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Missouri State Auditor

Missouri Employers Mutual Insurance Company

February 2012

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CITIZENS SUMMARY

Findings in the audit of the Missouri Employers Mutual Insurance Company

Background

The Missouri Employers Mutual Insurance Company (MEM) was created by state statute to provide Missouri employers, particularly small businesses, with a means to obtain workers' compensation liability at a reasonable cost. MEM holds the dominant market share (approximately 16 percent) in Missouri. MEM has accumulated a surplus of $163 million and has an excellent financial strength rating from A.M. Best.

Summary

MEM enjoys the federal income tax exempt status of a "public corporation", an advantage that competitors do not enjoy. With the help of this advantage, MEM has accumulated a surplus totaling in excess of $160 million, and has become the dominant provider in the state's workers' compensation market. In addition, MEM essentially operates as a private entity, compensates officers and employees at rates that are in excess of public sector entities, incurs expenses that are not considered acceptable in the public sector, and does so without complying with state open records laws. State law is also not clear regarding MEM's purchase of a taxable subsidiary.

Board Appointments

Section 287.905.1, RSMo, states that the Governor shall appoint the initial five member board of directors, each of whom were to serve 5-year terms, after which the policyholders were to elect new directors in accordance with provisions determined by the board. Because the initial MEM board was appointed by the Governor, MEM was considered a public corporation, entitled to tax-exempt status. In an attempt to maintain its tax-exempt status, in 1997, MEM amended its bylaws to require the governor's approval of the majority of directors elected by policyholders.

Tax-Exempt Status and Statutory Obligations

MEM enjoys an advantage over its competitors by virtue of its tax-exempt status as a public corporation. It appears MEM has saved approximately $50 million in federal taxes since 1993.

MEM has certain statutory obligations other non-exempt companies do not have. Although it contended the additional costs of these obligations offset any advantage from being tax-exempt, MEM was unable to quantify the financial impact of these additional requirements.

Compensation

In 2010, MEM paid a total of over $15 million in compensation and $2 million in employee incentive bonuses for approximately 200 employees. Its top 10 highest paid employees received a total of $2,460,921 in salaries and incentive payments, for an average of almost $250,000 each. Incentive payments are generally prohibited for public employees.

In addition, certain executive employment contracts included significant perks, such as paid health insurance coverage for an executive's spouse, 5 weeks paid time off, a company vehicle with paid maintenance and insurance, paid dues for professional societies and organizations, paid golf and athletic club memberships, and reimbursement of any employment-related expenses.

MEM paid approximately $1.58 million in severance benefits or payments to four former executives and employees who resigned or were terminated in 2009 or 2010, which may not comply with state law and/or may not be in the best interest of the company.

Expenditures	MEM made a number of expenditures in 2010 which would be considered excessive or unreasonable for a public sector entity, including more than $300,000 for an all-inclusive retreat to Hawaii for 64 invitees; $17,000 for St. Louis Cardinals suite tickets, some of which went unused; nearly $80,000 for University of Missouri athletic events; $280,000 to sponsor, donate or contribute to various events and entities; and $80,000 for other company functions, such as retreats, golf outings, and jackets and a luncheon for its 15 year anniversary. A MEM internal investigation also identified political contributions totaling $8,000 to the Missouri Democratic Party, monetary and in-kind donations to a Political Action Committee, $4,000 in contributions for gubernatorial festivities, payment of a former executive's legal fees, and $8,300 for 2010 playoff tickets (when the St. Louis Cardinals failed to make the playoffs).
Sunshine Law	MEM denies it is a quasi-public governmental body and, therefore, does not comply with state law regarding open records.
For-Profit Subsidiary	MEM paid $7.2 million for a for-profit insurance company that held insurance licenses in other states, but state law may not allow it to provide coverage to Missouri companies that employ workers in other states.
Surplus and Dividends	The MEM board has not established a dividend policy, and it has yet to declare a dividend to its members despite having accumulated a surplus of approximately $163 million.

Because of the nature of this audit, no overall rating is provided.

American Recovery and Reinvestment Act (Federal Stimulus)	The Missouri Employers Mutual Insurance Company did not receive any federal stimulus monies during the audited time period.

Missouri Employers Mutual Insurance Company
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THOMAS A. SCHWEICH
Missouri State Auditor

Honorable Jeremiah W. (Jay) Nixon, Governor
and
Members of the Missouri Employers Mutual
Insurance Company Board of Directors
and
James C. Owen, President and Chief Executive Officer
Columbia, Missouri

We have audited certain operations of the Missouri Employers Mutual Insurance Company in fulfillment of our duties under Chapter 29, RSMo. The company engaged BKD LLP, Certified Public Accountants & Advisors (CPAs), to audit the company's financial statements for the year ended December 31, 2010. We reviewed the report and substantiating working papers of the CPA firm and performed other procedures that we considered necessary in the circumstances. The company engaged Swink, Fiehler & Company P.C., Certified Public Accountants & Consultants, to audit the company's financial statements for the year ended December 31, 2009. The scope of our audit included, but was not necessarily limited to, the 2 years ended December 31, 2010. The objectives of our audit were to:

1. Evaluate internal controls over significant management and financial functions**.**

2. Evaluate the company's compliance with certain legal provisions, including the requirements of Sections 287.900 thru 287.920, RSMo (i.e. the "Missouri Employers Mutual Insurance Company Act").

3. Evaluate the economy and efficiency of certain management practices and operations, including certain financial transactions.

Our methodology included reviewing minutes of meetings, written policies and procedures, financial records, and other pertinent documents; interviewing various personnel of the company, as well as certain external parties; reviewing other state workers' compensation insurance funds; and testing selected transactions. Citing attorney-client privilege, management withheld certain information contained in the Missouri Employers Mutual Board minutes, reports, and other documents. We could not audit certain information because of the limitations imposed on the scope of our audit.

We obtained an understanding of internal controls that are significant within the context of the audit objectives and assessed whether such controls have been properly designed and placed in operation. We also obtained an understanding of legal provisions that are significant within the context of the audit objectives, and we assessed the risk that illegal acts, including fraud, and violations of contract or other legal provisions could occur. Based on that risk assessment, we designed and performed procedures to provide reasonable assurance of detecting instances of noncompliance significant to those provisions.

Except as discussed in the second paragraph, we conducted our audit in accordance with the standards applicable to performance audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform our audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides such a basis.

The accompanying Organization and Statistical Information is presented for informational purposes. This information was obtained from the company's management and was not subjected to the procedures applied in our audit of the company.

For the areas audited, we identified (1) no significant deficiencies in internal controls, (2) noncompliance with a legal provision, and (3) the need for improvement in management practices and procedures. The accompanying Management Advisory Report presents our findings arising from our audit of the Missouri Employers Mutual Insurance Company.

Thomas A. Schweich
State Auditor

The following auditors participated in the preparation of this report:

Deputy State Auditor:	Harry J. Otto, CPA
Director of Audits:	John Luetkemeyer, CPA
Audit Manager:	Robert E. Showers, CPA, CGAP
In-Charge Auditor:	Robert L. McArthur II
Audit Staff:	Nathaniel Fast, M.Acct., CPA

1. Missouri Employers Mutual Insurance Company (MEM)

The Governor's appointment of a majority of the company's Board of Directors allows MEM to continue operating as an "independent public corporation", thereby remaining exempt from federal income taxes, and appears to be inconsistent with state statute. Employee compensation levels, incentive payment plans, and large severance benefits paid by MEM would not be considered reasonable in the public sector. We also noted MEM made other expenditures which would not be considered appropriate for a public sector entity. In addition, MEM contends it is not subject to state open records laws, and it is not clear whether MEM could legally purchase its taxable subsidiary.

Board appointments

The majority of the MEM Board is appointed by the Governor as described in MEM bylaws. However, this practice and MEM bylaws conflict with Section 287.905.1, RSMo, which states the Governor only is to appoint the **initial** five member board of directors with policyholders to elect new directors in accordance with provisions determined by the board.

Section 287.905.1, RSMo states, "The governor shall appoint the initial five members of the board with the advice and consent of the senate. Each director shall serve a five-year term . . . . At the expiration of the term of any member of the board, the company's policyholders shall elect a new director in accordance with provisions determined by the board." The term of the last initial director appointed by the Governor expired in July of 1999.

In December 1997, MEM amended its bylaws to require the governor's approval of the majority of directors elected by the policyholders. MEM believes that this amendment to its bylaws allows it to retain public corporation status, even though the terms of the five initial board members appointed by the Governor pursuant to the statute have expired. The question for the General Assembly and/or the courts is whether the MEM Board can prolong its public corporation status beyond that allowed by statute by amending its bylaws to require governor approval of new directors. The SAO takes no position on this matter, but notes that MEM sometimes acts like a public corporation, in that it receives substantial tax advantages, and sometimes acts like a private corporation, in that it compensates its employees and makes significant expenditures for business development and employee morale at levels which would not be acceptable in the public sector.

Tax exempt status

By maintaining its federal tax-exempt status, MEM enjoys an advantage over similarly sized mutual and other insurance companies with which it competes, and has helped the company establish a strong financial condition. We estimate the tax exempt status has saved MEM about $50 million[1] in federal taxes since the company was created in 1993. As of December 31, 2010, MEM:

- Maintained a workers' compensation market share in Missouri of approximately 16 percent, according to Department of Insurance, Financial Institutions and Professional Registration data. This was approximately 13 percent more than the company with the next largest market share, and approximately 5 percent more than the next largest group of related insurers.

- Had accumulated a surplus of $163 million, which includes a $20 million surplus note.

- Held an excellent financial strength rating from A.M. Best.[2]

MEM officials indicated state statutes require MEM to incur additional operating costs that other non-exempt companies do not have. For example:

- Per Section 287.915, RSMo, MEM is required to underwrite policies for all of the estimated 4,000 agents licensed to sell workers' compensation insurance in the State of Missouri. For every agent that writes a workers' compensation insurance policy, MEM must underwrite the policy, maintain a file on the insurance agent, and pay that agent commissions. This is a requirement private companies do not have; thus increasing MEM's operating costs.

- MEM is required by Section 287.902, RSMo, to give preference to small business owners with annual premiums not greater than $10,000. Over 80 percent of MEM policyholders are small businesses with annual premiums not greater than $10,000. Per a MEM official, this increases MEM's operating costs.

- MEM is required by Section 287.917, RSMo, to formulate, implement, and monitor a work safety program for all policyholders. Per a MEM official, private companies do not have a similar requirement or the associated costs.

MEM officials contend these additional costs offset any advantage MEM receives from being tax-exempt. However, MEM was unable to quantify the impact of these additional requirements.

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[1] SAO calculation based on MEM's Unassigned Surplus of approximately $143 million as of December 31, 2010, multiplied by the federal corporate tax rate of 35 percent.

[2] A.M. Best is a rating agency designated as a Nationally Recognized Statistical Rating Organization by the United States Securities and Exchange Commission. A.M. Best issues financial-strength ratings measuring insurance companies' ability to pay claims. It also rates financial instruments issued by insurance companies, such as bonds, notes, and securitization products.

Compensation

Our review of MEM's employee compensation and benefits showed high executive compensation levels, significant severance payments made to former executives, and significant incentive bonuses paid to all employees; all of which would be considered unreasonable for a public sector entity.

Executive salaries

Executive salary compensation at MEM appears significantly higher than would be considered appropriate for a public sector entity. In addition, the latest compensation study performed by MEM in 2008, shows MEM employee compensation, including salaries and bonuses, by grade generally fell between the 25th and 75th percentile of the selected markets, with most executives near the 90th percentile. The markets MEM was compared to included mostly private insurance companies in the Midwest region. Per MEM officials, the year which the last study was based (2007) was an exceptional year for MEM which resulted in significant bonuses. However, MEM officials indicated more recent salary analysis performed by MEM suggests salaries and bonuses currently fall near the 50th percentile as compared to their peers.

Compensation and employee incentive bonuses for 2010 totaled over $17 million for approximately 200 employees, an average total payout of approximately $85,000 per employee. The salaries of the top 10 compensated employees for 2010 were as follows:

Employee		Salary
#1	$	312,820
#2		186,368
#3		182,796
#4		181,894
#5		169,676
#6		168,545
#7		159,812
#8		157,590
#9		149,473
#10		132,542
Total	$	1,801,516

In addition to the salaries presented above, MEM paid these employees a total of $659,405 in incentive payments, an average of $65,940 per employee.

In addition to executive salary and incentives, we noted certain executive employment contracts which included significant perks, such as paid health insurance coverage for the executive and their spouse; 5 weeks paid time off; a company automobile including all vehicle maintenance and insurance; paid dues in professional societies and organizations as deemed appropriate; paid golf and athletic club memberships; and reimbursement of any employment related expenses.

Severance or Settlement Payments

MEM paid approximately $1.58 million in severance benefits or settlement payments to four former top executives and employees who either resigned or whose employment was terminated during the years ended December 31, 2009 and 2010.

Section 287.907.1, RSMo, states, "…the board shall hire an administrator who shall serve at the pleasure of the board…". In the public sector, such statutory language would generally indicate the entity/agency would not be liable or bound to pay that official any substantial compensation or severance benefits after employment is terminated. However, the MEM Board entered into employment agreements with its President/Chief Executive Officer, which may not comply with the Missouri Constitution and/or may not be in the best interest of the company.

Due to confidentiality agreements in place between MEM and the terminated employees, the State Auditor's Office agreed not to disclose details of the severance agreements approved by the Board. However, based on our review, the severance benefits paid to these former executives appear excessive. Recent discussions with a MEM official indicate that any future severance benefits paid to executives will be substantially reduced, or eliminated.

Incentive Payments

Annually, MEM provides its employees with significant annual incentive payments. Currently, these incentive payments are based on organizational performance in the areas of premium growth, combined ratio (i.e. underwriting profit), and return on net premium (i.e. net income as a percentage of net premium revenue). If the established performance benchmarks are not met, an incentive would not be paid. Employee incentive payments based on 2010 and 2009 performance, paid out the following year, totaled approximately $2 million and $1.7 million, respectively.

The payment of severance and incentive payments is generally not acceptable or allowable in the public sector.

Expenditures

Our audit identified MEM expenditures that would be considered excessive or unreasonable for a public sector entity. MEM also conducted an internal investigation of various expenditures which was made available for our review. The following instances were noted during the year ended December 31, 2010:

- MEM paid for an all-inclusive "Presidents Trip" for 64 invitees to Lanai, Hawaii from February 20 through 25, 2010, at a total cost of over $300,000. Per MEM officials, MEM annually holds a "President's Trip", recognizing and rewarding MEM's top ten insurance agency performers. The agencies are scored based on their performance in premium growth, premium retention, and loss ratio. Per MEM officials, the top ten performers are invited because they play a significant role in MEM profitability and maintaining its position in the Missouri workers' compensation market. Each agency principal and their guest are usually hosted by MEM's President, Vice President of Sales and Marketing, and their guests.

Since this was the 15th anniversary of MEM's establishment, 64 invitees attended, including all 4 current board members and 3 guests, 7 executive staff and their guests, and a program employee. Agency attendees included the top ten performers, plus the ten most profitable agencies since MEM's inception, and their guests.

- MEM obtained 20 St. Louis Cardinals suite tickets per game for 8 regular season games, at a total cost of approximately $17,000. MEM did not purchase the suite tickets from the Cardinals, but from an associate of a former board member. The suite is used to entertain insurance agents as an incentive for doing business with MEM. Per a MEM official, MEM attendees generally include the Business Development Manager(s) whose agents are attending, the Director of Sales, and/or the Vice President of Sales and Marketing, and sometimes the Chief Executive Officer.

  We noted MEM was unable to use the suite tickets for a June 2010 game because the tickets were not received until the day of the game. In addition, 20 suite tickets for a July 2010 game were given to St. Louis branch office staff because the tickets were received 3 days prior to the game and there was not enough time to invite agents.

- MEM paid approximately $60,000 for a suite, tickets, and parking passes for University of Missouri football games; and approximately $12,000 for basketball tickets and parking passes. Attendees were generally similar to those noted for St. Louis Cardinals' games. MEM also spent approximately $5,000 to cater its tailgate party at the University of Missouri's homecoming in 2010.

- MEM sponsored and made contributions or donations to various events and entities totaling approximately $280,000. Per a MEM official, some of these expenditures are directly related to workers' compensation. For example, MEM contributed $49,866 to the University of Central Missouri Foundation for expansion, renovation, and equipment for the University's Department of Safety Sciences, as well as establishing a scholarship within the department which offers safety programs for graduate and undergraduate students. In addition, MEM contributed $17,870 to the Congressional Action Fund to have its opinion, along with other similar state workers' compensation funds, represented in Washington, DC. Other expenditures may not be directly related to workers' compensation, but the MEM official further stated that it is MEM's philosophy to have strong corporate values and be a good corporate citizen. For example, MEM provided a sponsorship of the 2010 Show-Me State Games at a cost of $20,000, contributed $16,667 to the Missouri Theatre Center for the Arts, and donated $7,000 to the Heart of Missouri United Way.

- MEM expended approximately $80,000 for company functions for the year ended December 31, 2010. These expenses included $10,000 for a Board of Directors retreat held in Ridgedale, Missouri, which included board members, executive staff and their guests; approximately $8,800 on 15 year anniversary jackets; and approximately $7,000 on a 15 year anniversary luncheon. MEM also spent approximately $16,000 for its annual golfing tournament.

Similar expenses were also noted for the year ended December 31, 2009. In addition, we noted the Chairman and Vice Chairman of the Board and their guests were in attendance during the 2009 "President's Trip" to Cabo San Lucas, Mexico. However, per MEM officials the attendance of the Chairman and Vice Chairman of the Board is not the typical practice each year.

Internal Investigation

MEM also conducted an internal investigation of various expenditures dating as far back as 2003. Our review of this material noted the following additional expenditures which would be considered excessive or unreasonable for a public sector entity:

- Political contributions totaling $8,000 made to the Missouri Democratic Party.

- Political contributions since 2003 totaling $2,600 and in-kind contributions totaling approximately $4,800 to the Insurance Coalition Political Action Committee.

- Contributions totaling $4,000 for gubernatorial inaugural festivities in both 2005 and 2009.

- Payment of approximately $8,000 for a former top executive's personal legal fees.

- Concerns over payments to, and charges made by, a former independent contractor who worked at MEM's St. Louis office.

- St. Louis Cardinals' baseball suite and ticket purchases, including $8,300 for 2010 playoff tickets (when the St. Louis Cardinals failed to make the playoffs).

- Concerns related to MEM's print shop performing "significant outside work" unrelated to company operations.

- Executive team restructuring that was not carried out as planned in January 2011.

After MEM's review of the above expenditures MEM took a number of confidential personnel actions with respect to various officers, employees and contractors. Reimbursement of political contributions and refund of unused St. Louis Cardinal tickets will be pursued, according to MEM officials. Finally, MEM strengthened controls in several related areas by approving new policies, mandating code of conduct training, and approving a criminal background check process for new and existing board members.

Sunshine Law

Chapter 610, RSMo, commonly known as the "Sunshine Law", applies to public governmental bodies. Section 610.010(4), RSMo, defines a public governmental body as any governmental entity created by statute when operating in an administrative capacity. A quasi-public governmental body is also subject to the Sunshine Law. Section 610.010(4)(f), RSMo, defines a quasi-public governmental body as any corporation authorized to do business pursuant to Chapters 352, 353 or 355 of the Missouri statutes, or performs a public function as evidenced by a statutorily based capacity. While the MEM acknowledges that it is an "independent public corporation" it denies that it is a public governmental body or quasi-public governmental body for the purposes of the Sunshine Law. However, Section 287.902, RSMo, states that MEM was created to insure Missouri employers against liability from workers' compensation liability and " . . . shall have the powers granted a general-not-for-profit company pursuant to section 355.090, RSMo, . . . ". As such, the MEM is a quasi-public governmental body for the purposes of the Sunshine Law.

Purchase of For-Profit Taxable Subsidiary

State law does not specifically address whether MEM may provide coverage to Missouri companies that employ workers in other states. In January 2011, MEM acquired a for-profit insurance company that held insurance licenses in other states. Based on our survey of similar entities in other states, we noted at least four with specific statutory authority to participate in such programs. In addition, the state code of Utah specifically allows the Workers' Compensation Fund of Utah to form or acquire subsidiaries for such a purpose.[3]

[3] Title 31A, Chapter 33, Section 103.5

Since 2003 MEM had contracted with a company that underwrites coverage for Missouri employers with employees who work outside the state, and then assumed coverage risk pursuant to a reinsurance agreement. However, on January 1, 2011, MEM acquired all the issued and outstanding shares of the United Security Insurance Company (USI), a Colorado-domiciled property and casualty company for $7.2 million. The USI holds licenses in 18 states, primarily focused in the Midwest. Per MEM officials, the acquisition of this taxable unaffiliated subsidiary will allow MEM to provide out-of-state coverage directly and at considerably less cost. USI operations are expected to commence effective January 1, 2013. Per a MEM official, the insurance regulatory agency in the states of Missouri, Colorado, and Kansas approved, or at least did not object to MEM's acquisition of USI. Although MEM officials have stated USI will only be utilized to serve Missouri employers with out-of-state employees, the acquisition allows MEM to potentially serve employers outside of Missouri through USI.

While state law created MEM " . . . for the purpose of insuring Missouri employers . . ." the law does not specifically address whether MEM may insure workers employed outside the state.

Conclusions

MEM enjoys the federal income tax exempt status of a "public corporation", an advantage that competitors do not enjoy. With the help of this advantage, MEM has accumulated a surplus totaling in excess of $160 million, and has become the dominant provider in the state's workers' compensation market. In addition, MEM essentially operates as a private entity, compensates officers and employees at rates that are in excess of public sector entities, incurs expenses that are not considered acceptable in the public sector, and does so without complying with state open records laws. State law is also not clear regarding MEM's purchase of a taxable subsidiary.

Recommendation

The General Assembly determine if MEM is operating and performing as initially intended, whether MEM continues to fulfill a necessary public mission, and clarify state law as is deemed appropriate. Specifically, the legislature should determine whether 1) it is appropriate for MEM to continue as a "public corporation" and maintain a tax exempt status, and if so, whether additional restrictions regarding employee compensation and operating expenditures are needed, 2) MEM is subject to the Sunshine Law, and 3) it is permissible for MEM to participate in "other state programs" through the purchase of its taxable subsidiary.

Auditee's Response

The following response was provided by MEM:

MEM is independent from the State. Missouri Employers Mutual commends the Auditor's staff for their courteous and professional work during this one-time, voluntary audit. In its 16-year history, MEM has never been subject to a state audit because (a) the statutes creating MEM specifically provide that it "shall not be a state agency," (b) MEM has no contracts with the state and *(c) the only money ever received by MEM from the state was a startup loan that was repaid with interest in 1999. Although MEM is exempt from federal income taxes due to an IRS provision, MEM pays all state and local taxes and assessments. MEM agreed to this audit to clearly demonstrate that the company has proper internal controls in place, which this report confirms.*

MEM has addressed the expenditures identified in the audit report. The Auditor's report raises some immaterial, questionable expenditures that MEM already had identified and addressed prior to the audit. MEM's new management has strengthened governance policies to be sure that expense policies are clearly understood and followed and that the company follows best practices. MEM's Board and management are responsible stewards who operate with integrity.

MEM's compensation and expenses are reasonable and necessary for a mutual insurance company. MEM respectfully disagrees with the Auditor's assessment that compensation and certain other expenses are unreasonable. This audit compares MEM to a public sector entity (i.e. state agency), which it is not. The statutes creating MEM state that the company "shall be organized and operated as a domestic mutual insurance company and it shall not be a state agency." Legislators made this explicit in the statute to allow MEM to compete with private insurers to solve the workers compensation crisis in Missouri and prevent it from reoccurring. Accordingly, MEM competes with nationally recognized private insurance companies for the same business, agents and employees. MEM's employee compensation averages in the 50^{th} percentile, and its expenses and operating practices are consistent with that market. If MEM cannot continue to compete with other insurance companies by compensating employees at market levels, rewarding agents in keeping with industry norms and protecting proprietary information, MEM will be unable to successfully fulfill its statutory purpose.

Though MEM is not subject to the Sunshine Law, its operations are carefully regulated and as transparent as competitive circumstances permit. MEM is not a quasi-governmental body under the plain language of the Sunshine Law. The Auditor's report erroneously concludes that because MEM has been given the "powers of a not-for-profit pursuant to section 355.090, RSMo," that MEM is a quasi-governmental body under the Sunshine Law. However, MEM was created by Section 287.902 RSMo., and is authorized by the Missouri Secretary of State and the Department of Insurance to operate under Chapter 379 governing "Insurance Other than Life" companies. Accordingly, MEM does not meet the definition of a quasi-governmental body as stated in the report.

More important, MEM already is subject to significant public oversight. Pursuant to state law, MEM is audited by state insurance regulators and an independent auditor, and those audits are public. No significant deficiencies *in internal violations or pattern of noncompliance with legal provisions were identified during the audit, and internal policies are in place to catch, prevent and report any instances of noncompliance.*

MEM's subsidiary is authorized by state law and beneficial to its policyholders. With the approval of state regulators, and at the request of its agents and policyholders, MEM purchased a taxable, wholly owned subsidiary to better serve the needs of Missouri businesses which operate in other states. This transaction was specifically allowed under Missouri statutes applicable to domestic mutual insurance companies. Without this subsidiary, premiums from Missouri businesses will continue to flow to out-of-state insurance companies.

MEM serves its public purpose. MEM was created as a mutual insurance company with a public purpose to improve the workers compensation system, serve small policyholders and bring safety to workplaces. For 16 years MEM has served-and still serves-this public purpose and has earned its position as the market leader in Missouri through a commitment to service and safety. Today, more than 12,000 Missouri businesses-more than 80% of which are small businesses-and their 1,300 insurance agencies trust MEM as their workers compensation expert.

2. Surplus and Dividends

The MEM Board of Directors has not established a policy to clarify when a policyholder dividend should be paid. The MEM has accumulated a surplus of approximately $163 million (151 percent of 2010 premiums), but has yet to declare a dividend to its members. Per Section 287.920.4, RSMo, if the MEM achieves an excess of assets over liabilities, necessary reserves and a reasonable surplus, then a cash dividend may be declared or a credit allowed. In reviewing financial information available for other states' workers compensation funds, we noted several state workers' compensation funds that had previously issued policyholder dividends, many on an annual basis.

According to MEM officials, several factors are considered in relation to their ability to pay a policyholder dividend, including workers' compensation market conditions and the potential downgrade of their A.M. Best financial strength rating. MEM officials indicated reserves have been conservatively estimated, and this practice helps ensure the company has the financial strength to meets its future obligation. As a result, MEM officials indicated the MEM is currently in a position to pay a policyholder dividend and they are considering paying a dividend of approximately 2 to 3 percent of its surplus to qualified policyholders for 2012.

Establishing a dividend policy would allow the Board to establish how much surplus is deemed necessary for the MEM to maintain its financial security and would provide MEM policyholders with information regarding when potential dividend payments would be declared.

Recommendation

The MEM Board of Directors establish a policy to determine when dividends are paid to policyholders.

Auditee's Response

The following response was provided by MEM:

MEM's policyholder equity is reasonable and necessary. Like all insurance companies, MEM must retain its policyholder equity (known in the insurance industry as "surplus") to guarantee the solvency of the company and remain the insurer of choice for thousands of Missouri businesses. This equity is also necessary for MEM to maintain its A- rating issued by A.M. Best, a key rating that measures a company's financial strength. MEM's policyholder equity is not profit; it is necessary to ensure the company's ability to pay all present and future claims and remain viable.

MEM has adopted a financial policy concerning dividends. With the help of financial experts, MEM has carefully evaluated when it could issue a dividend without threatening the financial strength of the company and harming its policyholders/owners. As the audit report notes, MEM informed the Auditor that it was considering a dividend in 2012 based on year-end 2011 results and the opinions of its financial experts. As the Auditor recommends, MEM has established a policy that allows the company to continue to maintain a reasonable level of policyholder equity while also giving back to policyholders in the form of dividends and/or lower rates when financially appropriate.

Missouri Employers Mutual Insurance Company Organization and Statistical Information

The Missouri Employers Mutual Insurance Company (MEM) was created in 1993 by Section 287.902, RSMo, to provide employers, particularly small businesses, with the means to obtain workers' compensation insurance, and at a reasonable cost. MEM was organized as a domestic mutual insurance company and by statute, is not a state agency. In March 1995, MEM began operations with the help of a $5 million startup loan from the state which it paid back early in 1999. Subsequently, no additional state funding has been provided to MEM.

MEM is the largest worker's compensation insurer in the state with approximately 12,000 policyholders, mostly small businesses. MEM is a self-supporting and self-sustaining insurance company operating on investment income and premiums generated from policyholders.

MEM is governed by a five member board who serve staggered 5 year terms. In 1997, MEM members voted to amend their bylaws to allow the Governor's office to make the majority of its board appointments (i.e. three of five members), allowing the company to receive federal tax breaks for quasi-public workers' compensation insurers.

Other State Funds

Beginning in the early 1900s, legislators across the country began establishing state workers' compensation insurance funds to provide a stable source of workers' compensation insurance coverage. Today there are 26 such funds across the country. While some state funds operate without competition, and others operate in a competitive market, depending on the laws under which they were created, the funds share basic concepts and principles. MEM has similar characteristics to many of these other state funds, including:

- Defined by applicable state law as an independent public corporation operated as a mutual insurance company.

- Non-profit and tax-exempt.

- Not being a state agency, nor considering themselves subject to open meeting or records laws (although this has been recently challenged in several states.)

- Having a majority of board members appointed by the Governor (some states' boards are appointed by state legislature.)

- Having an "other state program" to provide workers' compensation insurance to policyholders that are domiciled within the state, but with employees working in other states.

- Maintaining a significant share of the state's workers' compensation market and having accumulated a sizeable surplus (many other state funds exceed MEM's market share and surplus, several doing so significantly.)

The MEM Board of Directors at December 31, 2010, were:

Members	Term Expires*
Douglas D. Morgan, Chairman (1)	July 1, 2012
James C. Owen, Vice Chairman (2)	July 1, 2014
James J. Jura (3)	July 1, 2015
Gary B. O'Neal (4)	July 1, 2016
Vacant (5)	July 1, 2013

* All members continue to serve on the board until replacements are appointed by the Governor or elected by the MEM's policyholders.

(1) Resigned effective May 2011, and was replaced by Charles Caisley in August 2011, elected by MEM policyholders.
(2) Governor appointed in September 2010, to fill the unexpired term vacated by Roger B. Wilson who resigned effective January 2010, to become President and Chief Executive Officer. Seat was vacated in December 2011 when Owen was named President and Chief Executive Officer. A replacement has not yet been named.
(3) Reappointed by the Governor in February 2011, to new term expiring July 1, 2015.
(4) Elected by policyholders in April 2010, to replace Karen Pletz who resigned in March 2010. Reelected July 2011, to new term expiring July 1, 2016.
(5) Seat left vacant upon the resignation of Stuart Campbell in December 2010. Judith Heeter was appointed by the Governor in February 2011, to fill the unexpired term.

At December 31, 2010, MEM had approximately 200 employees in its Columbia headquarters and branch offices in Kansas City, St. Louis, and Springfield. Dennis W. Smith had served as the Chief Executive Officer since MEM's establishment, until his retirement in May 2009. Roger B. Wilson served as the interim Chief Executive Officer from June 2009 until January 2010, when he accepted the position of Chief Executive Officer. He resigned this position effective June 2011. James C. Owen replaced Wilson on an interim basis effective June 2011, and was officially named the Chief Executive Officer in December 2011.

American Recovery and Reinvestment Act 2009 (Federal Stimulus)

MEM did not receive any federal stimulus monies during the 2 years ended December 31, 2010.

A summary of MEM's financial activity is presented in the following appendix.

Appendix

Missouri Employers' Mutual Insurance Company
Comparative Statement of Revenues, Expenditures and Surplus - Statutory Basis
(Dollars in thousands)

		Year Ended December 31,				
		2010	2009	2008	2007	2006
BEGINNING SURPLUS	$	154,351	134,723	133,486	113,584	93,513
REVENUES						
Premiums earned, net of reinsurance		107,790	109,910	128,872	135,809	130,400
Net investment income		14,323	14,202	13,374	11,790	9,190
Net realized capital gains		2,109	-	-	1,924	326
Other income		473	364	306	538	198
Total Revenues		124,695	124,476	142,552	150,061	140,114
EXPENDITURES						
Losses incurred, net of reinsurance		66,860	58,916	67,168	68,492	69,306
Loss expenses incurred		11,465	12,114	12,213	14,100	13,865
Other underwriting expenses incurred		35,167	38,829	45,498	45,464	40,394
Net realized capital losses		-	903	2,625	-	-
Loss from premium balances charged-off		1,160	837	1,123	633	410
Total Expenditures		114,652	111,599	128,627	128,689	123,975
NET INCOME		10,043	12,877	13,925	21,372	16,139
OTHER SOURCES (USES)						
Change in non-admitted assets		(4,920)	2,134	(1,221)	532	1,938
Change in net unrealized gains/(losses)		3,714	4,617	(11,467)	(2,002)	1,994
Other		(91)	-	-	-	-
Total Other Sources (Uses)		(1,297)	6,751	(12,688)	(1,470)	3,932
ENDING SURPLUS	$	163,097	154,351	134,723	133,486	113,584
SURPLUS						
Surplus note and accrued interest		20,036	20,036	20,058	20,083	20,080
Unassigned surplus		143,061	134,315	114,665	113,403	93,504
TOTAL SURPLUS	$	163,097	154,351	134,723	133,486	113,584

Source: MEM Annual Audit Reports