

# THE FEELING'S "DEMUTUAL" DRAFT FEDERAL LEGISLATION RELEASED FOR DEMUTUALIZATION OF PROPERTY AND CASUALTY INSURANCE COMPANIES

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On February 28, 2015, Canada's Department of Finance published two draft regulations<sup>[1]</sup> under the *Insurance Companies Act*<sup>[2]</sup> (the "**Draft Regulations**") that, if implemented, would allow the demutualization of federally regulated mutual property and casualty insurance companies ("**P&C Mutuals**").<sup>[3]</sup> The Draft Regulations address the two forms of corporate structure: P&C Mutuals with only mutual policyholders and P&C Mutuals with both mutual policyholders and non-mutual policyholders. Demutualization would allow P&C Mutuals to convert from policyholder-based ownership to share-based ownership and subsequently issue shares on public markets. The Draft Regulations are open for a 30-day public comment period.

## Structure of P&C Mutuals

P&C Mutuals have a similar structure to traditional share-based corporations in Canada, subject to one key difference. In P&C Mutuals, the policyholders take on the role of both the owner and customer, while in corporations the roles are much more distinct. This distinction can lead to a divergence of interests in a corporation. For example, surpluses in Mutual P&C Companies are returned to the member policyholders in the form of dividends or reduced premiums. In these instances, policyholders benefit from the success of a Mutual P&C. In contrast, surpluses in corporations are returned to investors without necessarily benefiting the policyholder.

## The Road to Demutualization

Regulations for demutualization of life insurance companies have been in place since 1999 (the "**Life Regulations**").<sup>[4]</sup> However, it was not until four years ago that the push towards demutualization of P&C Mutuals began. In late 2010, Economical Insurance<sup>[5]</sup> announced its intention to pursue demutualization in Canada. The federal government responded in its Budget 2011 by proposing to develop a framework for demutualization. The Draft Regulations represent this long-awaited framework.

## Summary of the Demutualization Process

In developing the framework, the government's goal was to provide P&C Mutuals with an orderly and transparent process that would ensure the fair and equitable treatment of all policyholders. To achieve this goal, a considerable emphasis on corporate governance has been integrated into the framework. The process itself must be initiated by a board of directors, and can be halted at any time prior to the issuance of letters patent should the board determine that demutualization is no longer favourable. Transparency is also integrated, and is furthered by required valuations and prescribed disclosure to policyholders. Finally, to facilitate the transition process and prevent takeovers of newly converted companies, there is a requirement, subject to exemptions, that all converted companies remain widely held for two years following a conversion.

Compared to the Life Regulations, the Draft Regulations provide far greater protection for non-mutual policyholders. As discussed below, this is ensured through the required negotiation process. However, the supervision of this protection is almost entirely delegated by the Ministry of Finance to the courts.

Although the steps for conversion are similar between the two governance structures, conversion of P&C Mutuals with non-mutual policyholders is far more cumbersome than conversion of P&C Mutuals with only mutual policyholders.

### ***Conversion of P&C Mutuals with only mutual policyholders***

For P&C Mutuals with *only mutual policyholders*, the process is relatively simple. The board must pass a resolution to recommend conversion and provide a conversion proposal to each eligible policyholder.<sup>[6]</sup> The proposal must identify the benefits of demutualization and be accompanied by a formal valuation, verifying that the proposed apportionment of benefits is fair and equitable to the eligible policyholders. The proposal to demutualize must then receive approval by a special majority of policyholders. If that approval is obtained, the company must then seek the approval of the Minister of Finance within three months.

### ***Conversion of P&C Mutuals with non-mutual policyholders***

(1) The board of directors must pursue demutualization:

For P&C Mutuals with non-mutual policyholders, the process also begins with a resolution of the board of directors recommending the conversion. However, the board must now identify all eligible policyholders<sup>[7]</sup> and other persons who would otherwise qualify under the regulations to negotiate the conversion proposal.

(2) Eligible mutual policyholders vote on whether to negotiate a conversion proposal:

In order for the process to proceed, eligible mutual policyholders must vote by special resolution to negotiate a conversion process with non-mutual policyholders.

(3) Negotiating the conversion proposal:

At this stage, the negotiation comes under the court's supervision. The company must file an application with the relevant court for an initial order setting out how, among other things, policyholders may participate in the process. The court then receives applications and appoints counsel to each of the two groups of policyholders. Once counsel have been selected, interested policyholders may submit to counsel applications to sit on one of the two policyholder committees. It is the committees, composed of the appointed policyholders and represented by counsel that will then negotiate a conversion proposal.

(4) Eligible mutual policyholders vote to amend by-laws and all eligible policyholders vote on the proposal:

Once the proposal has been negotiated, it must be approved by the Superintendent to ensure that it does not pose undue operational or prudential risk and that it complies with the regulations. After this approval is received, the eligible mutual policyholders must vote by special resolution to amend the company's bylaws to extend the right to vote on the proposal to the eligible non-mutual policyholders. If the right to vote is extended, a special meeting will be called where all eligible policyholders will vote on a special resolution to approve the proposal. If the special resolution passes, the company must seek the approval of the Minister of Finance within three months.

### **Comments on the Draft Regulations**

The Draft Regulations represent a significant milestone for P&C Mutuals. While they are subject to change, the ultimate question is when, and not if, these regulations will be put in force. The process has been ongoing for over four years and the short 30-day comment window may be indicative of the government's desire to have this legislation move forward quickly.

P&C Mutuals desiring to demutualize argue that conversion will open up additional avenues for growth and access to capital, allowing them to compete with the rest of the insurance industry. Further, as the P&C Mutuals enter the capital markets, investors will be provided with a new industry segment in which to invest. From a corporate governance perspective, conversion will allow P&C Mutuals to unfetter themselves from the restrictions associated with mutual policyholders.

Despite the advantages to P&C Mutuals, it is important to note that there is a divide within the industry and there remains uncertainty as to the far-reaching effects of this legislation. While major insurers such as Economical Insurance are pushing for demutualization, the Canadian Association of Mutual Insurance Companies ("**CAMIC**"), takes a cautionary approach. CAMIC, which represents the bulk of the industry, warns that demutualization may actually penalize many policyholders, and could result in a retreat of insurers from rural Canada.<sup>[8]</sup>

With regards to the industry, the Draft Regulations may signal the end of an era for P&C Mutuals. Many of these

companies began as a cooperative effort to mutually insure other rural farmers at a time when most joint stock insurers refused. The result was an affordable member-owned insurance program, where the interests of owners and customers were aligned. Newly converted entities may not embrace these same principles. Further, while the framework only provides the option, not an obligation, for P&C Mutuals to demutualize, it remains to be seen whether smaller niche Mutual P&Cs can compete against the larger converted entities, or maintain their relevance. This issue may be amplified if the provinces independently pursue a similar demutualization framework for provincially regulated insurers.

Finally, the question remains whether or not the Draft Regulations will embody the orderly and transparent process hoped for to ensure the fair and equitable treatment of all policyholders. The Draft Regulations delegate much of the burden to boards and the courts to ensure a fair and transparent process. Further, it is unclear exactly where some aspects of the financial burden of the process (including counsel fees) lies and whether such burden would fall in line with the government's goal of fair and equitable treatment throughout the process.

Regardless of one's position, the Draft Regulations represent a long-awaited mechanism for change within the industry. Interested parties are encouraged to make comments, which will be accepted until **March 30, 2015**. McMillan expects to provide more information on the Draft Regulations as it becomes available.

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[1] The first applies to Mutual P&C Companies with only mutual policyholders, available [here](#). The second applies to Mutual P&C Companies with a mix of mutual policyholders and non-mutual policyholders, available [here](#) (collectively the "**Draft Regulations**").

[2] SC 1991, c 47.

[3] The Regulatory Impact Analysis Statement released alongside the Draft Regulations notes that "[t]he federally regulated Mutual P&C sector is narrow and consists of seven companies, most of which operate rurally and regionally. They are Wawanesa Mutual, Economical Insurance, Gore Mutual, Portage La Prairie Mutual, North Waterloo Farmers Mutual, Saskatchewan Mutual, and The Kings Mutual."

[4] See the *Mutual Company (Life Insurance) Conversion Regulations*, SOR/99-128. Four life insurance companies have completed the demutualization process: Canada Life Insurance Company, Manufacturers Life Insurance Company, Sun Life Assurance Company of Canada and Clarica Life Insurance Company (formerly The Mutual Life Assurance Company of Canada).

[5] At the time it announced its intention, the company was known as Economical Mutual.

[6] As defined in the Draft Regulations.

[7] These include both eligible mutual policy holders and eligible non-mutual policyholders, as defined in the Draft Regulations.

[8] Mckenna, Barrie & Nelson, Jacqueline, "Federal demutualization plan divides mutual insurance companies", The Globe and Mail (March 2, 2015), online

<http://www.theglobeandmail.com/report-on-business/demutualization-plan-divides-canadian-mutual-insurance-companies/article23255408/?cmpid=rss1>.

### **A Cautionary Note**

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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