



FRATERNAL MERGER/CONSOLIDATION BASICS

This document has been prepared at the request of the American Fraternal Alliance to assist members in consideration of mergers, spinoffs, and product line divestitures and acquisitions. These various forms of fraternal consolidations are referred to collectively as “mergers” in this document. This is designed to provide a high level overview of the key steps and considerations in fraternal mergers. Although each transaction will have its own unique circumstances and issues, there are some elements that are common to fraternal mergers. This document is not to provide legal, tax or other professional advice. You will need to contact your professional advisors for this. We are hopeful that this will be a valuable resource for American Fraternal Alliance members to help understand the overall process and to provide a starting point for consideration of a merger.

The steps listed in this document are generally listed in the order of completion. However, a merger is a fluent process and you may be working on more than one of these steps simultaneously.

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STEP 1 GETTING STARTED

A. **Defining Overall Business Objectives:** It is difficult to achieve goals and objectives for your organization without first clearly defining those goals and objectives. This is particularly true with mergers. Any consideration of a merger needs to begin with a determination of the benefits that the society would hope to achieve through the merger. These may include:

- 1) greater surplus and protection against insolvency,
- 2) economies of scale,
- 3) marketing opportunities,
- 4) product diversification,
- 5) coordination of charitable and fraternal efforts,
- 6) licenses and distribution resources,
- 7) leadership and succession.

The key objectives of a merger should be clearly defined and documented at the start of the process. These objectives will help guide decision-making throughout the process.

B. **Fiduciary Responsibility:** Fraternal benefit society leaders, including delegates, directors, and officers are required to always perform their duties and make decisions in the best interest of the society and the membership as a whole. Meeting these fiduciary duties is particularly important, and often more challenging, in the context of a fraternal merger. There are differing member interests and objectives that need to be considered. In addition, fraternal leaders may have personal interest in the outcome of a merger, such as risk of losing their position with the organization. It is important to keep in mind that the fiduciary duties of fraternal leaders require selflessness for the good of the society as a whole. The specific fiduciary duties that apply to fraternal leaders are:

1. **Duty of care:** to act in a fully informed manner after the exercise of due diligence appropriate under the circumstances—with the care an ordinary person would exercise under similar circumstances and in a manner that the leader reasonably believes to be in the organization’s best interest.
 - a. Fraternal leaders are required to act carefully in light of their actual knowledge and the knowledge they should have gained by reasonable care and skill. Practically, fiduciaries who review and consider reasonably available information and apply their best judgment based

on the facts and information before them have fulfilled their duty of care.

- b. Fraternal leaders may reasonably rely on the reports of another, as long as:
 - i. The other has been selected with a reasonable degree of care.
 - ii. The person reporting is doing so in an area within his or her area of professional expertise.
 - iii. The director acts in good faith in relying on the report.
 - iv. There is no "red flag" that would indicate to an ordinarily prudent person that the report is not reliable.

- c. Practical steps in making decisions with due care:
 - i. Attend meetings.
 - ii. Avoid haste, and the appearance of haste, in making decisions. Take full opportunity to review, question, and understand all available information material to the decision.
 - iii. Prepare adequately. Be informed of an upcoming action as far as possible in advance. Have necessary reports or facts available for consideration before the actual time of action. Whenever appropriate, have a person making a report available for questions.
 - iv. Ask questions. Fraternal leaders must not merely accept information presented to them, but should also probe it, judge its reliability and accuracy, and understand it fully.
 - v. Exercise independent judgment. A fraternal leader's judgment may be informed by his or her individual experience and affiliations, but every decision must be in the interest of the fraternal.
 - vi. Avoid giving approval to a transaction or policy without prior knowledge and review of all the material terms.

2. **Duty of Loyalty:** to always act in the best interests of the organization and its constituents, and to subordinate any personal interest to that organizational interest.

- a. Conflict of interest/duty to disclose: A fraternal leader who has a material or personal interest in a matter must disclose that fact and excuse him/herself from acting on the matter.

- b. Opportunities: Business opportunities may be available to the society that would also be valuable to a fraternal leader. The leader, of course,

must exercise discretion in favor of the society. If the society decides not to avail itself of the opportunity, the leader, after proper disclosures, may take advantage of the opportunity, though much would depend on the nature of the opportunity and the perceptions about it.

- c. **Confidentiality:** A fraternal leader must keep confidential all information that is not a matter of public record. This duty extends to all third parties, including employees and constituents. An individual fraternal leader should not be a spokesperson for the society unless he or she has been expressly designated as such.

3. **Special Duty:** A fraternal leader with the knowledge or belief that the entity is engaging in illegal activity is obligated to act on that knowledge or belief. The fraternal leader should follow the society's internal procedures for reporting the activity.

- C. **Identifying Key Resources:** It is important to identify the key resources you will utilize to identify, evaluate, and execute a merger. Identifying and engaging these resources early in the process can help make the process more efficient and effective. Some of the key outside resources you will need to engage may include:

1. Accountants
2. Actuaries
3. Attorneys
4. Consultants

You will want to be sure that your outside resources are familiar with the unique aspects of fraternal benefit societies and fraternal mergers.

In addition, you will want to assign internal accountability for the various merger steps and assemble internal resources to carry out those tasks. You should consider having internal staff involved in the merger process sign a confidentiality agreement and provide instruction regarding fiduciary duties, antitrust requirements, communications, and other matters.

- D. **Defining Governance Processes.** Any fraternal merger must be ultimately approved by the supreme governing body of the society. You will want to consider governance authority and accountability for matters relating to the merger and leading up to the final approval by the supreme governing body. Authority and accountability for various tasks should be delineated and delegated to the full board of directors, to a committee of directors, or to society staff as appropriate. By clearly defining roles and accountability, you can help ensure that the organization will speak

with one voice during negotiations, complete required activities in a timely manner and in the appropriate sequence and maintain focus on the goals and objectives of the society. You should also make sure your process is consistent with your Constitution/Articles and Bylaws.

- E. Defining a Proposed Timeline.** It is helpful to develop a realistic time frame for completion of various required tasks. Development of the time frame should take into account a variety of factors including: Timing of scheduled conventions or other society meetings, time frames for regulatory approvals, and business opportunities or other factors which may influence the timing of the merger.

STEP 2

UNDERSTANDING MERGER ALTERNATIVES

While the most frequently used form of fraternal consolidation is a total merger with another fraternal benefit society, there are a variety of other alternatives to consider. Each has features that may fit the objectives of the society.

- A. Total Merger.**
- 1. Merger with Fraternal Benefit Society:** Under this alternative, two fraternal benefit societies merge to form one society. All assets, liabilities, contracts, products and other elements of each society become part of the merged society.
 - 2. Merger with a Commercial Company:** It is also possible for a fraternal benefit society to merge with a commercial company. The most practical is to merge with a mutual company. The process for the merger is first for the fraternal benefit society to convert to a mutual company utilizing the procedures outlined for the conversion in the fraternal code. The organizations would then merge to become one mutual company. In this type of merger, the lodge system and not-for-profit status of the organization are not retained.
- C. Merger and Spinoff.** It is also possible for a fraternal benefit society to merge with either a fraternal or commercial company and spinoff an organization that would continue the charitable and benevolent aspects of the organization. The spinoff organization can take a variety of forms, including:
- 1. A non-insurance fraternal society described in § 501(c)10 of the Internal Revenue Code.** This type of organization is the most like a fraternal benefit

society in that it operates under the lodge system but it does not have insurance activities.

2. A community service organization described under § 501(c)4 of the Internal Revenue Code. A community service organization like the Jaycees or Lions Clubs performs charitable and benevolent activities as well as social activities for its members but does not operate on the lodge system.
3. A public charity described in § 501(c)3 of the Internal Revenue Code. This type of organization engages in charitable and benevolent activities.

D. Product Line Divestiture or Acquisition. It is also possible to provide for divestiture or acquisition of specific product lines. This can be done through an exchange program where members are encouraged to exchange their policies for comparable policies of another fraternal benefit society or commercial company, or through an assumption of business by another fraternal benefit society, if permitted by the applicable insurance department.

STEP 3

UNDERSTANDING ORGANIZATIONAL STRENGTHS AND WEAKNESSES

Negotiations with a potential merger partner include demonstrating to the potential partner the value that connecting with your organization will bring to theirs. It is important to thoroughly assess your own organization and the benefits and drawbacks your organization may bring to a potential partner. The due diligence aspects of the merger process involve taking a close and detailed look at the various aspects of the organization. For this reason, it makes sense for you to initially perform due diligence on yourself and identify those issues that will be uncovered during the course of negotiations which may cause challenges to the consummation of a merger. To the extent you identify challenges such as compliance issues or risks, you may be able to take steps to correct any deficiencies prior to the start of negotiations.

To the extent a merger is driven by a state insurance department concerned about the solvency of the organization, you will likely have limited bargaining leverage in dealing with a potential merger partner. For this reason, it is important to consider merger options prior to financial crisis and during a period where you have more bargaining leverage to be able to get concessions from the merger partner to benefit your members.

STEP 4

IDENTIFYING ESSENTIAL ELEMENTS OF MERGER

Prior to beginning negotiations, it is important for you to identify the essential elements of a merger. You may also wish to identify elements that, while not essential, would be positive attributes for a merger partner or agreement. Determining these elements up front can help you to screen potential partners and to focus your negotiations on those elements that really matter. It is also important to consider your organization's strengths and weaknesses to be able to identify essential and preferred elements that are realistic.

STEP 5

IDENTIFYING, SCREENING AND CONTACTING POTENTIAL PARTNERS

Your overall business objectives and essential elements of merger should assist you in identifying potential merger partners. To the extent that you are affirmatively seeking a merger partner, as opposed to being contacted by another organization to consider a merger, you may wish to broadly consider possible merger partners and develop criteria for screening those potential partners into a manageable number. Factors to consider include: 1) common bond, 2) size and financial strength, 3) product offering and distribution, and 4) mission and vision.

Once you have identified one or more potential merger partners, you will want to contact them to gauge their interest in considering a merger and to gather additional information as to whether the organization would be a good fit. You should consider both objective factors, such as financial strength, as well as subjective factors such as culture and values.

You should be sure to enter into a confidentiality agreement with the other organization prior to exchanging any nonpublic information. You should also carefully consider impacts of antitrust rules to ensure that you have proper documentation and procedures in place so as not to run afoul of any applicable antitrust rules.

You will want to gather enough information at this stage to narrow your list of potential partners to one, unless a multiple organization merger is contemplated. The detailed due diligence review required to continue the merger process is generally very time consuming and you will not want to go through that process with a potential partner that would ultimately be screened out for other reasons.

STEP 6

INITIAL DUE DILIGENCE & LETTER OF INTENT

You will want to start with a high level review of a potential merger partner. After completing this initial due diligence and determining that you wish to proceed with merger negotiations, you will want to enter into a letter of intent with the other organization. This letter is designed to capture the commitment of the organizations to pursue the merger and to lay out at a very high level the steps that will be taken to consummate the merger. The value of completing a letter of intent is to reach tentative agreement on some of the key elements of the merger prior to investing significant resources in due diligence and a final merger agreement. Sometimes the letter of intent is skipped, such as when the merger is under a tight timeline.

Following the letter of intent, the detailed due diligence review should be completed.

STEP 7

PERFORMING DUE DILIGENCE

After completing initial screening and narrowing your potential merger partners, the next step is to perform detailed due diligence. This involves looking very closely at a wide range of business and risk issues to assist in a final decision as to whether a merger with the organization would be in the best interest of your membership. There are many organizational and compliance risk issues that you will want to evaluate to ensure there are no hidden landmines that would impact the benefit of a merger to your membership. You will want to develop a detailed due diligence checklist and assign responsibility for gathering from the other organization the information necessary to ensure that you have a complete and accurate picture of the organization. Examples of the types of information to collect include:

1. Corporate Status and Structure

-) Articles/Constitution as amended to date
-) Bylaws as amended to date
-) Minute Books for past five years
-) Capital structure
-) Organizational chart
-) Marketing structure chart
-) Business plans
-) List of jurisdictions in which the Society may transact business and a copy of the necessary filings with government agencies/bodies in each jurisdiction
-) All corporate reports, correspondence and filings with U.S. federal, state and local regulatory agencies, including insurance regulatory agencies for past five years

2. Material Contracts and Related Documents

-) All outstanding loan and debt agreements
-) Marketing
 - General agent, agent and broker contracts
 - Advertising contracts
 - Advertising materials
-) Covenants not-to-compete (for and against society)
-) Affiliated and nonaffiliated reinsurance agreements
-) Real Estate
 - Mortgages
 - Titles
 - Leases
 - Environmental liabilities
 - Other regulatory issues
-) Intellectual property
 - Licensing agreements
 - Trademark/tradename
 - Copyright
-) Miscellaneous contracts (government, etc.)
-) Material investment management or advisory agreements for society investment portfolio
-) Any material agreements relating to mergers, acquisitions or divestitures, including letters of intent for the past five years
-) Any material agreements evidencing tax arrangements between the society and any other parties
-) Agency agreements, administrative service agreements, and management service agreements with non-affiliates
-) Any consulting agreements

3. Financial

-) Statutory financial statements of the Society for the past five years
-) Security interests
-) All audit reports, review reports, “comfort letters,” reports on internal control structure and other management reports prepared by independent auditors or any domestic governmental regulatory agency for the last five years
-) All ratings of society by A.M. Best, Moody’s, Standard and Poor’s, etc., within the past five years.
-) Bank accounts

-) Personal property
-) Any defaults by the society

4. Employee/Employment Issues

-) Employment contracts and other commitments, including executive benefit plans
-) Compensation agreements, including golden parachute arrangements, severance arrangements, etc.
-) Employee benefit plan agreements, including recent financial statements, valuations and audit reports
-) Personnel information, including files, unemployment claims, workers compensation claims, employee turnover
-) Retirement and welfare plans
-) All reports to and filings and correspondence with the IRS, DOL and PBGC submitted within the last five years with respect to employee benefit matters
-) Employee handbooks and policy manual.

5. Litigation/Administrative Proceedings

-) Papers relating to all domestic and foreign litigation, administrative proceedings or domestic and foreign governmental investigations or inquiries, pending or threatened, affecting the society
-) Copies of audit letters
-) Any material domestic or foreign consent decrees, judgments, settlement agreements and other agreements, decrees, and orders to which the society is bound
-) Any pending society regulatory or administrative proceedings

6. Taxes

-) Tax returns (federal, state, and local) for last five years
-) Audits
-) Federal, state, and local disputes and litigation
-) Payroll
-) Liens
-) Insurance product tax compliance information

7. Insurance Practice

-) Types of insurance coverage provided and copies of insurance policies provided by the society

-) List of policyholders
-) All pre-existing written descriptions of underwriting and claims practices, guidelines, and policies of the Society
-) Rate filings
-) Total amount of coverage underwritten
-) Organization of policy files
-) List of outstanding claims
-) List of rejected claims for past six years
-) Lapse rates
-) Universal life policies – minimum guaranteed interest rate on outstanding policies
-) Surrender value of whole life policies
-) Amount and adequacy of reserves held for policies
-) Dividends paid on policies in past five years
-) Guaranty fund assessments (for commercial insurers)
-) Surrender value of annuities

8. Society's Insurance Policies

-) General liability
-) E&O
-) D&O
-) Other

9. Miscellaneous

-) Any material management consultant reports and industry analyses relating to the society in the past five years
-) Investment analysis or research reports and industry publications about the society in the past five years
-) List of charitable activities funded

You will want to develop a due diligence checklist and tailor it to the specific circumstances. You may need to add additional items after beginning the review process to address items discovered during the course of the review.

STEP 8

Entering Into A Merger Agreement

After completing all due diligence, you will next need to enter into the fundamental document of the merger, the Agreement between the parties. Depending on the structure of the transaction, this could be a Merger Agreement, Asset Acquisition Agreement or Assumption Reinsurance Agreement. This Agreement is designed to capture the key elements and conditions to the merger. This document may include representations and warranties by the parties regarding the condition of the respective organizations and assurances that no material issues are present that have not already been disclosed and reviewed during the course of due diligence. This document will also lay out the key elements of the merger. These will differ depending on the particular circumstances of the merger, but may include:

1. Membership requirements/common bond
2. The name of the merged organization
3. The Articles/Constitution and Bylaws of the merged organization
4. Location of the home office
5. Surviving entity
6. State of domicile
7. Directors
8. Convention delegates, if applicable
9. Lodges
10. Officers
11. Employees
12. Allocation of surplus
13. Agents
14. Products – before and after the merger
15. Proposed merger date

Entering into the Agreement sets the baseline of the merger terms. You will want to work with your advisors to ensure that all of the essential elements of the merger are adequately captured in the Agreement. It is much more difficult to change course or negotiate or alter the terms of the merger after an Agreement has been developed.

STEP 9

OBTAINING APPROVAL FROM SUPREME GOVERNING BODY

The Agreement will not become effective until it is approved by the supreme governing body of the society. You will want to carefully consider the requirements for obtaining this approval included in your Constitution/Articles and Bylaws and the applicable Fraternal Codes. You will want to

carefully consider what will be needed to adequately and completely present the merger to your supreme governing body. To the extent the supreme governing body can be engaged and involved in the process, this can assist in obtaining buy-in to the proposed merger and avoid having to spend considerable time and resources in completing due diligence and preparing an Agreement only to have the Agreement rejected by the supreme governing body. You will also want to consider the types of member communications you will provide during and after the merger process.

STEP 10

OBTAINING REGULATORY APPROVAL

No merger of a fraternal benefit society can be consummated without approval of the applicable insurance departments. You will want to carefully consider the appropriate timing of contact with and involvement of the insurance departments. Depending on the circumstances, this may be very early in the process to encourage early buy-in and cooperation, or later, after due diligence and initial negotiations have been completed. Approval of the merger is only required by the insurance departments of the states of domicile. However, you will also want to consider the contact, if any, to be made with other states in which the organizations are licensed. While these states do not have authority to prevent the merger if it is approved by the states of domicile, they do have authority over licensing, product approval and other areas of business of the merged organization. You will want to work closely with your advisors to determine the best strategies for dealing with the insurance departments.

Another issue you will need to consider is whether or not a Hart-Scott-Rodino filing must be completed relating to the merger. This is a filing with the Federal Trade Commission. If the filing is required for the merger, the organizations will need to provide information to demonstrate that the merger will not have the effect of unduly restraining trade as well as a filing fee. Some smaller mergers may be exempt from this requirement.

Another issue to consider is whether to get an IRS letter ruling on merger issues. This is not required to complete the merger, but it may be helpful to address risks identified during due diligence.

STEP 11

CLOSING

The Agreement will list the date proposed for closing of the merger and all of the conditions that must be met prior to the closing, including regulatory approval. The parties will need to work toward completing each of these required elements. The merger will occur at the time that all of these conditions are met.

STEP 12 INTEGRATION

The final step following the closing of the merger is to integrate the organizations. The Agreement may cover many of the issues involved in the integration of the organizations, but will certainly not cover all of the issues. Some of the issues that will need to be addressed are:

1. Notification of the membership of the merger
2. Policy endorsements
3. Society licensing
4. Agent licensing, appointments, and contracts
5. Society name
6. Product integration
7. Staff integration
 -) Reorganization/severance
 -) Employment policies
 -) Employee benefits integration
8. Board integration
9. Bylaws
10. Subsidiary mergers
11. Investments
12. Systems
13. Contracts/Vendors
14. Reinsurance

In the event that a merger and spinoff is done, the new/surviving not-for-profit organization will need to be established, as outlined in the Agreement and its governance and other matters will need to be established.

You will need to work through the merger process and the unique aspects of a transaction with the assistance of your professional advisors. This document is not to provide you legal or tax advice, but rather a high level overview of some of the issues you will want to consider when contemplating a merger.