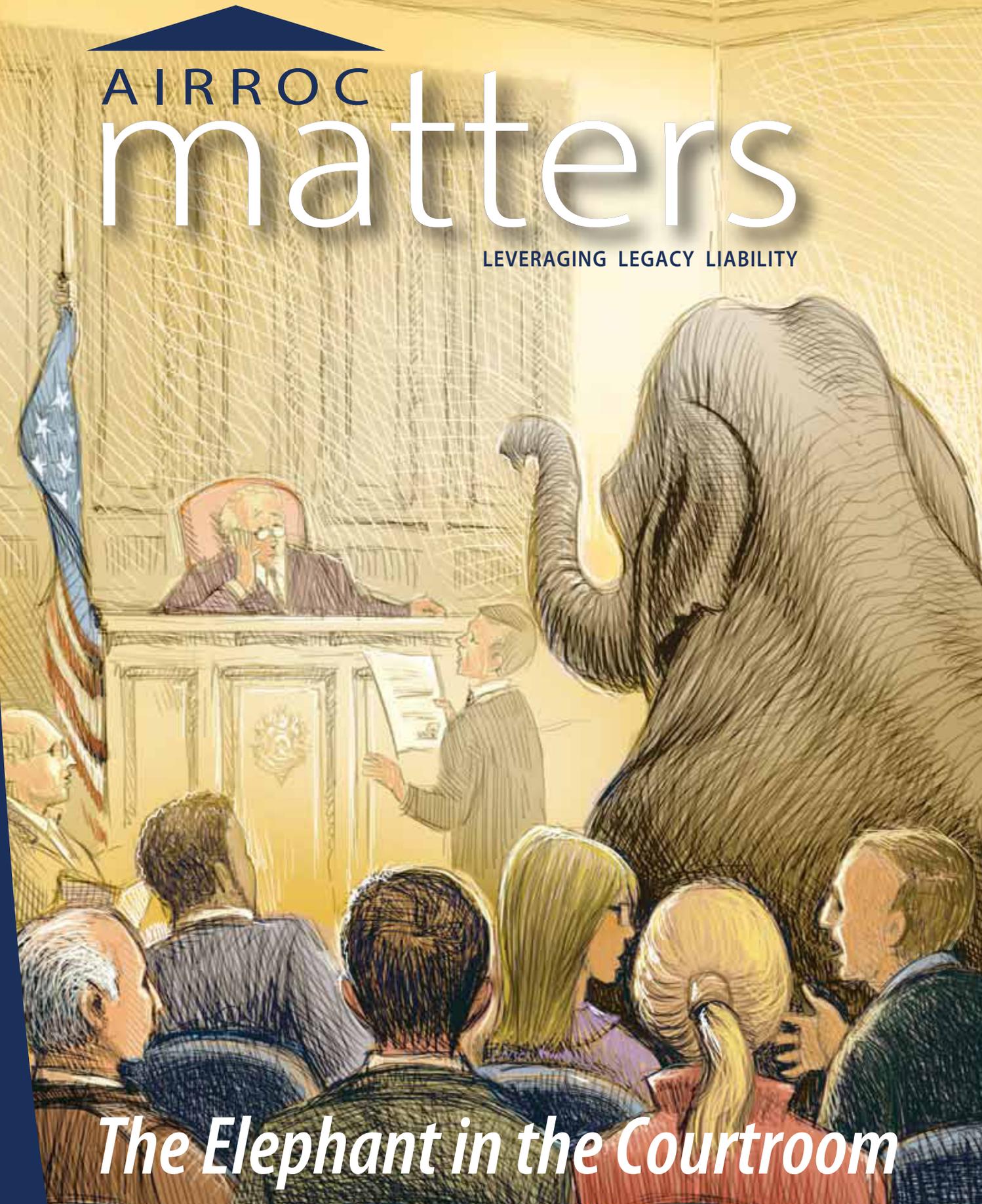


# AIRROC matters

LEVERAGING LEGACY LIABILITY



## *The Elephant in the Courtroom*

WHO'S GOT YOUR BACK? • DAVID VAUGHAN ON LIFE AFTER RUN-OFF • FANFARE FOR FAHEY  
AIRROC EDUCATION GOING REGIONAL • ARBITRATION PANEL VACANCIES



cutting through complexity

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# “Go Ahead, Make My Day”

Peter A. Scarpato

*Though not expressed in Clint Eastwood's teeth-clenched, steely style (and certainly not for the same purpose), the Publications Committee strives to “make your day” in a good way as we try out the wings of your new, souped-up magazine. Notice in this edition more artistic style, more critical analyses and more personal focus on people and players in the legacy business. Designed to enlighten and enliven, these elements bring clarity and sharpness to the issues of the day and people of the moment.*

We begin with Peter Bickford's *The Elephant in the Courtroom: Or how the Receivership Process has failed Executive Life Insurance Company of New York, its Policyholders and Annuityants*, an insightful dissertation on the New York Insurance Department's two decade, unsuccessful attempt to rehabilitate Executive Life Insurance Company of New York, culminating in a court order declaring the company insolvent but ignoring the Department's accountability for the result. In *Who's Got Your Back? A.M. Best's Treatment of Schedule F in the Rating Process*, Charles Huber summarizes his comments from our 2012 March meetings, taking us behind the curtain to examine and understand the impact of Schedule F analyses on company rating.

Our “cup runneth over” in the AIRROC Update section: first, in *Legacy Liabilities* and *AIRROC Education Going Regional*, Trish Getty (1) highlights AIRROC's legacy focus, (“what you write today will be your legacy book tomorrow”) and (2) stresses the importance of AIRROC's regional educational meetings, beginning with our June 11, 2012 Chicago meetings. Next, we welcome our new Executive Director, Carolyn Fahey—*Fanfare for Fahey*—who brings in-depth experience and a stellar reputation to AIRROC. Watch the next issue for an interview with Carolyn. Finally, Connie O'Mara and Bina Dagar crisply tackle two formidable topics from the March membership meetings: Connie's *Tightening the Belts and Suspenders: Panel Discussion on Collateral/Security* and Bina's *What's Ahead? Legislative Update/Forecast for Insurance Run-off Industry*. The security article summarizes the panel's discussion on the impact of major regulatory reforms on collateral in reinsurance. The legislative update outlines the design, implementation and industry impact of recent and anticipated changes in federal law and insurance regulation.

The newly dubbed section, *Who's Talking*, contains *Off the Cuff: David Vaughan on Life after Run-off*, our own Maryann Taylor's interview of David Vaughan, which tracks the history and current state of market demand for runoff expertise against the background of David's own experiences.

Our Legalese section offers *Resign, Replace, Resume: Recent Decisions on Arbitration Panel Vacancies*, in which Daryn Rush and Thomas Klemm analyze recent cases deciding under what circumstances parties may replace arbitrators who resign midstream.

Of course, Nigel Curtis' Present Value, News & Events section keeps us up to date on the movers and shakers of the runoff world.

We thank all who contacted us with feedback on the new AIRROC Matters magazine. As illustrated by this issue, we strive to raise the bar and improve its appearance, substance and relevance. Your opinions, ideas and criticisms are vital.

Let us hear from you... and, go ahead, make my day! ●




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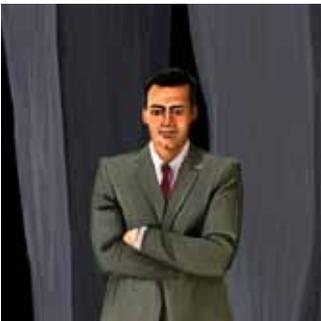
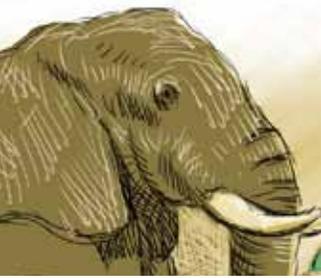
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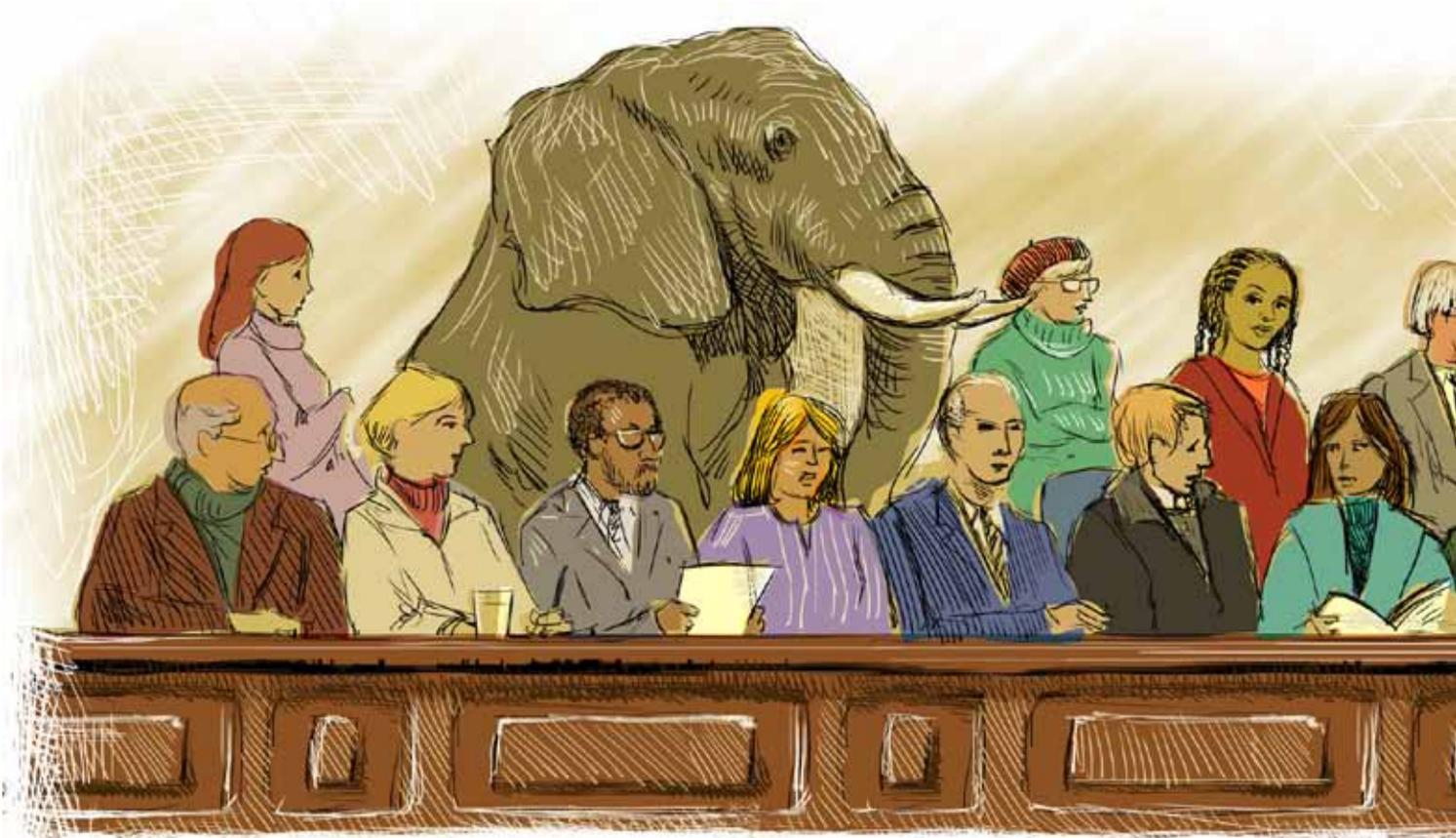


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# The Elephant in the Courtroom

Or how the Receivership Process has failed Executive Life Insurance Company of New York, its policyholders and annuitants



*In 1991, Executive Life Insurance Company of New York (ELNY), the stressed but solvent subsidiary of its insolvent parent, Executive Life Insurance Company of California, was placed in rehabilitation in New York to protect it from cash surrenders becoming “a run on the bank.” Twenty-one years later, the rehabilitator petitioned the court to declare ELNY insolvent, order it liquidated and approve a plan for the restructuring of its remaining policies alleging that ELNY’s liabilities exceeded its assets by \$1.6 billion.*

The burden of this deficit will fall largely on individual annuitants, policy owners and the insurance companies that fund the state life insurance guaranty funds. How ELNY got to this position after two decades of receivership charged with the preservation of the company and protection of its policyholders is a cautionary tale of the failure of the receivership process to do either.

The hearing on the rehabilitator’s petition to liquidate ELNY and approve the restructuring plan<sup>1</sup> commenced on March 15, 2012 before Acting New York Supreme Court Justice, John Galasso, in Nassau County. After ten days of testimony and one day of closing arguments, the court issued a

decision on April 17, 2012 approving the rehabilitator’s petition, determining that ELNY is insolvent, ordering it liquidated, and approving the proposed restructuring plan. A word of caution, however, to anyone who might consider the court’s approval of the petition and plan a final resolution of the long ELNY saga. The Court’s ruling is more about the allocation of pain than a solution to the underlying problem. *The elephant in the courtroom — the lack of accountability in the receivership process in New York — remains unaddressed.*

On its ELNY web page, the New York Liquidation Bureau sets the blame for the failure of ELNY squarely on the economy:



Illustration / Rafael Edwards

downturn. The economy may have contributed to the pace of expansion and size of the deficit but does not explain or excuse the long, painful story of ELNY's failed receivership.

### Saving ELNY

When ELNY's parent was placed in receivership in California, the New York Insurance Department determined that an "increase in surrenders had caused a material erosion of ELNY's assets to the detriment of policyholders with nonsurrenderable policies, primarily structured settlement annuities."<sup>3</sup> As a result, New York's Superintendent of Insurance sought and obtained an order of rehabilitation in April 1991, and was appointed as rehabilitator charged with the management of ELNY. A year later, in March 1992, the rehabilitator submitted and the court approved a plan of rehabilitation for ELNY. Under the 1992 plan, ELNY's traditional whole life, term life and deferred annuity books of business were transferred to Metropolitan Life Insurance Company with substantially all the supporting statutory reserve assets. The book of single premium immediate annuities (SPIAs), primarily issued to meet structured settlement obligations, remained with ELNY together with the remaining assets, mostly of "junk" status. Neither the 1991 rehabilitation order or the 1992 order approving the rehabilitation plan declared ELNY to be insolvent.

For the twenty plus years since the approval of the rehabilitation plan, the rehabilitator continued to pay all annuitants in full. However, faced with a \$1.6 billion shortfall, in September 2011 the rehabilitator asked for the first time that the court declare ELNY insolvent, order its liquidation and approve a restructuring plan for the ELNY annuities.<sup>4</sup>

*Neither the 1991 rehabilitation order or the 1992 order approving the rehabilitation plan declared ELNY to be insolvent.*

### Restructuring Plan

Under the restructuring plan, the remaining ELNY assets are to be transferred to a new entity — a District of Columbia captive — owned and controlled by the participating state life insurance guaranty funds, which will contribute funds to the new entity in amounts based on their individual state fund laws. The ELNY contracts will be restructured to a level that can be supported by these assets, and the obligations as restructured will be assumed by the new entity. Because most of the annuities are relatively small and fall within guaranty fund caps, the rehabilitator estimated that roughly 84% of all annuitants would continue to receive their full periodic annuity payments. That percentage does not tell the full story, however.

ELNY's assets, based on its December 31, 2010 statements,<sup>5</sup> cover only about 36% of its obligations and the rest will come from the various state life insurance guaranty funds. These guaranty funds, however, have statutory caps. The most common cap is \$300,000 although the New York cap is \$500,000. As applied by the restructuring plan, the cap is the maximum allocated to each contract, so that the guaranty fund contributes the difference between a contract's pro-rata share of ELNY assets and the applicable fund cap.<sup>6</sup> Because of the life guaranty fund limitations, the benefits under any annuity with a present value in excess of the applicable guaranty fund cap will be cut significantly — many of them by a half or more.

The rehabilitation of ELNY has been negatively impacted by sustained periods of adverse economic conditions, including low interest rate environments and unfavorable equity markets. In addition, the stock market collapse of 2008 worsened ELNY's already fragile financial condition. As a result of these adverse economic conditions, ELNY's assets are no longer adequate to continue to support the payment of 100% of the benefits ELNY annuity contract owners and other payees and beneficiaries expect to receive into the future.<sup>2</sup>

However, ELNY was *de facto* insolvent long before the current economic

## The Elephant in the Courtroom (continued)



Illustration / Rafael Edwards

The restructuring plan also includes a few enhancements, and a consortium of contributing life insurance companies have committed to establishing a \$100 million “hardship fund” to be administered outside of the plan. These additional benefits may or may not prove to be meaningful, but they will not come close to making many annuitants whole.

### Failure of the Receivership Process

To understand the dilemma facing the current rehabilitator, it is helpful to go back to the beginning. *The 1992 ELNY rehabilitation Plan, like the Titanic, was doomed the moment it left port, and the current rehabilitator is the one left to deal with the consequences.* How was it doomed? The original rehabilitation plan stripped out all the traditional life and annuity business and transferred it to Met Life with the supporting, statutory reserve assets. These contract

holders received an equivalent policy from Met Life and suffered no material financial consequences. Unlike the typical property/casualty insolvency, where contracts are terminated, assets marshaled, and claims assessed and paid as of a pre-determined cut-off date, transferring policy obligations to another carrier or carriers has been the historic method of addressing financially stressed life insurance companies. The single premium individual annuities (SPIAs) did not fit this mold, however, and for whatever reason the most volatile, long-tailed book of ELNY business was left in ELNY together with its weakest assets.<sup>7</sup>

*The 1992 ELNY rehabilitation Plan, like the Titanic, was doomed the moment it left port...*

The assessment of the portfolio in the 1992 rehabilitation plan was remarkably prescient stating that:

The cash flows produced by ELNY’s bond investments and Common Stock dividends are projected to be sufficient to cover current SPIA payouts for at least ten (10) years.<sup>8</sup>

That is precisely what happened. The cash flow from ELNY’s remaining assets was sufficient to meet the SPIA payments for almost ten years as predicted. As shown by the annual reports of the Liquidation Bureau (unaudited for years prior to 2006) obtained over the years through Freedom of Information Law requests,<sup>9</sup> *ELNY’s cash flow went negative in 2002, ten years after the Plan of Rehabilitation and six years before the economic downturn of 2008* (see table).

To fully understand how ELNY could have been allowed to continue to pay full benefits while insolvent for a decade and with no action taken to address the inevitable, one must consider the receivership process in New York.

*Counter intuitively, when a company is placed in rehabilitation in New York the company ceases to be regulated.* The superintendent of insurance (now the superintendent of financial services), as rehabilitator, stands in the shoes of the company and is charged with its management. The superintendent delegates this management role to the Liquidation Bureau, a separate entity that acts solely as the superintendent’s agent in his non-regulatory role as rehabilitator. The rigorous statutory requirements for filings, reports or certifications imposed on other licensed companies are no longer imposed on estates in rehabilitation; there are no periodic regulatory reviews, examinations or communications; there is no regulatory oversight of the operations, assets or finances; and there is no mechanism for regulatory oversight of financial condition or

Year	Assets (\$Millions)	Liabilities (\$Millions)	Surplus/ (Deficit)	Percent of Coverage
1994	\$1,648	\$1,632	\$16	100.0%
1995	\$1,657	\$1,624	\$33	100.0%
1996	\$1,678	\$1,633	\$45	100.0%
1997	\$1,794	\$1,697	\$97	100.0%
1998	\$1,857	\$1,710	\$147	100.0%
1999	\$1,926	\$1,724	\$202	100.0%
2000	\$1,770	\$1,613	\$157	100.0%
2001	\$1,646	\$1,605	\$41	100.0%
2002	\$1,465	\$1,575	(\$110)	93.0%
2003	\$1,528	\$1,643	(\$115)	93.0%
2004	\$1,495	\$1,642	(\$147)	91.0%
2005	\$1,429	\$1,621	(\$192)	88.2%
2006	\$1,379	<b>*\$2,645</b>	<b>*(\$1,266)</b>	52.1%
2007	\$1,345	\$2,539	(\$1,194)	53.0%
2008	\$1,042	\$2,438	(\$1,396)	42.7%
2009	\$984	\$2,516	(\$1,532)	39.1%
2010	\$906	\$2,474	(\$1,568)	36.6%

\* Note: \$1.02 Billion added to reserves based on a revision to the life and annuity valuation basis as of 12/31/06.

compliance with the insurance law or regulations.

The Bureau often argues that it is subject to statutory oversight by each receivership court. However, receivership courts in New York are courts of general jurisdiction and not dedicated receivership courts like Federal bankruptcy courts. Also, courts generally only consider matters that are brought before them, and certainly do not consider themselves to be regulators. Even if they were so inclined, however, because there are no statutory requirements for filing any financial or actuarial statements or other periodic reports with the court, they would not have the tools necessary to do so.<sup>10</sup> And, curiously, the rehabilitator can change venue on its own *ex parte* motion.<sup>11</sup>

*From the time it was placed into rehabilitation in 1991 until after 2006 no audit of ELNY was required...*

That ELNY was insolvent for years and becoming progressively and irreparably beyond recovery was quite evident from a study of the Liquidation Bureau's own albeit limited published records. From the time it was placed into rehabilitation in 1991 until after 2006 no audit of ELNY was required or had been conducted. As shown on the chart above, the 2006 audit resulted in a 63% increase in reserves and a 650% increase in the stated deficit. This reserve adjustment was not a sudden awakening, however. Even before the audit the Liquidation Bureau

acknowledged that the reserve standard used in the annual statements were substantially understated. From 1998 through 2005 the Liquidation Bureau's unaudited statements for ELNY included the following note:

The Balance Sheet was prepared for the internal use of the New York Liquidation Bureau. Specifically, the Balance Sheet reflects the use of historic reserve standards solely for the purpose of comparison to prior periods. *The use of historic reserve standards substantially understates reserves when compared to reserves that would be required to satisfy regulatory requirements for a going concern insurance carrier.* As a consequence, the use or interpretation of these financial statements by anyone other than the New York Liquidation Bureau would be materially misleading. [*Italics added for emphasis*]<sup>12</sup>

This incredibly telling note begs the question: why weren't proper accounting and reserve levels required or maintained, particularly for an entity that was solvent at the time it was taken into rehabilitation to protect it and its policyholders?

## The Hearing

To many observers, the Court's approval of the rehabilitator's petition approving ELNY's liquidation and restructuring its remaining contracts was a forgone conclusion given the condition of ELNY and the statutory limitations. Although the decision gives the receiver and the guaranty funds the result they sought, a review of the testimony and arguments presented by all sides at the hearing provides a useful window on the issues that are likely to continue to haunt this estate and the receivership process in New York.

The rehabilitator argued that ELNY was insolvent to the tune of over \$1.6 billion, that it could not be allowed to continue to operate in rehabilitation and that the proposed plan was the best available outcome under the law considering the current condition of ELNY. Furthermore,

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## The Elephant in the Courtroom (continued)

the rehabilitator argued that under the proposed plan:

- The vast majority of annuitants (about 84%) will have no reduction in benefits;
- ELNY’s assets will be allocated pro rata to all contracts so there is no class preference;
- The life guaranty fund contributions are controlled by each state’s statute, and cannot be changed by this court;
- The relatively small number of annuitants whose benefits are reduced (primarily because of the limitations of guaranty fund coverage) will still be better off under the plan than in a straight liquidation; and
- If the plan were not approved, the commitments by the 40 participating guaranty funds and the voluntary enhancements provided by the consortium of 39 life insurance companies would likely be lost to the detriment of all annuitants.

Poignancy was brought to the proceeding by the appearance and emotional testimony of a number of “shortfall payees” – representative of the 16% of payees who will have their benefits reduced under the proposed plan, many by 50% or more. Among the principal points by these plan objectors were:

- Given the complexity and consequence of the proposed plan, the notice provided to payees was inadequate and untimely;
- The plan will be administered and overseen by the very people that caused the shortfall — the rehabilitator and his agents;
- The people most affected by the plan, the shortfall payees, were not consulted in the development of the plan and have not been given any reasonable opportunity to consider and propose an alternative plan;
- The requested judicial immunity for the rehabilitator and everyone connected with the plan and its implementation is unprecedented and unwarranted given the failed history of the rehabilitation;



Illustration / Rafael Edwards

- By placing the full burden of the shortfall on a small percentage of the payees, the plan is neither fair nor equitable, and creates an improper subclass of claimants; and
- Collectively these objections, including a denial of any right to opt out of the plan, constitute an unconstitutional taking of property without due process.

Understanding the ELNY math is important to fully appreciate the scope and effect of the plan on a small segment of annuitants. According to the report and testimony by the rehabilitator’s expert,<sup>13</sup> the market value of ELNY’s assets at year-end 2011 was \$957 million against an estimated current value of liabilities of \$2.604 billion, a shortfall of \$1.647 billion. Assuming a plan closing on or about July 1, 2012, the new entity would receive about \$1.691 billion in

assets to assume roughly an equal amount of current value liabilities, leaving in excess of \$900 million in present value liabilities uncovered.

Following is a breakdown of the contributions (in millions) to the new entity:

Remaining ELNY assets	\$ 919
Guaranty Fund Contributions	\$ 701
Life Insurance Company Contributions: <sup>14</sup>	\$ 71
<b>Total Funding for New Company</b>	<b>\$1,691</b>

The \$900 million remainder of current liabilities not assumed by the new entity is eliminated through the reduction in benefits to annuitants. But this reduction in benefits is not spread across the board.

## The Elephant in the Courtroom (continued)

As stated repeatedly by counsel for the rehabilitator and the guaranty associations, about 84% of all annuitants will continue to receive their full annuity payments under the restructuring plan. This means that about 8,150 of the 9,700 current payees will not have their benefits reduced or changed at all – they will continue to receive 100% of their future periodic and lump sum payments. *So the entire \$900 million in reductions is borne by the remaining 1550 payees, and all but 31 of these contracts are structured settlement annuities. The average loss in current value of benefits being borne by each of these 1550 annuitants is \$600,000!*

Shortfall annuitants who testified at the hearing included victims of trauma dependent on the income from their settlements for their basic quality of life; and people who put their life savings into an investment they were assured was fully guaranteed by the law and the insurance industry.<sup>15</sup> In the objectors' view, the financial burden of the shortfall is unfairly, and without due process, falling on the most vulnerable segment of annuitants. The plan proponents countered that the plan is a far better deal for all annuitants, including the shortfall annuitants, than under a straight liquidation, and that it was the best result under the law.

### The Elephant in the Courtroom

In the end, the court accepted the rehabilitator's arguments substantially *en toto*, concluding that the law gave him no choice but to either approve the petition and plan as presented or risk a straight liquidation that would put even more payees at risk of losing significant benefits.<sup>16</sup> Justice Galasso seemed to accept that he had little authority or flexibility to address issues raised by the objectors, although even in the court's self-imposed limitation of authority, he recognizes that there are a number of unresolved issues:

"This means, the scope of the hearing before the undersigned was limited by the Insurance Law and could not

include inquiries into why the insurer failed in the first instance, its investment and operation prior to failure, how the Superintendent and his agents supervised the affairs of the insurer, or why a settlement was not reached or this order to show cause brought before the Court sooner."<sup>17</sup>

*Justice Galasso seemed to accept that he had little authority or flexibility to address issues raised by the objectors...*

With several objectors vowing to appeal or take other action to seek redress for their losses, there are a number of legal issues relating to the ELNY rehabilitation and eventual liquidation that could linger in the courts for years, including:

- The propriety of the court including the rehabilitator's request for judicial immunity for himself and his agents in the signed liquidation order;
- Whether the up front netting of the guaranty funds' subrogation rights (so that no guaranty fund actually pays its full cap on any claim) contradicts the legislative intent of the caps;
- Whether the plan results in an improper sub-class of claimants — the shortfall annuitants;
- The scope of claim-over rights of shortfall annuitants against policy owners, insurance brokers, attorneys or others involved in the original settlements;<sup>18</sup>
- The role and rights of factors that acquired claim payments from annuitants;<sup>19</sup> and
- The scope of responsibility of the rehabilitator and his agents as fiduciaries for all ELNY policyholders and payees for the failed rehabilitation.

The fact remains that the \$1.6 billion loss occurred during twenty-year's of unregulated management by the proponents and overseers of the plan – the rehabilitator and his agents. Throughout the hearing

counsel for the rehabilitator succeeded in diverting attention away from an examination of the failed history of the rehabilitation arguing, among other things, that the original rehabilitation plan was approved by the court (It's the court's fault!); and the economic recession ate the assets! These arguments fail under scrutiny and are nothing more than smokescreens to hide the elephant in the courtroom: *New York's receivership system has failed ELNY, its policyholders and beneficiaries, as well as the insurance industry and its customers.*

### Who Protects Us from the Receiver?

Without any regulatory interference, and with little if any incentive to take remedial action so long as the cash flow permitted continuing payment on all annuities, the ELNY estate was allowed to move slowly toward the inevitable day of reckoning recognized by the 1992 rehabilitation plan. When economic circumstances worsened, and the reserve deficiencies became too significant to ignore, the pace quickened to the point where the inevitable could no longer be postponed.

If ELNY had not been in rehabilitation, and had been required to continue to file statutory financial statements, including annual independent accounting and actuarial certifications, it is highly unlikely that the regulators would have allowed it to get to the point where the estate is today. It is also inconceivable that the company's management and its agents would be allowed to propose and carry out a plan to correct its financial woes once it was materially impaired. If its dire condition had for some reason eluded the regulators, the company's officers and directors, its independent auditors, actuaries and other agents, could all potentially — and probably would — have been held accountable for their actions or inactions contributing to its failure.

With ELNY in rehabilitation, however, the parties charged with the management of the company for the past two decades are the proponents and overseers of the restructuring plan. And they sought



Illustration / Rafael Edwards

ELNY policyholders under the plan, but provides nothing more than the funds necessary for the ELNY liquidation. Therefore, once ELNY is liquidated, whether under the approved plan, some variation of the plan, or in a straight liquidation, the cap will be exhausted and no further funds will be available for any future life insurance company insolvency in New York without an act of the Legislature.

## Conclusion

The ELNY story is yet another consequence of the failure of the New York receivership process that took control of a solvent company and managed it for twenty years under the radar and without the most basic elements of accountability. The restructuring plan touted by the current rehabilitator and approved by the court may solve the immediate problem (at the expense of the most vulnerable group of annuitants), but it does not address the underlying systemic defects. Regulators, legislators, guaranty funds, and interested industry and consumer groups should thoroughly examine how ELNY got to this point – from its ill-conceived rehabilitation plan in 1992 to the steady, predictable but unchecked management of liabilities and erosion of assets leading to ELNY's current condition.

The rehabilitator failed in his mission to protect ELNY, its policyholders and annuitants due largely to a receivership process lacking in basic standards of accountability. The elephant needs to be recognized and properly addressed! ●

and obtained court immunity for doing so! The court's order includes the following provision as requested by the superintendent:

Judicial immunity is extended to the Superintendent in his capacity as Receiver and his successors in office, the New York Liquidation Bureau, and their respective attorneys, agents, and employees, and such immunity is extended to them for any cause of action of any nature against them, individually or jointly, for any action or omission by any one or more of them when active in good faith, in accordance with this order, or in the performance of their duties pursuant to Insurance law Article 74; . . .<sup>20</sup>

The New York Insurance Law does not provide immunity for the superintendent or his agents in his separate, non-regulatory role as receiver. The grant of judicial

immunity at the request of the rehabilitator further exacerbates the lack of accountability under the current receivership process in New York and raises the question: *if the court protects the receiver from us who protects us from the receiver?*

## Faux Protection?

ELNY's failure at the hands of the agents of the rehabilitator has also apparently exhausted the New York life insurance guaranty fund, so that following ELNY *there will be no viable life insurance guaranty fund coverage in New York.*

A bill working its way through the New York Legislature would increase the \$500 million aggregate cap for all life insurance company failures to \$558 million to cover funding of the ELNY restructuring plan.<sup>21</sup> This is an acknowledgement that the funds available to the life guaranty funds in New York are insufficient to meet their total obligations to the



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## The Elephant in the Courtroom (continued)

### Notes

1 Memorandum decision of Hon. John M. Galasso, JSC, Supreme Court of New York, Nassau County, Index No. 8023/1991, dated April 16, 2012. Justice Galasso also signed the order of liquidation as originally presented by the rehabilitator with his petition.

2 [www.elny.org](http://www.elny.org)

3 ELNY Plan of Rehabilitation, March 22, 1992, page 3.

4 Copies of the superintendent's petition for liquidation and the "Agreement of Restructuring in Connection with the Liquidation of Executive Life Insurance Company of New York," and other documents relating to the superintendent's petition and the plan can be found on the ELNY website, at [www.elny.org](http://www.elny.org).

5 According to the superintendent's petition for liquidation filed with the rehabilitation court on August 31, 2011, as of December 31, 2010, ELNY had \$905,945,201 in admitted assets, and \$2,474,317,343 in liabilities, for a deficit of \$1,568,372,142.

6 For example, if a New York annuity has a value of \$1 million, the restructured value under the plan is \$500,000 with ELNY's assets covering about \$170,000 and the guaranty fund covering the balance. Under this interpretation, where the life insurance guaranty funds net out their subrogation rights against the estate, no fund has to pay its full cap amount to any ELNY annuitant. The author gives no opinion on whether this is a correct application of the life insurance guaranty fund statutes.

7 It is also interesting to note that, in addition to receiving all the traditional business and related assets, the ELNY estate has paid a fee to Met Life since inception of the 1992 rehabilitation plan to administer the payment of benefits under the SPIAs.

8 ELNY Plan of Rehabilitation, March 22, 1992, page 12.

9 The FOIL requests were not made to the Liquidation Bureau, which has successfully argued in court that it is not a State agency and therefore not subject to FOIL (see *Dinallo v. DiNapoli*, NY Court of Appeals, 9 NY3rd 97, decided October 17, 2007). The FOIL requests were made instead to the superintendent of insurance as the recipient of the reports, not in his role as rehabilitator.

10 For a full analysis of the receivership process in New York, see my 2009 article, "The Insurance Insolvency Process in New York," which can be found on the Publications page of my website at <http://www.pbnylaw.com/publications.html>. This article was also published in two installments in the May 18 and June 1, 2009 issues of *Insurance Advocate* magazine.

11 NY Insurance Section 7421.

12 1998 through 2005 Annual Reports of the Liquidation Bureau under Section 7405(g) of the NY Insurance Law.

13 Expert Report of Jack L. Gibson, FSA, CERA, MAAA dated February 27, 2012.

14 This amount does not include a "hardship fund" of \$100 million purportedly being established by the consortium of life insurers outside of the plan. How the fund would operate — including the application process, criteria for coverage, decision-making authority and any right of appeal — were not addressed at hearing.

15 One of the annuitants testified that the acting superintendent of insurance at the time ELNY was placed into rehabilitation in 1991 assured him that his investment was fully protected by the life guaranty funds in New York. If a company representative or broker had made such an assurance, that individual would have been subject to discipline for violating Section 7718 of the Insurance Law.

16 For instance, the court, at p.2 of the decision, states: "It is important to note that in a liquidation proceeding, the Court's only authority by law is to approve or

disapprove the plan. A court cannot amend or supplement a plan to allow objectors to submit a proposed plan." However, there is precedent in New York for a court to do just that. See *In Re Constellation Reinsurance Company*, Sup.Ct., NY County, Index No. 043178/1986, in which Justice Shackman, in July 1992, not only entertained but also ultimately approved an alternative proposal to the liquidator's plan.

17 April 16, 2012 Memorandum Decision at p. 2.

18 In structured settlements, there are two basic kinds of annuity purchasers: so called "buy and hold" companies that remain obligated for the original settlement even after the purchase of the annuity; and those owners that made a "qualified assignment" of the settlement obligation upon purchase of the annuity, and who are therefore released from further obligation under the original settlement. There were no statistics presented at the hearing on the number of or breakdown between buy and hold owners and qualified assignments. There were also no statistics presented on the number of buy and sell owners that may not be solvent and are unable to meet any continuing obligation.

19 Over the years many ELNY annuitants have sold or factored some or all of their payments to companies specializing in the field of acquiring payment streams from annuitants and others in return for up-front lump sum payments. Again, there were no statistics presented at the hearing on the number or extent of such transfers by ELNY payees.

20 See footnote 1.

21 New York Senate Bill 6507A was passed by the Senate on March 29, 2012 and a comparable bill, A9607, was passed by the Assembly on May 21, 2012. At the time this article was prepared, the bill has not been submitted to the Governor for signature.

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# Who's Got Your Back?

Charles Huber

## A.M. Best's Treatment of Schedule F in the Rating Process

*The use of traditional reinsurance to provide capacity, stabilize underwriting results and protect surplus can play an important role in helping to determine the financial strength of property/casualty insurance companies. A.M. Best's assessment of a company's ceded reinsurance program begins with a discussion with management on the types, amount and cost of reinsurance that is used. Companies that increase their dependence on reinsurance reduce their net retained risk and capital requirements for that risk. However, capital requirements for the associated reinsurance credit risk are increased.*

The importance of an analysis of Schedule F depends upon the extent that reinsurance is used and how highly leveraged surplus is. Underwriting leverage is determined by evaluating current premiums, amounts to be recovered from reinsurance and loss reserves. Several factors are employed in assessing whether a company's underwriting leverage is prudent: the types of business written (i.e., short tail vs. long tail), the quality and appropriateness of the reinsurance program and the adequacy of loss reserves.

In recent years, catastrophe models used in evaluating property coverage have begun projecting higher potential gross loss estimates from hurricanes than previously thought. These models also predict that significant losses may occur further inland than previous forecasts. Some companies have questioned the results of those models and are taking a closer look at whether their reinsurance limits are adequate. Hurricanes are not the only worry. Catastrophic tornadoes



Illustration / Myers Creative

such as those that occurred in 2011 in Missouri, Alabama and other states, as well as earthquakes that ravaged Japan and New Zealand, along with an overall increase in other severe weather events have prompted companies to examine coverage for catastrophic property losses on an occurrence and on an aggregate basis.

Reinsurance credit risk is one component of overall credit risk evaluated in Best's Capital Adequacy Ratio model (BCAR). Schedule F Parts 3, 4 and 5 in the Statutory Annual Statement are important tools in assessing the quality of that credit risk and whether the credit risk is spread out among many reinsurers or concentrated in a few. A company's reinsurers are assessed for the quality of their financial strength and payment activities and whether amounts to be recovered under reinsurance can be easily collected.

Reinsurance recoverables from domestic and foreign affiliates are originally assessed a baseline charge of 10%. This charge may be adjusted, based on a thorough analysis of the affiliate's creditworthiness. For consolidated rating units (several legal entities that share the same rating of the parent or lead company in the group) with intercompany reinsurance transactions, A.M. Best eliminates those recoverables from the credit risk analysis. Recoverables from affiliates that are not in the rating unit remain in the credit risk analysis. In addition, recoverables from all affiliates remain in the credit risk analysis when performing an analysis of a company on a stand-alone basis.

Similarly for nonaffiliated reinsurers, A.M. Best's capital model starts with a baseline 10% charge for reinsurance recoverables. The capital model allows the analyst to assign variable risk charges based on each reinsurer's financial strength rating from A.M. Best. Those charges range from a low of 2% for a



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## Who's Got Your Back (continued)

reinsurer with a financial strength rating of A++ (Superior) to charges of more than 50% for reinsurers with ratings in the "Vulnerable" range, or for those not rated. Risk charges for unrated reinsurers could reach 100% unless additional information is provided, which may possibly result in a lower risk charge.

The use of unauthorized reinsurers (reinsurers not regulated in the ceding company's state of domicile) traditionally requires that the unauthorized reinsurer provide collateral to the ceding company by either depositing funds, setting up trust accounts whereby the ceding company is the beneficiary, or by providing the ceding company with an irrevocable letter of credit to offset statutory penalties. A.M. Best may consider these forms of collateral as an offset to amounts recoverable from a reinsurer. A thorough review of a letter of credit or trust agreement will reveal if there are any restrictions on the ceding company's ability to draw down on these instruments to satisfy their outstanding balances. Due to the associated transfer, timing and credit risks associated with letters of credit and trust agreements, A.M. Best typically allows for a maximum credit of 90% for the value of the letter of credit or trust fund that is not in excess of the outstanding reinsurance recoverable. Other risk factors may further reduce the credit. However, offsets tied to the occurrence of specific conditions before the collateral is posted might not receive an offset credit until the collateral option is exercised. The reason is that the collateral cannot be accessed until certain thresholds have been triggered.

Some companies may be considered overly dependent on unaffiliated and foreign-affiliated reinsurers, given their lines of business and financial resources. That would lead analysts to impose additional capital requirements or surcharges. For those insurers, A.M. Best increases the overall credit risk charge for their recoverable balances regardless of the underlying credit quality. This additional charge reflects the increased exposure to reinsurance disputes and

cash flow problems often experienced by companies that are unusually dependent on reinsurance.

*A thorough review of a letter of credit...will reveal...any restrictions on the ceding company's ability to draw down on these instruments to satisfy their outstanding balances.*

Higher exposure to dispute risk exposes a company's surplus to increased risk. A company with reinsurance recoverables equal to five times its surplus could lose 50% of its surplus should its reinsurer successfully dispute 10% of its recoverables. To recognize this exposure to dispute risk, A.M. Best employs two tests to measure a company's dependence on reinsurance. The first test compares the company's ratio of reinsurance recoverables from unaffiliated and foreign-affiliated reinsurers to an industry benchmark. The second test examines the company's total ceded leverage to thresholds of five, seven and 10 times its surplus. This may result in risk charges of 15%, 20% and 25% of recoverables from unaffiliated and foreign-affiliated reinsurers. A company's total ceded leverage is defined as its recoverables plus ceded written premium from unaffiliated and foreign-affiliated reinsurers as a ratio to surplus. The test for total ceded leverage is forward-looking as it includes not only existing recoverables but also the potential exposure to be added in the upcoming year.

The factor assessed for reinsurance dependence may be reduced for recoverables from foreign affiliates with a demonstrated history of substantial support, and that are expected to continue to provide support. In addition, the domestic company must be a significant contributor to the operations of the consolidated organization and the foreign affiliate must be located in a jurisdiction that would not hinder the quick transfer of funds that may become necessary to support the domestic company.

Ceding companies recently have explored purchasing credit enhancements that protect its reinsurance recoverables against the risk of becoming uncollectible. If those recoverables are insured by an unaffiliated third party with reduced credit risk, A.M. Best will reduce the risk charges. However, the factor assessed against reinsurance dependence may not change if the contract does not cover the possibility the amount cannot be collected because of a dispute.

Often times a company's ceded reinsurance program includes participation in mandatory or voluntary underwriting pools and associations. A.M. Best's BCAR model applies a charge of 10% to pools and association balances. These balances might be adjusted based on an evaluation of the creditworthiness of the pool and the state's regulatory environment. A.M. Best does not assess credit risk for ceded reinsurance associated with risk-free servicing-carrier business.

Reinsurance recoverable credit risk is just one component of total credit risk in BCAR. Underwriting risk, loss reserves and net written premium generally make up two-thirds of total net required capital in the model with the remaining one-third comprised of credit risk, investment risk, interest rate risk and business risk. Schedule F is just one tool in the evaluation of the appropriateness and quality of an insurance company's reinsurance program. This tool supplements in-depth discussions that A.M. Best analysts have with the senior management teams of interactively rated companies. ●



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## “Legacy Liabilities”

## Notes from Executive Membership Director

Some may refer to managing legacy books as managing run-off. An interesting comment that a member made to me recently was that, “What you write today will be your legacy book tomorrow.” He hit the nail on the head.

Whatever you want to call it, some companies are reluctant to recognize that every writer has a legacy book. So why should ongoing writers join AIRROC and how does AIRROC make a difference? Three reasons: education, networking and learning how to best leverage your legacy liabilities. Managing your legacy book effectively requires recognizing today’s trends and the legislative efforts which could affect many of us. To understand that, become an AIRROC member if you are not already in the fold. At AIRROC meetings, you will learn more about balancing legacy liability and asset management.

At AIRROC, we promote professionalism and integrity in legacy liability resolutions. With this effort, we seek solutions for our members. Through articles in our magazine, “AIRROC Matters,” we bathe in the wisdom of those most active in legacy management worldwide. And management trends differ little in the U.S., London, central Europe or Far East.

Networking is key. If you don’t need that relationship today, you most likely will need it tomorrow. Reinsurance coverage and companies may change over the years but the people basically remain the same. Most recognize that the reinsurance industry is not that large and the players will continue in one fashion or another.

### On my radar screen:

**Regional Education** – (see article below) coming soon to many cities so watch our website

**DRP Education** – workshops for further understanding of the process

As exemplified in our March education sessions, more of our members are taking an active role in education. Sharing experiences and methodologies is important. Breaking bread together, invaluable. ●



Trish Getty is AIRROC’s Executive Membership Director and a member of the AIRROC Matters Publications Committee. She has been active in the insurance/reinsurance industry for over 40 years. [trishgetty@bellsouth.net](mailto:trishgetty@bellsouth.net)

## AIRROC Education Going Regional

## Trish Getty

AIRROC has listened to their members’ opinions regarding the great value of our education sessions. We understand that budgetary constraints of several members prevent them from sending staff to our New York membership meetings. These employees could otherwise greatly benefit from our educational programs. As we focus on leveraging legacy liability, education is key to effective management of claims run-off. Many speakers are member participants with valuable experiences to share - experiences that could make a difference for our members and others as they manage their legacy book.

This year, AIRROC’s regional education sessions begin in Chicago on June 11, 2012. The sessions address

settlements or commutations directly connected with Schedule F, focusing on how to understand and use it as a tool in commutation negotiations. The program also includes a debate, or mock argument on current issues from the ceding and assuming companies’ perspectives. Let the debate begin!

Last year AIRROC provided education sessions in both London and the



U.S. All were well-received, cutting edge educational sessions, with no registration fee for members.

The development of the mock DRP (Dispute Resolution Procedure) presentation is underway. The mock presentation team includes AIRROC members who have used the process as an effective and economical solution to resolve smaller claims in dispute. AIRROC plans to roll out the mock in future regional education sessions in cities close to the majority of our membership.

Watch the AIRROC website ([www.airroc.org](http://www.airroc.org)) for upcoming education sessions.

AIRROC has its ear to the ground and continues to seek solutions. ●



## Fanfare for Fahey

The Board of Directors of the Association of Insurance and Reinsurance Run-off Companies (“AIRROC”) is pleased to announce that Carolyn W. Fahey has been chosen as the organization’s Executive Director.

“Carolyn brings to the organization the professionalism and experience to allow AIRROC to grow and execute its strategic plan and enhance the organization’s value added proposition for our Members” said Art Coleman, AIRROC’s Chairman.

Carolyn has a diverse background as an association executive with 17 years experience in educational initiatives, member and industry services, creative marketing techniques, and non-dues revenue sources.

She was with the Reinsurance Association of America (RAA) for 13 years – rising to Vice President & Director, Marketing and Communications. At the RAA, she worked with insurance and reinsurance industry experts to expand and develop the RAA’s educational programs and many key member services. She is known for her leadership on numerous RAA and industry committees, and her work on the curriculum for the RAA’s ReEd programs. Ms. Fahey played a key role in the creation of the RAA’s legal resource library—Digest of Reinsurance Caselaw, Compendium of Reinsurance Laws and Regulations, Reinsurance Contract Clauses, Manual for the Resolution of Reinsurance Disputes, RAA Arbitrators Directory.

Her immediate past position was with HB Litigation Conferences as the company’s Vice President of insurance and reinsurance programming and HB’s InHouse programs.

Ms. Fahey commented “I am extremely pleased to join AIRROC, which is viewed as being one of the leading organizations in the insurance and reinsurance industry. I look forward to the challenge of taking the organization into its next stage of development.”

She can be reached by email at [carolyn@airroc.org](mailto:carolyn@airroc.org) or by phone at 703-730-2808. ●

## AIRROC Educational Session Summaries March 2012

*A membership meeting was held from February 29 to March 1 at the offices of Dewey & LeBoeuf. Two of the sessions are summarized by Connie O’Mara and Bina Dagar below. The third session—“How to Read/Understand Schedule F”— is the subject of an article by Charles Huber of A.M. Best, moderator of that panel, entitled “Who’s Got Your Back?” (see page 17)*

## Tightening the Belts and Suspenders

### Panel Discussion on Collateral/Security

Summarized by  
Connie O’Mara



Recent seismic changes in the regulatory and banking environments have impacted the use and forms of collateral in reinsurance business.

The state of this aspect of the reinsurance market was the topic of a panel discussion moderated by George Mitchell, Vice President Reinsurance Finance, Chartis.

Mindy Kipness, Senior Vice President, Chartis, opened the discussion with an overview of the key roles of collateral/security as a way of managing credit risk in the reinsurance business: 1) collateral may be required by government regulation, or 2) it may be a component of the contract between the parties; 3) it may be used to manage counterparty risk, and 4) it may be required during a legal dispute as “pre-answer security.”

Robert Quinn, Senior Vice President, Wells Fargo Trust Group, then discussed the forms of collateral in use in the market and the current banking environment. The financial crisis has made traditional Letters of Credit considerably more expensive and harder to obtain. Reinsurers, cedents and captives are using alternatives. A fairly simple alternative is a “Funds Withheld” arrangement (pre-funded deductible program). But since this option transfers the asset from the depositor’s balance sheet, it is not as attractive as a “Collateral Trust” arrangement. In the latter, the assets in trust remain on the client’s balance sheet as restricted assets. Assets that can fund such a trust must be financial assets such as cash or secure investments but many facets of the

## AIRROC Educational Session Summaries March 2012 (Continued)



arrangement may be negotiated between the parties.

Myra Lobel, Managing Director, Guy Carpenter, provided a detailed overview of recent watershed changes in the regulatory arena. “Credit for reinsurance” laws and regulations have changed in response to competitive pressure from non-US jurisdictions that do not require collateral from unauthorized reinsurers. New York, Florida, New Jersey and Indiana have changed their laws and regulations (each with specific requirements and restrictions) to allow full credit to be taken without full funding of obligations. Numerous unauthorized reinsurers have now applied for and been approved for eligible status in the above states. (Florida and New York have special listings on their insurance department websites; for decants domiciled in Indiana and New Jersey, queries should be made to the relevant department). After a long running “soap opera” of debate on this issue, as part of the NAIC’s Solvency Modernization Initiative, the NAIC examined the need for the US regulatory regime to meet European equivalency standards. In November of 2011, it adopted amendments to its model law and regulations on “credit for reinsurance” which, if adopted, allow a state to declare reinsurers meeting collateral reduction eligibility requirements as being “certified.” New Jersey was the first to use the new NAIC law to propose regulations (2/21/2012).

*After a long running “soap opera” of debate... the NAIC examined the need for the US regulatory regime to meet European equivalency standards.*

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Circling back to the first part of the day’s agenda, Myra noted that when accounting for reduced collateral on Schedule F, cedents should reflect the difference between collateral required and the reinsurer’s total obligations in the “Other Allowed Offset Item” column in Schedule F, Part 5.

Putting this in the larger context of national regulation and global markets as a preface for his Legislative Update (the final section of the day’s educational program) Charlie Landgraf (Dewey & LeBoeuf LLP) provided insight on the impact of the Dodd Frank Act on collateral requirements. The Federal Insurance Office (FIO) within Treasury is empowered to make agreements with other countries on insurance matters. FIO is also to determine when State measures are inconsistent and preempted by those agreements. Non-domestic reinsurance credit rules will be preempted if the ceding insurer’s domestic state is NAIC-accredited; and the ceding insurer’s domestic state allows credit for the ceded reinsurance. If a reinsurer’s domestic state is NAIC-accredited, then the domestic state will

be solely responsible for regulating the financial solvency of the reinsurer; and no non-domestic state may require the reinsurer to provide any financial information other than the information the reinsurer is required to file with its domestic state. ●

Connie O’Mara of O’Mara Consulting, LLC, practices in the areas of arbitrations, mediations, and expert review. [connie@cdomaraconsulting.com](mailto:connie@cdomaraconsulting.com)

## What’s Ahead Legislative Update/ Forecast for Insurance Run-Off Industry

Summarized by Bina Dagar

The Dodd-Frank Act, which encompasses Wall Street reform and consumer protection, is as complex as it’s described to be. Charles Landgraf of Dewey & LeBoeuf started with summarizing the elements of the Act. New entities and requirements currently in process are:

- Financial Stability Oversight Council (FSOC)
- Federal Insurance Office (FIO)
- FDIC Resolution and Assessment Authority
- Volcker Rule
- Extension of Broker-Dealer Fiduciary Duty to Investment Advisors



Additionally, on July 21, 2011 regulatory changes to the transfer of Thrift Holding Company Supervision to Federal Reserve and Non-admitted and Reinsurance Reform Act (Title V, Subtitle B) took effect. The latter has two major parts: Surplus Lines Reform and Reinsurance Reform.

The FSOC has 15 members representing all Federal and State financial regulators including Roy Woodall, voting insurance expert; Michael McRaith, non-voting FIO Director and a Presidential appointment; and John Huff, non-voting Insurance Commissioner chosen by the States. Federal Reserve, SEC, Treasury Department, FDIC all fall under this Council's umbrella. The Council is charged with automatic heightened supervision of designated failing insurers. Under the proposed Rule, any non-bank financial institution, such as large insurance companies that pose systemic risk, will also receive Federal Reserve supervision at a macro level. The consequences for an insurer of being thus designated are to implement enhanced prudential standards at the holding company level. These include Financial Impact through enhanced capital, leverage & liquidity and counter-party credit limits; Governance ensuring management of liquidity and Board of Directors' risk committee requirements; and Oversight and Reporting requiring supervisory

and company-run stress tests with incremental public disclosure.

To the extent that the FIO Director determines that a state insurance measure is inconsistent with a covered agreement or results in less favorable treatment of a non-U.S. insurer, the FIO may preempt these measures; this is a potential tool to use on Solvency II with Europe and will force an agreement between U.S. and Europe. A system of transition or delay could be agreed between the two. The core European complaint is that the NAIC Model Law is not a prudential rule; rather, it is a blunt tool and one that treats the likes of Swiss Re and Lloyds equally with "Taliban Re".

*The core European complaint is that the NAIC Model Law is not a prudential rule; ...*

FIO Director was obliged to provide a comprehensive report to Congress by January 21, 2012, a missed deadline. The forthcoming report must focus/examine ways to modernize and improve the system of insurance regulation in the U.S.

Federal Advisory Commission on Insurance (outside of Dodd-Frank) has one foreigner, Lloyd's, and one reinsurer; the rest are state commissioners and industry and consumer groups. Their first formal meeting was set for March 30, 2012.

The Volker rule applies to state financial laws that are not safe for any insurance product. The statute requires agencies to accommodate the business of insurance within an insurance company. Regulations on Volker rule don't exist yet and are now due in July 2012. Federal agencies will retain authority to enforce the Volcker Rule against insurers if they find state laws are insufficient to protect the soundness of the financial institution.

*Regulations on Volker rule don't exist yet and are now due in July 2012.*

Anticipated Congress Actions in 2012:

- National Flood Insurance Program (NFIP) chronically runs in the red; therefore, Congress will authorize use of actuarial tools; this piece of legislation is most likely to be enacted this year.
- Holocaust Insurance Accountability Act would authorize lawsuits in U.S. on 1933-45 policy claims.
- Iran Sanctions Enhancement would sanction insurers of marine or other covers of vessels involved in Iran petroleum or WMD shipments.
- Miscellaneous Dodd-Frank repeal/change/clarify, e.g. FIO's subpoena powers over insurance companies. ●

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## News &amp; Events

Nigel Curtis

## INDUSTRY NEWS

## Hartford to Sell Life Business

The Hartford Financial Services Group is exiting the annuities and life insurance businesses to focus on property and casualty insurance, placing its individual annuity business into runoff. The insurer stopped selling new annuities effective April 27 and expects to spin off or sell its individual life business.



## Chadbourne &amp; Parke Named as Outside Legal Counsel to AIRROC

The international law firm of Chadbourne & Parke has been selected as outside legal counsel for AIRROC. Chadbourne, which is well known in insurance and reinsurance circles and has been a long-time supporter of AIRROC, will represent the association on the full range of its legal issues. Chadbourne partner David Raim and counsel Susan Aldridge will lead the representation.

Mr. Raim is the chair of Chadbourne's reinsurance and insurance group. Ms. Aldridge has nearly 20 years of experience representing insurance and reinsurance companies. Her active involvement with AIRROC includes chairing educational seminars in New York and London. Mr. Raim and Ms. Aldridge are resident in the firm's Washington, DC office.

## Dewey &amp; LeBoeuf Exodus

On May 28, Dewey & LeBoeuf filed for Chapter 11 bankruptcy in the U.S. Bankruptcy Court for the Southern District of New York following lower-than-expected profits, concerns over compensation, high debt and liquidity constraints. Over 160 of its 300 partners had resigned by May 11.

Among the exodus, James R. Woods, co-chairman of the firm's global insurance industry practice, left for Mayer Brown. Leading insurance attorneys John Nonna, Larry Schiffer, Eridania Perez and Suman Chakraborty joined Patton Boggs' commercial litigation practice in New York.

John Pruitt and Cynthia Shoss, the New York-based leaders of the firm's insurance regulatory practice; and Jeffrey Mace, head of the firm's Lloyd's of London and Lloyd's Market practice, as well as James Dwyer, managing partner of the Chicago office were signed on by Sutherland Asbill & Brennan.

Another twelve insurance partners, including Michael Groll, co-chair of the insurance sector group, left for Willkie, Farr & Gallagher, and Peter A. Ivanick, a bankruptcy partner specializing in insurance, moved to Hogan Lovells.

## PEOPLE



**Robert V. Deutsch** has joined the board of directors of Enstar's wholly-owned subsidiary, Enstar Holdings (US) Inc., the ultimate parent company of Enstar's U.S. operations. Mr. Deutsch was the founding Chief Executive Officer of Bermuda-based specialty insurer, Ironshore Inc., and prior to that he served for five years as Chief Financial Officer of CNA Financial Corporation.

## MARK YOUR CALENDAR

July 18-19, 2012

AIRROC Membership Meeting  
New York City, USA[www.airroc.org](http://www.airroc.org)

September 7-13, 2012

Rendez-Vous de Septembre  
Monte Carlo, Monaco[www.rvs-monte-carlo.com](http://www.rvs-monte-carlo.com)

September 20, 2012

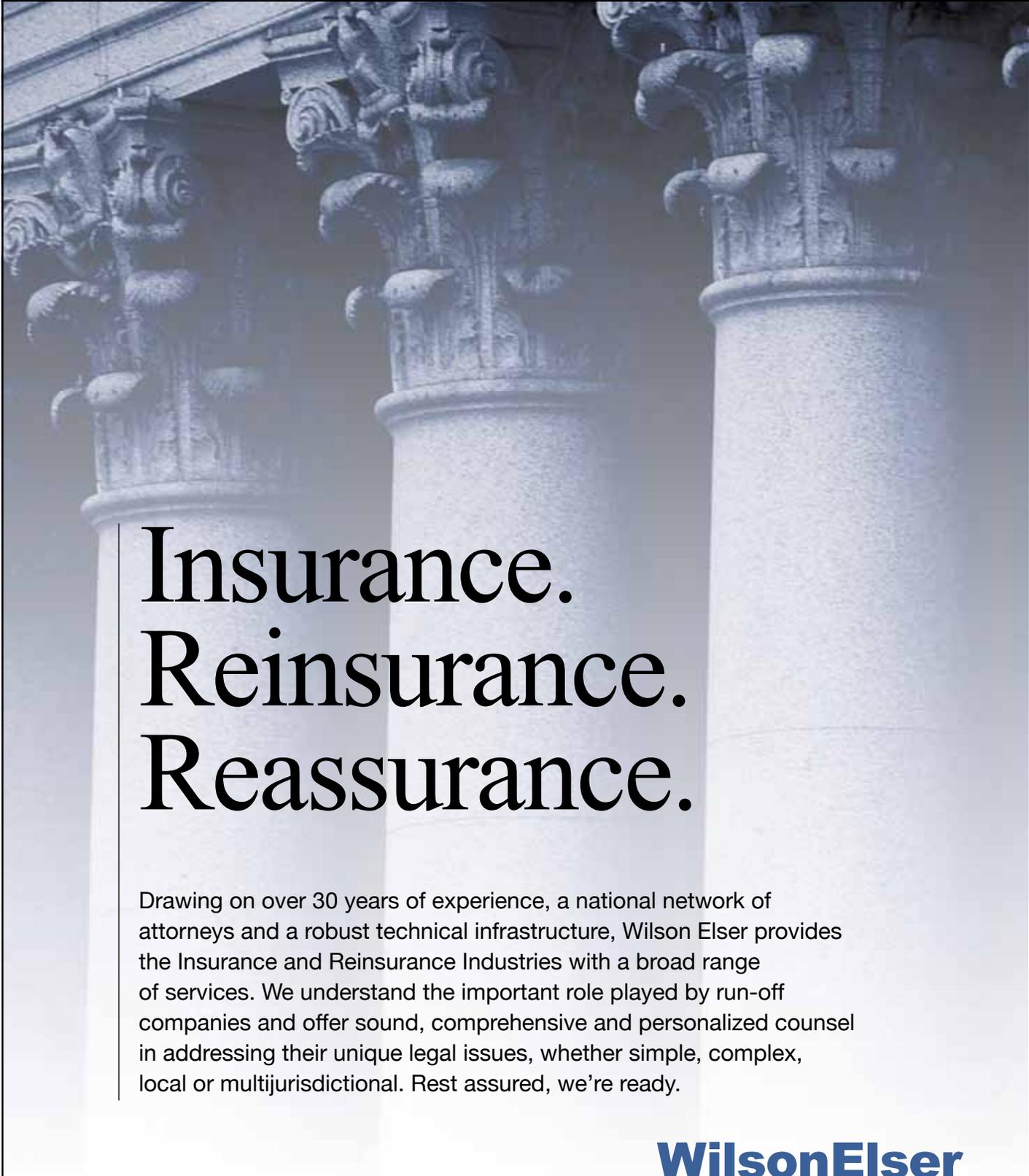
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October 14, 2012

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**Carolyn Fahey** has joined AIRROC as Executive Director. Her immediate past position was as a Vice President at HB Litigation Conferences. Prior to that she was a Vice President at the Reinsurance Association of America.

If you are aware of items that may qualify for the next "Present Value", such as upcoming events, comments or developments that have, or could impact our membership, please email **Nigel Curtis** of the Publications Committee at [ncurtis@fastmail.us](mailto:ncurtis@fastmail.us).



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## Off the Cuff

Maryann Taylor

### David Vaughan on Life after Run-off



*David Vaughan, the Chief Operating Officer of Tawa, plc sat down with Maryann Taylor of Boundas, Skarzynski, Walsh & Black, LLC for an interview with AIRROC Matters in which David discussed his experiences in moving from insolvencies to investing in acquiring legacy portfolios, as well as Tawa's move from being a pure run-off risk owner towards being a multi-segment investor in the live insurance market.*

**Maryann Taylor:** *Thank you very much David for agreeing to participate in this interview. Please tell us about your background and how you started out?*

**David Vaughan:** Well I was quite interested in a bank career and so when it came to university I studied economics and accounting. I qualified as a Chartered Accountant with Deloitte Haskins & Sells as it was then called, and later worked for both RTZ at a zinc smelter and Standard Chartered Bank in credit finance. I then joined Coopers & Lybrand's Management Consultancy focusing on Financial Services where in January 1987 I was asked to work "for one or two weeks" on an insolvency which was going badly: there I linked up with Coopers' insolvency arm, Cork Gully and dealt with two people, a partner who was very well respected and just died in May 2012, Gerry Weiss, and his senior manager

at the time, Phillip Singer, who will be well known to a lot of the readers. Both were leaders in the industry and I was assisting with the run-off of an insolvent insurer. After a few weeks, my boss within Management Consultancy advised that he was getting positive feedback on what I was doing and asked if I would stay with it and make a career move. The operation was relocated from London to Bristol where I then lived. So I became involved in run-off, totally by accident. That was the beginning of the journey.

**Maryann:** *In the late 1980s, early 1990s, insolvencies were infrequent in the UK such that a small insolvency would come along every few years. Would it be fair to say that it was not a vibrant market at that point in time?*

**David:** Yes and there was absolutely no career path at that point. We were of the

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## Vaughan Interview (continued)

view that the work would end shortly, but in 1992 there was this big bang in insurance insolvencies. The financial problems affecting Lloyd's (through the creation of Equitas) also affected the rest of the insurance market. Claims spiraled, predominantly from the US, but also because of bad underwriting and it created a lot of insolvencies. Also, quite a few broker insolvencies occurred and our run-off operation just blossomed.

In the beginning, there were two employees in Bristol, which grew to a staff at one stage to about 50 people. That operation was a good training ground with many having done very well, such as Andy Ward at PwC, Kevin Gill at Ernst & Young.

**Maryann:** *What changes to the market did you see as the run-off industry matured?*

**David:** It was very busy between 1992 to about 1995. Phillip Singer, who was quite entrepreneurial, thought up the idea of solvent schemes as a way to bring finality to run-offs. Prior to that I can recall doing the conference circuit in the US where I would always joke that run-off was a club you could join but you never leave because you never knew when the last claim was coming in and you could only leave when that last claim arrived. Schemes allowed companies to ascertain their last claims by actuarial evaluation and it meant that run-offs as a result could be closed. We started applying that to a few insolvencies; Cambridge Re in Bermuda, Halvanon, Charter Re and Fremont in the UK, to name a few.

We thought that if this can work for insolvents, why can't this be applied to solvent run-offs? We started doing it. The first one that I was involved with was Mutual of Omaha UK, which was one of the very earliest solvent schemes in the UK. Mutual of Omaha was paying an exorbitant amount in run-off costs. In closing down their book, that company realized cost savings and creditors were paid in full. This set the trend for solvent schemes to be used to finalise UK run-offs.

**Maryann:** *How did Tawa come about?*

**David:** A group of us from PwC, including Colin Bird, Phillip Singer, Jonathan Bank and Marvin Mohn began thinking about investing in Property and Casualty run-offs. The game plan was to purchase the run-off rather than just advising. We started looking at run-off as an investment opportunity, and analyzed the value that could be extracted by applying our skills. We left PwC and set up Tawa in May 2001.

*We started looking at run-off as an investment opportunity, and analyzed the value that could be extracted by applying our skills.*

I am proud Tawa has thrived and now 10 years later, we are still going strong and expanding into new markets. Tawa is now a UK AIM quoted company with over \$200 million net worth. We have created something which is long-standing, with approximately 400 employees worldwide. Originally centered in the UK, we have recently expanded into the US, Germany and Argentina with our purchase of Chilmington and our investment in Lincoln General, so it is a wide-spread organization.

**Maryann:** *What is your current role in the organization?*

**David:** I am a director of Tawa and Chief Operating Officer. More recently, I was the CEO of Pro, which is our service arm. I now have an oversight role with respect to Pro and focus more on our portfolio of risk carriers that we have acquired. The first run-off we purchased was CNA Re London, which had \$2.2 billion of liabilities. We renamed the company CX Re. We now have a portfolio of six insurance entities in run-off. I am also involved in our new project incubations; Q360 is a wholesale broker that we just launched and Lodestar, a marine MGA which

writes P&I business. STRIPE is another fairly new web-based initiative. I am also responsible for liaising with our US operations. So quite a varied role: quite different from my insolvency origins.

**Maryann:** *You mentioned that CX Re was the first acquisition, can you tell us about that experience and what stands out as you made that change from consultant to risk bearer?*

**David:** We set up Tawa in May 2001 and by April 2002 we had agreed to terms on CX Re. We completed the transaction after regulatory approval in November 2002. CX Re was owned by CNA, who was experiencing some difficulties. Initially the transaction was to sell CX Re to Tawa for \$1; Tawa then invested \$25 million to show the regulators it had "skin in the game".

It was quite a roller coaster ride. CX Re had \$2.2 billion of liabilities with segments that were very volatile. There was an APH segment, both direct from Fortune 500 companies and also from US cessions and in later years CX Re had tried to become a market leader, expanding in a soft market by taking large lines without much reinsurance.

CX Re was personally a dramatic change of scene: I had been a partner at PwC and suddenly I am dealing with on-going companies who were angry because CNA Re London had been underwriting up to about June 2001 and now they were dealing with a different owner, a company in run-off with a limited balance sheet and high liabilities. Quite naturally they wanted their money paid as quickly as possible.

The brokers and our counter-parties were accustomed to receiving payment very quickly with very little claims scrutiny. We enhanced the claims procedures by looking at the placing information, the wording and requesting more detailed claims presentations in order to gain a sufficient understanding. A lot of our counter-parties thought this was unreasonable.

At the time we received complaints from some of the big brokers and large

## Vaughan Interview (continued)

insurers in both the UK and the US about CX Re's claims practice. We had a wonderful regulator at that stage, Paul Taylor, who was very practical. He said to us, "There's nothing wrong with what you're doing, you just need to explain your claims process to the outside world." So we followed his advice and the "noise" went away.

We de-scaled CX Re from \$2.2 billion to currently approximately \$140 million, half of which was accomplished through commutations.

One of the skills that you acquire from legacy is an in-depth claims knowledge. The CX Re claims personnel are now working for our service arm, Pro. They are outsourced on current Lloyd's Syndicates and are now part of the current market, having transitioned from run-off to the live market which previously never seemed to happen.

**Maryann:** *What do you see as some of the obstacles in transitioning a run-off labor force to the live market and how do you believe those hurdles can be overcome?*

**David:** Run-off had the reputation of a place where perhaps lower skilled staff went; however, there has been a real change to that perception. Run-off has become more professional, more strategically focused, with more resources invested into the process, systems and staff.

We are seeing that in London, the current market has experienced very good results and has not had to deal too much with claims issues. Now, dealing with Solvency II which is also focusing on claims, there is a lot of strain on resources. The current market is seeking additional claims personnel and they are sourcing that experience from the legacy market.

**Maryann:** *You mentioned Tawa's investment in Lincoln General. Tell us about Lincoln General and what type relationship you have with the regulators?*

**David:** Lincoln General is a problem company. The Pennsylvania Department wanted owners that they could have a good working relationship with and that

has proven to be quite beneficial since we took control of Lincoln. The Department has been very supportive of our strategy for improving the policyholder's position. Lincoln is a very narrowly solvent company and our efforts are producing returns for policyholders, but it is still a very volatile situation.

*Run-off has become more professional, more strategically focused, with more resources invested into the process, systems and staff.*

I do not think the Department necessarily has expectations that Lincoln will be completely rehabilitated and avoid some sort of receivership. However, if, in fact, at some point it does go into rehabilitation, Lincoln will be much better off in that it will be smaller and easier for the State to handle. The value added will not necessarily be the end result but getting to the end result.

The transaction with Lincoln has given Tawa two things: a foothold in a restructuring position within the US, as well as a staff of 60 or so that we can refocus over time in to the service industry. In other words, it has given critical mass to our service arm.

**Maryann:** *Yes, it sounds like you tap your resources throughout the organization to respond to changing circumstances.*

**David:** That is a good observation. We have made significant investment recently on work flow process and moving from paper to imaging. I am a great supporter of imaging and we have linked it up with workflow, mirroring modern day industry's processes. Imaging is quite sophisticated and for a run-off, files are your lifeblood which cannot ever be lost.

The flexibility allows us to move in a direction where the more menial tasks are being performed by junior staff at

cheaper locations. This frees up our senior staff to focus on the serious claims issues. It is far more effective and we have achieved significant savings as a result. Pro, our service arm is also process reengineering its clients, leading to some impressive turnaround and cost savings.

**Maryann:** *Can you explain what you mean by "process reengineering" and give us an example?*

**David:** Well STRIPE is a classic example when you are performing a task and realize, you can do something better. The idea for STRIPE came from our experience with commutations. Every time we were working on a commutation, the cedent would have a different set of numbers that did not match up with our records. In most instances, the broker had not yet reported them to us. In reality, it is not surprising because there is a time lag between when a cedent presents a claim and when the claim presentation eventually reaches all reinsurers.

STRIPE is a Web based system that enables you to compress or eliminate the time lag. A master file of contract documentation is maintained on the system, as well as key claims history and it enables the cedent to load on to the Web based system the claims details, the supporting documents, and the payment requests.

At the press of a button, the information is securely submitted to each reinsurer instantaneously — by way of an email with a Web link. The reinsurer can then immediately access the Web link and download all the information and relevant documents. Any claims discussions or questions can be transmitted through the system, so there is a record on the system.

It is a pretty neat bit of work. I am surprised other people have not thought about it because it actually dramatically shortens the reporting process. Cedents dealing with a broker face a black hole: they do not know what the broker has or has not been doing.

Reinsurers also face barriers: requesting a loss update from the broker is a manual



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## Vaughan Interview (continued)

task that costs the broker money. The broker actually has to go right back through the chain to the cedent. It is inefficient and the turnaround time drags on and often the reinsurer gets no response so its claims get older and out of date. A major current market issue facing London is how to keep claims up to date. Direct communication between cedent and reinsurer would be a benefit.

**Maryann:** *What has been the broker market reaction to STRIPE? Do they see it as infringing on their territory?*

**David:** Well I think the broker community has a slightly mixed reaction. On one hand, brokers maintain that they provide their clients with a valuable service. However, from what I see on legacy books, in fact even for current clients, the broker turnaround time is generally too slow. You have to ask why the broker wants to handle claims, especially on legacy business as it is not cost effective or practical. I think the broker is balancing reputation with current clients with the fact that from a claims processing standpoint, they are just re-inputting information that started off electronically in the first place. It costs the brokers money and they do not do a proper job and need to change: cedents want control of the process and speed. Brokers need to figure out their optimal value-add in the claims sector and to eliminate reprocessing.

On the other hand, brokers generally like STRIPE when dealing with the system because it solves their dilemma: how to provide a service, when they are not set up to do it in the technologically efficient manner that today's market demands?

**Maryann:** *Getting back to the topic of transitioning from run-off to supporting the current market, what skill set have you found beneficial in expanding from the legacy sector into the live market?*

**David:** We have redeployed our infrastructure knowledge, basically redeploying people from their run-off function to a similar type of role in the current market. We also have a very talented technology unit and have

managed to harness their expertise to enhance current systems and processes. Run-off is described as a melting ice cube. You are always reducing in size if you are successful; whereas in live business you are growing. It is a slightly different environment but the skill set is transferable.

**Maryann:** *Do you see this cross-over from run-off to live market as a growing trend?*

**David:** *Now I am not sure if this is good news or bad news to AIRROC members, but certainly in the UK run-off is becoming a very small sector of the market. This is not the case as much in the US because the legal methods to reduce run-off or bring finality to run-off are not as prevalent.*

The reason we transitioned into the live market was because of the UK's declining run-off market. Pro had two big clients, the English and American and the WFUM pools, whose work has now largely ended, and was facing a brutal truth. If you do not advance into the current market you will be out of a job. This is emblematic of run-off if you are successful.

We started strategically looking to where we could employ our skills and one solution was infrastructure in two areas: start-ups and sub-scale businesses because they normally cannot afford the best systems and are therefore inefficient and face control issues. In the UK for instance, compliance with FSA is very difficult and a start-up may only need 25% of a compliance officer's time. Yet from a quality and efficiency standpoint, 25% of a compliance officer is unobtainable. So the idea of providing a best in class infrastructure was a natural progression and this is what we have executed for both our broker and MGA incubation operations. The client is able to access a vibrant business platform which is cheaper and better than what they could achieve by themselves. The client also benefits from our expertise, control and knowledge about the pitfalls and hazardous landscape.

**Maryann:** *Do you believe the US is following the same path and going to face the same issues as the UK?*

**David:** Yes, people do not want to be button-holed directly in the run-off, they want to be able to morph into supporting current business. Run-off is always renewing; there are always new run-offs. The question I have is in the UK the ability to reduce exposure and accelerate finality is less of a problem, whereas, I wonder in the US whether it is as easy to achieve. Basically, the London market run-off was a legacy problem that has now been largely resolved. It was a backlog problem but legal mechanisms, such as Schemes and policy transfers, allied with increased buyer capacity have now dramatically descaled the UK run-off market's size. I do not know how the US is going to deal with that and the challenge is whether the US can proactively achieve that same end result.

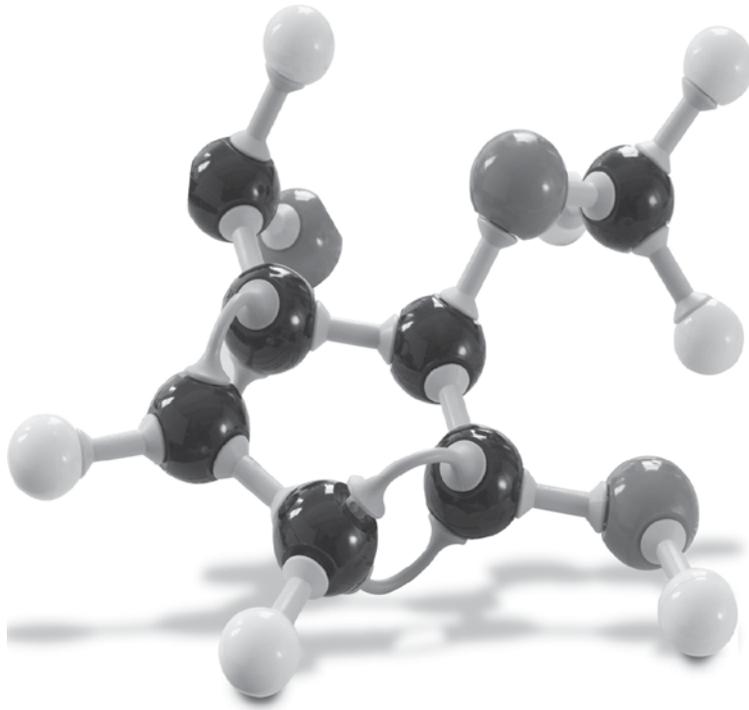
Some of the legal solutions are advancing in the US, such as the Rhode Island statute and I understand there might be a Part VII equivalent in one State shortly.

Market consolidation will be the next phase. We found in the UK as the run-offs decrease in size, they become sub-optimal and need to be consolidated from a cost perspective. The company could become a portfolio in a larger company and you will not then have the accounting, the compliance overhead. I believe consolidation will probably begin to happen in the US.

**Maryann:** *Thank you David for your time and insight.* ●



Maryann Taylor is a Principal of Boundas, Skarzynski, Walsh, & Black, LLP and concentrates her practice on reinsurance and insurance regulatory matters. [mtaylor@bswb.com](mailto:mtaylor@bswb.com)



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# Resign, Replace, Resume

Daryn E. Rush, Thomas E. Klemm

## Recent Decisions on Arbitration Panel Vacancies



*Courts have looked at panel vacancies that occur through unforeseen events, such as the death of an arbitrator, differently from resignations.*

As a general rule, subject to important exceptions, most courts have held that when a member of an arbitration panel dies or becomes too ill to proceed, the arbitration must start over from the beginning before a new arbitration panel. Courts have held that this is the only fair outcome because requiring a party to name a replacement arbitrator could put that party at an unfair disadvantage. A replacement arbitrator, for example, could be joining the proceeding late in the game and face a steep learning curve or other disadvantages. Generally, the courts have rejected the “start over” rule in the context of arbitrator resignations due to concerns that parties and arbitrators might use resignations to manipulate the process. If the “start over” rule applied in the resignation context, a party might be tempted to ask its arbitrator to resign in order to delay the proceedings or to get a fresh start in an arbitration that is not going well, a so called “strategic” resignation. While by

no means commonplace, such tactics, unfortunately, have been known to occur in reinsurance arbitrations. Thus, courts have rejected the “start over” rule in the case of resignations due to the concern that such resignations might, in fact, be “strategic.” No doubt, courts recognize that distinguishing “non-strategic” resignations, such as an arbitrator resigning due to concerns about partiality or workload, from “strategic” resignations would in many cases be difficult, if not impossible, and would require a very fact intensive inquiry. Three recent decisions reflect judicial concern over whether a party can replace an arbitrator and the circumstances that should be evaluated to avoid manipulation.

*... courts have rejected the “start over” rule in the case of resignations due to the concern that such resignations might, in fact, be “strategic.”*

The Second Circuit decision in *Ins. Co. of N. Am. v. Public Serv. Mut. Ins. Co.*, 609 F.3d 122 (2d Cir. 2010) (“INA”) establishes a baseline analysis by dealing

with the resignation of a panel member due to serious illness. Notably, in this case, the court did not compel the parties to start over with a new panel. After the panel had granted summary judgment to the cedent, Public Service Mutual Insurance Company (hereinafter PSMIC), but before a motion for reconsideration could be heard by the panel, the arbitrator that had been appointed by INA (the reinsurer) resigned, stating he could not effectively continue his service to the parties. The parties and the remaining panel members could not agree on how to proceed. INA wanted a new panel. PSMIC wanted INA or a court to appoint a replacement arbitrator. The Second Circuit held that the general rule applicable when an arbitrator dies (i.e., starting over) does not apply when an arbitrator resigns. Instead, the arbitration process must proceed with a replacement arbitrator without starting over. The key to the court’s decision was the threat of manipulation. The court held: “applying a broad rule requiring that a new panel be convened to vacancies occasioned by resignations would open the door to significant potential for manipulation.”<sup>1</sup> While such potential for abuse is “not present in the case of an arbitrator’s death” it is very real in



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## Resign, Replace, Resume (continued)

cases regarding resignations.<sup>2</sup> Although the court emphasized that there was no allegation of manipulation present, and in fact one could label this a “non-strategic” resignation, the court feared that “it would be tempting for a party to pressure its party-appointed arbitrator, implicitly or explicitly, to resign following an adverse ruling so that it could get another shot at winning before a new panel.”<sup>3</sup>

*...the arbitration process must proceed with a replacement arbitrator without starting over.*

These concerns outweighed any counter-arguments, including any argument regarding prejudice to the party that lost its arbitrator. As the court held:

given the potential for manipulation and the waste inevitably occasioned by convening a new arbitral panel, we find that this potential unfairness is not sufficiently strong to require application of the [“general”] rule to resignations.<sup>4</sup>

In the *INA* case, in fact, the Court directed that the original arbitrator, who had recovered during the appeal, be reappointed. When he refused the appointment, *INA* was directed to choose a replacement. While only a handful of other courts have dealt with the matter, they have produced rulings consistent with the Second Circuit’s decision in *INA*.<sup>5</sup>

### The Special Problem of “Strategic” Resignations

As discussed above, central to the decision in *INA* was the risk that a party-appointed arbitrator, at the request of the party or at his own behest, might resign from a panel as a tactical maneuver in an effort to force a new arbitration. The *INA* rule — that with such resignations the arbitration process does not start over but simply continues with a single replacement arbitrator — was specifically crafted to avoid the potential for abuse and manipulation.

*Even under this rule, however, there remains the potential for manipulation of the process through strategic resignations.*

Even under this rule, however, there remains the potential for manipulation of the process through strategic resignations. Strategic resignations might be attempted in order to delay the proceedings, to replace an ineffective arbitrator or to change the dynamics of the panel. Arbitrations are often fluid proceedings, and they can veer in directions not anticipated by the parties at the start. In such circumstances, it may become apparent that a particular arbitrator was not the best choice. The secondary challenge that arises in the context of arbitrator resignations is a challenge to whether the arbitrator should be allowed to resign at all or whether the party who appointed the arbitrator loses its right to select a replacement.

Although such strategic resignations have almost certainly occurred, until very recently there were no court decisions discussing such circumstances. Interestingly, however, in 2011, two separate courts dealt with this very issue. Not surprisingly, these courts focused on the same issues that other courts have considered when addressing other arbitrator vacancies (i.e., death and “non-strategic” resignations): the prejudice to the party who lost their party-appointed arbitrator and the potential for abuse and/or manipulation. While both courts ultimately allowed the resignations to occur, one court did so hesitantly and only based on the unique facts present in that case, suggesting that in other situations such resignations might not be allowed.

#### 1. *Northwestern National*

In *Northwestern National Ins. Co. v. Insko, Ltd.*, 2011 U.S. Dist. LEXIS 50789 (S.D.N.Y. May 12, 2011) (“*Northwestern National*”), *Insko Ltd.* (“*Insko*”) requested that all members of a three-person arbitration panel resign due to alleged conflicts of interest. *Insko*’s

party’s arbitrator resigned. The other two members did not. Thereafter, *Insko* contacted the umpire and the opposing party, *Northwestern National*, “reiterating that it sought a new panel and informing [*Northwestern National*] that *Insko* would select an additional party-appointed arbitrator.” *Northwestern National* then filed a petition requesting “judicial appointment of an ARIAS-certified arbitrator to replace *Insko*’s arbitrator.”<sup>6</sup> When *Insko* later named a specific replacement arbitrator (who was ARIAS certified), *Northwestern National* objected.

The court allowed *Insko* to name a replacement arbitrator. Citing *INA*, the court acknowledged the general rule that resignation of a party arbitrator does not require the arbitration to start over. Although the court recognized that the arbitrator had been specifically asked to resign, the court nonetheless allowed a replacement. The court reasoned: “[t]he replacement of one arbitrator during arbitration does not create the same incentive for manipulation as would allowing for the arbitration to begin anew with a fresh panel.”<sup>7</sup> Thus, the court did not appear to consider the threat of manipulation or abuse caused by a potentially strategic resignation to be significant. It held: “[e]ven if a party pressured its party arbitrator to resign and replaced him or her with an arbitrator more likely to rule in its favor, it could not affect the rulings of the other two arbitrators.”<sup>8</sup>

#### 2. *IRB*

The Southern District of New York dealt with the “strategic” resignation issue in late 2011. The court ultimately allowed the resignation but only after expressing concerns regarding the practice and noting that a few key facts existed to minimize the potential for abuse and waste. In *IRB v. Nat’l Indem. Co.*, 2011 U.S. Dist. LEXIS 136640 (S.D.N.Y. Nov. 29, 2011) (“*IRB*”), under a complicated set of facts, National Indemnity Company (“*NICO*”) asked its party-appointed arbitrator to resign from a panel two years after the arbitrator was

## Resign, Replace, Resume (continued)

nominated. The arbitrator complied and resigned, and NICO sought to nominate a replacement. IRB-Brasil Resseguros S.A. (“IRB”) objected to the new appointment and filed a petition requesting, *inter alia*, that the court prohibit NICO from changing its party-appointed arbitrator or, alternatively, to permit IRB to choose NICO’s arbitrator.

The court allowed NICO to choose its own replacement arbitrator. Its analysis begins by acknowledging that courts have held (perhaps universally) that the party whose arbitrator resigns is free to select a replacement arbitrator. The court concluded that this was the only fair outcome holding that “[t]o deny [party] the party-appointed arbitrator of its choice would... deprive it of a basic expectation in entering the arbitration agreement” and “[t]he fact that the arbitration agreement is silent on a specific method for replacing arbitrators does not, by itself, vitiate [party’s] entitlement to this right.”<sup>9</sup>

In this case, however, the court expressed concern that the original arbitrator was specifically *asked* to resign and stated that it was “hesitant to ratify NICO’s choice of [replacement arbitrator] given that NICO directly solicited the resignation of its original selection.”<sup>10</sup> It went on to explain that while the “risk of manipulation” was less in the resignation context because (unlike the death context) the arbitration does not start all over, the court was “wary of creating an unfettered right to alter the composition of an arbitration panel” as “[s]uch a right would enable parties to endlessly delay the arbitration process.”<sup>11</sup> The court

further explained “such a rule would inject an intolerable level of uncertainty into the arbitration system.”<sup>12</sup>

*... the court expressed concern that the original arbitrator was specifically asked to resign ...*

But, despite such concerns, the court allowed the replacement arbitrator to serve on the panel due to “two reasons specific to the facts” of the case.<sup>13</sup> First, the arbitration had not proceeded very far — indeed, the whole panel had not yet been constituted. The relatively undeveloped status of the proceeding minimized the risk of delay and the likelihood of prejudice to the opposing party. Second, the replacement arbitrator was serving on another arbitration between the same parties. The court noted that inasmuch as IRB had requested that the two arbitrations be consolidated, having the same arbitrator on both panels “would only seem to bolster” IRB’s request for consolidation.<sup>14</sup> In other words, the court implied that NICO’s replacement would probably benefit IRB.

### Conclusion: Proceed with Care

The court decisions above highlight the competing public policy considerations courts evaluate when confronting issues regarding “strategic” resignations. The *Northwestern National* court focused on the right of a party to proceed with the arbitrator of its choice and concluded that the risk of abuse or manipulation

was minimal.<sup>15</sup> The *IRB* court focused on the threat of abuse and manipulation that “strategic” resignations caused but also closely examined mitigating facts that reduced these threats and the potential prejudice to the opposing party.

These cases appear to establish a fairly clear rule that parties will generally be permitted to replace party-appointed arbitrators — even when the proceeding is already underway. The cautionary language in the *IRB* case, however, suggests that there are likely circumstances in which a court would not allow an arbitrator to be replaced. As evidenced by the *Northwestern National* decision, the mere fact that a resignation occurs at the specific behest of the party is not necessarily considered a manipulative act such that the resignation will not be allowed. Prejudice is the key, and it must be considered from both sides. ●



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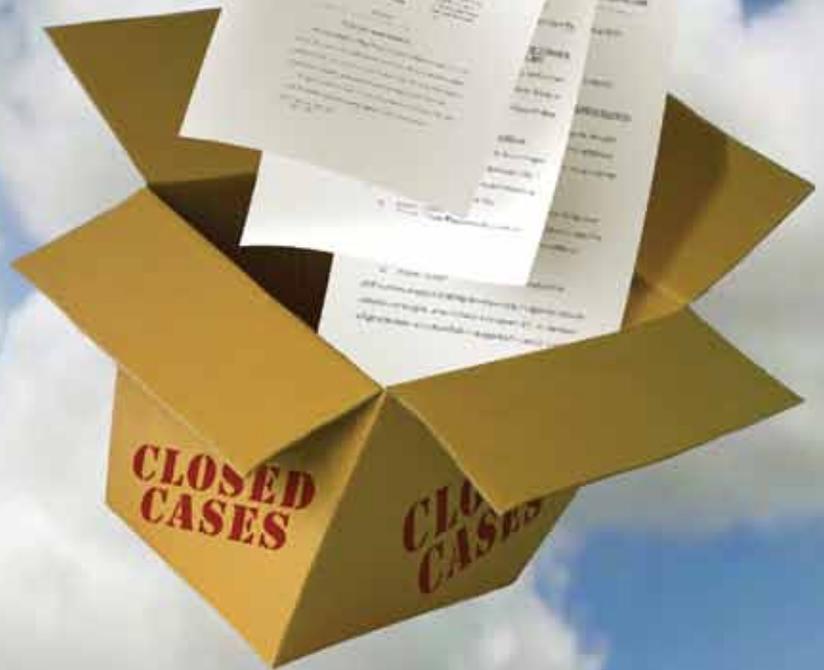
### Notes

- 1 *Id.* at 130.
- 2 *Id.*
- 3 *Id.*
- 4 *Id.*
- 5 *WellPoint, Inc. v. John Hancock Life Ins. Co.*, 576 F.3d 643, 646-47 (7th Cir. 2009); *Nat’l Am. Ins. Co. v. Transam. Occidental Life Ins. Co.*, 328 F.3d 462, 465-66 (8th Cir. 2003).
- 6 *Id.* at \*5.
- 7 *Id.* at \*12.
- 8 *Id.*

- 9 See *IRB*, 2011 U.S. Dist. LEXIS 136640, at \*11-12 (noting opposing party could cite to no cases in which “a court has displaced a party’s selection of a replacement arbitrator after that party’s initial choice has resigned”) citing *Northwestern National*, 2011 U.S. Dist. LEXIS 50789, at \*7 (“[N]either this Court nor either party has found any case where a court selected a replacement party arbitrator that differed from the one selected by the party.”)
- 10 *Id.*
- 11 *Id.* at \*12-13.
- 12 *Id.* at \*13.
- 13 *Id.*
- 14 *Id.* at \*13-14.
- 15 While never citing the case, the court’s decision is very similar to *Wellpoint Health Networks, Inc. v. John Hancock Life Ins. Co.*, 547 F. Supp. 2d 899 (N.D. Ill. 2008). Here, the court made a very similar decision regarding “strategic” resignations with the court stressing the need for a party to freely select and choose the arbitrator it wants in an arbitration.

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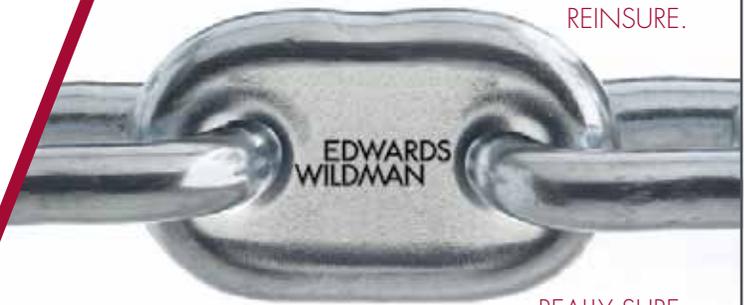


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