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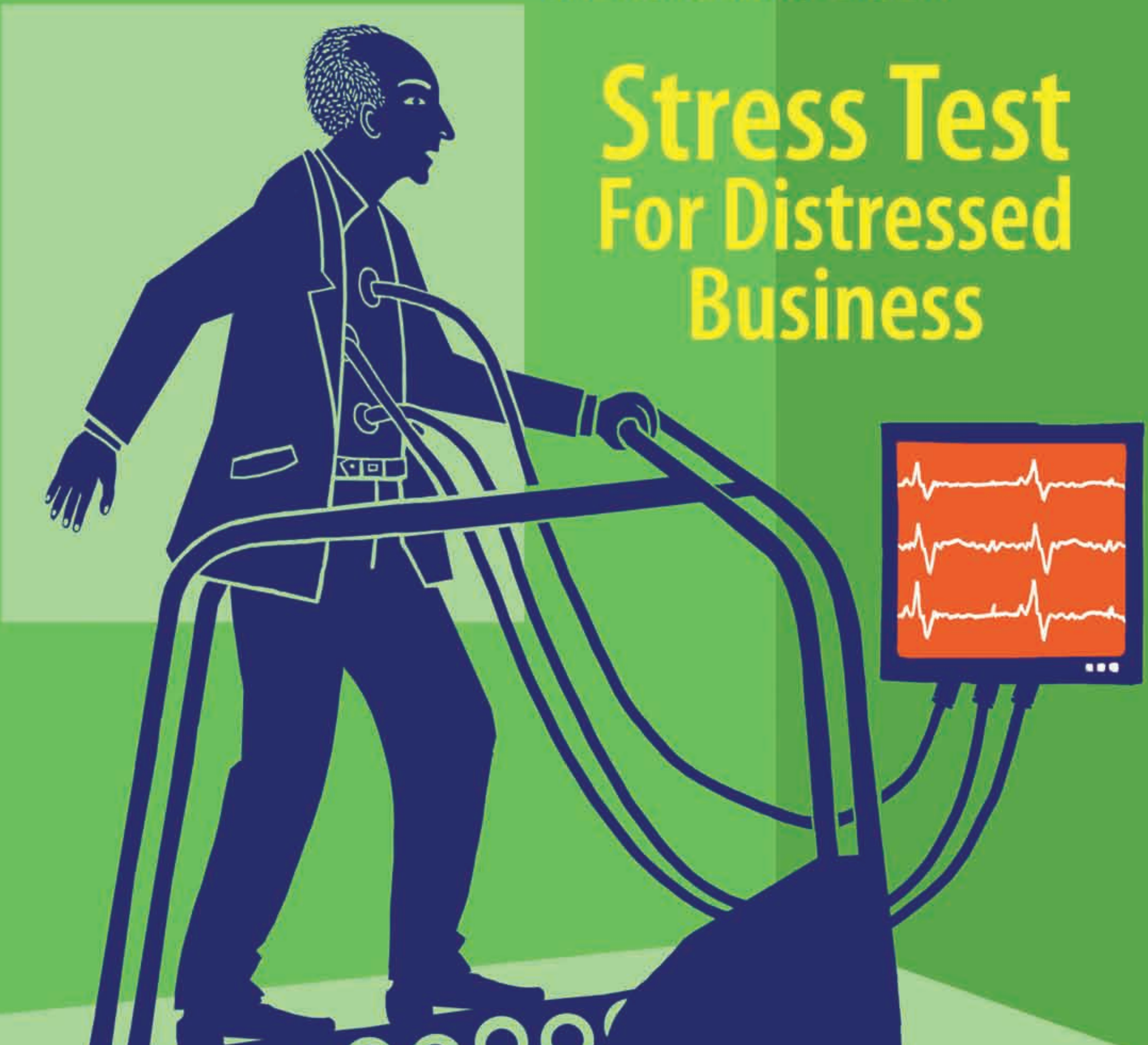
AIRROC matters

LEVERAGING LEGACY LIABILITY



Stress Test For Distressed Business

CHECK VITALS STAT! • BANNISTER'S BYGONE BOUNTY • BREAKING BELLEFONTE
CHUCK'S SHAKESPEAREAN CHORTLE • SPREAD LIGHT ON LITTEL • EDUCATIONATION

Stressful Times

Peter A. Scarpato

Concepts of risk and stress go hand in hand. Assume risk, and you're under stress. Assume too much risk and … well, you know what happens. Like preventative medicine, the key is monitoring "vitals," diagnosing the source of stress and prescribing the proper remedy. The same applies in legacy and run off business, where the risk/stress ratio often skews beyond the tolerance of reserve strength and management resolve. Here, in this taut, exciting space, we thrive, teetering on the edge of the actuarial abyss. Don't look down!

Our featured Think Tank article, *RX for Run Off – Four Experts Expound*, taps into the identity and import of a run off company's vitals. There, Andrew Rothseid, Martin Mankabady, Brian Johnston and Gerry Glombicki explore everything from factors prospective purchasers should consider, to differences in the U.S. and UK perspectives on the role of run off manager, to the key question whether agencies like Fitch should rate run off companies. Their lively, symbiotic discussions probe deep, offering valuable information for seller and purchaser alike. Kudos to our own Connie O'Mara and Fred Pomerantz for their report.

Next on the hit parade is *Bygone Companies,* Julius Bannister's semi-autobiographic introduction into his world of mining data on "our members" and reporting on legacy and run off commutations. With his usual flair, Julius gives us a peek into what drove him to thrive in this milieu of readily available, insightful financial information.

Jumping to the legal venue, Harry Cohen and Mike Robles bring us up to date on recent legal developments which are *Assaulting the Bellefonte Citadel.* Known by many in reinsurance, the 1990 *Bellefonte Reinsurance Co. v. Aetna* decision capped a reinsurer's liability at the dollar amount stated in the "Reinsurance Accepted" provision of the applicable facultative certificate. Harry and Mike report on two recent, noteworthy cases that have "bucked the trend" in prior, decade's long support for the *Bellefonte* ruling, the courts focusing more on the specific language and structure of each *fac cert* before following *Bellefonte* as a matter of law. As the subtitle indicates, "Reinsurers Win… Not So Fast."

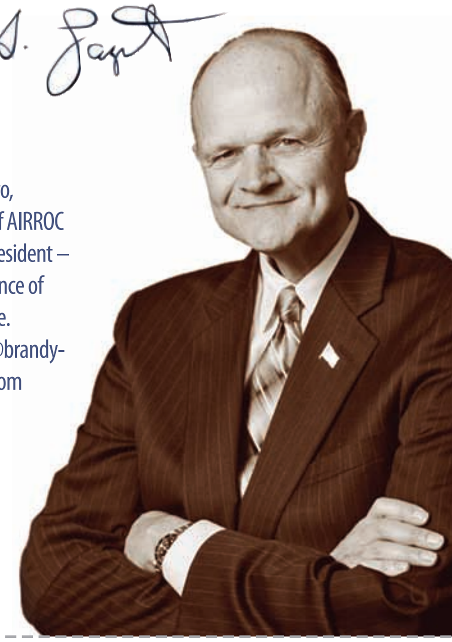
And remembering always that comedy lurks everywhere, even in our business, Charles Ehrlich serves up *Why Are We Here?,* a raucous romp through tales that touch a familiar nerve. Chuck weaves story after funny story, each with a laugh and a message – that ultimately doing something right is hard but preferred, and that run off managers will always be in demand since "you can't put an insurance company down like you can a horse."

We continue our run of notable Spotlight friends with *Bill Littel, Allstate's All Round Achiever.* Ever the world traveler and a respected AIRROC Board member, Bill gives us a glimpse into the many facets of his work and non-work life, and suggestions to strengthen our organization.

Our Executive Director Carolyn Fahey provides the latest and greatest on AIRROC's success in *Flying from Virginia and Back with AIRROC…*including progress on our soon-to-be-rolled out Certified Legacy Insurance Professional designation. We summarize presentations at our most recent education event, outline the success of our Princeton seminar on Utmost Good Faith and close with the ever-present Present Value news, events and comings and goings of people in the biz.

Let us hear from you!

Peter Scarpato



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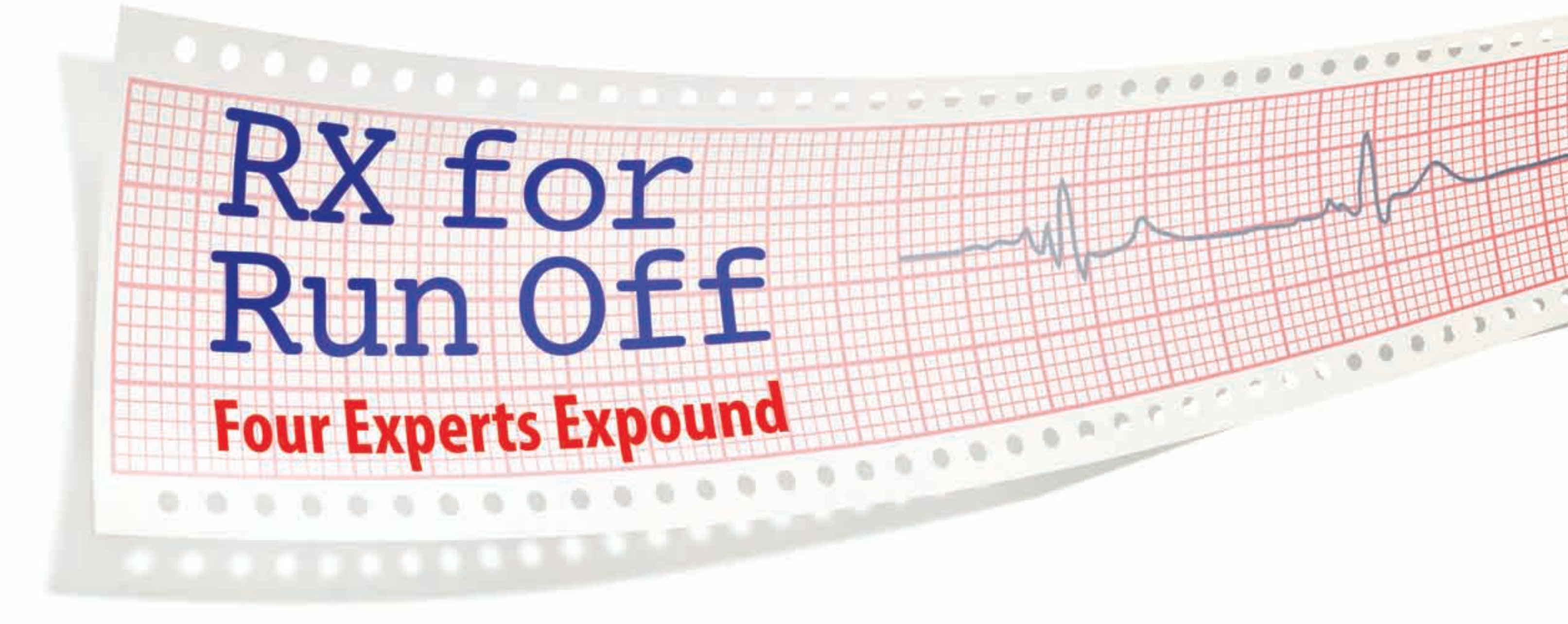


RX for Run Off

Four Experts Expound

Fred Pomerantz, Goldberg Segalla, and Connie O'Mara, O'Mara Consulting, had an opportunity to pose questions on the topic of rating run-off reinsurers to key players in the business: Gerry Glombicki, a Director of Fitch Rating Agency; Brian Johnston, a Senior Vice President and Chief Operating Officer of SOBC Corporation; Andrew Rothseid, President and CEO of RunOff Re.Solve LLC; and Martin Mankabady, a Partner of Clyde & Co in the UK.

Fred Pomerantz: *How do Runoff's managers and potential purchasers value a Runoff book of business?*

Brian Johnston: I would say that, depending on the line of business and the risk profile that is inherent in the Runoff book that you are trying to value, the key is the ultimate claim reserves. So the key document to review is the actuarial report and to understand what the actuary's estimates ultimately are going to be.

You can audit the case reserves in the due diligence, but the negotiation on the price is going to be on the actuarial report.

Second, part of the valuation will be on the unadjusted loss expenses on an annual basis, which is known as the runoff provision in the UK. You need to estimate how long the potential purchaser thinks it will take to run off that book of business. Then apply a net present value to the estimate that will be in addition to the value of the claims.

Andrew Rothseid: I think Brian is correct, that as a general matter the expense associated with running off the book of business together with the projected reserves and projected liabilities of the business are two significant factors.

There are other factors as well that I think mesh with those that are important for runoff acquirers. What is the nature of the underlying liabilities? And how will the runoff acquirer be able to terminate its exposure to those underlying liabilities while honoring the policyholder obligations, maintaining solvency, and determining whether there's an exit strategy alternative available to it?

How does the book of business align with the runoff acquirer's existing portfolio of business? Is there a synergy that allows for savings on the ULAE expense?

What jurisdictions does the company operate in and how does that affect the assets side of the balance sheet as it relates to certain lines of business? For instance, Workers' Compensation liabilities and Workers' Compensation trust funds that have to be funded in various jurisdictions.

What type of reinsurance goes along with the portfolio once it's acquired? And how does that reinsurance affect the operation of the business and the profitability that the acquirer may see or expect to see over a period of time? What jurisdictions does it operate in and what regulatory issues may arise as a result of those issues?

And finally, is this the book to be acquired in an area that has significant exposure to reserve development; or is it an example of the types of exposures we've seen in recent years acquired by runoff consolidators where the underlying platform is insufficient to sustain ongoing underwriting, but doesn't have the significant legacy drive of liabilities such as you would see in traditional asbestos pollution and health hazard risks? And, therefore, is there an asset-rich balance sheet that is available to be acquired simply because the business can no longer survive with an underwriting platform?

Connie O'Mara: *This question is directed principally at Gerry Glombicki. Gerry, it's our understanding that Fitch rates insurance companies in runoff. Could you tell us about that and what data they use to do a rating?*

Gerry Glombicki: Typically this includes GAAP or international accounting statements, actuarial reserve reports, earnings call transcripts and any internal reports the company generates. Rating committees are required to verify that the data was sufficient and robust, relative to the rating decision. To the extent that the committee feels that the information was not sufficient or robust, no rating action will be taken or maintained.

Pomerantz: *How do any of these interested parties assure themselves of the accuracy of the insurer's financials?*

Johnston: It is a case of getting a hold of the independent actuarial report. The potential purchaser may want to have its own actuary look at the financials as well, and depending on the jurisdiction that you may be moving the portfolio into, if you are going the portfolio transfer route, that state's insurance department may also require an independent actuarial review.

Also, the other reports to review are the external CPA audit report and any available triennial state exam reports and any other regulatory filings. These financial reports all help to provide a picture of the overall management of that portfolio and would be able to provide comfort as to the accuracy of the financials.

Martin Mankabady: Clearly leaving aside the due diligence that can be done to verify an insurer's financials, if there is a transaction such as an acquisition taking place, then the buyer of the portfolio in question would also seek additional comfort as to the financials by way of warranties and indemnities.

Glombicki: Financial statements are never "accurate." Rather, auditors review them to ensure that they fairly represent the company's financial situation as of the time of the audit. Fitch does not audit companies. It is important to deal with high quality/reputable firms that have market acceptance. Again, this minimizes risk but does not eliminate it.

O'Mara: *In conjunction with that, could you talk about how the runoff claims are evaluated?*

Johnston: This would take place in the due diligence carried out, as Martin referred to. There is a high value placed on any due diligence – you are going to be reviewing the key policy files and the key claims that are driving the reserves in the financial reports.

So you are carrying this out from the ground up; actually reviewing the files to establish the way the payout patterns have been set in the past; the way the company has been managing the claims; looking at the specifics of how many have been closed in a year; and how many new claims have been opened or reopened.

In addition, you are also looking at how many claims are in arbitration, dispute or litigation. How aggressive has the insurance company been in that regard? Is there a pattern of disputes, how many have increased in the past few years and what is the result of those claims that have been placed in arbitration or litigation?

More often than not, you will see regulators take more of a deep dive into solvent, yet troubled, companies to understand their balance sheets.

— Andrew Rothseid

Another key element is the reinsurance recoverable – a key component in the balance sheet. You need to get comfortable with and understand the reinsurance wordings: what does that reinsurance offer you, as the potential purchaser? Knowing that if the company is going into runoff, it could change the assuming reinsurers' view on the way they are paying out because they've no longer got an ongoing relationship with that client. It really is critical to evaluate the solvency of the reinsurers of the target portfolio as well to make sure they are able to pay in the future.

Pomerantz: *How does the method of evaluating runoff claims that has been discussed jive with the capital standards used by a regulator to evaluate the solvency of an insurer?*

Rothseid: I think that regulators really look at a runoff portfolio from a number of different perspectives. There's clearly the pure regulatory perspective, which is based upon risk-based capital. And all those regulations are set forth in most jurisdictions. They really don't always tell the tale of the viability of the business and its ability to survive adverse loss development.

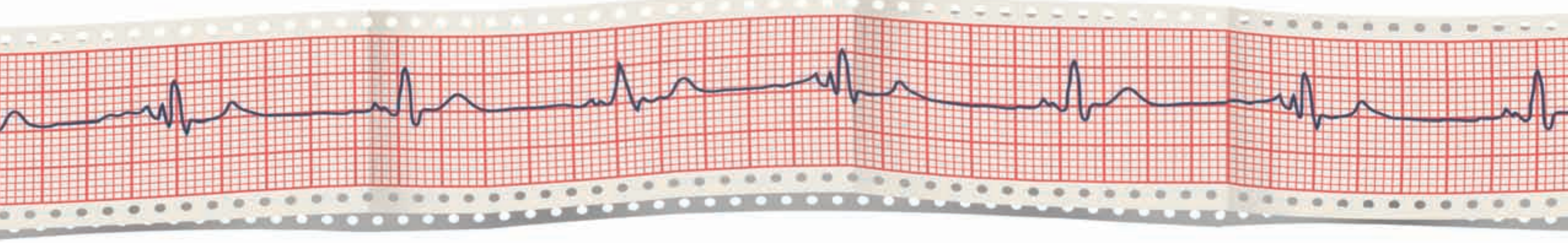
More often than not, you will see regulators take more of a deep dive into solvent, yet troubled, companies to understand their balance sheets. They may meet with management to understand what their runoff plan is and to understand what financial model, if any, exists in order to access the likelihood that this company may become impaired in the near future and what assistance the regulator can provide in terms of permitted practices to allow the company to meet its obligations to its policyholders.

Johnston: The regulators are constantly looking at the capital standards in the U.S. and overseas with the advent of Solvency II and the implications for the U.S. market, if any. I think they have done a great job looking at troubled companies or companies that are putting portfolios into runoff because there have been so few liquidations recently.

They are doing a far better job after the implementation of the risk-based capital requirements and the fact that the states are reviewing companies' balance sheets before they go into a troubled situation.

Mankabady: Just to add, clearly around the world the different regulators may have different emphases in terms of their key objectives. It is probably fair to say that no regulator is responsible for a zero failure regime, so there is also the possibility of insolvencies on their watch.

Where you have risk-based regimes, as mentioned, clearly two very important risks in the case of runoff companies are reserves and default risks and what



RX for Run-off (Continued)

we're seeing this side of the Atlantic, over here in Europe, is a lot of focus around reinsurance arrangements and making sure there's sufficient security to meet reinsurance obligations.

O'Mara: *As a significant component in evaluating a book of business, I think that the parties make some assumptions about how long it will take to run off the claims against the insurer.*

And I'm wondering if one of you can talk about what general considerations go into determining how long that tail is.

Rothseid: The most significant indicator of the length of the tail exposure relates to the nature of the underlying liabilities. Obviously, where you have short-tail exposures, that should be resolved in a relatively quick period of time.

Quick is a relative term, especially as it relates to Workers' Compensation liabilities, which have quite an extended tail exposure. So you need to understand the nature of the underlying obligations that were written by the company in runoff and then look to the actuarial estimates to determine where the opportunities exist for accelerating those exposures.

Workers' Compensation exposures are difficult, if not impossible, to accelerate to closure because there's no incentive on the part of the underlying claimant to compromise that claim.

Where you have assumed reinsurance exposures, however, even for asbestos pollution and assumed reinsurance liabilities related to workers' compensation risks, then you have an opportunity to accelerate the closure of the business and depending upon where that insurer and runoff is domiciled and whether it's in the UK, Bermuda, or some other commonwealth law-governed country.

In the state of Rhode Island, you have the opportunity to accelerate that closure through a fairly transparent process known in the UK, obviously, as the scheme – solvent scheme of arrangement – and in Rhode Island as a commutation plan.

Johnston: Although to add there – and I agree with everything that Andrew said – looking at the book of business, you look at the counterparties as well, where the business is coming from. This is an assumed reinsurance book of business. Who's ceding and who's the retro-reinsurer on the other side?

> *I think in some jurisdictions, there's perhaps been a more passive approach to runoffs for various reasons: cultural, local regulatory reasons, tax reasons.*
> *– Martin Mankabady*

And thinking about their appetite for the commutation or their book of business and policy buyout and where you could actually close down and get the early closure with the agreement of all parties, then you could actually cut off the tail and think about then taking it into, again, something that Andrew mentioned, with the schemes of arrangement, if it's U.S. risks, going into Bermuda or the UK.

Mankabady: I agree with what's been said in terms of looking at counterparties and the nature of underlying business. I think in some jurisdictions, there's perhaps been a more passive approach to runoffs for various reasons: cultural, local regulatory reasons, tax reasons. But you may see, partly driven by Solvency II over here in Europe, a more active approach to runoff management. And that wouldn't necessarily mean seeking finality, but it may mean seeking different exits.

Pomerantz: *Does the rating have much value to a prospective purchaser deciding whether and how much to pay for the runoff book of liabilities?*

Johnston: I think it has some value when looking at the potential price of the entity or the runoff portfolio. It's reflecting how well-capitalized that company is. So the stronger the rating the more likely you are in the ballpark area for the pricing. You are focusing on net asset value and so the price will be a multiple or a discount to the net asset value. The rating offers a guideline that puts you in a range for the purchase price. But although it is of some value, the main price driver is the valuation of the portfolio and the claims as we described earlier.

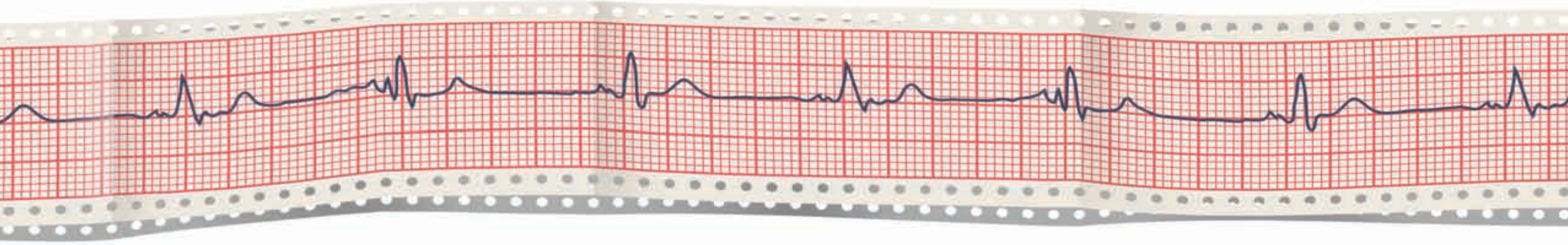
Glombicki: At Fitch, we don't necessarily comment on perceived values of ratings per se, but as credit analysts, capital is an important part of ratings and holding excess capital, which is usually good for the credit ratings, but may be counter-productive for a runoff company particularly in the area of commutations.

Then one of the important questions is: how did the runoff company get placed into runoff? And what I mean by that is there's two ways you can get there primarily. The first is you buy a book in runoff and you just run it off, which is nothing more than a time value of money equation.

The second is you're an ongoing entity operation and you've bought something or you've tried something and it didn't work out well and that underperforming segment is placed into runoff.

In those cases, usually the companies would like to get rid of the run-off operations as quickly as possible to reduce management distraction and focus on the ongoing operation, assuming that they can get a fair price for it.

If they can't get a fair price for it, they'll



likely keep the run-off operation. Typically companies want the primary/ongoing business to still be rated but request that the run-off ratings be withdrawn. However, Fitch, at the end of the day, decides what we rate – not companies.

So companies can request it but that doesn't mean that we honor their request.

Rothseid: I think, other than some rating which might indicate that the company is teetering on insolvency, I can't see a rating assigned to a business in runoff having much impact on a buyer.

A lot will depend obviously on the business and operating model of the acquirer. But more often than not, the purchaser will view the liabilities and exposures of the discontinued book of business and the relayed rating, which is assigned in business in runoff, only enhances that disparity of perspective on the value of the liabilities.

So, too much goes into the manner by which the business is going to be handled once it is acquired and a rating, especially a negative rating, can only enhance that disparity as well.

O'Mara: *Assuming that payout patterns change when an insurer goes into runoff, could the valuation of the ultimate liabilities then change also? And if so, in what way?*

Johnston: Yes, I think the ultimate liabilities could change. In managing the runoff, part of the strategy could be to commute with your key counterparties or look for policy buyouts. Being successful in these strategies will change the payout pattern. That may well affect the actuary's estimate of ultimate liabilities just because they have not been using the industry loss development factors or some other method to come up with the ultimate net loss. It is going to affect the ultimate valuation, depending on what you are doing to disrupt that payout pattern.

Glombicki: I agree. Basically when you look at value it's just a time value of money equation. So there's really two things that matter on the income side: premiums and investment income and on the liability side it's payments and timing of those payments. Anything that affects those four would ultimately change the value.

We also have the new LIMA legislation in Vermont. So we do have a few states reviewing legislation to offer exit strategies for the insurance companies.

– Brian Johnston

Rothseid: One of the issues that comes into play when you acquire a book of business in runoff and the payout pattern that may be extended as a result of that, is the asset side of the balance sheet.

As a consequence of an extended payout pattern by a runoff acquirer, the asset side, particularly the reinsurance recoverable asset, can deteriorate to such a point that the financial viability of the payout pattern is adversely affected by the financial solvency of the company due to deterioration of the reinsurance asset and that has to be taken into consideration.

O'Mara: *What exit strategies are there for an insurance company in runoffs?*

Mankabady: Depending where the insurance company is located and carried on business, there may be more or fewer exit strategies but the range will include, firstly, retention of the relevant book and runoff. The pros and cons with that are you don't get an absolute exit that way and you're retaining your exposure to advance loss development.

Secondly, outsourcing to a third party. You're freeing up management time but you're also giving up some control. There's reinsurance. Here, you may get some capital relief but you're exposed to the credit risk of the reinsurer.

The fourth exit strategy is a sale, an outright sale. You get finality this way, but it could be expensive. There could be some residual liability. Another exit strategy is a portfolio transfer. Again, there are pros and cons with this. It does achieve finality, but there may be question marks over the enforceability of this in certain jurisdictions.

Finally, there's the scheme of arrangement, which is available in certain jurisdictions. You do achieve finality, but there may be regulatory concerns around this including enforceability.

Johnston: In the US, we have the Rhode Island legislation. I believe they're coming out with some proposed legislation as well and Andrew maybe can add to this.

There is some proposed legislation about a voluntary restructuring of solvent insurers that looks to mirror the Part VII Transfers in the UK. So a grand novation, if you like, with the court's approval. We also have the new LIMA legislation in Vermont. So we do have a few states reviewing legislation to offer exit strategies for the insurance companies.

Rothseid: Certainly, as Brian has mentioned, Rhode Island has had a statute in place since 2002, effective in 2004, for the acceleration of commercial liabilities and the closure of those exposures through a commutation plan similar to the UK solvent scheme arrangement.

This process has been used once successfully on behalf of GTE Reinsurance Company. Through that process, all policyholder obligations submitted were resolved in full and the company was extinguished from prospective liability and

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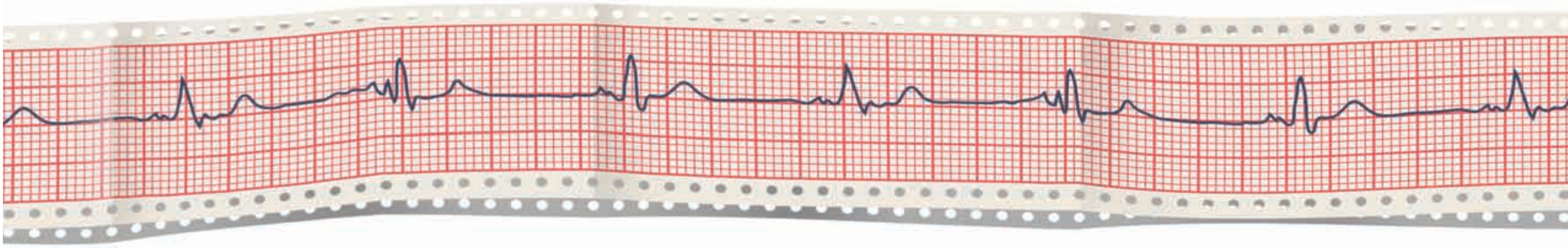


RX for Run-off (Continued)

prospective operating expense exposure.

In 2007, the Rhode Island statute was amended to allow companies that operated outside of Rhode Island, or even in Rhode Island that had eligible portfolios of business, portfolios of business eligible for closure under the Rhode Island commutation plan's statute to be transferred to a newly-capitalized or segregated cell entity in Rhode Island for purposes of closure.

Regulations have been proposed that would allow for that novation process and it is a multi-faceted proposal. The regulation requires that the transferring party receive the approval of its current domiciliary regulator and that the assuming party receive the approval of the Rhode Island regulators, before it submits its planned insurance business transfer plan to the Rhode Island Superior Court for approval.

Once approved, the portfolio of commercial liability business would be novated to the assuming party. This is a process which is somewhat distinct from the Part VII transfer in that it requires approval by the current domiciliary regulator as opposed to simply by the assuming regulator and is distinct also from Vermont's newly enacted Legacy Insurance Management Act, otherwise known as LIMA.

O'Mara: *Do you know when those proposed regulations in Rhode Island will come into effect?*

Rothseid: Hopefully soon. In January there was a public hearing. In February, additional comments were submitted and it is now up to DBR to determine the process forward, but I would expect that this matter will be resolved in the second quarter of this year.

Pomerantz: *Next question. Is the role of runoff manager viewed the same way in the U.S. and the UK? And I guess the second part of this is what challenges are causing business to dry up, particularly in the US?*

Rothseid: I don't know that there has ever been a robust market for runoff managers in the US, as compared to the UK. The U.S. marketplace has been less inclined to accept outsourcing solutions for its runoff liabilities whereas the UK market and European markets have been more inclined to do so as a general rule.

Moreover, as portfolios of business are being consolidated with runoff acquirers, the remaining portfolios in runoff are predominately those businesses that exist within large, active writing entities and often in the same legal underwriting entity within a large insurer as its active business. As a consequence, many large companies have established their own runoff units to handle those types of liabilities.

Johnston: I agree with Andrew on that. Certainly the role of runoff manager is much more accepted in the UK than it has been in the US. I think the actual role of runoff manager has changed as well from where it was historically to what it is today.

A runoff manager 10-15 years ago was really just that; taking an annual administration fee and not providing an exit solution. Then, due to competition in the market place, runoff managers started to change. They began to raise capital and started to take risk onto their balance sheet. This was the beginning of buying portfolios of claims and offering a closure route for insurance companies.

That transition took place in the UK, partly driven by the opportunity for scheme of arrangements and Part VII transfers, to allow the closure of books and companies.

Many of these companies found it very competitive in the UK and started to come onshore to the U.S. and target the U.S. market. So many U.S. runoff managers/buyers are originally UK- or Bermuda-based but are targeting the large market in the US.

The second part of the question are the challenges. The drying up – and I agree with Andrew, many of the large insurance companies are creating their own internal department for runoffs and segregating their runoff business into one area and professionally managing that down with their own staff.

There are a few U.S. companies, such as AIG, QBE and Munich Re, that have taken this strategic decision. It could be a pattern for the future in the US. This is a strategic direction which is different from the UK.

I think it was last week, that I read an article regarding four or five very large insurance companies in the UK looking to go into a bid process for their asbestos books of business with billions of reserves to go to professional service providers to manage those books and perhaps move it off their balance sheets.

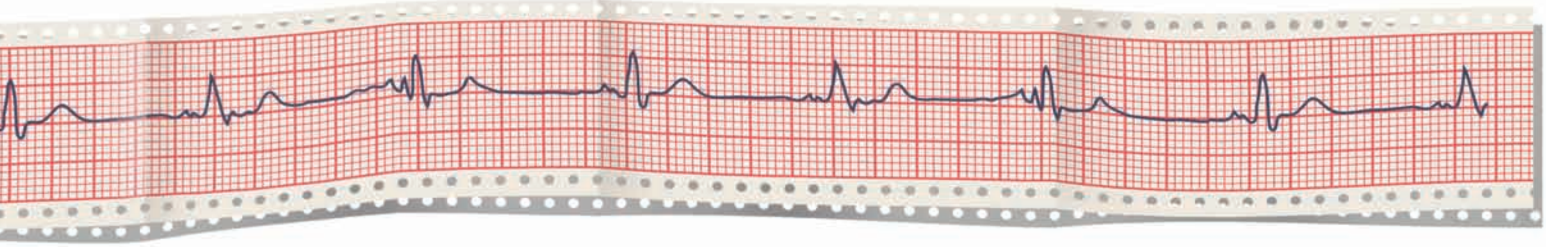
As a consequence of this business drying up, there are fewer service providers. A few runoff managers have become far larger as they have eaten up the smaller service providers, both the UK and the US.

O'Mara: *Why do you think they look less friendly on service providers in the U.S. than they do in the UK? Is there a reason for this?*

Johnston: I'm not sure if it is cultural or geographic. The London Market, as we know, is very relationship driven and it may be that a smaller geographic market has allowed this relationship to go on; the service provider being available, being partly a broker, a Lloyds-approved broker that can present the claims into Lloyds and be part of the cash and the payment settlement networks.

Mankabady: And there's certainly, you know, a pretty widespread acceptance of outsourcing in the UK and particularly we've seen that in the UK runoff market. We don't have some of the cultural concerns that you see across the channel in continental Europe.

And yes, you're giving up control but it's a small market; you tend to know the actual providers and get comfort that way.



RX for Run-off (Continued)

We are seeing this sort of shift – I think certainly over there – that a more holistic view of runoff appears to be emerging. There's a shift away from approaching legacy – approaching runoff – as a separate silo towards more active liability management and actually treating the runoff team as part of the core businesses. They're integrated in a way that they weren't a number of years ago.

Johnston: I would also say that the historic stigma of runoff is completely gone in the UK. In the US, I think it has as well and I think that has really come down to organizations like AIRROC that, having been established for ten years, promoted the runoff industry to become prominent and acceptable in the U.S. market. We must realize that runoff is obviously here to stay and, if managed properly, can actually create profit centers for companies.

Pomerantz: *Should rating agencies such as Fitch and AM Best go to the trouble of rating an insured in runoffs and, if so, why?*

Glombicki: Fitch is in the business of rating companies so it really is no trouble to rate a runoff company. At the end of the day, Fitch will provide a rating to end-users where we feel there's a value or a need for the ratings.

Pomerantz: *Gerry, can you give us any interesting examples of the recent runoffs Fitch has rated?*

Glombicki: Fitch maintains a public rating on ENSTAR Group Limited, which traditionally was a runoff manager but has recently entered the primary space. Several other companies that Fitch rates aren't necessarily exclusively runoff but do have runoff books of business that they manage as well. For example, Berkshire Hathaway, Fairfax and White Mountains. Again those are smaller entities embedded into the larger ongoing insurance operation itself.

O'Mara: *Are there any sources of new runoff business coming down the pike?*

Johnston: We talked earlier about Solvency II and the movement of capital around. Because of the new capital guidelines on a global scale, we will see more mergers and acquisitions. Capital efficiency requirements will affect portfolios of business, if not runoff entities, and we will see an increase in the runoff space.

There is also a lot of M&A activity that is happening right now, which has been driven by soft pricing in the reinsurance market, partly due to the capital in the ILS space.

The M&A that is taking place will give rise to some runoff opportunities. There are also the "buy to kill" strategies entering the marketplace. Companies looking to renew good policies and the good business and putting the old policies into runoff. We are returning to the 'good bank, bad bank' days that existed in the '90's.

So I think these are areas that are going to be sources for the new runoff business and it may well be down the road where we see these aspects arising. We can talk about fracking as a new source and of course cyber-crime is the topic at every conference these days. So looking way ahead, these areas could be the new opportunities in the runoff space.

Rothseid: We've seen a proliferation of discontinued business in the mono-line and credit insurance areas over the last three to four years. And we've also been living in a significant period of soft underwriting rates and low investment returns.

As a consequence, we can expect that over the next number of years, we may encounter additional books of business relating to relatively recent writings that are going to move into runoff as a result of this extended period of low investment returns and soft underwriting rates.

Mankabady: I agree with that analysis and I think the trigger for more runoff activity particularly on the M&A side may well be some of the local regulatory changes, which we've discussed as part of this round table.

Glombicki: I would just add that I think you are starting to see some of the stand alone runoff operations. For example, ENSTAR with the acquisition of Torus Insurance Holdings entering the primary space as well. So I think you're starting to see a little bit more of a blurring, not anymore only runoff or only active. I think you are seeing some mixing there. And, as companies get more involved in the ongoing/primary space, the more likely they are to get a rating.

Mankabady: Yes. And going back to what I was saying earlier, they're changing the runoff managers. Where there used to be live underwriting and you created a runoff division, you have a manager running off that division. So now we've come full circle. Runoff managers, after managing some of these policies in the death cycle, are now coming back into the birth cycle. So they're going back from death to birth again and managing live underwriting operations.

Pomerantz: *That's all we have time for. Thank you, everybody, for participating.*

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Bygone Companies

Julius Bannister

Bannister's Ballywick

It is an unusual name, Julius. Christened, by my idealistic parents in the later 1950's, named after the Czech anti-Nazi journalist Julius Fučík, and now with my work offices about a mile from where the Roman Emperor, Julius Caesar, invaded Britain in 55 / 54 B.C.; that serves as an introduction. I write, looking over my shoulder: "Beware the Ides of March," the soothsayer's message to Julius Caesar, warning of his death in mid-March 44 B.C. But enough of ancient history.

According to the 2013 year annual statements that we have reviewed, amongst the companies using commutations were:

INSURER (2013 YEAR)	NUMBER OF COMMUTATIONS
American Home Assurance Company	12
Arrowood Indemnity Company	9
Clarendon America Insurance Company	9
Clarendon National Insurance Company	20
Clearwater Insurance Company	10
Commerce & Industry Insurance Company	12
Continental Casualty Company	11
Global Reinsurance Corporation of America	6
Liberty Mutual Insurance Company	6
National Union Fire Insurance Company of Pittsburgh	12
Providence Washington Insurance Company	6
TIG Insurance Company	12
Zurich American Insurance Company	12

AIRROC asked me to introduce my research to the membership. Since the millennium, I have run my own bijou publishing empire, BIRO (Bannister International Research Organisation), writing about the insurance sector: the London Market and, in particular, the run-off/legacy sector. My regular research newsletter (Insurance Legacy News) reports on a multi-billion dollar area of the market that is ignored by the mainstream trade press. Prior to that, I was a founder of the Risk Research Group and later Head of Insurance Research Publications at Lloyd's.

I can't imagine that at the age of 8 or 12, any of us would have thought: I know – I want to make a career out of working in insurance, let alone collecting statistics on legacy insurance.

But, I think we all know that life takes us on many interesting paths and that, although a natural dinner party conversation-stopper (if handled in the wrong way), we have found that the 'legacy' insurance industry is full of ground-breaking challenges, people, and characters that keep us coming back for more.

I well remember back in the 1980s attending cocktail parties and press conferences for famous underwriting names of the run-off, legacy world as they were being actively launched into an unsuspecting London Market. On one occasion, I was greeted by none other than Prince Michael of Kent, a cousin of our Monarch, Queen Elizabeth II, at an event promoting the KWELM companies / London United Investments (H.S. Weavers) in Chicago.

So, if I don't have 'run-off' in my blood, at least I have the memory of its warm glow of hospitality in my veins…

So, if I don't have 'run-off' in my blood, at least I have the memory of its warm glow of hospitality in my veins – and some quite unusual 'gifts', including English & American's famous floating ball-point pen set, a much-treasured Municipal Mutual glass paper weight, and a fine motoring atlas, as well as countless music disks sponsored by a major UK failure, Independent Insurance.

March 2015 marks the publication of the last year's financial statements of US property-casualty insurers and reinsurers. With a trusted list of target companies, we've managed, over the years, to compile a major listing of commutations, the chosen weapon of many in the legacy sector to assist in their quest to find the Holy Grail of 'finality' to their liabilities. We have, so far, identified around 3,000 commutations, both between US insurers and those overseas, that make a 'fascinating read' (well, not quite of New York Times best-seller list proportions) and throw some daylight onto this quiet, shady, and hidden world.

So over the next few issues of AIRROC's research magazine, I'm going to share one or two insights into the 'legacy' news that are hidden away within a forest of pages of the annual statements;

Bygone Companies (continued)

Amongst the largest, in financial terms, were these commutations in 2013 between US insurers and their reinsurers:

INSURER	REINSURER	DOMICILE	FINANCIAL IMPACT $ WHOLE
Clarendon America Insurance Company	Lincoln National Life Insurance Company	USA	-10,716,955
Clarendon America Insurance Company	Hannover Ruckversicherungs AG	Germany	-13,246,000
Clarendon America Insurance Company	Everest Reinsurance Company	USA	-45,447,025
Liberty Mutual Insurance Company	North American Specialty Insurance Company	USA	62,252,485
Liberty Mutual Insurance Company	Partner Reinsurance Company Ltd	Bermuda	-26,698,481
Liberty Mutual Insurance Company	National Indemnity Company	USA	-26,698,481
TIG Insurance Company	Arc Re Corporation (part of Transamerica)	USA	31,327,000
Zurich American Insurance Company	Zurich International Ltd	Bermuda	17,699,900

data provided in free text format, so not routinely picked up as a database item.

You can find more information about this topic in our US Legacy Yearbook, which provides details of the majority of the active run-offs in the US property-casualty sector, a glance at asbestos / pollution (APH) reserves, and around 250 pages of commutations.

Julius Bannister of Bannister International Research has written and commented on the insurance sector, in particular the legacy market, for more than one third of a century.
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Assaulting the Bellefonte Citadel

Reinsurers Win…Not So Fast

In the 1990 landmark decision of Bellefonte Reinsurance Co. v. Aetna Cas. & Sur. Co., 903 F.2d 910 (2d Cir. 1990), the Second Circuit Court of Appeals held that the reinsurer's liability was capped at the dollar amount stated in the "Reinsurance Accepted" provision of the applicable facultative certificate.

In doing so, the court relied on the portion of the applicable certificate which provided that Bellefonte agreed to reinsure Aetna "*subject to the … amount of liability set forth herein*."[1] *Id.* at 914. According to the Court of Appeals, as a matter of law, all costs and expenses incurred by Aetna were "subject to" the "amount of liability" (*i.e.*, the "Reinsurance Accepted"). *Id.* Although the applicable certificate provided for the payment of expenses "in addition" to the reinsurer's "proportion of settlements," the Court of Appeals held that any construction of the certificates that contemplated payment of an amount in excess of the dollar amount set forth as the "Reinsurance Accepted" "would negate" the "subject to" phrase. For the next two and half decades, all appellate courts and most trial courts considering the "Bellefonte" defense – some under different contract language – reached the same result as in *Bellefonte*.[2]

Two recent decisions have bucked that trend. *See Utica Mut. Ins. Co. v. Munich Reinsurance Am., Inc.*, 594 Fed. Appx. 700 (2d Cir. 2014) ("*Munich Re*"); *Century Indem. Co. v. OneBeacon Ins. Co.*, No. 02928 (Mar. 27, 2015 Ct. of Common Pleas, Phila. Cnty.) ("*OneBeacon*"). Those courts declined to reflexively follow the *Bellefonte* line of cases, and instead engaged in a more focused and nuanced analysis and interpretation of both the language and structure of the certificates before them.

In *Munich Re*, the Second Circuit Court of Appeals – the same court that issued the *Bellefonte* decision – reversed a district court order granting summary judgment to the reinsurer, holding that the trial court misapplied *Bellefonte* (and its progeny). In doing so, the Second Circuit underscored the critical importance of contract language, stating that "in the reinsurance context as in any other, a party is bound by the terms to which it has agreed." 594 Fed. Appx. at 704. Unlike the certificate at issue in *Bellefonte* (and other cases), Munich's certificate provided for indemnification "against *losses or damages* which the Company is legally obligated to pay under the policy reinsured…*subject to the reinsurance limits shown in the Declarations*." *Id.* at 703 (emphasis added).

…the Second Circuit underscored the critical importance of contract language, stating that "in the reinsurance context as in any other, a party is bound by the terms to which it has agreed."

Rather than reflexively embracing *Bellefonte*, however, the Second Circuit held that "the Certificate's statement that 'losses or damages' are 'subject to' the limit of liability reasonably implies that expenses are not." *Id.* at 704. While this "negative implication" was "not strong enough… to demonstrate that expenses are unambiguously excluded from the limit of liability," the Court concluded that "it is sufficient to render the Certificate ambiguous." Accordingly, the Court remanded the case to the district court for "consideration of extrinsic evidence." *Id.*

Similarly, in *OneBeacon*, a Pennsylvania trial court just last month denied a reinsurer's motion for summary judgment on the *Bellefonte* issue. Picking up on the Second Circuit's "recent[] clarif[ication] that *Bellefonte* did not establish a blanket rule that all limits of liability are presumptively expense-inclusive," the court found that the certificate at issue, "while similar to *Bellefonte*, contains slight variations which leads to a different conclusion," and "cannot be ignored." *OneBeacon*, No. 02928 at 5-6. Specifically, unlike the certificates at issue in *Bellefonte* (which, as indicated above, provided that the reinsurer agreed to reinsure Aetna "*subject to the … amount of liability set forth herein*"), the certificates at issue in *OneBeacon* provided that OneBeacon reinsured Century/PEIC "subject to the general conditions set forth on the reverse side hereof." *Id.* at 2. One of those general conditions, like the certificate at issue in *Bellefonte*, provided for the reinsurer's payment of expenses "in addition" to its "loss payment[s]." According to the court, the difference in certificate language warranted a different conclusion than that reached by the court in *Bellefonte*:

> Instead of the terms being subject to the liability as in *Bellefonte*, the liability is subject to the terms and conditions. This places greater emphasis on the conditions themselves…As a result, a condition that excludes expenses in calculating the total loss limit holds more weight than the amount of 'Reinsurance Accepted' when interpreting these certificates.

Id. at 6.

Noting that "*Bellefonte* highlighted the importance of the 'subject to' language, and *Utica* demonstrated the ability of a court to reach a different interpretation" than was reached in *Bellefonte*, the Pennsylvania trial court concluded that "[i]f anything, the terms of the certificates may have created a presumption of expense-*exclusiveness*." *Id.* (emphasis in original).

Moreover, the court noted that even if it had "interpreted the certificate as being analogous to *Bellefonte*, the court would still have denied defendant's motion on the grounds that a latent ambiguity exists." *Id.* The court explained that, under

Pennsylvania law, "custom in the industry or usage in the trade is always relevant and admissible in construing commercial contracts and does not depend on any obvious ambiguity in the words of the contract." *Id.* at 7. According to the court, "[t]he application of industry custom and usage influences the meaning of the certificates, and highlights the existence of genuine issues of material fact which are to be determined by the finder of fact." *Id.*

In sum, two courts recently refused to rule in favor of either the reinsurer or the cedent as a matter of law on the "Bellefonte" issue. These cases reflect the courts' recognition that language matters, that a proper interpretation of facultative certificates requires a careful analysis of contract language and structure, and that even "slight variations" in certificate language can lead to "different conclusions." ●

Endnotes

1 Three years prior to *Bellefonte* a North Carolina federal court in *Penn Re, Inc. v. Aetna Cas. & Sur. Co.*, No. 85-385-CIV-5, 1987 WL 909519, at **5-10 (E.D.N.C. June 30, 1987) held that the applicable certificate unambiguously obligated the reinsurer to pay expenses in addition to the dollar amount set forth as the "Reinsurance Accepted."

2 *See, e.g.*, *Unigard Sec. Ins. Co. v. N. River Ins. Co.*, 4 F.3d 1049, 1068-69 (2d Cir. 1993); *Excess Ins. Co. v. Factory Mut. Ins.*, 3 N.Y.3d 577 (2004); *Pacific Employers Ins. Co. v. Global Reinsurance Corp.*, No. Civ. A. 09-6055, 2010 WL 1659760 (E.D. Pa. Apr. 23, 2010); *Global Reinsurance Corp. v. Century Indem. Co.*, No. 13 CIV. 06577, 2014 WL 4054260 (S.D.N.Y. Aug. 15, 2014), *reconsideration denied*, 2015 WL 1782206 (S.D.N.Y. Apr. 15, 2015); *Continental Cas. Co. v. MidStates Reinsurance Corp.*, 1-13-3090, 2014 WL 5761928 (Ill. App. Ct. Nov. 4, 2014); *Utica Mut. Ins. Co. v. Clearwater Ins. Co.*, No. 6:13-cv-1178, 2014 WL 6610915 (N.D.N.Y. Nov. 20, 2014); *but see TIG Premier Ins. Co. v. Hartford Accident & Indem. Co.*, 35 F. Supp. 2d 348, 349-51 (S.D.N.Y. 1999) (denying reinsurer's motion for summary judgment motion on the *Bellefonte* issue because California law applied, which "is notably more willing than New York to consider extrinsic evidence in determining the true meaning of a contract").


Harry P. Cohen and Michael K. Robles are Partners at Crowell & Moring LLP and members of the Insurance/Reinsurance group. They are part of a team of more than 40 attorneys who represent and counsel insurance and reinsurance companies, brokers, agents and others in negotiations, mediations, arbitrations and litigations, and have been involved in matters involving virtually every procedural and substantive issue that relates to reinsurance. hcohen@crowell.com, mrobles@crowell.com

Why Are We Here?

"Whether to laugh or to cry, that is the question"

illustration / Rafael Edwards

That's not quite what Hamlet said, but he would have had he been in the run-off business instead of the prince business.

Perhaps Don Regan, the one-time Chief of Staff to President Reagan, best described what we do: "Some of us are like a shovel brigade that follow a parade down Main Street cleaning up."

Not that run-off is less than an honorable profession. We aren't the glamour kids, though. We are the ghosts of mistakes past, of the failures that had many fathers when they were shiny new ideas but are now orphaned in dismal disappointment. No one ever says, "this book/program is a great success, let's put it into run-off." So, by definition, we deal in failure.

So many great ideas: The Los Angeles County Bar Association, extended warranties, film finance, bail bonds, Environmental Impairment Liability, workers' compensation carve-out. So many dismal disasters: See previous sentence.

Please don't think I'm complaining. Run-off put my two girls through great schools, bought my wife an SUV that she loves, and kept me off the streets. I worked with wonderful people (not all) and learned a lot (I had a lot to learn).

So, when I was asked whether I might pen some fond memories of a run-off career, I agreed to try. But I still don't know whether to laugh or to cry.

Run-off Adventure #1 – The Tale of The Draftsmen

A fundamental rule of contract interpretation is that if different words are used in similar contexts, different meanings must have been intended. So, if one part of a contract speaks of "piglets" and another of "swine" a judge will try mightily to figure out what different meanings were intended. In an insurance coverage case, her mighty efforts will be aimed at finding a way to help out the poor, innocent, Fortune 50 insured whose net worth is many times that of the evil, grasping insurance company. Of course, she will be helped by the inventive mind of the policyholder's "insurance asset recovery" attorneys whose outrage at the insurer's intransigence is matched only by their imaginative interpretation of the contract.

Now you, the run-off claims person, won't take this lying down. You'll scour to the ends of the earth to find the underwriter who will explain everything so clearly and sensibly that even the asset recovery folks will shamefacedly close their briefcases and slink off into the night.

And, "Eureka!," you find Joe Giancana, who admits to being involved in drafting the policy thirty years ago. You grab your counsel (more on that later), fly off to wherever Joe has chosen as his golden years home, and get ready for the great revelation – why using "piglets" and then using "swine" made complete sense and is totally congruent with your theory of the case.

And, what is the luminescent answer?

"Well, we were kind of in a hurry so I put together the first part of the policy and Charlie Marcello did the second part. We were cutting and pasting from London forms that Charlie had collected over the years. So there's no particular reason that I can think of for the different wordings; we must have cut them out from different forms."

Your lawyer, grasping at straws, suggests that Joe and Charlie surely went over the finished document together to ensure that they were on the same page as to coverage. The answer, of course, is "gosh, not really – we were under a lot of time pressure back then."

Welcome to Run-off World.

Run-off Adventure #2 – How Hard Can It Be?

The outside world finds insurance boring; has anyone ever been successful with a pickup line on the order of, "Hi, I'm in insurance, what do you do?"

On the other hand, movies are really glamorous. "Would you like to go to the premier of the new Warren Beatty picture," is a pretty good line.

So, how might an insurance underwriter who wants something more in life join the beautiful people? Not much chance, you'd think.

Ah, but there is a way. Here's the story.

It turns out that the movie business is very risky; you can lose a ton of dough. So, movie studios don't put up all their own money for a project – they get financing. When a studio shows up at, say, Chase Bank, looking for millions to finance the latest brainstorm, Chase sees big potential returns but knows it could get hosed. Chase likes big returns but doesn't like to get hosed. So, how to find someone to take the hose if the movie tanks?

The man to be hosed is our humble but ambitious underwriter. The studio, which knows something about films, doesn't want to take on overly much risk. Chase Bank, which may or may not know anything about films, doesn't want risk. Our underwriter, knowing no more about films than he might read in the Sun or the New York Post thinks, "how hard can it be?"

Indeed, when he skims through the prospectus, he gets a tummy warming sense of security. After all, how can you go wrong with George Lucas, Mr. Star Wars? Or the perennially sexy and charming Warren Beatty and Dustin Hoffman? Or the popular Will Ferrell? Or sexy Warren Beatty again, this time paired with the ever-charming Diane Keaton?

So, our underwriter signs up. And he gets tickets to the glamorous opening featuring stars, lights, a red carpet and the team from Entertainment Tonight. His date is very impressed.

Such promising films – such terrible flops: Howard the Duck (Lucas), Ishtar (Beatty and Hoffman), Land of The Lost (Ferrell), Town & Country (Beatty and Keaton), and on and on.

And even if we don't have a true turkey on our hands, Hollywood accounting makes the Mafia look honest. Officially at least 80% of Hollywood movies lose money, including such improbables as Star Wars: Return of the Jedi, Forrest Gump and Harry Potter and the Order of the Phoenix.

The outside world finds insurance boring; has anyone ever been successful with a pickup line on the order of, "Hi, I'm in insurance, what do you do?"

So, someone gets hosed.

It's not the studio. It's not Chase Bank. It's not Mr. Underwriter personally; in fact, he's moved on (with a big raise) to another company eager for his expertise. It's our good old insurance company that gets hosed.

How hard can it be?

Run-off Adventure #3 – The Eighteen-Hole Lawyer

Some years back, we were putting an active company into run-off. Outside of our conference room, a very pleasant young lady was working on the never-to-be-held-company-client golf outing. Golf, it turned out, was very important to this company.

We got together with the claims team to discuss their larger claims and DJs. Chatting about the lawyers handling the matters, it soon became clear that there was a rather direct relationship between who was assigned to the significant matters and who had treated the claims folks to nice golf excursions.

Of course, there's no rule that a good golfer can't be a good lawyer – I know several – but it was amazing how golf engendered trust. For example, complicated coverage cases didn't have any copies of policies in the claims file – or in any other file for that matter ("Oh, we'd need to get that from the broker."). If Arnold Palmer said there was a good coverage defense, well then why should anyone on the claims side waste time actually looking at the policy when they could be reading Golf World instead?

I wish I could say that golf prowess predicts legal prowess. That would greatly simplify selecting counsel; just have them submit their handicap.

Sadly, we found no such correlation.

What's The Lesson?

Is there a lesson in all of this? I think it is that doing things the right way isn't easy. Shortcuts are usually a path to failure. And, because you can't put an insurance company down as you can a horse, that's where the run-off professionals come in – to laugh and to cry.

Disclaimer: "The author pens this article in the anticipation that it may amuse his colleagues in the business; nothing herein is intended as fodder for cross-examination, citation in a brief or any other overreaching misuse."

A lawyer and former senior insurance executive, Chuck Ehrlich serves as an arbitrator and expert witness. charles.ehrlich@gmail.com

Bill Littel

Allstate's All Round Achiever

Global traveler Bill Littel feels that one has to take risks or lose the opportunity to move forward. Bill just returned from a vacation in Australia and is planning one to South America next winter. His travel advice to Americans is to not dress like an American, i.e. baseball cap, jeans and sneakers. Some of his favorite memories of savoring the tastes of local foods while traveling include eating pasta with white sauce in Rome and danishes in Iceland.

Illustration / Rafael Edwards

"The only bad shot is the one not taken." Wayne Gretzky

Background questions

Work History – lessons learned?

After working for two years at the public accounting firm Johnson Atwater, conducting insurance claim audits, I took a job at Allstate Insurance Company. For more than 30 years at Allstate, I have been in a number of areas in the Accounting, Controller, Claims Systems, and Underwriting Departments. Allstate has given me the opportunity to gain knowledge and skills in a number of complex work environments.

If you could have a second career, what would it be?

Based on my love of numbers and a hobby of traveling the world, if I had the opportunity to pursue a second career, it would be in the investment banking arena or as a commercial pilot.

Current

What do you like best/worst about your current position?

My position in the Assumed Claim Department, managing the dispute resolution process, is challenging and full of unique experiences. Handling complex claim billings from companies all over the globe is a major change from the mundane assignments that I undertook as an independent auditor in my first job. The downside is that, unlike in the past when we saw swift resolution of claims, disputes take many years to resolve.

What industry publications do you read on a regular basis?

I wish I had time to read more but I need to limit my reading to publications that have a direct impact on my current job. In addition to AIRROC Matters, I also read Business Insurance, Best's Review, Mealey's Reinsurance, and the Wall Street Journal.

What educational sessions or conferences do you attend and why?

In the past I used to attend a number of conferences, but with the Internet, I can now access desktop training. Additionally, I attend the AIRROC Quarterly and Regional Sessions, semi-annual ARIAS Conferences, FETTI Conference, and the Illinois CPA Reinsurance Seminar.

Personal

What is your favorite book?

Over the years my favorite book has changed many times. My most recent favorite is American Sniper by Chris Kyle. The inspiring true story lays out what it takes to stand for a set of principles and the perseverance and courage it takes to stay true to those traits.

What is your favorite leadership manual/book?

Winning – The Ultimate Business How to Book, by Jack Welch.

What might (someone) be surprised to know about you?

My wife and I both enjoy traveling the world. To date we have visited 40 countries, with our favorites being Iceland, Norway, and Fiji.

Industry

What sorts of trends do you see?

The continued consolidation of the run-off industry under a few large companies has significantly changed the dynamics of the historical relationships that existed between cedents and reinsurers. Pure financial decisions have replaced good faith negotiations with long-term partners.

Connie D. O'Mara & Bina T. Dagar

AIRROC

Tell us how you first got involved with AIRROC.

Allstate was a founding member of AIRROC. Early on we saw the value of an association that offered shared experiences in reinsurance run-off and provided a venue to meet periodically to discuss opportunities to commute legacy business. Allstate continues to see the value of AIRROC and takes great pride in the contributions we have made in growing and improving it.

What was your first impression of AIRROC?

Our first attendance was delayed due to a snowstorm that kept us from making AIRROC's inaugural meeting. After subsequent meetings, we quickly saw benefits to building relationships and the resulting improvements to our run-off book.

If you could change one thing about AIRROC, what would it be?

I think we should continue to look for ways to expand the companies and services within the Association. Internally, Allstate markets the value of AIRROC through the many contacts we make at the various group events. Inclusion of more companies would assist us internally in demonstrating the importance of AIRROC to Allstate's Senior Management.

The interest in AIRROC seems to be growing. Why do you think that is?

AIRROC clearly fills a long-existing need in Reinsurance Run-off. Members of the industry can meet, discuss and share issues that promote the efficient handling of large financial exposures. Also, AIRROC has developed a strong reputation as a creative, cost efficient provider of educational programs. This has enabled the use of knowledgeable people, adding to the overall value of the Association.

What would you like to see in the Magazine?

Question and Answer segments with middle management staff that are active in claims, accounting, commutations, and finance within reinsurance run-off. Knowing how others handle challenges of ceding claims and collecting reinsurance would be useful. ●

Connie D. O'Mara, connie@cdomaraconsulting.com and Bina T. Dagar, bdagar@ameyaconsulting.com

AIRROC UPDATE

Flying from Virginia and Back with AIRROC…

Carolyn Fahey

Message from the Executive Director

Feeling much like a cardinal, the state bird of Virginia, my home state, I find myself writing this article while in flight on my way back home from the United Kingdom. I flew to the U.K. not only to attend the IRLA Congress, but also to offer our first international event in five years to AIRROC members "across the pond." The event was met with great enthusiasm and attendance from our EU colleagues.

In March and April, I represented AIRROC in New York City and Princeton, New Jersey for our Spring Membership Meeting and a workshop on the changing duty of utmost good faith. Details regarding the successes and insights of both of these program may be found in this issue of AIRROC Matters.

Coming up, we have a Negotiation Workshop on June 2, 2015, at St. John's University, as well as our summer membership meeting July 22-23. In July, we are offering sessions on cyber risk (both from an underwriting as well as a claims perspective), an update on key current decisions, and sessions pertaining to various new and emerging issues, including drones. The dates for the 2015 AIRROC Commutation and Networking event run from October 18-20, 2015, and we are excited to return to New Brunswick, New Jersey to the Heldrich Hotel. Watch for registration to open very soon!

Additionally, AIRROC is making final preparations to roll out our new designation – Certified Legacy Insurance Professional (CLIP). The first applications for CLIP will be accepted in July. Find out more about the qualifications and how you can be among our first applicants on the AIRROC website.

Interacting with our members and partners, continuing to offer high quality education, and attending industry events to let people know what AIRROC is and what we stand for, is energizing for me. I look forward to my next "flight" from Virginia to continue to carry AIRROC forward. ●

Carolyn Fahey joined AIRROC as Executive Director in May 2012. She brings more than 23 years of re/insurance industry and association experience to the organization. carolyn@airroc.org

Educational Summaries: March 19 Event– New York City

More than 150 AIRROC members attended the March 18-19 Spring Membership meeting. Held at Chadbourne & Parke's new offices in New York, the educational panels included Workers' Compensation Commutations and Trends in Buying and Selling Runoff Business. Members had full days of education and also productive networking and business meetings.

The "Ins and Outs" and "Ups and Downs"

Workers' Compensation Commutations: Motivations, Pricing and Disputes

Summary by Michael H. Goldstein

Matthew Moore, Senior Solutions Specialist, Inpoint (an Aon business), moderated this panel of commutation veterans who promised to delve into the many facets of workers' compensation commutations. The panel consisted of Holly Drake, AVP, Head of Asset Management North America – Group Reinsurance, Zurich North America; Gregg Frederick, Executive Vice-President – Reinsurance, Legion Insurance Company (in Liquidation); Ben Gonson, Partner, Nicoletti Gonson Spinner LLP; James Kleinberg, Senior Solutions Specialist, Inpoint; Michael Goldstein, Partner, Mound Cotton Wollan & Greengrass LLP; and Andrew Rapoport, Managing Director, Aon Benfield Analytics.

Mr. Moore introduced the panel of distinguished reinsurance practitioners and Holly Drake and Gregg Frederick kicked things off by providing an insightful overview of the commutation issues at play. These presenters focused their discussion on the relevant parties' motivations to commute and broke them down into the following categories:

- Finality;
- Cedant's motivation and considerations to commute (*e.g.*, solvency of assuming reinsurer, ability and willingness to pay, etc.);
- Assumed reinsurer's motivation and considerations to commute (*e.g.*, solvency of cedant, GA claim handling, ability to control costs and assert offsets, etc.);
- Contract language (commutation and sunset clauses) that forces commutation;
- Distinguishing between treaty and facultative; and
- Arbitration feasibility.

Aon's Andrew Rapoport and James Kleinberg then presented their in-depth "Tabular Claimant Model," which applies discounts based upon a mortality or morbidity table. This is to be differentiated from non-tabular discounts, which are determined from aggregate payment patterns rather than mortality tables. The presenters then walked the group through the relevant specific and global assumptions and factors and presented an illuminating "base case" valuation.

The Aon presentation concluded with its "key takeaways," which were presented as follows:

- A few large claims will drive treaty settlement costs;
- The impact of assumptions is dependent on how close payments are to the layer:
  – In or close to the layer – Small impact;
  – Far below the layer – Big Impact;
- Annual medical rates and medical escalation get costs into the layer;

Educational Summaries (continued)

- Mortality and discount affect costs in the layer; and
- Contract wording affects calculations.

Ben Gonson made the next presentation and provided additional insights into the significance of commutation clause wording and stressed that not all commutation clauses are created equal. Mr. Gonson walked the audience through several examples of commutation clauses that he has come across over the years and broke down what can set them apart as follows:

- Voluntary/compulsory spectrum;
- Who has the option to invoke the clause?;
- Commute individual losses versus entire WC exposure to the reinsurance agreement;
- Definition of "Reserves" in the clause;
- Multiple years of contracts – differing language;
- Contract language applicable to dispute resolution; and
- Relationship with "Sunset Clauses."

Mr. Gonson then explained the role of "Sunset Clauses," provided some typical examples of them, and explained their interplay with the commutation clause itself. His presentation concluded with the results from a March 2011 AIRROC actuarial survey regarding discounting for commutation in which 77% of the thirty respondents answered that they compute projected costs in the layer and then discount the layer (in the P&C context).

Michael Goldstein rounded out the morning's presentations and provided a comprehensive cross-section of recent arbitration panel and U.S. District Court opinions to examine commutation and sunset clauses in the workers' compensation context. The three court cases that began in arbitration illustrate some of the problems and pitfalls of arbitration. For example, in *Underwriters at Lloyd's v. PARG* the U.S. District Court for the District of New Jersey examined the underlying panel award, which had spelled out what it considered to be examples of mandatory commutation provisions and required the parties to calculate the claims under the applicable treaties accordingly. Because of perceived ambiguities in the Award, the parties landed in court.

The District Court remanded the dispute to the arbitrators in order to answer the following questions:

- Of the 24 treaties that are in dispute between the parties, which ones, specifically, fall within the parameters of the panel's Final Order?
- With respect to calculating the value of the commutations contemplated by the Final Order: On its face, the Final Order requires only that the parties perform certain calculations.

  – Did the panel intend to order only that the parties perform calculations, or did the panel intend to order that the parties come to an agreement on the value of the relevant commutations? (Or, alternatively, did the panel intend something else?)
  – If the panel intended that the parties agree, then what is the effect of the Final Order if the parties cannot agree?
  – Assuming that the parties do not agree, and mindful that the COURT's only role is to confirm and enforce the award – not to engage in independent fact-finding – how did the panel foresee resolution of this dispute? In other words, by what formula must the parties calculate the damages contemplated by the Final Order?

The same District Court closely analyzed sunset/notice of loss clauses in the workers' compensation context. Mr. Goldstein concluded the panel by discussing several other recent holdings involving commutation disputes arising from sunset clauses and valuation, as well as tensions between standard arbitration clauses and valuation by neutral actuaries.

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Let's Make a Deal

Current Trends in Buying and Selling Runoff Business and Blocks

Summary by Randi Ellias

David Schieldrop, Managing Director and Global Co-Head of the Insurance Investment Banking Division of Barclays, Sylvain Villeroy de Galhau, EVP of AXA Liabilities Managers, and David Alberts, Partner at Mayer Brown, shared their insights on the current marketplace for buying and selling runoff business. The consensus of the panel was that market conditions – including downward pressure on premium, low interest rates, and the availability of alternative capital – are ripe for increased opportunities to buy and sell run-off business in 2015. The panel further noted that demand is outpacing supply in this market.

The panel also provided an overview of the respective market forces that motivate the counterparties to the purchase and sale of a run-off book. For their part, sellers seek to alleviate regulatory pressure, solvency pressure, and resources pressure, and to recognize the book value of their business. On the buyers' side, there is now more money invested in run-off, there are new entrants in the marketplace, including private equity funds that are expressing interest in the sector, and buyers of run-off books are increasingly able to manage those books effectively.

Buyers seeking to purchase a run-off book should understand the business plan and administration for that book, as well as the nature of the liabilities, the asset mix, the ability to extract capital, how to structure the transaction in order to separate the book from its parent (that is, whether the transaction will involve the sale of an entity or a reinsurance arrangement), and tax and regulatory implications. In selecting a buyer, sellers may focus on price (although price may not be the primary driver of the transaction), the creditworthiness of the potential counterparty and collateral, the counterparty's track record with regulators, claims and operations, and, in closing deals, the potential ease and speed of execution of any deal that may be reached, the ramifications on outward reinsurance, human resource issues, and the reputation of the buyer (particular if the seller will have ongoing relationships with any policyholders in the book being sold).

In sum, the panel opined that, in 2015, one would see more activity in the runoff market, including both buy-to-kill deals and retro reinsurance arrangements. ●

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Princeton, New Jersey

Utmost Good Faith

Bringing the Issues to Life

Summary by Connie D. O'Mara

Does the Duty of Utmost Good Faith still exist or has it been eroded beyond recognition by courts and arbitrators? As it is such a fundamental concept to the industry, AIRROC conducted a seminar that focused on the Duty and how it has evolved in recent cases. The daylong session hosted by Munich Re brought together reinsurance lawyers, industry representatives, and arbitrators for an interactive discussion that culminated in a mock arbitration. All of the participants were involved in mock settlement negotiations that dramatized the arguments, positions, and potential resolutions/decisions that resulted from arguments asserting an alleged breach of the duty. The mock panel deliberation demonstrated how an arbitration panel steeped in industry pattern and practice viewed the parties' conduct in light of this fundamental principle of the cedent/reinsurer relationship.

The seminar began with an overview of the case law presented by Robin Dusek (Freeborn & Peters, LLP) and Seema Misra (Stroock & Stroock & Lavan, LLP). Their debate over the case law reviewed a line of cases, starting with *Commercial Union v. Seven Provinces* and ending with *Associated Industries Insurance Co. v. Excalibur Reinsurance Corp.*, and discussed key facts and arguments that persuaded courts that a party's conduct, either in the underwriting or claim process, breached the duty. The seminar also involved a discussion of how generic cedents and reinsurers approach the cases in dispute settings. [The case law is covered in "Is the

Educational Summaries (continued)

Duty of Utmost Good Faith in Runoff?" in the Spring 2015 issue of AIRROC Matters, by Joseph McCullough and Peter Steffen, starting at p. 12].

This set the stage for a lively panel discussion moderated by Aaron Stern that included: Craig Brown, VP and Deputy General Counsel, Riverstone; Thomas Wamser, Associate General Counsel, ACE Group; Joseph McCullough, Freeborn & Peters; and Daryn Rush, White and Williams. In addition to discussing how the Duty of Utmost Good Faith can be used to frame the facts and assert that the opposing party is a "bad guy", the panel addressed intriguing questions that included: Has the bar been raised for finding a violation of the Duty? Can withholding payments in and of itself be a breach of the Duty? Are courts and panels more skeptical of run-off companies and their motives? Should arbitration panels send a message by expressly "punishing" conduct they find to be a breach of the Duty? The answers highlighted the differences between making the argument in courts and before arbitrators. Of note was a polling of the audience, asking whether attendees would prefer to bring a claim for violation of the Duty to a court rather than an arbitration panel, with the result being only a small majority of the audience preferred arbitration. One panel member remarked that the fact that so many in attendance prefer courts to address such issues reflects a growing dissatisfaction with reinsurance arbitrations.

By watching how counsel argued the issues to the panel, the audience could compare the arguments to those they themselves had made in the settlement negotiation exercise.

In the afternoon, the audience, divided into six opposing teams, three each for cedent and reinsurer, got to "walk the talk" and attempt to negotiate a resolution of a hypothetical dispute. None of the three sets of negotiations came close to settling the dispute. Reporting back on each set of negotiations, in a discussion moderated by Michael McMonagle of Munich Re, the results of the settlement negotiations demonstrated the similar and disparate results and viewpoints reached by the groups working from the same set of facts.

In the final session of the program, Peter Steffen and Edward Diffin (both of Freeborn & Peters) presented their closing arguments on those facts to a highly experienced panel of Jonathan Rosen (umpire), Howard Denbin and Roger Wiegley. By watching how counsel argued the issues to the panel, the audience could compare the arguments to those they themselves had made in the settlement negotiation exercise. The audience was then treated to a "behind the scenes" view of panel deliberations and how the panel used their combined years of experience in the industry to decide the issues. The culmination of the session was a dramatic decision by the panel that awarded fees and costs against the cedent whose conduct violated the Duty of Utmost Good Faith while enforcing the contract by compelling payment of the disputed billing.

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News & Events

Regulatory News

FIO Reinsurance Report and the NAIC and Industry Response

On December 31, 2014 the Federal Insurance Office (the "FIO") released its Reinsurance Report ("The Report"), entitled *"The Breadth and Scope of the Global Reinsurance Market and the Critical Role Such Market Plays in Supporting Insurance in the United States,"* as required under the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Report provided no surprises and was more descriptive than proscriptive.

After providing a description of the history of reinsurance, the different forms of reinsurance, the growing importance of reinsurance to the U.S. insurance industry, and the current state regulation of reinsurance, it focuses on where federal law "regulates" certain aspects of reinsurance, the global reinsurance market and current state and federal regulatory proposals..

The Report lists existing areas of federal involvement and oversight in reinsurance, and includes, for example:[1] The Federal Crop Insurance Corporation; The Overseas Private Investment Corporation; The National Flood Insurance Program; and the Terrorism Risk Insurance Act. The Report also provides a brief summary of Part II of the Non-Admitted and Reinsurance Reform Act of 2010 (the "NRRA") and the advantages it provides for the regulation of reinsurers. The Report was clear to point out that the FIO Director is authorized to recommend that a "nonbank financial company" be subject to supervision by the Federal Reserve and have enhanced "prudential" standards. Reinsurers would be considered a "nonbank" financial company.

The Report also focused on how a "substantial portion" of reinsurance supporting the U.S. sector is provided by companies not licensed in all states and, in many cases, neither domiciled nor licensed in the United States and focused on the issue of credit for reinsurance. The NAIC adopted amendments to the Credit for Reinsurance Model Act and Regulation in 2011[2] (the "Model Act"), which, as of April, 2015, has been adopted by 26 states with 11 more states set to enact the law in 2015. The FIO has expressed its concerns with the Model Act and believes that the federal proposal for Covered Agreements introduced in the FIO's 2013 Modernization Report will provide a "nationally uniform treatment with respect to collateral requirements."

Whereas the FIO points to inconsistencies among the states in implementing reinsurance collateral reform, the NAIC totally disagrees. At the recent NAIC meeting in Phoenix, for example, it was made clear by the Reinsurance Task Force that the adoption of the Model Act is the method to pursue and is "neither convinced nor persuaded that a covered agreement is necessary." The industry, on the other hand, is not necessarily in agreement with the NAIC. At the Task Force meeting, trade groups representing international reinsurers asked the task force to reconsider its opposition to Covered Agreements. Reinsurers stated that they are continuing to face roadblocks to doing business in non-U.S. reinsurance markets, and one reinsurer reported that they are no longer able to do business in certain European countries,particularly in Poland and the Netherlands. The trade groups and reinsurers believe that Covered Agreements could resolve these problems.

[1] See page 20 of The Report for a complete listing of federal involvement in reinsurance programs.

[2] As of April, 2015, John M. Huff, the Chair of the NAIC Reinsurance Task Force, announced that 26 states had adopted the NAIC Model Act, with 11 more states to enact the law in 2015.

Industry News

The first quarter of 2015 has seen a continuation of the active merger and acquisition scene that began toward the end of last year. The most interesting development is the ongoing competition to acquire **PartnerRe Ltd. ("PartnerRe").** In late January 2015, **Axis Capital Holdings Ltd. ("Axis Capital")** and PartnerRe announced their agreement to merge, with the resulting company anticipated to be among the top five largest reinsurers in the world. Before the proposed merger could be acted upon by the PartnerRe shareholders, however, PartnerRe received an unsolicited $6.4 billion cash offer ($130 per share) from **Exor SpA**, the investment company of Italy's Agnelli family, the descendants of the founder of Fiat.

As of the date of submitting this column, the offer had been rejected by PartnerRe and new deal terms with Axis Capital announced that would allow PartnerRe to pay its shareholders a one-time special dividend of $11.50 per share to address Exor's all cash proposal. For its part, Exor has committed to continuing its bid directly with the PartnerRe shareholders.

The first quarter also saw a number of other interesting industry transactions albeit less dramatic than the PartnerRe situation.

After failing to complete an acquisition of Aspen Insurance Holdings last year, Bermuda-based **Endurance Specialty Holdings Ltd. (Endurance)** has reached an agreement to acquire reinsurer **Montpelier Re Holdings Ltd. (Montpelier)** for $1.83 billion.

In May, Hong Kong-based **Fosun International Limited ("Fosun")** announced it was planning to purchase the remaining 80% of **Ironshore, Inc**. that it did not already own for $1.84 billion. This is a continuation of Fosun's program to expand its global insurance presence.

AXA Liabilities Managers (AXA LM), an AIRROC member with a spot on the AIRROC board, announced the signing of the acquisition of the **GERA Pool (European Aviation Reinsurance Group)**, which came into effect on January 1st, 2015. The transaction, in which AXA LM took over the shares of the existing 25 pool members, was conducted by AXA LM's investment vehicle AXA DBIO, which invests in run-off portfolios and companies.

Member Updates

Pro-Global Insurance Solutions, plc (Pro) has become a member of AIRROC. Pro has been involved in AIRROC for many years through its management of legacy portfolios such as WFUM, English & American and American Bankers. Pro states that "Legacy management is a key service provided by Pro and we look forward to continuing and strengthening our relationship with AIRROC and its members."

RLR Management Services, Inc. (RLR) has become an AIRROC Corporate Partner. RLR emphasizes that "[t]he objectives stated in the AIRROC Mission Statement are very similar to the core values and services of RLR. We provide insurance companies in runoff with solutions that drive organizational, operational and performance efficiency."

People on the Move

James Wrynn, the 40th and last Superintendent of Insurance before creation of New York's Department of Financial Services, has joined Guy Carpenter & Co. as Vice Chairman of US Strategic Advisory and a Managing Director. Since leaving the NY department in 2012, Mr. Wrynn had been a partner with the law firm of Goldberg Segalla in its New York City offices. james.wrynn@guycarp.com. Andrew Marcell, CEO of US Operations for Guy Carpenter stated that "Jim brings extensive legislative and legal experience to Guy Carpenter and we are thrilled to have him lead our regulatory practice within US Strategic Advisory."

Jeremy ("Jerry") Capell has joined Butler Rubin Saltarelli & Boyd as its Chief Operating Officer where he will oversee the firm's strategic and day-to-day operations. With more than 25 years of experience, his background includes extensive experience in financial (P/L) management, administrative management, marketing, sales, risk management and human resources.

Maryann Taylor, Assistant Editor of **AIRROC Matters**, has been named Vice Chair of the AIRROC Publication Committee. Maryann, who also recently rejoined D'Amato & Lynch, LLP as a Partner in their reinsurance department, can be reached at mtaylor@damato-lynch.com. ●

SUMMER 2015 MARK YOUR CALENDAR

July 22-23, 2015
AIRROC Summer Membership Meeting and Networking Day
New York, NY
www.airroc.org

July 30-August 4, 2015
American Bar Association Annual Meeting
Chicago, IL
www.americanbar.org

August 14-17, 2015
National Association of Insurance Commissioners (NAIC) Summer National Meeting
Chicago, IL
www.naic.org

September 24, 2015
AIRROC Regional Education Day
Chicago, IL
www.airroc.org

October 18-20, 2015
AIRROC Commutations & Networking Forum
New Brunswick, NJ
www.airroc.org

If you are aware of items that may qualify for the next "Present Value," such as upcoming events, comments or developments that have, or could impact our membership, please email Fran Semaya at flsemaya@gmail.com or Peter Bickford at pbickford@pbnylaw.com.

COMMUTATIONS & NETWORKING FORUM

October 18-21, 2015

The Heldrich, New Brunswick, NJ

AIRROC

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- *2 Full Days for Meetings*
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For further information contact

Carolyn Fahey carolyn@airroc.org

Full access registration: Prior to Sept. 14th
$595 for AIRROC Members and Partners
$895 all others
(after Sept. 14 $695 member, $995 others)

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