THINK TANK
Jonathan Rosen's response to Terry Kelaher's "Claim Estimation" article that appeared in our last issue. 4

Regulatory Supervision in Insurance Company Run-offs
Does the Caretaker become the Undertaker? 7

A Risk-Based Approach to Email Management
Have ewe proof-red yore e-male? If knot reed this… 11

In Re British Aviation Insurance Company
Its Relevance to U.S. Regulation of Solvent Run-off Companies 14

Association of Insurance and Reinsurance Run-off Companies

AIRROC Matters

A Newsletter About Run-off Companies and Their Issues

Vol. 1 No. 2 www.airroc.org Winter 2005/2006

Message from CEO and Executive Director

AIRROC is a Smashing Success: Here's Why

Trish Getty

By Trish Getty

As we approach the end of our first year as AIRROC, we look back at our accomplishments in the past twelve months. I must say that we are pleased. Our membership has grown to forty-two as we pick up momentum and sharpen our focus. In spite of the hectic schedules of the AIRROC board, all have contributed immensely to the growth and direction of our association. I would like to personally thank our board members for the time they have dedicated to developing AIRROC. They have made my job as Executive Director delightful.

The inaugural AIRROC/Cavell Commutation and Networking Event in the Meadowlands on October 24-26, 2005 was indeed a smashing success! We had over 270 attendees. The event opened with a cocktail party followed by a spectacular gala dinner. As the attendees entered the event, I observed so many, many acquaintances greeting each other, jovial and expectant. They were not disappointed. As the concert pianist played on, the evening unfolded into a marvelous kickoff. We congratulate Paul Dassenko (Converium Re) who was honored at the dinner as the Run-off Person of the Year.

The next morning, all enjoyed breakfast while listening to the first panel

continued on page 12

Ms. Getty is CEO and Executive Director of AIRROC. She can be reached at trishgetty@bellsouth.net.

Notes from the Editor

More of a Good Thing

By Peter Scarpato

First and foremost, thank you all for your kind words and helpful feedback on our inaugural issue. As your Publications Committee we are dedicated to the proposition that *AIRROC Matters* offers insightful, relevant information to our membership. We appreciate your support.

continued on page 3

Also in this Issue

Notes from the Editor 1
Message from CEO and Executive Director 1
KPMG Policy Support Update 16

LeBoeuf Lamb

Global Legal Advisers to the Insurance and Reinsurance Industries

The Run-off Tool Kit for AIRROC Members

Employee retention and other human resource plans

Administration technology

Assuring constructive intermediary relationships

Effective capital management

Legal Advisers Who Know

The reinsurance business

Negotiating and closing reinsurance transactions

Regulatory issues

- Special compliance and corporate governance issues
- Solvency issues

Reinsurance arbitration and litigation

Offices Worldwide

New York
Washington, D.C.
Albany
Boston
Chicago
Hartford
Houston
Jacksonville
Los Angeles
Pittsburgh
San Francisco

London
a multinational partnership

Paris

Brussels

Johannesburg
(Pty) Ltd.

Moscow

Riyadh
affiliated office

Bishkek

Almaty

Beijing

www.llgm.com

LeBoeuf, Lamb, Greene & MacRae LLP

Notes from the Editor

More of a Good Thing

continued from Page 1

Peter Scarpato

The Winter 2005/2006 issue continues this trend. In addition to our regularly recurring articles, we begin with **Jonathan Rosen's** "Bringing Claim Estimation into Perspective," a spirited response to Terry Kelaher's "Claim Estimation" article and examination of the NAIC's newly adopted Insurer Receivership Model Act (IRMA). Next, the Committee's **Hal Horwich** comprehensively examines the benefits, challenges and hazards of placing run-offs into supervision instead of rehabilitation in "Regulatory Supervision in Insurance Company Run-offs." **Jonathan Bank's** and **Jon Neiditz's** article, **"**A Risk-Based Approach to Email Management," provides a timely and relevant discussion of the critical relationship between controlling your email and IT information, and asserting and protecting your rights. And, in "In Re British Aviation Insurance Company," **Sue Kempler** presents a meticulous analysis of both the court's opinion and "lessons learned" for proposed U.S. solvent run-off legislation. Of course, we continue to provide **KPMG's "**Policyholder Support Update" of U.K. schemes of arrangement for solvent and insolvent insurers.

We thank the many authors for their fine submissions. But the need for more ideas and insightful articles remains. *AIRROC Matters* is your vehicle for comment, dialogue and debate. As **Trish Getty's** piece "AIRROC is a Smashing Success: Here's Why" and the pictures from our successful Commutation Event (pp. 12-13) confirm, we have an experienced, motivated membership capable of great things. As we move forward in 2006 and beyond, your Committee will reach out to you for input — we welcome your letters to the editor, opinions and ideas for timely articles.

All the best for 2006! 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

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 Board of Directors

Terry Kelaher *(Vice Chairman)*
Allstate Insurance Company

Dale A. Diamond
AXA Liabilities Managers, Inc. (U.S.)

Mike Fitzgerald
CNA Global Resource Managers

Ali E. Rifai
Centre Group Holdings (U.S.) Limited

Michael C. Zeller
AIG Reinsurance Division

Karen Amos
Equitas Limited

Jonathan Rosen
The Home Insurance Company in Liquidation

Andrew Maneval *(Chairman)*
First State Insurance Co./Horizon Management

Keith E. Kaplan
Reliance Insurance Co. in Liquidation

John M. Parker
TIG Insurance Co./Riverstone Group

Marianne Petillo
ROM Reinsurance Management Company

Joseph J. DeVito *(Treasurer, non-Board Member)*
DeVito Consulting

Edward J. Gibney *(Secretary, non-Board Member)*
CNA Global Resource Managers

AIRROC
Publications Committee

Chair
Ali Rifai
ali.rifai@centresolutions.com

Editor
Peter A. Scarpato
peter@conflictresolved.com

Jonathan Bank
jbank@lordbissell.com

Art Coleman
art.coleman@citadelriskmanagement.com

Nigel Curtis
nigel.curtis@citadelriskmanagement.com

Bina T. Dagar
bdagar@comcast.net

Harold S. Horwich
harold.horwich@bingham.com

Cecelia (Sue) Kempler
ckempler@bellsouth.net

Alan J. Sorkowitz
asorkowitz@sidley.com

James R. Stinson
jstinson@sidley.com

Charles D. Thomas
charles.thomas@cna.com

James Veach
jveach@moundcotton.com

Nicholas Williams
nick.williams@cliffordchance.com

Publicity and Marketing Consultant
G. Pirozzi Consulting
gina@gpirozzi.com

Design & Production
Myers Creative Services
nicole@myerscreative.net

AIRROC Matters is published to provide insights and commentary on run-off business in the U.S. for the purpose of educating members and the public, stimulating discussion and fostering innovation that will advance the interests of the run-off industry.

Publishing and editorial decisions are based on the editor's judgment of the quality of the writing, its relevance to AIRROC members' interests and the timeliness of the article.

Certain articles may be controversial. Neither these nor any other article should be deemed to reflect the views of any member or AIRROC, unless expressly stated. No endorsement by AIRROC of any views expressed in articles should be inferred, unless expressly stated.

©2005/2006 AIRROC (Association of Insurance and Reinsurance Run-off Companies)

www.airroc.org

Second in a series of articles on the pros and cons of accelerated claim estimation

Think Tank

Bringing Claim Estimation into Perspective

By Jonathan Rosen

One can readily appreciate reinsurer resistance to attempts by liquidators of insolvent carriers or administrators of distressed entities to cede "bulk" or "pure" incurred but not reported ("IBNR") reserves carried on the cedent's books, but for which no actual liability has been established in relation to an underlying claimant. One can equally appreciate resistance, absent a contractual mandate, to forced commutations or crystallization of liabilities at the reinsurer level for the sole purpose of obtaining reinsurance "close out," either to achieve a successful solvent scheme for shareholder benefit or to merely accomplish cash realization for distressed or insolvent entities whose estates are a long way off from final maturity.

It is, however, difficult to come to grips with the wholesale denouncement of estimation by certain members of the reinsurance community, particularly within the realm of policy buy-backs, which have an element of contingency as a principal component. The cession of contingent or unliquidated liabilities determined in an estate in relation to known exposures identified by insureds or claimants is an issue of critical importance to liquidators, charged with the obligations of marshalling assets and obtaining expeditious and efficient estate closure, and administrators of distressed entities, whose primary objective is to secure a wind-up at maximum creditor value.

> The cession of contingent or unliquidated liabilities determined in an estate ... is an issue of critical importance to liquidators, … and administrators of distressed entities…

There is, of course, nothing unique about the concept of a policy buy-back, which is endemic within the insurance arena where long tail liabilities exist and the reinsurance community has generally been receptive to the notion of loss curtailment through that mechanism. Indeed, courts have long imposed reinsurer liability for underlying settlements involving the resolution of future exposures (for example in relation to environmental impairment, where future clean-up obligations are resolved at net present value, or with respect to future asbestos liabilities which, because of their anticipated magnitude, would cause excess layer policy exhaustion as a matter of course), provided the settlements are reasonable, the settled exposures are arguably within the scope of coverage and there is nothing untoward in the settlement allocation.

So why does a mis-alignment emerge when a cedent becomes financially distressed? The answer is self-evident – cessation of ongoing underwriting relationships, whether through liquidation or run-off, changes everything. While this may be psychologically understandable, its impact is extremely deleterious.

Within the liquidation context, from a pure contractual perspective, traditional insolvency clauses require reinsurers to effect without diminution payment to the reinsured or its liquidator **on the basis of the liability** of the reinsured. In practice, the liability of the reinsured is ascertained through a claims determination process that, of necessity, includes within its ambit an evaluation of exposures having a future loss component, with a net present value ascribed to those future elements for determination purposes. Thus, while estimation is brought to bear in the liability determination process, there should be no perceived contractual impediment to reinsurer indemnity obligation in relation thereto.

At its recent Winter meeting, the National Association of Insurance Commissioners ("NAIC") unanimously adopted an Insurer Receivership Model Act ("IRMA"), a number of provisions of which will be required to be enacted by the various states as a means of obtaining or retaining NAIC accreditation. As a general proposition, the section of IRMA dedicated to reinsurer liability specifically mandates that nothing in the Act shall be

Mr. Rosen is Chief Operating Officer at The Home Insurance Company in Liquidation in NYC. He can be reached at jonathan.rosen@homeinsco.com.

construed to authorize a liquidator or any other entity to compel payment from a reinsurer on the basis of estimated IBNR losses or loss expenses and case reserves for unpaid losses and loss expenses.

However, in recognition of overriding public policy considerations embedded in the general purposes of IRMA, which have as their underpinnings early closure of an estate in conjunction with the ability of a liquidator to marshal assets and act in the best interests of estate creditors, the allowance of determined contingent and unliquidated claims arising from known exposures at underlying has been excepted from the general preclusion. The rationale for this exception lies in a recognition that while estate closure can only be attained once all proofs of claim filed in an estate have been determined, it is inconsistent with their cardinal charge to require receivers to wait for actual loss development of long tail liabilities as a precursor to effecting disposition of claims filed by identified claimants in relation to known exposures before having the right to secure reinsurance recoveries.

Furthermore, consistent with its espoused purposes ... IRMA contains a specific provision that, subject to certain caveats, authorizes a liquidator to enter into voluntary commutations.

Furthermore, consistent with its espoused purposes, and as an additional exception to the general preclusion relative to the scope of reinsurer liability, IRMA contains a specific provision that, subject to certain caveats, authorizes a liquidator to enter into voluntary commutations. Should the parties be unable to achieve voluntary commutation before an estate has reached a defined point of maturity, or if a reinsurer's risk based capital level falls below a defined threshold, IRMA also permits a liquidator to seek an order from the receivership court compelling the parties to submit commutation proposals for resolution by an arbitration panel.

To preserve contractual sanctity, however, in the event that either party declines commutation as resolved by the arbitration panel, IRMA obligates the reinsurer to create a reinsurance trust to the extent of such resolution, inclusive of its IBNR and case reserve components. The reinsurance trust remains subject to upwards or downwards adjustment depending on subsequent development, and as a means of ensuring harmony and symmetry between IRMA's provisions, the liquidator is specifically entitled to obtain release from the trust of the reinsurer's obligations with respect to ensuing claims determined at underlying and admitted in the estate, including claims determined on an unliquidated or contingent basis. As a result, even in the absence of commutation, estate closure can be occasioned following the determination of all filed proofs of claim without the risk of deprivation of reinsurance recoverables.

Certain reinsurer constituents, however, continue to balk at the exceptions in IRMA to the general preclusions circumscribing reinsurer liability. Such resistance, if acceded to, would potentially create a reinsurer windfall through a deprivation of reinsurance capacity with respect to contingent and unliquidated claim determinations, having the chilling effect of a liquidator being reluctant to determine claims on that basis and rather electing to wait for liability at underlying to become certain. Aside from detracting from the liquidator's statutory charge, this would certainly operate to the detriment of creditor interests by inordinately prolonging the life of an estate (thereby exponentially increasing administrative costs) as well as foreclosing on the liquidator's ability to obtain advantageous early settlements in relation to known long tail liabilities that history has confirmed only get worse over time.

On the flip side, by proceeding in the face of limitations creating incongruity between policyholder and reinsurer levels in relation to underlying determinations, a liquidator could be caught in the invidious position of achieving finality at the direct insurance level for actual identified exposure, albeit with a future loss component, while depriving an estate of valid future reinsurance recoveries because of the cessation of a continuing loss development relationship with the insured.

Accordingly, if the will of reinsurer detractors prevails not only will public policy considerations invariably be sacrificed, but the contractual obligation of reinsurers to pay **on the basis of the liability** of the cedent will be seriously undercut. These are surely untenable results.

Those resistant to estimation as a wholesale proposition argue that such endeavors subvert the

continued on next page

notification requirements contained in the insolvency clause, deprive reinsurers of their contractual right to investigate claims and interpose defenses in relation thereto, and are, by their nature significantly infirm because of their reliance on inherently uncertain actuarial projections. As a normal everyday business practice in the industry, there is, of course, nothing novel in the reinsurance commutation concept and ceding companies and reinsurers routinely strike deals that are wholly founded on indefinite prognostication. That is not to say that forced commutation should be legally sanctioned, but the issue of contingent and unliquidated determinations, which are equally prognosticatory, is an entirely different matter.

Furthermore, following notification, a reinsurer is fully entitled to investigate the asserted claims and interpose coverage defenses if it so elects.

Because policy buy-backs are dependent on claims filed in an estate, for which there is a contractually mandated reporting obligation, it is difficult to conceive how the insolvency clause notification requirement can be subverted merely by virtue of the claims having an associated future loss component. Furthermore, following notification, a reinsurer is fully entitled to investigate the asserted claims and interpose coverage defenses if it so elects. Also, IRMA mandates the opportunity for reinsurer input as a precursor to underlying contingent and unliquidated claim determinations and reinsurers retain the right to challenge the reasonableness of such determinations before the receivership court at the time that the allowance is being considered for estate admission. Finally, the arbitration rights of reinsurers remain expressly preserved, so reinsurers are hard pressed to assert that their contractual and due process entitlements have been eviscerated because an estimation facet is incorporated into the claims determination process.

In sum, while not all forms of estimation are appropriate or desirable in the run-off and liquidation arenas, a blanket conclusion that estimations are the root of all evil is hardly compelling. It is rather incumbent on the industry to respond reasonably and responsibly to a change in financial circumstances that upsets traditional relationships but has the best interests of creditors as a fundamental objective. ■

Innovative and practical solutions for insurers and reinsurers.

Navigant Consulting offers a full range of insurance and reinsurance services. Our professionals have diverse experience and in-depth market knowledge of the US, UK, and other international markets. Services include:

» Run-off management
» Actuarial consulting
» Audits, inspections and commutations
» Reinsurance recoveries, debt collection and novation
» Dispute resolution, special investigations and expert testimony
» Risk and regulatory compliance
» Finance and accounting advisory services
» Internal audit outsourcing
» Claims management

Navigant Consulting – turn to us for direction[s].

Contact » Jerry Capell, 312.583.5734
Michael Cook, +44(0)20.7469.1117
Saeed Fotovat, 312.583.5887
Kristine Johnson, 312.583.5713
Laura White, 646.227.4261
www.navigantconsulting.com

NAVIGANT
CONSULTING

©2005 Navigant Consulting, Inc. All rights reserved. "NAVIGANT" is a service mark of Navigant International, Inc. Navigant Consulting, Inc. (NCI) is not affiliated, associated, or in any way connected with Navigant International, Inc. and NCI's use of "NAVIGANT" is made under license from Navigant International, Inc.

Feature Article

Regulatory Supervision in Insurance Company Run-offs

Harold S Horwich

By Harold S. Horwich

Insurance company run-offs come in a wide variety of financial circumstances. Some are highly solvent companies that have made a strategic decision to disengage from a particular market. However, many others involve companies that are financially impaired or approaching financial impairment. The potential for financial impairment inevitably causes regulators to take interest in a company's plans and prospects. While some regulators might leap to the conclusion that receivership is the only solution, most regulators today look for less drastic interventions into a company's affairs if they think the company has reasonable prospects of running off without insolvency proceedings. As part of such run-off efforts, regulators frequently enter an order of supervision as to the company. This article explains the use of supervision orders, and provides some insights into the perspective of regulators on insurance company run-offs.

While some regulators might leap to the conclusion that receivership is the only solution, most regulators today look for less drastic interventions into a company's affairs…

Supervision and other tools available to the insurance commissioner

While supervision varies some from state to state, it generally has the following features. Supervision commences upon the issuance of an administrative order by the insurance commissioner. The order appoints a supervisor for the company who is answerable to the commissioner. The officers and directors of the company retain their positions and their general authority to manage the affairs of the company. However, the order of supervision provides that transactions out of the ordinary course of business and transactions involving sums over a threshold amount are subject to approval by the supervisor. Supervisions may be either public or confidential at the discretion of the insurance commissioner.

Supervision statutes typically provide that the insurance commissioner can issue an order that requires management to obtain the commissioner's approval of nearly any significant transaction undertaken by the company. While this gives the commissioner a significant amount of control over the affairs of the company, it does not, by itself, provide the regulator with the tools needed to regulate a run-off. Before a regulator can exercise meaningful oversight, the regulator typically needs a significantly greater amount of information. In settings where management has recognized the company's problems and engaged the insurance commissioner in a dialogue to solve them, information is generally made readily available.

However, not all troubled companies fully recognize their problems when the department becomes involved. As to such companies, the supervisor may need to exercise the commissioner's examination powers. These powers enable the commissioner to investigate every aspect of the company's business practices and financial condition. With the use of these powers the commissioner can develop a complete understanding of the company's problems. A lack of cooperation by management in the course of examination may suggest that the company's problems are deeper than they appear at first, and may doom a run-off effort before it starts.

The commissioner has the right to petition the court for an order authorizing seizure of assets or commencement of receivership. In most states, the commissioner has the right to request a seizure order that grants possession of all of the company's assets to the commissioner. Such orders can be entered ex parté where the commissioner has grounds for commencing receivership proceedings and such order is necessary to protect the interests of policyholders. Seizure orders typically precede an order commencing receivership proceedings. Seizure orders are typically confidential and typically give the regulator the right to oust management. The threat of a seizure order may convince

continued on next page

Mr. Horwich heads the Insurance Group of Bingham McCutchen. He can be reached at harold.horwich@bingham.com.

uncooperative management that the regulator is serious about correcting the company's problems. At the same time, the confidentiality of the order protects the company from adverse publicity that could make an orderly disposition of the company impossible.

Risks inherent in run-off

The availability of the foregoing tools frames the continuous dialogue between the insurance commissioner and the management throughout the supervision. At the same time, there are risks that the commissioner assumes in permitting a company to engage in a voluntary run-off under an order of supervision.

Failure to preserve such causes of action in a future receivership would subject the commissioner to criticism by a wide array of parties.

First, the commencement of run-off tends to promote instability. It may cause defaults in loan or reinsurance agreements. It may also cause concern among employees and policyholders.

Second, the continuation of a run-off delays the commencement of receivership proceedings. The fact of this delay may ultimately be important to creditors. Under receivership law, the receiver has the right to set aside certain of the insurer's pre-receivership transactions under theories of preferences, fraudulent transfers, and claims against management. The receiver may also have the right so seek recourse against professionals and management for misdeeds or negligence. Some of the avoidance causes of action have short look-back periods (ninety days for preference in some states) or short statutes of limitation. Actions against officers and directors for mismanagement also frequently have relatively short statutes of limitation. Moreover, the insurance policies covering officers and directors may require the purchase of an extended reporting period in order to remain viable. Actions against professionals such as accountants and actuaries may have even shorter limitation periods. In receivership, these are often significant assets of the estate. Supervisors must pay careful attention to these issues in their decisions to continue efforts to run-off a company. Failure to preserve such causes of action in a future receivership would subject the commissioner to criticism by a wide array of parties. Causes of action may be preserved through tolling agreements, which are agreements between the company and potential defendants that stay the running of limitation periods. While these may often be available from management, they are often not available from professionals and other third parties.

Third, the longer the supervisor remains involved in the affairs of the company, the more difficult it becomes to establish liability of management or professionals for mismanagement of the company's affairs. Management and professionals will maintain that the commissioner is responsible for the failure of the company due to his or her failure to act. Even if such contentions are not well founded, it may complicate litigation. Defendants will assert that the involvement of the supervisor broke the chain of causation that connected the defendants with the claim. The supervisor's involvement may also become an issue in establishing damages. At a minimum, the commissioner will be challenged for the conduct of the supervision in a highly public forum.

Fourth, the management or creditors may challenge the actions of the commissioner and seek to hold the commissioner legally responsible for the failure of the run-off. While many states have immunity statutes that protect supervisors from liability for actions during supervision, not all states have such statutes. Moreover, even in states that have immunity, supervisors may not be protected where claims are based on allegations that the supervisor acted beyond the scope of the supervisor's authority.

The backdrop of potential receivership

Run-offs are not uniformly successful and the outcome of a run-off is seldom apparent at the start. As such, the supervisor must keep the possibility of receivership in mind throughout the run-off.

In general, commitments by the company during supervision do not create commitments by the receivership estate – even if the supervisor authorized those commitments. It is well settled that the receivership estate is a new entity, separate and apart from the company. It is also well settled that the commissioner as receiver is different from the commissioner acting in the capacity of regulator and supervisor. Thus, contracts entered into during supervision are subject to being disavowed in liquidation and obligations

continued on next page

incurred during the supervision are subject to the priority scheme applicable to receiverships, although property wrongfully obtained during supervision is still subject to the rights of its owner. However, parties have argued that liquidators are estopped to disavow or deny contracts entered into during supervision. Even if such contracts can be disavowed, it reflects poorly on commissioners and their departments when companies in supervision undertake obligations they ultimately cannot perform. This is particularly so when the supervision is not disclosed and the other party to the transaction is not financially sophisticated.

The supervisor should be expected to carefully analyze whether the discount approximates the results in receivership.

The priority scheme under the liquidation statute relegates ceding reinsurers and general creditors to a subordinate position. In liquidation, they seldom receive full payment. Further, policyholders with substantial net worth and certain policyholders with large claims may not receive significant protection from guaranty funds in a liquidation case. As such, when these creditors receive payments during a supervision, they likely receive better treatment than they would in receivership. If the supervisor has substantial doubt about the future of the company, the supervisor must be wary about payments to such creditors. Significant payments to creditors that might not otherwise receive them in receivership may reflect poorly on the supervisor.

In many supervisions, the company actively solicits commutations of its large policy claims and its ceded reinsurance. These commutations typically reflect a solvency risk discount. The supervisor should be expected to carefully analyze whether the discount approximates the results in receivership. In addition, the supervisor must consider issues of liquidity. While commutations are typically designed to enhance capital and surplus, they frequently do so at the expense of liquidity, which is often the precipitating cause of insolvency proceedings. The commencement of insolvency proceedings without liquidity imposes an increased burden on guaranty funds because it delays (or even prevents) the early access payments to which guaranty funds are entitled under receivership laws. In determining the appropriateness of transactions undertaken by the company during supervision, the supervisor must weigh the potential benefit to the company against the risk to the guaranty funds.

Relationship with management, board of directors and shareholders

While orders of supervision grant the supervisor approval over significant financial transactions and transactions out of the ordinary course of business, it is not intended that the supervisor will conduct the run-off. The conduct of the run-off remains with management and the board of directors. In a large company, a supervisor exercising the full authority granted by an order would need to review an enormous number of transactions. As such, the supervisor must define the scope of review that will be implemented. This may vary widely from case to case, and may continue to evolve throughout a case. The directives implementing the supervision order should define the scope of authority that the supervisor intends to exercise. Otherwise, there is room for misunderstanding as to which transactions must be approved.

As a practical matter, supervision breaks down when management lacks integrity. Supervision, like other aspects of insurance regulation, depends on having truthful, honest management. If management has no regard for the restrictions of the supervision order or their duty to provide the supervisor with timely accurate information, then management cannot continue. Certainly, the commencement of receivership proceedings replaces management. However, short of receivership proceedings, the board of directors and shareholders (if independent) may take action once provided with evidence that management cannot be trusted.

Some supervisors have insisted on attending board of directors meetings. Attendance and even participation in board meetings may be appropriate, but participation carries with it an increased risk of allegations that the supervisor has exercised actual control. In some circumstances, the supervisor will want to talk with the shareholders of a company if the supervisor is not satisfied with the responses of management and directors.

Actual control of the company by the supervisor, if proven, could lead to claims that the regulator is liable for the failure of the company. While regulators have broad immunity in dealing with the affairs

continued on page 20

Insurance company restructuring, without the bitter aftertaste.

Insurance company restructuring can be hard to swallow for everyone involved. Innovative solutions must be crafted so that whenever possible, all parties can resolve positions equitably. Bingham McCutchen LLP has the legal knowledge and worldwide experience to resolve these troubled situations and ensure that important relationships don't sour.

BINGHAM McCUTCHEN

Legal insight. Business instinct.

Boston
Hartford
London
Los Angeles
New York
Orange County
San Francisco
Silicon Valley
Tokyo
Walnut Creek
Washington
bingham.com

Feature Article

A Risk-Based Approach to Email Management

Jon Neiditz

Jonathan Bank

by Jon Neiditz and Jonathan Bank

The ever-growing focus on emails in investigations and litigation, together with increasing e-discovery costs and spoliation sanctions, have led many of our insurer and reinsurer clients to focus on how they are managing email retention. When they do, they often find challenges in assuring compliance with their complex recordkeeping requirements and records management policies, as they relate to electronic documents, and particularly to "unstructured" documents like emails.[1] We are also seeing that these documents are becoming the repository of information, both business-critical and sensitive. Emails have, in many instances, taken the place of short telephone conversations, replacing a largely undocumented form of communication with an indelible record of what was said.

> **Unstructured emails pose greater challenges because they (1) are much more likely to fall into multiple categories, (2) are written much more easily… and (3) are disseminated much more widely…**

Approaching records management and email destruction programs with these major risks in full view focuses the mind. Records management programs have generally been driven by regulatory retention requirements with every category of document being assigned a number of years of retention. This approach to records management generates a highly detailed schedule for all companies that face complex regulations of their businesses, including not only insurance regulation but areas such as environmental, human resources, benefits and payroll documents. However, with a relatively very small percentage of paper documents falling into 'boilerplate' categories, it was historically relatively easy to determine that a document fell into one and only one category, and to retain such documents for only the number of years required.

Unstructured emails pose greater challenges because they (1) are much more likely to fall into multiple categories, (2) are written much more easily so that there are vastly more of them, and (3) are disseminated much more widely to many more recipients and are much more easily saved by direct and indirect recipients (particularly prospective plaintiffs). The third point is the critical one; in litigation and investigations, the only safe assumption may be that once an email has been written it cannot be destroyed; and it may emerge as a "smoking gun" at precisely the wrong point in litigation — not only regardless of your destruction policy but because of that policy — for had you not destroyed the email and known about it, it would be far less lethal. Moreover, the risks associated with these "smoking gun" emails is generally far greater than the risks associated with failure to comply with regulatory retention requirements.

Until recently, email destruction programs were most often established by IT departments with storage costs in mind. Obviously, the 30-, 60- or 90-day email destruction policies that emerged do not comply with regulatory retention requirements in a legal environment in which emails are "documents" subject to those differing and various requirements. But even aside from those contradictory policies, any tech-savvy investigator or plaintiff knows that electronic storage costs have been dropping precipitously — an average of 38% a year over the past four years.[2] In this cost environment, now that emails are also known to be central to most corporate investigations and litigation, companies may become concerned that a rigid and quick email destruction policy — even one that complies with regulatory retention requirements — may be viewed as an effort to obscure business practices that do not meet the highest standards.

Thus, the benchmark of a good electronic document

continued on page 23

Mr. Neiditz is Of Counsel in the Atlanta office of Lord, Bissell & Brook and can be reached at jneiditz@lordbissell.com. Mr. Bank is Of Counsel in the Los Angeles office and can be reached at jbank@lordbissell.com.

Message from CEO and Executive Director

AIRROC is a Smashing Success: Here's Why

continued from Page1

present on "Solvent Schemes (US Perspective)." Then the commutation meetings began. Many attendees expressed the same observation about the incredible "buzz" in the ballroom filled with round tables constantly occupied with attendees bent forward discussing commutations.

As we all shared a delicious lunch, we listened to an interesting panel present on "The Transition into Run-off – The Cash Flow Challenge." Again, back to the commutation meetings. Wednesday morning's breakfast panel presented on "Solvent Schemes (UK Perspective)" and during the luncheon we enjoyed

continued on next page

Inaugural AIRROC/Cavell Commutation and Networking Event, October 24-26, 2005

Art Coleman, President of Citadel Risk Mgmt. (Commutation Event Chair)

Trish Getty, CEO & Executive Director of AIRROC, Alan Quilter of Cavell

Joe DeVito, President of DeVito Consulting (AIRROC Treasurer)

Left to right: Art Coleman, Jack Ignatowitz, EVP of Citadel, Cheryl Sheridan of GRM and Tony Weller, Managing Director of Citadel Re

Paul Dassenko, AIRROC Run-off Person of the Year, Converium Re

Left to right: Ray Eppinger of Cambridge Integrated Services, Rick Dupree of St. Paul Travelers, Brad Barron and Steven Bazil of Bazil McNulty, Marianne Petillo of ROM (AIRROC Board Member), Dave Presley and Calvin McNulty of Bazil McNulty

Dale Diamond, AXA Liability Managers and Klaus Kune, Hannover Re

Left to right: Jonathan Sacher of Berwin Leighton Paisner LLP, Neil Gaynor and Dan Schwarzmann of PricewaterhouseCoopers, unidentified attendee, Michael Zeller of AIG (AIRROC Board Member)

Andrew Maneval of First State (AIRROC Board Member – Chairman) and Trish Getty

Left to right: Andrew Stuehrk of Kemper, Diane Myers of Reliance, Bina Dagar of Ameya Consulting, Renny Hodgskin of Cambridge Integrated Services, Francoise Gelot of Optimum Risk Research, Steve Herman of GRM and Ann Christin Neilson of WASA

Left to right: Jim Stinson and Charlene McHugh of Sidley Austin and Nigel Morson of Royal & Sun Alliance Group, UK

the presentation of "Commutation Negotiations/ Networking", a mock commutation process. All presenters were excellent and enlightening.

The meetings finalized with dinner and fun at the Meadowlands Racetrack.

AIRROC and Cavell express their gratitude for the support of the sponsors who not only made this event possible but brought valuable education as well as entertainment to make our inaugural commutation event a resounding success. Most important was that many attendees were able to realize significant progress in their commutation efforts through the opportunity to meet with so many parties in the space of two days.

AIRROC offers their tremendous gratitude and thanks to Cavell for waiving their right to their share of profits from the commutation event as extended by Alan Quilter on October 24 during the AIRROC Board of Directors and Annual meetings.

AIRROC will kick off 2006 with its membership meeting on February 16 at the home of member GE Insurance Solutions in Kansas City. The Education Committee is diligently working to present a valuable education presentation for its members during the meeting. AIRROC committees will also meet again to formulate and further their plans for AIRROC in 2006. We are delighted with the incredible participation of AIRROC's experienced, talented members on our committees. We believe that this awesome pool of knowledge will present solutions to our common issues.

We also express our gratitude of the Publications Committee to again offer another excellent issue of *AIRROC Matters*!

-*Trish*

Feature Article

In Re British Aviation Insurance Company
Its Relevance to U.S. Regulation of Solvent Run-off Arrangements

By Cecelia Kempler

Introduction

This article discusses key issues raised by the High Court of Justice, Chancery Division, Companies Court (the "Court") in its decision declining jurisdiction and criticizing British Aviation Insurance Company's ("BAIC" or the "Company") proposed solvent run-off Scheme of Arrangement (the "Scheme").

The Court's critical analysis is instructive for industry representatives and regulators who support the enactment of solvent run-off legislation in the United States.

The Court's critical analysis is instructive for industry representatives and regulators who support the enactment of solvent run-off legislation in the United States ("U.S."). Such legislation has been enacted in the United Kingdom ("U.K.") and other jurisdictions important to the insurance and reinsurance industries.

In the U.S., only the State of Rhode Island has enacted a law formally authorizing solvent run-off arrangements which permit creditor participation and articulates procedures for termination of creditor rights. *See,* R.I. Gen. Laws §27-14.5 (2002) (Voluntary Restructuring of Solvent Insurers). Support for solvent run-off legislation is emerging in the U.S., and at least a few state insurance regulators and legislators, in addition to Rhode Island, have expressed interest in considering the merits of such legislation. *See e.g.* S. 1301, 2005 Gen. Assem., Jan. Sess. (Conn. 2005) (An Act Concerning the Voluntary Restructuring of Insurers). U.S. federal courts (pursuant to section 304(c) of the United States Federal Bankruptcy Code) have reviewed certain U.S. creditor objections to non-U.S. solvent schemes authorized by the laws of foreign countries. *See e.g. In re* Bd. of Dirs. of Hopewell Int'l Ins., Ltd., 238 B.R. 25 (Bankr. S.D.N.Y. 1990), *aff'd* 275 B.R. 699 (S.D.N.Y. 2002). In the Hopewell decision, for example, the court placed particular emphasis on the procedural fairness of the Bermuda judicial proceedings used to review the solvent run-off scheme. *Id*. at 59 ("As long as the manner in which the scheme acquired statutory effect comports with our notions of procedural fairness, comity should be extended to it.")

Further evidence of the emerging business significance of solvent run-off arrangements in the U.S. is the formation earlier this year of the Association of Insurance and Reinsurance Run-Off Companies ("AIRROC"). AIRROC's membership has already gained broad industry support.

BAIC, a U.K. Company, owned directly and indirectly by three major insurers, ceased writing new business in 2002 and placed all of its existing business in run-off. In 2004, BAIC proposed the "Scheme", as allowed under U.K. law, for only a portion of its business. *See*, Financial Services and Markets Act 2000, c. 8, §104 (Eng.); Companies Act 1985, § 425 (Eng.); Re British Aviation Insurance Co Ltd [2005] EWCH 1621 (Ch). After presenting the Scheme to the Financial Services Authority (the "FSA"), which voiced no regulatory objections to it, BAIC submitted the Scheme to the Court for approval, also as required by law. The Court declined jurisdiction, but also concluded that it would not approve the Scheme, if it had jurisdiction. The Court's decision in BAIC was the first time that a court concluded that a solvent run-off scheme, despite the lack of objection by the FSA, was unfair to certain creditors of an insurer. Proponents of the Scheme have announced that they will not appeal the decision. See www.BAICSolventScheme.co.uk. While some experts observed that Justice Lewison's opinion in BAIC could signal the demise of solvent schemes under the Companies Act, Justice Lewison's subsequent decision approving a solvent scheme as being "fair in the sense that an honest and reasonable creditor acting

Ms. Kempler is President of Kempler Consulting Corp, in Palm Beach, Florida. Ms. Kempler was the Co-Chair of the Insurance Practice Group of LeBoeuf, Lamb, Greene & MacRae when she retired in 2003. She can be reached at ckempler@bellsouth.net.

continued on next page

in his own interest could properly vote in favor of the schemes", offers some comfort to the industry. *See* DAP Holding N.V. & Others (Case No. 4621 of 2005), Tape Transcription of Judgment at p.2.

…refer to http://AIRROC.org/TrainingMaterial.asp for a summary of the Court's description of the legal framework applicable to the Scheme.

Thus, the BAIC decision offers an excellent case study for U.S. state insurance regulators and insurance industry representatives advocating development and enactment of laws and regulations supporting solvent schemes of arrangement similar to those currently authorized under the laws of the U.K., Bermuda, certain other countries, and the State of Rhode Island.

Legal Framework

Please refer to http://AIRROC.org/TrainingMaterial.asp for a summary of the Court's description of the legal framework applicable to the Scheme.

Factual Background and the Scheme

The Court commenced its consideration of facts underlying the Scheme with a review of BAIC's balance sheet. There was no argument against the fact that BAIC was solvent. *Id.* ¶¶ 5-7. The Court reviewed the types of policies in run-off and those subject to the Scheme, categorizing the significance of each with respect to timing of losses and claims payments. *Id.* ¶¶ 9-11. In fact, the Court noted that the "Company has met and continues to meet its contractual liabilities in full. If the scheme is not sanctioned, there is no reason to suppose that it would not continue to do so in the future. The Company has promoted the scheme on the basis that it is solvent and is able to meet all its liabilities in full… It is an important consideration that the scheme does not include the whole of the business written by the Company. As regards business excluded from the scheme, the Company will remain in conventional solvent run-off." *Id.* ¶¶ 12-13.

In reviewing expert testimony for both sides, which substantially differed as to the valuation of contingent claims, i.e., IBNR, the Court having been unable to cross examine such experts, concluded that the decision would need to be based on the approach that views of each witness were reasonable. *Id.* ¶ 19.

Scheme terms recited by the Court, which are material to this article are set forth below and provided in greater detail at http://AIRROC.org/TrainingMaterial.asp.

All business subject to the scheme included liquidated and unliquidated claims, or accrued and contingent claims (hereafter referred to respectively as "Accrued Claims" and "IBNR Claims." (Holders of such claims are hereafter referred to in the aggregate as "Scheme Creditors," those with Accrued Claims as "Accrued Creditors" and those with IBNR Claims as IBNR Creditors, as the case may be.)

Scheme Creditors were given 120 days to submit claims, or have their claims valued at nil and deemed paid in full. These creditors were required to submit their claims on the form provided by BAIC and were required to submit additional documentation required by BAIC, including claims valuation utilizing BAIC's "Estimation Methodology". A Scheme Manager was appointed to review each claim form. If the Scheme Manager did not agree with all or part of the submission, he would notify the Scheme Creditor and provide reasons for the rejection. He could also require additional information. Disputes were referred to a Scheme Adjudicator, who was an independent actuary. The Scheme Adjudicator could require additional information, and in accordance with the Scheme's Dispute Resolution Procedure, render a decision that would be final and binding, as allowed by law. Scheme terms prohibited commencing any legal proceedings against BAIC, other than those allowed by law, which Scheme opponents argued effectively resulted in the Scheme replacing all policyholders' existing legal rights.

Of note is the fact that Scheme terms provided: "If, at any time before the Company makes any payment in respect of an Established Liability, the Company believes that the Scheme is no longer beneficial to it, the Company may send notice to all Scheme Creditors of whom it is aware that the Scheme will terminate." In the event of such termination no payments would be made under the Scheme and Scheme Business would revert back to being run-off in the traditional manner.

The Court reviewed procedures for notification of policyholders prior to applying to the court for permission to convene a meeting for approval of the

continued on page 18

Policyholder Support Update — Alert No. 10 (November 2005)

Submitted by KPMG LLP (UK)'s Corporate Recovery Insurance Solutions team.

This alert includes recently reported details, relating to schemes of arrangement for both solvent and insolvent insurance companies predominantly in the United Kingdom, which you may find of interest.

A summary of all cut-off schemes of arrangement with effective dates after 1 January 2004 may be found on our websitewww.kpmg.co.uk/insurancesolutions, which is updated regularly. Please refer to this site for the latest position on these cases.

SOLVENT SCHEMES

Upcoming Key Dates

1) **THE MERCANTILE & GENERAL REINSURANCE COMPANY LIMITED**

A solvent scheme was approved at its meeting of creditors on 26 April 2005 and has subsequently been sanctioned by the Court of Session in Scotland. It became effective on 22 September 2005. The bar date is set for 20 January 2006. Further details are available at www.mgre.co.uk.

2) **THE SCOTTISH EAGLE INSURANCE COMPANY LIMITED**

A scheme was approved at the meeting of creditors on 5 September 2005 and was subsequently sanctioned by the Court. It became effective on 31 October 2005. The bar date has been set for 1 March 2006. Further information is available at www.scottisheaglesolventscheme.co.uk.

3) **LA MUTUELLE DU MANS ASSURANCES (IARD)**

The scheme was approved at the meeting of creditors on 5 September 2005 and was subsequently sanctioned by the Court. It became effective on 31 October 2005. The bar date has been set for 1 March 2006. Further information is available at www.mmaukbranchsolventscheme.co.uk.

4) **DUTCH AVIATION POOL**

Schemes for the 18 Scheme Companies which participated in the Dutch Aviation Pool, were approved at their respective meetings of creditors on 15 September 2005 and were subsequently sanctioned by the Court. The Schemes became effective on 30 September 2005. The bar date is set for 30 March 2006.

For further information contact: DAP Holding N.V., Hoogoorddreef 54E, PO Box 23320, 1100 DV Amsterdam Z.O., The Netherlands. Email: dapscheme@assurpools.nl.

5) **GLOBAL GENERAL AND REINSURANCE COMPANY LIMITED**

By Order of the Court a meeting of scheme creditors is to be convened for the purpose of considering and, if thought fit, approving a scheme. The Meeting of Creditors will be held on 17 January 2006 at the offices of PricewaterhouseCoopers LLP, Plumtree Court, London, EC4A 4HT, UK. Further information is available at www.globalre.com/ggre-uk/scheme.

6) **RELIANCE NATIONAL INSURANCE COMPANY (EUROPE) LIMITED**

By Order of the Court a meeting of scheme creditors is to be convened for the purpose of considering and, if thought fit, approving a scheme. The Meeting of Creditors will be held on 2 February 2006 at the offices of Freshfields Bruckhaus Deringer, 28 Tudor Street, London, EC4Y 0AY, UK. Further details are available at www.omniwhittington.com.

7) **NRC REINSURANCE COMPANY LIMITED (BERMUDA)**

By Order of the Court a meeting of scheme creditors is to be convened for the purpose of considering and, if thought fit, approving a scheme. The Meeting of Creditors will be held on 22 March 2006 at the offices of Appleby Spurling Hunter, Canon's Court, 22 Victoria Street, Hamilton HM EX Bermuda. Email stephen.a.ward@us.pwc.com.

Other Recent Developments

8) **THE BRITISH AVIATION INSURANCE COMPANY LIMITED ("BAIC")**

Following the High Court's refusal to sanction the proposed scheme at the hearing on 21 July 2005, BAIC have decided not to proceed with an appeal. Further details are available at www.baicsolventscheme.co.uk.

9) **LION CITY RUN-OFF PRIVATE LIMITED**

The Creditors' Meeting originally scheduled for 1 September 2005 to consider a proposed scheme has been postponed. Details of the re-scheduled Creditors' Meeting are yet to be announced. Email Andrew Campbell at LionCityRun-Off@omniwhittington.com.

10) **CAVELL INSURANCE COMPANY LIMITED**

The proposed solvent scheme was approved by scheme creditors at the reconvened meeting held on 25 April

2005. The Company has postponed their application to the English High Court for the Scheme to be sanctioned whilst they await the outcome of an appeal to be heard in the Canadian Court on 29 November 2005. Further information is available at www.cavell.biz/schemes.

11) THE SCOTTISH LION INSURANCE COMPANY LIMITED

On 3 October 2005 the Court approved the withdrawal of the current proposed Scheme with immediate effect. Further information may be obtained by contacting The Scottish Lion Underwriting Agencies Limited, 5th Floor, Cutlers Exchange, 123 Houndsditch, London, EC3A 7PQ, UK or at www.scottishlionsolventscheme.co.uk.

12) GORDIAN RUNOFF (UK) LIMITED (FORMERLY GIO (UK) LIMITED)

The proposed solvent scheme was approved by scheme creditors at the meeting held on 3 March 2005. The 22 July 2005 hearing scheduled to sanction the scheme has been adjourned whilst Gordian considers the impact of recent court decisions relating to schemes. The Scheme is not yet effective. Further details are available at www.gordianuk.co.uk.

13) QBE REINSURANCE (UK) LIMITED (FORMERLY ALLSTATE REINSURANCE CO. LIMITED)

The proposed solvent scheme was approved by scheme creditors at the meeting held on 27 July 2005. The petition for sanction has been delayed whilst the Company considers the impact of recent court decisions relating to schemes. The Scheme is not yet effective. Email at zuginfo@qbe-europe.com.

INSOLVENT ESTATES

14) COMPAGNIE EUROPEENNE DE REASSURANCES SA

The above company's scheme was approved at its meeting of creditors on 7 July 2005 and has been sanctioned by the Court. The Scheme became effective on 20 July 2005. The bar date of 10 November 2005 has now passed. All queries should be directed to the Joint Scheme Administrators, Compagnie Europeenne de Reassurances SA, 31 Great George Street, Bristol BS1 5QD, UK.

15) MUNICIPAL GENERAL INSURANCE LIMITED

The bar date for the above scheme is 15 January 2006. All Scheme Claims must be notified to the Joint Scheme Administrators, Municipal General Insurance Limited, Friary Court, 13-21 High Street, Guildford, Surrey, GU1 3DG, UK by 5p.m on that date.

16) BELVEDERE INSURANCE COMPANY LIMITED

By Order of the Supreme Court of Bermuda a meeting of scheme creditors for the above company is to be convened for the purpose of considering and, if thought fit, approving a scheme. The Meeting of Creditors will be held at the offices of KPMG, Crown House, 4 Par-la-Ville Road, Hamilton HM08, Bermuda on 1 December 2005. Further information may be obtained by contacting KPMG, Crown House, 4 Par-la-Ville Road, Hamilton HM08, Bermuda (Tel: +1 441 294 2652; fax: +1 441 295 8280). Email belvedere-liquidation@kpmg.bm.

17) OCEANUS MUTUAL UNDERWRITING ASSOCIATION (BERMUDA) LTD

The sanction hearing, originally scheduled for 14 October 2005 has been postponed. Further details are available at www.deloitte.com/uk/oceanus.

18) KWELM (KINGSCROFT INSURANCE COMPANY LIMITED, WALBROOK INSURANCE COMPANY LIMITED, EL PASO INSURANCE COMPANY LIMITED, LIME STREET INSURANCE COMPANY LIMITED, MUTUAL REINSURANCE COMPANY LIMITED)

Following the 29 September 2004 bar date the Scheme Administrators of KWELM have set substantive closure Payment Percentages, details of which are listed at www.kwelm.com. The increased payments will be paid to creditors on the Substantive Closure Distribution Date of 15 December 2005. Further information is available by contacting KWELM Management Services Limited, John Stow House, 18 Bevis Marks, London EC3A 7JB, UK. Email:creditor.helpdesk@kwelm.com.

19) HIH CASUALTY AND GENERAL INSURANCE LIMITED, WORLD MARINE & GENERAL INSURANCE PTY LIMITED, FAI GENERAL INSURANCE COMPANY LIMITED, FAI INSURANCES LIMITED

By Order of the Court, a meeting of scheme creditors is to be convened for the purpose of considering and, if thought fit, approving a scheme. Details of the Creditors Meeting are yet to be announced. Further details are available at www.kpmg.co.uk/insurance solutions

Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future.

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

Feature Article

Re British Aviation

continued from Page 15

Scheme by Scheme Creditors. The Company received approval for the meeting, which was chaired by a Company Director. Scheme Creditors admitted to vote, voted in favor of the Scheme. The Court noted, among other things, the following with respect to the votes: (1) one of the largest claimants had no IBNR Claims, (2) two creditors who had Accrued Claims and IBNR Claims voted their unsplit claims in full; (3) 16 of the 34 reinsureds who voted in favor of the Scheme were also reinsurers of the Company; (4) the majority of reinsureds had no or only modest IBNR Claims; (5) those insureds who had IBNR Claims, and who voted for the Scheme, except for two of them, were admitted to vote their claims in full; and (6) IBNR Creditors who voted against the Scheme were admitted to vote only on the basis of substantially reduced IBNR Claims, and six such claims were valued at nil. *Id.*

Scheme opponents proffered six objections, which included (1) the lack of jurisdiction of the Court to sanction the Scheme on the grounds that BAIC failed properly to constitute creditor classes; (2) claims of opposing creditors were improperly adjusted for voting purposes; (3) those who voted in favor had special interests not representing those of opponents; (4) the Scheme is unfair because it would benefit the Company, which is solvent, by allowing a release of surplus to its shareholders to the disadvantage of creditors; (5) that insurance and reinsurance creditors interests differed from those with IBNR Claims, whose contracts would be effectively rewritten by a forced commutation of their liabilities, since it would be impossible to value fairly such claims; (6) Scheme Creditors would be unfairly deprived of their rights of access to the courts; and that (7) certain Scheme provisions, such as the Company's exclusive right to terminate the Scheme and others are one-sided. *Id.* ¶¶ 45-53. In its conclusion that it lacked jurisdiction and findings that the Scheme did not satisfy applicable legal standards, the Court accepted most of the opponents' objections to the Scheme.

The Court Opinion

The Court concluded that its scope of review included considering the propriety of conduct and outcomes in the prior stages of Scheme proceedings. *Id.* ¶¶ 81-82. The Court agreed with Scheme opponents that case law relied upon by proponents involved an insolvent company, which was not the case with BAIC. Scheme opponents' counsel proposed and the Court agreed that the proper analysis in BAIC, was that it was highly unlikely that its owners would ever allow BAIC to go into liquidation. Therefore, separate scrutiny of the Scheme's treatment of creditors with Accrued Claims and those with IBNR Claims was required. *Id.* ¶¶ 82-83, and 88-90. The reason for this was that, if BAIC were to remain solvent, IBNR Creditors would fare better by having the Scheme rejected because they would be paid in full when their contingent claims were accrued, since under the Scheme, they would be forced to accept the valuation pursuant to the proponent's methodology. Whereas, Accrued Claim Creditors would be paid in full under the Scheme. *Id.*

The Court acknowledged that: "They [IBNR Creditors] have already paid their premiums for the insurance cover, so they are at risk of no further expenditure in relation to a valid claim. Under the Scheme, they will receive cash up front. It may be an amount that is greater or smaller than the liabilities that eventually materialize, but it will not be the same. The risk of inadequate resources to meet such liabilities is retransferred from the insurers to them. So the scheme will disadvantage them." *Id.*

In analyzing the meeting composition and voting structure, the court found it to have been unfair to IBNR Creditors on the grounds that "those with accrued claims and those with IBNR have interests which are sufficiently different as not to make it possible for them sensibly to consult together… In truth, they do not have a common interest at all." *Id.* ¶¶ 90-92.

In deciding that the legal rights of IBNR Creditors differed substantially from the rights of other Scheme Creditors, the Court concluded that the meeting summoned by BAIC was not properly constituted and that the Court had no jurisdiction to sanction the Scheme. It was the Court's opinion that two meetings should have been held, one for accrued claim creditors and the other for IBNR Creditors. Nonetheless, the Court concluded that it would be appropriate to consider the substantive merits of the Scheme. *Id.* ¶ 97.

Having concluded that the meeting was defective because there should have been separate meetings for Accrued Creditors and IBNR Creditors, the Court posited that even if its view on this issue were incorrect, the Court would not be required to accept the majority vote. According to the Court, the exercise of its authority is especially important where valuation methods were controversial. *Id.* ¶ 118. After hearing and rejecting many of opponents various arguments regarding the interests of Scheme Creditors and valuation of claims, the Court concluded that it was not satisfied that opposing IBNR Creditors were properly represented in light of the devaluation of their claims for voting purposes. *Id.* ¶ 124. The Court held that two key issues caused the Scheme to be fundamentally flawed. These were

continued on next page

the meeting composition and the value assigned to voting Scheme Creditors.

In evaluating the fairness of the Scheme, the Court noted, among other things, that the Estimation Methodology left great flexibility in valuing claims, although agreeing that such flexibility is probably necessary to the process of valuation, the Court concluded that valuation methodology would need to be considered as a factor in deciding whether to sanction the Scheme. *Id.* ¶ 128. The Court also accepted opponents' objections to BAIC's sole reservation of rights to terminate the Scheme without consulting its creditors or considering their interests. *Id.* ¶¶ 136-137.

The Court acknowledged that it should be reluctant to overrule a vote favoring a scheme, but stated that if it had jurisdiction, it would not have sanctioned the Scheme for the following reasons: (1) the votes allowed to be cast were not fairly representative of the creditors (especially direct insureds) with large IBNR Claims; (2) the Estimation Methodology did not provide a clear basis to assure like treatment of all creditors, thereby producing uncertainty; (3) there are no limits on the Company's power to revert to traditional run-off; and (4) the Scheme largely benefits BAIC and its shareholders. *Id.*

The Court's opinion stated that "…the most powerful consideration is that it seems to me to be unfair to require the manufacturers [insureds] who have bought insurance policies designed to cast the risk of exposure to asbestos claims on insurers to have that risk compulsorily retransferred to them. The Company is in the risk business; and they are not. This is not the case of an insolvent company to which quite different considerations apply... The purpose of the scheme is to allow surplus funds to be returned to shareholders in preference to satisfying the legitimate claims of creditors. No matter how usable and reasonable an estimate may be, the very fact that it is an estimate is likely to make it an inaccurate forecast of the actual liabilities of policyholders." Given the circumstances that there was no real possibility of BAIC's shareholders allowing it to become insolvent, the Court found it unreasonable to require dissident policyholders to accept reduced claim payments, unless their vote in favor of a scheme fairly reflected the interests of such creditors. In essence, if the vote had, in the Court's view, fairly represented creditor classes, the Court might have accepted it.

Lessons Learned

The following lessons can be learned from the Court's decision in BAIC for future proposed solvent run-off legislation in the U.S.

1. Any law or supporting regulations should contain special procedures for single entity solvent run-off arrangements that subject all or a portion of business to run off where insolvency is not a meaningful threat.

   (a) Such procedures must articulate standards for equitable valuation of IBNR claims, including independent third party review and regulatory sanction *prior* to a creditors' vote.

   (i) Standards should include regulatory mechanisms to resolve expert valuation variances above a certain threshold.

   (ii) Prior to distributions of capital and surplus to shareholders, such amounts could be placed in trust to allow IBNR creditors some capped upside as a hedge against valuation differences exceeding a certain threshold.

2. If the legal standard is not specific as to when creditor classes must be separated for voting, regulatory review could occur prior to a vote for determination of: (a) whether creditor classes should be separated, (b) expert valuations for each side are reasonable and (c) how the amount of value to be allowed for voting purposes can be fairly calculated.
3. If legislation articulates standards for review of claims valuation and procedures prior to creditors' meetings and voting, it would be reasonable to limit repeated judicial retrospective reviews of prior stages of the proceedings, e.g., such as in BAIC, where the Court ordered that the meeting and vote be summoned, only to later reject the meeting composition and vote.
4. Equitable issues are always of paramount concern when creditors' rights are terminated. Any legislation favoring solvent run-offs where the threat of insolvency is not present must account for how and the extent to which creditors' rights in these circumstances will be terminated. Hopewell 238 B.R. at 53-54; *In Re* Gee, 53 B.R. 891 (Bankr. S.D.N.Y. 1985). ■

If you are interested in having commutation discussions with Converium Reinsurance (North America) Inc. please contact:

Raymond Dowling at (212) 898-5040
Email: ray.dowling@converium.com

Feature Article

Regulatory Supervision…

continued from Page 9

of regulated entities, such immunity is not available in all states. Moreover, when the regulator exercises control over an entity that is not a regulated entity, immunity may not be available. Thus, the supervisor must determine whether the risk of increased participation is worth the increased level of risk. Where the supervisor believes that management has committed misfeasance or that management is not capable of executing a run-off plan, the supervisor is likely to conclude that meeting with the board of directors is appropriate.

During the course of run-off, supervisors often get caught up in the affairs of the company and feel invested in the outcome of the run-off.

During the course of run-off, supervisors often get caught up in the affairs of the company and feel invested in the outcome of the run-off. However, the only role of the supervisor is to approve or disapprove transactions proposed by management. The supervisor should not initiate transactions and should not interfere in existing transactions between the company and third parties. The approval and disapproval of transactions must be explainable to management and must be explainable in terms of principles. One such principle is that the proposed transaction would impair the rights of policyholders in the event that receivership ensues. Another principle is that the transaction is either illegal or breaches the fiduciary duties of management to creditors. Thus, a supervisor may refuse the use of cash to commute with reinsurers where payments to policyholders are in jeopardy. The supervisor may also decline to approve transactions on the basis that they are not according to reasonable market terms or terms typical in similar transactions.

Holding company groups

One of the challenges of insurance company supervisions comes from holding company structures. The supervision laws in most states only authorize supervisors to supervise regulated insurance companies. However, insurance companies frequently have access to key assets and personnel only through non-insurance company affiliates. These affiliates are not typically subject to supervision. These arrangements may not present any actual problem to regulators if they are well documented and the parties are performing their obligations. However, in some situations, the regulator will discover that affiliates have siphoned off funds from the insurance company or will discover that the affiliates are in the process of terminating key agreements with the insurance company that would leave the company in jeopardy.

In such situations, the regulator has relatively few options available, and such cases typically result in receivership proceedings. The regulator should insist on full and prompt return of assets and should insist on the appointment of an independent board of directors for the insurance subsidiary. Directors and officers that have potentially conflicting obligations to the insurer and the holding company cannot be expected to responsibly implement a run-off plan for an insurer. Thus, a run-off plan that does not provide for independent management may not be approved by regulators, and a company may be forced into receivership.

It is important for management and regulators to husband the resources of insurance companies. Regulators typically want to prevent those resources from flowing upstream to holding companies and affiliates. Clearly regulators have authorization to prohibit dividends. However, most funds typically flow to affiliates under various types of agreements. Such agreements often provide compensation for the furnishing of facilities and personnel by the holding company or affiliate. They may also provide “royalties” or other types of payment that do not compensate for specific services. These payments would almost certainly be subordinate to policyholder claims in receivership and supervisors often insist that such payments desist during runoff, at least to the extent that the payments do not represent the current fair value of actual services.

Confidentiality

Under most supervision laws, the commissioner has the authority to disclose the supervision or maintain it in confidence. Disclosure creates the risk that policyholders and other creditors will take precipitous action that will destabilize the company. In the case of Mutual Benefit Life Insurance Company, the receivership of the company was triggered by policyholders redeeming policies in response to a public perception that the company lacked liquidity. However, maintaining supervision in confidence withholds an important piece of information from the public about the status of a company. Creditors and policyholders that do business with the company on an ongoing basis would appear to have a legitimate interest in knowing that regulators have intervened in the affairs of the company.

Confidential supervision presents challenges because it is nearly impossible to prevent all leaks of information.

Confidential supervision presents challenges because it is nearly impossible to prevent all leaks of information.

continued on next page

The regulator must decide well in advance how members of the insurance department will respond to direct inquiries (both casual inquiries and inquiries under the Freedom of Information Act) as to whether the company is the subject of a supervision order. The regulator would likely decline to comment on rumors of supervision. However, silence may present problems where policyholders or other constituents seek information to determine whether they should redeem policies or take other action to limit their exposure. Moreover, if enough inquiries are received, the regulator may well determine that disclosure of the order is advisable.

Confidential supervision also presents challenges to the company, particularly if it is publicly held.

Confidential supervision also presents challenges to the company, particularly if it is publicly held. Under securities laws, management is required to disclose material information about the company. Thus, management is caught between the obligation to disclose a supervision order to the holders of public securities and an obligation to the insurance regulator to maintain it in confidence. Typically, in this situation, management chooses disclosure to public securities holders.

Strategy, planning and implementation

When asked the question, "What is the primary objective of management in financial restructurings?" a cynical restructuring professional once replied, "To retain their jobs as management." While this observation may be a bit harsh and a bit simplistic, it highlights the difference in goals between a troubled company's management and the insurance regulator. Management typically seeks to preserve the integrity of the enterprise, preserve value for shareholders and preserve their jobs, if possible. In contrast, the regulator's primary goal is to protect policyholders. Subsidiary goals are to protect the industry from runaway guaranty fund assessments, to protect the interest of other creditors and to protect the jobs of employees, if possible. As such, it may be challenging to reconcile the goals of management and the regulators during supervision. However, if the regulator and the management can agree on a run-off plan that addresses operating issues such as retention of personnel, cash flow, facilities, accounting and disclosure issues, reconciling the goals of the parties may be feasible.

Before commencing supervision, the regulator must consider the immediate impact on the company. The company may have loan agreements, reinsurance agreements or other financial arrangements that will contain default provisions that are triggered by supervision. The regulator and the company must weigh the consequences of such defaults. The regulator must also consider the potential impact of supervision on the company's employees and policyholders. One of the early tasks of a supervisor is to inform employees about the supervision and respond to questions about it.

Choosing personnel for pursuing a run-off presents a particularly difficult problem for regulators. Clearly, regulators can insist on the replacement of managers that have committed fraudulent acts, or have engaged in self-dealing or gross mismanagement. However, proving allegations of fraud, self-dealing and gross mismanagement is often difficult. Moreover, even if the regulator succeeds in convincing a board of directors or a shareholder to replace current management, the shareholders and board of directors retain the power to appoint their successors. While a regulator may appropriately suggest qualifications for replacement management (or even offer a list of candidates if requested), it is dangerous for a regulator to insist on the appointment of particular individuals.

Supervisors should require management to document and present a strategy and a plan for the run-off that comports with risk based capital laws. Under risk-based capital laws, plans for the correction of risk-based capital deficiencies are required. That plan will be carefully reviewed by the commissioner's staff and discussed at length with the company. If the plan is not plausible, the commissioner should reject it and should provide specific reasons for the rejection. While it is often appropriate to provide management an opportunity to revise a plan, the delay in proposing an acceptable plan may present unacceptable hazards to a company.

The regulator must develop a separate plan for regulatory action with respect to the company in supervision. To some extent, the risk-based capital rules provide elements of the plan. When the company fails to meet specified financial criteria, the regulator must take control of the company. However, in most cases, the regulator should identify circumstances short of financial deterioration to the mandatory control level where the regulator should determine to intervene. The development of an intervention plan is particularly important if the company is given an extended period to develop its own plan.

Once the company has developed a plan, the supervisor will need to continue to monitor the implementation of the plan. At the same time, the regulator should review its own plan to determine whether it should be modified in light of the company's proposed course of action. Requests by the company for authorization of particular transactions must be measured against the company's own plan as well as the regulator's plan. In most cases, transactions that comport with the company's plan are likely to also comport with the regulator's plan. Variances to the company's plan

continued on page 23

Winning team

What else would you call a reinsurance group that's the choice of 65 of the world's top reinsurers on four continents? We've resolved their disputes by trial and arbitration, and we've structured their IPOs, mergers and acquisitions.

We championed their interests. Let us champion yours.

www.lordbissell.com

Feature Article

Email Management…

continued from Page 11

retention program today cannot be simply that it complies with regulatory timeframes, and/or that it reduces electronic

… a good electronic record retention program must properly balance risks and costs in the new legal landscape for emails and other unstructured data such as instant messaging, SMS messages and voicemail.

storage costs. At a minimum, a good electronic record retention program must properly balance risks and costs in the new legal landscape for emails and other unstructured data such as instant messaging, SMS messages and voicemail.

Based on the unfortunate recent experiences of companies like UBS and Morgan Stanley in finding and restoring backup tapes, all companies are well-advised now to consider using backup tapes only for disaster recovery purposes, rather than for archiving and retrieval. But that conclusion only begs the question of what kind of archiving will be most useful. For example, what search capacities will make an electronic archive most useful for day-to-day retrieval, and will best manage costs in litigations and investigations? And how should your archiving choices influence your choices for filtering incoming emails?

Recognition that casual emails are creating immense risks for companies is also leading many companies to focus on preventing the problem. Policies and training on responsible use of emails are nothing new: however due to emails' 'false sense of privacy' and ease of use, those policies and trainings are often ignored. Along with tighter policies and training that makes the magnitude of the risks clear, we are seeing a trend toward (1) more stringent sanctions, consistently applied, (2) more regular monitoring of employee emails and (3) more specific company-wide notice of that monitoring. Recent results of a survey indicate that 25% of U.S. employers acknowledge having terminated employees for misuse of the email system. 55% of U.S. employers retain and review emails, and over 80% indicate that they notify employees of web monitoring, email monitoring, company storage, review of computer files and monitoring content, keystrokes and time spent online.[3] Increased focus on controls as a result of Sarbanes-Oxley, and a desire to make all compliance programs satisfy the U.S. Sentencing Guidelines' standards for compliance programs are major drivers of these developments.

Control of your email is increasingly central to control over your information, including the ability to defend yourself and assert your rights. Your IT and records management experts must come together with your legal, financial and claims departments to take on this challenge. And remember, when you want to "reach out and touch somebody," you still have a telephone…wireless no doubt. ■

Notes:

1 "Structured" documents are made up of elements that readily fall into classifications that can be queried, searched and sorted automatically, whereas in "unstructured" documents, such as emails, words and numbers are not inherently tagged with machine-readable significance, posing a challenge for electronic records management systems.

2 IDC reported that the dollar-per-gigabyte price of external disk storage was down 36% in 2004, 33% in 2003, 40% in 2002 and 43% in 2001. Lucas Mearian, Computerworld Hong Kong Daily, March 7, 2005.

3 American Management Association/ePolicy Institute 2005 Electronic Monitoring Survey, May 2005.

Feature Article

Regulatory Supervision…

continued from Page 21

should only be approved if they do not conflict with the regulator's plan. Moreover, if there are numerous requests for variances, it suggests that the company's plan is not feasible and needs to be revised or abandoned.

One of the dangers of supervision is the proximity of the supervisor to the company. Often, the supervisor resides at the company throughout the period of supervision. This may cause the supervisor to become more casual in reviewing decisions because the supervisor may assume that he or she has a complete understanding of the company. Supervisors should continue to require formality in the approval of all material transactions. There have been several instances where receivers have attempted to renounce transactions approved during supervisions that turned out to have been based on inadequate or misleading information.

Conclusion

Supervision provides regulators an opportunity to intervene in a company's affairs without displacing management. Supervision used in conjunction with a run-off plan provides an opportunity to wind up the affairs of a company without the need for receivership. But it also presents challenges and hazards to the regulator if it is not properly conducted. ■

SIDLEY AUSTIN LLP

SIDLEY

Our Insurance and Financial Services Group is comprised of over 50 attorneys who provide dispute resolution and transactional services to the insurance industry and its regulators, including with respect to,

- Insurance Company Run-offs
- Reorganizations and Insolvencies
- Reinsurance Disputes and Transactions
- Mergers and Acquisitions
- Securities Offerings and Defense of Insurers in Class Actions

For more information, please contact:

Richard G. Clemens	**Alan J. Sorkowitz**	**James R. Stinson**
One South Dearborn Street	787 Seventh Avenue	One South Dearborn Street
Chicago, Illinois 60603	New York, New York 10019	Chicago, Illinois 60603
T: 312.853.7642	T: 212.839.5791	T: 312.853.7203
E: rclemens@sidley.com	E: asorkowitz@sidley.com	E: jstinson@sidley.com

www.sidley.com

BEIJING BRUSSELS CHICAGO DALLAS GENEVA HONG KONG LONDON LOS ANGELES NEW YORK SAN FRANCISCO SHANGHAI SINGAPORE TOKYO WASHINGTON, D.C.