RECORD OF SOCIETY OF ACTUARIES
1993 VOL. 19 NO. 4B

REHABILITATION FALLOUT

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- Accounting issues (statutory and GAAP) for:
  - Companies under rehabilitation
  - Companies assuming business in rehabilitation
  - The industry paying the costs of rehabilitation
- Tax issues for:
  - Companies under rehabilitation
  - Customers of companies under rehabilitation
  - Companies assuming business in rehabilitation
  - The industry paying the costs of rehabilitation

MR. JEFFREY C. HARPER, JR.: I am going to give a brief introduction of the panel in aggregate, and then introduce them and their topics as they are speaking.

These panelists are all balanced and diverse in their background. They all have some experience with rehabilitations and some, in fact, from multiple perspectives. Bob Ewald is, by training and background, an insurance company senior executive and he is going to bring the perspective of the insurance industry in aggregate to our discussions. Rich Veed is an accountant by training. He has experience as a member of company management, and as a consultant, both for a company that is insolvent and an assuming company. Chuck Petty is an attorney by training, and he will bring us an outside legal perspective, both from the viewpoint of a company that is insolvent and from one assuming business. I have had the privilege of working closely with all three of these panelists over the last two or three years and, while they are not actuaries, they are still fine professionals.

Let me make a couple of introductory comments with respect to the topic. Obviously, there are a lot of discussions these days about insurance company insolvencies, and these discussions have brought a great deal of attention to us over the last few years. I think the main concern of late has been just the sheer size and the repercussions of some of these insolvencies. There is also an ongoing discussion over in the regulatory arena which is, to a large extent, a turf war about who is going to manage insurance company solvency. Will it be the state regulators or the federal regulators?

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Also, there has been some concern about parallels to other financial institutions, banks, and savings and loans. Each of these are interesting and timely topics, but they are not really what we are going to concentrate on. Since insolvency has been discussed in other forums, in Society and Academy papers and at committee meetings and hearings, we are going to talk about the fallout after a company has been put into rehabilitation. Let me present a brief scorecard.

Through about 1989, the life and health insurance industry was fairly calm with respect to insolvencies, and there was not a whole lot of attention paid to them, with the notable exception of Baldwin United in 1983. But beginning in 1989 things started turning worse for the industry. In 1988, there were about 14 insolvencies involving companies with assets totalling about $56 million. That number increased to 44 companies in 1989 and 32 in 1990, and the assets were $1.4 billion and $1 billion, respectively, an increase by a factor of about 20. By 1991, it had jumped up to 41 companies and the amount of assets involved were $44.5 billion, which is an increase by a factor of 40.

By 1992, it had dropped off, down to 26 companies and "only" $1.6 billion in assets. In 1993, the company count kept going down (it is now up to about ten), but the assets have bounced back up to about $2.4 billion. As all of you in this room are probably aware, the 1991 blip, (we hope blip, and not trend), was due to Executive Life of California, Executive Life of New York, Monarch, Fidelity Bankers, First Capital, and Mutual Benefit. These six companies aggregated almost $43 billion, or 96%, of the total assets owned by companies that became insolvent.

If you look at these insolvencies relative to the total industry, and say we have about 2,100 companies and about $1.5 trillion of assets, then the insolvencies are something like 2% by count and 3% by assets. As an actuary, if that was a lapse rate, I would be fairly pleased. If it was a mortality rate of a supposedly vibrant group of individuals, I would be a little bit concerned. The actual cost of these insolvencies is something like $85 million in 1987 and something like $662 million in 1992. That is an increase by a factor of about eight over a five-year period.

I think Bob is going to talk a bit about the annual assessment capacity of the industry, which is something like $3.6 billion, which means that even at this high level we are only up to about one-sixth of the assessment capacity. For the typical insurance company, however, that can be 1.5% of revenues and, given our profit margins these days, that could easily be 20% or more of our total profits.

In rough terms there are really four steps in an insolvency. The first step is just watching and monitoring, and risk-based capital (RBC) is supposedly a tool to help us with that step -- at least it helps us decide who to watch and monitor. The second step is when a company is put into conservation or supervision, but at this point the company is still under its own control; the management decisions just need to be more closely associated with the regulators. The third step is rehabilitation, where the regulators have taken over and are in the process of trying to turn the company around. The fourth step is liquidation or dissolution, at which point the regulators have basically decided to dissolve the company.

What we are going to talk about is those last two steps – the rehabilitation and the liquidation. Actually, as you will find out, some of these things go on for many years. When you get companies the size of Executive Life, with $13 billion worth of assets, you do not resolve the issue overnight. The fallout lasts for several years. I am not sure we yet know what the final half-life is of Executive Life.

There are a number of reasons why this impacts actuaries and why we really need to listen to these panelists. I did not sit down and try to make an all-inclusive list, but several reasons come to mind right away.

First, we as a profession are viewed as watchdogs and, once something goes wrong, an ineffective watchdog is not normally welcomed into the house as a beloved house pet; so we need to be aware of the dangers. Second, there has been a great deal of interest in various media, from Congress and C-Span all the way down to *USA Today* and *The National Enquirer*. This is an important issue for the industry because people are aware of it, which makes it important for our companies, and, in turn, important for us.

Next, there are a lot of different publics involved, and the Society and the Academy are trying to bring the actuary into the forefront. This is an issue for which we are a logical profession to be in the forefront. The publics include regulators, conservators, policyholders, creditors, guaranty associations, and rating agencies. Last, this is not going to be free. As an actuary, we have to think of it both in pricing a product and in such issues as cash-flow testing.

Our first speaker is Bob Ewald. Bob was educated at Rutgers and received a special honors degree in economics. He spent about 35 years in the insurance industry, ranging from the Prudential to New York Life, to Massachusetts General, to Reserve Life, to National Ben Franklin, and finally to Blue Cross/Blue Shield of Illinois.

Starting in about 1983, he left the industry and moved into the ranks of the guaranty associations. His career up to that point had included being an accountant, an auditor, a financial, tax and administrative Vice President, and finally chairman, president, and chief executive officer (CEO) of insurance companies; so he had a broad perspective to bring to the guaranty associations.

Starting in about 1984 until now, he has been involved both on the state and the national level. He spent eight years as executive director of the Illinois Life & Health Guaranty Association which, by the way, also handles HMOs in Illinois. He is currently a member of the Disposition Committee for the National Organization of Life & Health Guaranty Associations; in fact, he has been a member since its creation in 1989 and currently stands as the chairman of that committee.

He is on something like eight boards of directors and is a member of some eight professional organizations. After all of this, his proudest achievement, he tells me, is successfully counting cards at blackjack and being removed forcibly from several casinos. He might make an actuary after all. He comes to us from Chicago via several other stops, and as near as I can tell, his present address is in care of United Airlines. Bob's topic is going to be rehabilitation from an industry perspective.

MR. ROBERT E. EWALD: One of the great truths that I have learned in all this travel that I would like to pass on to you is that the shortest distance between two points is under construction.

My remarks will be tailored in the direction of talking about what happens in an insolvency that you will be interested in from the point of view of forecasting what it is likely going to cost to deal with it. In the process of doing that, we can talk a little bit about how the typical guaranty association statute is structured and what the statute expected. When speaking of "the statute," I am talking about the Model Act, which is followed by perhaps half of the states and in some form or other by many others. Then we will talk about how it really works.

Before going on, I would point out that some of the statistics that Jeff was quoting come from a the National Organization of Life & Health Guaranty Associations (NOLHGA) publication. This data, having been gathered from the individual guaranty associations as to assessments levied and assessments paid, are not sufficiently accurate and I would not recommend anybody use them for forecasting purposes. This is not because they did not do a good job; it is because there are so many ways of dealing with this information that it cannot be regarded as very reliable. For example, in Illinois, before the end of the year 1991, the guaranty association levied approximately $150 million of assessments, almost all of which was for Executive Life. Now, when I say levied, I mean the Board of Directors voted an assessment which created a liability for all of the member companies. We then proceeded to call a very small part of that. I am not sure whether these cited data include the full amount levied or only the amount that was billed. In any event, we did not bill the first installment until the next year.

The steps in proceeding to an insolvency or a liquidation, as Jeff indicated, generally begin with some form of regulation short of taking control of a company, which might be a cease and desist order. The guaranty associations are notified of these. Alternatively, it might be a conservation order, in which case it depends on whether or not they go to court and get a sequestered order or an open order. The public does not know and the guaranty associations do not know about sequestered orders.

The next step is rehabilitation and then finally liquidation. Once a company goes into rehabilitation, the odds are extremely high that it will then proceed to liquidation. Rehabilitation is usually a halfway post. Some guaranty associations are triggered by a rehabilitation order and others are not. The expectation then is that, once it goes into rehabilitation, the guaranty system had better get on its horse and start moving amongst the people with information, trying to prepare for a liquidation, because that is the most likely scenario that will play out.

It is perceived in the statute that guaranty associations will be triggered or activated upon a finding of insolvency by a court of competent jurisdiction. In some states it requires a specific order of liquidation in order to activate and in others it does not. It is then expected that, having been activated, the guaranty associations will acquire the records, value the assets/liabilities -- both Rich and Chuck are going to talk more about valuation problems and issues and I will not get into that -- acquire the policyholder records, arrange for reinsurance, pay off the policyholders, and then pursue recovery from the estate of the insolvent company. Nice and neat. But it just does not work that easily.

This is why it is virtually impossible to forecast what the assessment demand on your client companies is going to be, or what the tax offset availabilities are going to be. Also, there is considerable variation amongst the states in handling these issues.

I might, as an aside, say that I do not regard individual state differences as a negative prospect. I think that, in their wisdom, the legislatures of the various states have chosen to protect their policyholders under certain conditions and up to certain limits. There is nothing wrong with a state that is capable of doing so providing higher coverage than the state next door.

What happens in the real world is that receivers, upon seizing a company and putting it in rehabilitation, believe that they can work it out without funding from the guaranty system. We all applaud that idea, but nine times out of ten the receivers are dreaming about making deals that just cannot be made, and ultimately most of them come to the guaranty system and say, "Gee, I guess we are going to need a few million dollars," which generally is multiplied by ten before you are through. Then we begin to acquire information.

These things do not happen in a matter of weeks. They happen over periods of time that extend, in one extreme example, over a four-year period of rehabilitation. During that time many millions more disappeared before it became clear that the receivers were going to need guaranty association involvement. Then, the process of acquiring records, whether you do it en masse for the entire country through a NOLHGA facility or make arrangements with the receiver to have local administration, again is a process that takes months. Companies that go into rehabilitation or insolvency typically (and there are some exceptions to this) have extremely poor records, even to the point of such things as no record in the home office of manuscript endorsements to policies made in the field, to take one terrible example.

Our job in the guaranty system then is to find a home for these policyholders, which means we have to put together some kind of valuation package for prospective bidders for the business to look at, which is not to say we do their due diligence for them. They have to do their own examination and they have to visit and talk to the people at the company, if there are any left. This is a process that can take several months, and we have on many occasions had to reject all bids and go back and start over again.

In the meantime, policyholders who want their money, be it a health insurance claim or a guaranteed investment contract (GIC) or a surrender value, are typically on hold with a temporary moratorium. We have resisted the idea of long range moratoriums in all those cases where we could because it is contrary to the purpose of the statute in the beginning. There have been a number of instances, however, in which it was the only sensible way to work out an insolvency. Guarantee Security was one of them, Executive Life was another, and Mutual Benefit still another. These moratoriums really amount to imposing penalties on withdrawals, which go down over a period of four or five years.

What we have found in dealing with receivers is that it is frequently the case that we are somehow regarded as interlopers. The guaranty system has had difficulty in getting sufficient information from receivers in order to do its job. Ultimately we always do, but it takes a lot of explaining and a lot of discussion. It takes confidentiality agreements and it requires a lot of professional help.

The guaranty system is always concerned about the activities of receivers in doing things in good faith which turn out to be preferential to one block of business or another and creating voidable preferences. We do not want to go to war with a receiver, but if necessary we will challenge these kinds of activities. The assessment process then depends, first of all, upon getting reasonably reliable information. It is rare that we get anything better than soft numbers, which will change several times over the months, and you cannot wait because you need funding to do your job. This means that whatever we assess is probably going to result in either an additional assessment later or a refund later.

The guaranty system generally tries not to raise money until it is needed. In the Executive Life case in Illinois, the amount levied used up our capacity for 1991 and, as it turned out, it was a good thing we did because we had to use virtually all of our capacity again in 1992 because of additional insolvencies that hit Illinois harder than most other states -- Inter-American for one, AMS Life for another. There was about $200 million involved in just those two cases in Illinois.

If money is raised but is not needed immediately (and we cannot time it perfectly by any means), the money does get invested in the most secure kinds of things -- short-term money market funds of one kind or another, CDs, and that kind of thing. We try not to have money on hand -- the idea is to raise the money to meet specific needs. As a result of that, we sometimes misjudge and have to borrow money in order to fund a reinsurance agreement. If we are lucky, the reinsurer will accept our notes. Guaranty associations, in effect, have the power to tax and we try to use that wisely.

Trying to predict what your assessment cost is going to be involves knowing the unknowable. We do not know how many insolvencies there are going to be, what the magnitude of them is going to be, or how they are going to break down by line of business. We do not know how soon we are going to be able to place the business. We generally have a good idea of what the immediate cash needs are in terms of policyholder servicing, but the cost of moving the business or reinsuring it is unknown for some period of months.

When it comes to tax offsets, there are variations amongst the states. They do not all have the same tax offset laws. Some have none. Some have a straight five-year amortization against your premium taxes and other fees and taxes. Some have limits. There are timing problems involved in forecasting how soon you will get that back. In addition, there are problems in forecasting or anticipating how fast you will recover from the estate of an insolvent company.

Another approach is a vehicle such as Guarantee Reassurance Corporation, which is owned by the guaranty associations and where we can accept assets at a value agreed upon with the receiver. (That is always an interesting negotiation.) The liabilities are generally accepted at their reserve values on a statutory basis. Then we are in a position to do a measured, deliberate workout of both the assets and liabilities.

Guarantee Reassurance, which is something that Rich will talk more about, was created with the idea of having a warehouse for these assets and liabilities until such time as we could find the best value and dispose of them properly. In most current situations, we do not have that option available to us and we have to go find a home for these businesses. We have not acquired assets other than cash so far, but we may very well do so in the future.

Another problem that can greatly affect any given liquidation is litigation over major issues, such as those that we have had in both Mutual Benefit and Executive Life – issues about what is covered and what is not, what the priorities are against the estate, etc. When you are talking about billions of dollars, it can dramatically affect the cost to the industry.

Finally, although we did not touch on it, I happened to have chaired the Assessment Data Gathering Task Force of NOLHGA for the period during which they accumulated the data: 1988-91. As a result, we developed some issues that are still unresolved, but we felt it was not up to the guaranty system to resolve them, and have referred them to the National Association of Insurance Commissioners (NAIC) and they are pondering what decisions they should make on some of these issues. Among them is what is an unallocated annuity, how do you treat guaranteed separate accounts, how do you treat transfers from unallocated to allocated in pursuance of purchasing an annuity for someone who retires? There are a few other less important but still relevant issues.

Overlaying all this is the need for regulators to be on top of things and to catch things before they get as bad as they have in many instances. It is easy to bash the regulators for not doing their job, but most insurance departments are underfunded. Most insurance departments do not have sufficient examination staff to do all of the things that they need to do. This is certainly not necessarily the fault of the department's director or commissioner. It is a matter of how much the legislature is willing to give them.

I think what I have done so far is basically sketch out a little bit about how the system works and how it does not work, and what are some of the problems that we have and need to anticipate. It is by no means an exhaustive discussion. If we were to sit around a table and tell war stories, there are a lot of things that we could talk about that we have experienced.

MR. HARPER: Our next speaker is Rich Veed. Rich was educated at the University of Nebraska and he followed that by earning his certified public accountant (CPA) at a tender young age. His insurance career was primarily at Arthur Andersen. He was there for something like 18 years, where he was eventually a partner from 1987 to 1992. Throughout his career he has concentrated in providing audit and consulting services to insurance companies both on the life and health side and on the property and casualty side. Rich basically started as an accountant and is still an accountant, though sometime in 1992 he decided to at least change jobs.

Rich was hired as the interim president of Guarantee Reassurance Corporation, which is the reinsurance company that was set up by the guaranty associations to take on the $600 million gross liability resulting from the insolvency of the Guarantee Security Life Insurance Company of Florida. This interim presidency then expired in 1993 when they got a full staff, and Rich joined the Asset Allocation & Management (AAM) Capital Partners LP, which is an equity investment fund sponsored by the AAM Group in Chicago.

He currently works in the Chicago area. His topic is going to be accounting issues, from the perspectives of Guarantee Reassurance, which is an assuming company, and Guarantee Security, which was in essence the insolvent company.

MR. RICHARD A. VEED: Usually I try to say that I threw my accounting hat away when I left Arthur Andersen, but Jeff is absolutely correct. It seems to keep flying back and I keep catching it out of the wind. I have the good fortune to speak to you about accounting issues. I am going to try, however, to stay away from debits and credits and theory.

As Jeff indicated, I was lucky enough to work with the guaranty associations in the establishment of Guarantee Reassurance. That involved several aspects. Number one, I was there when the receiver was still responsible for managing the assets and liabilities of Guarantee Security Life. I also had the opportunity, as we ended up negotiating the agreement, to help him effectively comanage that receivership. He obviously was still responsible to the courts but, because the guaranty associations were taking it over, the guaranty associations were allowed to have a representative, me, to help manage the assets and liabilities.

I also had the opportunity and the good fortune to then progress on to the new company, to help establish the new company, and to see the assumption of that block of business into a new company. I have had the good fortune to see the accounting issues and the management issues with respect to assumption reinsurance in the assuming company, and also with respect to the accounting issues and management issues of the rehabilitated company.

As I said, I do not want to focus on the debits and credits. I want to focus from the financial perspective, on some issues that I think are important to you from the standpoint of companies that are under rehabilitation or companies that are assuming business from a rehabilitated company, and the impact on the industry of the cost of all of this. Bob has talked a lot about the estimation process and how the guaranty associations go about it, but I want to talk about it more from your perspective and your company's perspective.

First, with respect to the companies under rehabilitation, I have approached this from the standpoint of what it is like for the rehabilitator. Some of these issues apply to the rehabilitator, some apply to the guaranty associations, and some are issues for combined efforts, and I have not tried to necessarily distinguish those. I think these areas should be important to you for a couple of reasons.

First, ensuring that the rehabilitator or receiver is doing a good job and doing or carrying out the things that I am going to point out is important because it basically helps reduce the cost of the receivership, thereby reducing the cost to the guaranty associations. It also helps package the business and sell those blocks of business at a higher price than might be possible otherwise.

The second benefit is really to companies that may be looking at assuming business from a company under rehabilitation. If the receiver and the guaranty associations carry through with some of these issues, I think that you will find that it is much easier to deal with them in assuming blocks of business and you are much more willing to put a higher value on those blocks.

Let me address issues facing a rehabilitator. First, I think one of the key issues that faces a rehabilitator as he steps into the picture is the identification of assets and getting physical control over those assets. As Bob has already said with respect to a company that has gone into rehabilitation, the records are bad, including identification of assets. As a matter of fact, they are usually terrible. Guarantee Security was somewhat better than most, probably quite a bit better than most, but they still have gone through many trials and tribulations as they have tried to identify all of the assets and ensure that they have good title for them.

As a result, there is a large-sized project that has to be performed by the receiver and his consultants, namely to go out and inventory assets – find assets that are missing or, on the other side, determine that there are assets that are recorded that really do not exist and cannot be found. That leads to a number of other things that we will talk about later.

After the assets have all been identified, the receiver really needs to get proper control over them. That is easy with respect to securities, desks and chairs, and locking the front door. A lot of times though, the things that kind of get left behind are things like making sure that good physical control over the books and records are in place and that they are retained. There needs to be good control over receipts and expenditures. Again, there are often difficulties in getting those established quickly and promptly. Any assets that get out the door are often difficult and expensive to recover.

Another key issue with respect to identifying and making sure that you have custody over the assets is ensuring you have clear title. Chuck will certainly talk about this issue as he looks at this from the standpoint of a company that is acquiring a book of business and assets from a company under rehabilitation. It is a key issue and it is one that gets very confusing because of all of the holding companies and subsidiaries and also because of a number of the transactions that some insolvent companies have entered into to kind of disguise or hide that insolvency.

After they have found all the assets and gotten control of them, one of the toughest things comes up: the valuation of assets. Valuation of assets is easy if it is basically just a set of bonds and stocks, i.e., a normal, ordinary, everyday portfolio. When it comes to portfolios of junk bonds, junk subsidiaries, and real estate, it gets tough to set a value. The reason it gets tough to set a value is that the situation is unlike that with stocks and bonds, where you can get a market value that really represents a liquidation value and represents a future value (at least the best estimate of a future value).

With most of these assets, there is a significant difference between what the liquidation value is and what the future value is. With respect to Guarantee Security, there was something like a $30 million difference between the liquidation value of their investments in subsidiaries or what they could get if they had to sell them promptly – which ranged all the way from airlines to women's clothing stores – and what they would get for them if they were able to manage them, run them off, and wait for the business cycles to turn and potentially add some capital to those companies.

There are significant differences in values, and the only way that the receiver can properly address these is really to go out and hire the experts in the right areas, not only to do the valuation, but also to help them as they manage those assets. I will talk about that a little bit more later.

You might ask, why is the future value particularly important to the receiver? Effectively, the receiver is not going to be there. Without the receiver knowing or making a good estimate of the future value – and that is not always very easy to do, as we have seen with the junk bonds in Executive Life – it is really important to get that valuation so that the receiver can get the best possible price and reduce those costs and potentially reduce the profits that somebody is going to get from acquiring those assets.

After the assets have been valued, it is really incumbent upon the receiver to make sure that he has systems to control those assets, to make sure that he is properly recording receipts and disbursements and controlling the assets going forward, and cleaning up those systems with respect to assets so that the company that comes in to acquire the book of business and/or the assets has good quality records that are up to date and clean for them to review.

Finally with respect to the asset side is an issue that I mentioned before, and that is basically hiring the right manager. It is incumbent upon the receiver to ensure that he retains value, and that he also enhances the value of the assets for which he is responsible. Really, the only way to appropriately do that is to ensure that the proper consultants are there either from an industry standpoint or from the standpoint of the specific type of assets. You certainly do not want a normal portfolio manager managing a portfolio of junk bonds, because it just does not work. The information is too difficult to pass on and to assemble to be able to manage properly.

Turning to the liability side for a minute, again I would point out that the records are usually a mess. Bob has already alluded to that and to the difficulty of knowing who your policyholders are, what the policy provisions are, and what sorts of changes should have been made to the policyholder master file. It really becomes a process of cleaning up that mess, effectively testing it, rebuilding the records, and hopefully putting together something that can be used not only by the receiver in and the guaranty associations to determine what the liabilities are to the policyholders, but also by anyone who is going to come in and acquire the business.

Another area that Bob alluded to, which is extremely critical for a receiver, is determining the cash requirements and determining if cash can be paid out to the policyholders in the interim, or if a period of moratorium on benefit payments and death claims will be required. Obviously it is key here to have a good working relationship with either the actuaries that may be still in house at the company under rehabilitation or to work with an outside consultant to determine the liabilities, or what's more important, the cash-flow requirements of those liabilities.

The liability cash flows, combined with the potential asset values, the cash that is going to be thrown off by those assets, and the timing of that cash, allows the receiver to determine what the shortfall is. It is very early and it is very difficult to do, but at least this exercise gives him some clue as to whether or not he can go to the court and ask for payment of benefits and what percentage of those benefits should be paid ultimately.

Let's touch on several other areas that are important and sometimes overlooked. There are usually some excellent opportunities or, on the other side of the coin, exposures, with respect to the Internal Revenue Service (IRS). The IRS is certainly going to come in and make huge claims against the company. The receiver's ability to fight those claims and support the positions that the previous administration of the company might have taken is very valuable and very important. It is also extremely important to look at prior tax returns and find out if there are opportunities to file for additional refunds.

We have certainly found tremendous levels of opportunities at Guarantee Security to file for tax refunds. One thing that the previous management of Guarantee Security did not want to do was get sideways with the IRS; so they actually probably paid a lot more in taxes than they ever needed to pay. Also, a general overstatement of some assets and of some investment income resulted in more taxes paid even though they did not turn out to exist.

A second area that is sometimes overlooked and maybe is focused on a little bit too much by some receivers, is the whole area of potential litigation. This involves identifying those cases early on, working with legal counsel to develop the best possible case, and at the same time ensuring that you are not chasing a figment of your imagination and incurring a lot of costs. Also there is the opportunity to chase windmills to try and make sure the bad guys pay. It is incumbent upon the receiver to properly evaluate litigation recovery potentials and the potential cost of them.

Reinsurance recoveries is a difficult area that we could probably spend a lot of time talking about. Actually, I will let my wife talk about that since she helps the Illinois Department on certain reinsurance recoveries that I am sure Bob would like to talk about further.

The last two issues really are things that will help the receiver as he gets ready to sell the business. Obviously, he needs to prepare the business for sale, working with the guaranty associations, packaging the assets, packaging the liabilities, and ensuring the maximized value. Second, it is important that he worry not only about reporting to the receivership court, but also about maintaining the financial records such that they are easy for potential assuming companies to come in and evaluate.

Let's turn to the other side: the companies assuming business from companies in rehabilitation. I know Chuck is going to talk a lot more about this, but I want to touch on some areas that I think are important and maybe different from the normal situation where you assume business. To a large degree, assuming business from an insolvent insurer is very similar to a normal assumption of a block of business, but there are some differences. One of those key differences is the ability to impose potential moratoriums, impose policy revisions and changes, have those approved by the court, and potentially issue new policies to the policyholders in place of their old policies with the old insurance company. There are some opportunities that do not exist with respect to a normal assumption. As I indicated earlier, one of the most difficult things with respect to a company in rehabilitation is the questionable nature of their records or the mess that exists within their records. As a result of that, due diligence and assembling the right team are very important. Due diligence is important because of the valuations that are very necessary to determine what certain assets are going to be worth and whether or not certain assets should even be taken in to an assuming company.

There are certainly exposures with respect to environmental liabilities and exposures with respect to potential litigation risks that would tend to make an assuming company want to leave certain assets behind. Certainly the higher NAIC class assets probably want to be left behind anyway. So there is a lot of due diligence that needs to be done. Chuck will talk about the due diligence team and its make-up; it is really very similar to what the normal due diligence team would be, but there is probably a lot more emphasis on valuation, information systems and legal issues than what you would see in a normal due diligence effort.

One thing which is critical to this process for the assuming company is developing a good relationship with the receiver and his consultants. One of the things that you do not want to do is end up in a situation where you are trying to get the business but on opposite sides and trying to make this be a clean transfer of business.

Obviously, determining the value of the business is very similar to the situation in any assumption. There are probably quite a few differences with respect to valuing assets. You have to determine what the future potential value of certain assets is, rather than what the historical value or the liquidation value may be. Also, the cost of administration and cleaning up is quite a bit different from your normal everyday assumption, and that needs to be looked at closely.

Let me mention several other quick thoughts that are important for the assuming company's recognition on their financial statements of the assumption. It is critical for the actuary who is involved in the due diligence to help determine the GAAP, statutory, and tax reserves so all of those ramifications can be determined for the negotiation of the business and also for the financial statement impact.

After all the due diligence is done and there has been some review of the proper price, then the negotiation process starts and you can begin determining the ability to make modifications in the policies, what assets will be taken, what liabilities will be taken, and what potentially will be left behind. That is an area that Chuck is going to touch on. It turned out to be extremely critical during our Guarantee Security phase. I know he has some good thoughts and suggestions there.

After the negotiation is successfully completed, it is extremely important to work with the receivers as they get court approval for this transfer of business. That ensures not only a timely resolution, which certainly can get bogged down in the receivership court, but it also assures that you are not there in the courthouse renegotiating the deal. Chuck will probably talk a little bit more about that too.

As far as the accounting, it is very similar to other assumptions. The debits and credits are much the same. I guess the two key things that I focus on, certainly coming out of my experience, is asset values and reserves. First, with respect to asset values, you must determine which values you are going to carry to the books, whether or not they are going to be a liquidation value, whether they are going to be an expected future value, and how you are going to justify those to your outside auditor. Second, if you are going to make modifications to the policies and put restrictions on them, you must determine how you are going to recognize it in your reserve assumptions and the reserves that are recorded for the financial statement.

The last area that I want to touch on is the impact on the industry and paying the cost. I want to touch on a couple of pure accounting and financial-type issues. First, the accrual for the cost is an ever-changing area and it is an area that is being looked at by the AICPA Insurance Companies Committee. It is on their agenda; they have not done anything with it yet, so I cannot report to you what, if anything, they are thinking about.

Certainly there is an issue with respect to the timing and the amount that is going to be recognized. The amount is extremely difficult, as Bob has already alluded to. Not only is it difficult to determine what the amount for the insolvency is going to be, but also what is your particular share of the amount in your particular state, depending on what your book of business is in a particular state. It is extremely difficult with the limited amount of information that is available to you to make a determination of these amounts.

Also, with respect to the timing of making the accrual, until you actually have knowledge of an assessment that has been done by the guaranty associations, it is really difficult to know how much the cost of the insolvency is going to be from your standpoint. I think that most companies end up in a situation where, once an assessment has been made, they do recognize it for both statutory and GAAP. There have been times in the past where companies have waited until there is actually a cash call from the guaranty associations, and that is clearly inappropriate. I know that both the NAIC and the AICPA frown on that practice severely and basically focus on the assessment period or the assessment date. I think there is the opportunity, and perhaps the AICPA will be pushing to not only accrue costs as of the assessment date, but basically look further back and try and accrue costs from the failure as best you can determine. So I think that is a risk and an exposure and one that is going to cause severe difficulty in making estimations of what that cost is.

The other side of the coin is the opportunity for recovery of those guaranty assessments. In a number of states, there is an opportunity to recover a certain portion of those assessments from an offset against your future premium tax payments. There are limitations in the timing, and certainly it assumes that you are going to continue to write business so that you can recover it. The recognition of any asset with respect to that potential recovery is also a difficult area to put on the financial statement.

MR. HARPER: There were a lot of issues in there that are actuarial. Any time there is some confusion as to the amount of or the timing of realization of an asset, for example, that is an area to which an actuary can bring expertise. I think the official definition is assigning the current financial impact to a future contingent event.

Our last speaker is Chuck Petty. Chuck was educated at Wheaton College and then graduated from Duke Law School. He was educated as a physicist and became an attorney. He began his career in the Office of the Secretary of the Army. He went into private practice in the mid-1960s after getting out of the service. He joined Hopkins & Sutter in 1967 in the Washington office, and has been with them ever since. He became a partner in Hopkins & Sutter in 1980.

Chuck's areas of expertise include tax issues and RBC. In fact, he has written a white paper on RBC.

He belongs to a number of professional institutions, as well as the Board of Duke University Law School. He currently lives in Maryland, but works out of the D.C. office. He covers what he describes as the eastern seaboard, and defines that as something from New York to San Juan, which you will notice is mostly coastline. Also, he does seem to know more about the Honolulu hotels than the New York hotels. His topic is tax and legal issues and, again, he can speak from two perspectives.

MR. CHARLES W. PETTY, JR.: In an attempt to disguise or avoid marketing my former law firm, I did not indicate that I was a partner in another law firm from 1972-80. It did not take me that long to come into the brotherhood at Hopkins & Sutter.

The whole guaranty system and the whole guaranty association approach to insolvencies is very much exposed at this point. Janet Potts, who is a senior staffer for Representative Dingell, has indicated that, in her view, going back in the history of insurance regulation, you see cycles of federal interest and federal threat to regulate the insurance industry, followed by changes in state insurance regulation, followed by that threat going away.

There is a solvency bill pending, HR1290, which is not getting a lot of attention right now. The health care legislation has moved it off the center of the table. Some of Dingell's people are also working on the North American Free Trade Act, which has kept them from worrying too much about solvency. It is certainly true that the performance of the guaranty association system in dealing with insolvencies has a great effect on the future of this whole area. Will we continue to see much of a state-centered system, or will there be successful efforts to federalize it?

I come primarily from a banking regulatory side of the financial institutions work in a firm that has been also heavily involved since the 1920s in insurance and insurance taxation. The opportunity to work on the Guarantee Security case was an interesting one for me.

I do not know how much you know about the history of this company. It was acquired as a small company, $100 million in liabilities, back in the mid-1980s by a couple of stockbrokers from Kentucky who apparently had read Andrew Tobias' book, *The Invisible Bankers*, and said, "We have got to have us one of these." They acquired one in Florida, changed its name, adopted a aggressive marketing strategy of increasing commissions to independent insurance agents and increasing interest crediting rates on their products, which were mostly annuity products with some single-premium whole-life, and developed this company from $100 million to over $1 billion in a very short period of time by attracting the interest of independent agents around the country. They had some problems generating the income to pay those high credited interest rates and those commissions, which they solved by investing substantially all of their assets in junk bonds, which they acquired mainly from Drexel-Burnham, with some help from Michael Milliken. Those bonds catered, which immediately precipitated the crisis in Guarantee Security. In fact, the company probably was insolvent from the very beginning, but at each year-end, in order to avoid problems showing up through the application of statutory accounting principles, they sold their junk bond portfolio, or large portions of it, to a stockbroker at the end of a year. Instead of junk bonds, they carried cash due from the broker on their books and did not take a 20% haircut on the value of those bonds. Then, of course, they bought them back the first day of the next year. They followed that practice for several years. Otherwise, they probably would have been insolvent on a statutory basis from the beginning.

As Rich has alluded, they engaged in some other innovative transactions for surplus relief, which had the effect of deflecting the interest of the Florida Department from the true situation of the company until fairly late in the game.

When the guaranty associations were called, the company had basically $300 million of assets and $600 million of liabilities as a result of the crash in the junk bond market. The guaranty associations formed a task force, of which Bob Ewald was a very important member, to deal with this situation. That task force then retained assistance to look at Guarantee Security and to design an approach.

It was decided fairly early on to follow the concept of forming a new company, now known as Guarantee Reassurance, which Rich has talked about. Originally we just called it Newco because we did not have anything better to call it. The company was formed for the purpose of acquiring the assets, or most of them. We had some questions about those with obvious environmental liability tails, and needed to have a period of time to work the situation out. We hoped to realize higher values for those assets than would have been possible in a sale by the receiver.

They owned a plastics company, Canada's largest retail marketer of cotton clothing for large-frame women, and an interesting Allegheny-type commuter airline. It is surprising to see this variety of businesses in the portfolio of a Florida-based, mainly annuity-issuing insurance company.

The team was organized to approach this situation. We had legal counsel, and Rich as the accountant. We had a Tillinghast actuary, one of Jeff's colleagues, and we had valuation assistance from Duff & Phelps, a very good firm in that area. The team then set out to investigate the situation very carefully. We were aware of big problems in the value of the bond portfolio. We were aware of substantial concern about the ability to sell off these subsidiaries in any short-term time frame at a value that would represent their potential, particularly given the economy at the time. We were aware that there were substantial allegations against the former owners, their management practices with respect to the junk bond portfolio, recently the surplus relief transactions that I alluded to, and also against the former outside professional advisors, both legal and accounting, and the stockbroker firm that I mentioned.

I think that, looking back at that experience, there is one thing I would recommend for anyone who wanted to replicate it. Looking at it from the standpoint of the team that worked with the task force very closely to form the new company and to negotiate the acquisition of Guarantee Security's assets and liabilities, I would recommend hiring a good client. In this case, I consider Bob Ewald and Herb Hopkins, the chairmen of that task force, to be the client. They understood how important it was to take a really unified and coordinated approach to the negotiations with the receiver.

The other thing I would suggest is to be lucky enough to have a cooperative receiver. This receiver was very open and intellectually committed to the whole idea of having a corporation that would be formed to take over these assets and liabilities and work them out. We did not have some of the issues with respect to release of information, or very hard-fought confidentiality agreements that you have seen in other cases. We were able to investigate very thoroughly the situation at Guarantee Security to set about planning the Newco approach, and then to negotiate the acquisition with the Florida receiver.

That process took a long time. We started in January with a term sheet, laying out the terms and conditions of the acquisition. (By the way, that is a lot better way to start than by laying a 160-page, single-spaced definitive agreement on the table and trying to deal with some of the concepts that necessarily have to be dealt with in such an agreement.) We decided to attempt a tax-free reorganization. I am not going to say much right now about that, but I may come back to that at the end. It was viewed by us as a proper "G" reorganization, Code Section 368(A)(1)(g).

Unlike a situation in which you are buying an insurance company from a financially responsible seller, we did not have the luxury of getting representations and warranties from the receiver. The receiver acquired these assets and liabilities pursuant to his public function and was passing them on to us. Beyond telling us that he had the authority to do this, he was not in a position to represent and warrant the value of the assets that we were acquiring. That meant that we had to get involved in an extremely detailed due diligence effort, and we certainly did -- we spent thousands of hours on that.

We had to look at the possibility of litigation, because when you have an insurance company with a $300 million hole and you have the kinds of allegations that were being made against the former owners and professional advisors obviously the proceeds of litigation were potentially an important asset. There was a tension there with the receiver and his perception of his job, which in part was to chase bad guys. Therefore, he wanted to retain control of that litigation, and be the primary coordinator of it with outside litigation counsel in Florida. We, on the other hand, were primarily interested in the result of that litigation to the extent it produced proceeds that would reduce the cost of the workout for the guaranty associations.

Ultimately, the compromise that was reached was to leave the primary control of the litigation with the receiver, funded with some retained assets from the estate, recognize the principle that the proceeds of that litigation come into the estate and go to reduce the cost of the receivership, although some additional compromises were made with respect to a third of the money potentially coming out of that litigation and they were acquired in ways that solved other problems that we had in the litigation.

At Guarantee Security we had mainly covered policyholders. The number of uncovered policyholders was relatively small, and there are two reasons for that. By the time of the rehabilitation of Guarantee Security, most states had guaranty association coverage in effect. Louisiana, Colorado, and the District of Columbia were issues there, and we had some other states that were resolved by Florida stepping up and taking responsibility, but generally we had guaranty association coverage in the states in which the policy liabilities were concentrated.

To the extent we did not have the coverage or to the extent we were not responsible, there was another area of tension between the receiver and the guaranty associations with respect to those uncovered policyholders; policyholders particularly in Louisiana, by the time the values settled down, were looking at less than 50 cents on the dollar. The receiver, in a number of ways, has been highly desirous of giving coverage to those people both during the negotiation of the deal and in subsequent litigation. There has been a need to negotiate with respect to additional benefits for those uncovered policyholders. The guaranty associations take the basic attitude that there is no statutory authority to cover uncovered policyholders. The receiver has a different view.

Some other issues came up, and Rich has alluded to some of these. These transactions will not work if the policyholders are in a position to pull their cash values out very shortly after the rehabilitation period starts. We imposed a restricted amount charge of 25% on cash values of policyholders, which steps down 5% a year over a five-year workout period. That is one of the things that gives any of these deals a fighting chance of producing the benefits that we are all interested in: namely, an opportunity to maximize the value, take care of the policyholders with the highest possible values that we can generate, particularly for the uncovered policyholders, and to reduce the cost to the guaranty associations.

Interest crediting rates are extremely important in terms of the ultimate cost to the guaranty associations. Those were reset somewhat to lower minimums during this workout period, but hardship provisions were continued and policyholders who could show, under the standards approved by the receivership court, that they had a hardship and needed to withdraw cash values were accommodated.

We also have the potential that, once the plan is announced to policyholders, some will choose to opt out and perhaps even pursue litigation on the theory that the guaranty associations had not fully met their statutory obligations to policyholders by any plan that involves a five-year workout period. The first barrier that any such policyholder has is that he really can only ask for his pro rata share of the assets out of the defunct company based on those liquidation values that would have applied in the case of a quick sale of assets. These would have been even lower than the restructuring percentage which was set in the deal and on which we hoped to improve. There is very much an incentive to the guaranty associations to do the best we can to produce an attractive package for policyholders to avoid any substantial number of opt outs. In fact, the opt out percentage has been extremely small in the case of Guarantee Security.

I would like to address a couple of special topics here. In addition to the claims that were obvious from the very beginning, against the former owners and professional advisors of Guarantee Security, there have been a number of companies that had engaged in reinsurance transactions with Guarantee Security shortly before it went down. There is a strong temptation on the part of a receiver, and a looking-over-the-shoulder interest by the guaranty associations, to know whether those transactions could be considered abusive in any way.

Reinsuring a block of policies with a company that seems headed for receivership where a large or high percentage ceding commission comes back to the reinsuring company may simply put additional assets that will have to be dissipated into the hands of the management of the company. It may have a major effect in increasing the cost of the bailout or the workout by swelling the size of the company, dissipating those assets, and leaving those liabilities to be picked up by the guaranty associations. Litigation has been undertaken by the receiver against a couple of companies that engaged in reinsurance transactions with Guarantee Security before it went down.

The response by those companies has been that reinsurance transactions are a way of life in the industry and the guaranty associations exist to take care of the losses that result. There probably will be settlements in those cases. I think that a resulting business management planning point is if you are looking at reinsuring a block of policies with a company that is either rated very low or is obviously in trouble, be careful, pick your counterpart carefully, or just say no to a deal that seems too attractive.

The Guarantee Security transaction, as I indicated, was structured as a tax-free reorganization. For those of you who have an interest in that area, the technique was to use the statutory powers of the receiver with respect to the policies of the Guarantee Security policyholders and to restructure them down so that the liability on those policies was less than the available assets by 5%, which put the company, before the next steps were undertaken, in the position of having a positive net worth of 5%. The guaranty associations then used Newco (Guarantee Reassurance) to reinsure its statutory liability to pick up the shortfall on those policies and in the process paid the old policyholders for their 5% interest.

That satisfied the very archaic requirements for continuity of ownership, and my tax partners tell me it resulted in a tax-free reorganization under 368(A)(1)(g). I used to do a lot of tax work, but this transaction was one that I had to rely on my partner, Alex Melanie, to deal with. If any of you are interested in more details on that, I can certainly put you in touch with the right guy.

MR. FRANKLIN C. CLAPPER, JR.: I noticed your list included considerations for assuming reinsurers, Rich, and that there were a lot of things that had to do with assets. Of course, the reinsurer could assume the assets, but I think quite often the reinsurer may want to assume only the liabilities. I know that is what happened with Executive Life and in a couple of other situations. I was wondering if you could say a little bit more about the considerations and feasibility of splitting the assets and liabilities and how the different parties would deal with that.

MR. VEED: Certainly a lot of the points that I had on there dealt with the assets, and obviously it is much easier for the guaranty associations, the receivers, and all parties involved on that side to have the transaction be in that form. That was the form that Guaranty Reassurance took. Obviously there were some assets left behind. It is very critical that the receiver find innovative ways to package not only the assets, but the assets and liabilities, if possible. As you have indicated, and it is very true, it is extremely difficult for an insurance company to take on both the assets and liabilities.

Having said that, certainly from the guaranty association standpoint, you have to either provide notes or cash for those assumptions. It really is much better or easier for them to dispose of the assets at the same time, so you have to kind of play out those two dynamics of what you are trying to accomplish. When you sever off the assets, there is always an issue with respect to how you dispose of the assets and what their worth is if you are breaking apart the liabilities. If you keep the liabilities together, it is a little bit easier when those are all taken, but frequently that does not happen either. So there are a lot of complexities with respect to segregating the assets, determining the value, and determining which asset has the most risk. Those issues all have to be considered and determined in separating it. With Mutual Benefit, even though it is hopefully going to be a solution where most of the pieces are kept together, there is certainly still an issue of how the assets are separated and split between the individual liabilities, policyholder accounts – the covered and the uncovered. It is a very difficult area and there is certainly a number of dynamics that need to be balanced to make it work.

MR. EWALD: I might add to what you said, Rich, that most of the reinsurance deals that we have made have been cash deals, paid for with cash, or temporary notes while assessments were collected, but basically cash deals. The issue is a very real one because some of the biggest reinsurances that we have done have involved asset transfers of that kind. There are a lot of issues related to reinsurance that we did not get to talk about and all of the different kinds of reinsurance too.

FROM THE FLOOR: I did not understand whether reinsurance was assumed or ceded and whether there were novations with the reinsurance into Guarantee Security.

MR. PETTY: If you are talking about the incoming policies that I mentioned, then there were no novations. From a technical standpoint, the ceding company is still jointly liable on those policies, or at least that is the allegation in the litigation that is being brought. If there had been actual novation with acceptance by the policyholders of Guarantee Security as their insurance company, there would not be an issue. Then, of course, the lawyers can always get into arguments as to whether the passage of time or the acceptance of correspondence without complaint, etc., constitutes a novation. There was no formal novation in those cases.

FROM THE FLOOR: Has the Security Benefit case been settled by the 10th Circuit decision which is, I believe, a court of appeals?

MR. PETTY: The Security Benefit case is certainly a factor in settlement discussions and tends to get the attention of the reinsuring companies, but these cases are going to be resolved by settlement. I do not think anybody on either side wants to see extended litigation.