.2. So, the company's policyholders will have identical rights in the mutual holding company that they had in the insurance company previously. If they had a dividend-paying policy, that would continue on and the company would continue the same dividend practices that it had in the past.
- f) He has read and is familiar with Federal Trust Exhibits #1 through 4 and Attachments A through G. The factual representations and assertions contained therein are true and correct.
- g) For audit purposes the company has been told in the past that \$350,000 would be material. In his mind, if it started to impact the solvency of the company or the risk-based capital ratios that the company had, then it would be a material impact. But the expenses involved in putting this [transaction] together are minimal and certainly under the materiality threshold that they had talked about from an audit perspective and certainly would not have an impact going forward. The primary expenses are the legal expenses and the notification expenses to the members. Once the conversion takes place, there will be minimal expenses that will take place on an ongoing basis. He anticipates the ongoing expenses would be under the materiality threshold.

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<sup>2</sup> The provision is located at Section 9.6 of the Plan.

<sup>3</sup> Mr. Austin had earlier testified that nonparticipating plans could be renewed as a participating policy pursuant to the Plan.

- h) The company was not anticipating having to pay the statutory deposit. He believes this still needs to be determined.
- i) The corporate company, which is now the mutual company, has a statutory deposit with the Department. He believes the deposit is \$1.5 Million.
- j) If the company were to pay another statutory deposit at the mutual holding company level of \$1.5 Million, that would have an impact on the insurance company. That would be material under the definition he has stated.

11) Upon further examination, Mr. Austin testified as follows (R.42-6):

- a) The company's ability to provide an insured a nonparticipating policy as a substitute for a participating policy upon renewal does not apply to life policies. Both the Statute<sup>4</sup> and the Plan say except for life policies. This provision is in the Plan because it is required by Section 59.2(b)(iii) [215 ILCS 5/59.2(b)(iii)].
- b) The company's participating policies are life policies. The company would not have the ability on those life policies to provide a nonparticipating policy in substitution of a participating policy.
- c) There is no requirement in Section 59.2 for a mutual holding company to provide a statutory deposit. There are a lot of other provisions in this Section regarding mutual holding companies, but nothing about it providing a deposit.
- d) The deposit would be redundant with the deposit already on file by the insurance company.
- e) If the company were required to provide a statutory deposit, those funds would come through the form of a surplus note or some other provision. It would reduce the capital of the insurance company that is needed to support its business.
- f) He does not believe splitting up the assets and putting a \$1.5 Million in deposit for the mutual holding company would lead to efficient investment policies and results.
- g) In his view, it is not necessary to hold another deposit at the mutual holding company level because all the assets of the mutual holding company will be held in trust as required by Section 59.2 for the benefit of Federal Life's policyholders.
- h) He believes that holding money at the mutual holding company in a deposit would be inconsistent with the requirement that the mutual holding company's assets be held in trust. A suggestion that takes some of the assets out of the trust and puts them in a statutory deposit would be inconsistent with the trust requirement.

12) Upon examination by the Hearing Officer, Mr. Austin testified as follows (R.46-8):

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<sup>4</sup> 215 ILCS 5/59.2

- a) Federal Life Mutual Holding Company will be at the top of the new corporate structure, then FEDHO Holding Company, and then the Federal Life Insurance Company.
- b) There are some accident and health policies that are participating. These are not policies that are currently members of Federal Life.
- c) The \$350,000 number is a figure that has been put to the company by previous auditors. It is not necessarily a hard number that is going to be in all cases for all companies. The company has been told it is based on the company's size. It is a general guideline the company has been given in the past.

13) Upon further examination by the Department, Mr. Austin testified as follows (R. 49-50)

- a) The company has not yet received either a private letter ruling from the U.S. Internal Revenue Service (IRS) or the tax opinion of legal counsel. The company also has not yet received the securities law opinion.<sup>5</sup>
- b) The company will be receiving a no-action letter from the U.S. Securities Exchange Commission (SEC) and will receive an opinion from counsel on the IRS.<sup>6</sup>

14) Paul Murphy, Federal Life Insurance Company's actuary, testified in this matter as follows (R. 54-60):

- a) He serves as the company's appointed actuary, its illustration actuary, and he is the head of the actuarial department.
- b) He joined the company in July 2002.
- c) He has a bachelor's and a master's degree from the University of Illinois in mathematics. He went into the actuarial profession and earned his ASA and, later, his Fellow of the Society of Actuaries designations. He also a member of the American Academy of Actuaries.

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<sup>5</sup> See Article 5, Sections 5.1 and 5.2 of the Plan.

<sup>6</sup> Mr. Goodman clarified that the company has been in discussions with the SEC. The company requested a no-action letter from the SEC. The SEC usually asks the request to be modified so they are comfortable providing the response requested. The company has provided the SEC with its final modification. The attorney at the SEC they have been working with is on vacation for two weeks. The company should have the no-action letter before the end of September, if not well before. The SEC letter is just to have the SEC agree that the issuance of membership interest in the mutual holding company is not a security, so the federal laws dealing with securities, registration, and sales of securities do not apply. (R.50-3)

The company is also providing a tax opinion of Freeborn & Peters to the IRS for the matters required by the Plan. The tax opinion confirms that the issuance of a mutual holding company membership interest to the policyholders in exchange for their membership interest in the insurance company is not a taxable event. The company has talked to the IRS about getting a private letter ruling. They are not sure when they will get that letter, so they will do what has been done in other mutual holding company conversions and get a SEC no-action letter, but it will be an opinion of counsel on tax issues. The other mutual holding company conversions Mr. Goodman is aware of did not get a IRS private letter ruling. (Id.)

The company will provide the IRS response, its letter to the SEC and the SEC response to the Department when they get responses. (R.53)

- d) The approach he used formulating the actuarial opinion, Exhibit G to Federal Life Exhibit #1, was very similar to what he does every year when they do their asset adequacy analysis for the entire company's business. In this case, however, he was focused exclusively on the 4,000 policies, roughly, that make up the dividend block of business. He used his actuarial techniques to model the liability side of the business. He also took a pro-rata share of the company's assets that support the entire insurance portfolio and assigned this to the [dividend] block. He used a software package fairly well known in the industry, Tillinghast Actuarial Software, to model the business projected for 50 years under a variety of interest rate scenarios to verify that, under different interest scenarios, the assets used to back this liability, the [dividend] block of business, would be adequate at all points in time.
- e) The total face amount of the participating policies is approximately 1.2% of the total face amount of all the company's in-force policies. The total premium on those participating policies is 1.5% of annual premium on all in-force policies. The total dividends paid on the participating policies were \$297,151 for 2013. The anticipated dividends for 2015 are around \$283,000 because it is a declining block.<sup>7</sup>
- f) If the company were to set up a closed block for the participating policies, the company would pick certain assets to set aside to support this block. There would be certain separate analytical and reporting requirements for that block, almost as if you set up a separate company in a way. Setting up a closed block would entail expenses and an administrative burden for the company that are not justified given the size of the block of participating policies. Setting up a closed block essentially increases the expenses on participating policyholders.
- g) If the Director grants a waiver to setting up a closed block, it will not change the company's dividend policies. After the effective time, the participating policies will have the same rights to receive dividends that they have had in the past.

15) On examination by the Department, Mr. Murphy testified as follows (R.60-3):

- a) He has read Actuarial Standard Number 37, entitled "Allocation of Policyholder Considerations in Mutual Life Insurance Company Demutualizations", but it has been awhile.
- b) Preserving reasonable policyholder dividend expectations is more of a matter of the company's philosophy and the company's approach as evidenced over history. The company established dividend scales many, many years ago and has preserved them over all the years. Whether there is a conversion or not, the company will continue to [preserve] them.

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<sup>7</sup> See Federal Life Exhibit #1, Attachment G.

- c) He considered the actuarial standards of practice he deemed relevant while performing his work. The standards relevant to asset adequacy analysis, standards of practice and the ethics involved and communication standards were relevant to his work.
- d) No material issues have come to light since he has performed his work that would cause him to change or qualify his view.

16) On examination by the Hearing Officer, Mr. Murphy testified as follows (R.64-8):

- a) In his opinion, the Plan will continue the reasonable expectations of the policyholders after the conversion.
- b) He did not hear Mr. Austin's testimony, but the \$350,000 materiality threshold is a ballpark figure. Over the years, a 5% differential has generally not been considered material. That is, perhaps, what is being referred to in this instance. The \$350,000 is a percentage of the total reserves, he believes.
- c) He is not aware of any attempt to quantify the costs and expenses of setting up a closed block. In general, from his perspective, the work he did just to do the analysis he did in support of his memorandum required maybe a month or so. If the company had a closed block, then he would be repeating that work every year. And time focused on this is time not focused on something else. Moreover, he assumes that the company would have to bring in auditors to check that work and to sign off on it, so there would be a cost there. There is bound to be other regulatory filings or the like, but he is not an expert on that. Those are the nature of the costs he certainly sees. The company would also have to do something with its systems if it truly wants to allocate things off, both on the liability and asset side. It might be a pretty big operation to [create a closed block].

17) Upon further examination, Mr. Murphy testified as follows (R.68-9):

- a) The costs to set up a closed block, would be allocated to the closed block. Those costs would have the effect of essentially reducing the amount paid to participating policyholders compared to what they get now.

18) Upon examination, Marcy Savage, Acting Assistant Deputy Director of the Department, testified as follows (R.69-75):

- a) She has worked for the Department for 28 and a half years. She has worked in the Corporate Regulatory Unit for 27 and a half years.
- b) The Corporate Regulatory Unit is responsible for all licensing of domestic insurance companies, foreign insurance companies, any corporate changes, mergers, redomestications, recordkeeping plans, and dissolutions.
- c) Her duties include the review of mutual holding company conversions. She has had the occasion to review the documentation for the conversion of Federal Life into a mutual

holding company structure during her course of employment. She reviewed the Plan, the Policyholder Information Statement, the Notice of Special Proxy, the amended articles for the mutual holding company, the intermediate company, and the stock company, as well as the bylaws for all three. She used the requirements of Section 59.2 as standards for her review.

- d) There were numerous requirements that needed to be changed, whether it was typos or range of directors or just different technical changes, requirements in Article II and III for a domestic company. [215 ILCS 5/6-5/35.1; 215 ILCS 5/36-5/60] The company made requested changes to the documents.
- e) She was able to determine from the final documentation whether the conversion of Federal Life into a mutual holding company met the standards of Section 59.2. The issue of the statutory deposit requirement is still in question. If you look at Section 59.2(11)(a), [it reads], “A mutual holding company shall have the same powers granted to domestic mutual companies and be subject to the same requirements and provisions of Article III and any other provisions of this Code applicable to mutual companies that are not inconsistent with the provisions of this Section, provided, however, that a mutual holding company shall not have the authority to transact insurance pursuant to Section 39(1).”
- f) It is her view that since mutual companies have to provide the Department with a \$1.5 Million deposit, a mutual holding company would have to do the same under that provision.
- g) The statutory deposit is set up for the benefit of all the policyholders and creditors. Although a mutual holding company is not going to have policyholders, they could possibly have creditors, potential creditors, and that deposit would be there for those potential creditors. Also, all other mutual holding companies have all been required to make this deposit. Illinois currently has four mutual holding companies. It did have five. All have made the \$1.5 Million deposit with the Department. One of the companies went into liquidation and the deposit was ultimately used to pay policyholder claims.
- h) Everything else concerning the Plan is in order.

19) Upon examination by Federal Life, Mrs. Savage testified as follows (R.75-92):

- a) She received Federal Life Exhibit #4 in December 2014.<sup>8</sup> She recognizes Federal Life Exhibit #5. It is an email dated March 20, 2015 from her to Mr. Goodman following the initial documents in which she asked questions about the actuarial review, Mr. Murphy’s review, and the request for the waiver of the requirement to form a closed block.
- b) She recalls receiving Federal Life Exhibit #6, an email dated March 27, 2015 from Mr. Goodman to her. It contains a discussion of the reasons and rationale behind the actuarial

justification request for waiving the closed block requirement. Federal Life Exhibit #6 was entered into the Record.

- c) She recalls receiving Federal Life Exhibit #7, a three page letter dated May 18, 2015 from her to Mr. Goodman. The letter asks for a number of changes, technical changes often, to the Plan and exhibits to the Plan. The second and third sentence of the first paragraph of the letter states at the time she still had some concerns about not establishing a closed block, however, in lieu of establishing a closed block, she would require that the company include language that it would not change the existing dividend scale without approval from the Department. Federal Life Exhibit #7 was entered into the Record.
- d) She recognizes Federal Life Exhibit #8, a June 1, 2015 email from Mr. Goodman to her with a proposed revised version of Article 8 of the Plan, including blacklined against the original version submitted in December 2014. Federal Life Exhibit #8 was entered into the Record.
- e) The blacklined document attached to Federal Life Exhibit #8, the second paragraph of Section 8.2 of Article 8 reads, "In connection with the Director's review of such modifications to the post-conversion dividends practices and policy, the Director may retain at the expense of Federal Life Insurance Company an independent qualified actuary to review whether the assumptions made by Federal Life Insurance Company's internal actuary in his consideration of the modifications to the dividends practice and policy are appropriate."
- f) The company could today change its dividend principles and policies without approval of the Department. Because of the provision [just read] the company is saying it will not change its dividend principles and policies without approval of the Department. This helps preserve the reasonable policyholder expectations of the participating policyholders.
- g) She was not involved in the review of the mutual holding company conversions of other mutual holding companies, but she is familiar with the terms of those conversions. She cannot recall if the requirement for a closed block was waived in the case of other conversions because she was not involved.
- h) Federal Life Exhibit #9, a June 2, 2015 email in response to Federal Life Exhibit #8, from her to Mr. Goodman reads, "The actuaries and legal have reviewed the changes and the only change that we would like the company to make is in the first sentence of the language you added in 8.2. Rather than saying 'Federal Life Insurance Company may modify the dividend principles and policy in effect on the Effective Date with the approval of the Director', we would like it to say, 'Federal Life Insurance Company may modify the dividend principles and policy in effect on June 1, 2015, with the approval of the Director.'" The change she requested was made to the Plan. Federal Life Exhibit #9 was entered into the Record.



- i) The first line after “Thank you” in Federal Life Exhibit #10, a June 3, 2015 email from Mr. Goodman to her, reads, “That change is fine.” Federal Life Exhibit #10 was entered into the Record.
- j) She recognizes Federal Life Exhibit #11, a June 4, 2015 letter to her from Mr. Goodman submitting revised versions of the Plan and exhibits thereto, including the Policyholder Information Statement and Notice of Special Meeting and Proxy, as well as the various articles and bylaws, blacklined against the original documents submitted in December 2014. Federal Life Exhibit #11 was entered into the Record.
- k) She recognizes Federal Life Exhibit #12 is a June 24, 2015 letter from Mr. Goodman to her enclosing a revised copy of the Plan, which includes a correction, a typo in Section 6.2. Federal Life Exhibit #12 was entered into the Record.
- l) The company addressed or made changes to all of the comments the Department had to the Plan.
- m) If an insurance company makes a deposit of \$1.5 Million and the mutual holding company also makes a deposit of \$1.5 Million, that is a total deposit of \$3 Million dollars for the benefit of the insurance company policyholders.
- n) A life insurance company that is not part of a mutual holding company would only have a deposit of \$1.5 Million, but a life insurance company that is part of mutual holding company would have an aggregate deposit that is twice that amount.
- o) She does not deal with the actual investment of the deposits. The Department has a tax and audit department that advises companies as to what investments can be made with the deposit.<sup>9</sup>
- p) Section 59.2 does not expressly refer to a requirement for a statutory deposit.
- q) The money to provide a statutory deposit would come from the stock company. It would take money out of the surplus. It would also reduce its total risk based capital because it would lower the surplus. It is still an asset of the company.
- r) Section 59.2(11)(d) requires that assets of the mutual holding company be held in trust for the benefit of the converted company. The assets of the mutual holding company are to be held in trust for the benefit of the policyholders of the mutual company. If money is taken out of the insurance company and put in the mutual holding company, it should be, under this requirement, held in trust for the benefit of the policyholders of the converted company. If assets are being held by the Department on deposit, though, those assets would not be held in trust. The statutory deposit with the Department is for both creditors and policyholders of the mutual holding company; the assets held in trust are just for policyholders of the converted company.

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<sup>9</sup> Section 26 of the Code specifies the types of investments that may be made with the statutory deposit. 215 ILCS 5/26(b).

20) Upon examination by the Hearing Officer, Ms. Savage testified as follows (R.93-6):

- a) The Department has established a standard with other mutual holding companies to make a statutory deposit, and the Department should stay consistent. Section 59(11)(a) does not specifically require a deposit, but it does not exempt [a mutual holding company] from having one, either.
- b) She does not know the risks of requiring the company to make a statutory deposit versus permitting all assets to be held in trust.
- c) In at least one instance, the statutory deposit has been used to pay the policyholders during a liquidation.
- d) If a company were to become insolvent and all of the assets of the trust were already gone, then there would be nothing left to pay the policyholders. It would be possible to draft a trust to protect a certain amount of assets to be held untouched unless certain triggers occurred, such as the company going into rehabilitation or liquidation. It would be up to the Director to decide whether such a trust would be satisfactory.
- e) She has no concerns with Federal Life not establishing a closed block.

21) Upon further examination by Federal Life, Ms. Savage testified as follows (R.96-8):

- a) She was not involved in the conversion of the mutual holding company that was liquidated; she did not read the file. The first trust agreement that she has read was the one Mr. Goodman provided, so she is not very familiar with such agreements. She is not sure how the assets in the trust could be gone if they are being held by a trustee.
- b) The assets in the trust are held solely for the benefit of policyholders, whereas the assets in a deposit potentially are for both policyholders and creditors.

22) Upon examination, Susan Lamb, Associate Actuary of the Department, testified as follows (R.100-04):

- a) She has worked for the Department for 12 years. She currently is an associate actuary in the Life Actuarial Unit of the Financial Corporate Regulatory Division. She has a bachelor's degree in mathematics from the University of Illinois at Springfield; she will complete her master's degree in business administration at Benedictine University this coming October [2015]. She is an associate of the Society of Actuaries, a member of the American Academy of Actuaries, a Fellow of the Life Management Institute, and she has 26 years of actuarial experience.
- b) In the Life Actuarial Unit, she reviews life and annuity policy forms, as well as actuarial opinions and memoranda. She assists with consumer complaints, participates in NAIC working groups, and helps draft legislation and regulations.

- c) She reviewed the dividend plan for Federal Life's mutual holding company. She reviewed the initial and revised versions of the Plan of Conversion, but she mainly focused on the actuarial opinion and memorandum provided by Mr. Murphy. Her standards for review were the Illinois Standard Valuation Law [215 ILCS 5/223], Regulation Part 1408 [50 Ill. Admin. Code 1408], and Actuarial Standard of Practice 37. She found that Mr. Murphy's opinion was supported that adequate assets were allocated to the dividend-paying block. There is no actuarial reason not to accept Mr. Murphy's opinion.
- d) She considers her testimony a statement of actuarial opinion. She meets the American Academy of Actuaries qualification standards to issue the statement of actuarial opinion.
- e) She did not consider anything else noteworthy about the Plan of Conversion and the dividend plan.

23) Upon further examination by Federal Life, Mrs. Lamb testified as follows (R.104):

- a) As an actuary, and based on her review, the Plan as modified in response to her requests and others from the Department would preserve the reasonable expectations of the participating policyholders.

24) The Record was held open until September 3, 2015 for the limited purpose of allowing the parties to offer legal analyses as to whether requiring the mutual holding company to maintain a statutory deposit would be inconsistent with the purposes of 215 ILCS 5/59.2(11)(a). (R.105-08). Both parties submitted their analyses within the permitted timeframe. Federal Life also submitted an August 19, 2015 draft of a trust agreement to be made with Wells Fargo for the assets, collateral, and equities held by the mutual holding company, as well as their proceeds.

25) Midwest Litigation Services recorded the testimony in this proceeding and charged the Department \$355.25 for the court reporter's attendance and the transcript of the proceeding.

#### DISCUSSION AND ADDITIONAL FINDINGS

The purpose of this proceeding was to recommend approval, disapproval, or approval with conditions of Federal Life's Plan for Mutual Holding Company Conversion ("Plan"). The standards for approval of a plan of MHC conversion are found in Section 59.2. 215 ILCS 5/59.2 provides in relevant part:

- (5)(a) After adoption or amendment of the plan by the mutual company's board of directors, the plan of MHC conversion shall be submitted to the Director for review and approval. The Director shall hold a public hearing on the plan. The Director shall approve the plan upon finding that:
  - (i) The provisions of this Section have been complied with; and
  - (ii) The plan is fair and equitable as it relates to the interests of the members.

Additionally, the Hearing Officer was authorized to hear testimony and receive and review evidence regarding (iii) whether the Director's approval of the Plan should be subject to any conditions reasonably necessary to protect policyholder interests, including but not limited to any of the conditions provided in Section 59.2(5)(c) of the Code (215 ILCS 5/59.2(5)(c)); (iv) whether the Director should waive the requirement for the establishment of a "closed block" (as contemplated by Section 59.2(8)(b)(iv) of the Code (215 ILCS 5/59.2(8)(b)(iv)) because it is in the best interests of the participating policyholders of Federal Life to do so; and (v) whether the resulting mutual holding company formed pursuant to the Plan, if approved, should be required to comply with the statutory deposit requirement of Section 53 of the Code (215 ILCS 5/53).

## **I. Compliance with the provisions of Section 59.2.**

### *Required provisions of the Plan*

The Plan contains all of the required provisions set forth in Section 59.2(8) with the exception that Federal Life requests a waiver of the requirement contained in Section 59.2(8)(b)(iv) for the establishment of a closed block of business for the participating policyholders. That paragraph allows the Director to waive that requirement.

In particular, as required by statute, the Plan contains:

The reasons for the proposed conversion as required by Section 59.2(8)(a). The Preamble sets forth that the Board believes the "[c]onversion will enhance Federal Life Insurance Company's strategic and financial flexibility by creating a corporate structure that will enable it to more easily raise capital, enter into business relations with other mutual insurance companies and mutual holding companies, providing an avenue for expansion, efficiencies of increased size and diversification through a mutual holding company structure" and will benefit Federal Life Insurance company and be in the best interests of the policyholders. (Federal Life Exhibit #1, p.4).

Section 7.5 of the Plan provides that all policies of the converted company in force on the effective date of the conversion shall continue to remain in force under the terms of those policies, except that any voting or other membership rights of the policyholder provided for under the policies or under this Code and any contingent liability policy provisions of the type described in Section 55 of this Code shall be extinguished on the effective date of the conversion as required by 5/59.2(8)(b)(i). (Federal Life Exhibit #1, p.12; See also Mr. Austin's testimony at R.19).

Sections 8.1 and 8.2 of the Plan provides that that holders of participating policies in effect on the date of conversion shall continue to have the right to receive dividends as provided in the participating policies, if any as required 5/59.2(8)(b)(ii). (Federal Life Exhibit #1, pp.12-13, tab G).

Section 8.1 also provides that, except for the mutual company's life policies, guaranteed renewable accident and health policies, and non-cancelable accident and health policies, the converted stock company may issue the insured a nonparticipating policy as a

substitute for the participating policy upon the renewal date of a participating policy as permitted by 5/59.2(8)(b)(iii). (Federal Life Exhibit #1, p.12).

Section 7.1 of Plan sets forth the requirements for granting membership interests to future policyholders of the converted company as required by 5/59.2(8)(c). Policy holders will become members of the mutual holding company and have the same rights as members of the mutual holding company that they had with the insurance company previously. (Federal Life Exhibit #1, p.11; Mr Austin's testimony at R.19).

Section 9.15 of the Plan sets forth information sufficient to demonstrate that the financial condition of the converted company will not be diminished by the Plan as required by Section 5/59.2(d). Specifically, the Plan states, "The Conversion will not diminish the financial condition of the Insurance Company. The costs and expenses of the Conversion will not be material to the financial condition of the Insurance Company." (See also Mr. Austin's testimony at R.32).

Section 9.6 of the Plan contains a declaration that there is no intent to issue shares of an intermediate holding company (FEDHO) or the converted company to the public or to other persons who are not direct or indirect subsidiaries of the MHC. There is a further declaration that, if common stock is offered to the public, the MHC will own directly or indirectly a majority of the voting rights of the common stock sold as required by 5/59.2(8)(e). (Federal Life Exhibit #1, p.14; See also Mr. Austin's testimony at R.19).

Section 9.2(a) of the Plan provides that the directors and officers of the mutual company immediately prior to the Effective Time of Conversion as the directors and officers of the MHC and intermediate holding company until their successors have been duly elected and qualified as required by 5/59.2(8)(f). (Federal Life Exhibit #1, p.14)

The Plan includes provisions that the Department specifically requested after reviewing an earlier draft of the Plan. The Director has not requested any other provisions not contained in the current Plan. (Mr. Austin's testimony at R.20, Federal Life Exhibits #8, 9, 10, 11, & 12; See 215 ILCS 5/59.2(8)(g)).

Additionally, as permitted by the statute, the Plan contains a provision requesting an exemption by the Director from the requirement to establish a closed block of business. The Plan also appends the opinion of an appointed actuary. See 215 ILCS 5/59.2(8)(b)(iv); Federal Life Exhibit #1, Section 8.1 & 8.2, pp.12-13 & Tab G).

#### *Other Requirements Satisfied By the Time of the Hearing*

Besides the contents of the Plan, Section 59.2 of the Code requires the mutual company to take other actions before or at the same time as it submits the Plan for the Director's approval. The statute contemplates further steps for final implementation of conversion after approval of the Plan by the Director. Some of these steps require the separate approval of the Director. Based on the testimony at the hearing and the exhibits admitted, Federal Life has complied with all of the provisions of Section 59.2 of the Code that may be complied with at the time of the hearing. In particular,

The Plan has been approved by Federal Life's Board of Directors by an affirmative vote of at least two-thirds of the directors. The Board voted unanimously to approve the Plan on November 20, 2014 as required by Section 59.2(4)(a). (Federal Life Exhibit #1, Section 2.1, p.6).

The Plan has been submitted to the Director for approval as required by 5/59.2(5)(b)(i)(A), (Federal Life Exhibit #1).

The proposed articles of incorporation and bylaws of the MHC, the intermediate holding company (FEDHO), and the converted company have been submitted to the Director for approval as required by 5/59.2(5)(b)(i)(D). (Federal Life Exhibit #1, Tabs A-F). The proposed articles of incorporation for the MHC include the provisions required in Section 59.2(1)(f). (Federal Life Exhibit #1, Tab C).

The form of notice required by Section 59.2(6)(b), and the proxy to be solicited from eligible members, have been submitted to the Director for review and approval as required by Section 59.2(5)(b)(i)(B)-(C). (Federal Life Exhibit #2-3).

The Plan provides that the assets of the MHC will be held in trust for the benefit of the policyholders as required by Section 59.2(11)(d). (Federal Life Exhibit #1, Tab C; *See also* Mr. Austin's testimony at R.34-5).

## **II. The Plan is fair and equitable as it relates to the members.**

Based on an examination of the Plan, the testimony of the witnesses at the hearing, the exhibits introduced, and the conditions recommended to be imposed, the Hearing Officer finds that the Plan is fair and equitable to the interests of the members. Section 59.2 of the Code addresses members' interests both as policyholders and members. Those interests will remain substantially equivalent before and after the Conversion.

### *Interests of the Member Policyholders*

The member policyholders will have the same rights after the Conversion as they did as policyholders prior to the conversion. Under Section 7.5 of the Plan, the policies in force on the Effective Date will remain in force following the Conversion under the same terms as before. (Federal Life Exhibit #1, p.12). Under Sections 8.1 and 8.2, this principle applies to participating policies, whose dividends, if any, will be determined after the Conversion under the same terms as before. *Id.* at pp.12-13. According to Mr. Murphy, the company established dividend scales many years ago, has preserved them for years, and will continue to preserve them. (R.62).

Regulatory oversight by the Department will not diminish after the Effective Date. Payments of dividends by the MHC will be subject to the Director's approval. *See* Section 9.3 of Plan (Federal life Exhibit #1, p.14). Susan Lamb, Associate Actuary for the Department, testified that the Plan as it currently stands would preserve the reasonable expectations of the participating policyholders. (R.104).

She also testified that there was no actuarial reason not to accept Mr. Murphy's actuarial opinion. (R.103).

The ownership interest of the member policyholders immediately after the Conversion will be functionally equivalent to that interest as before the Conversion. Mr. Austin testified that members of Federal Life would have the same rights under the MHC as they do under the current mutual company. (R.40). A member in the mutual company before the Conversion will immediately become a member of the MHC after the Conversion, as will any person who becomes a policyholder after the Effective Date. *See* Section 7.1 of Plan (Federal Life Exhibit #1, p.11). As members of the MHC, the policyholders will elect its directors. *Id.*; *see also* (R.19-20). The MHC will own 100% of the shares in FEDHO, which in turn will own 100% of the shares of the converted company. (Federal Life Exhibit #1, p.4). According to Section 9.6 of the Plan, there is no plan for the public sale of stock in FEDHO or the converted company. If common stock in either of these entities were to be offered to the general public, the MHC still would own directly or indirectly a majority of the voting rights of the common stock sold. (Federal Life Exhibit #1, p.14). Section 9.4 of the Plan provides that all dividends and other income payable to the MHC will inure to the benefit of its members. *Id.*

### **III. Other Approval Conditions to Protect Policyholder Interests**

For the protection of policyholder interests, the Director may set conditions on her approval of the Plan. 215 ILCS 5/59.2(5)(c). The Statute provides examples of such conditions without limiting the Director to them. The Hearing Officer finds that it would be in the best interest, as a condition for approval of the Plan, that Director's prior approval be obtained for any of the following:

- a) any acquisition or formation of an affiliated entity of Federal Life Mutual Holding Company;
- b) any changes to the articles of incorporation, bylaws, or capital structure of any intermediate holding company;
- c) any initial public offering or other issuance of equity or debt securities of any intermediate holding company or converted stock company in a private sale or public offering. The term "issuance of equity" includes, but is not limited to, any proposed sale, exchange, subscription, award, or transfer of stock, warrants, options, voting rights, or other ownership rights or interests in the issuer or of any securities directly or indirectly convertible or exchangeable into any of the foregoing;
- d) any change or expansion of the converted company into lines of business, industries, or operations not presented at the time of the conversion;
- e) any changes to the dividend principles, with respect to the determination of divisible surplus or the allocation of divisible surplus of, or the calculation, declaration, or payment of dividends or distributions from Federal Life Insurance Company or any intermediate holding company;

- f) any dividend distribution from the converted stock company or any intermediate company;
- g) any waiver by Federal Life Mutual Holding Company of any dividends or distribution payable to the mutual holding company by any intermediate holding company;
- h) the pledge, encumbrance, or transfer of stock of Federal Life Insurance Company;
- i) the trust agreement required under 215 ILCS 5/59.2(10)(d) and any changes to the trust agreement; and
- j) the distribution or employment of excess accumulated earning of the mutual holding company, which shall inure to the exclusive benefit of the members of the mutual holding company.

All of the foregoing actions should be approved by the Federal Life Mutual Holding Company Board of Directors prior to submission to the Director.

#### **IV. Participating Policies as a Closed Block**

Section 59.2(8)(b)(iv) of the Code provides that a Class I mutual company's conversion plan must provide that its "participating life policies in force on the effective date of the conversion shall be operated by the converted company for dividend purposes as a closed block of participating business except that any or all classes of group participating policies may be excluded from the closed block...The Director may waive the requirement for the establishment of a closed block of business if the Director deems it to be in the best interests of the participating policyholders of the mutual company to do so." 215 ILCS 5/59.2(8)(b)(iv).

The Plan at issue here states that the actuarial memorandum demonstrates that the dividend-paying block of business is insignificant and the reserves are adequate to support them without the need to establish a closed block of business. *See* Section 8.1 of Plan (Federal Life Exhibit #1, p.12). The actuarial opinion states that "it is in the best interest of the policyholders that Federal Life not establish a formal Dividend Paying Block for this group of policies." (Federal Life Exhibit #1, Tab G).

William Austin, President and COO of Federal Life, also testified that the size of the dividend-paying block of policies is insignificant. He stated that no dividend-paying policies have been issued since 1988. The dividend-paying block currently represents 1.2% of Federal Life's in-force face amount and 1.5% of Federal Life's annualized premium. The total dividends paid out annually amount to less than \$300,000 and are decreasing every year. The reserves for those policies exceed the requirements from cash flow testing prepared by Federal Life's actuary. (R.29). The company's accountants have stated that, from an auditing standpoint, \$350,000 would be a material item for Federal Life. (R.30).

Mr. Austin further testified that Federal Life has amended the Plan in the six months preceding the Hearing in this matter based on discussions with the Department about the requested waiver of the closed block requirement. Specifically, the Plan was amended in Section 8.2 to state that the company may modify its dividend principles and policies in effect on June 1, 2015 only with the Director's



approval. (R.30; Federal Life Exhibit #1, p.13). The Plan was also amended in Section 8.4 to state that the company will annually submit to the Director a report on the book of dividend-paying policies, including the number of such policies, the aggregate face amount of the policies, and the total dividend paid on the policies. (R.31; Federal Life Exhibit #1, p.13).

Robert Murphy also testified on the matter of the closed block waiver as the appointed actuary, illustration actuary, and head of the actuarial department for Federal Life. He drafted the actuarial opinion appended to the Plan. (R.56-7; Federal Life Exhibit #1, Tab G). He testified that the dividends paid for 2013 were \$297,151, and that the anticipated amount for 2015 was around \$283,000 because it is a declining block. If Federal Life were to set up a closed block, it would have to select assets to set aside in support of the block and would be subject to analytical and reporting requirements, almost as though it were setting up a separate company. (R.58-9).

Susan Lamb, Associate Actuary of the Department, testified that there was no actuarial reason not to accept Mr. Murphy's actuarial opinion. (R.103). Marcy Savage, Assistant Deputy Director of the Department, testified that, in lieu of establishing a closed block, she requested that the company not change the existing dividend scale without the Director's approval. (R.79).

Based on the exhibits and testimony presented at the hearing, the Hearing Officer believes that it would be in the best interest of the policyholders of Federal Life for the Director to waive the requirement that Federal Life operate a closed block of business for its participating policies.

## **V. Statutory Deposit**

Section 53 provides, "A company subject to the provisions of this Article shall make and maintain with the Director for the protection of all creditors, policyholders and policy obligations of the company, a deposit of securities having a fair market value equal to the minimum surplus required to be maintained under Section 43." 215 ILCS 5/53(a).

Section 43 of the Code provides, "Every company subject to this Article and organized after December 31, 1985 under this Article must maintain minimum surplus applicable to the class or classes and clause or clauses of Section 4 describing the kind or kinds of insurance which it is authorized to write, as follows...[The statute then lists surplus amounts according to the insurance classes and clauses from Section 4 of the Code]" 215 ILCS 5/43(6).

However, Section 59.2 provides, "A mutual holding company shall have the same powers granted to domestic mutual companies and be subject to the same requirements and provisions of Article III and any other provisions of this Code applicable to mutual companies that are not inconsistent with the provisions of this Section, provided however that a mutual holding company shall not have the authority to transact insurance pursuant to Section 39(1)." 215 ILCS 5/59.2(11)(a). Section 59.2 neither expressly requires nor expressly waives any requirement for mutual holding companies to make the statutory deposit provided in Section 53.

Section 59.2(5)(c) provides that the Director may conditionally approve a plan when she determines a condition is "reasonably necessary to protect policyholder interests." 215 ILCS 5/59.2(5)(c). The mutual holding company, formed for the benefit of the former mutual company's

policyholders, and being the ultimate controlling party of the converted stock company, will make investment, operational, and business decisions directly impacting the interest of its policyholder members. Requiring a mutual holding company make a statutory deposit for the protection of the policyholders would not be inconsistent with Section 59.2(5)(c). *Id.* Furthermore, Section 53 requires all companies subject to Article III to maintain a deposit with the Director for the protection of all *creditors*, policyholders, and policy obligations of the company. 215 ILCS 5/53(a). The mutual holding company will almost certainly incur liabilities which the statutory deposit is intended to protect.

Federal Life argues that imposing a statutory deposit requirement on the mutual holding company is inconsistent with Section 59.2(11)(d) in that it requires assets be held in trust “for the benefit of policyholders of the converted company.” 215 ILCS 5/59.2(11)(d). However, not all assets of the company are required to be held in trust. Section 59.2(11)(d) provides that any assets not held in trust be subject to a lien in favor of the converted company policyholders. *Id.* A statutory deposit requirement is not inconsistent with 59.2(11)(d) because assets not held in trust will be deposited with the Department for the protection of converted company policyholders, now policyholder members. Federal Life argues, that requiring the mutual holding company to make a statutory deposit results in assets being held for the benefit of creditors. It does not follow that although assets are held in trust for the benefit of the policyholders that the deposit would be held for the protection of solely creditors. The deposit is held for the protection of policyholders and policy obligations, in addition to creditor protection.<sup>10</sup> There are circumstances foreseeable which would require the mutual holding company deposit to be used for the protection of policyholder members and policyholder members’ policy obligations in addition to creditor protection.<sup>11</sup>

Also, it should be noted that pursuant to Section 26 of the Code, Federal Life converted stock will be required to maintain a statutory deposit in the amount of \$1.5 Million. Section 26 requires that a stock company make and maintain a deposit with the Director “having a fair market value equal to the minimum capital and surplus required to be maintained under Section 13.” 215 ILCS 5/26(a). For life insurance companies, Section 13 requires the maintenance of a minimum paid-up capital of \$1 Million and a minimum paid-up surplus of \$500,000, the total amount of which is \$1.5 Million. 215 ILCS 5/13(1)(a) and (3)(a). Mr. Austin testified that Federal Life currently maintains a statutory deposit of \$1.5 Million as required of mutual insurance companies. (R.42). Accordingly, Federal Life’s conversion from a mutual company into a stock company will not affect the amount required to be maintained on deposit with the Director by the converted stock company.

Finally, in its post-hearing brief, Federal Life challenged the need for the Department’s practice of issuing a certificate of authority to mutual holding companies. The Record was only held open after the hearing for the limited purpose of presenting legal analysis as to whether a mutual holding company was subject to the statutory deposit requirement in Section 53 of the Code. (R.105-08). Accordingly, the

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<sup>10</sup> Article XIII (215 ILCS 5/187 et. seq.) includes deposits in the definition of “assets” of a company in receivership or rehabilitation. 215 ILCS 5/187(6). The statutory deposit would be subject to the order of distribution of general assets set forth in Section 205, which prioritizes the payment of claims over creditor obligations. 215 ILCS 5/205.

<sup>11</sup> Federal Life also argues that the converted stock company would have to transfer assets through a note or other debt instrument to the mutual holding company to enable it to make the deposit. Federal Life argues this will ultimately impact the converted stock company’s capital, surplus, and adjusted capital will be reduced. However, the converted stock company could issue a guaranty fund certificate in the amount of the deposit pursuant to Section 56. 215 ILCS 5/56. To avoid reduction of surplus and adjusted capital, the converted stock company could then request a permitted practice to admit the note as an asset.

Hearing Officer declines to consider the issue and does not recommend disturbing the practice of requiring mutual holding companies to obtain a certificate of authority to do business in Illinois.

### **CONCLUSIONS OF LAW**

Based upon the above Findings of Fact and the entire Record in this matter, the Hearing Officer offers the following Conclusions of Law to the Director of Insurance:

- 1) Anne Marie Skallerup was duly appointed Hearing Officer in this matter pursuant to Section 402 of the Illinois Insurance Code (215 ILCS 5/402).
- 2) The Director of Insurance has jurisdiction over the subject matter and the parties in this proceeding pursuant to Sections 59.2, 401, 402, and 403 of the Illinois Insurance Code (215 ILCS 5/59.2, 5/401, 5/402, and 5/403).
- 3) Pursuant to Section 59.2 of the Code (215 ILCS 5/59.2), the Director has authority to approve, conditionally approve, or disapprove the reorganization of Federal Life Insurance Company by forming a mutual holding company and converting from a mutual insurance company into a stock insurance company.
- 4) Pursuant to Section 59.2 of the Code (215 ILCS 5/59.2), the Director may waive the requirement to create a closed block of business.
- 5) Pursuant to Section 408 (215 ILCS 5/408), the Director may assess the costs of the hearing against the parties of the hearing.

### **RECOMMENDATIONS**

Based upon the above Findings of Fact, Conclusions of Law and the entire Record in this matter, the Hearing Officer offers the following Recommendations to the Director of Insurance:

- 1) The Director approve the Plan of Conversion of Federal Life Insurance Company (Mutual) subject to the following conditions:
  - a) The Director's approval of the trust agreement in accordance with 215 ILCS 5/59.2(11)(d).
  - b) All of the following actions are subject to prior approval of the Director in accordance with the standards set forth in 215 ILCS 5/59.2(5)(c):
    - i) any acquisition or formation of an affiliated entity of Federal Life Mutual Holding Company;
    - ii) any changes to the articles of incorporation, bylaws, or capital structure of any intermediate holding company;

- iii) any initial public offering or other issuance of equity or debt securities of any intermediate holding company or Federal Life Insurance Company in a private sale or public offering. The term “issuance of equity” includes, but is not limited to, any proposed sale, exchange, subscription, award, or transfer of stock, warrants, options, voting rights, or other ownership rights or interests in the issuer or of any securities directly or indirectly convertible or exchangeable into any of the foregoing;
- iv) any change or expansion of the converted company into lines of business, industries, or operations not presented at the time of the conversion;
- v) any changes to the dividend principles, with respect to the determination of divisible surplus or the allocation of divisible surplus of, or the calculation, declaration, or payment of dividends or distributions from Federal Life Insurance Company or any intermediate holding company;
- vi) any dividend distributions from the converted stock company and any intermediate holding company and any waiver by the mutual holding company of any dividends or distributions payable to the mutual holding company.
- vii) the pledge, encumbrance, or transfer of stock of the converted company;
- viii) any changes to the trust agreement; and
- ix) the distribution or employment of excess accumulated earnings of the mutual holding company, which shall inure to the exclusive benefit of the members of the mutual holding company.

All of the foregoing actions must be approved by the Federal Life Mutual Holding Company Board of Directors prior to submission to the Director.

- 2) The Director waive the requirement for the converted company to operate its participating policies for dividend purposes as a closed block of business pursuant to 215 ILCS 5/59.2(8)(b)(iv). The converted company shall comply with the requirements of 215 ILCS 5/233.
- 3) The minimum surplus requirements of 215 ILCS 5/43(1) and the statutory deposit requirements of 215 ILCS 5/53 shall be required of the mutual holding company.

- 4) The Director require the Federal Life Insurance Company to pay all fees and expenses incurred by the Department in the amount of \$355.25.

Respectfully submitted,

*Anne Marie Skallerup*

Date: November 6, 2015

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Anne Marie Skallerup  
Hearing Officer

CERTIFICATE OF SERVICE

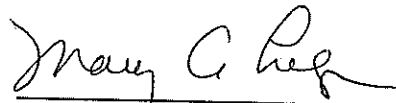
I HEREBY CERTIFY that on 12-3, 20<sup>15</sup>, I caused a true and correct copy of the foregoing instrument to be served upon the Attorneys of Record or Parties to the above captioned matter, by the designated means:

Mark R. Goodman  
Counsel For Federal Life Ins.Co.  
Freeborn & Peters LLP  
311 S. Wacker Dr., Suite 3000  
Chicago, IL 60606

first class mail  
 certified mail # 1804  
 hand delivery  
 electronic mail  
 via facsimile

James C. Rundblom  
Counsel for Department  
Illinois Dept.of Ins.  
320 W. Washington St.,4th Fl.  
Springfield, IL 62767

first class mail  
 certified mail # \_\_\_\_\_  
 hand delivery  
 electronic mail  
 via facsimile



Mary Ann Lelys  
Administrative Assistant