May 8, 1964

George F. Mahoney, Commissioner Insurance

Jerome S. Matus, Assistant Attorney General

Distribution of Dividends of a Domestic Mutual Insurance Company

FACTS:

A domestic mutual insurance company desires to amend its by-laws at its annual meeting by providing as follows:

> The directors shall from time to time within their sole discretion and judgment provide for the declaration and distribution of dividends, subject, however, to the following limitations:
>
> 1. No dividends shall be payable to policyholders unless the terms of the policy with respect to the payment of premiums shall have been fully complied with, and it is expressly understood that payment following legal proceedings for the collection of premium shall not constitute such compliance.
>
> 2. If the directors in their sole discretion shall so determine, dividends may be paid to a policyholder only to the extent the dividends exceed the loss, if any, paid to a policyholder during the same period for which a dividend is payable.
>
> 3. Dividends shall be declared and paid on an annual basis only, and no dividend shall be payable to a policyholder whose policy is terminated during a policy year.

QUESTION:

May the domestic mutual insurance company so amend its by-laws without being in derogation of State Law?

ANSWER:

See opinion for answer.

OPINION:

The first proposed change makes payment of dividends conditioned on prompt payment of premiums. It is clear that such an amendment may be made to the by-laws. 44 C.J.S. 672, §114 states:

> "Conditions on right. The right to a dividend may be conditioned on the policyholder's compliance with the terms of the policy, such as payment of the premiums due. A proviso that payment of premium following legal proceedings shall not constitute compliance with the terms of the policy as to payment is not invalid as arbitrary if made applicable to all policyholders. An unwarranted action for premiums by the company against a policyholder who is not in default does not deprive him of his right to dividends under such a condition."

The second proposed change would give directors authority to limit dividends to a policyholder to the extent that dividends exceed a loss. Such a change could violate insurance rate regulation. The pertinent provisions of R. S. 1954, c. 60, § 317 reads as follows:

> "I. Rates shall be made in accordance with the following provisions:
>
> "A. . . .;
>
> "B. Rates shall not be excessive, inadequate or unfairly discriminatory;
>
> "C. Due consideration shall be given to . . . dividends. . . ."
>
> "II. . . .
>
> "III. Nothing in this section shall be taken to prohibit as unreasonable or unfairly discriminatory the establishment of classifications or modifications of classifications of risks based upon size, expense, management, individual experience, purpose of insurance, location or dispersion of hazard, or any other reasonable considerations, provided such classifications and modifications apply to all risks under the same or substantially similar circumstances or conditions."

It is clear that due consideration shall be given to dividends in establishing a rate. A classification of dividends that might result in an excessive, inadequate, or unfairly discriminatory rate would be an illegal classification.

Subsection III of § 317 sets out the type of classifications which are not considered unreasonable or unfairly discriminatory. All of the classifications allowed to be established are based on facts which can be determined at the time a risk is placed on the books of the company. The proposed classification sets as a criteria a prospective loss. For this reason the insurance commissioner could properly find that the establishment of such a classification was unreasonable or unfairly discriminatory for purposes of rate-making and violative of State Law.

The third proposal gives the directors discretion to create a classification based on the amount of time a person is a member of the company. At the time a person becomes a policyholder in a mutual insurance company, it is not determinable whether his policy will be terminated during the policy year. It follows that the classification is one depending upon facts which are not in existence at the time the classification is made, and for that reason the insurance commissioner could find that such a classification would upset rate-making, and therefore be violative of State Law.

There is a further and more basic reason why the second and third proposals would not be valid. Directors of a domestic mutual insurance company can create a policy for declaring and distributing dividends to policyholders in their company, subject to the by-laws and charter of the company and the general law of the State. Directors may establish classes of policyholders and the dividends among the policyholders in a class may not be arbitrary or discriminatory. A leading treatise on insurance states the general rule in regard to mutual life insurance companies, and the same rule should apply to mutual fire insurance companies.

> "Under either insurance statute or general principles of equity, a mutual life company may not discriminate in its distribution to its members, and an agreement by one company to pay a larger proportion of dividends to one policyholder than to others in the same class is illegal and void." 18 Appelman Insurance Law and Practice, page 150, §10060.

There is an absence of authority regarding the legality of proposals in the nature of the second and third suggested changes in the by-laws, which, if they are to be legal, must establish proper classifications. In Pink v. Town Taxi Co., Inc. our Court quotes from a leading authority (Richards on the Law of Insurance, §548) and states the basic concept of what mutual insurance is in fact:

> "The principle which lies at the foundation of mutual insurance, and gives it its name, is mutuality; in other words the intervention of each person insured in the management of the affairs of the company, and the participation of each member in the profits and losses of the business, in proportion to his interests. . . . He is at once insurer and insured." Pink v. Town Taxi Co., Inc. 138 Me. 50.

This principle establishes basic characteristics of a mutual insurance company. Any change in by-laws of a mutual insurance company that does not comply with this basic concept is contrary to our general law unless a specific statutory provision can be found to permit such a change in the concept. We have found no such provision. Our Court has said that a mutual company is somewhat in the nature of a partnership. In Pink v. Town, supra, at page 52 in discussing the concept of mutual insurance, our Court said:

> " It is that form of insurance in which each person insured becomes a member of the company, and members reciprocally engage to indemnify each other against losses, any loss being met by an assessment laid on all members. . . .A mutual company is one in which the members are both the insurers and the insured; and the premiums paid by them constitute the fund which is liable for the losses and expenses, and they share in the profits in proportion to their interest, and control and regulate the affairs of the company. . . . A mutual company is somewhat of the nature of a partnership; insured becomes a member of the corporation by virtue of his policy, is entitled to a share of the profits, and is responsible for the losses to the extent of his premium paid or agreed to be paid. Yet an incorporated mutual company is not a partnership in the strict legal sense of the term."

One of the reasons a mutual insurance company is not a partnership in a strict legal sense is that members of the company, as long as they are members, must share with other members in a properly constituted class in the profits in proportion to their interest. Unless there is statutory authority, a classification

that erodes the principle of mutuality, which is the concept that lies at the very foundation of mutual insurance, is an improper classification. A classification based on the amount of time a person is a member of a company is such a classification. If such a classification were made, a mutual company would be one whose members would share in the profits in proportion to their interest with other members in a properly constituted class--not as long as they were members, but only if they were members for a stated period of time. This changes the basic concept of mutuality in a mutual insurance company and is therefore in derogation of our law.

A classification as conceived by the second proposal would also eat away at the principle of mutuality. If such a classification were made, a mutual company would be one in which the members of the company must share in the profits in proportion to their interest with other members in a properly constituted class--not as long as they were members, but as long as they were members who did not suffer a loss during the same period for which a dividend was payable. For this reason the second proposal is also in derogation of State Law.

(Addendum: It should be noted that the language of the second proposal, as it now reads, would allow the directors in their sole discretion and judgment to select which of certain policyholders having losses in excess of dividends could be paid dividends. This opportunity to select is on its face arbitrary and discriminatory and violative of State Law. It is recognized that the language could be changed to eliminate this objection. This opinion was based on the broader grounds as stated.)

Jerome S. Matus

JSM/eh