The INSURANCE RECEIVER

Promoting professionalism and ethics in the administration of insurance receiverships.

Volume 7, Number 4

WINTER 1998

President's Message

By Robert Craig, Lamson, Dugan, & Murray

Greetings to all from sunny Omaha, Nebraska.

Robert Craig

Before my comments, a much deserved "thank you" to Doug Hartz who has served the association in exemplary fashion as president for the past year and as a board member for the past several years. I know that the Board looks forward to Doug's continued active involvement.

Also, "thank you" to the Board and association members who have honored me with the opportunity to serve as president for the upcoming year. I hope to be able to live up to the high standards set by those who preceded me.

Over the past year, there have been several developments concerning IAIR that are cause for excitement and optimism. The certification program is in the process of being revamped, and new applications are being approved almost every quarter. There are now 32 IAIR members who have been awarded the CIR or AIR designations. The Uniform Receivership Law has now taken form and is being supported by a number of organizations including NCOIL and the IAIR Board. As it gains momentum in various states, IAIR members can position themselves to provide knowledge of how this law can improve the administration of receiverships.

We all look forward to 1999 as a year of growth for the association. To that end, I urge those of you who can to attend the Board meeting in West Palm Beach the evening of February 3 where the primary focus will be on ways to expand member participation and to increase our members' visibility as professionals qualified to take on receivership responsibilities. A detail: If you plan to attend the board meeting, please e-mail me so we can be sure to have a large enough room.

My e-mail address is: rcraig@ldmlaw.com

See you at Chuck and Harolds.

Immediate Past President's Message

By Douglas Hartz, Missouri Department of Insurance

It has been a great privilege, pleasure and honor to serve as the President of IAIR for the last year.

My thanks for a successful year go out to the members of the Board of Directors (especially the new members added to the Board when we expanded it to fifteen members last year) and to all of the committee chairs and committee members who worked diligently to further the goals of IAIR. While all of the individuals deserve great credit for becoming engaged in the activities and goals of IAIR, there are a few persons that deserve a special mention.

Those persons are Mike Cass, for taking on the Chairmanship of the Membership Committee and for his years of service in producing the member features in the IAIR Insurance Receiver, Jim Stinson for taking over the Publications Committee and continuing the improvement in that area, Steve Durish for taking over the extremely active education functions of IAIR, Paula Keyes for her endless contributions in the area of receivership education, and Philip Singer for something of a life time achievement award in the area of increasing our international membership.

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Winter 1998

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WANTED

IAIR is seeking an administrator to perform duties for the group. Increasing membership and other revenue sources are a high priority. Duties include: maintenance of central office, membership recruitment and dues maintenance, meeting coordination, production of publications, performing all financial and reporting services. If you are aware of someone who is interested in serving as IAIR's administrator, please have them send a resume to: jgordon@md1st.com

Orlando Meeting Recap

By Mary Cannon Veed

I've always thought that one of the pleasures of being an American was the sheer variety of the place — and the ability we have not to take ourselves too seriously. Guess you could say the same thing about being in the insurance business. Reading over last quarter's recap from New York, and trying to follow it up with the story of this time in Orlando is like getting reports from two different planets — but it was all the same folks.

Whereas last time IAIR distinguished itself chiefly by its absence, this time it was far and away the most interesting locale. Partly that was catching up, partly the impending elections, and partly the fact that everybody else was more interested in taking the kids to Walt Disney World. But all in all, it was a performance which more than justified the membership dues.

The Roundtable wasn't showy, but it was certainly fascinating. I got my meeting's quotient of education from an excellent explanation of how an HMO can run off the rails — and how re-sorting its financial and statistical information can uncover the causes. I was suitably impressed, also, by the startling speed with which the company subject of discussion went from apparent prosperity to panic simply because its various departments made what, individually considered, were very sensible adjustments to their business approaches — but which, when combined, made a positively explosive mixture.

It was also a very timely demonstration of the weaknesses in common accounting practices for HMO's, which in this case had generated financial statements which looked perfectly OK until the company basically ran out of cash. If the first sign of financial difficulty is that the company is bouncing checks, its auditors should review their malpractice insurance. Recognizing that this sort of thing seems to happen to both TPA's and HMO's (e.g. Anchor, United Health Care...) with distressing frequency, I would hate to be the accountant who had to defend an internal controls opinion that gave that company's information systems a clean bill of health. Although many commercial and social factors contributed to the situation being reported on, the main reason their effect was not recognized in time was the accounting system's failure to appreciate the size and significance of a backlog of incurred liabilities. That backlog was no secret to the company, but it was not being accounted for, permitting management (and probably a regulator or two) to remain fat, dumb and happy for a little too long. That has also been a characteristic of many of the other HMO "surprises" we've seen over the past few years, and it is almost certain to be part of the wave of HMO failures we are beginning, inevitably, to see.

Another interesting presentation was the session on prosecuting insurance crooks. I can't say the individuals had any dazzling insights into the nature of insurance fraud — indeed the crimes involved were pretty elementary, and the whole room was visibly being tolerant of the speakers' assumption that they had the insurance business all figured out. But they at least got that far, and had the nerve and stamina to make their charges stick, and may their tribe increase.

Truth is, if you can't explain an insurance fraud to a bright 7th-grader, it probably can't be prosecuted, and shouldn't be. It may be infuriating, outrageous, tragic, expensive, and shocking to the knowledgeable, but it probably isn't what the ordinary civilian would recognize as a crime. Florida should be appreciated for having the sense to pursue what amounted to garden-variety embezzlement, and resisting the temptation to pursue more exotic charges that would make sense only in a particularly well-managed civil case.

The finale, a brainstorming session on where IAIR is or ought to be going, was really a triumphant acknowledgment of how far it's come. From a "regulators only", "don't rock the boat" fledgling, it had grown into a sophisticated and occasionally daring advocate for integrity, competence, and professionalism, confident enough in its own stature to accept and indeed encourage criticism. OK, so what if the only unanimity we got was opposition to the prices at the reception. It was still fun, and felt good.

Last but not least, we re-elected directors, and the directors elected officers. Congratulations to Bob Craig, Liz Lovette, Jim Stinson, Dale Stephenson, and Jim Gordon, new officers.

I confess to considerable glee when the great state of California presented a session on its new organization and sense of missionary purpose. They seem to think they are the first ones to notice that Balkanizing your liquidation operations is a waste of time and money. Should one be glad they figured it out, or curious why it took so long or how long it will last? In good entrepreneurial fashion, having invented efficiency, they propose to export it, soliciting appointment by other states to lend economies of scale to less fortunate venues. It's safe to say they have a formidable public relations problem, but one well worth addressing even if they never capture an outside contract.

A by-product of the new spirit of candor was a fat bookful of financial information about California receiverships. Although I assume most of this material was already available from the individual receiverships, it is vastly more informative presented in such an accessible fashion. Indeed, any agency with a statutory charge of handling a lot of other people's money ought to be able to do the same thing, more or less on demand, as a matter of principle. But how many of our estates could actually do it? And how many who can, do? California has thrown down something of a gauntlet. Anyone care to pick it up?

Which is not to say that California is the first state to recognize that intelligible information about an insolvency is as much the policyholders' right as their eventual dividend. You might recall that last quarter I accused the UDS group of treating financial reporting for estates like the weather — a lot of talk but no action. I evidently missed the boat, because as of this meeting they are pressing forward, with committee sanction, on the development of reporting standards. Indeed, an informal working group threatens to meet in Phoenix in the interim and

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IAIR Roundtable Schedule

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

NAIC Meeting - June 5 - 9, 1999
Kansas City, Missouri
IAIR Roundtable
June 5, 1:00 - 5:00 p.m.

NAIC Meeting - October 2 - 6, 1999
Atlanta, Georgia
IAIR Roundtable
October 2, 1:00 - 5:00 p.m.

NAIC Meeting - December 4 - 8, 1999
San Francisco, California
ABA/IAIR National Institute
December 3-4, 1999

The Insurance Receiver

The Insurance Receiver is intended to provide readers with information on and provide a forum for opinion and discussion of insurance insolvency topics. The views expressed by the authors in *The Insurance Receiver* 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; Erika Fuhrman, Administrative Coordinator.

Editorial Board: James Stinson, Publications Committee Chair; Ellen Fickinger, Tom Clark, Mary Cannon Veed, Michael Cass & Charles Richardson.

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Directors: Richard Darling, CIR; Steve Durish; Robert Greer, CLU; Douglas Hartz; Michael Marchman, CIR; Charles Richardson; Ellen Robinson; Philip Singer; Lennard Stillman, CIR and Michael Surguine.

Orlando Meeting Recap

(Continued from Page 3)

actually come up with something. Already the guaranty fund standards are working well enough to make the vacuum on the receivership side pretty obvious — and pretty obviously unnecessary. By now, Doug must be used to being assigned to bell cats, but I think it would be nice if he weren't left (or even allowed) to do the whole job alone.

And what were the rest of the NAIC doing besides food, family, and fun? A great deal of consolidating of gains, as far as I could see. There is workmanlike progress on actuarial and accounting standards, for instance, but nothing showy. The Surplus Lines task force got the Lloyds trust fund documents sorted out just timely enough not to appear irrelevant. The Guaranty Fund working group is wrestling valiantly with equity-indexed annuities, hearing a mind-boggling presentation on their infinite variety which did not, as far as I could tell, help much in deciding how or whether to protect them. The CLEAR project seems to have crashed and burned, which will not, unfortunately, make the problem go away. The demises of the Inter-Affiliated Pooling and the Liability-Based Restructuring Groups was duly noted, although neither of those problems will go away, either.

There seemed to be only a couple of topics that deserved more than a sentence. One was the continued work of the "Access to Information" white paper group, which has a genuine white paper nearly finished — but for the conspicuous absence of conclusions. That's deliberate, and it has had a salutory effect of giving everyone interested in the problem of public access to compliance work a chance to think about all sides of the problem. But there's a frightening residue of hostility barely under the surface, and deep and intransigent mutual suspicion. It will be a triumph of diplomacy if they can usefully finish the paper without giving in to the name-callers and panic mongers.

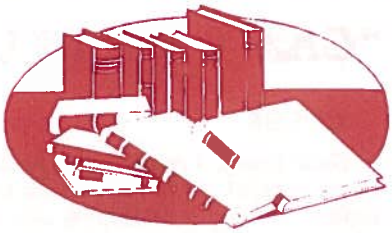
Emboldened by the tolerance of its white paper, (and apparently undaunted by the departures of some of their number) the Re-engineering folks set out to write some model laws that put their ideas into practice. But where new ideas are concerned, apparently it depends on who raises them, and how politely they are expressed. The property/casualty trades circulated a paper proposing "price normalization" for all lines, suggesting that if deregulation is good for commercial lines, it would also help if applied to the market "where most insurers sell their insurance and most people buy their policies". Their economics were unimpeachable, but their language was not at all diffident:

"Price controls have:
distorted the regulatory system;
distorted the marketplace;
made insurance pricing a political act;... [and]
become a relic of an economic theory discredited at home and around the world....

"These laws enable the insurance regulatory system to slow down, deflect, delay and ultimately defeat an insurer's effort to adjust its price in the market place. ... While they are touted as the way to keep prices down, they in fact, keep them down only for a charmed few, while they create availability problems for many more. ...Whether we're examining price controls on auto insurance in Massachusetts or New Jersey, or the action of the Florida regulators after Hurricane Andrew, or the enactment of Prop 103 in California, price controls have not solved problems. They have merely exacerbated them. ...When the price is suppressed below the true cost of the risk, insurers have responded by limiting their sales to only those customers they can safely insure at the suppressed price."

This modest proposal was discussed in at least three committees I could find, but it got treated as a chill wind, not a breath of fresh air. The most constructive reactions were expressions of desire to refer the matter to committee — notably some other committee than the one then meeting. Nobody stood up to defend price controls, but instead they pretended offense at the "tone" of the request. As any good, and cynical, lobbyist would do in a similar jam, the trades claimed it was all their fault the lobbyees had been offended, and set about salvaging good will that should never have been in jeopardy. They apparently are not used to the role of the kid who points out that the Emperor has no clothes, and seemed to sort of wish they hadn't mentioned it. But now that it's been said, what is the Emperor going to do about it?

Other News & Notes By Charles Richardson



The Dangers of E-Mail . . .

Does anyone doubt that the star of the Microsoft antitrust trial was e-mail? Day after day we heard about old e-mails coming back to haunt the witnesses, with messages that no-one at the time (least of all Bill Gates) thought would have a shelf life longer than a few days.

Americans send roughly 400 million electronic messages a day, from both home and office. And you can bet that a high percentage of that number — even the purely business ones — represent communications sent with less than careful reflection. They frequently are sent without full consideration of the impact on the recipient and with virtually no regard to the implications if the message gets into the wrong hands years later. In short, people are coming to realize in light of the unfolding events in the Microsoft trial that e-mail messages can stay in a computer system for years and provide inflammatory evidence in legal disputes ranging from antitrust to employment practices to breach of contract. The very attributes that have made e-mail so popular — chief among them its tendency to induce off-the-cuff candor and immediate access to the top bananas in business and government — are driving employers to conclude that the unfettered use of e-mail has to be reined in.

I suppose what that means for us in the insurance insolvency business is no different from what it means for the rest of American commerce. Put aside for the moment the fact that e-mail messages may represent a potential treasure trove of evidence in your next reinsurance, director/officer or other third-party litigation case. For now, focus on what we as receivers, guaranty associations, consultants and managers should be considering to make sure the e-mail bag does not contain some unpleasant, embarrassing surprises for us. Here are some suggestions:

1. Think before you send. Don't deal with a substantive issue without considering whether your message is complete. Tone down the language. A reader a year from now will probably attach more weight to the message than you ever intended.

2. If you wouldn't say something in a meeting, don't say it in e-mail.

3. Establish an e-mail policy for your employees, with a clear explanation of expectations about business v. personal use, rules regarding purging/deletion/retention, access to the internet, monitoring by management, etc.

4. Be careful — very careful — about confidentiality issues. Do not use e-mail for documents and ideas where there is a fear of breaching the attorney-client privilege or jeopardizing the confidentiality of proprietary information.

5. Go back to #1 at left and think again before you send! If you would not want the message to show up in your local newspaper a year from now under your picture, then don't send the e-mail. If it is routine, the message can be sent by e-mail. If it is not routine, then consider whether the better way to communicate is by letter, telephone or meeting where you can be more sure that all relevant pieces of the legal or business puzzle have been discussed and considered.

* * * * * *

E-mail has become so popular that my issuing all these legal footnotes and warnings seems downright wimpy. But all you need is one misstep on that computer screen or buried in that server to convince you that this is no small matter.

H.R. 10 Dies in the Senate . . .

Financial services reform will have to wait another year, because the Senate failed to pass H.R. 10 prior to adjournment of the 105th Congress.

After making it out of the House by one vote, the bill ultimately died due to opposition by Sen. Phil Graham (who believed the bill would have greatly expanded Community Reinvestment Act requirements on financial institutions) and a threatened veto by President Clinton (who wanted the Office of the Comptroller of the Currency, rather than the Federal Reserve Board, to regulate the non-banking activities of national banks).

The political landscape for this year's legislative effort will be markedly different, since Sen. Graham succeeded Alfonse D'Amato as chairman of the Senate Banking Committee. In addition, many believe that the Administration will actively seek financial services reform legislation that will preserve the OCC's place at the regulatory table.

In the meantime, the OCC is reportedly primed to expand its turf by permitting national banks to engage in broader non-banking activities through their operating subsidiaries.

While the debate over H.R. 10 was hot and heavy, there continues to be a fear on the part of many of the moderates that H.R. 10 represented the best (last?) hope of preserving some kind of equilibrium between state regulation of insurance and the onslaught of federal regulation.

"CAN'T WE ALL JUST GET ALONG?"

By Daniel A. Orth, III

12/5/98

Dear Diary, I really need to be more careful. It happened again today. During a telephone discussion about whether the transfer of liabilities from a guaranty association to an assuming carrier should generate "an asset that belonged to the estate" or whether the guaranty association may fulfill its statutory obligations by merely making a net payment to the assuming carrier, the person I was talking with said, "Hey, you actually enjoy this stuff, don't you?" Of course I denied it.

When a state guaranty association "reinsures" its statutorily imposed obligations (i.e., transfers them to a solvent insurer), is it possible for a "ceding fee" to be generated? If "yes", then to whom does that "fee" belong and why? If "no", why not? I recently pondered these questions, but was unable to reach any definitive conclusion, so I asked some of the smart and experienced people I know to share their thoughts on these issues with me. You are invited to join me on the journey on which their answers took me, as reflected in a hypothetical conversation held between a guaranty association representative and a deputy receiver.

(Setting: Saturday afternoon, at the site of an NAIC meeting.)

GA: That was an excellent IAIR Roundtable today - don't you think?

Receiver: Yes, it was. Too bad it couldn't have dealt with the issue you and I still have to resolve, that is who is entitled to the ceding fee generated by the transfer of the GA's obligations.

GA: Well, let's stop in at the lobby bar, where we can discuss it over a beer. I'll buy. Maybe you can help me to understand your claim for a ceding fee in an insolvency.

It strikes me as trying to make something out of nothing - like the hobo who said, "If we had some ham, we could have ham and eggs, if we had some eggs".

Receiver: O.K., I'll get the ball rolling. We are dealing with the liquidation of the Toolitttle Life Insurance Company (Toolittle), an insolvent company that sold annuities. The guaranty association has been triggered. After setting aside funds for administrative expenses, the estate has only $ .70 for every $1.00 of liability at the policy level. The statutory reserve for the annuity block was $100 million. The statutory reserve for the "covered obligations" portion totaled $90 million; the uncovered obligations $10 million.

Solvent companies have come in and looked at Toolittle's annuity business and have made bids on the annuity block. The likely winner, the highly-rated Bigbucks Life Insurance Company, (Bigbucks), has said that it will assume the "covered obligations" for assets of $87,750,000, which I calculate results in a "ceding fee" of $2.25 million. As the Receiver, I believe that any such ceding fee should come into the estate and be distributed equally among policy level creditors, 90% to guaranty associations and 10% to the uncovereds.

GA: And speaking for the guaranty association, I believe the estate has no claim to any "ceding fee" generated by a guaranty association transfer. In fact, I'd say our dispute was over whether there is any such a thing as a ceding fee in an insolvency situation.

Receiver: Well, in either case we need to look closely at how ceding fees "come to be," which requires that we look at reserves. A reserve is generally defined as an estimate of the present value of future benefits. Every "legal reserve life insurance company" is required by law to establish statutory reserves for any policy obligation it takes on. Assets are required to be set aside to support the statutory reserve. When a company applies statutory accounting methods, a statutory reserve is calculated, using a formula that assumes certain interest rates established by law and mortality or morbidity tables established by law-those rates and tables are conservative and tend to create larger-than-needed reserves.

GA: O.K., let's look at the ceding fee that arises when business is transferred between two solvent companies. The company that originally wrote the business, and now wishes to "cede" or transfer those policies to someone else, is called the "ceding company." To induce another company to assume the policy obligations, the ceding company will have to pass over assets to the company assuming the policies to enable it to meet the assumed policy obligations.

In a typical situation the ceding company will seek bids from several interested companies to see which of them will require the smallest amount of assets to assume the policies. The winning (usually lowest) bidder becomes the "reinsurer"; it takes on the obligations of the transferred policies upon its receipt from the ceding company of assets of a value equal to its bid.

Receiver: And it is here that differences in the calculation of future liability become important. The ceding company's statutory reserve calculation was derived from the conservative formula that used certain required interest rate assumptions, mortality tables, etc.

Similary, the reinsurer must also calculate a statutory reserve using the same formula. In addition, however, the reinsurer will probably also calculate the amount of assets required to meet the policy obligations using pricing assumptions designed to develop a "more likely" liability estimate, which probably will be a smaller number. The reinsurer will bid an amount it needs to discharge its ultimate policy obligations. The reinsurer will refer to the difference between the statutory reserve and the smaller amount it received as the "ceding fee expense."

GA: Let's apply what you said to an illustration: the ceding company has set aside $1,000 of assets in support of its statutory reserve. The

Daniel A. Orth, III, has been the Executive Director of the Illinois Life and Health Insurance and the Illinois Health Maintenance Organization Guaranty Associations since 1993.

He had previously been in-house counsel to an Illinois domestic life and health insurer for 27 years, during which time he had represented his company on two state guaranty association boards (Oregon for 17 years; Illinois for 5 years) and had served on the NOLHGA Board from 1989 - 1993.

reinsurer, using other pricing assumptions, calculates a more likely estimate of liability to be $970. Let's say they do "the deal" and the reinsurer assumes the policy obligations upon its receipt of that (lesser) amount of assets.

The transfer relieves the ceding company of the need to have any statutory reserve for those obligations. Having turned over $970 in assets, the $30 of remaining assets that had been set aside is now "released," and adds to the ceding company's statutory surplus. The addition to surplus is labeled "ceding fee income."

Now with solvent companies, all of that makes sense. But I can't understand how the estate can claim to be entitled to a "ceding fee" when the insurer was insolvent. Consider it from the guaranty association's perspective. As we have seen, in a transaction between solvent companies, the "fee" for the ceding company is made up of released (i.e., "left-over," assets). In an insolvency, where the estate lacks sufficient assets to support an assumption agreement without additional assets from outside of the estate, "ceding fee" would seem to be creating something out of nothing, i.e., the "ham and eggs" scenario.

Receiver: I view any fee that is generated from the sale of the business of the insolvent company as constituting an asset of the estate. I think the asset was there when the liquidation order was entered. As Receiver, I merely seek recovery of that asset for the estate when the asset becomes recoverable, even if time must pass and events must transpire before that can occur. Like a share of stock or a piece of land, I suppose an asset's value can change from day to day, but on the date of the assumption reinsurance transaction I know what that asset is worth and I claim it.

GA: We just struck our first area of disagreement.

Receiver: Well, O.K., but I have my reasons. Start with the definition of a ceding commission in the Glossary of the NAIC *Receiver's Handbook*. It defines a ceding commission as an allowance by the reinsurer for part or all of the expenses incurred by the ceding company in acquiring the ceded business and other costs. The ceding commission may be thought of as having been built into the conservative statutory reserve formula, or not, but that is one way you could measure the asset I claim.

GA: (Bartender, two more, please.) Go on.

Receiver: My second reason is a court case, decided in Missouri, arising out of the insolvency of Continental Security Insurance Company. The court in that case found the liquidator was entitled to the ceding commission generated in two insurance transactions based on the court's determination that a ceding commission is paid by the assuming company to reimburse the ceding company for its previously incurred expenses. Again, that supports my position.

GA: Hmmm, you'll need to "Show Me more!"

Receiver: That's cute. But the fact is I believe there is an equitable right on the part of the estate to insist that any benefit that flows from the transfer of the insolvent company's business should inure to the estate. Equity is about fairness, and that seems only fair. The insolvent company spent the funds up-front to imbed value in that business, so it is only fair that the value become the estate's when the business is transferred and someone else pays for it.

GA: There's our second area of disagreement. No one else **is** "paying for it". In the reinsurance transaction between solvent companies we discussed, real assets (left-over assets) were released to surplus from reserve support. Such a release requires solvency, and cannot occur without it.

As to fairness, how could it be "fair" for the guaranty association to pour in money to accomplish a transfer of obligations that otherwise could not occur, only to have the so-called "ceding fee" go to the estate, which then gives a portion of that estate asset to uncovered claimants?

If entitlement to a ceding fee were tied exclusively to assets, I suppose one could construct a formula that would divide the ceding fee into two parts; one part to the guaranty association, based on its asset contribution; the second part to the estate, based on the portion of the transferred assets that came out of the estate.

In an insolvency, however, where there is a transfer of "covered obligations", I believe **nothing** goes to the estate and that such a result is entirely fair. That's because I don't believe ceding fee entitlement has anything to do with **assets**, or their source. Rather, it has everything (and only) to do with **obligations**, and who "owns," or has the legal responsibility for the obligations. That is the only party that can cede them. I think it goes back to what happens when the court of equity activates the guaranty association by its liquidation order with a finding of insolvency.

Receiver: Specifically, what do you mean?

GA: Well, let's look way back in time, at what used to happen when a company became insolvent before the existence of guaranty association laws.

An impaired company was found to be insolvent and was ordered liquidated. The liquidator marshaled assets, paid off the highest level creditors, and found a solvent company willing to take the policy obligations, not at their full benefit level, but at a level equal to what the available assets would buy. These were called "restructured" policies. They were less valuable than the original policies would have been had the original company not gone broke. The policyholder (a consumer) had made a purchase decision that had turned out to be an unfortunate one. It was a free market environment (within regulatory parameters); "You pays your money and you takes your chances." You choose wrong, you lose. Harsh, but fair.

If a liquidator was unable to find a solvent carrier that would take over the business — even on a restructured policy basis — the liquidator would calculate a value for each policy. Some liquidators might use statutory reserves; others cash values; still others, some other equitable measure of value. If assets were available to support only 30% of full value, each policyholder would receive $ .30 for each $1.00 of the value of his/her policy, and would probably not receive it until years down the road. Lost insurability was another part of the price paid by the consumer who made the wrong purchase decision. Still fair, but very harsh.

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Guaranty associations changed all that. Guaranty association laws worked hand-in-glove with the rehabilitation and liquidation laws. They "carved out" a portion of the obligations of an impaired insurer and made those obligations (called the "covered obligations") the responsibility of the guaranty associations to fulfill. This "carve out" occurred instantly, by operation of law, (i.e., without further action by anyone) upon the entry of the order of liquidation with a finding of insolvency. The same legal event, of course, both activates (or "triggers") the guaranty association and creates the estate.

Now, what happens, legally, when "covered obligations" are created? I'm not certain I know. If the liquidation order causes a direct legal "transfer" of the covered obligations from the insurer to the guaranty association, I think that means the "covered obligations" **never become a part** of the estate. That would be as though the insolvency court gave the holders of covered obligations a card which read: "Go directly to the guaranty association; do not pass through the estate; do not collect $200". If that were the way it worked, of course, the estate could never be entitled to a ceding fee arising from the later transfer of covered obligations to the reinsurer, because the covered obligations never were the estate's obligations to fulfill.

I think I might agree that if the estate were to transfer any **uncovered obligations** (that had become claims against the estate upon the entry of the order of liquidation) the estate would have the right to claim any benefit generated by that transfer. I just do not see any way for the estate to claim a benefit that is tied to the covered obligations after the entry of the order.

Receiver: What is the basis for your conclusions?

GA: Mostly the guaranty law. To begin with, it seems clear that policy benefits from covered obligations (such as payment of a death benefit under a life insurance policy when death occurs after the date of liquidation) become the responsibility of the guaranty association after its activation.

The guaranty association is liable to fulfill the covered obligations of the insolvent insurer up to the statutory coverage limits. It might choose to do that by retaining liability itself for the policy obligations, and never reinsure them. Then no "ceding fee" is ever generated for the estate and the guaranty associations to argue over. Or it can "reinsure" by purchasing coverage from a solvent insurer. I believe that if the guaranty association does the latter, it is entitled to purchase that coverage at the lowest possible net price. No "ceding fee" is created by that transaction. It is merely a flat purchase.

Also, it's my understanding that, after the liquidation date, the estate (created by the liquidation order) is responsible only for the "residual value" of the policies. That "residual value" recognizes or takes into account the asset insufficiency.

If that is true, another thing must have happened, by operation of law, upon entry of the order. There must have been a conversion, if you will, of the obligation that the insurer (pre-liquidation) had for all its policies, to the reduced liability the estate has for claims of amounts equal to the equitable value of all of the insolvent's policy obligations. That conversion would have occurred at the same moment that the liquidation order created the guaranty association's liability for the covered obligations.

Receiver: That's a lot for one order to accomplish, especially when I'm not sure the wording of the order says any of that. And, by the way, I know of at least one deputy receiver shop that calculates what it believes the ceding fee should have been (in the case where the guaranty association "retains," rather that reinsures, the business) and credits the guaranty association with having received that amount from the estate.

GA: Really? That is far out - and I believe deserves future discussion. But I wasn't quite through yet. There is another way to think about what happens between the guaranty association and the covered obligations upon entry of the order.

I've suggested the possibility that the order of liquidation with the finding of insolvency, by operation of law, transferred the covered obligations directly from the impaired insurer to the guaranty association, creating in the guaranty association the sole statutory responsibility to meet the covered obligations.

At least a second possibility exists as to what may happen when the guaranty association is activated. Consider the creation in the guaranty association, upon entry of the order, by operation of law, of an entirely new set of obligations, identical to the covered obligations, parallel to them in all respects, but separate and distinct from them. These guaranty association obligations would identically "mirror," but would be separate from, the covered portion of the obligations originally created by the company that has now become insolvent.

The estate would have been created by the order. The claims against the estate would be claims for the reduced "converted" obligations, i.e., for the residual values of all of the policies. Those claims would be equal in value to each policy's proportionate share of the estate assets.

The estate's distribution for each policy, whether covered or uncovered, would depend on the asset coverage percentage at the policy level. The guaranty association would be obligated by its law to meet the new, statutorily created, "covered obligations," and the guaranty association would be subrogated to the rights of the policyholders to the extent of those covered obligations.

There would never have been a transfer of anything from the insolvent insurer or its estate to the guaranty association.

Just as in the previous scenario, there would once again be no basis for a claim by the estate to a ceding fee, because the obligations that the guaranty association transferred to the assuming reinsurer were newly created by the liquidation order.

As statutorily created ("mirror") liabilities, they never had been the obligations of the company prior to its insolvency, nor were they ever the estate's after the insolvency.

Receiver: That's very interesting and is certainly food for thought. And after we've both had some time to give it some thought, I think another discussion session would be in order, but for now, I've got to run. Thanks for the beer - next time I'll buy. I'll look to see you at the NAIC reception tomorrow.

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WINDING-UP PROCEDURES IN BERMUDA (OR) COLLECTING FROM ALIEN REINSURERS IN THE BERMUDA TRIANGLE

By Ian Kawaley, Head of Insolvency and Corporate Rescue, Milligan-Whyte & Smith, Hamilton, Bermuda.

This paper was delivered at the IAIR Roundtable in Boston on June 20, 1998.

"Safety in harbour is the King's ship; in the deep nook, where once thou call'dst me up at midnight to fetch dew from the still - vex'd Bermoothes, there she's hid..."
-- William Shakespeare [1]

A. INTRODUCTION

Excluding commutation and arbitration, there are three principal means of collecting a liquidated sum of money in Bermuda from a Bermuda insurance and reinsurance company. (Liquidated sum means a specific sum of money which is already ascertained or which may be ascertained by means of mere arithmetic - in other words, a quantified debt as opposed to a claim where the measure of damages recoverable falls to be ascertained by the court.) The three main collection procedures available are:

- civil proceedings commenced by a specially endorsed writ;
- a statutory demand under section 162(a) of the Companies Act; and
- winding-up proceedings under Section 161-163 of the Companies Act 1981.

The usual overriding concern of creditors will be to recover the sum due, or as large a portion of it as is reasonably practicable, quickly with the least possible expense. In Bermuda, as in England, the unsuccessful party in most court and arbitration proceedings is likely to be ordered to pay a sizeable portion of his opponent's legal costs in addition to his own legal costs.

The risks involved give rise to a need to select the most efficient recovery mechanism. As sums may be recovered from companies which are insolvent or on the brink of insolvency, it is important to ensure that monies collected are not liable to successful attack under the law of preferences, a subject which falls outside the scope of the present discussion. (However, the general principle is that a payment made in response to legal or commercial pressure is not voidable as a preference under Bermuda law).

This paper addresses the two winding-up options available to insurance creditors under Bermuda Law.

B. BERMUDA

Perceived Collection Problems

Those seeking to pour scorn on the viability of collecting reinsurance recoverables from offshore reinsurers located in Bermuda would do so in reliance on past fact and fiction, part myth and part reality.

Bermuda was first settled in 1609 when British ships headed for Virginia were wrecked there, a hundred years after Juan de Bermudez had first set foot there.

Shakespeare based his 'Tempest' (written in 1610) on Sir George Somers' shipwreck, describing the islands as a mysterious and dangerous place. By the 18th Century, fiction merged with fact as privateering (legalized piracy in which Bermudians would stand on Wreck Hill and lure enemy ships onto the treacherous reefs, sack the vessels and sell their cargo with the Crown earning a commission) became a mainstay of the Bermuda economy. This foreshadowed, cynics would say, Bermudians' modern efforts to attract foreign insurance premiums to its shores, only to strip out assets that should be reserved to meet claims.

In the 20th Century, Bermuda achieved fame - or attracted notoriety - with the publication in 1974 of Charles Berlitz's 'The Bermuda Triangle'. This book chronicles a series of supposedly factual unexplained disappearances of aircraft and ships in the area to the south of Bermuda, and attributes the disappearances to some form of magnetic force field effect. It is the Bermuda Triangle, cynics have suggested, that is responsible for the mysterious disappearance of the solvency that the Good Ship EMLICO enjoyed prior to entering Bermuda waters. An equally plausible causation of loss (according to un-named Californian sources) is the El Nino effect.

Against this background it is not surprising that both perceived and real difficulties have been experienced by some U.S. creditors seeking to collect from alien reinsurers in the Bermuda Triangle. But as Bermuda has developed into a major international reinsurance centre, the range of legal services available to serve the needs of U.S. creditors has broadened, together with the options available in terms of practical relief.

Evolution of Bermuda into a major reinsurance domicile

John Milligan-Whyte has described the "market-driven genesis" of Bermuda's captive insurance industry as follows:

"Suddenly in 1974 through 1976, property, casualty, products liability and malpractice insurance coverage became unavailable or scarce and exorbitant rates were prevalent in the established insurance markets. Several leading American insurance companies approached insolvency in that period as massive underwriting losses of more than $9 billion were sustained."

The proliferation of "captive" and other reinsurance companies in Bermuda and elsewhere occurred, in part, as solutions to that 1974 to 1976 crisis, and brought new and needed capital from outside the insurance and reinsurance industries into the international insurance and reinsurance markets. Singapore currently is developing as a comparable Asian/Pacific centre for captive insurers. There are currently approximately 1346 insurance and reinsurance companies operating in Bermuda. In 1987, these companies had approximately US$12.6 billion in gross premiums and assets of nearly US$31 billion and capital and surplus

in excess of US$10 billion. There have been only 16 compulsory court supervised liquidations of such Bermuda companies to date.

Bermuda expressed its concerns at a December 1987 meeting of international insurance regulators regarding the rapidly growing number of insolvencies of insurance and reinsurance companies in the United States. Bermuda is implementing innovative solutions under its existing law to generic international reinsurance insolvency problems." [2]

The recent decision of the U.S. Court of Federal Claims in Washington in *Kidde Industries Inc. v. United States* confirming the tax deductability of premiums paid to a Bermuda captive "not only gives a green light to Bermuda captives, but also sets a national precedent in the United States," lawyers say. [3]

C. WINDING-UP PROCEDURES

Statutory Demand

Bermuda's 1981 Companies Act is substantially based on England's 1948 Companies Act. Its relevant provisions are those given below:

- a company may be wound up by the court if it is unable to pay its debts (Section 162(e);
- a company is deemed to be unable to pay its debts if a creditor to whom the company is indebted in a sum of more than $500.00 has served a written demand for the sum due on the company and the company has neglected to pay the sum for three weeks thereafter (section 162(a));
- a creditor may apply to the court by petition for a company to be wound up (Section 163(1)).

A statutory demand under Section 162(a) may not be an appropriate collection procedure where there is an ongoing commercial relationship between the parties. A winding-up petition based on statutory demand cannot be properly presented where a debt is disputed (either as to liability or quantum). A debt which is not disputed on bona fide or substantial grounds may form the basis of a statutory demand, however. The utility of this procedure is most likely to arise either:

- where the creditor company is seeking to enforce a commutation agreement, civil judgment or arbitral award; or
- in cases of near insurance insolvency where the debtor has clearly failed to pay an admitted debt.

Presenting a Petition

Under Section 163(1) of the Companies Act 1981, a winding-up petition may be presented, inter alia "by any creditor or creditors, including any contingent or prospective creditor or creditors". However, in *Mutual Fire Marine & Inland Insurance Company (In Rehabilitation) v. Chesapeake Insurance Company Ltd.* [4] the Bermudian Court of Appeal ruled that a single contingent creditor of an insurance company could not petition to wind up an insurance company by virtue of the provisions of Section 34 of the Insurance Act 1978.

Section 34 of the Insurance Act 1978 provides that an insurance company may be wound up on the petition of ten or more policy-holders (i.e. contingent creditors). The Supreme Court (Sir James R. Astwood, C.J.) in *Mutual Indemnity Insurance Company v. Aneco Reinsurance Underwriting Ltd.* [5] had previously ruled that Section 34 of the Insurance Act 1978 merely provided an additional ground for winding up an insurer and did not restrict the right of a single contingent creditor to petition for the winding up of an insurance company. (This was overruled in an appeal argued at the same time as the Mutual Fire case.)

It is respectfully submitted that the view of the Chief Justice is to be preferred, but for the time being only creditors of an insurance company (as opposed to contingent creditors of general trading companies) may present a winding-up petition. The right of the company itself, its shareholders or the Registrar of Companies to present a petition falls outside the present discussion.

Grounds for Winding up

For all practical purposes in a debt collection context, the sole ground on which a winding-up petition

(Continued on Page 17)

Meet Your Colleagues

Gary A. Hernandez

Gary is a partner in the San Francisco office of Sonnenschein Nath & Rosenthal, a 500 lawyer full-service international law firm. He practices insurance regulatory, insolvency and reinsurance law and leads his firm's insurance regulatory practice group.

Gary formerly served as the Deputy Insurance Commissioner and Chief of Enforcement in charge of insurer enforcement and market conduct, fraud investigations and management of all failed insurance entities in California. He served as a Deputy under Commissioners Garamendi and Quackenbush.

According to Gary, he is "a product of the University of California," where he earned his law and undergraduate degrees. Gary was a varsity heavyweight wrestler and national championship judo player at Berkeley. "Two skills that come in handy even today, especially during contentious insolvency matters," he tells us.

Gary is an Independent Assessor for the Insurance Marketplace Standards Association (IMSA) and a member of the California State Bar Insurance Law Committee, the Receivership Law Advisory Committee to the Interstate Insurance Receivership Commission, and the International Association of Insurance Receivers.

He serves as a Board member of the Hispanic Community Foundation, American Cancer Society (San Francisco Unit), and U.S. Public Technologies. He was also appointed in 1998 to serve a four year term on the Board of Directors of the California Coastal Conservancy by the Speaker of the California State Assembly.

Gary lectures frequently on insurance and regulatory issues to private groups and organizations. He has published numerous insurance related articles in publications including *Insurance Litigation Reporter, California Insurance Regulatory Reporter, Mealey's, Insurance Week, Underwriter's Report, Claims Magazine,* and *John Liner Review.*

George Gutfreund

George Gutfreund is a Vice President of KPMG Inc., the corporate recovery and insolvency practice of KPMG in Toronto, Canada. He received a B. Comm. Degree from Dalhousie University in 1969 and his Chartered Accountant designation in 1977. George is a Licensed Trustee in Bankruptcy, Certified Insolvency Practitioner and a Certified Insurance Receiver - ML.

He is a member of the Nova Scotia, Ontario and Canadian Institutes of Chartered Accountants, Canadian Insolvency Practitioners Association, Ontario Insolvency Association and International Association of Insurance Receivers.

George became involved in insolvency matters commencing in 1986 with the liquidation of United Canada Insurance Company. He has also handled the liquidation of the Canadian business of American Mutual Liability Insurance Company and Ontario General Insurance Company, both of which were property and casualty companies.

In 1992 George became involved in the liquidation of Sovereign Life Insurance Company and is currently involved with Confederation Life Insurance Company, which was placed in liquidation in August 1994.

Currently George is a member of the IAIR Accreditation and Ethics, Codes and Conduct and International Membership committees. He is also Chair of the Test Development committee.

In 1995 George was asked by the Office of the Superintendent of Financial Institutions of Canada to serve as one of their advisors to suggest amendments to the Winding-Up Act and the drafting of the new Canada Winding-Up and Restructuring Act. Previously, George had performed consulting services for the Government of Canada pertaining to the insolvency status of native people.

George and his wife Penny have a son Jay at York University and a daughter Shawna just finishing high school. An avid cyclist, George also enjoys swimming and hiking and has become increasingly involved in not-for-profit organizations.

George M. Gotteimer, Jr.

George M. Gottheimer, Jr. is President & Chief Executive Officer of Kernan Associates, Inc., an insurance and reinsurance consulting organization in New York City. He holds a B.S.B.A. degree in insurance; an M.B.A. in insurance management and a Ph.D. in management.

In addition, George holds the professional designations of Chartered Property Casualty Underwriter (CPCU), Chartered Life Underwriter (CLU) and Associate in Reinsurance (ARe).

Prior to forming Kernan Associates in 1986, he was Senior Vice President and Treaty Manager with Crump Re. His underwriting experience includes Maryland Casualty Company, AIG, Midland Insurance Group and General Re.

At Kernan Associates, George directs the insurance and reinsurance consulting and strategic planning practices. In 1984, he developed the highly successful "Insurance/Reinsurance Solvency Workshop" for the CPCU Society, which was presented eleven times from 1984 to 1987.

In 1986, he was invited to testify before the U.S. House of Representatives' Commerce and Energy Committee on the subject of insurer solvency.

He has been involved in most of the major insolvencies over the past 14 years, as consultant, underwriting expert and arbitrator. He has worked with insurance departments in New York, Missouri, and California, as well as agencies of the federal government and state guaranty associations. His expert opinion has been cited in decisions of the Third, Fifth, Sixth and Tenth Circuit Courts of Appeals.

In 1997, after 25 years serving as adjunct associate professor, George became a full-time faculty member of The College of Insurance, where he serves as Associate Professor. He and his wife Pat live in Berkeley Heights, New Jersey. His daughter Nancy is an emergency room nurse, while his younger daughter Kerry teaches autistic children.

Michael Cass

Mike Cass is President & Principal Consultant for R.M. Cass Associates, an independent consulting practice formed in 1987 and located in Barrington, Illinois. The firm offers consulting services in reinsurance and related matters.

Cass is a graduate of Penn State and Temple University School of Law. He is a CPCU and member of the New York Bar. Prior to starting his consulting practice, he obtained eighteen years of industry experience with a primary insurance company, a direct writing reinsurer, broker oriented reinsurers and a reinsurance broker. Cass had various line and management responsibilities in underwriting, marketing, claims and administration.

Cass has assisted receivers in several states in connection with reinsurance issues. These assignments have included the analysis of reinsurance contracts, collections, commutations and most recently, the valuation and estimation of outstanding liabilities for a book of assumed reinsurance.

With respect to litigation, he has been a consulting expert and expert witness in actions against reinsurers, reinsurance intermediaries and outside accountants on matters related to reinsurance. Cass also serves as an arbitrator and is a member of the American Arbitration Association's panel of neutrals and a certified arbitrator for ARIAS-U.S.

Mike is a charter Associate Member of IAIR. He has served on the publications committee and chaired the membership committee. He also coordinated and served as moderator for a mock arbitration presented at an IAIR training session. Cass is past chair of the Excess, Surplus Lines and Reinsurance Committee of the ABA's Tort and Insurance Practice Section. He is currently chair of that section's International Tort and Insurance Law & Practice Committee. Cass has authored many articles on reinsurance issues including a chapter of Reinsurance Contract Wording, (Strain Publications) and is a contributing author to Reinsurance Practices, 2nd Edition, (American Institute), the text for the ARe 142 Reinsurance Practices program.

Cass enjoys traveling to far and varied destinations and playing golf – a very compatible combination. When the golf game isn't right, his therapy includes masquerading as an executive chef. This means he spends considerable time in the kitchen!

Receivers' Achievement Report

Ellen Fickinger, Chair

Reporters: Northeastern Zone -J. David Leslie (MA); William Taylor (PA); Midwestern Zone - Ellen Fickinger (IL), Brian Shuff (IN); Southeastern Zone - Belinda Miller (FL); Michael R. D. Adams (LA); James Guillot (LA); Mid-Atlantic - Joe Holloway (NC); Western Zone - Mark Tharp (AZ); Amy Jeanne Welton (TX); Melissa Kooistra (CA); International - Phillip Singer (England); and John Milligan-Whyte (Bermuda)

Our IAIR achievement news received from reporters covering the second quarter of 1998 is as follows:

RECEIVERS' ACHIEVEMENTS BY STATE

California (Melissa Kooistra, State Contact Person)

Use and distributions made to policy/contract creditors and Early Access 1st & 2nd quarter, 1998

Receivership	Amount
California Standard Indemnity	$6,137,165.00
California Benefit Life	3,360,749.00
Dual Plus Insurance Company	26,086.00
Pacific Standard Insurance Company	85,165,300.00
Reserve Insurance Company	159,607.00
TransContinental Title Company	55,643.00
Total	**$94,904,550.00**

Delaware (George J. Piccoli, State Contact Person)

Receivership Estates Closed	Year Action Commenced	Licensed	Category	Dividend Percent
Tara Life Ins. Co. of America	1983	Yes	Life	100% (Care Fund)

Illinois (Mike Rauwolf, State Contact Person)

Receivership Estates Closed	Year Action Commenced	Licensed	Category	Dividend Percent	
Health Plan of Central Illinois, In Liquidation	1991	Yes	HMO	Class A: 100%	$670,469.00
				Class C: 100%	$455.00
				Class D1: 69.84%	$2,329,354.00
United Diversified Corp. In Liquidation	1987	No	A & H	ClassF: 20.99%	$68,078.77

Use and distributions made to policy/contract creditors and Early Access

Receivership	Amount
Amreco	$880,201.00
Centaur	26,049.00
Coronet	71,506.78
Inland American	251,427.24
Inter-American	124,433.00
Millers	23,636.00
Pine Top	100,331.00
Plus six (6) additional estates where disbursements for each estate were below $10,000	1,799.00
Total	**$1,479,383.02**
* Correction to last report	
Reserve	$9,342,128.00
Resure	$180.00

Kansas (Daniel L. Watkins, State Contact Person)

Receivership Estates Closed	Year Action Commenced	Licensed	Category	Dividend Percent
Farm and Ranch Life Ins. Co.	1987	Yes	Life	53.50% (FINAL)

Use and distributions made to policy/contract creditors and Early Access

(Continued on Page 16)

Melissa Kooistra Eaves (CA) advises that California Insurance Commissioner Chuck Quackenbush announced a $205 million distribution to the policyholders and claimants of Mission Insurance Co., Mission National Insurance Co. and Enterprise Insurance, collectively known as the "Mission Trusts". On February 24, 1987, the California Insurance Commissioner was appointed liquidator of the Mission Trusts by order of the California Superior Court, County of Los Angeles (Receivership Court). During the course of the liquidation proceedings, the Department sought collection of the assets of the Mission Trusts. So far, on behalf of the Mission Trusts the Department has recovered over $1 billion. As a result, the Commissioner has made three early access distributions to the California Insurance Guaranty Association and entities performing a similar function in other states (collectively, the IGAs) who, to date, have received approximately $342 million from the Mission Trusts' estates.

In early 1998, William W. Palmer was appointed Chief Executive Officer and Special Deputy Insurance Commissioner of the Conservation & Liquidation Office of the California Insurance Commissioner. Mr. Palmer has overseen the distribution of $347 million during the first three quarters of the year, with an additional $45 million projected for distribution in the fourth quarter. By year-end, California Insurance Commissioner Chuck Quackenbush will have distributed over $394 million to claimants within a one year period.

Mike Rauwolf (IL) reports that the Illinois receiver continues to manage the reinsurance run-off for **American Mutual Reinsurance Company (AMRECO)**, in rehabilitation. Reinsurance payments to date total $119,755,040.00, Loss and LAE $30,449.00 and LOC drawdown disbursements of $9,613,386.00. Additionally, Illinois continues to manage the run-off of **Centaur Insurance Company**, in rehabilitation.

Total claims paid inception to date are $50,552,013.00 for Loss and LAE, $4,945,493.00 in Reinsurance payments and $13,876,555.00 in LOC drawdown disbursements.

James A. Gordon (MD) provides further information on civil litigation and criminal prosecutions. Collections during the second quarter of 1998 for **Trans-Pacific Insurance Company, et al.,** against former employees and rental income totaled $405.00 plus interest of $630. Further, the receivership of **Land Title Research of Maryland, Inc.** was closed by court order in April, 1998. Collections included $899.83 plus interest of $330.87. Finally, collections during the second quarter of 1998 for **Grangers Mutual Insurance Company** totaled $252,388.51.

Bill Taylor (PA) continues to provide information on the ongoing rehabilitation of **Fidelity Mutual Life Insurance Company (FML) in rehabilitation.** Policyholder death benefits and annuity payments continue to be paid at 100%. Creditor above policy guarantees. As of June 30, 1998, **FML** showed a statutory surplus in excess of $85,000,000. In March, the Rehabilitator filed a petition to settle certain unsecured creditor claims offering immediate payment of principle only for all allowed creditor claims if the creditor is willing to waive any applicable interest and penalty. Two objections were filed to the petition and responses have been filed to the objections, but no hearing has been scheduled. Eight other petitions are also pending before the Court, including a petition requesting authority for coordinated settlement of premium taxes and guaranty assessments. On June 30, the Rehabilitator filed a Third Amended Plan for Rehabilitation, proposed bid procedures for selection of an investor and a petition for approval of a new dividend scale, all of which had been negotiated over the last two years with the court appointed Policyholders Committee. The court approved the notice package over the objections filed by the Policyholders Committee and notice packages were mailed out in August. The court set a deadline of October 23 for objecting to any of the Third Amended Plan, Bid Procedures Petition or Dividend Petition.

For **Bermuda, John Milligan-Whyte** reports that on October 9, 1998, **Belvedere Insurance Company** Ltd. was wound up by order of the Supreme Court of Bermuda and Malcolm Butterfield and Anthony McMahon of KPMG Peat Marwick were appointed as Joint Provisional Liquidators. The First Meetings of Creditors and Contributories are scheduled to take place in Bermuda on December 18, 1998. The US Bankruptcy court granted **Belvedere's** provisional liquidators a preliminary injunction under section 304 of the US Bankruptcy Code on November, 1998.

On April 22, 1998, the Supreme Court of Bermuda wound up **B.N.I.B. Insurance Company Ltd.,** and continued the earlier appointment of Richard Patching and Paul Evans of PricewaterhouseCoopers as Joint Provisional Liquidators. The First Meetings of Creditors and Contributories were held in Bermuda on June 17, 1998.

IAIR's 1999 Educational Events

NAIC/IAIR
Insolvency Workshop
February 3-4, 1999
West Palm Beach, Florida

IAIR
Staff Training
Seminar
May 1999 *(tentative)*

IAIR/NOHLGA
Joint Seminar
November 1999

IAIR/ABA
Fourth National Institute
on Insurer Insolvency
December 3-4, 1999

Receivers' Achievement Report *(Continued from Page 14)*

Kansas (Daniel L. Watkins, State Contact Person)

Receivership	Amount	
Farm and Ranch Life Ins. Co.	$3,843,774.00	Class 1 & 3 G.F. & ANC.
	469,022.00	PH
National Colonial Ins. Co.	12,514,787.00	Class 1 & 3 G.F. & ANC.
Total	**$16,827,583.00**	

Maryland (James A. Gordon, State Contact Person)

Use and distributions made to policy/contract creditors and Early Access

Receivership	Amount	
Land Title Reserarch of Maryland, Inc.	$35,376.49	
Grangers Mutual Ins. Co.	27,494.67	MD
	2,682.50	DC
	1,863.00	GA
	25,362.37	NC
	699.95	TN
Total	**$93,478.98**	

Pennslyvania (William S. Taylor, State Contact Person)

Use and distributions made to policy/contract creditors and Early Access

Receivership	Amount	
American Integrity	$93,200.00	(52)
Corporate Life	15,000,000.00	(5)
Quaker City	29,543.77	(NJ)
World Life	2,000,000.00	(PA)
Total	**$17,122,743.77**	

WINDING-UP PROCEDURES IN BERMUDA (OR) COLLECTING FROM ALIEN REINSURERS IN THE BERMUDA TRIANGLE

(Continued from Page 11)

presented by the creditor of an insurance company will be granted is where the company is unable to pay its debts within Section 161(e) of the Companies Act. Under Section 162 of the Companies Act 1981, a company will be deemed to be insolvent if:

- a debt is unpaid three weeks after a statutory demand is served on it (assuming, of course, the debt is not a disputed one);
- a judgment is unsatisfied after execution has been levied; or
- the company is proved to be unable to pay its debts (i.e. proved to be commercially insolvent).

A creditor should have no great difficulty in obtaining a winding-up order based on a statutory demand or judgment; the proof of commercial insolvency will be more challenging and costly.

Commercial Insolvency

An insurance company debtor may be wound up where the petitioning creditor can establish that the company is commercially insolvent in the sense that it is unable to pay its debts as they fall due. This basis for a winding-up petition is not free from difficulty; however, it may be an effective means of debt collection where the existence of a debt (in a liquidated amount) is clear and the debtor company is plainly insolvent. However, it is necessary to read Section 162(c) of The Companies Act with the solvency requirements of the Insurance Act 1978 and related regulations which impose more stringent solvency standards on insurers than general trading companies.

Although only a *bona fide* dispute on substantial grounds as to the existence of liability (as opposed to quantum) can justify striking out a petition based on commercial insolvency (as opposed to statutory demand) the Bermuda Courts are only likely to accede to a winding-up petition in very clear cases (See, for instance *Mutual Fire, Marine and Inland Insurance Company v. Focus Insurance Company Ltd.* 1990) [6] where both significant indebtedness in a liquidated amount and insolvency were admitted. In contrast the decision in *Mutual Fire v. Chesapeake* in 1991 held that the petitioning creditor reinsured's refusal of the respondent reinsurer's inspection request constituted substantial grounds for disputing the debt. More recently in 1997 the Court of Appeal for Bermuda has confirmed that the existence of cross-claims asserted by the debtor does not impede a petitioning creditor who is clearly owed something from seeking to wind the debtor indebted company up. [7]

Commercial insolvency may often be difficult to establish and is generally the least effective collection mechanism of the three statutory bases for a winding-up petition. The exception to this is in cases where a winding-up order is desired (as opposed to payment) to prevent the dissipation of assets to the detriment of the general body of creditors of the debtor company.

D. CONCLUSION

The selection of the most appropriate mechanism for recovering the liquidated sum will depend on a variety of factors, such as the size and nature of the claim and the commercial relationship between the parties. In each case the success of the recovery exercise will probably in large measure depend on the ability of the creditor company to document clearly that an undisputed liquidated sum is due.

In cases where collection difficulties are anticipated, creditors would be well advised to try to obtain admissions of specific, quantified liabilities in open correspondence and/or to conclude commutation agreements in respect of specific amounts.

Where collections are made by means of any of the mechanisms discussed above from companies which are subsequently held to have been insolvent, the Bermudian law of fraudulent preferences will not normally be problematic for the recipients of payments made as a result of commercial and/or legal pressure to pay.

So while it may be mistakenly assumed that reinsurance recoveries are hard to make in offshore domiciles, winding-up procedures under Bermuda law are usually a highly effective collection device, even when pursuing alien reinsurers in the Bermuda Triangle.

Footnotes:

1 **The Tempest**, Act I Scene II

2 "Introduction to Bermuda Insurance an Reinsurance Insolvency Law and Practice" (American Bar Association: 1988) 5-6.

3 "Latest Captive Court Score: Tax payers 2, IRS,O:" National Underwriter Property & Casualty / Risk Benefits Management Edition, March 16, 1998 p. 3.

4 Civil Appeal 1991: No7. The appeal was heard jointly with *Mutual Indemnity Insurance Co. -v- Aneco Reinsurance Underwriting*, Civil Appeal 1991: No. 18.

5 Supreme Court of Bermuda, Civil Jurisdiction 1991: No. 179, decision of July 4, 1991.

6 Supreme Court of Bermuda, Civil Jurisdiction 1990: Nos. 369 and 370, Sir James Astwood, C.J., decision of December 18, 1990.

7 *Glencore Grain Ltd. -v- Agros Co. Ltd.*; Civil Appeal No. 16 of 1996, decision of June 25, 1997 (affirming Narinder Hargun, J. (Acting) at first instance), a non-insurance case.

UK Insurance Insolvency and the FSA

*By Vivien Tyrell **

There are reforms on foot in the United Kingdom in the field of financial services which will have a significant effect on insurance insolvency in the London Market.

The Financial Services and Markets Bill which was issued on July 31, 1998 promised to be essential holiday reading for all those working in the City of London. The Bill hands control of the regulation of all matters in the financial services industry to, what will become, the giant Financial Services Authority (the FSA).

Having already assumed the regulation of banks, it will take up its role as sole regulator most probably in the year 2000. Already some 1500 employees have been absorbed by the FSA. Until it takes total control, the existing regulatory authorities continue to perform their role of supervising and disciplining members of the industry.

The regulator of insurance and reinsurance companies will remain the Insurance Directorate of Her Majesty's Treasury but under the aegis of the FSA.

A review of the Bill suggests that a powerful combination of watchfulness and flexibility will be achieved with the regulator being given extensive powers to implement binding rules applying to those which it authorises, supervises and disciplines.

The London Market continues to be in a state of change. The ability to implement rules easily should result in a system which is quick to respond to the needs created by this change.

It is true to say, however, that whilst reforms which have been heralded in insurance insolvency since the end of 1994 are now certain to come about, it is disappointing to find that the nature of those reforms are merely hinted at in the Bill and will be subject to further consultation. It is probably useful to look back a few years to the origins of the intended reforms and explain, particularly for the purposes of United States readers, the need for change.

The fall of LUI and the KWELM companies in the early 1990s started a landslide of insolvencies in the London Market during this decade. The need to reorganise and achieve the best return for creditors of these insolvent companies was fulfilled by stretching UK insolvency procedures to their limit.

The result has been an effective channelling of the insolvents' assets to creditors on a timely basis, but the shortcomings of the current procedures were brought out into the limelight and the need for improvement became apparent.

In December, 1994 the Department of Trade and Industry, the then regulator, issued its first consultative document on the insolvency of non-life insurance companies. The problems that were highlighted arose out of the fact that if an insurance company is insolvent, liquidation might be the obvious formal insolvency regime which, once in place, relieves the directors of any personal responsibility; allows clawback of assets transferred at an undervalue and preferences; and provides a strict set of rules for the payment of creditors *pari passu* (i.e. on an equal footing).

However, a regime favouring the treatment of the insolvent company as if it were continuing to trade in run-off was the preferred option in KWELM and subsequent insurance failures. This allows the insolvents to continue to participate in the market by dealing with its inwards claims as they fell due and recovering from its reinsurers on the strength of those claims. The strict rules which apply when a company goes into liquidation, however, prevented such regimes being implemented.

The fact that liquidators have to maintain the company's assets in the compulsory Insolvency Services Account (ISA) (with its limited range of investment and high fees on transactions) was an overriding disadvantage of the liquidation procedure. In the case of KWELM an estimated £250,000,000 was saved on ISA costs by keeping the insolvent companies out of liquidation.

A liquidator has only very limited powers to continue trading, his obligations being to identify creditors and estimate their contingent claims with a view to paying claims via a limited number of dividends. If the solution is a continued run-off, it can be seen that liquidation is inappropriate.

The cost and time involved in preparing schemes of arrangement have been major reasons why reform has been considered.

Further, from a fiscal point of view, trading losses are not always capable of being carried forward to subsequent financial years to reduce the insolvent's tax bill as liquidation might be considered to be a cessation of trading and also, when liquidation is imposed, foreign currency claims have to be converted at the liquidation date. All of these aspects militate against continued run-off of the insolvent estate.

Many will be aware that to avoid the above problems most of the insolvent insurance companies in the London Market were not placed into liquidation. Instead an automatic stay on proceedings and protection of the company's assets is achieved by the appointment of provisional liquidators under Section 135 of the Insolvency Act 1986 (Section 135) with winding-up proceedings being adjourned for however long it is required to have this automatic stay period (or moratorium).

Moratoriums in insolvency since 1986 in the UK have been achieved through the procedure of "administration" which has been compared to Chapter 11 of the United States Bankruptcy Code.

However, under Section 8(4)(a) of the Insolvency Act 1986 administration is expressly excluded in the case of insurance companies authorised

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by the Insurance Companies Act 1982. Instead reliance has had to be put on Section 135.

The original purpose of Section 135, however, was to provide protection for a limited period, being intended to bridge the gap between the presentation of a winding-up petition and the making of a full winding-up order placing the company into liquidation. It was originally intended to be similar to a interim injunction preserving the assets of the company in an emergency.

The effect of the appointment of provisional liquidators is as close as can be achieved to the procedure of administration. During the moratorium stage schemes of arrangement under Section 425 of the Companies Act 1985 (Section 425) have invariably been implemented creating a tailor made regime for the fair distribution of the company's assets to its creditors and avoiding the problems of liquidation proper.

The cost and time involved in preparing schemes of arrangement have been major reasons why reform has been considered. The current desire is to streamline the procedures, it is to be hoped, taking the best characteristics of liquidation, the automatic stay and Section 425 and producing a complete solution for the treatment of insolvent insurance companies.

It is now possible that such reform will take place in the next parliamentary session and the wider reform of the regulation of all financial services throughout the City of London has presented an opportunity for this to take place.

Various improvements to the current situation suggested in the December 1994 Consultation Document encompassed the following:

- A new liquidation procedure specifically for insurance companies deploying rules similar to those found in run-off schemes of arrangement. This was thought unworkable because of the amount of re-drafting which would have to be done of the Insolvency Act and Rules.

- Administration would be made available to insurance companies. A scheme of arrangement would still need to be implemented as a method of distributing assets to creditors.

- Reform of Section 425 to include a moratorium period, powers to the scheme promoter and superviser to clawback assets transferred at an undervalue or pursuant to a preference and to pursue directors in wrongful trading and ensuring that the procedures for approving the scheme amongst creditors were simplified (e.g. the need to have separate meetings for separate classes of creditor would be abolished).

So what has the Financial Services and Markets Bill proposed in the case of insolvent insurance companies? As Howard Davies, who heads the FSA has observed [1] the Bill "is deliberately a framework bill giving considerable discretion to the FSA to set principles, make rules and issue guidance".

It is unsurprising, therefore, that the draft bill itself contains no reference to the rules applying. A hint of what is contemplated is found in Chapter 17 of the accompanying Overview Document and, in particular, four and a half lines of print at Section 17.6.

This states that Her Majesty's Treasury will be given power to remove the current prohibition against insurance companies going into administration and to establish a procedure for making administration orders in respect of such companies.

There is reference to this being subject to separate consultation in due course. It is expected, therefore, that we will see an end to provisional liquidators being appointed over insolvent insurance companies. Instead, they are likely to be administrators. However, being an administrator in the currently accepted sense of the word is only one step on the road to be taken to effect a fair distribution of the company's assets.

The question remains as to whether schemes of arrangement under Section 425 will still be widely used.

The sanctioning of a Section 425 Scheme is one of the four purposes identified in the current legislation for which administration orders of non-insurance companies are presently made. It would seem that there is a continued need for such schemes.

Whilst there are justifiable criticisms about the costs and technical procedures involved, it is nonetheless clear that as schemes have developed over the years a common understanding of their purposes and terminology has developed amongst scheme draftsmen and promoters.

The learning curve is now almost flat so that excessive costs ought no longer to be one of the characteristics of a scheme.

It will be interesting to see the contents of the further consultation document which the Treasury is to issue as well as the industry's responses. Insolvency practitioners in the UK will not have forgotten that administration itself (as it currently applies to non-insurance companies) has not proved to be the panacea originally expected.

It too has had criticisms of undue cost and difficulty levelled at it. Indeed it too has been subject to consultation and anticipated reform. The Insolvency Service of the Department of Trade and Industry identified the need for a simpler procedure in certain cases in its consultative document of April 1995.

The debate continues. It seems clear that if administration is introduced to insurance companies, it must closely reflect and appropriate for itself the best characteristics of the proposed reform of the existing administration procedure.

If improvements to the current insurance insolvency procedures are implemented by the Treasury in a fair and speedy manner, this will demonstrate that the all embracing FSA can acquit itself as an effective regulator.

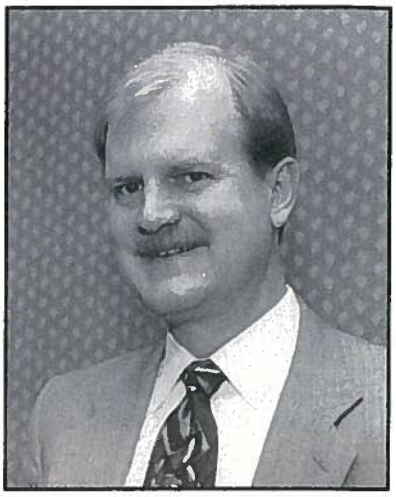
The alternative description of it potentially being a "rule bound monster, a new Securities and Exchange Commission - the US regulator that many European financiers view as the embodiment of bureaucratic meddling and legalistic inflexibility"[2] might then seem to be unfounded.

Footnotes:

1 *Fianancial Times*, August 19, 1998

2 George Graham, *Financial Times*, August 3, 1998

Immediate Past President's Message *(Continued from Page 2)*



Douglas Hartz

It is my honor to inform all of you that the distinguished gentleman from Nebraska, Robert Craig, is your new President, that the distinguished gentlewoman from Indiana, Elizabeth Lovette, continues as your First Vice President, that Jim Stinson is now Second Vice President, that Dale Stephenson is now Treasurer and that Jim Gordon continues as Secretary for IAIR.

This is an excellent group that will assure that IAIR continues to move in a positive direction. From my vantage point the future of IAIR looks very promising.

I can not thank everyone enough for their support of IAIR and their involvement over the last year.

In regard to one particular matter, I am also pleased to inform you that the IAIR Board passed a resolution in support of the Uniform Receivership Law on the basis of its probability to increase the uniformity of receivership laws amongst the states and that such resolution was read into the record at the National Conference of Insurance Legislatures (NCOIL) meeting in San Diego in November.

May Your New Year Be All That You Wish!