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Old Assets, New Tricks: Insurance Portfolio Management in the Twenty-first Century

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INTRODUCTION

By the beginning of this century, many U.S. companies had invested a significant effort in recovering lost insurance assets. Two decades of rapid acceleration in the pace of merger and acquisition activity on the one hand, and litigation on the other had led to broad recognition that an organization’s historic insurance assets were easy to lose track of—and very valuable. In particular, organizations with significant exposure to asbestos, environmental, or product liability claims were likely to have had some experience with insurance archaeology, a term that came to denote not only recovery efforts for specific lost policies but also broad-based projects to reconstruct and organize their historic insurance portfolios.

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Change accelerates apace, and in the early years of the current century, many organizations have found that a one-shot insurance audit is not enough: insurance asset management requires constant updating and maintenance. Heightened activity on three fronts—changes in corporate identity, erosion of insurance assets via insolvencies and run-offs, and a fresh surge of environmental activism coinciding with the first rumblings of global warming litigation—have made the task of maintaining the historic insurance portfolio more essential and more challenging than ever.

Companies faced with exhaustion and erosion of insurance assets have been spurred to look more closely at documenting gaps in the key programs within their portfolio. Gaps that may have seemed insignificant or manageable only a few years ago may now be critical to fill. Whether companies are just starting an audit or are focusing on gaps remaining from prior audits, the objective is clear: document as much coverage as possible and pursue solvent coverage while it is still available.

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At the same time, current business conditions have heightened the difficulty of reconstructing of these gaps in the historic insurance portfolio. Consolidation inevitably causes institutional memory loss. Records disappear as a company reorganizes—often spinning off operations that later return to compete for coverage under the corporate policies. Information is also lost through the imperfect transition of legacy computer systems as well as through the inevitable layoffs attending every merger. Even companies relatively unaffected by consolidation themselves are subject to the effects of consolidation within the insurance, brokerage, professional services, and storage industries when they seek to track down insurance records.

Companies have had to adapt their insurance recovery efforts accordingly. While the task is more challenging than ever, the massive expansion of information available on the Internet coupled with improved data mining techniques have increased the resources available to track down missing coverage. Software and record-keeping techniques have also been developed to facilitate the ongoing tracking of insurance assets by companies that have learned the importance of keeping their insurance portfolios up-to-date and organized.

This article examines the trends in litigation, insurance industry practice, and M&A (mergers and acquisitions) that are turning insurance portfolio management into a core component of risk management. It then outlines the new tools and techniques developed to meet the challenges of insurance asset recovery and ongoing insurance portfolio management.

INSURANCE PORTFOLIOS UNDER SIEGE

Insurance archaeology exists because insurance policies often last longer than the companies that bought them and the carriers that wrote them. Companies merge, spin off, go public and then private again, change locations, and go global. Liabilities often emerge decades after a triggering event, and have become a constant fact of corporate life. Old “occurrence-based” insurance policies live as long as the liabilities that were triggered during the policy period (in fact, like wines and violins their value often increases with age, as older policies have fewer exclusions and sometimes contain no aggregate limits). Ever-shortening institutional memory, ever-lengthening liability nets, and policies of enduring value together create an ongoing need to maintain the historic insurance portfolio.

ENVIRONMENTAL LIABILITIES: GETTING HOT AGAIN

Like geopolitical conflict, environmental and asbestos liability seemed to abate somewhat in the 1990s. A 2002 RAND report noted, “By the early 1990s, asbestos litigation appeared to have stabilized” (Carroll et al., 2002). In 1997,

however, the Supreme Court reopened the asbestos floodgates by striking down a settlement that would have barred people claiming asbestos exposure from filing suit unless they became sick. By 2002 Tillinghast-Towers Perrin was projecting total costs to reach \$200 billion by 2049 (Beronson, 2002). Subsequent attempts to reach a global settlement have failed repeatedly, and asbestos bankruptcies continue apace.

After a long lull, environmental enforcement has picked up more recently. A 2006 report on National Enforcement Trends by the EPA's (Environmental Protection Agency) Office of Compliance and Enforcement shows a clear trend starting in 2006 to reverse previous flat or dropping enforcement. In 2006 EPA inspections were at their highest level ever, 23,231, up from 17,560 in 2001. Administrative enforcement penalties, which ranged from \$23.8 million to \$29.3 million from 1998–2005, jumped to \$42.0 million, and Penalty Order Complaints totaled 4,647, more than twice any previous yearly total (Environmental Protection Agency, 2006).

The 2006 elections will likely spur further environmental action. Senator Barbara Boxer, D-California, now Chair of the Senate's Environment & Public Works Committee, declared a commitment days after the election to "reclaiming the bipartisan consensus in favor of great environmental protection" (Boxer, 2006) The elections also brought in a fresh cohort of attorneys general inclined to continue the trend towards active environmental enforcement, including Andrew Cuomo in New York, Gary King in New Mexico, and Jerry Brown in California.

Cuomo lost no time in setting a new tone, moving in February 2007 to sue Exxon Mobil and four other companies to clean up a fifty-year-old spill of an estimated eight million of gallons of oil lying under Brooklyn's Greenpoint neighborhood and to repair environmental damage inflicted on nearby Newtown Creek. That same month Cuomo appointed Katherine Kennedy, well-known for twenty years of environmental activism, as the Special Deputy Attorney General for Environmental Protection, announcing that "she will be a leader in our efforts to prosecute polluters and defend our natural resources" (Cuomo, 2007).

In June of this year, announcing six alternatives for cleaning up the most polluted section of the Passaic River under an accelerated plan, regional EPA Administrator Alan J. Steinberg voiced a similar commitment to aggressive enforcement when he proclaimed, "Let there be no mistake about it, we will get this river cleaned up and make it a jewel of New Jersey." The total cost estimate of the options developed by EPA and other agencies to clean up just this eight mile stretch of the river exceeds \$2 billion (Passaic River Coalition, 2007).

The uptick in environmental enforcement actions has doubtless been driven in part by surging awareness of global warming. The Supreme Court decision in *Massachusetts v. EPA* not only enjoins government regulation of

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greenhouse gases (GHGs) but also potentially opens the litigation floodgates. The Court's finding that Massachusetts has standing to sue because it showed that global warming had caused real injury to its environment may enable suits against GHG producers, not only by government agencies but potentially by anyone claiming property damage or bodily injury (Davis and Paul, 2007).

In addition to litigation pressure, companies are facing demands by activist investors, organized under the auspices of groups including the Investor Network for Climate Risk and the Calvert Group, to disclose their environmental liabilities and risks more fully. This imperative is also exerting pressure on companies to audit their historic insurance portfolios to demonstrate that they have assets to offset these environmental liabilities.

The liability risks of global warming may be mitigated by concerted action on the part of government, industry, and the insurance industry. Conversely, global warming could trigger a litigation tsunami that dwarfs the asbestos wave. Whichever way these threats play out, marshalling its historic insurance portfolio is an essential part of any organization's due diligence on the environmental front.

THE EROSION OF INSURANCE ASSETS

The unceasing drumbeat of litigation over the past several decades has exhausted many companies' policy limits and driven many carriers into insolvency. An alarming number of carriers are now running off old liabilities while policyholders contend with protracted and uncertain negotiations as their assets erode in the process. In the United Kingdom these challenges are further complicated by the emergence of solvent schemes of arrangement, in which solvent London Market companies set a bar date by which policyholders must settle standing claims and negotiate the estimated value of future liabilities.

While insurance company failures are relatively rare, over the course of decades they impact a large percentage of users. Historically, the annual failure rate in the U.S. for all insurance companies has ranged between .3 percent and 1.4 percent (Schatt and Hepler, 2007). These figures fail to capture the impact of insolvencies on companies with significant asbestos, environmental, and product liability claims, upon whom the largest failures in recent decades have had a disproportionate impact. The failure of the Mission Insurance Cos. in 1985 epitomized the worst case scenario for policyholders, who waited twenty-one years before the liquidation was complete and claims were settled. Like Mission, several of the largest insolvencies struck insurers that had written a large share of the liability coverage sold in the 1950s, 1960s, and 1970s, a period when policies were less restrictive than at present and in which the bulk of environmental and asbestos liabilities that staggered so many companies in the decades following were triggered. Global Risk Capital, a private

equity firm that purchases uncollected corporate insurance assets, estimates that companies with significant A&E and product liabilities typically have a 10–30 percent insolvent component in their historic coverage.

Far larger than the percentage of the insurance industry in insolvency is the percentage in run-off. In Europe, according to a 2007 PricewaterhouseCoopers survey, discontinued insurance business exceeds E204 billion, with more projected in the upcoming year (Shillito Market Intelligence, 2007). In the U.K., total liabilities in run-off in the nonlife market were approximately 40 billion GBP in 2006 (Brewer, 2007), approximately 20 percent of the market. In the U.S., according to a 2006 Task Force Report of the Connecticut Department of Insurance, there are approximately 500 insolvent and 400 solvent U.S. insurance companies in run-off. The report estimates global reserves in run-off at \$300 billion, with U.S. companies accounting for approximately half the total (Connecticut Dept of Insurance, 2006).

In the U.K, a “scheme of arrangement,” under section 425 of the Companies Act of 1985 is an agreement between a company and its creditors to run-off the company’s liabilities according to an agreed schedule and rules. While insolvent schemes of arrangement have been in use for some time, solvent schemes are a fairly recent innovation. Under a solvent scheme, an insurance company proposes to finalize all its liabilities by a fixed “bar date,” settling all claims and future liabilities, theoretically at full value, by that date. The proposed plan must be approved by a majority in number and 75 percent in value of those voting at the scheme meeting. If the scheme is approved, a court must sanction it (Keenan, 2006).

Solvent schemes present many potential problems for policyholders. Most importantly, there is the risk of missing two deadlines: the meeting at which the scheme is voted on, and the bar date by which claims must be settled. A company that does not have a complete analysis of its London Market coverage may easily miss either date. Being prepared also affords options. Private equity firms can estimate the value of a company’s IBNR, claims that are incurred but not reported, and purchase those assets before the seller loses the value of these assets on the bar date.

While U.S. policyholders have contested solvent schemes in British courts, it is likely that the courts will uphold the practice, perhaps with some adjustments to ensure fairness to policyholders (Keenan, 2006). The continued use of solvent schemes provides one more impetus for policyholders to stay on top of their historic insurance assets.

MAINTAINING THE INSURANCE PORTFOLIO IN AN M&AD WORLD

The pace of mergers and acquisitions has been especially hard on companies’ ability to reconstruct missing insurance coverage. This task has become

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ever more complex in the past decade as merger and acquisition activity, globalization, and outsourcing have rapidly accelerated. According to a recent *Financial Times* report, the number of global mergers and acquisitions more than tripled between 1995 and 2006, from 9,251 to 33,141, while the aggregate value of transactions more than quadrupled, from \$850 billion to \$3,861 billion (Wolf, 2007). According to Dealogic, global M&A volume in the first half of 2007 was \$2.88 trillion, a 55 percent year-on-year increase over 2006's record pace (Basar, 2007).

With every merger, corporate records disappear. When a company is researching missing insurance coverage, this problem is compounded by consolidation within the industries of its natural partners in the search. Insurance carriers and brokers, accounting firms, law firms—all have been transformed by mergers up and down the food chain. In all of these industries, mergers result not only in the outright loss of records but in a degraded ability to retrieve data stored in legacy systems that have been imperfectly integrated.

The merger process takes its toll on human memory as well. Mergers of course are generally accompanied by layoffs, as well as by the voluntary departure of employees who see the handwriting on the wall or take the opportunity to cash out.

In a sense, every merger is like a small stroke, destroying synapses that enable memory retrieval. Over time, sustained retrieval efforts and targeted “therapies,” such as reconciling current and former data fields within merged systems, can restore much of what was lost. But the process is strenuous.

INSURANCE ARCHAEOLOGY: CORE TASKS AND NEW CHALLENGES

Over the past two decades insurance archaeology has developed a well-defined set of procedures for assembling and maintaining as complete an insurance portfolio as possible. Those procedures have been extensively publicized and incorporated to the point that they are now considered best practices in risk management. What was once considered to be a once-in-a-corporate-lifetime effort to organize historic insurance records, locate missing policies, and chart the coverage history is now often merely Phase I in an ongoing process of reconstructing an insurance portfolio that changes with every acquisition, major claim, or insurance company move into run-off.

TWENTY-FIRST CENTURY SEARCHES: DATA MINING AND DIGITAL FORENSICS

Over the years, insurance archaeologists have been portrayed as Indiana Jones—raider of the lost archive—but this colorful image is a relic of a bygone era. Today, insurance archaeology research is still painstakingly detailed but

highly technical. Data mining techniques, digital forensics, online research, and information management strategies have evolved to cope with wide-scale loss of information and to take advantages of technological advances.

The records storage industry has transformed the management of paper records. Storage vendors now provide companies with electronic access to information on indexing the content of tens of thousands of boxes of records. While access may be instantaneous, it is often incomplete—thanks in large part to consolidation within the storage industry itself. Critical information on coding, dates, locations, and even description fields has often been lost in the transfer of legacy systems in this industry. Identifying the relevant boxes is now a byzantine research project in itself and often requires running key word searches, cross-referencing codes and department names, and comparing descriptions from various indices prepared at different points in time.

In addition to paper records, the legacy systems of acquired companies or files from obsolete in-house systems often contain information in an electronic or digital format that can document missing insurance or provide leads to outside sources. If old floppy discs, backup tapes, and hard drives of old computers can be found, a forensic search of the full contents of the drives may enable valuable data recovery.

ONLINE RESEARCH

Much of the detective work in insurance archaeology involves identifying possible outside sources of records, such as names of former employees, brokers, outside counsel, and additional insureds. In an era when nearly every firm has merged and moved several times, and in many instances spun off some operations, the Internet has revolutionized the ability to identify successor firms and to locate former key personnel. Securities and Exchange Commission (SEC) filings, as well as numerous Web sites, can provide crucial leads in the reconstruction of a corporate history and leads to potential outside sources of documentation of missing policies.

Web sites of national phone directories can be utilized to locate former employees, brokers, and lawyers. Interviews with these key people often provide leads to brokers' records, court cases, law firms, and government agencies. Insurance archaeology projects increasingly focus on identifying and pursuing these outside sources.

Online searches often lead the researcher to hard copy records located in courts and government agencies. In the past, simply locating these buildings and the appropriate people within them was often a painstaking and time-intensive process. Today, an online search generally brings up the information relatively quickly. Westlaw and Lexis searches can also provide information on past litigation that may have involved third-party liability coverage. Copies

of policies have been retrieved from both the court records as well as the files of defense counsel in these actions.

PRESERVING THE PORTFOLIO OF HISTORIC INSURANCE ASSETS

The return on investment of time and resources to locate and organize the records will be greatly enhanced if the complex and detailed coverage information for each insurance program is input into a database and illustrated on charts. The ability to quickly search hundreds of policies issued to numerous named insureds will save critical time when notifying insurers and dealing with their inevitable demands for records and policy information. The charts can be used to illustrate several complex issues at a glance:

- Key coverage terms, e.g., the application of policy limits
- Aggregate limits that have been exhausted
- Carriers in insolvency or run-off
- Remaining gaps in the records
- Type of documentation available

The advantage of a visual presentation lies chiefly in the immediacy with which priorities can be identified and the monetary issues can be quantified. Understanding the complexities of a historic insurance portfolio at a glance is instrumental in formulating effective recovery strategies and negotiating with scores of insurers.

Once the insurance record is complete, the next challenge is to maintain a database flexible enough to track key terms and conditions of each policy and changes in policy language over time. By establishing clear procedures for entering new information for future acquisitions and renewals of the corporate program on an ongoing basis, the entire coverage history can be maintained in a consistent and accessible format.

As a final safeguard, the policies can be imaged so that the value of such an intensive logistical effort will be preserved in the event of a future merger or natural disaster.

AN ASSET FOR ALL SEASONS

The corporation that has quick access to its entire insurance portfolio is prepared for the predictably unpredictable challenges of the twenty-first century. Whether the challenge is notifying hundreds of insurers over several decades of toxic tort litigation or environmental actions, dealing with competing claims for the same policy limits from former subsidiaries, or enhancing sale value in a merger or real estate transaction, the return on investment from

continually updating a historic insurance audit will be dramatic. Millions of dollars of coverage will be preserved and at the ready.

“The past is never dead. It’s not even past.” In a global business environment that seems to undergo generational change every five years, Faulkner’s dictum may seem out of place. But it’s the literal truth when it comes to liability and insurance. Keeping musty old insurance assets green is one of the keenest managerial challenges facing today’s corporations.

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