



UPDATE ON INSURER SOLVENCY AND RUN-OFF STRATEGIES

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Insurers Persistently Under-Reserve for Asbestos and Environmental Losses

- House subcommittee has found that the insurance industry underreports loss reserves “by truly gargantuan proportions.”
- In 2003, several Hartford companies, Nationwide and Swiss Re increased reserves on policies issued before 1993 by nearly 40%. 30 other major insurers increased their long-tail reserves by 10%.
- On January 6, 2005, ACE announced that its asbestos and environmental reserves would be increased by more than \$350 million net of reinsurance and before tax.

The Innocent Explanation -- Long-tail Reserves Are Difficult To Estimate Accurately

- Decades can elapse between the time a policy was issued and an asbestos or environmental claim is reported and resolved.
- Asbestos and environmental risks can represent many years of underwriting activity, yet often must be absorbed into a single present reporting period.
- Accurate actuarial forecasts upon which reserves are based require relatively stable data.
- The Casualty Actuarial Society has stated that, in the insurance arena, “[a]ctuarial estimates are inherently uncertain because they are dependent on future contingent events.”

The Nefarious Purpose -- Reserves Reduce Income and Are A Drag on Reported Performance

PEOPLE OF THE STATE OF NEW YORK v. AMERICAN INTERNATIONAL GROUP

- During periods of growth, insurers report increased premium income and increased reserves to cover claims on new policies written.
- If premium is increasing, but reserves are not, regulators and analysts worry that the insurer is not setting aside sufficient money to pay claims.
- "A downward trend in reserves during a period of premium growth may also indicate that the insurer is engaged in financial trickery to boost profits."
- "In late 2000, AIG's stock price dropped, a decline analysts speculated was based on fears that AIG's reserves were released into income so that it could meet its projected income numbers. To counter this perception, defendants engaged in two sham transactions with GenRe, through which defendants hoped to create the appearance of additional reserves and thus fraudulent support the stock price."
- GenRe paid \$500 million to AIG in late-2000, which AIG booked as reserves in the next two quarters. In return, AIG provided GenRe reinsurance that carried no real risk.
- "[T]he only real service performed by either party was that GenRe created false and misleading documents to satisfy Greenberg's illicit goals."

Proposed SEC Disclosure Rule

- SEC has stated that publicly-traded insurance holding companies must disclose the effects of critical accounting estimates on their results and overall financial condition, including their sensitivities to changes and assumptions.
- A proposed rule would require qualitative and quantitative disclosures, and a description of the estimate, methods and reasonable alternative estimates on reported results.

Long-tail Liabilities Have A Material Effect On Performance

- In 2003, fifty-three publicly traded insurance holding companies reported long-tail risks through operating subsidiaries and affiliates. This represented more than half of the long-tail risks underwritten by all domestic insurers.
- The estimation and management of long-tail risks are material to the overall results of *every* publicly-traded domestic insurance holding company.

Finite Risk Reinsurance Protects Against Known Losses

- Traditional reinsurance typically is prospective in nature and covers unknown, but insured losses
- Finite risk reinsurance typically is retroactive in nature. It provides indemnity against losses that already have occurred, and will continue to occur in the future.

Permits Losses To Be Spread Over Time

- Permits insurers to avoid recording losses as a lump-sum deduction from income.
- Insurers instead can spread the losses over a long, pre-determined period of time.
- Permits insurers to avoid large one-time deductions from “surplus,” a key measure of the company’s financial strength.
- Guy Carpenter, a leading broker of reinsurance products, reported in 2001 that its “finite” reinsurance programs were growing 25% a year as companies faced internal pressures to achieve forecasted results.

Inherently Problematic

- Can mask the insurer's poor financial performance by spreading known and expected losses over a long period of time, thus artificially boosting the company's short-term surplus.
- Insurers in financial distress, in "run-off," or both, are often the heaviest users of finite risk reinsurance.
- Sometimes, no risk transfer is involved and the transaction is either a loan or completely fraudulent
 - Reciprocal of America/GenRe
 - Gerling Global/NICO
 - HIH/NICO
 - AIG/GenRe

Is Finite Risk Reinsurance The Cause Of The Further Decline Of Financially Troubled Insurers?

Kemper companies

- In 2001, the Kemper property and casualty insurance companies, most prominently Lumbermens Mutual Casualty Company and American Motorists Insurance Company, entered two finite risk reinsurance contracts with National Indemnity Company (“NICO”), owned by Berkshire Hathaway.
- In a 2002 report, the analysts at Fitch Ratings concluded that these two transactions reduced Kemper’s surplus by 15 percent and that “without the aid of financial engineering tools,” the company’s surplus would have declined by another 25 percent.
- The Kemper companies are on the brink of liquidation.

Home Insurance Company

- Finite risk reinsurance underwritten by Centre Re was largely responsible for regulators in New Hampshire to approve a complicated series of transactions in 1995 that caused the Zurich insurance companies to assume control over the Home Insurance Company.
- Home entered liquidation in 2003

Is Finite Risk Reinsurance The Cause Of The Further Decline Of Financially Troubled Insurers?

ACE

- ACE purchased a \$2.5 billion finite risk product from NICO in 1999 concerning its run-off entity, Century Indemnity Company.
- In January 2005, Century Indemnity was reported to be insolvent as a matter of statutory accounting.

Stonewall/Seaton

- These run-off insurers purchased hundreds of millions of dollars worth of finite risk reinsurance from NICO
- Likely will propose controversial partial “self-liquidations” in coming years

Direct Actions Against Sellers Of Finite Risk Reinsurance

- Premise -- Reinsurer took assets from the insurer, in the form of "premiums," that should have remained with the insurer to pay policyholder claims
- Potential Causes of Action
 - Assignment and assumption (express or implied)
 - Unfair business practices
 - Fraudulent transfer
 - Imposition of alter ego liability
 - Interference with contract
 - Interference with prospective economic advantage

Current Litigation Against Finite Risk Reinsurers

- Numerous Home policyholders are suing Zurich-related entities in San Francisco Superior Court seeking to hold them responsible for Home's obligations
- Kemper policyholders are suing NICO and related Berkshire Hathaway reinsurers seeking to hold them responsible for Kemper's obligations
- A number of policyholders of Reciprocal of America, as well as the insurance regulators of a number of states, are suing GenRe for causing the collapse of Reciprocal
- New York v. AIG
 - AIG faces shareholder suits and suits by policyholders that purchased coverage after the GenRe transaction based on the strength of AIG's loss reserves

Solvent Schemes Of Arrangement In The UK

- Section 425 of the Companies Act permits a *solvent* UK insurer, reinsurer, or portion of either, to enter into a “scheme of arrangement.” A solvent scheme will pay 100% of an “allowed” claim.
- If approved by creditors, and the courts, the company becomes immune from further litigation so that it may distribute assets in accordance with the scheme.
- Only seeks to distribute some of the company’s assets. The rest are kept by the owners.
- Increasingly popular exit strategy for UK run-off insurers and reinsurers seeking to avoid long-term claims expenses and the uncertainty of litigation. Nearly 50 solvent schemes have been approved to date.
- Similar statute exists in Bermuda.

Process Of A Solvent Scheme

- Plan is proposed to UK Financial Services Authority
- Creditor's meeting is noticed and scheduled
- Approved if supported by at least 50% of creditors appearing at the meeting (either in person or by proxy) representing at least 75% in value of those in attendance.
- Approved scheme is presented to High Court of England. Favorable ruling results in an order staying all further litigation against company and is binding on all creditors, even objectors
- Section 304 of the U.S. Bankruptcy Code permits a party to bring an ancillary proceeding in a bankruptcy court to enjoin suits or actions in the United States against a debtor in "insolvency" proceedings in a foreign country. "Insolvency" proceedings include reorganization actions initiated by "solvent" companies.
- Stay order "ancillary" to a foreign "insolvency" proceeding issued by a bankruptcy court curtails litigation against the insurer under a "scheme of arrangement" in federal and state courts, and in arbitration. *In re Hopewell International Ins. Ltd.*, 275 B.R. 699 (S.D.N.Y. 2002).

Challenges To Policyholders

- Solvent insurers otherwise are subject to litigation, adverse rulings and other pressures that can increase the value of a claim.
- Insurers in solvent schemes admittedly can pay all claimants. Questions invariably arise as to whether they are committing sufficient money to the plan, or are simply seeking to retain as much equity as possible.
- Because solvent schemes pay 100% of allowed claims, presently liquidated claims will fare better than contingent and unliquidated claims based on future claims estimates
- Notice period is exceedingly short. Creditors typically receive six weeks notice of a meeting. A claim must be presented to vote.
- Claim processing period is short. Bar date for final submissions, and supporting documentation, typically is six months after the creditors' meeting. Final scheme payments are typically scheduled to occur within a year of the initial notice to creditors that the company has proposed a solvent scheme.

Solvent Schemes In The U.S.?

- In 2002, Rhode Island passed a statute called “Voluntary Restructuring of Solvent Insurers,” modeled after Section 425 of the Companies Act. In 2004, the state passed Regulation 68 to implement the provisions of the law.
- Solvent insurers and reinsurers that re-domesticate to Rhode Island can enter into a “scheme of arrangement” if the plan is approved by 50% of creditors attending the creditor’s meeting representing 75% in value of those attending. As in the UK, court approval results in the issuance of a stay order.
- Stonewall Insurance Company and Seaton Insurance Company re-domesticated to Rhode Island in 2004 and likely will seek to take advantage of the law.

Enforcability Of Rhode Island Stay Order In Other States

- Rehabilitation and liquidation orders issued by a state court traditionally have been enforced in other states under principles of comity or reciprocity.
- Rhode Island statute is unique in the U.S. There are no statutes in other states from which a “reciprocity” argument can be fashioned. Whether a state court will enforce a stay order issued in Rhode Island in favor of a solvent insurer that admittedly has sufficient assets to pay all creditors is unknown.
- If litigation is not stayed nationwide against a Rhode Island insurer in a “solvent” scheme of arrangement, the scheme will fail.

The Attempted Walk-away: An Ace In The Hole

- The Insurance Company of North America (“INA”) divided itself into two companies in 1996. Its pre-1996 asbestos and environmental liabilities allegedly were transferred to Century Indemnity Company, a run-off company. ACE Ltd. acquired INA, Century Indemnity and related companies in 1999.
- ACE has proposed selling three reinsurance subsidiaries of Century Indemnity to Randall & Quilter Investment Holdings Ltd. for a total of \$3.00. The three reinsurers have \$1 billion in asbestos and environmental liabilities. The group in which Century Indemnity operates has a total of \$5.8 billion in asbestos and environmental liabilities.
- ACE has made no secret that it plans to try to sell the rest of Century Indemnity. Its president, Evan Greenberg, said during a January conference call with investors that the company is “exploring a variety of options” and that the elimination of Century Indemnity -- along with INA’s long-tail asbestos and environmental liabilities that it holds -- from ACE’s consolidated accounts would demonstrate the “finite nature” of ACE’s obligations to the company and to INA’s pre-1996 policyholders.

The Attempted Walk-away: An Ace In The Hole

- Mr. Randall and Mr. Quilter, the proposed purchasers of the ACE reinsurers, are large shareholders in the company that owns Stonewall Insurance Company and Seaton Insurance Company, both of which re-domesticated to Rhode Island in 2004.
- Pennsylvania Dept. of Insurance has scheduled a public “informational” hearing in Harrisburg in July 2005.
 - Morgan Lewis filed objections to the proposed sale, as did AIG, Chubb, St. Paul Travelers, Allstate, Liberty Mutual, and several other policyholders
 - Is the proposed sale a “trial balloon” that will lead to an attempt by ACE to sell the rest of Century Indemnity to Randall & Quilter, the re-domestication of Century Indemnity to Rhode Island and a proposed solvent scheme of arrangement?

INA's Asbestos And Environmental Liabilities Cannot Be Transferred Without Policyholder Consent

- Greenberg also stated during the January 6, 2005 conference call that Century Indemnity was created in 1996 as “the sole successor” to the asbestos and environmental liabilities of INA.
 - However, it has been settled as a matter of Pennsylvania law for nearly 100 years that an insurer may not transfer responsibility under its policies to another insurer without the express consent of its policyholders. *Jones v. Commonwealth Casualty Co.*, 255 Pa. 566, 573 (1917).
 - A California appellate court reached the same conclusion in rejecting INA's position that the restructuring “exonerated” INA from continuing liability under its policies. *AICCO, Inc. v. Insurance Company of North America*, 90 Cal. App. 4th 579 (2001).
 - The general rule throughout the United States is that “[a]n insurer may not transfer its liability to another company and compel its policyholders to accept the new company as their insurer.” *AICCO*, 90 Cal. App. 4th at 589 (*quoting 14 Holmes’ Appelman On Insurance 2d* (2000), § 109.1, p. 609).

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