The INSURANCE RECEIVER

Promoting high ethical standards in the administration of insurance receiverships.

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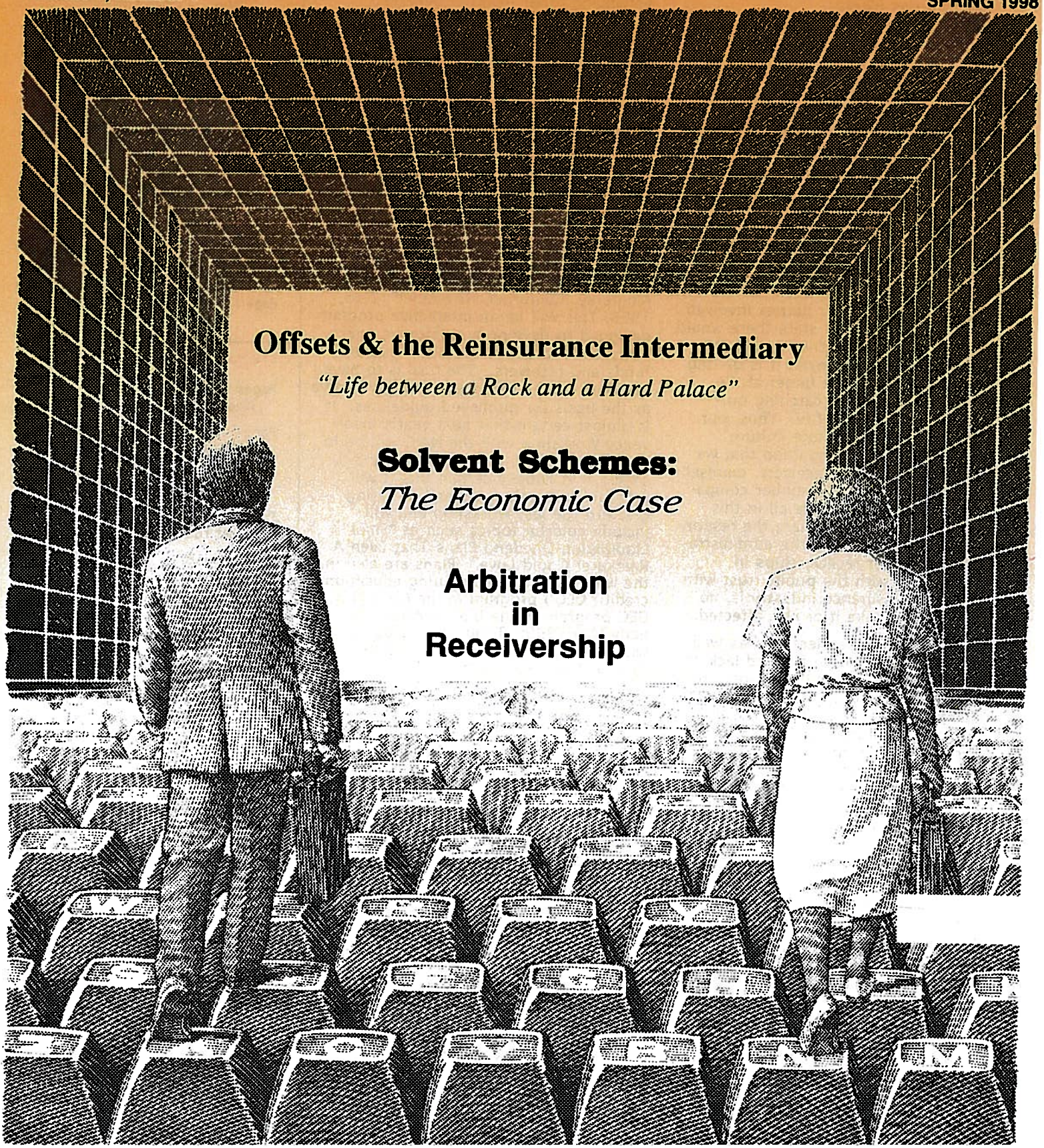

Offsets & the Reinsurance Intermediary

"Life between a Rock and a Hard Palace"

Solvent Schemes:

The Economic Case

Arbitration in Receivership

President's Message

By Douglas Hartz
Missouri Department of Insurance

At the Roundtable Meeting in Salt Lake City, after my brief comments on the "Plans for IAIR" topic assigned to me, Jan Ferguson asked me what should be the "corporate culture" of IAIR? Gee, thanks for the softball question. After a bit hemming and hawing, I finally answered, "shared responsibility." On reflection, that was not too bad a shot from the hip. IAIR is made up of members with a wide variety of interests in insurance receiverships. It has been far too easy to point to the other parties involved in receiverships and state there would be less problems if they would just straighten up. However, it is getting tougher to point the finger at the "other guy" without catching ourselves in the line of fire. Thus, our thinking and "corporate culture" should reflect a recognition that we regulators, deputy receivers, counsel, guaranty funds and member companies, and reinsurers are all in this together, and we all share the responsibility for improving the administration of insurer receiverships in accordance with the public trust with which the insurance industry is, no matter if you like it or not, affected.

The Roundtable Meeting was well attended (albeit, with a noted lack of SDR's and CIR's) and led to some truly interesting discussions. I want to thank Len Stillman, CIR for chairing the event (and for his slide show explanations of the do's and don'ts of insurer receivership) and congratulate both him and Steve Durish as Education Chair for a successful event. Special thanks also go to Brian Donnelly, Ipe "animal humorist" Jacob, Mark Femal and Mike Surguine for serving as speakers and to Jan Ferguson (who asked some rather pointed questions), Liz Lovette (who coordinates our quarterly coordinators) and Rheta Beach for serving as inquisitors. According to the flyer for the Roundtable, these last three were the Panel of Experts who 'offered' questions to our guests. However, declining the offer or 'Pleading the Fifth' just didn't really seem to be options.

On the topic "Plans for IAIR," my comments focused on accreditation and education. Our plans cover a great deal more - including expanding membership, assisting with continuing education requirements, producing a long-range plan, enhancing our publications, code of ethics and amicus procedures, and enhancing other member benefits, especially for our international members. However, accreditation and education are the two top priorities for IAIR. On accreditation, we are: 1) planning to develop tests for the AIR and CIR designations, 2) simplifying and updating the requirements for these, and 3) planning to simplify and quicken review. Things are moving very well in the accreditation area - thanks to a very diligent committee and its Chair, Robert Craig who, it should be noted, was voted in as Second Vice President at the SLC Board Meeting.

In the education area plans are set for our joint program with the NCIGF in Monterey, California, November 12-13, 1998. This will be an interactive program designed to develop and improve operations and procedures between guaranty funds and receivers. The goal is to have the work product from this program serve as the basis for published guidelines. It is almost certain that next year's Insolvency Workshop with the NAIC will be in West Palm Beach, Florida, February 3-5, 1999. It is equally certain that it will measure up to the outstanding rating given to the last Workshop and will include colorful topics such as "Final Liquidation Dividend Plans That Even A Reinsurer Could Love." Plans are also in the works for: 1) a continuing education credit ("CEC") program in the U.K.; 2) a CEC program in the U.S. sometime in early May 1999; 3) our joint program with NOLHGA in November of 1999 and 4) a joint program with the ABA on its Fourth National Institute on Insurer Insolvency in connection with the 1999 December NAIC meeting in San Francisco.

There is still a great deal of planning to go into each of these programs and Steve Durish, bless his soul for agreeing to chair the Education Committee, will be able to use all the help he can get. There will be a subcommittee for each of these programs and if you want to be on those you have only to contact IAIR, myself or Steve Durish (512) 345-9335 and let us know of your interest.

Finally, in regard to the upcoming Roundtable in Boston, June 20, J. David Leslie will be chairing the program which will have topic presentations limited to a few minutes followed by broadly participatory discussions.

Topics will include EMLICO (to the extent participants can discuss it), Blue Cross/Blue Shield plans (again, depending on current events), insolvency of and quaranty fund coverage for HMO or non-indemnity health plans (Daniel A. Orth will probably introduce this topic), insolvency administration in Bermuda (Ian R.C. Kawaley), developing regulatory systems for the insurance industry in emerging markets (Alessandro A. Iuppa - Superintendent of Insurance for Maine, who has, I can assure you, an historic perspective on insurer insolvency), and an update on the need for claims estimation for paying full liquidation dividends as claims mature with, or without, acceleration of reinsurance recoveries (for which I myself will dodge the tomatoes related to introducing the topic).

All in all, this promises to be an IAIR Roundtable that is not to be missed, and I hope to see you all there!

The Insurance Receiver
Volume 7, Number 1
Spring 1998

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Salt Lake City Meetings Recap

By Mary Cannon Veed

What a spooky feeling, being an insolvency practitioner in an NAIC which honestly doesn't expect to need one ever again! The substance of this recap: conventional wisdom, as expressed in Salt Lake City, avers that insurance receivership is obsolete. At a very minimum, the backlog of "To-Do's" for receivers is much reduced, witness the length of the EX5 agenda: There were a total of 5 meetings listed under EX5; the agenda for one consisted of hearing the minutes of the others. One of those was Federal Issues, in executive session, and one was the Handbook, which has settled down to a permanent series of updates. That left 2 real meetings. Ironically, the most substantive of the lot may well have been the "Uniform Data Standards" group which in spite of its stultifying title appears to be headed toward the development of something like GAAP for receivers. This is one of those evidently good ideas whose execution has always been prevented by a combination of entrenched habit and too many other things to do, neither one of which seems such a formidable obstacle today. The group, with the help of its technical support working group ("TSWG" pronounced tea-swig) or tea-swiggers, is supposed to come up with final formats by the September meeting.

In the category of "why didn't we try this sooner?" we can put the adoption by EX5 of a resolution supporting proposed federal legislation which would make clear that the federal priority law should not apply more harshly to insurers liquidated by states than to other companies being wound up in bankruptcy. (That troublesome law was long ago abrogated in bankruptcy — the effect on insolvent insurers occurs because of an eddy in the current of history.)

It wouldn't fix the broader problem of federal hostility to McCarran Ferguson, but it would surely put a stop to the more foolish super-priority cases. Apparently, there is cautious hope that it will be introduced in, and passed by, the houses of Congress.

Does anybody remember Larry Gabriel? He was the bankruptcy creditors' attorney who found a niche in the life insolvency wars asserting that the GA's ought to cover the so-called "unallocated" annuities. While he made his case on the discrepancies, unarticulated assumptions, and mixed intentions of the old GA laws, he could occasionally be heard wondering why the industry seemed so determined to let its banking and stockbroker competitors have a level playing field.

For cost and organizational reasons, GIC's was never going to be price-competitive with money market instruments — why not offer GA coverage, something the money markets lacked? I know I was in the minority, but I always thought he had a pretty good point. Sunday night found him justifying a ski trip by prowling the reception, oblivious to the GA group's intention, Monday afternoon, to endorse the option of GA coverage for GIC's — a change which became possible when the industry abruptly reversed field and announced neutrality on the point.

For the first time in my acquaintance with him, the news left him speechless. See what happens when you let your IAIR membership lapse?

As advertised, the working group not only accepted a proposed revision that made coverage optional, it dispensed with the usual exposure and comment periods, correctly concluding that the issue had already gotten enough exposure to earn an X rating from the MPAA.

The GA working group also tackled, with somewhat less vision, the question of coverage for health insurance organisms. One has to call them organisms —there is just no other word that is broad enough for the numerous phyla to which they belong. Which is, of course, the problem. How to create a system to regulate them when we cannot prevent them mutating themselves outside of our definitions, and thereby gaining a competitive edge over their regulated cousins which might as well be a kiss of death in this intensely competitive field?

Anybody who has to pay a fair share of the industry wide cost of failures is arguably doomed to join them if competitors can "morph" into new shapes and escape the cost burden. And it doesn't do a thing for regulatory efficacy if regulated companies die more frequently than unregulated ones.

The answer, of course, is to define "health insurer" broadly enough to capture any entity assuming the risk, for a fee set in advance, that health services will be called for.

Such a definition must defensibly establish jurisdiction vis-a-vis the Department of Labor or other federal agencies. Supposing it can be written, (and it's easier said than done) the next step is to figure out functional standards (meaning defined in terms of effect, not terminology) to regulate "health insurers".

Obviously, the group is on the right track in trying to define the organism before figuring out how to ensure its performance. But deferring the "CLEAR" (Consolidated Licensing of Entities Assuming Risk) project, as the working group did, has a seductive, and very dangerous, effect: it postpones action. Will this process ever get finished, until some looming disaster forces it to be finished precipitously? And will the disaster hold off long enough to permit a sensible consensus to develop?

One decision avoidance maneuver deserves some searching inquiry. "Don't worry", some advise us. The collapse of an HMO without benefit of guaranty association protection won't produce heart-wrenching scenes of patients turned out on the streets and cancer going untreated.

Service providers contract with HMO's and undertake, as part of their commitment, to treat their assigned patients regardless of whether they, themselves, are getting paid. The only losers, if an HMO fails, will be the doctors who probably own the thing anyway. The patients will be taken care of.

This kind of "best of all possible worlds" thinking ought to be recorded for posterity, where it will rank right up there with the unnamed Englishman who once told me life insurers never failed because the industry always took care of them, and the bright bulb who sailed the Titanic among those icebergs, confident in its impregnable and unsinkable bulkheads.

If the failure of an HMO ever precipitated the collapse of a major local hospital, or caused the physi-

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Salt Lake City Meeting

(Continued from Page 3)

cians to miss their children's tuition payments at Harvard, the supposed bulkheads would crumble like tinfoil. Sure, there is a sizeable reservoir of antipathy toward doctors in pursuit of fees, but anyone who has opposed tort reform would confirm that what the medical lobby lacks in public sympathy these days, it more than makes up in clout. It isn't smart to lobby against Doctor Kildare — especially when he points out, with perfect justice, that the HMO's promise to pay him is just as valid and binding, or not, as his own promise to provide treatment without additional compensation from the patient.

In an environment where HMO's possess something akin to monopoly power, can that hold harmless really be made to stick against a professional caregiver who merely seeks to bring home a living wage?

In recent years, we have seen the HMO industry expand tremendously, augmented by a flood of "innocent capacity". More recently, we are seeing the consolidation phase of a classic insurance cycle. One would think that phase would coincide with a rash of insolvencies, as the industry shook out its laggards. But it doesn't quite work that way; in fact, the peak of the insolvency curve tends to follow the nadir of a soft market by about 18-24 months.

The industry is not transparent, and it takes that long before market casualties find their way to the morgue. While you're counting months, think about what ought to go into an HMO guaranty system if you had to invent one in your state on short notice. And learn how to read medical jargon.

Another issue which seems to have descended into a morass of wishful thinking is the vexed question of interaffiliated pooling. This time the committee heard Rob Graham express the views of the industry advisory group.

The gist of their message was that the problem could be avoided entirely if the regulators involved were "co-operative" with each other. Apparently the idea is that, if regulators observe that one of their charges is getting into trouble and is a party to a pooling arrangement which would produce anomalous results if the company were liquidated, they should direct the company to "unwind" the treaty before liquidation intervenes, so that the pooling disaster does not occur. Likewise, if it appears that the group as a whole is headed for the graveyard.

I can see two problems with this sort of co-operation: voidable preferences (which are voidable even when they are honestly motivated) and fairness to the creditors of whichever company gets the short end of this stick.

The latter one is really insuperable: having had its own results burdened over the years by the cost of paying its affiliates' losses, and having obtained its customers on the strength of a balance sheet which reflected the pooling protection, now, when the protection is most needed, the company ought to gratuitously give it up?

The other prong of this suggestion, that regulators monitor the solvency of their charges' reinsurers, so as to head off the development of the pooling problem, attributes clairvoyance to the monitoring regulator well beyond that of the regulator of the reinsurer (not to mention the management of either company), and is simply fatuous. Which is more or less where we left off last quarter.

Outside of EX5, the issues haven't changed much either, although the temperature seems to have gone up a notch. In Seattle, the buzz words were "re-engineering", "mutual holding companies", and, coming up fast from the rear, "Lloyd's trust funds". Still true, with re-engineering apparently crossing the finish line, its white paper now being forwarded to the Commercial Lines committee, and its related licensing component, the ALERT program, being officially launched in seven states. (This seems to be an especially productive period for people who dream up cute acronyms.)

The Mutual Holding Company group released a draft white paper, which at this stage is a basically unintelligible jumble of conflicting conclusions—not surprising since the different sections were written by different people. But they're getting there.

The Lloyd's trust finds issue is

(Continued on Page 16)

IAIR Roundtable Schedule

NAIC Meeting - June 20-24, 1998
Boston, Massachusetts
IAIR Roundtable
J. David Leslie, Chair
June 20, 1-5:00 p.m.

NAIC Meeting - September 12-16, 1998
New York, New York
IAIR Roundtable
September 14, 1-5:00 p.m.

NAIC Meeting - December 5-9, 1998
Orlando, Florida
IAIR Roundtable
December 5, 1-5:00 p.m.

NAIC Meeting - March 6-10, 1999
Washington, D.C.
IAIR Roundtable
March 6, 1-5:00 p.m.

The INSURANCE RECEIVER

The IAIR newsletter is intended to provide readers with information on and provide a forum for opinion and discussion on insurance insolvency topics. The views expressed by the authors in the IAIR newsletter are their own and not necessarily those of the IAIR Board, Publications Committee or IAIR Executive Director. No article or other feature should be considered as legal advice.

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Frank Bistrom, CAE, Executive Director; Lisa Green, Administrative Coordinator.

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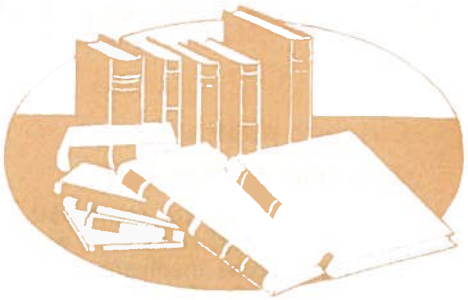
Other News & Notes

By Charles Richardson



Education, Dialogue & Expertise . . .

I try, often feebly, to stay up on the reported trends in American business, generally, and in the insurance sector of the economy, in particular. Like everyone else, I am bombarded with magazines, trade press articles, Internet resources, etc., and the job of keeping current is no mean feat. By and large, it looks like we in the United States are doing pretty well these days vis-a-vis our economic competitors abroad. In terms of customer focus, service orientation, efficient distribution systems, and overall quality delivery, the word on the street is that U.S. business and the entrepreneurs and employees that fuel our economy is doing better and better.

But consider this, thanks to a friend of my son who sent the information along over the Internet: 12 newborns will be given to the wrong parents daily; 114,500 mismatched pairs of shoes will be shipped/yearly; 18,322 pieces of mail will be mishandled/hourly; 2,000,000 documents will be lost by the IRS this year; 2.5 million books will be shipped with the wrong covers; two planes landed at Chicago's O'Hare airport will be unsafe every day; 315 entries in Webster's Dictionary will be misspelled; 20,000 incorrect drug prescriptions will be written this year; 880,000 credit cards in circulation will turn out to have incorrect cardholder information on their magnetic strips; 103,260 income tax returns will be processed incorrectly during the year; 5.5 million cases of soft drinks produced will be flat; 291 pacemaker operations will be performed incorrectly; and 3,056 copies of tomorrow's *Wall Street Journal* will be missing one of the three sections.

So, is it any wonder that as good as we think we are, we have to keep our focus constantly on doing better? That's IAIR's mission in the insolvency field — to produce better and better results to policyholders and others vitally interested in the clean-up of a failed insurer — so that the overall professionalism of the system increases and the delays, problems and mistakes of past insolvencies are not repeated.

I have seen IAIR's mission of education and increased professionalism play out in three specific ways over the last few months that lead me to realize how important it is that no part of the insolvency system — receivers, guaranty associations, courts, creditors, others — rests on its laurels or remain frozen in time.

Down Life. First came the NOL-HGA/IAIR Joint Seminar in Louisville in November. Under the microscope in a detailed case study format was pitiful Down Life Insurance Company. The last issue of the *Insurance Receiver* reported on two days of intense competitive work by the attendees at the session to design a solution that dealt with a tangle of legal, financial, asset, and actuarial challenges. How many times before have the various insolvency interest groups come together in such a case study format to talk it, slug it, and scream it out over their competing interests?

Seattle Roundtable. Then came the IAIR Roundtable at the Seattle NAIC meeting in December. Right up front, no holds barred, was a discussion of how receiverships needed to be run more like a business — indeed, the business of going out of business.

Think about that: receivers asking how they can do a better job of putting themselves out of a job. Another key topic was clearer, more unvarnished financial reporting by receivers to courts, creditors, and other constituencies.

How many times before have receivers been willing to confront head-on the increasing demand for financial reporting methods that mirror those used in private business?

Bubba Gump. Finally, many of you attended the NAIC/IAIR workshop in La Jolla in January. It also was a case study, this time on the property/casualty side.

Bubba Gump Insurance Company had just as many problems as poor Down Life, and the audience attacked those problems with the same enthusiasm, energy and skill.

Another case study. . . another chance to confront a problem without a clear solution.

For those of you who missed La Jolla, here is a report by Kevin Griffith and Tom Clark, who reported that they benefitted greatly from their participation in the workshop.

1998 NAIC/IAIR Workshop

Life is like a box of chocolates, you never know what you're going to get. Participants in the joint NAIC/IAIR "Insolvency Workshop 1998, Anatomy of a Liquidation from Grave to Grave" in La Jolla discovered how true that simple statement could be as they reviewed the plight of beleaguered Bubba Gump Insurance Company. The fictional Alabama insurance company was already under administrative supervision when the workshop's attendees received the first part of the company's case study. Those facts revealed a company suffering from some of the worst facts that receivers and guaranty associations have encountered in recent years. A company that had lost all control of its essential administrative operations to affiliated companies located out of state. A company that had no control over its records, and records that were in electronic form only. A company whose reinsurance partners were, with one exception, either insolvent or in financial jeopardy. A company whose management was denying any problem. And, of course, a commissioner that wanted a plan to resolve the Bubba Gump situation completely within five years.

Participants in the well-attended workshop were asked to evaluate Bubba Gump and determine how best to deal with the situation. Of course, new facts came to light from time to time to ensure that no determination was final. Should the Alabama commissioner seize the company? Was rehabilitation possible? Was liquidation inevitable? Was rehabilitation necessary hospice care for the company's policyholders before placing the company in the grave?

When were the "pesky" guaranty associations going to be brought in? Oh yes, what about the media, public perception, and political reaction?

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SOLVENT SCHEMES: *THE ECONOMIC CASE*

*By Ipe Jacob **

Current position

Economic background

In the non-life sector some 650 direct insurers and reinsurers worldwide have become insolvent since 1978. Two thirds of these insolvencies involved US companies while the UK saw the highest number of insolvencies in Europe. The US and UK, two of the largest insurance markets in the world, appear to have a higher proportion of failures than elsewhere in the world.

Some commentators suggest that there is a link between insurance insolvencies and the degree of regulation in various markets. In the insurance sector, the extent of a market's profitability is illustrated by the success of its underwriting and investment results, and capital is naturally attracted to markets which are perceived to be profitable. In heavily regulated markets, profits are higher and more stable. In turn, the level and volatility of the underwriting and investment results reflect the potential insolvency risk: higher and more stable market profits mean less risk of insolvencies.

A further consequence of strongly regulated markets is stability of premium levels. This is because the opportunity for new entrants to drive down or under-cut the pricing structure is limited by the regulatory requirements for gaining entry into the market. Only once an entrant has gained access can he obtain a slice of the underwriting profits. It is self evident that more insurers attempt to enter the market during profitable periods of the underwriting cycle. For instance, a number of Lloyd's syndicates grew from 330 in 1977 to 431 in 1982.

The pattern of performance and volatility in underwriting profits may be seen to reflect the different levels of regulation and competition in individual insurance markets.[1] However, there are peripheral factors that may also have substantial impact on underwriting profits. For example, there is particular volatility in US market patterns which to some extent is accounted for by the impact on underwriting performance of the rise in natural catastrophes: the down-turn in asset value as a result of the 1987 stock market crash and already low interest rates. Of course, underwriting profits are typically enhanced by the returns from investment income and although assets lose value when interest rates rise, high interest rates also mean increased income. Conversely, sustained periods of falling interest rates generally have a negative effect on investment results. The US volatility is also affected by the relatively few barriers to entering the US insurance market.

The UK insurance market exhibits similar characteristics to those of the US. It has a relatively relaxed regulatory system with low market-entry barriers. It is also strongly influenced by the effect of losses in the property/casualty sector. Overall, the underwriting trend in the UK is one of the most volatile.

In the last few years there has been a huge increase in the number and value of catastrophe losses affecting worldwide property and casualty sectors. Hurricane Andrew accounted for insured damage of US$15.5billion while Piper Alpha accounted for a man-made loss of US$2.4billion. Up to 1989, insured catastrophe losses each year amounted to about 0.2% of GDP worldwide. They have since doubled. Each year from 1989 to 1996 has seen at least one natural disaster with an insured loss exceeding US $1billion.

The growth in the number of unanticipated losses caused by natural disasters, together with a highly volatile trend in underwriting results, has resulted in an increase in the number of insurance insolvencies. Such insolvencies occur because insurance companies dispose of assets at times when funds are required to pay claims arising from these unexpected and previously unreserved liabilities. Furthermore, the trend is looking set to continue, particularly in the wake of El Niño. Yet recent reviews of reinsurance protections available suggest that an insufficient amount of catastrophe cover has been purchased by insurers. At the same time in unregulated markets the underwriting profits may already be lower than in regulated markets because of excess supply through free-market competition and resulting lower premium rates. The need to sell assets further reduces margin on underwriting profits since future asset investment income is sacrificed to fund claims.

London Market

London is now regarded as one of the world's foremost financial centres and has become internationally renowned for its banking and insurance capability. The world's twenty largest insurance groups are represented in London, and almost three-quarters of them are foreign-owned. The US is the most important source of overseas business for both the insurance company sector and for Lloyd's, accounting for one-third of the London Market's total premium income. Most business traded in the London Market is non-life insurance and reinsurance, with an emphasis on high-exposure risks.

Between 1989 and 1993 many London Market companies (including Lloyd's) suffered record underwriting losses. This led to the withdrawal of around seventy UK based companies and the reconstruction of Lloyd's. There are now over 150 London Market companies in run-off, leaving around 500 companies authorized to write new business.

The London Market has traditionally operated within a tolerant regulatory regime. The legal framework for supervision is set out in the Insurance Companies Act 1982 (as amended) ("ICA") together with supporting regulation. H M Treasury (formerly The Insurance Directorate) is conscious of the need to avoid over-regulation, and two significant de-regulation initiatives were introduced during 1996 for this purpose. Following the introduction of the single European market for direct insurance in 1994 when the Third EC Directives came into being a number of meetings of EU representatives took place to assess whether the single market was working effec-

** Mr. Jacob, a Partner in Robson Rhodes, was recently appointed Scheme Manager of HIR (UK) Limited, the first non-life London Market Solvent Scheme of Arrangement and; Beth Rees, is a Senior Manager in Robson Rhodes, until recently on secondment at the DTI in the Insurance Directorate (now HM Treasury).*

tively and whether insurers and policyholders alike enjoy the benefits of liberalisation. There has also been a wide ranging review of the existing UK solvency requirements, the aim of which is to update the process of regulation to take account of current market conditions, improve policyholder protection and enhance competition.

Solvency margins

All UK authorized insurance companies are required to maintain a 'margin of solvency' at all times. The margin of solvency of an insurance company is the excess of the value of its assets over its liabilities, the values being determined in accordance with any applicable valuation regulations. As a rule of thumb, the optimum solvency margin in the UK for non-life companies is excess of 200%; it is more for some life companies.

Calculation of the solvency margin in the US is a more complex exercise, based on the NAIC's 'risk based capital approach' in which four risk categories are considered; investment risk, credit risk, underwriting risk, and off balance sheet risk. All risks rarely occur simultaneously and certain risks are counter balanced by others this is factored into the risk based capital requirement calculation. Companies whose capital resources fall below twice the minimum value must provide the regulator with additional information regarding their financial situation and the resources available. Although this may be regarded as a step forward, it is by no means certain that the new requirements will lead to a reduction in the number of insolvencies. Notwithstanding the increase in the value and number of catastrophe, environmental and pollution losses, the UK and US systems of insurance regulation are such that they are still orientated toward the principle of freedom to fail. This in turn leads to a number of issues.

If the solvency margin of a UK insurance company falls below the amount required, the company must at the request of the Secretary of State submit a plan for the restoration of a sound financial position and must propose modifications to the plan if the Secretary of State considers it inadequate. If the proposals are insufficient to satisfy the Secretary of State or if the company declines to submit a plan, then the Secretary of State may withdraw the company's authorization to write new business.

This has the effect of placing the company in run-off. Of course, the company itself may conclude that it cannot maintain its solvency margin or its parent may no longer wish to continue to provide support. Consequently, it also has the option of approaching the Secretary of State and asking for its authorization to write new business be withdrawn. Either way the company will be in the position where it will be unable to release any capital until its last liability has been discharged in full.

Insurers in run-off

Many of the 150 London Market insurers currently in run-off, will have written a mix of business including long-tail contingent liabilities some of which are unlikely to crystallize for fifty years or more. In addition, some 33 or more London Market insurance companies have become insolvent since 1990. Of these, the majority had previously been in run-off and there has been a market perception that insolvency was an almost inevitable consequence of the run-off process. This is because insurers in run-off are exposed to a number of potential problems which impact on their ability to discharge their valid liabilities in full. These include the likelihood of a serious deterioration in reserves because of the value at which potential catastrophe and APH liabilities will be settled; a deterioration in the security of the reinsurance programmes in place coupled with a potential domino effect; a reduction in predicted investment returns as instruments are cashed in earlier than anticipated in order to pay unexpected claims and finally an escalation in the costs of running-off the business as the management of the whole run-off process becomes more problematic. Run-off carries with it its own inevitable spiral; a natural consequence is at best the erosion of shareholder's funds and at worst a demand for increased parental support or calls on group guarantees culminating in insolvency.

The way ahead

Alternatives to run-off

It has been widely recognized that one way of avoiding this situation and maintaining the capital base is to bring the run-off to an earlier conclusion than allowing it to continue to maturity. A number of alternatives to running-off the company to exhaustion have been explored. These include:

- Portfolio transfer pursuant to section 49 and schedule 2c of the Insurance Companies Act
- Reinsurance to close ("RTC")

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- Use of a letter of credit or parent company guarantee
- Reduction of capital
- Solvent liquidation
- Scheme of arrangement

All except schemes of arrangement present prohibitive difficulties. For instance, it is unlikely that a portfolio transfer could be achieved at a price which would be acceptable to a company's shareholders, or that reinsurance to close would achieve finality or that in a solvent liquidation it would be possible for the directors of a company which wrote long-tail business to be able to identify all of its creditors within a twelve month period from the date of the resolution to wind up the company. Schemes of arrangement offer a workable solution.

Schemes of arrangement

Schemes of arrangement have, over the last few years, been used as a process for dealing with insolvent insurance companies as an alternative to the traditional liquidation route. The advantages in the UK of such schemes compared with liquidations are well-documented and are summarized only briefly here:

- Flexibility
- Efficiency
- Regulatory recognition
- Greater return on investments
- Earlier payment
- Payment in currency of claim

In addition, a scheme of arrangement under section 425 of the Companies Act of 1985 is a process which is recognized as a foreign proceeding for the purposes of Section 304 of the US Bankruptcy Code while the scheme administrator is regarded as a foreign representative. This is understood by the legal profession to be the position regardless of the company's solvency.

Accordingly, Section 304 affords protection against litigation in the US to an insurance company (solvent or insolvent) which is in a scheme of arrangement.

There are two main types of scheme of arrangement: reserving and "cut-off" or "estimation" schemes. In a reserving scheme, claims continue to be paid as they are agreed whereas in a cut-off scheme claims which have already been quantified and agreed are paid as soon as possible after the scheme becomes effective.

Those which fall into the category of notified outstanding claims and IBNR will be established by agreement, assessed or estimated and then paid.

On 2 February 1998, HIR (UK) Limited, the first London Market Solvent Scheme of Arrangement to receive HM Treasury approval became effective, following the meeting of creditors held on 22 January 1998.

It is an estimation scheme and the scheme managers are Ipe Jacob and Nigel Ruddock, two partners in Robson Rhodes. There are several others in the pipeline.

Benefits to policyholders

The key benefits of solvent scheme proposals are likely to be some or all of the following:

- Payment in full.
- Obligations to policyholders (and reinsureds) will be discharged over a shorter time than would be the case if the run-off were to continue until all claims had materialised in the normal course (cut-off or estimation scheme).
- Claims which are not easily evaluated such as notified outstanding claims and IBNR will be established by an independent process designed to treat all claims fairly and to ensure that they are valued properly and independently.
- Interest will be paid on all valid liabilities of the company from the date that they fall due or become established.
- No discount will be applied to take account of early payment.

In the event of a dispute, the matter shall be referred to an independent Scheme Adjudicator.

Issues for reinsurers

The particular advantages for policyholders should be viewed in the context of schemes of arrangement generally. A UK scheme of arrangement is a compromise or arrangement between the company.

While schemes cannot bind reinsurers, there are a number of reasons why reinsurers may benefit from them. These are set out below:

- High degree of supervision by H M Treasury and others
- Scheme Administrator is a Controller for the purposes of the ICA 1982, therefore his appointment must be approved by Secretary of State
- Contractual rights and remedies of the reinsurer remain
- Reinsurances inure to the benefit of those for whom they were originally intended
- Potential for retrocessional bad debt is mitigated
- Certainty and finality are achieved sooner
- Exposure to unanticipated liabilities is reduced
- Broker net accounting may subsist
- A Scheme cannot place reinsurers in a worse position

Conclusion

In economic environments such as the UK and the US in which the regulatory regime is such that there is a high element of market competition, it is to be expected that there will be a number of insurance failures.

The situation is compounded by the high level of underwriting volatility and the classes of business written.

The inevitable consequence is that those who entered the market on a optimistic note when profitability was high will find that their capital is locked in until such time as the last valid liability is discharged in full.

This can take decades to be resolved. The consequence is an erosion of surplus assets with the possibility that a deficiency to policyholders arises.

As an alternative, solvent schemes of arrangement offer certain advantages to policyholders, and reinsurers alike, the ultimate consequence of which is to benefit the company's policyholders without prejudicing the position of the company's reinsurers or disenfranchising them.

When the last liability has been discharged in full, any surplus can be returned to shareholders.

1 The Sigma Report. No. 1/1995

Offsets & the Reinsurance Intermediary

"Life between a Rock and a Hard Place"

*By R. Michael Cass, CPCU, ARe **

One problem confounding reinsurers and receivers alike is the issue of offsets and the resultant implication on collections in a Receivership. Offset is the practice of net accounting whereby mutual debits and credits are applied in reaching a net balance. For insurance accounting, offset can involve premium, loss and loss adjustment expense payments, unearned premium and premium adjustments. The concept finds support in the common law and specific recognition in Section 34 of the NAIC Insurers Rehabilitation and Liquidation Model Act.

To reinsurers, offset is a commonly utilized practice. For insolvancy, the practice follows federal bankruptcy law. The subject of offsets in reinsurance arrangements has been considered extensively over the past decade as a result of the frequent and often substantial property and casualty insurance company insolvencies of the mid-1980's.

When any party seeks to use the concept of offsets to its advantage, that party is often quick to point out some of the major tenets supporting the principle of offset. Moreover, reinsurance contracts often specifically include a separate clause or wording which permits the offsetting of balances due the parties to the reinsurance arrangement.

A typical offset clause found in a reinsurance contract might read as follows:

The Company and the Reinsurer shall have the right to offset any balance or amounts due from one party to the other under the terms of this Contract. The party asserting the right of offset may exercise such right at any time whether the balances due are on account of premiums or losses or otherwise.

Further complicating the analysis of the relationship between ceding insurer and reinsurer is the reinsurance intermediary. Because reinsurance can be marketed either directly between the ceding insurance company and a prospective reinsurer or through a reinsurance broker or intermediary, reinsurance intermediaries are not involved in all reinsurance transactions. However, where intermediaries are involved, their role is not insignificant. For a fee/commission known as brokerage, the intermediary typically undertakes to work with the insurance company to structure its reinsurance program, find suitable reinsurance markets for the reinsurance program, write the contracts, and serve as a "clearinghouse" for the transfer of premiums and losses.

As a general rule, transactions where intermediaries are utilized involve numerous reinsurers and/or multiple layers of coverage within a reinsurance program while direct placements often entail one or a very few reinsurers. Nonetheless, even this distinction has become blurred over the past decade due to the continued consolidation and competition within the reinsurance industry.

With the relationships established, we examine the conflicts that can arise.

(Continued on Page 10)

*** Mike Cass, CPCU, ARe is principal consultant for R. M. Cass Associates, a consulting firm located in Barrington, Illinois providing professional services in reinsurance and related matters; Cass is past Chair of the American Bar Association's Tort & Insurance Practice Section Committee on Excess, Surplus Lines and Reinsurance. He is a contributing author to Reinsurance Contracts (Strain Publications) and Reinsurance Practices 2nd Edition text for the Associate in Reinsurance Program 142 (American Institute).**

When a reinsurance intermediary (Pritchard & Baird, a broker) became insolvent during the 1970's, millions of dollars in reinsurance premiums and loss payments in the hands of the bankrupt broker were in dispute as to which party would bear the credit risk.[1] The court ruled that the broker is the agent of the ceding company, concluding that all funds in the hands of the broker were the property of its principal. The significance of this decision was that premium funds paid by the ceding company to the broker were considered to have been paid to the reinsurer, while funds paid by the reinsurer to the broker were considered as paid to the ceding company. Furthermore, other cases have held that a reinsurance intermediary has a duty of utmost good faith to each of the parties in the reinsurance relationship.[2]

In an effort to address this issue from a regulatory standpoint, New York, adopted Regulation 98, which places the credit risk on the reinsurer instead of the Ceding Company. Regulation 98 requires that, in order to receive credit for reinsurance, the reinsurance contract must contain an intermediary clause. Typical wording for the intermediary clause is as follows:

XYZ Intermediary of Fredonia City, Fredonia, is hereby recognized as the intermediary negotiating this Contract for all business hereunder. All communications, (including but not limited to notices, statements, premium, return premium, commissions, taxes, losses, loss adjustment expenses, salvages and loss settlements) relating thereto shall be transmitted to the Company or Reinsurer through XYZ Intermediary, Fredonia City, Fredonia. Payments by the Company to the intermediary named herein shall be deemed to constitute payment to the Reinsurer. Payments by the Reinsurer to the intermediary shall be deemed payment to the Company only to the extent that such payments are received by the Company.

Compare this to the usual practice of submitting accounts when all parties to the reinsurance transaction are viable and ongoing. For example, assume the Titanic Reinsurance Company ("Titanic Re"), an Illinois reinsurer, is smoothly cruising along without a financial care in the world and as is the custom and practice of the reinsurance business, offsets are typically asserted by both reinsurer and reinsured as well as the reinsurance intermediary. When Titanic Re begins to list to one side, all parties doing business with Titanic Re attempt to solidify their position. Eventually, Titanic Re is deemed to be sinking too quickly to be saved and is declared insolvent by the appropriate state insurance department. As with all insolvencies, restrictions exist as to whether and when any debts can be satisfied by the insolvent entity, in particular offsetting claims against liabilities in the reinsurance context.

Article XIII of the Illinois Insurance Code deals with the rehabilitation and liquidation of insurance companies. Section 206 considers the subject of offsets:

Set-offs or counterclaims. In all cases of mutual debts or mutual credits between the company and another person, such credits and debts shall be set off or counterclaimed and the balance only shall be allowed or paid,...

Section 204 more specifically addresses voidable property transfers and liens and provides:

... A preference is a transfer of any of the property of the company to or for the benefit of a creditor, for or on account of an antecedent debt, made or suffered by the company within 2 years of the filing of a complaint under this Article...

(2) Any preference may be avoided by the Director as rehabilitator, liquidator, or conservator if:

(A) the company was insolvent at the time of the transfer, and

(B) the transfer was made within 4 months before the filing of the complaint;

When a reinsurance intermediary is involved in the transaction, at least three parties are affected by the netting of balances between the parties. This discussion centers on the implications for three scenarios involving offset.

Ceding Company Offset: Most ceding companies will have several different reinsurance treaties which make up their reinsurance programs. It would not be unusual for a larger company to have many reinsurance contracts applying to different books of business and for both ceded and assumed reinsurance. Where there is ceded reinsurance with Titanic Re participating and assumed business in which Titanic Re did not participate, a ceding company may attempt to net balances prior to making a net transfer to the reinsurance intermediary. Under this scenario, ABC Insurance Company (ABC) may have ceded a per risk excess agreement to Titanic Re and other reinsurers and assumed a quota share agreement not involving Titanic Re. Under the ceded excess, loss payments may be due from the reinsurer(s) including Titanic Re. For the assumed quota share, losses may be payable to the cedent. In the normal course of business, ABC might offset and remit the net difference for both agreements to the intermediary who handled both reinsurance transactions. However, following the insolvency of Titanic Re, the liquidator of the estate may not be aware of the netting that was employed by ABC and caused the reduced transfer to the intermediary. The intermediary is left to unwind the mess and to possibly make up the shortfall.

Where there is both assumed and ceded reinsurance involving Titanic Re, a ceding company may be due funds from Titanic Re on its outward program and owe Titanic Re on bills from reinsurance ceded to the insolvent reinsurer. The ceding company offsets the two balances and forwards the net amount to the intermediary who brokered both transactions. The statements ultimately received by Titanic Re from the intermediary may not accurately reflect the actions by the ceding company in netting balances.

Again, the intermediary becomes the focal point for disputes involving the appropriate accounting for the transactions.

Reinsurance Intermediary Offset: Following the determination of insolvency, amounts due from Titanic Re will require the submission of proofs of claim by creditors in order to participate in any distribution of estate assets.

All creditors, unless secured, should share equally in any assets left in the Titanic Re estate subject to the applicable schedule of priorities. Reinsurance intermediaries may occasionally misapply the funds due to an insolvent company to offset amounts to or from the estate.

For example, Titanic Re may owe premium to ABC Insurance Company and DEF Insurance Company. Following the insolvency, No.1 Company and No. 2 Company remit to

the intermediary premiums which they owe to Titanic Re. The intermediary has bills for ABC Insurance and DEF Insurance for loss payments owed by Titanic Re. Rather than forwarding the funds received from Co. 1 & Co. 2 representing premium to Titanic Re, the intermediary remits funds to ABC Insurance and DEF Insurance to cover payments for the balances owed by Titanic. These credit balances are from different reinsurance agreements facilitated by the same reinsurance intermediary. The payments to ABC and DEF may represent a preference under many insurance insolvency statues. As a result, the intermediary will be answerable to the liquidator of Titanic Re. Furthermore, the actions of the intermediary would also implicate the ABC and DEF as the recipients of an improper transfer. Based on how the transaction occurred, the intermediary might also then be subject to a claim from ABC and DEF as a result of their detrimental reliance on the intermediary.

Advances by the Reinsurance Intermediary: As is the case with many insolvencies, we can assume that as Titanic began to experience financial difficulties, it slowed down loss payments in order to improve cash flow.

The intermediary, under some pressure from creditor ceding companies, may have initiated a practice of advancing funds to cover balances owed by Titanic in order to preserve goodwill among its clients. This is not a problem when the parties are solvent but things change from an insolvency perspective.

Because the intermediary believes it is a creditor of the estate, a proof of claim is filed.

However, since there is rarely any contractual duty of the reinsurance intermediary to advance payments to the now insolvent reinsurer , the Liquidator may assert that the intermediary is a volunteer without any contractual rights to funds from the estate.

In order to receive recognition as a creditor, the reinsurance intermediary would need to have received a written assignment from each of the ceding companies to which it advanced funds.

Further, the intermediary's actions would be subject to any of the offset restrictions placed on all other creditors of the estate.

At the time property/casualty insurance insolvencies were occurring with great frequency in the mid 1980s, the implications of offset in insolvency were not well understood by most of the parties to the reinsurance transaction.

A relatively steep (and arguably quite costly) learning curve has improved the practices of individuals dealing with insolvent estates.

However, receivers should always review intermediary transactions to ensure that the offsetting of balances which take place under normal business conditions, did not continue after the reinsurer was placed in liquidation.

The author gratefully acknowledges the contributions of Daniel Guberman, Deputy General Counsel and Olga Morales, Reinsurance Specialist of the Office of the Special Deputy Receiver in Illinois.

1 ***Hartford Fire Ins. Co. v. Francis (In re Pritchard & Baird, Inc.)*, No. B 75-3202 (Bankr. D.N.J. Mar. 1, 1979).**

2 **E. g.) Commonwealth Ins. Co. v. Thomas A. Greene & Co., 709 F.Supp. 86, 88 (S.D.N.Y. 1989)**

Meet Your Colleagues

Ellen Robinson

Ellen Robinson has been involved in receivership litigation since 1981 when she and her partners filed the first civil RICO case against the directors, officers, auditors and reinsurers of an insolvent insurance company.

Since then, she and her partners - who have made it their practice only to represent receivers and regulators - have investigated, filed and prosecuted RICO suits, professional malpractice cases, director and officer liability actions and reinsurance recovery suits all over the country.

They have prepared amicus curiae briefs on behalf of the NAIC and have been selected by insurance departments for special counsel engagements involving regulatory issues.

Between 1966 when Ellen graduated from the University of Pennsylvania, and 1974, when she started law school at DePaul University College of Law, she had three children (two of whom are now lawyers despite her best efforts) and taught guitar.

She and her husband (yes, he's a lawyer, too) presently enjoy travelling and hiking in their free time.

Ellen is a strong proponent of IAIR as a forum at which receivers can share, to the fullest extent possible, their experiences and resources.

She has been a chapter editor and contributor to the Receivers Handbook and has been chairing IAIR's Amicus Committee, which she continues to believe has such a significant potential that it will eventually find funding to support its efforts!

Paul Evans

Paul Evans has been involved with corporate recovery work since 1976 and is a partner in the London office of Price Waterhouse. He is leading specialist in reorganisations and insolvencies within the insurance industry.

In recent years his assignments have included a number of substantial insurance companies in the London market, including London United Investments plc (the parent of HS Weavers and the KWELM companies) and English & American Group plc.

He has been particularly concerned with the development of innovative means of dealing with insurance failure, through the mechanism of a Scheme of Arrangement.

He is a Scheme Administrator of Trinity, Bryanston and Andrew Weir Insurance companies, and of The Orion Insurance Company, and The London and Overseas Insurance Company.

He is a provisional liquidator of North Atlantic Insurance Company and of associated companies in Bermuda and the Cayman Islands. He is also liquidator of a number of agencies at Lloyd's.

Paul is also at the forefront of the development of new alternatives for providing solvent insurance or reinsurance companies in run-off with a managed exit from the market by accelerating the run-off using estimation techniques to crystallise liabilities. He expects to see this approach to shortening the period of run-off as a viable option for many companies and their shareholders that want to avoid the potential difficulties of a seemingly never-ending run-off.

Paul is a UK Licensed Insolvency Practitioner and a member of the UK Society of Practitioners of Insolvency ("SPI") working group liaising with the Department of Trade and Industry about possible changes to insolvency law relating to insurance companies. He is also a member of the SPI General Technical Committee.

Paul is a graduate of Balliol College, Oxford, and lives in Hertfordshire, north of London. When "off-duty," he digs the garden, enjoys watching sports and, with Catherine his wife, listens to music and opera.

Nigel Montgomery

Nigel Montgomery is a partner in the London law firm of Davies Arnold Cooper where he and his colleagues specialize in insurance reconstruction and insolvency.

Nigel has been involved in many of the Schemes of Arrangement in the London Market in recent years and has been concerned with some of the innovations that we have recently seen in that sector.

As examples, Davies Arnold Cooper acted on Schemes of Arrangement for RMCA RE and ICS RE which broke new ground by commencing without the use of provisional liquidations and which used estimation to affix values to cedant's claims and imposed a bar date after which claims could no longer be made.

Montgomery and his colleagues have also pioneered the use of solvent Schemes of Arrangement and have just guided the first UK solvent Scheme through the requisite Creditors' Meeting and Court approvals.

This departure marks the first use of a Scheme of Arrangement that has been designed from the outset to enable a mature run off to be concluded more quickly than the normal process. The approach also uses estimation and adjustment to establish and set claim values as well as the use of a bar date.

Montgomery has addressed several IAIR quarterly roundtables and discussed UK legal topics, principally relating to cross-frontier enforcement between the US and UK.

He has also been a contributor to the Receivers Handbook on similar enforcement issues and was a speaker at the first IAIR meeting held last year in the UK.

In his spare time, Montgomery runs a small engineering workshop, a vintage Bentley and a family, not necessarily in that order.

He is also a member of the United Kingdom Veterans' Association, The Royal British Legion that looks after the interests of ex-service men and women. Apart from this, he manages to travel to the US and Far East several times a year on business and also for pleasure and is often seen at NAIC meetings.

Beverly M. Grant

Beverly Grant has been President of B.N. Grant Consulting, Inc. since 1984. The firm provides consulting and management services in insurance and reinsurance to self-insureds, intermediaries, insurance and reinsurance companies, and liquidators.

Grant has also provided expert witness testimony and litigation support. She received her Bachelor of Business Administration Degree from Ohio University and her Masters Degree from Boston College.

Grant began her career in 1970 with Allstate Insurance Company as a Field Claims Adjuster handling automobile, homeowner, general liability, and workers compensation claims.

In 1977 she broadened her expertise when she became a Claims Supervisor with Cameron and Colby, handling claims investigations and audits on behalf of the New England Reinsurance Company and First State Insurance Company.

She joined Commercial Union Insurance Company in 1978 serving two years as Senior Claims Analyst and was promoted to Reinsurance Claims Manager for Commercial Union Reinsurance in 1980.

Grant is a member of the Excess and Surplus Lines Claims Association, American Arbitration Association, and International Association of Insurance Receivers.

She has recently joined IAIR's membership committee and looks forward to attracting new IAIR members from the insurance and reinsurance industry.

Grant relocated her consulting firm from Boston to San Diego in 1989. While her assignments involve significant travel all over the U.S., Beverly enjoys her spare time when she is skiing, biking, exercising and involved in local volunteer work.

Receivers' Achievement Report

Ellen Fickinger, Chair Reporters: Northeastern Zone - William Taylor (PA); Midwestern Zone - Ellen Fickinger (IL), Southeastern Zone - Belinda Miller (FL); Western Zone - Mark Tharp (AZ), Amy Jeanne Welton (TX); Melissa Koolstra (CA); International - Phillip Singer (England) and John Milligan-Whyte (Bermuda)

Our IAIR achievement news received from reporters covering the third quarter of 1997 is as follows:

RECEIVERS' ACHIEVEMENTS BY STATE

Alaska (Joyce Wainscott, State Contact Person)

Use & Distributions made to policy/contract creditors

Receivership	Amount	
Pacific Marine Insurance Company of Alaska	$1,898,561.20	(4th partial distribution)
	$718,296.25	(Outstanding reserves & payment of 100% of paid losses.)

Arizona (Sara Begley, State Contact Person)

Use & Distributions made to policy/contract creditors

Receivership	Amount
Southwestern Indemnity Casualty Insurance Company	$268,000.00

Delaware (Richard C. Cecil, State Contact Person)

Receivership	Year Action Commenced	Licensed	Insurance Catagory	Dividend Percentage
Horizon Assurance Company	1990	Yes	P&C	20.55%
Tara Life Insurance Company	1985	Yes	Life	100%

Use & Distributions made to Delaware Insurance Guaranty Association

Receivership	Amount
Horizon Assurance Company	$1,711,556.00

Use & Distributions made to policy/contract holders

Receivership	Amount
Horizon Assurance Company	$10,727.00
Tara Life Insurance Company	$538,525.00

Use & Distributions made to all other creditors

Receivership	Amount
Tara Life Insurance Company	$43,378.00

Illinois (Mike Rauwolf, State Contact Person)

Use & Distributions for third quarter 1997, Early Access and policy/contract reditors

Receivership	Amount
AMRECO	$989,232.00
Centaur	$152,009.00
Coronet	$11,391.00
Merit	$22,466.00
Millers	$3,265,067.00
Pine Top	$367,796.00
United Fire	$2,462,212.00
Plus four (4) additional estate where disbursements for each estate werebelow $10,000	$7,270,173.00
	$2,934.00
Total	$7,273,107.00

New Jersey (John Kerr, State Contact Person)

Use & Distributions for third quarter, 1997

Receivership	Amount	
Integrity Insurance Company	$ 2,433,253.00	(GuarantyAssociations)
	$ 193,300.00	(Policy/Contract Creditors)
Total	$ 2,626,553.00	

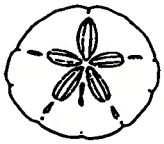
(Continued on Page 16)

Joyce Wainscott (AK) has advised that the Superior Court approved a closing plan on December 4, 1997, for **Pacific Marine Insurance Company of Alaska**. This closing plan provided for the payment of a fourth partial distribution. This distribution, together with prior distributions, paid all claimants with approved claims 100% of paid losses through December 31, 1996, 100% of paid losses through June 30, 1997, and a payment to discharge the outstanding reserves based upon an agreed figure with claimants. As such, all approved creditors have now been paid 100% of their losses through periodic distributions over the course of the receivership. The court has approved a plan calling for the closure of the claims administration of the estate. The receiver will apply for final discharge following the Supreme Court ruling on an appeal of a denied claim.

Michael Fitzgibbons (AZ) provided an updated report on **Southwestern Indemnity & Casualty Insurance Company (SWIC)**. Due to recoveries to the estate from reinsurers and other litigation matters, a 100% distribution was made to the Arizona Life & Disability Insurance Guaranty Fund, as well as to all other timely filed claimants. After payment of these approved timely filed claims, in full with interest as applicable, and payment of all late filed claims in full, the Receiver had sufficient cash remaining to pay all non-filing policyholders' unearned premium claims, former employees' claims, and general creditor claims. On August 25, 1997, the Court approved such a distribution and further ordered the closing of the estate.

Sara Begley (AZ) provided another update on **Farm & Home Life Insurance Company (FHLIC)**. On September 15, 1997, the Receivership Court approved Petition #268, Petition Approving Notice to Creditors and Fixing Time for filing Claims, thereby establishing claim procedures for filing claims in the estate no later than March 15, 1998, the bar date.

(Continued on Page 16)



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William T. "Bill" Long
Senior Vice President

Salt Lake City Meeting

(Continued from Page 5)

getting to be quite a circus. New York has always considered itself first among equals on this subject, and apparently has insisted that the trust fund documents contain language ensuring that any changes will meet its approval, and that in case of insolvency, it will be the conservator.

In Seattle, they sort of unilaterally announced changes to the trust fund requirements for Lloyd's which cut them in half — from 100% of gross liabilities to 50%.

That is actually a pretty reasonable proposal, but it caused a number of states to wonder just when New York got appointed to regulate the surplus lines market in, say, Louisiana.

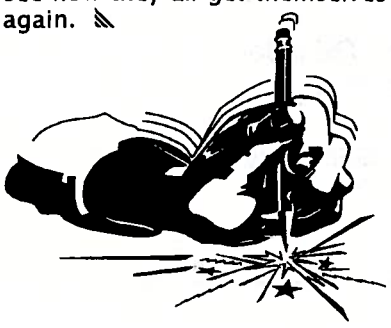
The answer is that it has been going on for years, and working out pretty well, all things considered, but looks increasingly peculiar.

The surplus lines task force has sort of invited New York to cede its position to the International Insurance Division of the NAIC, to which New York has responded that they would love to, but they have a legal opinion which says that they are prohibited from so delegating their authority.

That, of course, raises the question how the other states can make any similar delegation to New York (and why we let the NAIC draft annual statement blanks).

New York was quoted in *Business Insurance* as professing unconcern about the possibility that other states would refuse to recognize a trust fund that satisfies New York requirements but not the NAIC's. "We don't believe that the existing trust funds will go anywhere, but other states may require new trust funds to be established," he said. Not exactly a solution.

Now that everybody has efficiently painted everyone else into different corners, it should be interesting to see how they all get themselves out again.



Receivers' Achievement Report

(Continued from Page 14)

Pennsylvania (William S. Taylor, State Contact Person)

Receivership	Year Action Commenced	Licensed	Insurance Catagory	Dividend Percentage
Temple Insurance Company	1985	Yes	P&C	66.9%
Fortune Assurance Company	1987	Yes	Bonding	72.2%

John Kerr (NJ) reported that his Department has worked with 4 insurers in administrative supervision and 1 HMO in confidential supervision. At this time the names of these entities are confidential.

Mike Rauwolf (IL) advised that the Illinois receiver continues to manage the reinsurance run-off for **American Mutual Reinsurance Company (AMRECO)**, in rehabilitation. Reinsurance payments to date total $115,032,232.13, Loss and LAE, $30,448.74 and LOC Drawdown disbursements of $9,613,385.54.

Illinois additionally continues to manage the run-off of **Centaur Insurance Company**, in rehabilitation. Total claims paid inception to date are $50,384,205.69 for Loss and LAE, $4,945,492.57 in Reinsurance payments and $13,876,555.31 in LOC drawdown disbursements.

Jim Dickinson (KY) reports that, due to successful reinsurance collections and management of the **Delta American Re Insurance Company** over the past 12 years, payments totaling $150 million are being distributed to creditors. Franklin Circuit Judge William L. Graham has approved an initial dividend rate of 70%.

Under the court's order, **Delta's** creditors will receive initial dividends equal to 70% of their approved claims, subject to deductions for any balances owed to **Delta's** estate.

The estimated $150 million in payments are being distributed to **Delta** creditors whose claims have already been approved or will be approved this year. Additional dividend payments will be distributed to the remaining creditors as their claims are approved.

Payments made to creditors after October 1, 1997, will include interest. Claims for losses incurred but not reported as of December 31, 1995, will not be included in the initial dividend distribution. The plan provides that these losses could be considered in a future dividend distribution if current pending litigation is successful.

Bill Taylor (PA) has advised that **Fidelity Mutual Life Insurance Company (FMLIC)** continues to pay policyholder death benefits and annuity payments at 100%. Crediting rates are at or above policy guarantees. As of September 30, 1997, **FMLIC** showed a statutory surplus of $42,922,199.

The Rehabilitator continues to meet with the Policyholder Committee to resolve their objections to the Second Amended Plan which was filed in June of 1996. The rehabilitator hopes to file a revised rehabilitation plan in the first quarter of 1998, which will provide for the payment of all allowed creditor claims.

Ian Kawaley (Bermuda) reports that on November 19, 1997, the Privy Council in London handed down judgment in favor of the appellants in **Charles W. Kempe, Jr. and Nigel Hamilton (The Joint Liquidators of Mentor Insurance Limited)-v-Ambassador Insurance Company (in liquidation).** The Privy Council upheld the effectiveness of a clause in the scheme of arrangement adopted for **Mentor Insurance Ltd.**, in liquidation **(Mentor)** in 1993 establishing a final filing deadline for all creditors' claims by confirming the decision of the Supreme Court of Bermuda (Ground, J.), which held that the Court had no power to extend the time for appealing the rejection of a claim beyond the time limited by the scheme of arrangement entered into between Mentor and its creditors.

The decision by the leading court in the British Commonwealth (staffed by the members of the English House of Lords) gives welcome validation to the use of schemes of arrangement under Bermuda Law as means of achieving an expedited run-off according to the mutually agreed needs of an insolvent insurer and its creditors, free of the Court supervision applicable under the statutory insolvency regime.

ARBITRATION IN RECEIVERSHIP

By Robert M. Hall *

Introduction

A great deal of time and legal fees currently are being devoted to the issue of whether or not receivers are obligated to arbitrate disputes with cedents and reinsurers pursuant to arbitration clauses in reinsurance contracts. Each side to this controversy argues its position vigorously, and it is not the purpose of this article to critically evaluate the competing positions. While it may be too early to select a clear winner to this dispute, it would not be unusual for there to be a mixture of court decisions that will vary with the contract provisions, state statutory language and the vagaries of multi-jurisdiction litigation.

Given this likelihood, receivers should consider looking beyond the current litigation to a world in which they may have to arbitrate *some* disputes in *some* jurisdictions. By doing so, receivers can better understand the arbitration process and develop techniques to promote a level playing field. In this fashion, the legitimate rights of receivers, and the creditors they represent, can be reflected in the outcome of the arbitration process. Below, an overview of the arbitration process is provided as a preview to an examination of several arbitration issues which may be particularly troublesome to receivers.

By way of background, these comments come from one who has: (a) acted as a party arbitrator for a receiver; (b) represented receivers as counsel in a several arbitration proceedings; (c) acted as a party arbitrator in many disputes between solvent companies; and (d) served as a senior executive of domestic insurers and reinsurers.

The Arbitration Clause

A typical arbitration clause reads as follows:

As a precedent to any right of action hereunder, if any differences shall arise between the contracting parties with reference to the interpretation of this Contract or their rights with respect to any transaction involved, whether arising before or after termination of this Contract, such differences shall be submitted to arbitration upon the written request of one of the contracting parties.

Each party shall appoint an arbitrator within thirty (30) days of being requested to do so, and the two named shall select a third arbitrator before entering upon the arbitration. If either party refuses or neglects to appoint an arbitrator within the time specified, the other party may appoint the second arbitrator. If the two arbitrators fail to agree on a third arbitrator within thirty (30) days of their appointment, each of them shall name three individuals, of whom the other shall decline two, and the choice shall be made by drawing lots. All arbitrators shall be current or former disinterested senior officers of insurance or reinsurance companies or Underwriters at Lloyd's London, not under the control of either party to this Contract.

Each party shall submit its case to its arbitrator within thirty (30) days of the appointment of the third arbitrator or within such period as may be agreed by the arbitrators. All arbitrators shall interpret this Contract as an honorable engagement rather than as merely a legal obligation. They are relieved of all judicial formalities and may abstain from following the strict rules of law. They shall make their award with a view to effecting the general purpose of this Contract in a reasonable manner rather than in accordance with a literal interpretation of the language.

The decision in writing of any two arbitrators, when filed with the contracting parties, shall be final and binding on both parties. Judgment upon the award rendered may be entered in any court having jurisdiction thereof. Each party shall bear the expense of its own arbitrator and shall jointly and equally bear with the other party the expense of the third arbitrator and of the arbitration. In the event that two arbitrators are chosen by one party as above provided, the expense of the arbitrators and the arbitration shall be equally divided between the two parties. Any arbitration shall take place in the city in which the Ceding Company's Head Office is located unless some other place is mutually agreed upon by the contracting parties (or arbitrators).

The first paragraph quoted above reflects a strong desire on the part of the cedent and reinsurer to use arbitration to resolve all disputes related to the reinsurance contract. This is supported by an "emphatic federal policy in favor of arbitral dispute resolution." *Quackenbush v. Allstate Ins. Co.*, 116 S.Ct. 1712 at 1727 (1996). Many states have adopted a uniform arbitration act which represents a similar policy preference.

The second paragraph contains several vital provisions that provide for a knowledgeable panel of arbitrators and timely resolution to any disputes in their selection.

First, past or current service as a senior officer of an insurer or reinsurer is a prerequisite to serving on a panel. This reflects the desire for the panel to be comprised of experts who are able to knowledgeably resolve the dispute based on custom and practice in the insurance industry. While very useful in arbitrations between solvent companies, this qualification has some limitations in the receivership context which will be addressed in more detail below.

Second, the parties must select arbitrators within established time limits. While these limits are often extended, there is case law which allows one party to pick both arbitrators if the other party does not strictly adhere to the time limits in the arbitration clause. *Universal Reins. Corp. v. Allstate Ins. Co.*, 16 F.3d 125 (7th Cir. 1994) (5 days late due to clerical error); *In re Employers Ins. of Wausau v. Jackson*, 505 N.W. 2d 147 (Wis. Ct. App.), *aff'd*, 527 N.W.2d 681 (Wis. 1995) (16 days late). Thus, the temporal restriction encourages the parties to bring the matter to some resolution.

Finally, the second paragraph provides a means of selecting an

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* *Mr. Hall practices insurance and reinsurance law and serves as an arbitrator and mediator. The views expressed in this article are solely those of the author.* *Comments or questions are welcome and may be addressed to: robertmhall@erols.com.*

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umpire if the party arbitrators cannot agree. Usually each arbitrator strikes two of the three proposed by the other and the choice between the remaining two is made by predicting whether the Dow Jones Industrial Average will be even or odd for a future day.

The third paragraph frees arbitrators from the obligation to follow the laws of any or a particular state and allows them do justice to the parties rather than strictly follow the terms of the reinsurance contract. This is also particularly troublesome to receivers and will be discussed at greater length below.

The fourth paragraph allows a decision of a majority of the panel to be entered in court in the form of a judgment. While arbitration awards may be appealed, the grounds for such an appeal are quite limited. Under the Federal Arbitration Act, incorrect understanding or application of the facts or law is not a basis to overturn an award. The only grounds to overturn an award are:

- An award procured by corruption or fraud;
- Evident partiality or corruption of an arbitrator;
- Misconduct by arbitrators such as refusal to hear pertinent evidence; and
- The arbitrators exceeded their power under the contract in question.

See Robert M. Hall and Paige D. Waters, *Partiality Among Arbitration Panelists*, Mealey's Reins. Rep., Vol. 8 Iss. 3 at 18 (1997).

The fourth paragraph also states a location for the arbitration which is often that of the cedent's home office. To the extent that the contract places the arbitration at a venue distant from the receiver and the panel has the power to vary the location, an equitable argument based on preservation of assets may persuade the panel to alter the venue. Often the panelists come from a variety of different locations and have little stake in whether the hearing takes place in one city or another.

The Organizational Meeting

After the panel has been appointed, the umpire schedules an organizational meeting which allows counsel and the panel to become acquainted. Prior to the organizational meeting, counsel typically circulate a "preliminary statement" which outlines the issues in dispute and provides the more essential documents. This allows a more efficient and informed organizational meeting.

At the organizational meeting, the following areas are discussed:

- The panelists reveal relationships with the parties and counsel which might be construed as conflicts of interest;
- The parties generally agree to hold the panelists personally harmless from civil liability;
- Agreement is reached only when *ex parte* communication between the parties and panelists will cease;
- The issues to be arbitrated are explored;
- Security for performance is addressed if requested by one of the parties;
- Discovery procedures are agreed upon; and
- A schedule is agreed upon for the various stages of the arbitration including the hearing.

With some arbitrations, the organization meeting is handled by telephone. Should disputes arise between the organizational meeting and the hearing which require panel intervention, these are typically handled by conference call.

The Hearing

Typically, arbitration hearings last a week or less. Some last longer due to an unusually complex dispute or unusually contentious counsel. Most are conducted in relatively informal fashion with practical rather than technical procedural rulings by the panel. Witnesses testify and are cross examined. Counsel provide opening and closing statements plus briefs supporting their position. Given their expertise in the insurance business, panelists will often ask questions of the witnesses or counsel but seldom does this become a cross examination. It is the author's observation that the great majority of arbitrators try very hard to fashion a just solution to the dispute within their frames of reference. It may be advisable to

enlarge these frames of reference in order to properly reflect the nuances of the receivership process.

The arbitration panel often formulates its ruling immediately after the hearing while the evidence is fresh and the panel can interact in person. A written ruling usually is provided shortly thereafter. The written ruling is seldom a "reasoned decision" in the same manner as a judicial ruling is reasoned. Usually, the ruling simply states the winner and the damages awarded. There is considerable debate in the arbitrator community as whether or not the arbitration process would benefit from a fuller statement by the panel as to the reasoning behind their conclusions. Some believe that reasoned decisions will simply generate appeals which will unnecessarily increase the costs and time involved in the arbitration process.

Qualifications to Become an Arbitrator

Given the desire for a panel of experts, it is unsurprising that the great majority of arbitration clauses in reinsurance contracts require that the panelists be current or former senior officers of insurers or reinsurers. Employees of solvent (or ostensibly solvent) companies write these contracts and seldom concern themselves with the possible eventuality of insolvency. Receivers have little control over the language placed in arbitration clauses, and it is thus unlikely that in the future there will be material change in these qualifications. There are several ways, however, in which reinsurance arbitrators may become more

knowledgeable about receiverships.

Initially, an organization such as IAIR could compile a list of members and other individuals who have the requisite company background but are also very knowledgeable about the receivership process. For instance, Richard L. White, Special Deputy Liquidator of Integrity Insurance Company, was recently certified as a reinsurance arbitrator by ARIAS - US, the local manifestation of an international reinsurance arbitration association.

Second, a receiver may be able to persuade the adverse party to waive the qualifications for an outside counsel who is acknowledged to be expert in reinsurance matters, as well as receivership matters. IAIR has several such members.

Third, an organization such as IAIR might engage in a pro-active effort to educate those active in the arbitration process to the special context of an insurer receivership. With the possible exception of a few political issues (*e.g.*, setoff), insurance executives have no particular position for or against receivers. The more common alignments in reinsurance arbitrations are ceding company versus reinsurer (*e.g.*, declaratory judgment expenses) or domestic versus alien (*e.g.*, pre-answer security). For the most usual issues to be arbitrated, coverage and allocation of losses, the fact of receivership is irrelevant. However, knowledge of receivership law and practice may provide an essential backdrop to avoid unnecessary and inadvertent prejudice on such critical issues as late notice, priority of distribution, preferences, interest on awards and the operation of the insolvency clause.

Receivers might consider developing an educational process for arbitrators with the incentive that those who have completed the process would receive a designation which will be useful to them in obtaining future arbitration work. It might be possible to focus this effort through an organization of reinsurance arbitrators since it would be an opportunity to widen the marketplace for member arbitrators.

Arbitration of Receivership Laws

Another issue which is extremely troublesome to receivers is the arbitration of receivership law as part of a reinsurance arbitration. Most often, this involves setoff but other receivership law provisions may be impacted. The expertise of some insurance executives may be stretched thin by the nuances of receivership law. Arbitration of receivership law continues to be vigorously contested, and it is not the purpose of this article to evaluate the merits of the debate or predict the outcome. If arbitrators are allowed, however, to decide the meaning of receivership law, the educational process described in the section immediately above takes on heightened importance.

Conclusion

To the extent that receivers are forced to arbitrate *some* disputes in *some* jurisdictions, it behooves them to become more familiar with the arbitration process and to develop strategies to assist in any necessary leveling of the playing field.

One means of doing so is to develop a group of individuals who: (a) qualify to act as arbitrators under the terms of most reinsurance agreements; (b) are knowledgeable about the receivership process; and (c) can decide business disputes without unnecessary damage to the receivership process.

1998 NAIC/IAIR Workshop

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These issues are nothing new to the insolvency system, but they continue to be some of the most vexing problems encountered when an insurance company is heading towards insolvency.

The case study was well planned to highlight these and the host of other problems encountered in most insolvencies.

The attendees ranged from the most seasoned, to those seeking to broaden their practice from traditional bankruptcy into insurer insolvency.

Receivers and guaranty associations were all well represented. And, for the first time, a sitting judge having statutory jurisdiction over insurer insolvencies attended.

Participants were broken into 15 groups of seven to eight people. Each group was asked to review the facts and make recommendations at different stages of the workshop.

Although all of the groups identified similar issues that had to be addressed, the groups did come up with a wide range of ideas on how to handle different aspects of the Bubba Gump problem.

At the end of the day, all groups agreed that Bubba Gump was destined for the grave, although the paths taken to the cemetery varied.

Dues are now due - if you have not done so, mail them in today!

Sponsor a new IAIR member, it gives two people a great feeling!

Applications and an IAIR explanation brochure can be requested from the Association Office - fax your request to Lisa today, at 913 / 262-0174 !

Thanks for sharing!

Three examples of people in IAIR helping all of us do our jobs better...

Three examples of IAIR not hiding its head in the sand and clinging to the old ways. . . Three examples of IAIR giving each of us new tools to meet the demands of the marketplace. It's a new day, and the troops at IAIR are mobilized to deliver more than milk-toast discussions of stale legal issues.

Bob Craig, Accreditation & Ethics Chair presents AIR/CIA designation plaques to (from left to right) Dick Cecil,CIR, CLU; Betty Cordial, CIR; Mike Anderson, AIR and George Gutfreund, CIR.

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
NO. 005081 OF 1997
IN THE MATTER OF

FREMONT INSURANCE COMPANY (UK) LIMITED

AND IN THE MATTER OF SECTION 425 OF THE COMPANIES ACT 1985

At a meeting held on 15 December 1997 in London, the Scheme of Arrangement ("the Scheme") between Fremont Insurance Company (UK) Limited ("the Company") and its Scheme Creditors (as defined in the Scheme) was approved by the requisite majority of Scheme Creditors.

On 4 March 1998, the High Court of Justice of England and Wales ("the Court") sanctioned the Scheme in the form approved by the Scheme Creditors and dismissed the winding up petition.

On 10 March 1998, an office copy of the Court Order sanctioning the Scheme was delivered to the Registrar of Companies for registration. The Effective Date of the Scheme is, therefore, 10 March 1998.

An Order for permanent injunctive relief under Section 304 of the US Federal Bankruptcy Code providing for recognition of the terms of the Scheme in the United States of America, was made on 11 February 1998 in the United States Bankruptcy Court in the Central District of California.

Philip John Singer and Christopher John Hughes, partners in the United Kingdom firm of Coopers & Lybrand are the Joint Scheme Administrators responsible for implementing the Scheme.

Claims against the Company under contracts of reinsurance (or otherwise) should be submitted to the Joint Scheme Administrators at the following address:

Fremont Insurance Company (UK) Limited

c/o Coopers & Lybrand insurance services

Coopers & Lybrand House,
3 St Philips Central,
Bristol BS2 0XJ
United Kingdom

Dated this 10th day of March 1998