ASSOCIATION OF INSURANCE AND REINSURANCE RUN-OFF COMPANIES

AIRROC® MATTERS

A NEWSLETTER ABOUT RUN-OFF COMPANIES AND THEIR ISSUES

Vol. 5 No. 3 www.airroc.org Winter 2009/2010

Message from CEO and Executive Director

AIRROC Strikes Oil! . . .

Trish Getty

By Trish Getty

And we don't even live in Texas!

AIRROC Publications Committee: *Well oiled and pumping* out one after another cutting edge newsletters. So many desired to advertise in "AIRROC Matters" in 2010 that we finally had to decline further advertisers since the plate was full. Ali (Chair), thank you. Peter (Editor in Chief & Vice-Chair) and the entire Publications Committee, your energy and drive are incredible.

AIRROC Legislative/Amicus Committee: *Well oiled and pumping* awareness and usage of the AIRROC Dispute Resolution Procedure (DRP) with two sets of parties already utilizing the process. Since it is quite an economical solution to "clean out the deadwood," we anticipate that many more parties will take advantage of the DRP. At January 12, 2010, we have 44 AIRROC approved arbitrators of which 33 are ARIAS-certified. AIRROC members can review the list of approved arbitrators

AIRROC Marketing Committee: *Oil is pumping but more is possible* with active participation of more committee members. My 2010 plan, which I will soon present to the committee,

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AIRROC: Evaluating the Regulatory 'Toolbox' for Financially Impaired US Insurers

"Evaluating the Regulatory 'Toolbox' for Financially Impaired U.S. Insurers" *by Frank Kehrwald represents a counterpoint to the article by James Schacht entitled* "Enhancing the Insurers Resolution Toolbox" *which appeared in the Summer 2009 issue of AIRROC Matters (available at http://www.airroc.org/files/AIRROC_Summer_09_web.pdf). James Schacht's article explained the need for the proposed regulatory bill titled the Uniform Insurer's Run-Off & Resolution Law ("UIRRL") and examined the principles and objectives which guided the drafting of this new proposed legislation. In this article, Frank Kehrwald compares the UIRRL to the current version of the NAIC Insurers Rehabilitation and Liquidation Model Act and delves further into the pros and cons of each and whether the broad structure of the Model Act outweighs that of the UIRRL.*

These are the views of Mr. Kehrwald alone and are not the views of Swiss Reinsurance America Corporation.

Frank Kehrwald

By Frank Kehrwald

AIRROC has been presented on several prior occasions with status reports regarding a draft of a proposed regulatory bill titled the Uniform Insurer's Run-off & Resolution Law ("UIRRL"), designed to enhance the powers of insurance regulators to facilitate the wind-up of a financially troubled insurer and allow for the participation of and maximization of value for creditors. A review of the draft UIRRL proposal, particularly as compared to the NAIC Insurers Rehabilitation and Liquidation Model Act (hereinafter the "Model Act") is not only worthwhile, but is a great starting point for consideration of the merits and need for the adoption of UK-type creditor driven run-off plans for US domestic insurer run-offs.

The draft UIRRL bill has two features that may be sound improvements to the rehabilitation/receivership process: (1) the active involvement of creditors; and (2) the encouragement of a timelier wind-up of financially

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Notes from Editor and Vice Chair

"Neither Rain, Nor Snow, Nor Sleet Nor Dark of Night..."

Peter A. Scarpato

"...[S]hall keep AIRROC Matters from its appointed publication." True, a twisted version of the original, but nevertheless particularly apt, given the "snowmageddon" winter storms endured by many over the past few weeks. And as I gaze out my window, watching the third, 18-plus inch snowstorm in so many weeks, I feel warm and secure knowing that this version of AIRROC Matters lives up to the strength of its predecessors.

Following Trish's ebullient article *AIRROC Strikes Oil!...* celebrating the "well-oiled" AIRROC machine, we move to Frank Kehrwald's *AIRROC: Evaluating the Regulatory 'Toolbox' for Financially Impaired US Insurers,* an excellent counterpoint to Jim Schacht's prior article on the proposed Uniform Insurers Run-Off and Resolution Law. Next, Joseph Calandro, Jr. provides an insightful and erudite analysis in *Graham and Dodd, and Runoff Valuation–An Overview,* a piece discussing how the new Graham and Dodd "value investing" approach can be applied not only to insurance generally, but to insurance and reinsurance in runoff.

And in this ever-changing world of runoff, we can never have too many alternatives—the premise behind *Alternatives to Receivership Require Increased Attention from the US Insurance Market.* In their article, Michael Kurtis and Francine Semaya take us through the latest developments in New York Reg 141, solvent schemes of arrangement, and Part VII portfolio transfers.

AIRROC's Dispute Resolution Procedure ("DRP"), now well into its first year of operation, serves as the backdrop for a pair of articles. First, Charles Fortune provides useful comments and criticisms in *Creating an Environment for the Effective Resolution of Insurance and Reinsurance Disputes,* citing primarily the DRP's non-compulsory nature as a deterrent to its maximum potential. Next, AIRROC board member Michael Zeller, chair of the DRP Task Force, responds with *Achieving Cost-Effective Arbitration: A Reply,* highlighting circumstances which make parties more apt to choose the procedure. Both articles comment favorably on the need to explore master protocols requiring parties to refer certain disputes to the DRP, thus increasing even further its application and effectiveness.

And runoff decisions from the courts continue to support the old adage that

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The Editorial Board of AIRROC® Matters welcomes new and reprinted with permission articles from authors on current topics of interest to the AIRROC® membership and the run-off industry. The Board reserves the right to edit submissions for content and/or space requirements.

AIRROC

AIRROC® Matters – In this Issue

Vol. 5 No. 3 – Winter 2009/2010

AIRROC® Board of Directors

AIRROC: Evaluating the Regulatory 'Toolbox' for Financially Impaired US Insurers continued from page 1

troubled insurers. A regulator now facing the prospect of intervening in a corrective action regarding a financially troubled insurer would be well advised to carefully consider the tremendous advantages of both speed and the collective wisdom and input of creditors bearing the financial pain of the troubled insurer. And similar to current regulatory receivership processes, the UIRRL proposal continues to embrace the view that all similarly situated (single class) creditors should be treated similarly.

> *A review of the draft UIRRL proposal, particularly as compared to the NAIC Insurers Rehabilitation and Liquidation Model Act…is a great starting point for consideration of the merits and need for the adoption of UK-type creditor driven run-off plans for US domestic insurer run-offs.*

The need for the UIRRL, as expressed by the drafters, is that he receivership regulatory process must be:

(a) flexible enough to address variances unique to each estate; and

(b) provide enough structure so as to encourage prompt and forceful protection for both policyholders and all other creditors.[1]

The drafters of the UIRRL also noted that while sufficient general authority may exist in other currently existing regulatory statutes for regulators to achieve the speed and creditor involvement, protection for regulators from critics of rehabilitation plans, which under current statutes must be both unique and creative, would be beneficial.

> *The draft UIRRL bill has two features that may be sound improvements to the rehabilitation/receivership process: (1) the active involvement of creditors; and (2) the encouragement of a timelier wind-up of financially troubled insurers.*

After considerable debate and compromise in the extensive NAIC review process, the NAIC adopted in 2005 a revised Insurers Rehabilitation and Liquidation Model Act (hereinafter the "Model Act") which provides an excellent comparison for the UIRRL draft proposal because, like the UIRRL, the Model Act also includes both a voluntary and court-enforced process to wind up an estate. One might argue that the Model Act is vastly broader than the UIRRL because a regulator can evaluate the performance of an insurer not only against financial solvency criteria, but, in addition, the regulator is permitted and instructed to evaluate an insurer against 18 other non-solvency criteria, including regulatory compliance, trustworthiness of principals, transfer of assets, attempts to compromise judgments, etc.[2] One can also argue that the Model Act provides more than a sufficient shield for regulators from critics of a rehabilitation plan because of the specific inclusion in the Model Act of time requirements regarding the valuation of casualty claims by estimation. One of the key points of the Model Act is the protection it provides to smaller individual claimants by having an appointed Receiver to protect their interests in a public forum against the size and dollar interests of larger claimants and creditors.

> *One might argue that the Model Act is vastly broader than the UIRRL because a regulator can evaluate the performance of an insurer not only against financial solvency criteria, but…is permitted and instructed to evaluate an insurer against 18 other non-solvency criteria…*

The Model Act includes a specific methodology for the estimation of casualty claims. Should the Model Act be determined over time and after use in a variety of estates to be too slow in the wind-up of casualty claims, the time requirements of the Model Act regarding the estimation of casualty claims could readily be revisited.

The powers of a Rehabilitator granted by the Model Act are quite expansive: "The rehabilitator may take such action as the Rehabilitator deems necessary or appropriate to reform or revitalize the insurer."[3] As to timeliness, the Rehabilitator is required to file a plan to effect the proposed changes within one year of the entry of the Order of Rehabilitation.[4] The one noted required restriction on the Rehabilitation Plan in the Model Act is that the proposed Rehabilitation Plan be "fair and equitable to all parties concerned."[5]

Pursuant to the Model Act, incurred but not reported loss and loss expense are prohibited from inclusion in the valuation of claims for payment by a non-life reinsurer

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pursuant to Section 611(I), except as provided under Sections 614, 615 (reinsurance recoveries collateralized by reinsurance trusts) and 705 and the specific time constraints contained therein as noted below.

The Model Act allows for voluntary commutations between the estate and reinsurers at any time.[6]

Court-sanctioned commutations pursuant to the Model Act provide for the establishment of the commutation value via a 3-person arbitration-style panel proceeding with the possibility of using a retained expert.[7] The value of casualty claims is determined within 180 days of the commencement of the proceedings once the following time requirements pursuant to Section 614 have been met:

1. "At any time after seventy–five percent (75%) of the actuarially estimated ultimate incurred liability for all of the casualty claims against the liquidation estate… Is reached by the allowance of claims… and not… during the five-year period subsequent to the entry of order of liquidation;" or
2. At any time in regard to a reinsurer if that reinsurer has a total adjusted capital that is less than 250% of its Authorized Control Level Risk Based capital.

Similarly, contingent or unliquidated claims pursuant to Model Act Section 705, if of undetermined value, may be valued by estimate and billed to reinsurers, (including a value for incurred but not reported amounts) only if waiting for a liquidated value of the claim would "unduly delay the administration of the liquidation proceeding" … or the expense would be …"unduly excessive" when compared to value of assets available for distribution.

The UIRRL is a mechanism for a financially constrained insurer or its creditors by consensus to voluntarily and rapidly effect a wind-up plan.

In comparison, the UIRRL, in furtherance of its mission to remain flexible, has no identification in Section 8 of a method of estimating claims for valuation and wind-up of the estate. The UIRRL is a mechanism for a financially constrained insurer or its creditors by consensus to voluntarily and rapidly effect a wind-up plan. The protection for creditors is that the plan must be approved by each class of creditors by at least 50% by number and 2/3rds by value of claims or as approved by the court. Under the UIRRL, there is no appointed public representative charged with protecting and balancing the interests of smaller individual claimants.

There is nothing in the Model Act prohibiting either an estate or creditors from offering a voluntary plan to value and settle claims. A possible disadvantage of the Model Act is the inability to mandate that a class of or a single creditor must settle until the time limitations regarding casualty claims are met. Disadvantages of the UIRRL are the lack of methodology to value unliquidated claims and the absence of a representative charged with the protection of the interests of smaller individual claimants.

Other Considerations

Since admitted insurers currently remain regulated by each of the 50 states, unless all 50 states enact either the Model Act or the UIRRL, the question of enforceability of either the UIRRL or the Model Act in a non-reciprocal or non-enacting state remains. As well, it is not at all clear under either the Model Act or the UIRRL where a challenge to a question of fundamental fairness of the plan might be heard if challenged in court. Until some uniformity can be accomplished, it will remain, as always, the obligation of creditors to remain extremely vigilant of plans or proposals to settle claims.

The UIRRL permits creditors or the estate to propose a plan to be voted on by creditors to settle claims by class. Its advantages are speed and flexibility. Its protections are the requirement that 2/3rds of creditors by value approve the plan.

The UIRRL permits creditors or the estate to propose a plan to be voted on by creditors to settle claims by class. Its advantages are speed and flexibility. Its protections are the requirement that 2/3rds of creditors by value approve the plan.

The Model Act also allows for the voluntary resolution of claims by creditors by mutual agreement. The Model Act goes further and provides for court-mandated settlement of the estate; but for casualty claims, not until 75% of the casualty claims are liquidated as to value. The advantage of the Model Act is its extreme flexibility for establishing Rehabilitation Plans both to preserve value

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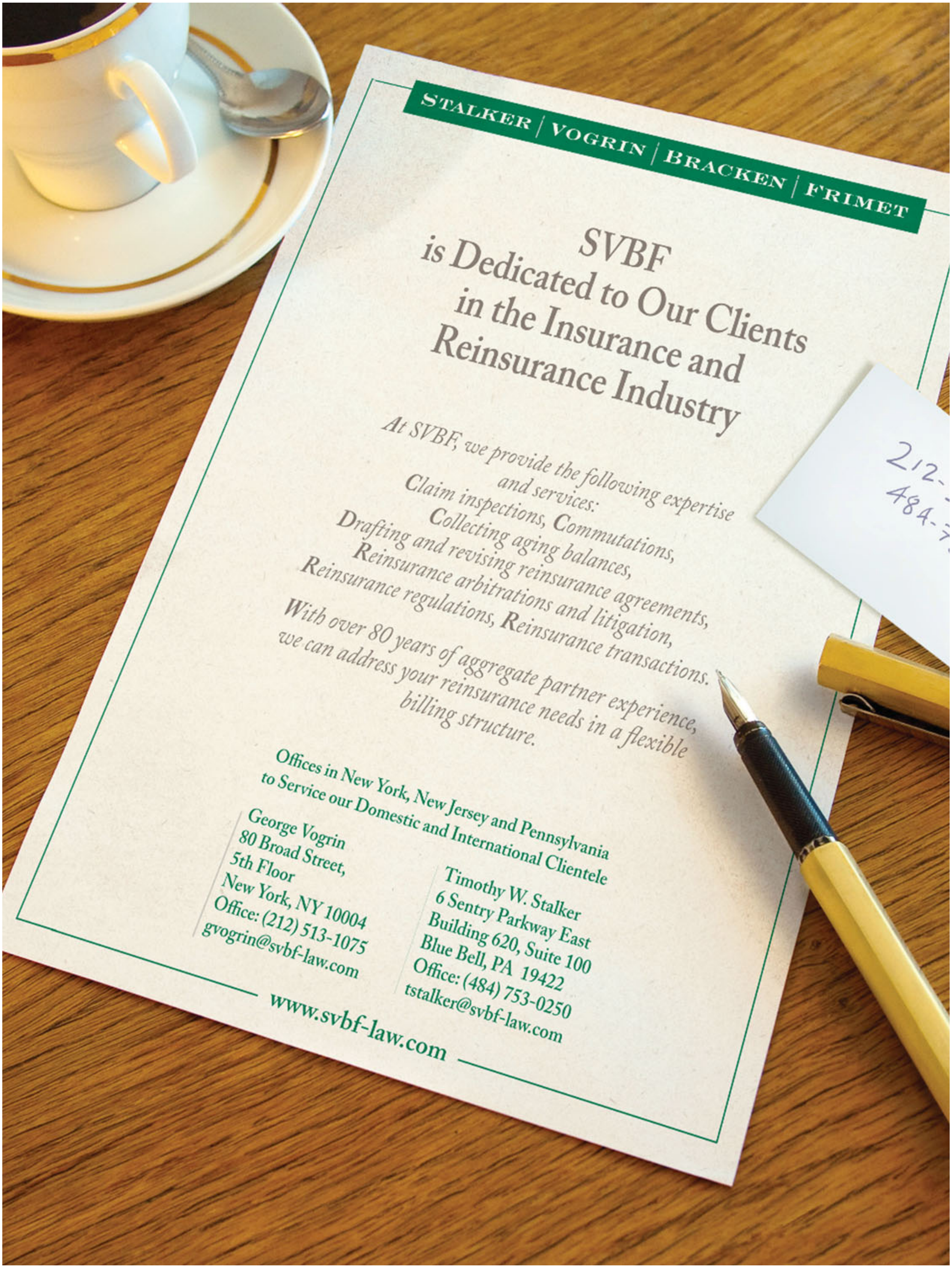
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Think Tank

Graham and Dodd, and Runoff Valuation – An Overview

By Joseph Calandro, Jr.

The late Benjamin Graham and David Dodd founded the school of investment thought that bears their names, which is more popularly referred to as "value investing." This school of thought has produced a number of incredibly successful professional investors such as Berkshire Hathaway Chairman and CEO Warren Buffett.

Almost from the start, value investing had a linkage with the insurance industry: Benjamin Graham himself was the Chairman of GEICO, which is apparently why Warren Buffett took an interest in insurance while he was studying under Graham at Columbia University in the early 1950s. Nevertheless, until recently the linkage between the two fields—insurance and value investing—was not explicitly made. The purpose of this article is to provide an overview of how the modern Graham and Dodd approach to valuation can be applied to the business of insurance in general, and insurance/reinsurance runoff in particular.

> *…until recently the linkage between the two fields—insurance and value investing—was not explicitly made.*

Modern Graham and Dodd valuation is based on a unique four level value continuum, which proceeds from net asset value to earnings power value, franchise value, and finally growth value.

> *Modern Graham and Dodd valuation is based on a unique four level value continuum…*

Net asset value (NAV) is based on balance sheet analysis, which is the foundation of value investing because it is the most "tangible" level of value. By tangible we mean generally based on components that can be inspected; for example, property and equipment can inspected and appraised, case reserve files can be audited, etc. Evaluating balance sheets entails adjusting historical cost-based values on a reproduction basis to derive more economic-oriented values. The asset adjustment process is heavily dependent on one's knowledge base, or "circle of competence," as analysts must know which adjustments they are able to make themselves and which require the services of professional appraisers. An example of a runoff line item that could require professional appraisal is reserves (both case and Incurred But Not Reported (IBNR)).

The next level of value along the continuum is earnings power value (EPV). Typically, many valuations are based on Discounted Cash Flow (DCF) analysis, which is correct theoretically but is very difficult to apply in practice. EPV differs from DCF in that it is based on a level of past earnings that is expected to be sustainable into perpetuity; as such, EPV does not consider growth. While this difference may not, at first, seem applicable to the runoff business the principle of evaluating earnings conservatively as a function of the past—rather than on assumptions or expectations of the future—is applicable to runoff deals, especially runoff M&A.

EPV is not as tangible as NAV, but because it is based on past earnings it is more tangible than the third level of value, franchise value. A "franchise" is Graham and Dodd nomenclature for a firm operating with a sustainable "competitive advantage." A competitive advantage is a strategic term used to describe a customer value proposition that is differentiated from others that are offered in the marketplace. The sustainability aspect of a franchise is a very demanding criterion because many, if not most, value propositions are relatively easy to copy especially in commodity-like industries such as insurance/reinsurance. Nevertheless, competitive advantages do exist in the insurance industry; for example, the successful implementation of a low cost automobile insurance strategy has turned GEICO into a powerful franchise.

However, franchises are relatively rare in all industries, and, as such, NAV will relatively reconcile with EPV in most valuations resulting in a pattern that we refer to as "base case value." Firms exhibiting the base case value pattern generate returns commensurate with the cost of their capital and the reproduction value of their assets,

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no more or less. Because of the frequency with which this pattern appears, it provides an important check on valuation assumptions, including those involving insurance/reinsurance runoff. To explain, consider a runoff deal in which the valuation derives an EPV much greater than the corresponding NAV. Such a result should immediately raise questions about the presence of a franchise, and if those questions are not answered in the affirmative then the assumptions underlying both valuations—NAV and EPV—should be carefully examined and revised. The Graham and Dodd framework facilitates such an examination because it addresses assumptions upfront in the valuation process at each level of value rather than embedding assumptions within a cash flow projection or asset pricing model.

Growth is the final level of value along the modern Graham and Dodd continuum. It is also the least tangible level because it is based on projections of the future, and is therefore completely uncertain.

Value investors typically formulate valuations based on three guiding principles that can be applied to any industry, including insurance/reinsurance and runoff. The first principle is the "circle of competence," which was mentioned above and essentially pertains to leveraging an identifiable information advantage. A simple example will illustrate this principle: assume a runoff valuation is being prepared and that the target's reserves are being assessed. Clearly, IBNR should be assessed by actuaries while case reserves should be evaluated by claims professionals; each reserve type being evaluated by a corresponding professional given their related expertise. This is a straightforward example; others include the use of real estate appraisers to assess property and equipment, marketing consultants to assess intangible assets, etc.

"Value investors typically formulate valuations based on three guiding principles that can be applied to any industry, including insurance/reinsurance and runoff."

The second principle is the principle of conservatism; meaning, that adjustments and assumptions should be arrived at moderately. This does not mean that adjustments should intentionally understate the value of a line item; rather, that all care must be taken not to overstate an adjustment. This principle obviously leverages the circle of competence, and is essentially what differentiates value investors from other investors. All investors desire to "buy low and sell high," but value investors approach this goal conservatively, not aggressively like so many others seems to. This principle is core to all kinds of investments, but it is particularly important with respect to special situation investments such as distressed investment and insurance/reinsurance runoff.

The third and final principle of modern Graham and Dodd valuation is the "margin of safety." Warren Buffett himself has stated that, "We believe this margin of safety principle, so strongly emphasized by Ben Graham, to be the cornerstone of investment success."[1] Significantly, this principle also applies broadly to insurance/reinsurance; for example, and as Warren Buffett has again indicated, "prices must provide a healthy margin of safety against the societal trends that are forever springing expensive surprises on the insurance industry."[2]

…the logic of both the Graham and Dodd valuation framework…and the approach's corresponding principles…make it an ideal method to apply to a host of corporate finance activities, including special situation-like investment opportunities such as insurance/reinsurance runoff."

Many professional investors have achieved a great deal of success implementing the Graham and Dodd approach; for example, Seth Klarman, Mario Gabelli and Mitchell Julis all have outstanding, long-term investment track records. However, the logic of both the Graham and Dodd valuation framework (in other words, the unique four level value continuum) and the approach's corresponding principles (meaning, the circle of competence, principle of conservatism and margin of safety) make it an ideal method to apply to a host of corporate finance activities, including special situation-like investment opportunities such as insurance/reinsurance runoff. One benefit of this approach is its transparency, which facilitates the vigorous checking, cross-checking and re-checking of key assumptions. Such activities are the hallmark of all successful investors and businessmen over time, including those involved in the insurance/reinsurance industry as Benjamin Graham, Warren Buffett and Prem Watsa (of Fairfax Financial Holdings) have dramatically demonstrated over time. ■

Endnotes

1 1992 Berkshire Hathaway Shareholder Letter, http://www.berkshirehathaway.com/letters/1992.html

2 1990 Berkshire Hathaway Shareholder Letter, http://www.berkshirehathaway.com/letters/1990.html

Feature Article

Alternatives to Receivership Require Increased Attention from the US Insurance Market


Michael J. Kurtis


Francine L. Semaya

By Michael J. Kurtis and Francine L. Semaya

Various alternatives to receivership are available to insurance and reinsurance entities that find themselves in financially troubled condition. The use of these alternative tools may reduce the negative financial impact and result in a quicker resolution as compared with a traditional receivership, allowing for cost control and continuous payment of claims. In addition, such mechanisms may allow greater flexibility and free up capital to continue "business as usual."

Various alternatives to receivership are available to insurance and reinsurance entities that find themselves in a financially troubled condition.

In recognition of the potential usefulness of alternatives to insolvency, the Restructuring Mechanisms for Troubled Companies (E) Subgroup of the National Association of Insurance Commissioners (NAIC) recently adopted a White Paper on Alternative Mechanisms for Troubled Companies, which highlights such non-traditional mechanisms. The White Paper examines what the NAIC characterizes as "alternatives to traditional receivership" and focuses on situations where an insurance or reinsurance entity is in a financially troubled condition which could potentially lead to insolvency in the foreseeable future.

Such mechanisms may potentially provide a speedy resolution as compared with a traditional receivership, while avoiding the cost typically associated with receivership. It may also allow for the continuous payment of claims. Such mechanisms, however, may also pose certain risks for consumers and claimants as they cannot guarantee fairness and equal treatment to all interested parties, requiring greater regulatory monitoring and controls. These alternative mechanisms may also allow the companies utilizing them to avoid the safeguards provided by the States' traditional receivership procedures and may also result in substantially reduced payments to policyholders, as compared with state receivership laws, which for a rehabilitation require a plan to be fair and equitable and for a liquidation may provide the protections of the state guaranty fund system.

New York Regulation 141

One such alternative mechanism that has received considerable attention is New York State Regulation 141. New York's statutory and regulatory scheme allows commutations to be utilized as a method for an insurer to eliminate impaired lines of business. Section 1321 of the New York Insurance Law authorizes the Superintendent of Insurance to allow an impaired or insolvent insurer to commute reinsurance agreements as a means of curing the impairment or insolvency. Regulation 141 of the New York Insurance Department, codified as 11 NYCRR §128, sets forth the standards to be utilized by the Superintendent in approving such commutations.

New York's statutory and regulatory scheme allows commutations to be utilized as a method for an insurer to eliminate impaired lines of business.

Once a company informs the New York Insurance Department that its capital is impaired, the Department will send a letter to the company, pursuant to Section 1310 (b) of the Insurance Law, ordering the company to eliminate the impairment within 30 days. The Regulation 141 Plan must include a current balance sheet and a pro-forma post-commutation balance sheet and a reconciliation between the two, as well as an exhibit setting forth obligations to every insurer, the proposed

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Alternatives to Receivership Require Increased Attention... *continued from page 13*

commutation offer in financial terms, and the details of any retrocessionaire participation. The plan must be approved in advance by the Superintendent of Insurance and within 30 days of such approval, the impaired company must deliver proposed commutation agreements to each ceding insurer.

No commutation of assumed reinsurance may become effective (and no consideration may be paid) until the Superintendent determines that enough executed commutation agreements have been returned to restore the company's surplus to the required minimum. An identical offer must be made to every ceding company. The offer is non-negotiable and there is a limited time for a sufficient number of cedants to accept the offer and the impaired company must consent in advance to rehabilitation and liquidation if the plan does not succeed in restoring the minimum required surplus. The executed commutations are effective only when the Superintendent determines that the surplus is restored to minimum required amount. Ceding companies who reject commutation terms are not bound by the commutations. If an insufficient number of commutations are executed, the plan fails and the Superintendent can proceed against the impaired insurer.

Solvent Schemes of Arrangement

Another alternative mechanism is the Solvent Scheme of Arrangement utilized in the U.K. and related markets. Solvent schemes of arrangement require majority credit approval representing at least 75% in value of all obligations in order to obtain final court approval. A Solvent Scheme is essentially a court-approved decree that resolves an insolvency proceeding and provides for a final distribution of assets, in a manner similar to a plan of reorganization under the U.S. Bankruptcy Code. Approval and enforcement of a Scheme is very similar to the effect of confirmation of a reorganization plan under the Bankruptcy Code.

> *Another alternative mechanism is the Solvent Scheme of Arrangement utilized in the U.K. and related markets.*

For an insurer or reinsurer that is engaged in both the U.S. and non-U.S. markets, it becomes necessary to obtain court approval of a Scheme in order to ensure the full protection that it is intended to provide. To that end, entities considering the use of Solvent Schemes may be encouraged by decisions that have been rendered by the U.S. Bankruptcy Court for the Southern District of New York, which have resulted in enforcement of Solvent Schemes. In one such case, the court ruled that the board of directors of a solvent foreign reinsurance company was a "foreign representative" qualified to file a petition to aid in the enforcement of a court sanctioned scheme of arrangement in accordance with law of Bermuda. *In re Petition of Board of Directors of Hopewell Intern. Ins., Ltd.*, 281 B.R. 200 (Bkrtcy S.D.N.Y., 2002).

> *For an insurer or reinsurer that is engaged in both the U.S. and non-U.S. markets, it becomes necessary to obtain court approval of a Scheme in order to ensure the full protection that it is intended to provide.*

Similarly, *In re Petition of Catherine Geraldine REGAN, as Foreign Representative of Riverstone Insurance (UK) Limited*, 2005 WL 2138734 (Bkrtcy S.D.N.Y., July 26, 2005), involved a petition to enforce a Scheme that had been approved by the High Court of England and Wales. New York's Southern District Bankruptcy Court observed that the High Court in England had sanctioned the Scheme and that the petitioner was the foreign representative of the companies that were party to the Scheme, within the meaning of the U.S. Bankruptcy Code, and the relief requested (enforcement of the Scheme) was consistent with the factors set forth in Section 304(c) of the Bankruptcy Code. The court therefore ruled that the Scheme should be given full force and effect in the United States and that it was binding upon, and enforceable against, all parties with contacts in the U.S.

Notably, interest has recently been shown by insurance regulators within the U.S. towards Rhode Island's Title 27, Chapter 14.5, which provides for voluntary restructuring of solvent insurers as an alternative to traditional run-off by bringing "solvent schemes of arrangement" to the United States. This provision allows solvent companies that are in run-off to reach a court ordered agreement with all creditors in order to accelerate completion of the run-off, thereby expediting what can be a lengthy process and reducing the typically significant costs often associated with run-off.

Part VII Portfolio Transfers

A "Part VII Portfolio Transfer" is a mechanism permitted in the U.K. under Part VII of the Financial

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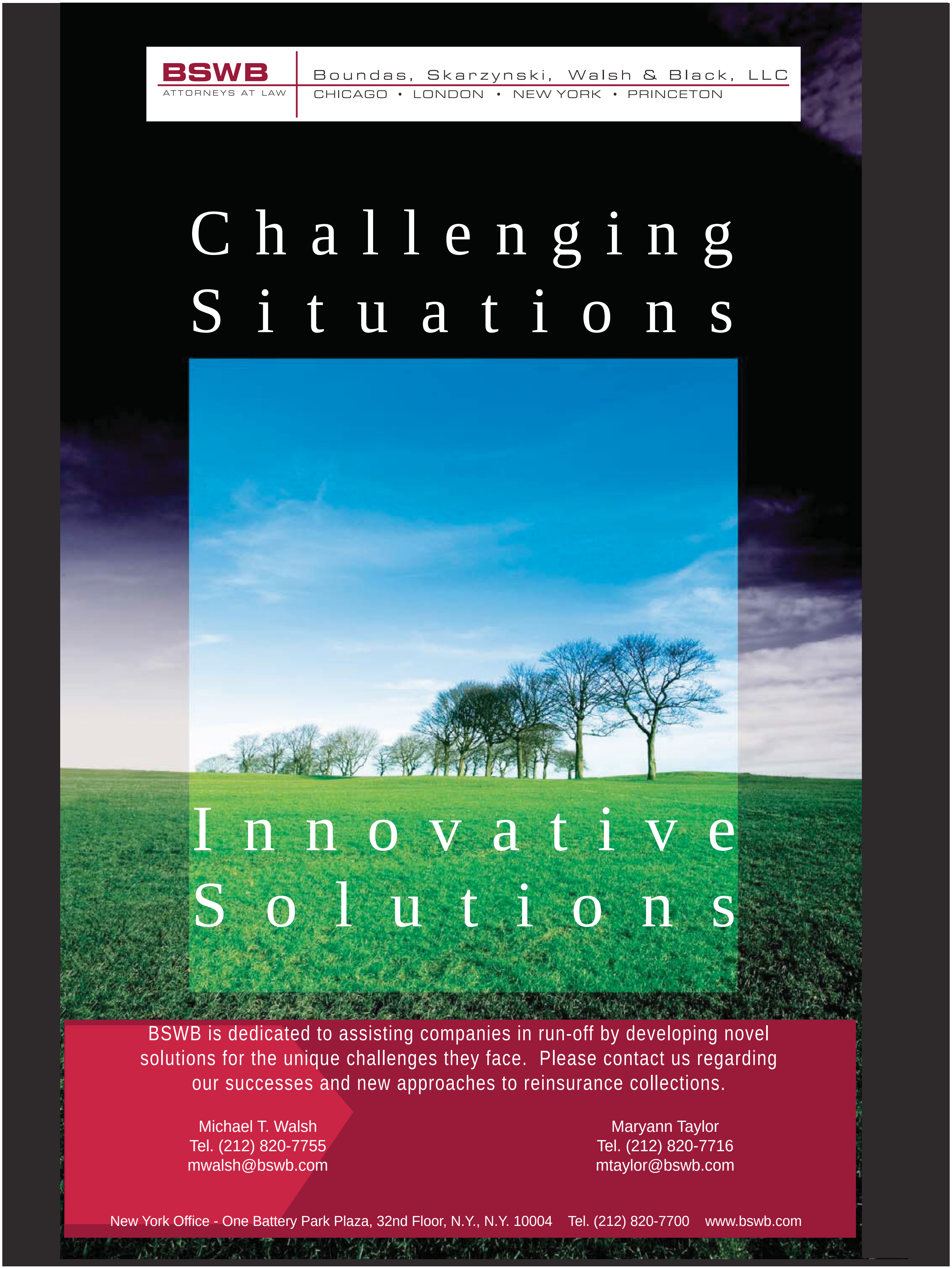
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Point

Creating an Environment for the Effective Resolution of Insurance and Reinsurance Disputes


Charles W. Fortune

By Charles W. Fortune

Dispute is inevitable in the insurance run-off environment and AIRROC member companies are understandably interested in alternative dispute resolution mechanisms that are faster and cheaper than resorting to the courts. Arbitration, in its many forms, offers an effective alternative to litigation, but only when the parties agree to conduct a fair and efficient proceeding. Arbitration exists solely by agreement of the parties, and if one party does not cooperate, the arbitration can easily go off track.

Arbitration, in its many forms, offers an effective alternative to litigation, but only when the parties agree to conduct a fair and efficient proceeding.

In an effort to enhance the viability of the arbitration alternative, AIRROC formed a subcommittee to look at common problems in arbitration and work on solutions to those problems. This subcommittee addressed first the arbitrations involving smaller, less complicated matters in dispute, where time and cost overruns are most frustrating. The result of over a year's work by the subcommittee is the AIRROC Dispute Resolution Procedure (the "Procedure") – which was released at the July 2009 membership meeting.

The AIRROC Procedure has the potential to improve the arbitration environment for the run-off community, but only if it is followed as the rule rather than as an exception. Parties wishing to reap the benefits of the Procedure should therefore consider means of rendering it mandatory for certain disputes and means of limiting as well their ability to deviate from the cost-saving protocols of the Procedure.

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The AIRROC Procedure has the potential to improve the arbitration environment for the run-off community, but only if it is followed as the rule rather than as an exception.

The AIRROC Dispute Resolution Procedure

The Procedure is a thoughtful response to many of the key problems in arbitration today. The often contentious and time-consuming process of selecting arbitrators to hear a dispute, is avoided under the Procedure with a joint request for AIRROC selection of an arbitrator. Thus, AIRROC will advance for consideration 15 candidates selected at random from a list of AIRROC-approved arbitrators, and will select one based on a match of party preferences, or randomly, as between multiple party preference matches. Arbitrations under the Procedure will be before a single arbitrator, and the arbitrator will be paid at a set rate of $150/hour (subject to a $2,000 retainer, of which $1,000 is non-refundable).

Other cost-containment measures in the Procedure include prompt consideration of organizational issues, an absence of discovery, and a lack of motions or applications for preliminary relief. Likewise, the Procedure contemplates submission of the dispute on papers, and provides for a one-day (or less) hearing only at the discretion of the arbitrator, and does not provide for witness testimony. The arbitrator must render an award within 30 days of submission of the case, and the award will ordinarily set forth only the disposition of the claims and the relief granted, without a reasoned explanation of the result.

Without doubt, adherence to the Procedure in a particular dispute will result in an efficient and low-cost arbitration. Moreover, the combination of random and "by agreement" factors in the selection of the arbitrator should reduce incidences of arbitrator bias, and should eliminate most attempts to select favorable umpires. Even

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Counterpoint

Achieving Cost-Effective Arbitration: A Reply

Michael Zeller

By Michael Zeller

In his thought provoking article on "Creating an Environment for the Effective Resolution of Insurance and Reinsurance Disputes," Charles Fortune describes the natural inclination of parties in the throes of a dispute to seek strategic advantage. Given this generally accurate assessment of human nature, Mr. Fortune questions how frequently parties will use AIRROC's new dispute resolution procedure in the context of individual matters referred to arbitration. Parties surely want to win their cases, and Mr. Fortune argues that a party will be unlikely to agree to AIRROC's expedited procedure when it perceives that an expansive proceeding will increase its chance of winning. He maintains that a meaningful solution to the inefficiency of arbitration must include parties agreeing to use a streamlined procedure like AIRROC's *before* an actual dispute arises. Specifically, Mr. Fortune proposes master dispute management protocols in which parties agree to make all future disputes under specific contracts or of a designated type or size (*e.g.*, < $1M) subject to compulsory resolution under a procedure like AIRROC's.

…a meaningful solution to the inefficiency of arbitration must include parties agreeing to use a streamlined procedure like AIRROC's before an actual dispute arises.

Much can be said for Mr. Fortune's proposal, and I will return to it shortly. First, a few points about the AIRROC procedure and why the task force decided to follow a somewhat different path.

The AIRROC procedure is intended as a blueprint for parties to consider in the resolution of smaller-sized and less complicated disputes. The objective was to develop a framework to resolve such disputes more efficiently than is possible under the plenary arbitration practices prevalent in the industry. The procedure's most novel aspect is the pool of AIRROC arbitrators willing to serve at $150 per hour. While other aspects of the procedure, including strong discovery restrictions[1] and an abbreviated hearing format, have been proposed or used before, it is believed that the establishment under AIRROC's auspices of a comprehensive small claims procedure represents an important new dispute resolution tool. Also of note is that the procedure allows parties to customize proceedings to a large degree.

The AIRROC procedure is intended as a blueprint for parties to consider in the resolution of smaller-sized and less complicated disputes.

Returning to whether parties will agree to use the procedure to resolve individual disputes, it is true that some parties will withhold consent to seek strategic advantage. A reinsurer, for example, may withhold consent in the hope that the unavailability of an efficient procedure will lead the cedent to abandon its collection efforts. I agree with Mr. Fortune that parties often do not share the costs and benefits of discovery equally in the context of individual matters referred to arbitration. This can produce inefficient behavior.

Notwithstanding the above, I am more sanguine than Mr. Fortune that parties will agree to use the AIRROC procedure to resolve smaller-sized disputes given a favorable set of circumstances. Such circumstances generally will include some of the following:

- The parties have an existing working relationship.
- The dispute involves fewer issues rather than many.
- The dispute primarily involves issues of contract interpretation or law rather than contested facts.
- The cedent is willing to produce relevant documents voluntarily.
- The reinsurer has certain incentive not to have the balance remain unpaid and unresolved. (Such

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Michael Zeller is Chief Reinsurance Compliance Officer of American International Group, Inc. and a member of AIRROC's Board of Directors. He chaired the task force that developed AIRROC's Dispute Resolution Procedure. He can be reached at michael.zeller@aig.com.

Creating an Environment for the Effective Resolution of Insurance and Reinsurance Disputes *continued from page 16*

if this does not, ultimately, render Procedure arbitrations more fair (an arbitrator from the list could carry a bias), the random generation of a large list of candidates from which only one can be selected (effectively by concurrence or randomly) cannot but increase confidence in the process.

The issue, of course, is whether parties will agree to apply the Procedure to their disputes. Absent compulsory adherence (perhaps under some future contracts) parties will employ the Procedure only if they perceive that it suits their purposes, in a particular matter in dispute. Certainly, the parties' purposes may include controlling expense, but the overarching considerations will usually be related to increasing the chances of prevailing in the dispute. The Procedure will be selected, then, when both parties perceive that it does not diminish their chances of winning.

Impediments to the Success of the AIRROC Procedure

If parties have, to date, failed to cooperate to resolve smaller, less-complicated disputes, what about the Procedure will cause them to begin to cooperate? Does the Procedure offer cost-saving opportunities unavailable elsewhere and sufficient to offset the desire of parties to win in arbitration? Will the AIRROC support for the Procedure cause parties to "see the light" they've been missing for years? Are parties so frustrated with arbitration that they will try anything that might improve the situation? Or, will parties continue to act as they have always done – cooperating and working towards prompt resolution of disputes in the rare cases when it is in their interests, and declining to do so when it is not?

Odds are that the Procedure will be viewed as a valuable cost-containment tool when parties are already in agreement that efficiency is the primary goal. It does not, however, seem likely that the Procedure will influence many to abandon their contentious ways. Thus, if a party perceives that delay or increased cost to arbitrate will improve its position in a dispute, that party will not agree to use the Procedure. Likewise, a party that believes it needs extensive discovery, or will benefit from motion practice or a lengthy hearing, will find little to recommend the Procedure Moreover, even if a party agrees, initially, to apply the Procedure, the opportunities to later take the arbitration off track are endless. The Procedure is entirely flexible, allowing the arbitrator to diverge from the default process and allow additional time, significant discovery and motion practice. Extensive briefing, testimony, and long hearings are also permitted under the Procedure, at the discretion of the arbitrator. In short, nothing in the Procedure prevents an arbitrator from doing what arbitrators do now – in allowing significant additional activity of one sort or another, at the request of one party, and over the objection of the other. Some arbitrators will even argue that absent a set compulsory procedure to the contrary, they are required, under the law, to allow a party to fully develop and present its case, as it desires. Surely the "default" provisions of the Procedure will not give these arbitrators the backbone to deny a party its "due process."

The conundrum is that parties to insurance and reinsurance transactions desire, only in the abstract, to reduce inefficiency and reduce the cost of resolving disputes, while in the context of a particular dispute, they want to win. Because the steps one might take to improve

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Present Value

By Nigel Curtis

$$PV = \frac{C}{i} \cdot \left[1 - \frac{1}{(1+i)^n} \right]$$

Run-Off News

Armour Re buys PMA Capital

Armour Reinsurance Group, headquartered in Hamilton, Bermuda, completed its acquisition of PMA Capital Insurance Co. and two related affiliates on December 24th, 2009, following regulatory approval from the Pennsylvania Insurance Department and the Cayman Islands Monetary Authority, among others. The purchased entities were formerly the run-off operations of PMA Capital Corp. As part of the transaction, PMA Capital Insurance Company is being renamed Excalibur Reinsurance Corporation.

ESG in Liquidation

ESG, which ceased writing new business in 1998, was placed in liquidation by the Supreme Court of Bermuda on December 24th, 2009. The company provided accident, medical, financial and special risk reinsurance and is managed by Quest Management Services in Bermuda.

Mike Morrison and Charles Thresh of KPMG Advisory Ltd. in Bermuda and Michael Walker of KPMG LLP in the UK were appointed joint provisional liquidators. Creditors and other counterparties of ESG have been urged to contact Michael Tagg at michael.tagg@kpmg.co.uk or Mark Allitt at mallitt@kpmg.bm for further information.

Compre expands Audit Team

Compre Services (UK) Ltd., the discontinued reinsurance specialists, has recruited a team of consultants to expand its auditing and consultancy practice. **Jonathan Hughes** – Audit Director, **Thomas Whittingdale**, **Robert Langstone** and **David Everington** have all joined Compre from Lambourn Insurance Services. In addition, **Mark Jeater** has also joined Compre Holdings to assist Mikko Sinko and Nick Steer in ongoing acquisitions of run-off insurance companies and legacy portfolios. See www.compre-group.com.

Alea UK sold

Alea Group Holdings (Bermuda) Ltd. has agreed to sell its UK subsidiary (Alea Holdings UK Ltd.) to Catalina Holdings (Bermuda) Ltd. Under the agreement, Alea UK will be sold at a slight discount to the book value as at December 31, 2008. Alea's UK operations have been in run-off since December 2005.

Acquisition of Shared Services by ISG

ISG Acquisition IV LLC has purchased 100% of the stock of Shared Services Insurance Group, a Pennsylvania insurance company, following approval of the Pennsylvania Insurance Department. See www.isgrp.co.uk.

Tawa acquires PRO

Tawa has acquired the PRO group of companies from Swiss Re, comprising PRO Insurance Solutions Limited, PRO Insurance Solutions, Inc. and Participant Run-Off (PRO), Iberica, SLU. Founded in 1993 and operating from bases in the UK, USA and Spain, PRO provides run-off management and professional services to ongoing insurance entities and those in run-off. Swiss Re has confirmed that PRO will enjoy preferred provider status for servicing its run-off operations. See www.tawaplc.com.

RSA sells British Engine

RSA Insurance Group plc (RSA) has sold British Engine Insurance Limited to Knapton Holdings Limited, a wholly-owned subsidiary of Enstar Group Limited, the Bermuda based insurance run-off holding company. British Engine, whose business included Engineering, Casualty, Financial Products, Property and Marine Aviation, has been in run-off since 2001. The transaction is subject to UK regulatory approval, and was expected to be completed by December 31, 2009. See www.rsagroup.com.

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mark your calendar

February 23-24, 2010: 11th ARC Discontinued Business Congress, Merchant Taylors Hall, London, England. See www.arcrunoff.com.

March 3-4, 2010: AIRROC Commutation Day and Membership Meeting, offices of Dewey & LeBoeuf LLP, NY.

May 13, 2010: AIRROC Membership Meeting, offices of Dewey & LeBoeuf LLP, NY.

July 15, 2010: AIRROC Membership Meeting, offices of Dewey & LeBoeuf LLP, NY.

October 18-20, 2010: AIRROC /Cavell Commutation Event, Details will be posted on AIRROC's web site in early 2010. www.airroc.org

2010 AIRROC Board of Directors

Back row left to right: Ed Gibney (CNA), Karen Amos (Resolute Mgmt. Services), John Parker (TIG), Keith Kaplan (Reliance), Marianne Petillo (ROM), Mike Fitzgerald, Ali Rifai (AIRROC Co-Vice Chair, Zurich), Frank Kehrwald (Swiss Re), Mike Palmer (R&Q Re), Art Coleman (AIRROC Co-Vice Chair, Citadel Re).

Front row left to right: Kathy Barker (Excalibur Re), Mike Zeller (AIG), Trish Getty (AIRROC CEO and Executive Director), Jonathan Rosen (AIRROC Chairman, The Home Insurance Company in Liquidation), Janet Kloenhamer (Fireman's Fund), Joe DeVito (DeVito Consulting), Jeff Mace (AIRROC General Counsel, Dewey & LeBoeuf).

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People

Steve Ryland has been appointed Senior Vice President of the Armour Re Group. Steve has many years of experience in the areas of insurance run-off and the provision of services to discontinued insurance and reinsurance entities, and spent the last 16 years at PRO Insurance Solutions, where he was Executive Director with responsibility for global business development.

Katherine Barker has been appointed President of Armour Risk Management Inc. and Vice President of Armour Reinsurance Group Holdings Limited. With more than thirty years experience in the claims and run-off fields of the insurance and reinsurance industries, Kathy was formerly President of PRO IS, Inc and SVP and Director of Reinsurance Management at Hartford where she was responsible for the runoff of First State Ins. Co., New England Reinsurance Corp. and Hart Re. Kathy is a member of the Association of Professional Insurance Women (APIW), serves on the Board of Directors of AIRROC and is co-chair of the Education Committee.

Vivien Tyrell, a partner for 24 years at DJ Freeman (latterly known as Kendall Freeman and Edwards Angell Palmer & Dodge, London office), has moved to take up the position of head of Reynolds Porter Chamberlain's Restructuring and Insolvency Group. An Authorized Insolvency Practitioner since 1989, Vivien is recognized by The Legal 500, Chambers UK and Euromoney as a leader in the field of insurance insolvency and restructuring.

William Sturge, a partner for ten years at Lawrence Graham, has joined the London-based law firm Carter Perry Bailey. His practice covers a wide range of insurance and reinsurance issues both in the UK and worldwide, including professional indemnity, directors and officers' liability and international trade. He is a qualified solicitor in England and Australia.

If you are aware of any items that may qualify for inclusion in the next "Present Value"; upcoming events, comments or developments that have, or could impact our membership; please email potential items of interest to Nigel Curtis of the Publications Committee at n.curtis@fastmail.us.■

Creating an Environment for the Effective Resolution of Insurance and Reinsurance Disputes continued from page 19

one's chances of winning often increase cost and lessen efficiency, the overall improvement of arbitration will lose out. No optional procedure can change this. Rather, the agents for effective change are compulsory procedures that focus on fairness and efficiency, or fundamental change in the nature of the underlying relationships between parties in dispute. For parties in run-off, it is not usually possible to alter relationships to focus on maximized mutual interest, thus we will concentrate on the notion of compulsory arbitration procedures.

A Proposal to Require Adherence to Efficient Arbitration Procedures

If parties desire, in the abstract, to maximize efficiency and cost-containment in arbitration, then they must accept (also in the abstract) that in certain disputes this efficiency will work against their particular interests. For example, arbitrations without discovery are likely to be less expensive than arbitrations with discovery – but in some instances a lack of discovery can hurt a party's chances of success. This does not mean that efficiency and cost-containment cannot be achieved, it merely means that parties wishing to save time and money in the long run will lose arbitrations in the short run, now and then. If the financial impacts of the arbitrations occasionally lost due to efficiency measures are outweighed by the overall cost savings efficiency brings, then, on balance, efficiency is the right choice.

If the financial impacts of the arbitrations occasionally lost due to efficiency measures are outweighed by the overall cost savings efficiency brings, then, on balance, efficiency is the right choice.

A party choosing efficiency over isolated favorable results must, indeed, make a choice. That party must agree, in advance, to adopt arbitration procedures that will promote efficiency, at times at the expense of fairness to that party. Of course, the counter-party that also agrees to such procedures will also save money, and will also accept the potential negative consequences of efficiencies that are not in that party's best interests in a particular dispute. But, if the agreement covers a range of disputes, then both parties can profit from it, in the long run.

For parties willing to sacrifice isolated arbitration successes for overall efficiency and cost-containment, the key is to designate certain business for agreement and then adopt rigid procedures that do not allow for any deviation that increases cost or time spent. The AIRROC Procedure, stripped of its discretionary component, is probably quite adequate for the task. Thus, parties could agree to AIRROC selection of arbitrators from the AIRROC list, and could agree to the default provisions of the Procedure, thus eliminating discovery and motion practice, and limiting time in hearing. If the parties restricted their agreement to certain smaller, less-significant disputes, then the risk of unfavorable results would be minimized, and the benefits of efficiency would be maximized.

Such a side agreement adopting a variation of the Procedure would have to be mandatory, as to the particular business designated, however. Otherwise, parties could self-select the matters they submitted to this process, and they would only submit the cases where less discovery and less activity worked to their advantage. Needless to say, their opponent would not likely agree and as a result, few, or no matters would ever go through the procedure. This means that any side-agreement for an efficient process would have to be drafted so that it operated as an amendment to relevant insurance/reinsurance contracts – so that a party refusing to submit a designated dispute to the agreed process could be forced to do so.

In short, flexibility in the process is the enemy of efficiency. And, the particular procedure used is far less important than rigid proscriptions against expansion of that process. Certainly, the AIRROC Procedure includes significant limitations that could reduce substantially the cost of arbitration, and includes some basic protections to keep arbitrator selection fair, so it is just a matter of getting an ongoing commitment from parties to use the Procedure (or some other efficient variation on the Procedure). But parties did not fail, over the years, to agree to resolve disputes in the most efficient and fair manner because they had no procedure to use. The failure was because they could opt out of efficiency and fairness whenever it suited their purposes. Only when parties relinquish the right to opt out of efficiency will they ever realize the elusive goal of cost-containment in arbitration. ■

Achieving Cost-Effective Arbitration: A Reply *continued from page 17*

incentive may exist, for example, if the reinsurer is an active trading partner of the cedent or, if in runoff, the reinsurer is trying to wind up affairs expeditiously.)

- The reinsurer understands that the cedent will commence plenary proceedings absent an agreement to use the procedure.

Parties are beginning to use the AIRROC procedure. Other parties are considering it. I am optimistic that many parties will recognize the procedure's value and use it over time.

> *…fashioning appropriate rules for discovery (if any) and an abbreviated hearing may be difficult when these rules will be applied to a portfolio of disputes arising long into the future.*

Mr. Fortune's broader proposal for master protocols in which parties agree to make all future disputes of a certain kind, or not exceeding a cap, subject to compulsory resolution under a procedure like AIRROC's deserves further consideration. Such a proposal presents substantial potential benefits in efficiency, but also substantial challenges. It is not clear how much of an appetite currently exists for such protocols. Even if two parties were generally willing to submit future disputes involving less than $1M to a compulsory expedited proceeding, what would happen if a $500k matter presents special importance to a party because of its potential precedential effect? The lack of an opt out provision could be problematic. Also, fashioning appropriate rules for discovery (if any) and an abbreviated hearing may be difficult when these rules will be applied to a portfolio of disputes arising long into the future.

In any event, considering the AIRROC procedure's flexible design, I believe it provides a suitable framework for the type of master protocols that Mr. Fortune proposes. In that vein, AIRROC could develop a master protocol form in the future, depending on its members' level of interest.

* * * *

For some time, the industry has needed a tool for smaller-sized and less complicated disputes that are palpably uneconomical to resolve when subjected to plenary arbitration practices. It is hoped that AIRROC's new procedure, including the organization's ongoing administrative and educational support, can help fill the void. As parties gain confidence using the procedure to resolve individual cases, this can only increase the prospects that the master protocols envisioned by Mr. Fortune will become a reality. ■

Endnotes

1. The procedure states that there "shall be no discovery or any motions …. for discovery, unless the parties agree otherwise." (AIRROC Procedure, Section IV.B.) I do not fully understand Mr. Fortune's comment that the procedure allows "significant discovery and motion practice. . . . [N]othing in the Procedure prevents an arbitrator from . . . allowing significant additional activity . . . at the request of one party, and over the objection of the other. Some arbitrators . . . even argue that absent a set compulsory procedure to the contrary, they are required, under the law, to allow a party to fully develop and present its case, as it desires." However, when one considers (i) the procedure's express cost-containment provisions and (ii) the awareness of AIRROC arbitrators that parties deciding to use the procedure will do so for the specific purpose of containing costs, it is believed that most arbitrators will enforce such restrictions with appropriate rigor.

Advertisers in this Issue

Scottish Lion Insurance Company Limited

Stop Press: As we went to print the Scottish Court of Appeal unanimously allowed the appeal by Scottish Lion on the preliminary issue of whether it would ever be fair for a court to sanction a solvent scheme in the face of creditor opposition. The Court held that there is no requirement for applications for sanction of solvent schemes to be treated any differently from those where a company is (or may be on the verge of becoming) insolvent. The financial position of the company is only one of the factors to be borne in mind by the court when it exercises its discretion. Likewise, the existence of a problem may favour the granting of sanction, but the Court did not consider it a precondition for sanction. A court will need to consider all the relevant evidence when exercising its discretion on whether to sanction a scheme.

Elizabeth Wheal

By Elizabeth Wheal

On 16 October 2009 the solvent scheme of arrangement proposed for The Scottish Lion Insurance Company Limited was dismissed by Lord Glennie of the Outer House, Court of Session in Scotland. This rejection of the scheme followed his ruling on 10 September 2009 on two preliminary issues following which he recommended that the opposing parties should seek to negotiate a compromise or amend the scheme to their mutual satisfaction. Scottish Lion did not present any proposed amendments to the scheme at the case management conference on 14 October 2009 with the result that Lord Glennie dismissed the scheme on the objecting creditors' application. Accordingly, subject to appeal, Lord Glennie's opinion on the two preliminary issues stands. Whilst this decision will have to be borne in mind by companies when dealing with their run-off, to ensure that policyholder obligations are adhered to (as noted by Richard Rutty of Resolute Management Services during the panel discussion on Commuting Reinsurance Agreements Before, During and After the Sale of Run-Off Business at the AIRROC Rendezvous 2009) the suggestion by some commentators that this judgment has signalled the death knell of solvent schemes seems to be premature.

Elizabeth Wheal (elizabeth.wheal@rpc.co.uk) is a Senior Associate in the Insurance Restructuring and Insolvency Team at London law firm Reynolds Porter Chamberlain LLP.

The Scottish Lion Insurance Company Limited proposed a solvent scheme arrangement under Part 26 of the Companies Act 2006. The purpose of the scheme was to quantify and settle Scottish Lion's liabilities to its policyholders under or in relation to policies of direct insurance. The hearing before Lord Glennie was to consider two issues:

(a) whether the individual vote assessor had correctly valued the creditors' claims for voting purposes; and

(b) whether it would ever be fair for a court to sanction a solvent scheme in the face of creditor opposition.

Due to it being a Scottish company, the application was heard before the Scottish Courts. Lord Glennie issued his opinion on 10 September 2009. On the first issue, Lord Glennie held that in deciding what can and cannot be taken into account by a court in exercising its discretion at the sanction stage was a matter for case-by-case development. The independent vote assessor's determination of the quantum of the creditors' claims for voting purposes could not only be challenged on perversity or irrationality. It is Lord Glennie's judgment on the second issue which is of particular significance and has led the insurance run-off market to re-evaluate schemes as an exit strategy.

> *…in deciding what can and cannot be taken into account by a court in exercising its discretion at the sanction stage was a matter for case-by-case development.*

A scheme of arrangement is a mechanism used by corporate lawyers for many different purposes. The essential features of a scheme are that the court convenes meeting(s) of creditors and if the creditors present and voting at the meeting(s) either in person or by proxy vote in favour of the scheme by a 75% majority in value and a simple majority in number, the scheme will then

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European Business Transfers: Significant European Court Decision

Vivien Tyrell

By Vivien Tyrell

Another cat has been set amongst the pigeons in the run-off restructuring arena. On 22 October 2009 the European Court of Justice (ECJ) issued a decision in the case of *Swiss Re Germany v. Finanzamt Muenchen*. The case decided that transfers of re-insurance business portfolios from one EU State to a third State are transfers of services and are therefore subject to Value Added Tax (VAT) in the State of the transferor. Rates of VAT in Germany ranged at the time from 7 to 19% (and in the UK they were 15% and now 17.5%). The prospect of such a levy on the amount paid for every portfolio transfer would surely put a brake on Part VII and other business transfers throughout the EU. Furthermore, the spector of retrospective payments having now to be made on past transfers has sent a shiver down the industry's collective spine.

…transfers of re-insurance business portfolios from one EU State to a third State are transfers of services and are therefore subject to Value Added Tax (VAT) in the State of the transferor.

The prospect of such a levy on the amount paid for every portfolio transfer would surely put a brake on Part VII and other business transfers throughout the EU.

So is it as worrying as first thought? The answer is: most likely not. However, like many things, it is not straightforward and it is therefore helpful to look quite closely at the significant aspects of the case itself.

Vivien Tyrell is a Partner in London law firm, Reynolds Porter Chamberlain where she heads the Restructuring and Insolvency Group and Insurance Restructuring and Insolvency team. Vivien.Tyrell@rpc.co.uk

Background to the appeal to the ECJ

Swiss Re Germany (Swiss Re) was the parent of the transferor, a German life reinsurance company which in January 2002 entered into a portfolio transfer agreement with the transferee (a company established in Switzerland). The transfer comprised 195 life reinsurance policies. Out of the 195, 18 were ascribed a negative value. The contracts which were transferred concerned exclusively undertakings in EU Member States outside Germany or otherwise were in non-EEA States. The Finanzant Muenchen (i.e. the tax and revenue office for Munich) had itself concluded that the transfer was a supply of *goods* and therefore VAT was chargeable. Swiss Re Germany therefore appealed to the Finanzgericht Muenchen (the court dealing with financial matters in Munich) against that decision but the appeal was rejected. Swiss Re Germany launched a further appeal to the Bundesfinanzhof (Federal Finance Court) (Germany) (FFC). The appeal was stayed as the FFC referred the case to the ECJ for a preliminary ruling.

What were the matters in issue?

Swiss Re claimed that the services based on the transfer were exempt from VAT and the Finanzamt claimed that the transfer was a supply of goods and therefore taxable. The FFC's view was that the transfer was a supply of services carried out in Germany and therefore taxable in Germany. Underlying these issues is the *Sixth Counsel Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment* (the Sixth Directive). The FFC referred the matter to the ECJ as it was unsure that its interpretation of German legislation (vatable services in Germany) was compatible with the Sixth Directive.

In the UK, the run-off industry has hitherto believed that Part VII transfers and other types of portfolio transfer did not attract VAT. The ECJ ruling means that VAT is definitely payable in Germany on such transfers and may well also be payable in other Member States.

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What exactly did the ECJ decide?

It is important to be aware of each of the points which the ECJ decided. It is in the nature of ECJ judgments to treat each of the arguments apparently with equal standing and not to stray beyond any questions which were put before it. This does mean that there are further arguments against its ruling which would still be available to be fought in the future (see below). The ruling was as follows:

- the transfer was not a "supply of goods";
- in view of that, under the Sixth Directive, it had to be a "supply of services" (Article 6(1)(i)). (Under the Sixth Directive there is no room to argue that the transfer was neither a supply of goods nor a supply of services);
- it was not an insurance nor a reinsurance contract and therefore was not exempt from VAT and Article 9(2)(e) or Article 13B(a); and
- it was not a "financial transaction" and therefore not exempt under Article 13B(d).

A further question which the ECJ dealt with was whether or not it was relevant as to who paid the consideration i.e. the transferee or the transferor. The ECJ side stepped this question. In 18 of the 195 life reinsurance contracts the consideration was paid by way of netting off as they were of negative value. The ECJ decided that the transaction i.e. the transfer constituted one overall service giving rise to an overall price for all 195 contracts and there was no distinction to be made between the 18 and the remaining 177 contracts. This aspect of the decision is ambiguous but the implication is that it is irrelevant as to who pays the consideration. This is, however, a point which remains to be tested in the future if necessary.

Put simply, the effect of the decision is that a transfer of a portfolio of insurance business by a company established in one Member State to a company established in a third State (e.g. Switzerland a non-EU country) attracts VAT in the transferor's State. However, this decision arguably only currently applies in relation to a transfer by a company established in Germany.

How does the ruling effect the VAT regimes in other EU States?

Taking the UK as an example, section 49 of the VAT Act 1994 and the VAT (Special Provisions) Order 1995 apply to insurance portfolio transfers. Subject to certain conditions, if a taxable person transfers *a business or part of it as a going concern* to another taxable person (TOGC) the transfer will not be a supply of goods nor of services, and VAT will not be chargeable. The following are the relevant TOGC conditions which have to be complied with:

- the transferor and transferee must be taxable;
- the assets transferred must be used to carry on an economic activity; and
- if part of the business is being transferred it must be capable of separate operation.

A narrow interpretation of the ECJ's judgment suggests that the *Swiss Re* case applies only to transfers from a transferor established in an EU State to a third State transferee e.g. established in Switzerland. However, the tax agencies in separate Member States may conclude that, now all portfolio transfers of insurance business are supplies of services and not transfers of businesses as going concerns.

> *A narrow interpretation of the ECJ's judgment suggests that the Swiss Re case applies only to transfers from a transferor established in an EU State to a third State transferee…However, the tax agencies in separate Member States may conclude that, now all portfolio transfers of insurance business are supplies of services and not transfers of businesses as going concerns.*

One interesting point is that formal observations were made to the ECJ in the Swiss Re case by the German, Greek and UK Governments which might indicate that these States have been watching developments very closely and may wish to respond to the decision.

What are the likely consequences of this decision?

Looking at the UK Her Majesty's Revenue & Customs (HMRC) may issue a Business Brief if it wishes to change the policy of accepting such transfers as TOGC. If a company in its VAT return proposes to rely on TOGC, HMRC might challenge that reliance and issue an assessment. The assessment could then be appealed by the company as the TOGC point was not argued in the *Swiss Re* case. However, to give an idea of timescale, the period which might elapse before a further ECJ decision may be given on the TOGC point (and indeed any other point such as the question of the relevance of who pays the con-

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European Business Transfers... *continued from page 27*

sideration) would take a very long time to be decided. Taking the UK as an example, typically it would take 3 years for an appeal to reach the first tier UK tribunal. There would be further appeals in the UK courts before the further reference to the ECJ on the TOGC and other points would be made. We can see that it took from the time of transfer in 2002 to 2009 for the ECJ to decide the points in the *Swiss Re* case.

Where does that leave us?

Undoubtedly there is substantial uncertainty. However, in the UK at least the status-quo currently prevails. The general view is that it is highly unlikely that HMRC would seek to unwind VAT returns submitted in relation to past transfers so that the effects of the ECJ decision, should there be any change of policy, are unlikely to be retrospective. It is possible that purchasers of insurance business portfolios will be more interested in buying whole companies in run off, i.e. via share purchases, than acquiring the portfolios themselves. A lot will depend on the different strategies investors/purchasers wish to deploy.

Finally, one interesting point is that the precise facts of the *Swiss Re* case are unlikely to be relevant in future. From 1 January this year, new rules have been implemented throughout the EU under Counsel Directive 2006/112/EC (Principal VAT Directive) and Counsel Regulation EC1777/2005 (Implementation Regulation) i.e. the Place of Supply Rules. Were these rules to be in place at the time of the original Swiss Re transfer, there would be no question of the transferor paying VAT but rather the transferee would only have had to pay what local taxes might be charged in Switzerland. The effect of the new rules is that where there is an EU to EU transfer or a non-EU to EU transfer, the transferee would account for VAT at the local rate. The place of supply is the country of the recipient of the supply. This is another aspect which will be taken into account in the case of cross border transfers. ■

Alert No. 31

KPMG Policyholder Support Update

KPMG's Restructuring Insurance Solutions practice has been providing Policyholder Support Alerts to the insurance industry regarding Schemes of Arrangement for a number of years. These alerts act as a reminder of forthcoming bar dates and Scheme creditor meetings. To subscribe to these alerts or access KPMG's online database of solvent and insolvent Schemes of Arrangement, please visit their website at www.kpmg.co.uk/insurancesolutions.

Solvent Schemes – Upcoming Key Dates

DEUTSCHE RÜCK UK REINSURANCE COMPANY LIMITED ("DRUK")

The above company's Scheme was approved at the Meeting of Creditors on 18 May 2009. The Scheme became effective on 16 June 2009 and the bar date was set as 15 December 2009. Further information is available at www.deutscherueckuk.com.

MARINER REINSURANCE COMPANY LIMITED

The above company's Scheme was approved at the Meeting of Creditors on 15 October 2009. The Scheme became effective on 23 October 2009 and the bar date has been set as 22 January 2010. Further information is available at www.mariner.bm.

TRIMARK 1968 AND PRIOR YEARS POOLS ("TRIMARK")

Schemes for the participating Trimark Pools companies were approved at Meetings of Creditors on 9 October 2009 and 30 October 2009. The Schemes for the 48 participating Trimark Pools companies were sanctioned by the Court on 11 November 2009 and the bar date has been set as 12 April 2010. Further information is available by e-mailing Ben Webber at ben.webber@kpmg.co.uk or Trevor Sage at trevor.sage@ctcaxiom.com.

THE MEADOWS INDEMNITY COMPANY LIMITED

The above company's Scheme was approved at the Meetings of Creditors on 27 May 2009. The Scheme became effective on 20 July 2009 and the bar date has been set as 18 January 2010. Further information is available at www.meadowsindemnity.com.

Other Recent Developments

ENGLISH & AMERICAN UNDERWRITING AGENCY ('EAUA') POOLS

A Practice Statement Letter was sent to all known brokers and policyholders on 15 October 2009 indicating that 16 companies which participated in the EAUA Pools intend to propose a Scheme of Arrangement in respect of business underwritten for them by the EAUA Pools. The participating EAUA Pool companies applied to the High Court of Justice of England and Wales for a court hearing on 30 November 2009 in order to obtain permission to convene Meetings of Creditors. Further details are available at www.englishandamericanpools.com.

ALLIANZ GLOBAL CORPORATE & SPECIALTY (FRANCE); ASSURANCES GÊNÊRALES DE FRANCE I.A.R.T.; DELVAG LUFTFARHT VERSICHERUNGS AG; NÜRNBERGER ALLGEMEINE VERSICHERUNGS AG (IN RESPECT OF THE CAMOMILE UNDERWRITING AGENCIES LIMITED BUSINESS)

A Practice Statement Letter was sent to all known brokers and policyholders on 30 April 2009 indicating each of the above companies' intention to propose a Scheme of Arrangement for each of the companies' involvement in the business underwritten for them by Camomile Underwriting Agencies Limited ("CUAL"). The above companies intend to apply to the High Court of Justice of England and Wales for permission to convene Meetings of Creditors although no date

continued on next page

for this application has been announced. Further information is available at www.CUAL-scheme.co.uk.

MINSTER INSURANCE COMPANY LIMITED, MALVERN INSURANCE COMPANY LIMITED, THE CONTINGENCY INSURANCE COMPANY LIMITED, PROGRESS INSURANCE COMPANY LIMITED, GAN ASSURANCES IARD, QBE INSURANCE (EUROPE) LIMITED AND RELIANCE FIRE AND ACCIDENT INSURANCE CORPORATION LIMITED

A Practice Statement Letter was sent to all known brokers and policyholders on 27 October 2009 indicating each of the above company's intention to propose a Scheme of Arrangement. The order granting leave to convene Meetings of Creditors was granted by the High Court on 4 November 2009. The meetings will be held at 11:00am on 18 January 2010, at the offices of Barlow, Lyle & Gilbert LLP, Beaufort House, 15 St Botolph Street, London EC3A 7NJ. Further information is available at www.minsterins.co.uk.

THE SCOTTISH LION INSURANCE COMPANY LIMITED

The petition to sanction the above company's proposed solvent scheme was dismissed by the Scottish High Court in Edinburgh on 14 October 2009. An appeal was listed to be heard from 1 December to 4 December 2009. Further information is available at www.scottishlionsolventscheme.com.

TOKIO MARINE EUROPE INSURANCE LIMITED

A Practice Statement Letter was sent to all known brokers and policyholders on 28 August 2009 indicating the above company's intention to propose a Scheme of Arrangement. The above company intends to apply to the High Court of Justice of England and Wales for permission to convene Meetings of Creditors although no specific date for this application has been announced. Further information is available at www.TMEISCHEME.com.

CITY GENERAL INSURANCE COMPANY LIMITED

The bar date for the above company's Scheme of Arrangement passed on 21 October 2009. Further information is available at www.citygeneral.co.uk.

Insolvent Estates

ENGLISH & AMERICAN UNDERWRITING AGENCY ('EAUA') POOLS (ENGLISH & AMERICAN INSURANCE COMPANY LIMITED, THE INSURANCE CORPORATION OF SINGAPORE (UK) LIMITED AND THE HOME INSURANCE COMPANY (IN LIQUIDATION) - INSOLVENT PARTICIPANTS)

HIGHLANDS INSURANCE COMPANY (UK) LIMITED

The above company's Scheme was approved at the Meeting of Creditors on 18 June 2009 and the Scheme became effective on 19 August 2009. The deadline for Scheme Creditors to submit a Claim Notification passed on 17 November 2009. Scheme Creditors who submitted a Claim Notification by the Claim Notification Date must provide full details of the claim and supporting documents by submitting a Final Claim Form no later than 5pm (London time) on 15 February 2010. Further information is available at www.ukhighlands.co.uk. ■

Please do not hesitate to contact Mike Walker, Head of KPMG's Restructuring Insurance Solutions practice in the U.K. at mike.s.walker@kpmg.co.uk should you require any further information or guidance in relation to insurance company schemes and insolvencies.

Scottish Lion Insurance Company Limited *continued from page 24*

proceed to the court sanction stage. The court then decides whether the scheme is fair and, if it does, will sanction it. If the scheme is approved then all creditors of the company are bound even if they did not vote or if they objected to the scheme. Objectors are entitled to raise objections at both the first court hearing and the final sanction stage.

Some commentators have suggested that, as a result of Lord Glennie's opinion, if a solvent scheme is to be sanctioned, it is now necessary to obtain unanimous support for the scheme from all the creditors. However, is that really correct?

Lord Glennie accepted that the court's power to sanction a scheme of arrangement is unfettered. However, he drew a distinction between schemes which were intended to resolve a "*difficulty or problem*" in the company and those where the arrangement was ultimately for the benefit of the company's shareholders. One of the key issues for Lord Glennie was the financial position of the company. There was no question that Scottish Lion was financially sound. Accordingly, in the ordinary course each of its creditors could expect to be paid as and when it made a valid claim on its policy of insurance. The judge did acknowledge that where a company was in financial difficulty there may be an incentive for creditors to seek to make some compromise with a company. There was no such imperative for Scottish Lion.

The judge considered that a scheme of arrangement would only be fair and "*creditor democracy*" should operate where there is some "*problem*" that needed to be addressed. The obvious example would be where the company is facing financial difficulties and may become insolvent. In such circumstances, Lord Glennie thought it was easy to see why the creditors must be required to act together and be bound by the majority. A dissenting minority should not be allowed to prevent a scheme coming into effect which is obviously for the benefit of a body of creditors as a whole. However, he did not see why the principle of "*creditor democracy*" should be allowed to prevail in all situations where a scheme of arrangement is proposed. In the case of Scottish Lion, Lord Glennie could see no reason, apart from the wishes of the shareholders, why the company should not continue with a run-off. It was solvent and able to meet its potential liabilities in the future. He stated that in a solvent scheme he would expect petitioners who apply for a scheme to be sanctioned to be able to justify why the minority should be bound by the decision of the majority.

The judge considered that a scheme of arrangement would only be fair and "creditor democracy" should operate where there is some "problem" that needed to be addressed. "

Accordingly, it appears that in the absence of a "*problem*" unanimous creditor support is required. However, the "*problem*" need not be a financial one. Another example of a "*problem*" which could be solved by a scheme would be where the majority of creditors recognise that the problem is one of administering claims. The scheme would present a streamlined process and early settlement of the claims.

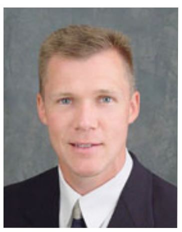
Lord Glennie also appeared to draw a distinction between two different types of scheme, one where the scheme is opposed and one where there is no opposition. In the case of an opposed scheme, the judge appears to apply more stringent considerations as to the existence of a problem which needs to be solved. This appears to be taking a very serendipitous approach. When a company commences promotion of a solvent scheme it will not be known into which category the scheme will fall. This cannot be what the legislation ever intended.

It has been suggested that Scottish Lion is a return to the principles espoused in the controversial decision of *British Aviation Insurance Company Limited*, where a scheme was dismissed in the face of opposition by creditors. Following initial caution following the *BAIC* decision, that decision has now become a useful set of guidelines to companies promoting schemes in considering whether their proposal is likely to be approved by a court. Subject to the issue over serendipity, Scottish Lion may come to be seen similarly. As ever, companies promoting schemes will be best served in consulting with their creditors early in the process to minimise or eradicate opposition.

At the time of writing, we understand that Scottish Lion is appealing the first instance decision. A hearing took place before the Inner House, Court of Session in December 2009 and the judgment is expected imminently. The run-off market will await the views of the Appeal Court with interest. ■

Survey: AIRROC and PACE, a Unit of Navigant Consulting, Partner in Survey to Explore Practices, Processes and Costs to Administer Asbestos Claims

Bradley Drew



Bob Petersen

By Bradley Drew and Bob Petersen

Asbestos claims continue to be a significant cost for companies in run-off as well as run-off units for live companies — in many cases there is an imbalance between amount of total claims costs and the attention they receive from company management. This may simply be due to the fact that the claims environment has matured and fewer claims are being filed each year. For too long the industry has been operating with a "keep handling the same way" attitude. However, it has been demonstrated that costs to administer and settle asbestos claims can be lowered today by applying appropriate technology and obtaining better intelligence on claims experiences. We strongly believe that the industry needs to better share information about how to manage asbestos claims more effectively and efficiently.

To identify those practices and convert them into actionable insights for AIRROC members, the PACE unit of Navigant Consulting is partnering with the Association on a member survey to explore, assess and ultimately better understand the practices, processes and ultimate costs to administer asbestos claims for a run-off organization or unit. **In advance of this newsletter an email was sent to members directing them to a link to participate in the survey. If you have not yet taken the online survey we urge you to do so since more full membership participate will yield better insights. The brief survey can be accessed at https://PACE-AsbestosCostsSurvey.questionpro.com. Please note that this is a blind survey and members need not identify themselves.**

Bradley Drew and Bob Petersen are Managing Directors of PACE, a unit of Navigant Consulting and can be reached at bdrew@navigantconsulting.com and bpetersen@navigantconsulting.com, respectively.

Our hope is to obtain a substantial set of data that can be synthesized in a way which enables management of AIRROC members to make more informed decisions on their approach to managing asbestos claims. We believe that by gaining a consistent understanding of how a broad range of organizations manage their asbestos claims it will enable better management information and intelligence, increased productivity, and lower administrative costs.

The survey will compile and report on the various costs that claim departments incur in order to manage the asbestos litigation for their insureds. Areas to be explored in the survey include:

- number of new claims on average by account
- average number of pending asbestos claims
- average asbestos claim payment by account
- asbestos book related to other claims
- number of policyholders with asbestos claims
- percentage of asbestos accounts where member is lead insurer
- level of company asbestos reserves
- type of structure in place to manage asbestos accounts
- number of company employees dedicated to processing asbestos claims
- consistency of staffing levels in asbestos claims group
- current processes for managing asbestos claims, and who performs them
- how outside legal costs are managed, and any increase/decrease in costs
- self evaluation in the use of technology in claims processing
- revision of procedures, systems and processes over time
- percent savings for new claims administration alternatives

Again, if you have not yet participated in the survey, please go to https://PACE-AsbestosCostsSurvey.questionpro.com. PACE and AIRROC will do our best to make your effort worthwhile by compiling and making available to members top line quantitative results, as well as an in-depth analytical qualitative report. ■

Alternatives to Receivership Require Increased Attention… *continued from page 14*

Services and Markets Act of 2000 that involves the transfer of insurance business under a court-approved process whereby an insurer or reinsurer may move all or certain of its business to another entity. Unlike a Solvent Scheme of Arrangement, which requires majority credit approval representing at least 75% in value of all obligations, a Part VII transfer requires only (1) policy holder notification, (2) a report by an independent expert, (3) UK high court approval, and (4) no objection from the Financial Services Authority (FSA) or other regulators or interested parties. It is a more "flexible" mechanism than a Scheme of Arrangement.

…a Part VII transfer…is a more "flexible" mechanism than a Scheme of Arrangement.

The transfer requires the appointment of an "independent expert," usually an actuary, who must submit a report expressing an opinion on the impact of the transfer scheme on the affected parties. In deciding whether to sanction the transfer, the court will be influenced by the findings of the expert's report and the "attitude" of the FSA. While the Act of 2000 requires that all direct and reinsurance policyholders must be notified individually of the proposed transfer, in practice this tends not to happen. In *WASA International (UK) Insurance Co Ltd and another v WASA International Insurance Co Ltd*, [2002] EWCH 2698 (Ch), the Chancery court ruled that the rights of a reinsurer may be transferred in a Part VII Transfer without the consent of the reinsurer.

Amendments intended to clarify elements of the rules governing Part VII Transfers went into effect on June 30, 2008. In particular, there was uncertainty as to certain aspects of the transfers with respect to reinsurance that is in place on transferred business. The court was presumed to have discretion to order the transfer of reinsurance contracts and early court decisions favored this view, but inconsistent decisions resulted in uncertainty, particularly where the reinsurance contract required consent of the reinsurer to effectuate a transfer. Most notably, the amendments affirm the courts' power to order a transfer even in the face of limitations on the right to transfer, giving the courts authority and discretion to override such restrictions or limitations where appropriate. The amendments also include a provision requiring the notification of all reinsurers whose agreements would be affected by a transfer under a proposed scheme. Notification to brokers or other authorized persons or entities is authorized under the amendments. No notice is required to be given to retrocessionaires, as they do not have a direct contractual relationship with the insurer seeking to transfer the business.

As with Solvent Schemes of Arrangement, a Part VII Transfer would require approval by a U.S. Bankruptcy Court in order to be enforceable with regard to interests in the U.S. In the recent case of *In re Rose*, 318 B.R. 771, 774 (Bkrtcy S.D.N.Y., 2004), in which court approval was sought for a transfer scheme whereby most of the assets and liabilities of certain solvent insurance companies would be shifted to another corporation in order to effect corporate restructuring, the Bankruptcy Court for the Southern District of New York ruled that the processes undertaken in furtherance of completing the transfer in the U.K. was not a proceeding brought for the purpose of "effecting a reorganization" and did not qualify as "foreign proceeding," as those terms are used in the bankruptcy statute governing cases ancillary to foreign proceedings. Based upon that reasoning, the court declined to issue the requested injunction in support of the Part VII Transfer, thereby declining to afford the Part VII Transfer the same deference as has been given to Solvent Schemes of Arrangement by U.S. courts. *Id.*

As with Solvent Schemes of Arrangement, a Part VII Transfer would require approval by a U.S. Bankruptcy Court in order to be enforceable with regard to interests in the U.S.

Conclusion

In contrast to what has been seen historically, state insurance regulators in the U.S. are now interested in developing alternatives to receivership in order to ensure healthy and vibrant insurance markets. The development of new and creative mechanisms hold some promise towards achieving that goal. Likewise, mechanisms that are similar to or modeled after mechanisms utilized outside the U.S. market, such as Solvent Schemes of Arrangement and Part VII Transfers, may be useful to the U.S. domestic insurance and reinsurance market. Their acceptance and use within the U.S. has been very slow, but if utilized may also facilitate quality business between the U.S. and non-U.S. markets. ■

AIRROC: Evaluating the Regulatory 'Toolbox' for Financially Impaired US Insurers continued from page 8

in operating companies which intend to continue or resume selling policies as well as for winding up a non-compliant company for reasons in addition to financial solvency reasons.

Some Final Thoughts

Does the flexibility of the Model Act, its protection for smaller creditors and its broad applicability outweigh the need for extreme speed in winding up an estate?

If state guarantee funds will play a role in the administration of claims for both the UIRRL and the Model Act plans, is it likely that sound data for valuing claims will not be available any sooner than five years after the inception of the plan, such that full and final settlements may be constrained in any event by the accumulation of claim data from state guarantee funds?

One possible conclusion is that, after extensive public debate, and a balancing and compromise of interests, the Model Act includes all the flexibility of the UIRRL and more, while providing a structure for valuing claims that has already been drafted, vetted and approved through the NAIC Model Act process.

One alternative approach may be to determine whether the insertion of:

(a) the appointment of a public representative to protect the interests of smaller individual claimants; and

(b) a methodology for the valuation of claims into the UIRRL draft bill might broaden its acceptability, if the need for creditor-driven plans can be demonstrated outside of the Model Act structure.

However, it remains unclear whether the Model Act is deficient in either speed or in protecting the interests of creditors.

A third alternative may be to determine if the addition of creditor committees may expedite the development and timely execution of rehabilitations under the Model Act.

A third alternative may be to determine if the addition of creditor committees may expedite the development and timely execution of rehabilitations under the Model Act.

Because reinsurance is often a major asset of a financially impaired insurer, one simple method of resolving the entire issue of claim estimation, is for the cedent and the reinsurer to agree to include within each relevant reinsurance contract, an agreed time for and method of effecting a full and final settlement of the reinsurance contract.

Considering that the current version of the NAIC Model Act was adopted in 2005 and that Rehabilitation Plans under prior variations of the NAIC Model Act exist today, some data from currently exiting estates might also be quite helpful:

- what are the time durations of US Rehabilitation Plans and how many years elapse before the plans reduce estate claims by 25, 50, 75 and 100%?
- whether the time constraints of the Model Act as to the valuation of casualty claims are an impediment to more timely wind up of the plans
- how policyholder claims and the interests of smaller individual claimants are protected and administered in UK creditor driven run-off plans? and
- time comparisons between the duration of UK wind-ups and US wind-up Rehabilitation Plans. ■

Frank Kehrwald sits on the Board of Directors at AIRROC and is Senior Vice President of Swiss Reinsurance America. He can be reached at frank_kehrwald@swissre.com.

Endnotes

1 To consider the effectiveness of the US regulatory receivership process, one might consider the percentage of claim distribution of recent US receivership estates as compared to the percentage/amount of claim distributions of other worldwide estate wind-up mechanisms. As well, if one was reviewing estates worldwide, one might consider the duration of the rehabilitation/receivership estate administration from the date of the initial notice of financial deficiency to the date of wind-up or return to active writings of insurance.

2 Model Act §207.

3 Model Act §402.

4 Model Act §403.

5 Model Act §403.

6 Model Act §504; §614.

7 Model Act §614.

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Message from CEO and Executive Director **AIRROC Strikes Oil! . . .** *continued from page 1*

will propose ways to navigate the rough waters of our current busy, changing times – the pressure is certainly on this committee. Call me if you would agree to assist in recruiting new members (770-664-7219). It's actually rather fun to connect the dots on relationships.

AIRROC Actuarial Committee: ***Oil pumps working*** as the committee is actively targeting their objectives and goals for 2010.

AIRROC Education Committee: ***Well oiled*** as presented in 2010 and quite prepared to embark on planning for our 2010 educational sessions. Our hats are off to Karen Amos and Kathy Barker! We had remarkable feedback on our 10/19/09 education program so plans are again underway for 2010.

AIRROC Commutation Event: ***Quite well oiled.*** It's all under direction of Art Coleman….and his whip! What else can I say? Art hears, bends, weaves, slides and secures, at the end of the day fulfilling all promises and delivering one successful event after another. Of course, we are lent the commutation expertise and execution skills of Cavell. Thank you, Alan, Jim and many others at Cavell. Our fifth AIRROC/Cavell Commutation & Networking Event was spectacular and we hope to achieve our goals again this year. Most importantly, so many parties furthered their business objectives. Thank you, Art.

Our thank you as well to Jeff Mace and Dewey LeBoeuf for your legal advice and an astounding meeting place, Joe and Susan DeVito of DeVito Consulting for your past and future services as AIRROC Treasurer plus Ed Gibney (CNA) for your past and future services as AIRROC Secretary. Most probably underestimate the time and commitment these people give each year through their excellent pro bono services.

We have an incredible AIRROC Chairman, Jonathan Rosen, and Board of Directors who will continue to guide us through 2010 and beyond. ***Well oiled.***

What's next at AIRROC? Stay tuned and connected to our website because Solutions Matter™. ■

Ms. Getty has been active in the insurance/reinsurance industry for over forty years, her keen experience in reinsurance claims, both inwards and outwards, harking back to 1972 when she began her experience in that sector of the industry with Berkshire Hathaway/National Indemnity Re. Trish has been employed in most fashions of the reinsurance industry, the majority as reinsurance claims manager, which led her to AIRROC and understanding its members' histories and today's needs. Trish readily recognizes the great value that AIRROC brings to its members at such a crucial time in the worldwide run-off industry. She can be reached at trishgetty@bellsouth.net.

Notes from Editor and Vice Chair **Neither Rain nor Snow. . .** *continued from page 3*

"the law is a seamless web," certainly some type of web in which the unwary can be snared and ultimately devoured. Elizabeth Wheal offers up *Scottish Lion Insurance Company Limited,* an in-depth discussion of the October 16, 2009 decision by Lord Glennie of the Outer House, Court of Session in Scotland. Elizabeth also comments on the development, as we went to print, of the Scottish Court of Appeal's holding that applications to sanction solvent schemes should be treated no differently than those where companies are, or are on the verge of becoming, insolvent. In our Legalese section, Vivien Tyrell provides *European Business Transfers: Significant European Court Decision,* addressing *Swiss Re Germany vs. Finanzamt Muenchen*, October 22, 2009. European Court of Justice case holding that transfers of reinsurance business portfolios from one EU State to a 3rd State are transfers of services, subject to VAT in the State of transferor.

Finally, we include a discussion on the AIRROC and PACE Survey from Bradley Drew and Bob Petersen of PACE, a Unit of Navigant Consulting. The Survey, which was previously distributed to all AIRROC members by email, is designed to explore, assess and better understand a runoff unit/organization's practices, processes and costs to administer asbestos claims. In their article, the authors also remind all members to please respond to the Survey.

Complete with Nigel Curtis' *Present Value* page, and KPMG's *Policyholder Support Update*, this addition proves that all things runoff are never boring, always changing and intellectually and strategically exciting. Words to live by.

Let us hear from you. ■

Mr. Scarpato is an arbitrator, mediator, run-off specialist, attorney-at-law and President of Conflict Resolved, LLC, based in Yardley, PA. He can be reached at peter@conflictresolved.com.