FIRST EXECUTIVE CORPORATION

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Statistics:
Public Company
Incorporated: 1964
Employees: 1,050
Assets: $19.26 billion
Stock Index: NASDAQ

Company History:

Incorporated in 1969, First Executive Corporation (FE) is a holding company engaged in the life insurance industry through its two principal subsidiaries--the California-based Executive Life Insurance Company (EL) and the Executive Life Insurance Company of New York (EL-NY). Insurance products include immediate and deferred annuities, individual term and whole life, group permanent life, and guaranteed investment contracts.

On the verge of folding in 1974, the company gained notice for innovations that made it into one of the fastest-growing insurers in the industry in the 1980s. First Executive became a top buyer of bonds from Michael Milken, head of the California operation of Drexel Burnham Lambert. This association cost the company much scrutiny as Milken came under federal indictment in 1989, and Drexel went bankrupt in 1990. The loss of public and agent confidence combined with a rocky junk bond market to result in the announcement of an $835.7 million fourth-quarter loss in spring 1990. The consequent subject of Securities and Exchange Commission (SEC) probes, lawsuits, and bad publicity, FE was required to develop a new strategy to fuel growth and win back confidence.

First Executive Corporation is the successor to a corporation formed in 1964. The company acquired 90% of Executive Life Insurance Company, of California, in 1967 and then, in 1968, acquired ICOA Life Insurance, of Salem, Oregon. ICOA then was merged into Executive Life. Later that year the parent company acquired 74% of Executive Life Insurance Company of New York.

In 1969 the company was reorganized as First Executive Corporation. Over the next five years, the company struggled to grow. By 1974, it had an insignificant investment portfolio and was behind on its interest payments, still losing money, and about to default on a $15 million loan. Fred Carr, then a much-publicized mutual fund manager, left his own consulting business to take over the reins of FE. Carr invested some of his own money in the company, renegotiated the loan, and was soon in the CEO seat. Within nine years, FE became one of the fastest-growing insurance firms in the United States.

Born to parents who ran a vegetable stand in Watts, California, and with his college education ended when he was drafted, Carr had worked at jobs that ranged from pumping gas to selling door-to-door by the age of 32, but always was interested in stocks. This interest was confirmed by his rise to prominence on Wall Street in the 1960s.

At FE, in 1974, Carr had room for innovation. FE's insurance business was small, with growth possibilities for new policies, clients, and products, and the small investment portfolio was not committed to low-yielding long-term investments. In the mid-1970s, the life insurance industry was changing. Until then, the best-selling products were whole life, a combined insurance and savings plan with modest interest rates, and term insurance, which provides coverage in the event of death. As interest rates increased in the 1970s, small insurers offered new products with higher returns than whole life. This business made them competitive with large insurers, who could not offer such products without running the risk of having customers cash in old policies.

In 1975 FE offered single premium deferred annuities (SPDAs), a product best suited for a company short of capital. What began as a defensive strategy became the company's fortune; sales of SPDAs went from $11.6 million in 1976 to $1.1 billion by 1981. The policy required just one payment, which earned tax-deferred interest for the duration of the annuity. Policyholders could withdraw money at any time and were guaranteed high first-year yields, with rates above a stated minimum thereafter. The policies were irresistible to investors--especially in 1981 and 1982 when rates on the annuities reached 15%. FE kept its staff small by working with independent agents. Company revenues bloomed from $727 million in 1977 to $1.6 billion by 1982.

With the earnings from SPDA sales, First Executive was able to build its investment portfolio. In 1979 FE introduced another product--irreplaceable life. A variation on the whole life policies, irreplaceable policies have lower premiums and higher cash-accumulation yields. Less flexible than universal life policies, they targeted upper-income buyers for whom the appeal was investment more than insurance. The lower premiums and higher yields were afforded by FE's portfolio, then generating higher yields than the major insurers. By the time SPDA sales slowed in 1983--in part because of lower interest rates and the 1982 Tax Equity and Fiscal Responsibility Act, which affected the penalties and tax-interest conditions of the SPDAs--FE's irreplaceable life policies were top sellers.

At the same time, FE's invested assets were profiting from innovation; its growth rate more than doubled between 1976 and 1982. A good portion of these were short-term investments and an unusually large amount was also high-risk. By the end of 1982, more than 15% of FE's portfolio was invested in the B- and BB-rated bonds known as junk bonds. Most of these bonds were issued by little-known companies. This investment allowed FE to offer higher yields on policies, soon to become a costly controversy. FE was one of Drexel Burnham Lambert's largest customers. Carr had close ties to the firm's high-yield-bond department head, Michael Milken, and Drexel subleased office space from FE. Both Drexel and Milken later would be involved in an extensive criminal investigation.

In 1982 Charter Corporation, the largest seller of SPDAs, abandoned the annuities after a rush by worried policyholders; the second-largest seller, Baldwin-United, went bankrupt, leaving FE in the lead in sales. That year, FE acquired Bay Colony Life Insurance Company of Delaware, which was renamed First Delaware Life Insurance Company. SPDA sales slowed, but the company's life insurance sales increased tenfold between 1981 and 1983. Clients were reassured by the 12.6% yield that FE's portfolio averaged during the first half of 1983, compared with an industry average of 9.9%. Policy surrenders remained at a minimum. First Executive was writing more new policies than industry notables Aetna and Connecticut Mutual, but Carr's unconventional investment practices attracted the attention of insurance regulators.

FE further expanded in 1984 by the purchase of Lincoln Liberty Life Insurance Company in Nebraska. In the same year, the New York State Insurance Department fined FE's New York subsidiary $100,000 for not cooperating with examiners. In 1987, FE paid a $250,000 fine when EL-NY pleaded guilty to violating eight sections of insurance law. It was the biggest fine ever imposed by the state on an insurance company. In addition, FE gave the subsidiary a $151.5 million cash infusion.

The fines and infusion primarily were related to problems with the company's surplus relief reinsurance arrangements. Reinsurance treaties are a standard part of the insurance industry; they essentially reduce risk by sharing it. A company reduces its liabilities by transferring future claims obligations to another insurer in return for a fee. This action also increases the company's surplus by reducing the amount of reserves required against future claims on issued policies. Treaties are subject to regulations as the resultant accounting of capital is integral to a company's ability to pay claims and support the issuance of new contracts. Because of EL's risky investments, regulations called for it to have a higher reserve than most. In the 1987 probe, the New York regulatory agency rejected nearly all of EL-NY's surplus relief from reinsurance contracts because of a circular arrangement made with companies that had connections to FE and letters of credit backed by the company's own assets. Additionally, the company failed to receive regulatory approvals, and file certain forms; it took credit for some treaties that never were executed. The industry regulators contended that the company had been undercapitalized for three years.

The New York inquiries sparked similar investigations into EL in California, FE's biggest unit. Within a week of the New York unit's fine, California insurance regulators were contesting $188 million worth of EL's reinsurance contracts, charging that the company was not complying with a 1985 order. The setback to FE was considerable; it relied heavily on reinsurance to support expansion by freeing up capital. In addition to the bad press of the regulatory investigations affecting sales, reinsurers began to command higher fees among other assurances.

Other problems were gaining momentum. The junk bond market was falling apart, and in 1987 junk bonds accounted for more than 40% of FE's assets. First Executive was still one of Drexel's largest customers, and Milken held stock in two companies in which FE was a major shareholder. The October stock plunge shook things up further; by December 1987, FE's $13 billion bond portfolio had $675 million worth of paper losses and its stock portfolio had $74 million in paper losses. FE put its New York unit up for sale.

FE's total assets, which had grown 65% in 1986, grew only 14% in 1987. Its annuity sales fell 42%. Although sales dropped, FE's policy renewal rates were still among the industry's best. In addition to the shadow of its association with Drexel and Milken and flagging sales and market uncertainty, FE was confronted with stiffer insurance regulations in 1988. The revision of tax laws by Congress eliminated many of the advantages of deferred annuities. Insurance regulators in California and New York tighted rules governing surplus relief reinsurance treaties. In 1987, FE was only able to buy half of the surplus relief reinsurance it was seeking. Accordingly, First Executive had to de-emphasize the sale of capital-intensive SPDAs, once its mainstay. It also had to reduce its enticing interest rate promises and rely less on high-yield, low-rated bonds. New York state regulators now limited the percentage of junk bond investments allowed in an insurance company's portfolio to 20%. In 1988, FE injected $345 million of new capital into EL. It later was charged that the California unit was insolvent on a statutory basis at the end of 1987.

In 1989 the Drexel specter expanded. Milken faced a 98-count federal indictment for securities crimes, and the SEC probe extended to Drexel's customers. At the same time, Congress was examining FE's role in the 1985 takeover of Pacific Lumber Company by a Houston, Texas, investor, who used Pacific's pension plan surplus to pay for the takeover. The pension plan then was terminated and replaced by an FE annuity. FE bought $70 million worth of bonds floated in the takeover and at issue was the $37 million contract for annuities to cover Pacific employees that was alleged to have been improperly won.

Carr contended that his enterprise was still healthy; debt was low and expenses were at a minimum. Cutbacks of capital-intensive annuities left more profit in the coffers, and FE pointed out that while revenues dropped $500 million from 1987 to 1988, earnings increased by about $28 million.

In July 1989 Executive Life and Drexel agreed to pay $30 million to settle a class-action lawsuit. The suit involved 4,200 investors who charged that they had been cheated in a tax-shelter scheme. The transaction involved notes purchased by Drexel, later sold to EL, on interests originally purchased by Hollywood, California, businessman Gerald Schulman, in a series of fraudulent transactions, at 80% below their value.

In December 1989 a transaction came to light that had taken place a year earlier involving six newly formed firms through which FE substantially reduced its stated junk bond holdings. The six companies were all incorporated on the same day, with the same address, and with the same CEO--a former consultant to EL. To each company, FE gave a cache of junk bonds and some cash, and received co-issued bonds in return. The six individual investments each were below the disclosure threshold. The arrangement allowed FE to alchemize $700 million in junk bonds into $800 million worth of securities. With a lessened reserve obligation, FE's balance sheet appeared sounder than it was. This transaction was later reversed by the California Insurance Department.

In January 1990, FE disclosed plans to take a $515 million charge against fourth-quarter earnings because of write-offs in its junk bond portfolio. It later came to light that, even after the write-offs, the bonds were worth $1.4 billion less than the company paid for them.

Earlier in the month, the impending $460 million sale of the New York unit collapsed. The buyer was unable to arrange junk bond financing. Then, in February 1990, Drexel declared bankruptcy amid the growing turmoil of the junk bond market. About 45% of FE's assets were in junk bonds at that moment; junk bonds were trading at about 60% to 80% of their face value. Customers began cashing in policies, creating more cash-reserve worry, and the SEC began to investigate FE's financial condition to see whether it had mislead its investors. The value of the company's stock dropped by almost 70%.

California's department of insurance installed two full-time examiners at EL to monitor the unit during a rush of policy redemptions and public worry in the wake of the junk bond market plunge. In April 1990 FE posted an $835.7 million fourth-quarter loss. Policy surrenders in the first two months of 1990 totalled $559 million. The company also confirmed that the SEC had opened formal investigations of possible violations of security laws since 1988. A number of civil lawsuits and state actions were filed alleging securities violations related to rights of offering. Other investigations were ongoing by the Pension Benefit Guaranty Corporation and the Labor Department regarding FE's pension terminations. In 1991 FE was involved in a number of federal and state stockholder lawsuits, charging entrenchment, mismanagement, material misstatements, and excessive involvement with Drexel, among other things. In May the company's New York unit was fined $25,000 and reprimanded for "sloppy" record keeping during the 1980s that prevented any accurate determination of company reserves.

Clearly, First Executive faced monumental challenges. The company needed a new growth strategy to fund the capital reserve necessary to rebuild its insurance business. First Executive Corporation faced an unstable bond market in 1990, and public investors were apprehensive.

Principal Subsidiaries: Executive Life Insurance Company; Executive Life Insurance Company of New York; First Delaware Life Insurance Company; First Stratford Life Insurance Company; Lincoln Liberty Life Insurance Company.

Further Reading:

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