Special Edition – Collateral Damage: Security in Run-off

Association of Insurance and Reinsurance Run-off Companies

AIRROC Matters

A Newsletter About Run-off Companies and Their Issues

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Think Tank

Former Regulators – Now in Commercial World – Weigh in on Collateral Reduction


Cecelia Kempler

By Cecelia Kempler

During a conference call held on December 12, 2006, Ernie Csiszar (former Commissioner of Insurance for the South Carolina Insurance Department), James Corcoran (former Superintendent of Insurance for the State of New York Department of Insurance) and James Schacht (former Acting Director of the Illinois Department of Insurance) were gracious enough to discuss, for the record, their respective views on the desirability of reduction of collateral requirements to support reinsurance obligations of unauthorized reinsurers.[1]

The discussion focused on whether (i) there was a need to change the current system, (ii) how best to achieve any change to assure that reinsurance funding will be available when due, and (iii) regulators should require

continued on page 6

Notes from the Special Editor

Searching for Security

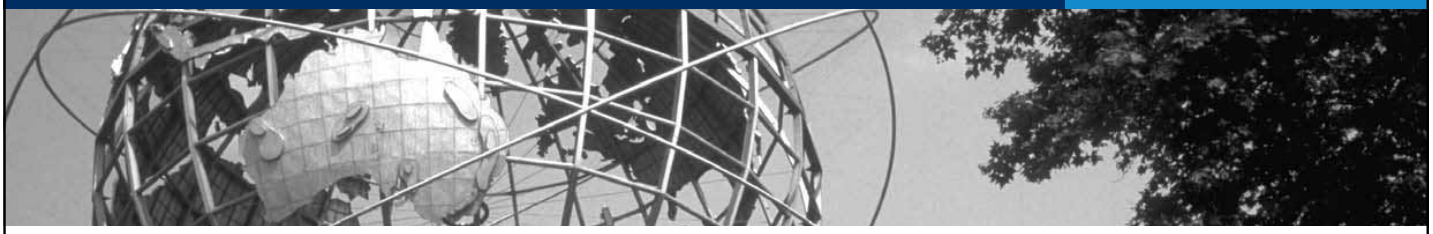

James Veach

By James Veach

Security – financial, airport, social – these days nobody can get enough and thus the theme for this special issue of *AIRROC Matters*. Heeding Peter Scarpato's call for a "topical theme issue," we focus on the role of security in run-off.

continued on page 3

LeBoeuf Lamb



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Notes from the Special Editor

Searching for Security continued from page 1

AIRROC Matters Editor Peter Scarpato, Publications Committee Chair Ali Rifai, and Special Editor James Veach

We begin where we left off in the Fall issue – the NAIC's proposed changes to the current credit for reinsurance collateral requirements. For a quick review of where things stood before the NAIC's Winter Meeting in San Antonio see Stuart Keir's article in our Fall issue: ***Reinsurance Collateral: What is All the Fuss About?,*** *AIRROC Matters*, pp. 9-11. Then read ***The Reinsurance Evaluation Office – REO, and Collateral Requirements,*** p. 8.

Change is hard. It's also hard to find experienced regulators who will speak their minds on a topic that is as surprisingly charged as the current collateral reduction proposal, but Cecelia Kempler found three. See her interview of Ernie Csiszar (SC), James Schacht (IL), and James Corcoran (NY), p. 1.

More importantly, should the current collateral reduction proposals apply retroactively, *i.e.*, to you? AIRROC's Board put that question to the members. Terry Kelaher reports on the results and provides a copy of the Board's proposed letter to the NAIC Reinsurance Task Force, p. 12.

Of course, ***AIRROC is a true cross-border association.*** Clive O'Connell and David Abbott give us their take on security for reinsurance reserves from a U.K./European perspective. "Thus in England . . . we can scour the earth looking for the best deal and if it appears that we can insure houses . . . with an insurer in Dili, East Timor, (we) are entitled to do so," p. 18.

Back in the states, run-off manager Charles Ehrlich asks: "What should a

continued on next page

Mr. Veach is a Partner in the New York City office of Mound Cotton Wollan & Greengrass, a firm of about 100 attorneys that focuses its practice on insurance and reinsurance. Mr. Veach concentrates his practice on run-off-related matters, including insolvency, commutation, reinsurance recovery, and government relations. He can be reached at jveach@moundcotton.com.

Notes from the Special Editor

Searching for Security

continued from previous page

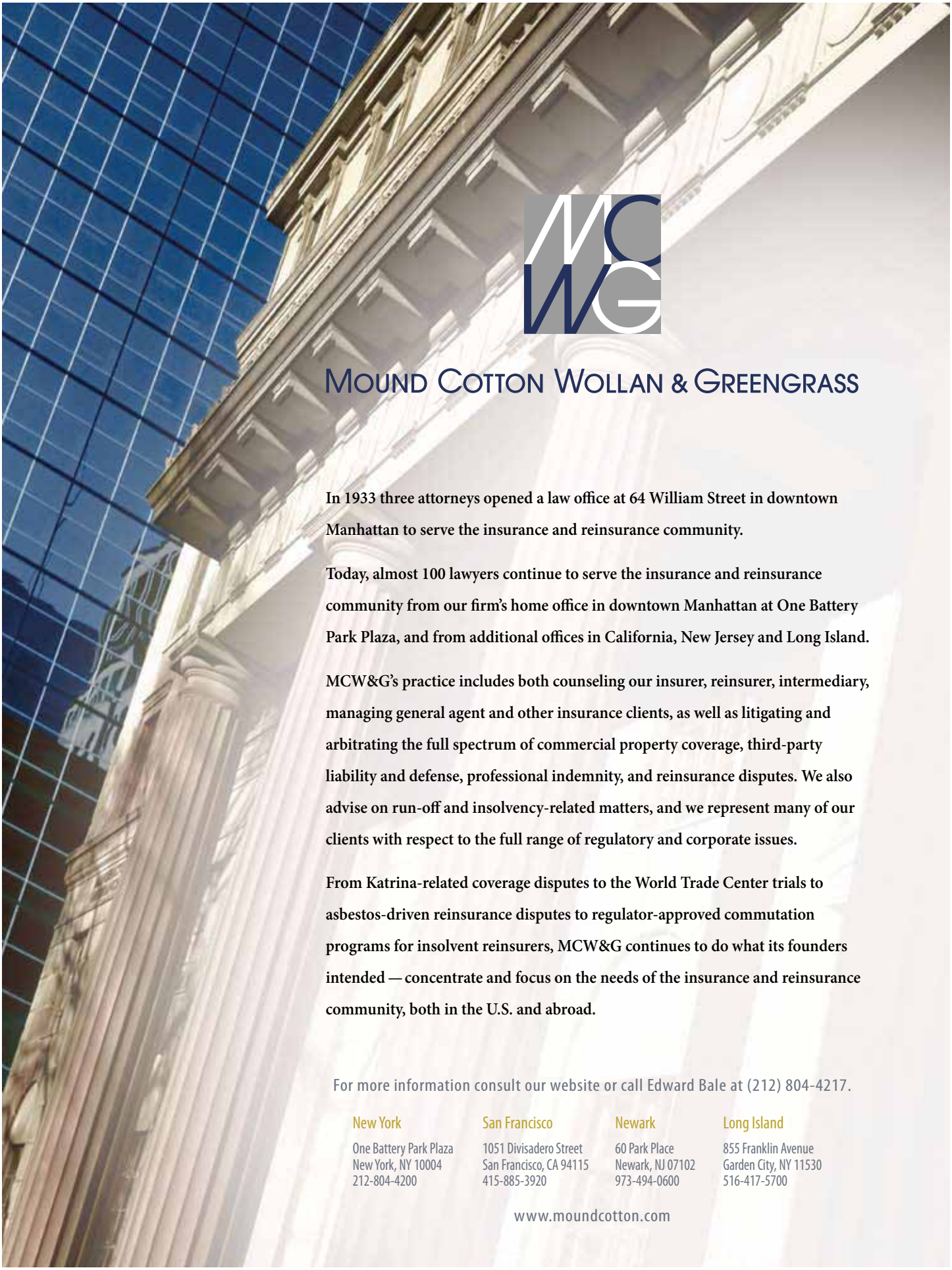
run-off manager do …. to get (her/his) arms around the extent and types of security that the company has out in the world and, second, free up that security? " C. Ehrlich, ***Found Money or Unobtainium: Security Deposits and the Run-off Company,*** p. 21.

One type of security comes out of the pens of arbitrators and trial court judges who have the power to direct that unauthorized reinsurers post collateral to ensure that an award or judgment will actually be paid. Your humble Editor provides ***Run-off and Pre-Award or Pre-Judgment Security: A Thumbnail Review,*** p. 24.

My article, however, is but a run-up to the main event — an interview with three hands-on run-off managers – Richard White, Jonathan Rosen, and Charles Ehrlich – who are also ARIAS-U.S. certified arbitrators. ***Security in Run-off: Arbitrators cum Run-off Managers Speak,*** p. 27.

In the middle of things, as always, you will find Trish Getty's report on the overwhelmingly successful Rendez-Vous, p. 15. And we conclude with the ***KPMG Policyholder Support Update,*** p. 30.

Your Publications Committee and your Special Editor thank all of our contributors and interviewees. The Committee welcomes your comments and suggestions and opens the door to the next Special Editor. ■



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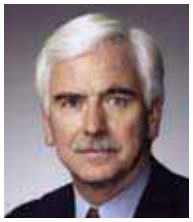
Think Tank

Former Regulators Weigh in on Collateral Reduction continued from page 1


Ernie Csiszar


James Schacht


James Corcoran

something that would inure to the benefit of consumers in exchange for collateral reduction, since reinsurers would benefit greatly from a release of capital, i.e., a quid pro quo for this generosity of regulatory spirit.

At the NAIC's December meeting in San Antonio, a proposal to be presented for final adoption by September 2007 would create a reinsurance evaluation office within the NAIC to determine minimum collateral for unauthorized reinsurance liabilities. The decision would be based on operating integrity and financial strength of unlicensed reinsurers. This proposal was not specifically discussed by the call participants, but as will be seen in this report, all three agreed that the quality of a reinsurer's regulatory supervisory authority is critical to evaluating the quality of a reinsurer.

A Change to the Current System

Two in favor and one against!

Messrs. Csiszar and Schacht agreed that there is a need for change because there is a need for additional reinsurance capacity in the U.S. market. They believe that today there is far greater global demand for reinsurance, which enables reinsurers to move capital out of the U.S. market, if they find the terms of doing business there to be too onerous. Mr. Schacht has always supported a different system, while Mr. Csiszar's views have evolved from that of a regulator to one who recognizes profound change in the reinsurance global marketplace. Perhaps even more relevant to Mr. Csiszar is the vast improvement in regulation in the U.K. and certain other jurisdictions. In fact Mr. Csiszar believes that the U.K.'s FSA can be a model for all regulators, even some aspect of it for U.S. regulators. Mr. Schacht also observed the significant regulatory advancements of Bermuda. In addition, Mr. Schacht held up emergence of the IAIS as illustrative of global regulatory improvement.

Mr. Corcoran stated that his view has not changed. He supported unauthorized reinsurance funding requirements as a regulator and continues to see the need for the requirement based on his experience in private practice. Mr. Corcoran has observed that reinsurers are not so quick to pay reinsurance obligations when a customer relationship is no longer at stake. Whether dealing with a receivership or simply deciding to withdraw from the U.S. market, Mr. Corcoran proffered that he has not seen demonstrations of good faith on the part of reinsurers when they lose interest in maintaining a customer relationship. Mr. Corcoran said that the sole basis on which he could be comfortable with collateral reduction would be if a mechanism existed where the non-U.S. regulator agreed in advance to compel

… today there is far greater global demand for reinsurance, which enables reinsurers to move capital out of the U.S. market, if they find the terms of doing business there to be too onerous.

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Mr. Csiszar is the former President and CEO of PCI and served as the President of NAIC in 2004. He can be reached at ernst.csiszar@yahoo.com.

Mr. Schacht of Navigant Consulting advises national and international clients on insurance and reulatory matters which also includes litigation support and expert testimony. He can be reached at jschacht@navigantconsulting.com.

Mr. Corcoran is the Principal of James P. Corcoran Co. and EVP of American General Corp. and former NYS Superintendent of Insurance. He can be reached at jpcorcoran@jpcorcoran.com.

payment by the reinsurer in that jurisdiction to pay without resort to judicial process.

…receivers appear unanimously opposed to collateral reduction because they believe that reinsurance collections will be slower…

All agreed that receivers appear unanimously opposed to collateral reduction because they believe that reinsurance collections will be slower, more often contested and that guaranty funds would bear the brunt of lost collections. Mr. Schacht observed that receivers often have difficulty submitting valid claims for reinsurance recoverables. They also acknowledged that the solvent market is the larger market by far and that a solution to absorption of capital based on collateral requirements would be beneficial. Mr. Corcoran, however, does not currently see a viable solution.

Getting There – Views on the Optimal System to Effect Change

Once again, Messrs. Csiszar and Schacht were in agreement. Each favors a "gatekeeper" system. Mr. Schacht noted that the concept of a gatekeeper was introduced and supported by him long before the recent proposal by the Interested Persons Working Group. However, Mr. Schacht believes that while the system should be established, for efficiency through federal legislation, authority should be vested in the NAIC to implement and enforce the law. According to Mr. Schacht, such a system would render collateral a negotiable issue for parties to the reinsurance to decide. Mr. Csiszar believes that a change of this magnitude for the insurance and reinsurance industries requires implementation and enforcement at a senior federal government level, such as the Department of Treasury. He remains steadfast in his support for this approach. Mr. Csiszar was sensitive to the fact that such a major change requires a transition mechanism during which regulators could become comfortable with a new system.

The Gatekeeper System

Under the new system, a reinsurer would not be required to post collateral for the cedent to receive credit for the reinsurance, if the reinsurer's domestic regulatory regime and the reinsurer qualified based on standards established pursuant to applicable enabling legislation. These standards would be implemented, monitored and enforced by the new U.S. reinsurance regulatory authority. Mr. Schacht expressed confidence that unqualified entrants could be barred unless they posted collateral deemed adequate for their circumstances. Mr. Csiszar agrees that this is the type of structure needed. Not one of the three participants was comfortable relying upon ratings agencies to do the regulators' job.

Now for the real world

When asked whether they were optimistic that enabling legislation could be passed in the near term, none was optimistic. Mr. Csiszar noted that insurance was not of profound interest to federal legislators, although he was more optimistic about Congress achieving something than individual states adopting an NAIC Model. Mr. Csiszar cautioned that there were risks and opportunities in pursuing federal legislation. The risks would involve sweeping federal legislation to regulate insurance and reinsurance, with the opportunities confining federal legislation to a limited role for reinsurance.

Not one of the three participants was comfortable relying upon ratings agencies to do the regulators' job.

The Quid Pro Quo – What About Reinsurance Premium Reductions?

Mr. Corcoran expressed some dismay that throughout the collateral reduction debate there was no discussion of whether reinsurance premiums would be lower and whether this would inure to the benefit of consumers. Messrs. Csiszar and Schacht thought that this was an idea that merited consideration. ■

Notes

1 Editor Peter Scarpato, Special Editor James Veach and Publications Committee Chair Ali Rifai participated in the interview.

Think Tank

The Reinsurance Evaluation Office – REO, and Collateral Requirements


Doug Hartz

By Doug Hartz

Many of the readers of this special issue of *AIRROC Matters* likely have already been closely following the NAIC's work on reinsurance collateral requirements (the last issue had related articles by Debra Hall and Stewart Keir) and will have heard that the NAIC adopted a proposal on something called the Reinsurance Evaluation Office (REO) under which collateral requirements would be reduced. The NAIC's website http://www.naic.org, in a front page article entitled, "REGULATORS ADOPT REO PROPOSAL – Reinsurance Evaluation Office Plan Amends U.S. Reinsurance Collateral Requirements," proclaims, "The Financial Condition (E) Committee of the National Association of Insurance Commissioners (NAIC) on Tuesday [December 12,] adopted a proposal from its Reinsurance Task Force, which recommends that the current regulatory framework for the supervision of reinsurance be amended to focus on broad–based risk and credit criteria, and not solely on U.S. licensure status.

It still may only be fair to say "The Conception" instead of "The Birth" of the REO because it appears that gestation and labor pains will continue for a while yet.

The Birth of the REO?

What actually happened at the December 2006 NAIC Meeting? It still may only be fair to say "The Conception" instead of "The Birth" of the REO because it appears that gestation and labor pains will continue for a while yet. The NAIC Reinsurance Task Force (RTF), at the December Meeting, only voted to recommend a change in how reinsurance is regulated. It is still not entirely clear what the REO will look like or how it will be implemented and operate. Implementation is especially murky because it will almost certainly require changes in the credit for reinsurance model law and regulation that are required for NAIC accreditation of states. This may then mean that the several year-long exposure and seasoning process for updated accreditation requirements will be applied, unless some form of interstate compact is used to get around this long process.

Implementation will be also complicated by the need to have regulators (that have immunity) make the final decisions on the evaluations made by the REO. The International Insurers Department of the NAIC (IID) operates in this way already in reference to direct business by alien reinsurers. However, evaluating every reinsurer in the world that may assume business from a US domiciled cedent will be a larger task with, possibly, more exposure in regard to mistaken evaluations that lead to disputes by reinsurers or by cedents.

There will be specific issues assigned to the RTF and several other task forces (Examination Oversight, Receivership and Insolvency, etc.) under the NAIC's Financial Condition (E) Committee in 2007 to complete the planning for the REO. There may not be time in 2007 to complete all of these charges or assignments. It may take longer than the 9-month time frame allotted to the labor in the RTF's recommendation.

…evaluating every reinsurer in the world that may assume business from a US domiciled cedent …

Whether the birth of the REO will be a benefit or a detriment to cedents (be they writing, running off or liquidating) will depend on the completed plan for the REO. That plan appears to be far from complete at this

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Doug Hartz, a recovering senior counsel at the NAIC (including work with the IID and RTF), now at Bingham McCutchen LLP and Bingham Consulting, concentrates his practice on troubled insurers, receiverships, run-off and insurance regulation. He has also been a receivership supervisor with Missouri and, prior to that, a contract deputy receiver for several states. He can be reached at doug.hartz@bingham.com.

point. What seems clear from the charge and recommendation made, both explained below, is the intention to have a change implemented starting in 2008 … or sometime soon.

The Charge to the RTF

In March 2006: The Joint Meeting of the Executive Committee/Plenary charged the RTF to:

[1] Develop alternatives to the current reinsurance regulatory framework, including the use of collateral within the U.S. and abroad;

[2] Consider approaches that account for a reinsurer's financial strength regardless of domicile, i.e., state or country;

[3] Identify and consider variations in state law and regulation relative to reinsurance contracts, financial reporting, etc.;

[4] Consult with international regulators in addition to all other interested parties and present a proposal to the members at the December 2006 Winter Meeting

It is unusual for a charge to be made after the first of the year at the March NAIC Meeting. The issue has been discussed for many years, but it took on a sense of urgency in 2006. Partly this may be due to the NAIC's leadership in 2006 being very involved in international insurance activities. Partly this may be due to a sense that if the states do not act in regard to these issues, then the federal government will act. Those that want the collateral requirements changed have been vocal and active. The collateral requirement has become a hot issue in 2006. But many issues become hot at the NAIC and then, as leadership changes every year, become less hot the next year.

The last issue of *AIRROC Matters* had articles by Debra Hall and Stewart Keir — covering, respectively, the larger topic of the entire reinsurance regulatory framework, "Framework Revisited" and the more focused topic of collateral, "What Is All The Fuss About?" — that, like the above charge, overlap. The main focus in updating the regulatory framework appears to be the collateral requirements. The first two and the fourth parts of this charge appear to be aimed mostly at the collateral requirement.

This reflects how the regulation of reinsurance in the US has developed. It has become regulation through the cedents and what they can take as credit for reinsurance in their financial reporting. In a sense the REO Proposal extends this regulation globally so that every reinsurer becomes subject to it. The current draft of the REO Proposal is on the NAIC Website at http://www.naic.org/documents/committees_e_reinsurance_reo_proposal_to_grant_credit_0612.pdf. Note, at page 12, that the Interim Reporting Requirements for "rated reinsurers" requires quarterly financial reports to the REO containing "information comparable to relevant provisions of the quarterly NAIC financial statement…."

The Recommendation of the RTF

The RTF's recommendation will be in the minutes. It will read something like the following:

> The RTF recommends that the NAIC regulation of reinsurance procedure be amended to focus on broad based risk and credit criteria and not solely on U.S. licensure status. In order to facilitate such a paradigm shift the RTF further recommends that for purposes of collateral recalibration that the REO proposal be a basis of a risk-based evaluation process to be further refined by the E Committee no later than September 2007. The RTF further recommends that the E Committee consider commercially reasonable means for the implementation of the new regime.

All states currently require unauthorized or unaccredited reinsurers to post collateral equal to 100% of the reinsurance obligations assumed under laws and regulations substantially similar to the NAIC Credit for Reinsurance Model Law and Credit for Reinsurance Model Regulation. Elimination of the 100% collateralization requirement and establishment of a new process for applying the credit criteria to reinsurers would therefore require amendment of the model law and regulation.

The updates to these models may not be a simple matter. They are somewhat complicated. For example, the NAIC's Model Credit For Reinsurance Model Law

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Section 2 provides:

> Credit for reinsurance shall be allowed a domestic ceding insurer as either an asset or a reduction from liability on account of reinsurance ceded only when the reinsurer meets the requirements of Subsections A [it is licensed in this state], B [it is accredited in this state], C [it is domiciled in a reciprocal state and has $20M in surplus and may be examined by this state], D [it is covered by a multiple beneficiary trust] or E [it is a regulator required reinsurer] of this section.

This seems to be all-inclusive, but Section 3 states if a reinsurer does not meet the Section 2 requirements, then it may post security that will allow the cedent to take credit. The reinsurers using a trust (under Subsection 2.D) are required to "report annually to the commissioner information substantially the same as that required to be reported on the NAIC Annual Statement form by licensed insurers." Under the REO Proposal this will need to be redrafted to reflect the intent that all reinsurers, if they want to be rated and not post 100% collateral, will be doing this reporting. Will reinsures go to the trouble and expense of being rated if they would still have to post collateral at 80%, 60%, 40% or, even, 20%? Will the end result be many reinsurers electing to simply post the collateral and not go through the trouble of being rated? Some may argue that it may not be too different from reinsurers electing not to become licensed, authorized or accredited in a state.

Will reinsurers go to the trouble and expense of being rated if they would still have to post collateral at 80%, 60%, 40% or, even, 20%?

More Time Needed?

Despite the calls of many of the interested parties working on the collateral issue that more time was needed to study the REO Proposal, the RTF voted 15 to 5 to approve the above recommendation. There are regulators, both on the RTF and outside of its membership, that do not see the need for a change. Five members of the RTF voted against the above recommendation even though it very generally stated that the REO Proposal "be a basis of a risk-based evaluation process" and required that to be "further refined by the E Committee." Even with such a general statement and some recognition that more time was needed to refine the concept, perhaps it was the time frame of completing that refinement "no later than September 2007" that caused those five states to vote against the recommendation.

It has been argued that the US system is out of date and lags behind where the EU and other specific countries are at this point.

Some believe it will be a detriment because it will put cedents at a disadvantage in negotiating with their reinsurers. This will be especially a concern when the cedents are trying to collect. Some believe it will be a benefit because reinsurers will need to focus on making timely payments or risk lower ratings (no matter their financial strength) based on their credit history.

There are many arguments for both making a change and for leaving the current accreditation required model laws and regulations as they have been. It has been argued that the US system is out of date and lags behind where the EU and other specific countries are at this point. The counter argument is that requiring collateral is more advanced with benefits that outweigh the costs. The Credit For Reinsurance Model Law was adopted by the NAIC in 1984. It was based on certain state laws that are more dated, but as NAIC models go (the receivership model originated in 1939), it is one of the newer models and it has been amended several times.

The action taken at the December 2006 NAIC Meeting was viewed as significant by those at the meeting, but as significant as it may have been, there is still much to be debated and discussed. This story is far from over. ■

Think Tank

AIRROC Didn't Matter This Time!!!

Terry Kelaher

By Terry Kelaher

For the past several years, alien reinsurers have sought a reduction in the current 100% collateral requirements for unauthorized reinsurers as mandated by state law and contained in the NAIC Model Credit for Reinsurance Law and Regulation. In 2006, the NAIC charged its Reinsurance Task Force Subcommittee with the directive to prepare and consider alternatives to the current 100% collateral requirements for unauthorized reinsurers. To that end, the Reinsurance Task Force Committee had disseminated two proposals for comment: (1) the Reinsurer Rating Proposal ("Rating Proposal"); and, later (2) the Reinsurance Evaluation Office Proposal ("REO Proposal") (subsequently amended). Both the Rating and REO Proposals provide reduced collateral requirements for alien reinsurers meeting certain requirements, and impose additional collateral requirements on licensed U.S. reinsurers.

Of the forty-five (45) eligible members we were only able to obtain sixteen (16) votes.

Given the interest of AIRROC members in legislation affecting run-off reinsurance arrangements including legislation impacting existing reinsurance agreements, AIRROC had drafted for the consideration of its members a letter to Julie Bowler, Chair of the Reinsurance Task Force, objecting to any retroactive application of either the Rating Proposal or the REO Proposal. The text of that letter follows below.

Following approval of the draft by AIRROC's Board and pursuant to AIRROC's Advocacy Policy, the draft was submitted to all AIRROC members for a vote. A key requirement of the Advocacy Policy is that an 80% supermajority must be obtained from a 50% quorum before any initiative can be adopted. Of the forty-five (45) eligible members we were only able to obtain sixteen (16) votes. We are therefore unable to proceed on placing our position in front of the task force. ■

Terry Kelaher, FIIC joined Allstate Insurance in 1988. He is a Vice President of the Allstate Insurance Company and since 1997, has been General Manager of the Specialty Operations Division. Terry currently sits on the Board of Allstate Insurance Company of Canada. He can be reached at tkelaher@allstate.com.

The draft letter reads as follows:

The Honorable Julianne Bowler
Chair, NAIC Reinsurance Task Force
Massachusetts Division of Insurance
One South Station
Boston, Massachusetts 02110-2208

Re: Objection by the Association of Insurance and Reinsurance Run-off Companies ("AIRROC") to the Retroactive Application of Reduction in Collateral Proposals

Dear Ms. Bowler:

We write regarding the NAIC Reinsurance Task Force Subcommittee's request for consideration of the Ratings Proposal contained in the Report of the Co-Chairs of the Reinsurance Collateralization Roundtable of September 29, 2005 ("September 29, 2005 Proposal"), its subsequent intent to undertake the drafting of a collateral reduction proposal, and the resulting NAIC Reinsurance Evaluation Office Proposal dated October 31, 2006 ("REO Proposal"). *AIRROC takes no position on whether there should be a change to the current rules on collateral requirements*. This is an issue on which AIRROC members have different views. However, AIRROC members strongly believe that, if there is a change in the current rules, any such change should only have prospective effect, and AIRROC here expresses this firm position.[1]

AIRROC is an association made up of over 50 insurance companies and was constituted to promote and represent the common business interests of insurance and reinsurance companies in run-off and liquidation. AIRROC's objectives include enhancing knowledge and communications within and outside the run-off industry.

AIRROC represents the interests of companies in run-off and liquidation. Thus, whether any change in credit for reinsurance statutes applies prospectively or retroactively is of paramount importance to our members. Significantly, Section 4 (A)(I)(iii) excepts from the REO Proposal "transactions entered into before [effective date]," but qualifies that exception "to the extent that they qualify for full credit under the standards in effect on that date." [2] Any change to the current collateral requirements must apply prospectively *only*, specifically applying only to contracts incepting after the effective date of the statute without qualification. In fact, the September 29, 2005 Proposal itself provided that "these new rules will apply prospectively only; *i.e.*, only to reinsurance contracts that incept from the date these rules become effective," without qualification or limitation A full prospective requirement is imperative in any drafting proposals undertaken by the NAIC. Many old contracts contain provisions therein requiring reinsurers to post collateral "as required by law" (or similar language). If the laws regarding collateral reduction are changed to reduce or eliminate collateral and such laws do not contain the appropriate language, then unauthorized reinsurers will argue that the new laws allow them to forego posting of collateral on old contracts. This could be a catastrophic result for ceding companies that are currently secured for old large "long tail" losses (*e.g.*, asbestos, environmental).

Additionally, retroactive application of a statute which reduces current collateral requirements poses significant constitutional and solvency problems. First, retroactive application of a statute affecting substantive contract rights may run afoul of express constitutional protections. *See* U.S. Constitution, art. I, and amends.V, XIV. Courts have struck down as void statutes applied retroactively which impair existing contract rights. Such an application of a statute reducing collateral requirements risks numerous challenges and ultimately, long delays to the enactment of a proposed statute, undermining any relief sought to be gained in the immediate future.

Second, retroactive application poses important solvency considerations. AIRROC represents the interests of companies which typically do not possess the possibility of offering new underwriting risks to the reinsurance community. Accordingly, run-off entities do not often have the same type of relationship with their reinsurers as those extending to reinsurers the prospect of on-going business, making the already difficult reinsurance collection process even more challenging. [3] As the NAIC knows, reinsurance collections have long been recognized as a significant factor in the financial solvency of a state's ceding companies. *Id.* Indeed, the White Paper contains the following heading: "*Quality of Reinsurance can be a Solvency Risk.*" NAIC White Paper at 9 (citing from *A.M. Best*) (internal citations omitted). *Reducing collateral on a retroactive basis only serves to heighten the difficulty of collecting on large long tail losses* (*e.g.*, asbestos and environmental), a substantial exposure to many run-off entities. Even retroactive application to a subset of existing obligations raises these same considerations.

Retroactive application of collateral requirements poses unique risks and concerns to run-off entities. For the above-stated reasons, AIRROC objects to a retroactive application of collateral requirements on the whole, to the language in the REO Proposal specifically, and in any drafting initiatives undertaken by the NAIC. We appreciate consideration of our objection.

Very truly yours,

Trish Getty, Executive Director
AIRROC Legislative Committee

[1] This document expresses the views of AIRROC but does not necessarily represent the view of each of its members.

[2] AIRROC does not understand what this excepting language means nor how it is to be determined whether the requisite transactions "qualify for full credit," who will undertake that analysis, and its corresponding right of review.

[3] As the NAIC has acknowledged, "Reinsurance collections have become a more difficult and contentious process, where the willingness to pay seems to be as big an issue as the ability to pay." *The NAIC U.S. Reinsurance Collateral White Paper,* October 2005 ("NAIC White Paper") at 9.

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Message from CEO and Executive Director

AIRROC Sails Out of 2006 on Peaceful Waters

Trish Getty

AIRROC sails out of 2006 on peaceful waters while reflecting on its accomplishments during the year. Membership swelled to 55 companies, education programs targeted the expectations of its members and *AIRROC Matters* maintained its superior level of quality.

The second AIRROC/Cavell Commutation & Networking Event in the Meadowlands on October 16-18, 2006 was simply awesome with over 320 attendees. We are gratified to receive a multitude of

continued on next page

Ms. Getty has been active in the insurance and reinsurance industry for over forty years, specializing in reinsurance claims. She has significant experience evaluating liability and reserve adequacy and planning and implementing claims and operational audits. In 1996, Trish expanded her focus to include sales and marketing of reinsurance services. In addition to active business, Trish has provided consulting services to regulators for the reinsurance administration of troubled and liquidated companies. She can be reached at trishgetty@bellsouth.net.

AIRROC's Run-off Person of the Year

Oliver Horbelt

Oliver Horbelt

AIRROC chose the President and Chief Executive Officer of the Centre Group of Companies (a business unit within the Zurich Financial Services Group)("Centre") as its 2006 Run-off Person of the Year.

Mr. Horbelt joined Centre Solutions in early 2003 and assumed strategic and operational responsibility in early 2004. Through restructuring, commutation, and asset sales, Centre produced $225 million in net income in 2005 and $130 million in net income the first six months of 2006. Centre's management team achieved these results while reducing Centre's liabilities from more than $7 billion when Mr. Horbelt took charge to less than $3.5 billion today.

A *summa cum laude* graduate of the University of Zurich (Switzerland) with a Masters in Economics and Business Administration, Mr. Horbelt is a former managing director of the Swiss Reinsurance Company and a former Associate with the Equity Capital Markets International Division of Credit Suisse First Boston. Fluent in English, German, and French, Mr. Horbelt observed that it is difficult to define run-off in English "without using the word run-off, which defeats the object," but that defining run-off in German requires at least three lines of small print.

AIRROC's Run-off Person of 2006 exemplifies a new breed of run-off professionals. He exemplifies a hard-driving leader who applies a broad knowledge of the capital markets and an entrepreneurial bent to complete a run-off with an eye to releasing capital for fresh underwriting efforts. Mr. Horbelt sees a merging of capital markets and insurance/reinsurance run-off. He is "astonished that there is not yet an established secondary market for insurance policies" or that the run-off industry has "not been more creative" using the cash flows from what is estimated to be $1 trillion in insurance liabilities tied up in the global run-off market.

Given this amount of frozen capital, and his track record thus far, he may soon be a contender for a *second* Run-off Person of the Year award. ■

Message from CEO and Executive Director

continued from previous page

complimentary statements from attendees. Delegates traveled from not only the U.K. and U.S. but Japan, Australia, Germany, Switzerland, France, Sweden, Denmark, China, Bermuda and the Guernsey Islands. Media covering the event was Business Insurance, JTW News and Global Reinsurance. One delegate commented that last year he knew virtually nobody in attendance but this year had meetings scheduled every thirty minutes! This speaks well of the value of these meetings, most importantly that companies are growing in the spirit of face-to-face negotiations. At the end of the day, most participants experienced progress or closure of books of business as well as dispute resolution and collections. That's progress! ***Mark your calendar for the October 15-17, 2007 AIRROC/Cavell commutation event again in the Meadowlands.*** Planning is already well underway.

AIRROC catapults into 2007 with confidence, member support and plans in place for its membership meetings, education and solutions for its members. We thank the members of our many committees for their dedication of time and effort to ensure continued value of our association. Our website, http://www.airroc.org, contains the dates and details of 2007 meetings.

Flying on the wings of our October commutation event, ***we have arranged a one-day commutation and negotiation event on February 21, 2007 in NYC followed by our next membership meeting on February 22.*** We offer our heartfelt thank you to Cavell who refused to take any profits from the October 2006 commutation event so that we can give back to our members. Part of those profits has enabled AIRROC to offer the February 21 commutation day without charge for registration or the luncheon to the attendees. We also thank the 2006 generous sponsors who provided the financial capabilities to again provide meaningful events.

The education forum presented at our May 2006 membership meeting in Hartford was so well received by the attendees that we will again present a similar forum during our February 22, 2007 meeting. Don't miss it! The

continued next page

AIRROC/Cavell Commut

tation and Networking Event

16-18 October 2006 • New Jersey

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D


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Captions

A Team Centre Supports Person of the Year. From left to right, Joe Magnano, General Counsel; Rudy Dimmling, Chief Administrative Officer (with back to the camera); Stuart Berman, Global Head of Litigation; James Veach, Mound Cotton and (at far right) Edward Stelzer, Deputy Global Head of Litigation

B. Klaus Kune of Hanover Re, Frank Kehrwald of Swiss Re America and Andrea Lerch of Hanover Re

C. John Madden of Chiltington, Caroline Gimblett of Deloitte & Don Wustrow of Chiltington

D. Trish Getty, CEO & Executive Director of AIRROC

E. Julie Ponsford of Cavell UK and Bryina Starks of CNA

F. Alan Quilter of Cavell UK and Andrew MacCarthy of Cavell UK

G. Andy Rothseid of PwC at the podium

H. Oliver Horbelt, AIRROC 2006 Person of the Year, celebrating in style

Message from CEO and Executive Director

continued from previous page

results of the election of the AIRROC Board of Directors on October 16, 2006 confirmed those board members running for re-election: Karen Amos (Equitas), Dale Diamond (AXA), Ali Rifai (Centre Holdings), Jonathan Rosen (The Home) and Michael Zeller (AIG). Two additional board slots were opened and elected to fill those seats were Art Coleman (Citadel Re) and Janet Kloenhamer (Fireman's Fund). Our congratulations to all! AIRROC is firmly positioned to maintain and further the value of membership particularly with this solid Board of Directors.

Continue to spread the word about AIRROC, the value of relationships and objectives… we seek solutions. ■

Feature Article

Security for Reinsurance Reserves – An English View


Clive O'Connell


David Abott

By Clive O'Connell and David Abbott

There are fundamental differences between the way in which reinsurance is regulated in the United States and the way in which it is regulated in many other jurisdictions including England and Europe. One of the most pronounced of these differences is in the requirement (or absence of requirement In England and Europe) for security to be provided by alien or non-admitted reinsurers.

Whereas, in the United States, a regulated insurer can only obtain credit for solvency purposes for reinsurance which is either admitted or which is backed by security, in England and Europe, no such requirements exist. There is a fundamental difference in approach between regulators. A simple analysis would indicate that in the United States, the regulators seek to regulate where the risk exists. In England and elsewhere, the regulation is focused upon where the insurance activity takes place.

…in the United States, the regulators seek to regulate where the risk exists. In England and elsewhere, the regulation is focused upon where the insurance activity takes place.

Thus in England, we are free to buy insurance in all but a few mandatory classes, from anyone who is willing to sell it to us. We can scour the earth looking for the best deal and if it appears that we can insure houses on favourable terms with an insurer based in Port Staley in the Falkland Islands or in Dili, East Timor, are entitled to do so. We must, however, purchase motor insurance or employers' liability insurance from an authorised insurer.

Clive O'Connell is a Partner and David Abbott an Associate at the London law firm of Barlow Lyde & Gilbert. They can be reached at coconnell@blg.co.uk and dabbott@blg.co.uk, respectively.

When it comes to reinsurance, an insurance company can look around the world for the best cover. Foreign reinsurers can, without going to the cost of authorisation, sit at home and write English reinsurance risks brought to them, either by enthusiastic brokers or by digital communication. There is no regulatory requirement upon them to put up any security for potential losses and no requirement on the reinsured to withhold a reserve from premium or in any other way.

…a reinsurer from Delaware or Delhi can compete with local English or European reinsurers on price.

What this means is that a reinsurer from Delaware or Delhi can compete with local English or European reinsurers on price. If a non-authorised reinsurer is required to post security there is a necessary cost involved. The removal of this pricing obstacle allows foreign reinsurers to offer the same price as local reinsurers, or, if their cost base is lower, potentially to offer a more competitive price.

Reinsureds do not, however, search out the cheapest deals. Well, not all the time. There are times, during particularly soft markets, where some reinsureds have sometimes operated on a basis which gives truth to the jaundiced maxim that in a soft market the only way to make money is to write as much business as one can at whatever price and then reinsure it out for less. To operate in this way is akin to setting one's SatNav for the quickest and most costly route to arbitration hearings and, potentially, insolvency.

Most reinsureds, however, and in hard markets, almost all, look for quality of security rather than the saving of a few cents in premium. In a hard market they can afford to. In addition, although there is no regulatory requirement to obtain security from one's reinsurers, regulators do look at the quality of reinsurance as part of their regulatory overview of insurers.

The financial requirements required of an insurer or reinsurer in the United Kingdom (of which England forms a part) are set out in the Financial Services Authority's Handbook. Principle 4 of the FSA's High Level Standards requires that an insurer must maintain

continued on next page

adequate financial resources. In turn the Integrated Prudential sourcebook (PRU) 1.2.22R requires every regulated insurer to maintain overall financial resources that are adequate to ensure that there is no significant risk that their liabilities, including both contingent and prospective liabilities, cannot be met as they fall due.

An insurer is required to assess its assets (which necessarily include its reinsurance asset) and liabilities and cash flow projections of assets and liabilities, but is not required to support contingent or prospective liabilities with cash or other security. The requirements are based more on an obligation to monitor and to assess risk and then to manage that risk. Systems must be in place to identify major sources of risk and among these are credit risks of reinsurers.

Thus, the focus of regulation is on effectively monitoring and managing all forms of risk including reinsurance solvency risk. Failure to monitor and manage this risk could lead to regulatory intervention.

The absence of any requirement to obtain security from reinsurers does not mean that English reinsureds do not sometimes require security. Contractual clauses requiring security are regularly inserted in some contracts, particularly contracts which are susceptible to larger losses. In these instances, the requirement to post security is frequently triggered by a drop in rating of the reinsurer. A drop in rating can, accordingly, have severe repercussions for a reinsurer who might then be obliged to fund huge amounts of reserves on the back of a declining revenue stream.

In the United States, it is usual for a reinsured to seek an order for pre-hearing security in reinsurance disputes. The power to order such security is statutory. In England, no such statutory authority exists. Indeed, the Arbitration Act of 1996 gives no power to arbitrators to award pre-hearing security and only power to make awards on part of the dispute at different times. In order to make a partial award, the arbitrators must have a full hearing and, accordingly, unless there is a preliminary issue which is likely to resolve or reduce the dispute, no partial award is usually made. The arbitrators do, however, have power to award security for costs under section 38 (3) of the Act. This security is, however, only to be awarded against the claimant, who is usually the reinsured, rather than reinsurer, and then only in very specific circumstances.

Americans seeking business from Europe have an advantage.

One of the issues often debated between American and European reinsurers is the supposed lack of a level playing field where the requirements for non-American authorised companies to post security places non-Americans at a cost disadvantage when competing for American business,-a cost disadvantage that does not apply to Americans seeking business from European insurers. The underlying regulatory philosophies will ensure that no easy answer is found to this imbalance. In the meantime, Americans seeking business from Europe have an advantage.■

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Feature Article

Found Money or Unobtainium: Security Deposits and the Run-off Company


Charles Ehrlich

By Charles Ehrlich

An insurer or reinsurer that goes into run-off is likely to have a large patchwork of deposits, trust accounts, LOCs and other security instruments that tie up significant financial resources. Suddenly, with no premium coming in, the company needs to free up cash to pay claims, to avoid liquidating illiquid longer-term investments or even to pay salaries and operating expenses. In the most favorable situation, freeing up deposits might even help liberate excess capital that should be released to the owner. Freeing security will be no easy task, however; with the company in run-off, cedents, regulators, foreign claimants and the like will be doubly concerned that security funds be maintained as protection.

What should a run-off manager do first, to get its arms around the extent and types of security that the company has out in the world and, second, free up that security? As with any other task facing a run-off, there are no simple, silver bullet answers. Success comes only with focus, proper resources, and perseverance.

The first step to making things right is dedicating competent, dedicated resources to the task of identifying and liberating security.

The company newly in run-off is likely to find that little, if any, attention has been paid to security postings. It will be unlikely that security has been actively and continually reviewed and adjusted. Indeed, in the worst case, there will not even be a good, consistent set of records showing all posted security.

Charles Ehrlich is Senior Vice President and General Counsel of TIG Holdings, Inc., RiverStone Resources, and related companies. He is grateful to Richard Coerver, Robin Ephraimson, and Luke Tanzer for sharing their vast experience. He can be reached at charles_ehrlich@trg.com.

The first step to making things right is dedicating competent, dedicated resources to the task of identifying and liberating security. That person or team, let's call it the "security management team," needs to be an effective combination of detective, bulldog, negotiator and diplomat. The team will then:

- Identify key security obligations: Determine which security obligations have the most potential for liberating cash, and establish a "priority hit list."
- Set targets for reduction: Once the company knows what its priority security situations are, the team needs to develop a plan for reduction, and, in consultation with management, set precise achievement goals, i.e., timetables and planned amounts
- Create incentives: The job of the security team is to liberate security. Pay them for success. Make getting the targeted reductions a substantial part of the security management team's bonus potential

Once the team knows what it is going after, and what the rewards for success will be, the process moves to the blocking and tackling stage:

- Verify legal obligations: Determine whether the posted security is actually required by the contract or regulation in question. It is likely that people became sloppy over the years and, for example, assumed they knew what a contract required without actually going back to look
- Vet all on-going posting requests: No new or added security should be posted without authorization by the security management team
- Review and challenge reserves: If the posting of a reserve will lead to an increased deposit requirement, be pro-active in assessing the validity of the reserve and challenging it if it is excessive
- Bring in the actuaries: A large security obligation

continued on next page

may benefit from actuarial review, especially if the obligation includes IBNR. If your actuaries and the counter-party's cannot come to an understanding on the numbers, consider agreeing to an independent review

- Look for offsets: while an increase in security may be required under a contract, another contract with the same party may over-secure, and thus no new money needed
- Pay claims from deposits: Rather than sending new money to pay a claim, look for situations in which the funds can b e drawn from a deposit

It is critical to build credibility with the regulators if you want to free up statutory deposits or liberate capital from the run-off.

- Look for substitutions: A posted security may have appreciated in value; replace it with a more appropriate security
- Hit the road: The telephone and e-mail dances create easy excuses for a lack of action. Get out on the road to meet with security holders and make deals
- Work closely with the regulators: It is critical to build credibility with the regulators if you want to free up statutory deposits or liberate capital from the run-off. This means keeping the regulators fully informed about what is going on with the run-off, providing them even more information than they ask for, responding to inquiries promptly and completely, and never getting near a line – much less crossing over it. Specifically:
  - Senior management should visit the regulators often to discuss the progress of the run-off, management's plans, and the company's successes and risks
  - The regulators should have advance notice of significant developments in the business, such as a key commutation, even if no regulatory action is needed

Keep on top of the effort: Management should be reviewing progress on security releases frequently; monthly is a good idea

  - When approvals are needed, the requests should be made sufficiently in advance for the regulators to handle them in the ordinary course of their business
  - Information should be presented in a comprehensive but user friendly format
  - Everyone in the regulatory world, from junior analyst to insurance commissioner, should be treated with respect
  - Do nothing that might cause embarrassment to the regulator
- Commute relationships: Commutations with securitized parties may not directly release cash; however, they can reduce the run-off's liabilities because they use encumbered assets rather than new cash
- Keep on top of the effort: Management should be reviewing progress on security releases frequently; monthly is a good idea

Peter Drucker said, "Plans are only good intentions unless they immediately degenerate into hard work." The admonition is doubly true in the run-off world, where every business challenge is made more difficult by the doubts and concerns that attach to the very status of being in run-off. The steps we've described above can help in dealing with security problems; however, success ultimately hinges upon the skill, drive and initiative of those charged with the mission. ■

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Feature Article

Run-off and Pre-award or Pre-judgment Security: A Thumbnail Review


James Veach

By James Veach

We offer for your consideration the oxymoronic search for security in an industry built on risk. Specifically, we ask how run-off affects what has become an almost reflexive request for pre-award or pre-judgment security in litigated and arbitrated reinsurance (and insurance) disputes.

We offer for your consideration the oxymoronic search for security in an industry built on risk.

In a companion piece, we interview three hands-on run-off managers: Charles Ehrlich (Riverstone Management, LLC); Richard White (Deputy Special Liquidator, Integrity Insurance Company in Liquidation) and Jonathan Rosen (The Home Insurance Company in Liquidation). All three of these gentlemen are ARIAS-U.S. certified arbitrators and thus often confronted with citation-laden applications for pre-award security.

The idea is to read these two articles together, although we trust each can stand alone. This is not an exhaustive survey, but rather a warm-up for the panel interview that follows.

Statutory Authority

Many U.S. jurisdictions have enacted statutes requiring that unauthorized foreign or alien insurers deposit cash, securities, or a court-approved bond before filing "any pleading in any proceeding against it . . . ." *See, e.g.*, New York Insurance Law § 1213(1) (McKinney's 2006) ("NYIL"). NYIL § 1213 was derived from the Unauthorized Insurers Process Act ("Model Law"), adopted by the National Association of Insurance Commissioners at a Winter Meeting held in New York City in 1948. Why did the NAIC draft its Model Law?

In the 1930s and 1940s, radio and direct mail advertising allowed a few unscrupulous insurers to locate in jurisdictions far from their market targets. These insurers sold policies, declined coverage, and, when sued, argued that they were not subject to the jurisdiction of the courts where the policyholder resided. Thus, an insurer domiciled in Montana could target a market in New York and under the case law extant in the 1930s argue that it was not subject to the jurisdiction of a New York state court. For additional background, see J. Veach, *"Pre-Answer Security" May Not Belong in a Reinsurance Arbitration*, Mealey's Litigation Reports: Reinsurance, Vol. 3, # 21, p. 16 (March 10, 1993)("*Pre-Answer Security*").

Mechanics

Ultimately, more than two dozen states joined New York in adopting the Model Law. Another dozen or so states have related legislation. See NAIC Model Regulation Service, Unauthorized Insurers Process Act (2006). These long-arm statutes apply to unauthorized foreign or alien insurers that, by mail or otherwise, issue or deliver contracts of insurance, solicit applications, collect premiums, or transact other insurance business with residents of states that have enacted the Model Law. By doing any of these acts, an unauthorized insurer is deemed, under New York's version of the Model Law, to have appointed the New York Superintendent of Insurance as its agent upon whom process may be served in any action commenced by an insured or policy beneficiary against the insurer in a New York court. NYIL 1213.

The plaintiff/policyholder/beneficiary must perfect the service as required by the statute. In order to file a pleading, including an answer, in a New York state

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court proceeding the insurer must: (1) post "cash, securities, or a bond sufficient to pay any final judgment entered against the insurer"; or (2) become licensed in New York State. NYIL 1213.

The Model Law withstood early constitutional challenges in New York and elsewhere. *See e.g., Dean Const. Co., et al. v. Agricultural Ins. Co.*, 42 Misc. 2d 834, 249 N.Y.S.2d 247 (N.Y.Sup.1964), *aff'd*, 22 A.D. 2d 82, 254 N.Y.S.2d 1964 (2nd Dep't); *Ace Grain Co. v. American Eagle Fire Ins. Co., of N.Y.*, 95 F. Supp. 784 S.D.N.Y. (1951), *but see Clifton Products, Inc. v. American Universal Ins. Co.*, 169 F. Supp. 842 (1959). One early attempt to stretch a Model Law long-arm statute to apply to a reinsurer was beaten back. *Safeway Trails, Inc. v. Stuyvesant Ins. Co.*, 211 F. Supp. 227 (M.D.N.C. 1962) *aff'd*, 316 F.2d 234 (4th Cir. 1963) (court strictly construed state statute and refused to extend it to reinsurers on the ground of "public policy"). This changed in the early 1990s with two cases — one in Supreme Court, New York County and the other in the Southern District of New York.

Model Law Applied to Reinsurers

In 1990, a dispute between the liquidator of Delta America Re (formerly Elkhorn Re), then domiciled in the Commonwealth of Kentucky, wound up before Magistrate Judge Kathleen Roberts sitting in the Southern District of New York. (Delta's liquidator chose New York as the venue to pursue a series of cases against Delta/Elkhorn's officers, directors, former owner, advisers, ceding insurers, intermediaries, and retrocessionaires). Magistrate Judge Roberts ruled in favor of the Delta Liquidator's motion to compel Delta's retrocessionaires to post more than $41 million in pre-answer security. *Morgan v. American Risk Management, Inc.,* 1990 WL 106837 (S.D.N.Y. July 20, 1990).

Other magistrate judges followed Magistrate Roberts' lead and some District Courts adopted the reasoning in the *Morgan* case. See cases cited in *Pre-Answer Security* at 18. The following year, a New York State Supreme Court Justice adopted the *Morgan* reasoning in an action brought by the liquidator of an insolvent New York insurer against its Bermudan reinsurer. *Curiale v. Ardra Ins. Co., Index No*. 9794/85 (Sup. Ct., N.Y. County, May 2, 1991). The Supreme Court required that Ardra post security of $10,351,877.38. Ardra advised the trial court that it could post no more than $1 million. After a hearing on the appropriate amount of security the trial court ordered that Ardra's answer be stricken. The Appellate Division, First Department, affirmed on interlocutory appeal. 189 A.D.2d 217, 595 N.Y.S.2d 186 (lst Dep't 1993). The trial court ordered the entry of a default judgment and that default judgment was affirmed on subsequent appeals. 211 A.D. 2d 473, 621 N.Y.S.2d 315, *aff'd*, 667 N.E.2d 313, 88 N.Y. 2d 268 (1996).

During these appeals, New York courts rejected Ardra's due process arguments. With respect to whether NYIL 1213 was ever intended to apply to foreign or alien reinsurers, New York appellate courts pointed to NYIL § 1101, which provides that alien reinsurers need not obtain a license to conduct the business of insurance in New York State, but that also "specifically provides… (that NYIL 1213) 'shall nevertheless be applicable to such insurers.'" *Ardra*, 644 N.Y.S.2d at 668. The *Ardra* case has been followed by several New York cases applying the NYIL 1213 requirements for pre-answer security to reinsurers. *See, e.g., British Intern. Ins. Co. Ltd. v. Seguros La Republica, S.A.,* 212 F. 3rd 138, 139 (2nd Cir. 2000). For a thorough summary of the arguments raised by reinsurers seeking to *avoid* security requirements and – with one exception – uniformly rejected by courts, see C. Hitchcock & P. Biging, *Tactical Use of State Laws Requiring Unauthorized Insurers to Post Pre-answer Security*, 31 Tort & Ins. L. J. 767 (Spring 1996).

While courts may have no choice but to enforce statutory security requirements against reinsurers, presumably arbitration panels have the equitable authority to ignore these statutes.

Equitable Authority

While courts may have no choice but to enforce statutory security requirements against reinsurers, presumably arbitration panels have the equitable authority to ignore these statutes. At the same time, the extent to which Model Law – related legislation has any place in an arbitration remains unsettled. Compare J. Veach, *Pre-Answer Security* *18-19 with M. Knoerzer & J. Tenney, *The Pre-answer Security Requirements of Section 1213 Apply to Reinsurers and Arbitration*

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Proceedings, 3 Mealey's Litigation Reports: Reinsurance 4 (June 23, 1993).

No one, however, challenges the power of arbitrators in a reinsurance dispute to issue interim awards to secure a final award. *See*, *e.g.*, *Atlas Assurance Co. of America v. American Centennial Ins. Co.*, 1991 WL 4741, at *2 (S.D.N.Y. 1991); *In Re Northwestern National Ins. Co. v. Generali Mexico Compania de Seguros, S.A.*, 2000 WL 520638, *11 (S.D.N.Y. 2000) ("arbitrators have the authority to order interim relief in order to prevent their final award from becoming meaningless").

935 F. 2d 1019, 1022-23 (1991) (parties' agreement to allow the arbitrators to treat the reinsurance agreement as an "honorable engagement rather than a merely legal obligation" grants the Panel the authority to issue interim security awards as "temporary equitable relief").

While most interim arbitral awards are not eligible for judicial review, *e.g.*, discovery or scheduling orders, security awards are generally subject to review. See, *e.g.*, *Pacific Reinsurance*, 935 F. 2d at 1023. But the ability to overturn these interim awards is limited. Both trial and appellate courts usually begin their opinions by citing authority holding that a party challenging an arbitration award: (1) bears the burden of proof; and (2) that burden is a heavy burden such that if a "'barely colorable justification' for the arbitration award exists, the award should be confirmed." *Cragwood Managers, L.L.C. v. Reliance Insurance Co.*, 132 F. Supp.2d 285 (S.D.N.Y. 2001).

The past couple of decades provide many examples of judicial reluctance to overrule arbitrators with respect to pre-award security orders…

The past couple of decades provide many examples of judicial reluctance to overrule arbitrators with respect to pre-award security orders, even in cases where the party required to post the security cannot or least appears unable to satisfy the security award, thus making it susceptible to a default award/judgment. *See*, *e.g.*, *Cragwood*, 132 F. Supp. 2d 285 (interim award required Cragwood, a management company, to post $4 million bond to satisfy Reliance's counterclaim even though Cragwood had only $4,073,000 in cash and outstanding legal bills of $370,000) and similar cases cited by the District Court in *Cragwood* at 288.

Today, we have reached the point where counsel in a reinsurance arbitration may cite Model Law-related statutes to bolster her/his requests for an interim equitable order.

Today, we have reached the point where counsel in a reinsurance arbitration may cite Model Law-related statutes to bolster her/his requests for an interim equitable order. Thus, a District Court recently asked to confirm a panel's interim order held that the Panel's "failure to follow the specific provisions of N.Y. Insurance Law § 1213 cannot be characterized as 'manifest disregard.'" In the very next paragraph, however, the Court also ruled that:

> despite the fact that N.Y. Insurance Law Section 1213 may not, by itself, apply to this case, it does provide a precedent in law for the arbitrators to find that the amount in controversy is a proper measure of a permissible amount at which to set the security.

British Insurance Company of Cayman v. Water Street Insurance Company, 93 F. Supp.2d 506, 516-17 (S.D.N.Y. 2000)(panel directed that reinsurer post $1,700,000 in pre-award security even though reinsurer provided affidavits establishing that this sum represented 85% of all assets available and preferred the security-requesting party over all other policyholders).

Fights over pre-answer and pre-award security have proliferated and generated a lot of case law on very fine points, but this, of course, is just a thumbnail sketch. Having set the stage, we now turn to our own panel of run-off managers/certified arbitrators. ■

Feature Article

Security In Run-off: Arbitrators Cum Run-off Managers Speak


Charles Ehrlich


Richard White

In the previous article, Special Editor James Veach reviews some of the case law that has evolved around applications to arbitration panels and courts for pre-award security. Then Mr. Veach interviewed three experienced run-off managers who are also ARIAS-U.S. certified arbitrators — Jonathan Rosen (The Home Insurance Company in Liquidation), Charles Ehrlich (Riverstone Resources, LLC), and Richard White (Deputy Liquidator, Integrity Insurance Company — then commented on these applications. Our Panelists also discuss generally the role of security in a run-off, be it voluntary or under an order of liquidation.

Veach: How common are applications for pre-award security where the party asked to post security is in run-off?

White: Without trying to ascribe percentages, I find that the number of arbitrations involving parties in run-off is high. Although my run-off and forensic accounting background may be exposing me to more run-off-related disputes than other arbitrators, I believe a close analysis of all pending reinsurance arbitrations would confirm that a high percentage of arbitrating parties are in run-off.

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Rosen: When you go into run-off, everything changes, because you no longer have an ongoing underwriting relationship, one effect of which is the elimination of net accounting of premiums and losses. These changed circumstances, among other things, tend to generate more disputes, although I am loathe to offer percentages. Also I may be seeing more run-off related arbitrations because this is the world in which I have been operating for many years.

Ehrlich: When I do the archeology of a reinsurance dispute, I am reminded that while in the past, due to ongoing business relationships, each party could give the other some future benefit that would resolve a dispute without arbitration; in run-off I often can't do that. For this reason, an increased number of run-off related differences aren't resolved at the business level. While it's difficult to conclude that being in run-off *per se* increases the odds that you will find yourself in arbitration, rather than settling the problem, in run-off you can't smooth over problems with next year's underwriting.

Veach: In determining whether a party requesting pre-award security is entitled to relief, is run-off status relevant?

White: I constantly see requests for security from reinsurers that are in run-off, often coupled with a subtext that the reinsurer or its parent is located outside the U.S.

Rosen: I have a number of arbitrations on the go where security applications are advanced as a matter of course.

Veach: How successful are these applications and how are they decided?

Rosen: For me, the determinant is the (reinsurer's) financial well-being. That a rating has been withdrawn is not, in and of itself, determinative. Furthermore, in my experience, applications are not dependent on whether the reinsurer is in this country or not. Also, in many instances applications are initially denied,

continued on next page

Think Tank

Security In Run-off: Arbitrators Cum Run-off Managers Speak …

continued from previous page

although with the cedant allowed to reapply if circumstances change. An award along these lines is often coupled with an interim order directing that quarterly reports be provided to the Panel and the other party and that the Panel be advised of any sudden changes in a reinsurer's financial health.

Ehrlich: It seems to me that most certified ARIAS-U.S. arbitrators are sophisticated enough to go beyond the argument that being in run-off alone is enough reason to require the posting of security. Have my fellow panelists had the same experiences?

Rosen: ARIAS-U.S. arbitrators are often former CEOs or CFOs of companies within large insurance groups. As such, a quick review of trust documents or annual statements is part of their everyday experience. Arbitrators with these backgrounds quickly size up the need for security.

White: Although I agree generally with my co-panelists, I would expect a higher ratio of 3-0 votes against security by panels faced with security requests, particularly where the applications were relatively non-fact-specific or were primarily based on a party's run-off status or its location outside the U.S., but that unfortunately has not been my experience.

While the panel members may be capable of reading a financial statement, I am not sanguine about the unanimity of a panel confronted with a request for pre-award security, regardless of the experience or background of individual arbitrators. This lack of unanimity isn't due to an arbitrator's inability to read an annual statement.

Veach: Shifting away from arbitration/litigation and focusing on your roles as run-off managers, can you comment on being confronted with demands for security when you stepped in as a run-off manager?

Ehrlich: My run-off companies have had enough statutory surplus, despite being in run-off, to avoid any claim that we should post more security simply because we were a dedicated run-off facility.

Rosen: On the assumed side, we maintained our existing contractual security obligations. On the ceded side, we ensured that letters of credit or other security devices were maintained. Most reinsurers with contractual obligations honored their obligations, as did insureds with retrospective premium and deductible arrangements. On the front end, we have had to enforce security arrangements through arbitration, but we have not had the need to resort to arbitration in the reinsurance context.

White: Integrity did not have difficulty with its reinsurers regarding letters of credit and other security devices. Integrity *did* have difficulties with security deposits in various states. We had a number of situations in which it was clear that the states had more than enough capital to discharge the distribution liability that the court had approved. We got these moneys back through moral suasion, rather than litigation or arbitration.

Ehrlich: Security in arbitration has been a good thing for us. We had as many as 1,500 reinsurers on our programs, and the ability to get security has been more of a sword than a shield. Often, through arbitration, we have obtained security.

Veach: Mr. White, when you speak of "moral suasion," does that include enlisting the support of fellow receivers?

White: I often get calls from other receivers or from run-off managers asking for my help reaching the appropriate person at the New Jersey Department of Banking and Insurance.

Ehrlich: This brings up the issue of your relationship with a home-state regulator. Some run-off managers seem to run and hide from their regulators when, in our experience, you should *embrace* your regulators.

White: Of course, in a receivership you have "instant access" to your domiciliary state regulator.

Rosen: With respect to state deposits, some states returned these funds. The few states that withheld their deposits or insisted on keeping large balances caused us to deduct early access payments from their deposits, but most states that were seriously overfunded returned their deposits.

Veach: Did any of you as run-off managers or receivers discover funds that you didn't anticipate finding?

White: To a degree, that's our job – looking for moneys in unexpected places. But we were surprised at Integrity

continued on page 29

to find that the liquidated estate was the beneficiary of many structured settlements; we wound up paying ourselves.

Ehrlich: We are always finding things. Companies get sloppy, particularly when they are trying to underwrite their way out of trouble.

White: One area of benign neglect that surfaces in a run-off or a receivership concerns surety arrangements. A run-off manager or receiver that aggressively pursues guarantors can uncover real money. I would say that we have had "disproportionate success" collecting from surety guarantors.

Ehrlich: I agree. For example, we started chasing small deductibles on a construction defect book. Some would say, "oh, you can't locate those guys or they've wrapped up their company." In fact, you *can* recover these funds, if you try.

Veach: Do you believe that run-off managers are doing a better job handling their subrogation cases or recovering other small balances than companies or MGAs writing new business?

Ehrlich: My feeling is that with respect to the construction defect book that I mentioned, we are doing a better job tracking down the deductibles than those who are actively underwriting. ■

KPMG

Policyholder Support Update — Alert No. 17

KPMG's Restructuring Insurance Solutions practice has been providing e-alerts to the insurance industry regarding Schemes of Arrangement for many months. These e-alerts act as a reminder of forthcoming bar dates and Scheme creditor meetings. If you do not already receive these alerts, please access www.kpmg.co.uk/insurancesolutions.

Solvent Schemes – Upcoming Key Dates

RELIANCE NATIONAL INSURANCE COMPANY (EUROPE) LIMITED

The above company's Scheme was approved at the Meeting of Creditors on 2 February 2006 and subsequently sanctioned by the Court on 20 October 2006 and has become effective. The bar date has been set as 21 May 2007. Further information is available on www.whittingtoninsurance.com/publicity/schemes.php and www.kpmg.co.uk/insurancesolutions.

NRG LONDON REINSURANCE COMPANY LIMITED

The above company's Scheme was approved at the Meeting of Creditors on 15 August 2006, subsequently sanctioned by the Court and has become effective. The bar date has been set as 14 December 2006. Further information is available by e-mailing scheme.manager@NRGV.co.uk.

NRG VICTORY AUSTRALIA LIMITED

The above company's Scheme was approved at the Meeting of Creditors on 15 August 2006, subsequently sanctioned by the Court and has become effective. The bar date has been set as 14 December 2006. Further information is available by e-mailing scheme.manager@NRGV.co.uk.

Other Recent Developments

ARION INSURANCE COMPANY LIMITED

By Order of the Supreme Court of Bermuda, a Meeting of Scheme Creditors for the above company is to be convened for the purpose of considering and, if thought fit, approving a Scheme of Arrangement. The Meeting will be held at the offices of Appleby Spurling Hunter, Canon's Court, 22 Victoria Street, Hamilton, HM EX Bermuda on 12 March 2007 at 11am. Further information is available by e-mailing saleem.malik@us.pwc.com.

CAVELL INSURANCE COMPANY LIMITED

The above company's Scheme was approved by the requisite majority of Scheme Creditors at the reconvened meeting held on 25 April 2005. The Company has postponed their application to the High Court of Justice of England and Wales for the Scheme to be sanctioned whilst they await the outcome of an appeal to be heard in the Canadian Court. Further information is available by e-mailing jim.moran@cavell.co.uk.

CHEVANSTELL LIMITED

The above company is proposing to implement a Solvent Scheme of Arrangement. A Practice Statement Letter was sent out to brokers and known policyholders on 7 December 2005. On 17 August 2006 an agreement to sell the company to Randall & Quilter Investment Holdings Limited was announced. A decision on whether to continue with the proposed Scheme is to be made following the completion of the sale. Further information is available on www.tryg.co.uk.

AXA INSURANCE UK PLC; ECCLESIASTICAL INSURANCE OFFICE PLC; GLOBAL GENERAL AND REINSURANCE COMPANY LIMITED; LA MUTUELLE DU MANS ASSURANCES I.A.R.D.; SWISS REINSURANCE COMPANY (IN RESPECT OF THE GLOBAL LONDON MARKET (GLM) POOL BUSINESS).

The 26 July 2006 hearing for leave to convene Meetings of Creditors for the above five companies which participated in the GLM Pool was adjourned. The date of the rescheduled hearing has yet to be announced. Further information is available on www.glmpool.com.

LA SALLE RE LIMITED

The above company was granted leave to convene a Meeting of Creditors by the Supreme Court of Bermuda. The Meeting will be held at the offices of Appleby Spurling Hunter, Canon's Court, 22 Victoria Street, Hamilton, HM EX Bermuda on 11 April 2007 at 11am. Further information is available on www.lasallerescheme.com.

NRG VICTORY REINSURANCE LIMITED

The Meeting of Creditors held on 23 May 2006 was adjourned. The date and location of the reconvened meeting has yet to be announced. Further information is available on www.nrg-solventscheme.co.uk.

OSLO REINSURANCE COMPANY (UK) LIMITED; OSLO REINSURANCE COMPANY ASA

The above companies were granted leave to convene Meetings of Creditors by the High Court of Justice of England and Wales on 29 November 2006. The Meetings of Creditors will be held at the offices of KPMG, 1-2 Dorset Rise, London EC4Y 8EN United Kingdom on 12 February 2007 at 11am. Further information is available on www.oslore.no and www.kpmg.co.uk/insurancesolutions.

RIVERSTONE INSURANCE (UK) LIMITED; MITSUI SUMITOMO INSURANCE COMPANY (EUROPE) LIMITED; SIRIUS INTERNATIONAL INSURANCE CORPORATION (PUBL) (IN RESPECT OF THE ORION POOL BUSINESS)

The above companies expect to apply to the High Court of Justice of England and Wales in 2006 for permission to convene Meetings of Creditors. Further information can be obtained by e-mailing OrionPoolScheme@rsml.co.uk.

WILLIS FABER (UNDERWRITING MANAGEMENT) (WFUM) POOLS

By Order of the High Court of Justice of England and Wales, Meetings of Scheme Creditors, for the Scheme Companies who participated in the WFUM Pools, were convened on 27 October 2006. The votes cast are being reviewed by the independent Chairman and the outcomes are expected to be announced in early 2007. The anticipated claims bar date has yet to be announced. Further details are available at www.kpmg.co.uk/insurancesolutions and www.wfumpools.com.

Insolvent Estates

UIC INSURANCE COMPANY LIMITED

The above company's Scheme was approved by the requisite majority of Scheme Creditors at the Meetings held on 25 September 2006 and was subsequently sanctioned by the Court. The bar date has been set as 7 March 2007. Further information is available at www.uic-gt.com.

WILLIS FABER (UNDERWRITING MANAGEMENT) (WFUM) POOLS (SOVEREIGN MARINE & GENERAL INSURANCE COMPANY LIMITED – INSOLVENT PARTICIPANT)

See Solvent Schemes. ■

If you wish to subscribe to the KPMG regular email alerts, please contact Mike Walker at mike.walker@kpmg.co.uk.