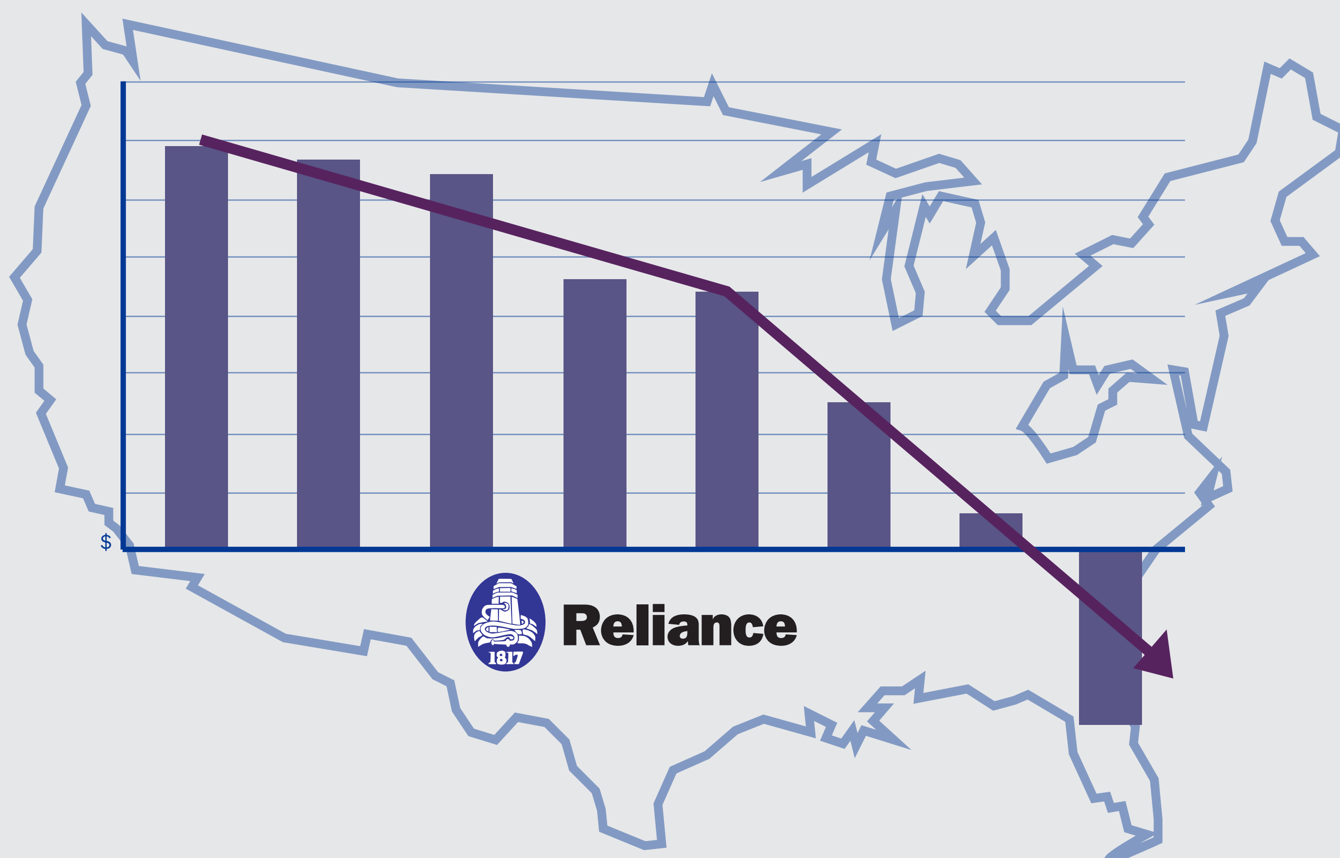
PACICC

Property and Casualty Insurance Compensation Corporation
Société d’indemnisation en matière d’assurances IARD

Why insurers fail

Lessons learned from the failure of Reliance Insurance Company



By

Ian Campbell

The latest instalment in the PACICC *Why insurers fail* series.

2020

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PACICC's mission and principles

Vision

To be, and to be recognized as, the authority in Canada supporting the resolution of severely distressed home, auto and commercial insurance companies.

Mission Statement

The mission of the Property and Casualty Insurance Compensation Corporation (PACICC) is to protect eligible policyholders from undue financial loss in the event that a Member Insurer becomes insolvent. We work to minimize the costs of insurer insolvencies and seek to maintain a high level of consumer and business confidence in Canada's property and casualty insurance (P&C) industry through the financial protection we provide to policyholders.

Principles

- In the unlikely event that an insurance company becomes insolvent, policyholders should be protected from undue financial loss through prompt payment of covered claims.
- Financial preparedness is fundamental to PACICC's successful management support of insurance company liquidations, requiring both adequate financial capacity and prudently managed compensation funds.
- Good corporate governance, well-informed stakeholders and cost-effective delivery of Member services are foundations for success.
- Frequent and open consultations with Members, regulators, liquidators and other stakeholders will strengthen PACICC's performance.
- In-depth P&C insurance industry knowledge – based on applied research and analysis – is essential for effective monitoring of insolvency risk.

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Executive Summary

This study examines the 2001 insolvency of Reliance Insurance Company in the U.S. and the implications this had for its Canadian Branch. The Reliance insolvency is notable for many reasons, including:

- the largest insurance company insolvency in U.S. history, with costs totaling over $4 billion;
- wholesale change in this once-staid company's risk appetite following a corporate takeover;
- the size of the company, extent of its operations and flaws in its corporate structure;
- a negative $3.4 billion change in the company's capital position in just three years;
- striking similarities to two other major international insolvencies occurring earlier in 2001;
- the unique, first-ever required liquidation of a solvent P&C Canadian Branch; and
- the precedent-setting and "novel approach" that PACICC took to resolve this insolvency.

Reliance was the 27th largest P&C insurer in the U.S., offering a full range of products from basic property and automobile to specialty lines such as workers' compensation, non-standard automobile and professional liability. In mid-1998, Reliance reported a record net worth of some $2.3 billion. Many people believed that a company of this size (with a 184-year history dating back to 1817) was too big to fail. Reliance had a solid history of steady growth, achieved through attentive underwriting and acquisitions that helped to build the business. The fate of Reliance changed in 1968 when it was purchased by a small computer leasing firm, led by CEO Saul Steinberg. Under his leadership over subsequent decades, Reliance would expand rapidly, and venture into new jurisdictions and far riskier lines of business that would ultimately lead to its demise. Although slow to become visible, when trouble came, it arrived quickly. In the space of only three years, Reliance experienced a shocking $3.4 billion decrease in net worth, moving from a record net worth of $2.3 billion in July 1998 to a negative surplus of $1.1 billion by October 2001.

The Reliance insolvency is an example of what can happen when an organization alters its focus and strays from the business approach that brought earlier success. When Reliance was placed into liquidation, its losses were continuing to mount. The Liquidation Order could not have come soon enough for affected policyholders and investors. The Reliance insolvency was remarkably similar to two other major insurance company failures that

same year – Australia's HIH Insurance Limited failure in March 2001(subject of our 2018 *Why Insurers Fail* study), and the U.K.'s Independent Insurance failure in June 2001. Each company was led by an industry maverick who exerted undue influence over operations, used aggressive underwriting to gain market share and ventured into high-risk lines of coverage.

The October 3, 2001 failure of Reliance in the U.S. marked the end of Act I of this drama. Act II would begin two days later in Canada, with the Office of the Superintendent of Financial Institutions ("OSFI") commencing the wind-up of the company's Branch, Reliance (Canada). This "solvent wind-up" was a unique situation. Fully reinsured, the Branch paid outstanding claims with interest. Residual business was assumed by another carrier. An estate surplus of $104 million was eventually forwarded to the U.S. Liquidator. The failure of Reliance (Canada) left Canadian policyholders scrambling to find alternate coverage. In November of 2001, PACICC's Board took a precedent-setting and "novel approach" (words used in the PACICC Board Minutes) to wind-up Reliance (Canada) – *a Loan and Services Agreement* whereby PACICC would borrow funds from the Canadian estate to reimburse unearned premiums and to settle outstanding claims, with the funds repayable only if dividends from the estate were less than 100 percent. The loan was backed by a pledge of PACICC's assessment power. This agreement enabled PACICC to speed the processing of policyholder claims, and to spare PACICC Members the time and related expense of a traditional industry assessment to resolve Reliance (Canada)'s outstanding claims.

PACICC's Priority Issue for 2020 is to expand the resolution "toolkit" it uses to deal with troubled insurers, including possible intervention in the absence of a Court-ordered wind-up. To this end, the Reliance insolvency and Home Insurance Canada insolvency (discussed in the Case Study accompanying this paper) serve as early launch points for a closer examination of creative new resolution options which could potentially enhance consumer protection, reduce costs to the industry and strengthen policyholder confidence in Canada's P&C insurance industry.

Introduction

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Early history

The story of Reliance Insurance Company begins in Philadelphia with the establishment of the Fire Association of Philadelphia in 1817. It provided fire-fighting services and fire insurance – the first successful association of volunteer fire departments in the U.S. On January 1, 1958, it changed its name to Reliance Insurance Company ("Reliance"). By 1967, Reliance had a strong position in the U.S. property and casualty (P&C) insurance industry, with more than 8,000 employees, 13,000 shareholders, $350 million in revenues and a reserve capital of more than $100 million.[1] The company was led CEO A. Addison Roberts who joined in 1938 and became CEO in 1964. He was intent on continuing to grow the company as a national P&C insurer. Mergers and acquisitions in the 1960s were changing the face of the industry. By 1968, Reliance had grown through the acquisition of 22 companies over the past two decades. Further expansion was placed on hold, however, as the company sought to recover from property losses caused by hurricanes, race riots the previous summer and other uncontrollable events. A large percentage of the company's stock was owned by institutional investors of the brokerage firm Carter, Berlind & Weill, Inc. ("CBW").

Enter Saul Steinberg and Leasco

Saul Steinberg would play a key role in the future of Reliance. He was born in August of 1939 in Brooklyn, New York. In 1959, he graduated from the Wharton School of Finance at the University of Pennsylvania, with a Bachelor of Science degree in Economics. At Wharton, Mr. Steinberg penned a term paper entitled, "*The Decline and Fall of IBM*." The title of his paper was catchy and entirely misleading. His research showed that IBM was not actually in danger. In fact, it was a highly profitable company that enjoyed great success in leasing large mainframe computers. In analyzing IBM's business model, it became apparent to Mr. Steinberg that there may be opportunity in purchasing used IBM computers after their leases expired, and re-leasing them to smaller firms at competitive rates. He would offer extended leases to attract generous federal tax benefits on depreciation.[2]

In 1961, Mr. Steinberg put his ambitious business plan into action. At the age of 22, he established Ideal Leasing Company ("Ideal") with $25,000 of seed money from his father. The company was incorporated in 1962 and grew exponentially. Ideal revenues increased from $1.8 million in 1963 to $8 million in 1964. In 1965, the company's name was changed to Leasco Data Processing Equipment Corporation ("Leasco"). In 1966, Leasco revenues totaled $21 million. In 1967, the company had $74 million in assets and 800 employees.[3]

[1] Joseph N. DiStefano, "Saul P. Steinberg and Reliance Insurance Co." (Three Parts), *The Philadelphia Inquirer* (Philadelphia, Pennsylvania, The Philadelphia Inquirer, LLC, December 2001), Pg. 8.

[2] Ibid., Pg. 4.

[3] Ibid., Pg. 4.

Leasco bought CTI-Container Transport International in September of 1968, turning it into the world's largest cargo container transportation company. Leasco was intent on further acquisitions, with investors expecting higher future earnings growth. The distinctly different worlds of Leasco and Reliance would soon intersect following the publication of an obscure client investment report by Edward Netter, a Wall Street financial analyst.

Edward Netter and the concept of "redundant capital"

In the late 1960s, the U.S. had more than 10,000 local banks and thousands of state-regulated insurance companies whose investment portfolios were growing as a result of a strong stock market. While this was no doubt enticing to Leasco, a big hurdle existed in the form of the *Glass-Steagall Act* of 1933. The Act required the separation of U.S. banking, insurance, investment and industrial company operations. On August 21, 1967, Wall Street financial analyst Edward Netter issued a CBW client report entitled, "*The Financial Services Holding Company.*" The report challenged a central tenet of the above *Act*, suggesting that it was possible for a non-financial holding company to take over a financial firm, and to then channel its investments into new businesses. The report noted that it was possible to circumvent strict insurance regulatory standards to create new investment opportunities. If an insurance company's unallocated surplus was transferred to an unregulated holding company, that company would then be free to invest the assets – in related activities to benefit the insurance company, or in other activities not necessarily related to the firm (e.g. unregulated growth industries).

Mr. Netter was a visionary, correctly forecasting the emergence of large, all-encompassing financial services firms. He recognized that conservative business practices in the P&C industry produced capital reserves that exceeded regulatory requirements. He referred to this surplus capital as "redundant capital" or "surplus surplus." Mr. Netter's thought-provoking report transformed the industry by demonstrating how company value could be "unlocked" for investors. Some parties would later cite the publication of this report as the beginning of the end for Reliance. Said industry observer John Brooks, "By implication Netter was pointing out – in the hope of earning finder's fees and brokerage commissions for his own firm – that ambitious diversified companies were missing a chance to better their circumstances by marrying fire-and-casualty companies for their redundant capital – or, more bluntly, for their money."[4]

[4] John Brooks, *The Go-Go Years: The Drama and Crashing Finale of Wall Street's Bullish 60s* (New York, New York, Open Road Integrated Media, Inc., 2018), Pg. 43.

The takeover of Reliance Insurance Company

Among the readers of Mr. Netter's report were Mr. Roberts and Mr. Steinberg. CBW saw potential in acquiring an insurance company with a strong balance sheet and surplus capital that could be repurposed for investments outside of the insurance industry. It examined several target companies. Reliance was identified as the most attractive takeover candidate. Mr. Netter estimated that it had surplus capital of $60 million. Mr. Steinberg's estimate was double this amount.[5] In December of 1967, Mr. Netter met with Leasco Corporate Planning Vice President Michael Gibbs to discuss his report's findings. Mr. Netter recommended the acquisition of an unnamed insurer (to avoid stock price stimulation and management opposition), for a $750,000 "finder's fee" payable to CBW. The timing of this was ideal, as Leasco was searching for acquisitions to expand operations beyond computer and shipping container leasing.

On June 21, 1968, Mr. Steinberg launched a debt-financed, unsolicited takeover bid for Reliance. Shareholders were offered convertible debentures (paying regular interest income with repayment upon maturity) and common stock warrants (providing time-sensitive stock purchase privileges). At first, Mr. Roberts strenuously resisted the takeover attempt. He launched a lawsuit accusing Leasco of manipulating Reliance's stock price. He also entered into merger discussions with a competitor. Mr. Steinberg responded with an enhanced shareholder offer and a benefits package for Mr. Roberts that abruptly ended his resistance to the takeover bid. On August 1, 1968, Mr. Steinberg secured the Reliance takeover with the issue of $400 million of stock to fund the deal. One of the largest P&C insurers in the U.S. was taken over by a company one-tenth its size, and not nearly as profitable. Mr. Steinberg now had ready access to $125 million of capital. Following the Reliance deal, few doubted his confidence or ambition. He later quipped, "You watch...I'll own the world."[6]

A drawdown on Reliance's surplus capital began in earnest in August of 1969 when a special bonus dividend was declared for shareholders. Reliance dividends increased sharply that year to $52 million, up from just $10 million in 1968.[7] As the largest Reliance shareholder (with 47 percent ownership), Mr. Steinberg benefitted greatly. That same year, he attempted an equally ambitious takeover of Chemical Bank, one of the largest U.S. financial institutions, worth $9 billion. While it too had 10 times the combined assets of Leasco, this did not deter Mr. Steinberg. A later sudden drop in the value of Leasco shares devalued his Chemical Bank offer. Although the takeover attempt ceased before a formal offer was made, this reinforced Mr. Steinberg's risk-taking reputation within the New York financial community.

[5] Op. cit., Pg. 6.

[6] Ibid., Pg. 1.

[7] Ibid., Pg. 10.

The 1970s: A challenging decade

The 1970s would be a challenging decade for Mr. Steinberg in managing his company's huge debt. It would also be a period of significant structural and operational change for Reliance. In 1971, Reliance Financial Services Corporation ("Reliance Financial") was established as an intermediate holding company. In 1973, Leasco changed its name to Reliance Group, Inc. ("Reliance Group") to reflect a new focus on financial services. Two other subsidiaries were added – RCG International, Inc. ("Reliance Consulting") and Reliance Development Group, Inc. ("Reliance Development"). In addition to struggles with a bear market in the early 1970s that led to large losses at Reliance Group, Mr. Steinberg would soon fall victim to "Moore's Law" – Intel Corporation co-founder Gordon Moore's principle that computer power doubles every two years as a result of rapid advances in hardware technology. In an April 1965 industry article, Mr. Moore predicted that this pattern of development would continue for a decade. Mr. Steinberg had been purchasing millions of dollars of used IBM computers to rent out on long-term leases. With ever-more-powerful and cheaper IBM machines now flooding the market, he found himself heavily invested in aged computers that no one wanted to rent.[8]

Reliance Group's stock price plunged dramatically in 1975. It had approached $100 in 1968, but was now less than $10. There was a silver lining here for Mr. Steinberg. He took advantage of the depressed Reliance share prices, shrewdly using company funds to purchase the shares back cheaply from disaffected investors. This increased the percentage of total shares he controlled, without the need to use any personal funds. Said New York stock analyst Irwin Perry, "He's really stealing the stock back from shareholders for next to nothing, and at the same time getting off the hook of regulation by the Securities and Exchange Commission by taking the company private."[9]

The 1980s: A change in business strategy

For many people, the 1980 election of President Ronald Reagan was like a breath of fresh air that would help to rid the U.S. of stagnation that plagued the 1970s. President Reagan pledged to reduce government regulation, lower taxes and use "supply side" economics for the benefit of all citizens. For Reliance, the 1980s would be a decade of growth and diversification, as the company sought to expand into new markets and broaden its reach through a large network of insurance brokers. Mr. Steinberg rebounded from near financial ruin in the 1970s by investing in cheap stocks. While he was often linked to hostile takeovers, he never actually completed one. If he was unable to take over a company by attracting investors, he would pressure the company to cut costs and then sell off his accumulated stock at a profit – a practice now commonly referred to as "greenmail."

[8] Ibid., Pg. 14.

[9] Ibid., Pg. 6.

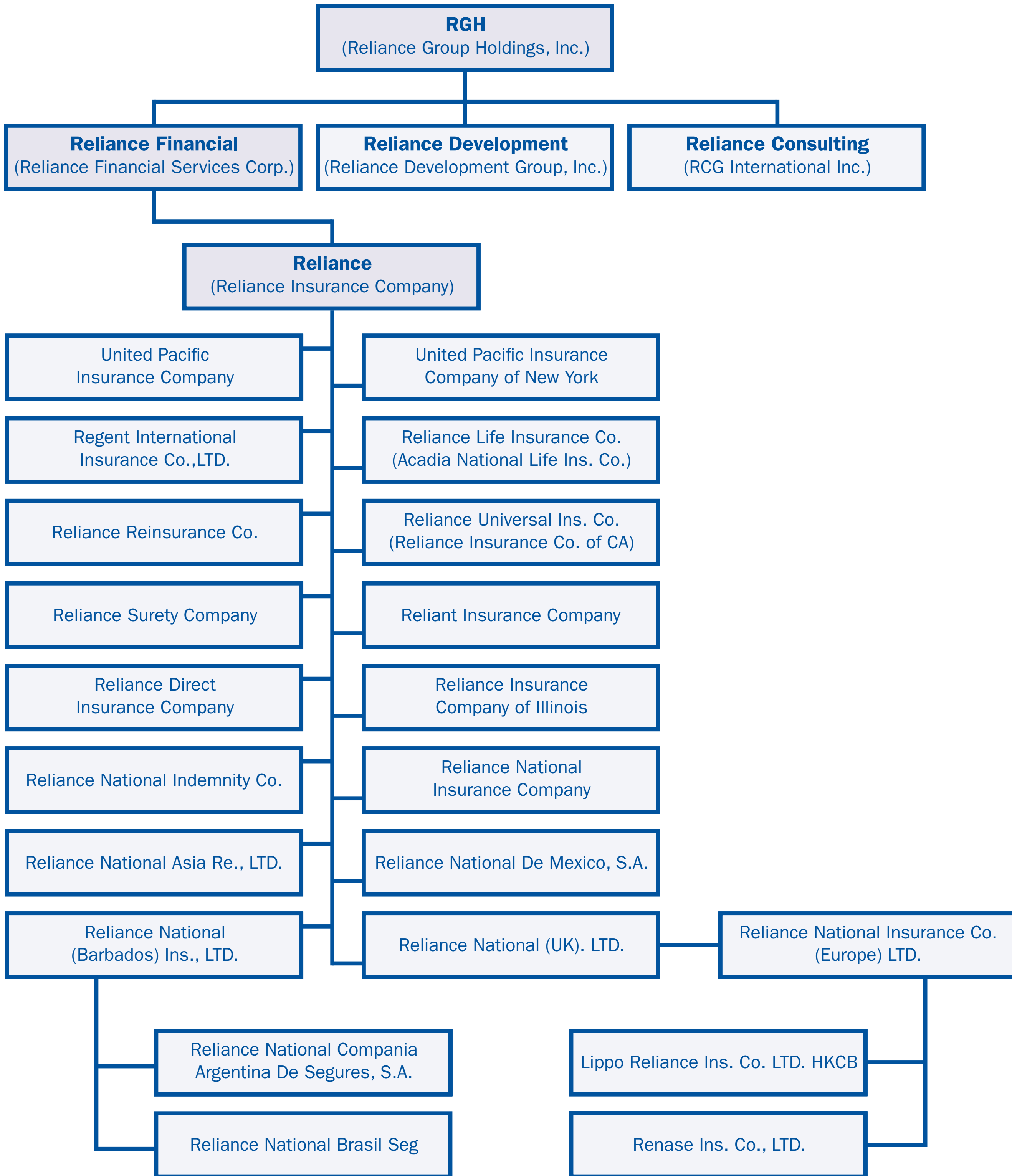
In 1980, Mr. Steinberg's $750,000 salary made him one of the best-paid executives in the U.S. He was earning more than the heads of many major banks. His salary was 10 times that of his predecessor at Reliance, and did not include the large dividends that he was also collecting. He lived a lavish lifestyle throughout the 1980s and supported numerous charitable causes, including the Metropolitan Museum of Art and his alma mater, the University of Pennsylvania. The latter received more than $30 million. One year, Mr. Steinberg hosted an opulent birthday party for himself that included live models depicting his favorite Renaissance paintings.[10] His company's headquarters were relocated to Manhattan. He had a 29-room mansion in Long Island, decorated with numerous Old Masters paintings, and a sprawling 80-room Park Avenue apartment built by billionaire John D. Rockefeller in the 1920s.[11]

In 1981, Mr. Steinberg founded Reliance Group Holdings, Inc. ("RGH"), a family-controlled holding company that acquired all outstanding shares of Reliance Group. Figure 1 shows the three-tier, holding company ownership structure for RGH. Shading in the diagram shows that the principal business of Reliance Group was ownership of Reliance and its P&C subsidiaries, through Reliance Financial. RGH held all of the common stock of Reliance Financial, Reliance Development and Reliance Consulting. Reliance Financial, in turn, owned all of the common stock of Reliance and its 21 subsidiaries. In addition to writing business in every U.S. state (and also the District of Columbia, Puerto Rico, Guam and the Virgin Islands), Reliance had subsidiaries in 12 countries (including Canada) and joint ventures in 50 countries. All three management tiers of Reliance were controlled by identical Boards of Directors, which remained firmly in place until control of the organization was seized by the Pennsylvania Insurance Department ("PID") in May 2001.

Mr. Steinberg's penchant for leveraged acquisitions meant that RGH was sitting on hundreds of millions of dollars of debt. Regular cash injections from Reliance were needed to pay the interest owed to RGH investors. Reliance's continuing profitability and transfer of dividends were critical to the ongoing success of RGH. There would be no issues as long as Reliance continued to generate steady profits. This tenuous arrangement was a winning strategy in the eyes of Mr. Steinberg.

[10] Dan Ackman, "Forbes Face: Saul Steinberg", *Forbes* (New York, New York, Forbes Media LLC, June 18, 2001), Pg. 2.
[11] Ibid., Pg. 15.

Figure 1 – Corporate Structure of RGH (Reliance Group Holdings, Inc.)



Source: A.M. Best Insurance Company Reports – P/C 2001 Edition, Reliance Insurance Co. Group Report, Document #0103.

Mr. Steinberg reorganized the RGH Board to ensure support for his ambitious plans for growth and diversification. The Board was far from independent. Mr. Steinberg was answerable to a small circle of hand-picked Directors that included his father Julius, brother Robert and several close friends. An identical Board of internal and external Directors controlled RGH, Reliance Financial and Reliance. The close personal relationships between Directors and management helped to ensure the unlikelihood that management would ever be challenged over strategy or use of resources. Internal Directors outnumbered external Directors. Many Directors were Officers of the company. A number of the external Directors knew each other through outside connections. Many Directors were long-serving – three served on the Boards for at least 16 years. Two Board members were beneficial owners of a company in which Reliance invested heavily.

RGH made extensive use of junk bonds in the 1980s to fund acquisitions. Mr. Steinberg hired the nation's leading financiers, including fellow Wharton School graduate and "junk-bond king" Michael Milken of Drexel Burnham Lambert & Co. Reliance was one of the country's largest purchasers of junk bonds. Mr. Steinberg was a champion of the swashbuckling era of billion-dollar mergers and junk bond finance.[12] He set his sights on the Walt Disney Company in 1984, picking Donald Duck's fiftieth birthday celebration as the day to unveil a ruthless takeover bid. He threatened to oust Disney's Board and sell off its cartoon characters.[13] While this "greenmail" bid appeared sinister, it had a practical purpose. The Disney Board quickly bought back all of Mr. Steinberg's stock at a premium, resulting in a $58 million profit on a short-term investment.[14] In some senses, Mr. Steinberg felt cheated by the failed Chemical Bank and Walt Disney takeovers, noting, "I always knew there was an establishment – I just thought I was part of it."[15]

Reliance's stock value plummeted following the stock market crash of 1987. The company's underwriting results also suffered due to property losses from natural disasters that included the 1989 San Francisco earthquake. Reliance was challenged to continue generating the large volume of dividends that RGH needed to service its massive debt. This led Reliance directly into riskier lines of business. Mr. Steinberg reorganized business operations in 1987. The flagship Reliance remained in Philadelphia, where it had been underwriting very predictable P&C risks for more than 150 years. It continued to focus on commercial insurance for mid-sized companies. A new subsidiary, Reliance National Insurance Company ("Reliance National"), was established to focus on non-traditional risks requiring greater underwriting expertise and an extensive network of brokers.

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[12] Ibid., Pg. 3.
[13] Ibid., Pg. 18.
[14] Ibid., Pg. 18.
[15] Ibid., Pg. 1.

Reliance National was positioned to handle "unique exposures" and high-risk undertakings that included: nuclear power plants, environmental disasters, earthquake-exposed construction, chemical manufacturers, professional liability, workers' compensation, high-risk drivers, health, transit, etc.[16] By 1993, Reliance National would account for 50 percent of Reliance's business. Through its other subsidiaries (Reliance Development and Reliance Consulting), RGH expanded into real estate development and consulting services via acquisitions and joint ventures. By the end of the 1980s, Reliance was active in new lines of coverage and numerous international jurisdictions, heavily in debt and in search of new capital. The company was entirely ill-prepared for the financial shocks and unexpected market developments that would follow in the 1990s.

The 1990s: Growth and diversification

The 1990s was a decade of further growth and diversification for Reliance. Following Michael Milken's confession to securities-law violations and the consequent collapse of Drexel Burnham Lambert in February 1990 after several years of legal problems, the market for junk bonds vanished. Pennsylvania adopted the National Association of Insurance Commissioners ("NAIC") *Model Holding Company Act* in 1993, governing the operations of holding companies and the acquisitions of insurers by non-insurers. At the federal level, the Department of Justice blocked acquisitions that it felt would lessen competition in the market place. These regulatory actions limited Mr. Steinberg's ability to pursue certain types of investment. Consequently, Reliance came under greater pressure to generate the surplus capital needed to service RGH's debt. Mr. Steinberg was in search of a new way of doing business. A key decision was to exit personal lines coverage, beginning in 1991.

Mr. Steinberg was not without his critics in the industry. In 1993, *Schiff's Insurance Observer* publisher David Schiff wrote a blistering article entitled, "Would You Buy a Used Car from This Man?" He warned that Reliance's flood of new customers would eventually bring with them some very expensive claims. Said Mr. Schiff, "How does an insurance company go bust? Slowly at first, then suddenly!"[17] Despite this criticism, Reliance kept opening new offices and announcing new business lines. Mr. Steinberg cautioned, "The insurance and financial markets are converging, and we are in the forefront of the trend…As we break new ground for our customers, we will continue to be disciplined in our underwriting and our risk selection."[18] Significant investments were made in new offices in Europe, Asia, Africa and Latin America. Reliance established new subsidiaries to handle the company's increasing expansion into selected specialty lines of insurance, including the incorporation of several new life insurance companies.

[16] Ibid., Pg. 26.

[17] Ibid., Pg. 25.

[18] Ibid., Pg. 27.

The fierce price competition that began in the industry in 1987 would continue well into the 1990s. Reliance suffered from catastrophic losses and poor commercial business results. In May 1994, Mr. Steinberg promised shareholders that underwriting results would improve through higher standards in a soft market, vowing, "We have not seen signs of the market hardening. We have to use underwriting discipline to improve earnings. We simply can't wait any longer to get large, extraordinary profits from steeply rising prices."[19]

RGH had nearly $900 million of debt at the end of 1994. This was top of mind for Mr. Steinberg, given his controlling position over RGH's common stock. Reliance was generating only modest returns (averaging 4 percent) between 1989 and 1994, with two-thirds of that coming through business that was shifting into Reliance National.[20]

1995-2001: The final years

The period from 1995 to 2001 would prove to be critical years for Reliance – and its final years. Increasingly, Reliance's focus was shifting from thin-margin, standard coverages (automobile and property) and into specialty lines, non-traditional risks and large business accounts. The company was staking its future on non-standard automobile (high-risk drivers), workers' compensation sold over the Internet, environmental exposure (hazardous waste) and international start-ups and joint ventures. The bold move to embrace riskier lines of coverage came at a challenging time for the company. Reliance was facing a soft market, with fierce price competition and aggressive marketing by its competitors.

Reliance had a breakthrough year in 1995. A.M. Best noted record earnings for the company following the restructuring of its operations. Its combined ratio showed a three-point improvement to 104 percent. In 1995, Reliance National and Reliance's surety operations accounted for over 70 percent of premiums. Reduced dividend payments and large investment gains helped Reliance to post 23 percent surplus growth in 1995. Personal lines coverage now accounted for less than one percent of gross premiums.[21] In his December 1995 *Wall Street Journal* "Heard on the Street" column, Salomon Brothers Analyst Max Holmes noted, "Saul Steinberg has mellowed. He's running his company more like an insurance company and a little less like a hedge fund."[22]

In his annual letter to shareholders that year, Mr. Steinberg noted, "At Reliance, the refocusing and restructuring are largely behind us…Our goal is to double the share of our business from overseas operations by the year 2000, an expansion consistent with controlled

[19] Dow Jones Newswires, "*Reliance Group Holdings Says Market Hardening Still Distant*" (New York, New York, Dow Jones Americas, May 12, 1994), Pg. 1.

[20] Ibid.

[21] A.M. Best, "Reliance Insurance Company, P/C" (Oldwick, New Jersey, A.M. Best Company, Inc., 1996).

[22] Leslie Scism, "Reliance Recovers, Boasts Gains", *Heard on the Street*, *Wall Street Journal* (Washington, D.C., Dow Jones and Company, December 6, 1995), Pg. 1

and profitable results."[23] He continued, "By virtually every important measure, 1995 was an outstanding year for Reliance…This success is particularly gratifying because we have made significant progress accomplishing what we set out to do when we first began transforming the company to respond to fundamental changes in market conditions."[24] While things appeared fine on the business front, there would be a personal challenge for Mr. Steinberg in 1995 – he suffered a stroke. His brother Bobby was appointed to take his place as CEO.

Reliance enjoyed favourable results for the next few years. Just one year after its establishment in August of 1997, Cybercomp (the first insurer offering workers' compensation over the Internet) accounted for almost 20 percent of Reliance National's premium growth. Reliance National itself was showing significant growth, from zero premiums in 1996 to $201 million in 1998.[25] On February 27, 1998, Reliance sold its title insurance business (Commonwealth Land Title Insurance Company and Transaction Title Insurance Company) to LandAmercia Financial Group, Inc. ("LandAmerica") for $657 million.[26] Reliance now had business operations in 50 countries. It was in a strong financial position with $3.4 billion of revenue, $12.8 billion in assets, $1.7 billion of statutory surplus (largest in its history) and a profit of $585 million.[27]

Reliance's business strategy appeared to be highly successful and was garnering favourable reviews. Paine Webber's Alice Schroeder reported, "Reliance Group remains our best mid-cap idea based on valuation. This specialty insurance writer has succeeded in a dramatic turnaround of its operations over a five-year period and will likely end 1998 with record earnings…We believe the stock is so compelling a value that we continue to rate it Buy… Further this is one of the few major companies that is not reporting severely constrained growth or deteriorating underwriting due to market conditions, because a combination of extensive reinsurance protection and new product specialties is enabling Reliance Group to grow profitably."[28]

[23] Reliance Group Holdings, Inc. Annual Report, Form 10-K (Washington, D.C., U.S. Securities and Exchange Commission, 1995).

[24] Ibid.

[25] Reliance Group Holdings, Inc. Annual Report, Form 10-K (Washington, D.C., U.S. Securities and Exchange Commission, 1998).

[26] A.M. Best, "Reliance Group Completes Sale of Title Subsidiaries", *Best's Insurance News & Analysis* (Oldwick, New Jersey, A.M. Best Company, Inc., March 2, 1998). Pg. 1.

[27] Reliance Group Holdings, Inc. Annual Report, Form 10-K (Washington, D.C., U.S. Securities and Exchange Commission, 1999).

[28] Alice Schroeder, "Reliance Group Holdings", *Paine Webber Research Note* (New York, New York, Paine Webber Inc., November 9, 1998), Pg. 1.

Table 1 – Net Written Premium – Reliance Insurance Company

$000s

Company	1991	1992	1993	1994	1995	1996	1997	1998	1999
Reliance Direct Insurance Company					1,420	0	369	5,216	13,215
Reliance Insurance Company of Illinois	14,623	14,859	16,193	15,257	15,058	17,195	19,652	23,078	23,908
Reliance Insurance Company	1,272,191	1,445,403	1,538,344	1,449,409	1,430,518	1,633,548	1,866,938	2,192,417	2,238,418
Reliance Lloyds	0	0	0	0	0	0	0	0	0
Reliance National Indemnity Company	14,623	14,859	16,193	15,257	15,058	17,195	19,952	23,078	23,908
Reliance National Indemnity Company	14,623	14,859	16,193	15,257	15,257	15,058	17,195	19,652	23,078
Reliance National Insurance Co. of NY	23,362	25,085	24,896	10,615	0	0	0	0	0
Reliance Surety Company	0	0	0	0	2	27	135	297	290
Reliance Universal Insurance Company	0	19,079	16,193	15,257	15,058	17,195	19,652	23,078	23,908
Reliant Insurance Company	-	-	-	-	-57	-5	-1	0	16,406
Sable Insurance Company	-	-	-	-	0	0	0	948	1,107
United Pacific Ins. Company of NY	23,362	25,085	24,896	10,615	1,307	0	0	0	0
United Pacific Insurance Company	146,229	-23,118	16,193	15,257	15,058	17,195	19,652	23,078	23,908

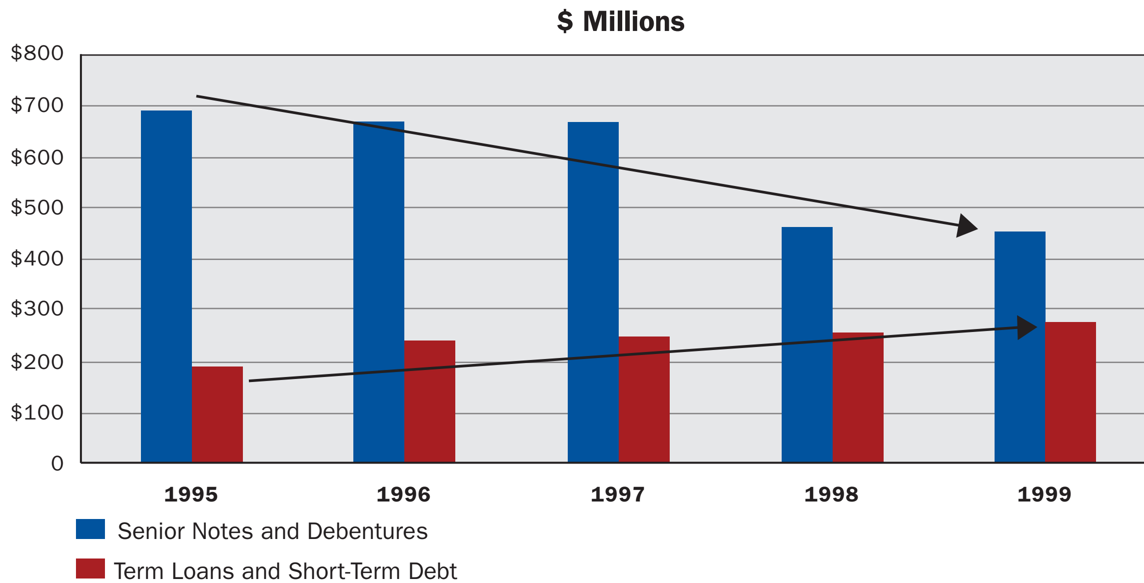
Source: NAIC Annual Statements as of December 31, 1995 and December 31, 19995 (5-Year History Exhibit - Row 12).

Table 1 shows significant premium growth for Reliance beginning in the mid-1990s.

Mr. Steinberg took on substantial debt when he purchased Reliance in 1968, and more when he repurchased shares in 1981 and increased junk-bond borrowings in the 1980s. RGH's crushing debt load would figure prominently in the late 1990s when the company's business strategy began to unravel.

Given its substantial debt load, RGH had an ever-present need for cash to pay investor interest. It was not clear that there was ever a strategy in place to retire the debt. Short-term debt and term loans were regularly rolled over to extend their maturities. At any given time, RGH had a five-year maturity window for its short-term debts. Figure 2 shows significant changes in RGH's short- and long-term debt levels between 1995 and 1999. The arrows show the volume of senior notes and debentures decreasing between 1995 and 1999, while the volume of term loans and short-term debt was increasing. The volume of senior notes and debentures decreased by 34 percent (from $690 million in 1995 to $455 million in 1999), while the volume of term loans and short-term debt increased by almost 50 percent (from $190 million in 1995 to $280 million in 1999).

Figure 2 – RGH – Total Debt Outstanding



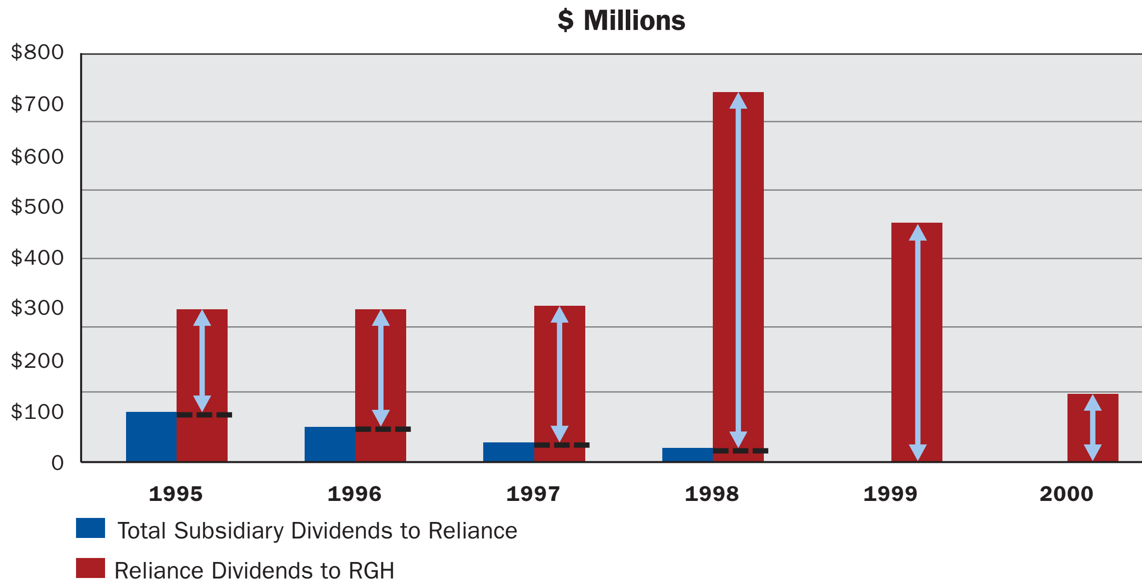
Source: Reliance Group Holdings, Inc. 10-K U.S. SEC Reports, 1995-1999.

RGH's aggressive acquisition strategy and insatiable need for dividends left Reliance vulnerable to cutthroat competition at a time that it was seeking to increase market share. Reliance continued to venture into untested markets and high-risk lines of business. The company was taking on additional risk by venturing into lines of business where it had no history. It was turning away from traditional insurance products and into hybrid products and highly specialized lines of insurance. An example of this was the fact that Reliance began to offer enterprise earnings protection insurance to help publicly held companies guard against earnings disruption volatility and adverse financial results. A lack of underwriting experience was not helpful to Reliance actuaries in developing case estimates. Past experience with some lines of business enables actuaries to examined run-off patterns used in the past, in order to more confidently price their products. Underwriting standards were compromised as Reliance ventured into riskier lines of coverage, and this led to unsustainable losses.

In 1999, 50 percent of Reliance premiums came from workers' compensation and general liability. California was Reliance's biggest market for workers' compensation. A 1997 Court decision in California had expanded the authority of primary treating physicians, who were given almost unilateral authority to determine levels of disability. The Court decision applied to claims before the date that the legislation took effect, causing claims costs to rise retroactively – a surprise development for Reliance. The company was now found to have underpriced its workers' compensation risks. This same over-concentration in workers' compensation was a contributing factor to the failure of Australian giant HIH Insurance Limited in 2001.

Figure 3 shows a significant draw on Reliance capital by the parent company. From 1995 to 2000, subsidiary dividends received by Reliance (totaling $86.6 million) were just a small fraction of the dividends that Reliance subsequently transferred to RGH (totaling $835.4 million) – just 10 percent. This clearly shows that surplus capital from Reliance was being used to pay down RGH debt. Reliance continued to pay increasing dividends to RGH at a time when it had been hit hard with unexpected losses on workers' compensation.

Figure 3 – Net Reliance Dividends to RGH



Source: Reliance Group Holdings, Inc. 10-K U.S. SEC Reports, 1995-1999.

Table 2 shows how dependent the parent company (RGH) was on Reliance dividends. In the absence of these dividends, RGH would have been in a loss situation in four of the five years. It is not clear from available information whether the dividend transfers were a concern for regulators.

Table 2 – RGH – Consolidated Income Statements

	1995	1996	1997	1998	1999
Revenues:					
Dividends from subsidiaries, including non-insurance subsidiaries	110,000	110,000	315,272	268,000	174,000
Interest	6,153	7,246	5,214	4,451	6,140
Loss on sale of investee company/subsidiary	-	-	-	(5,160)	(1,263)
	116,153	**117,246**	**320,486**	**267,291**	**178,877**
Expenses:					
Interest	88,391	89,220	76,032	62,071	11,189
General and administrative	35,600	36,081	42,268	40,597	37,383
	123,991	**125,301**	**118,300**	**102,668**	**48,572**
	(7,838)	(8,055)	202,186	164,623	130,305
Income tax bebefit	49,699	42,488	40,219	37,609	51,043
Income before equity in subsidiaries and investee companies	41,861	34,433	242,405	202,232	181,348
Equity in subsidiaries (net income (loss) less dividends received)	46,263	4,866	(12,907)	109,983	(464,822)
Equity in investee companies	7,792	8,908	7,675	22,000	30,778
Loss on sale of discontinued operation	(4,497)	-	(1,312)	-	-
Income (Loss) before extraordinary item and cumulative effect of accounting change	91,419	48,207	235,861	334,215	(252,696)
Extraordinary item	(3,363)	-	-	(7,766)	-
Cumulative effect of change in accounting	-	-	(6,442)	-	(57,850)
Net income (Loss)	88,056	48,207	229,419	326,449	(310,546)

Source: Reliance Group Holdings, Inc. 10-K U.S. SEC Reports, 1995-1999.

As noted earlier and as Table 3 shows, the Reliance Board was not well positioned to provide independent oversight to Reliance at such a critical period in its history. RGH, Reliance Financial and Reliance all operated with identical Boards. Internal Directors outnumbered External Directors. Many Directors shared outside affiliations. Several were relatives. A number of Directors served for at least 16 years.

Table 3

Directors	1994	1995	1996	1997	1998	1999
Internal Directors						
Saul Steinberg (Chair)	■	■	■	■	■	■
George Baker	■	■	■	■	■	■
George Bello	■	■	■	■	■	■
Lowell Freiberg	■	■	■	■	■	■
Robert Steinberg	■	■	■	■	■	
Dustin Busti	■	■	■	■	■	
Jame Yacobucci	■	■	■	■	■	
Dean Case	■					
Howard Steinberg						■
Externternal Directors						
Richard Snyder	■	■	■	■	■	■
Thomas Gerrity	■	■	■	■	■	■
Jewell McCabe	■	■	■	■	■	■
Irving Schneider	■	■	■	■	■	■
Bernard Schwartz	■	■	■	■	■	■
Thomas Stanton Jr.	■	■	■			
Carter Burden	■					
Bruce Spivey						■

Source: 1995-2000 A.M. Best Reports on Reliance Insurance Group; Reliance Group Holdings, Inc. 1999 10-K; and Reliance Financial Services Corp. 1994-1996 10-Ks.

In 1998, Reliance became heavily involved in fronting reinsurance through a workers' compensation reinsurance pool which was created by Unicover Managers, Inc. ("Unicover") in 1994. Unicover enabled insurers to share workers' compensation risk. Primary insurers kept responsibility for employers' liability and ceded occupational accident coverage to reinsurers. Commissions were paid each time business was passed along. As a result, the ultimate insurer had very significant commissions to pay. The volume and cost of claims were grossly underestimated. Problems were worst in California, which was Reliance's largest market (14 percent). The Unicover problem became public in February of 1999 when Cologne Re took a $275 million pre-tax loss on its involvement. This rattled Reliance investors.

Table 4 shows that Reliance's reinsurance practices were out of step with other insurers. Its reinsurance receivables (as a percentage of policyholder surplus) increased from 196 to 325 between 1996 and 1999, while the industry composite fell from 108 to 97. Its ceded reinsurance (as a percentage of policyholder surplus) increased from 310 to 512 (up 65 percent), at a time when the industry composite fell from 144 to 136. In 1999, Reliance retained 54 percent of the business, while the industry was retaining 75 percent of the business. Problems with Unicover and Reliance's fronting arrangements came to a head in 1999 when a number of large reinsurers demanded cancellation of retrocessional reinsurance contracts with the Unicover pool and facilities, including Reliance. Reliance would reach later settlements with the reinsurers, resulting in a pre-tax charge of $170 million in 1999.

Table 4 – Reinsurance Use – Reliance vs. Industry Composite

Year	Business Retention %		Reinsurance Receivables to Policyholder Surplus %		Ceded Reinsurance to Policyholder Surplus %	
	Reliance	Industry Composite	Reliance	Industry Composite	Reliance	Industry Composite
1996	60.5	80.2	196.2	108.6	310.7	144.3
1997	59.7	81.8	207.3	87.5	326.5	115.2
1998	56.6	79.1	179.4	86.3	298.5	116.3
1999	54.6	75.5	325.0	97.0	512.5	136.3

Source: A.M. Best Insurance Company Reports – P/C 2001 Edition, Reliance Insurance Co. Report, Document #0101, Pg. 10.

Reliance investors were shocked again on June 14, 1999 when the company announced losses of up to $250 million on its non-standard auto business. The value of Reliance stock dropped 18 percent that day. On June 15, 1999, Paine Webber's Alice Schroeder wrote, "Reliance management had indicated it had experienced a surprising amount of recent

deterioration in the property, transportation, and environmental impairment remediation lines for accident years 1997-1999. While some of this clearly related to overall industry market conditions, the company was booking claims at better combined ratios than the industry average, suggesting both a pricing and reserving problem."[29]

In October 1999, RGH announced the sell-off of its most profitable business (surety) and most promising new business (online insurance). It forecast losses of more than $100 million from Unicover. A.M. Best warned that it might lower Reliance's "excellent" credit rating. This scared off new business and renewals at Reliance. It also torpedoed its hopes of selling any bonds at reasonable rates. Despite growing financial uncertainty, Reliance continued to pay dividends to RGH, including $189 million in the nine months from June 1999 to March 2000.[30]

On January 21, 2000, Reliance took a $170 million loss on its Unicover exposures. With cash flow becoming an issue now, Reliance started to sell core businesses. The company was in full panic mode. In February 2000, it sold its profitable surety business to Travelers Property Casualty Inc. for $580 million. Reliance hoped to shore up its poor financial performance and avoid downgrades from rating agencies. In November, Mr. Steinberg fired his brother and appointed well-known turnaround specialist Robert Miller as CEO, in a desperate attempt to regain marketplace confidence. PID ordered Reliance to cease paying dividends to RGH, hampering the latter's ability to pay investors. As the largest shareholder, Mr. Steinberg stood to lose $10 million in annual dividends. He was forced to sell off assets to ensure cash flow in the short-term. This included the sale of the Park Avenue apartment and its contents, including 61 Old Masters paintings worth $50 million. Table 5 shows steady Reliance Officer compensation in the late 1990s, despite all the financial turmoil. Funds kept flowing to senior management and Steinberg family members.

Table 5 – Reliance Officer Compensation

Officers	1993	1994	1995	1996	1997	1998	1999
Saul Steinberg	$6,231,000	$3,843,000	$4,248,000	$5,199,000	$6,715,800	$9,917,700	$3,592,000
Robert Steinberg	$2,790,000	$2,572,000	$2,609,000	$2,995,000	$4,849,700	$8,498,700	$2,357,700
George Bello	$1,274,000	$1,426,000	$1,455,000	$1,472,000	$2,150,200	$2,830,950	$1,514,350
James Yacobucci	$1,132,000	$2,505,000	$3,755,000	$2,255,000	$2,754,700	$2,754,300	$1,754,800
Lowell Freiberg	$1,249,000	$1,355,000	$1,353,000	$1,364,000	$2,026,700	$2,674,200	$1,407,000

Source: Reliance Group Holdings, Inc. Proxy Statements, 1993-1999

[29] Alice Schroeder, "Reliance Group Holdings", *Paine Webber Research Note* (New York, New York, Paine Webber Inc., November 9, 1998), Pg. 1.

[30] Joseph N. DiStefano, "Saul P. Steinberg and Reliance Insurance Co." (Three Parts), *The Philadelphia Inquirer* (Philadelphia, Pennsylvania, The Philadelphia Inquirer, LLC, December 2001), Pg. 28.

Table 6 shows that, from 1995 to 1999, the Steinberg family received more than $165 million in combined compensation and dividends, not including any undervalued fringe benefits. One fringe benefit was a five-bedroom Boeing 727 corporate jet that executives used for personal travel (more than 50 percent of the time in some years).

Table 6 – Reliance Officer Total Compensation (Including Dividends)

Officers	1995	1996	1997	1998	1999	Total
Steinberg Family	$23,890,740	$25,220,800	$38,056,612	$53,498,376	$24,805,932	**$166,472,460**
George Bello	$1,853,772	$2,399,938	$3,458,969	$7,501,821	$3,834,504	**$19,049,004**
James Yacobucci	$4,422,841	$3,419,448	$3,618,424	$3,692,828	$2,287,026	**$17,440,577**
Lowell Freiberg	$2,144,935	$2,536,561	$3,479,790	$7,489,083	$3,518,444	**$19,168,813**

Source: Reliance Group Holdings, Inc. Proxy Statements, 1993-1999.

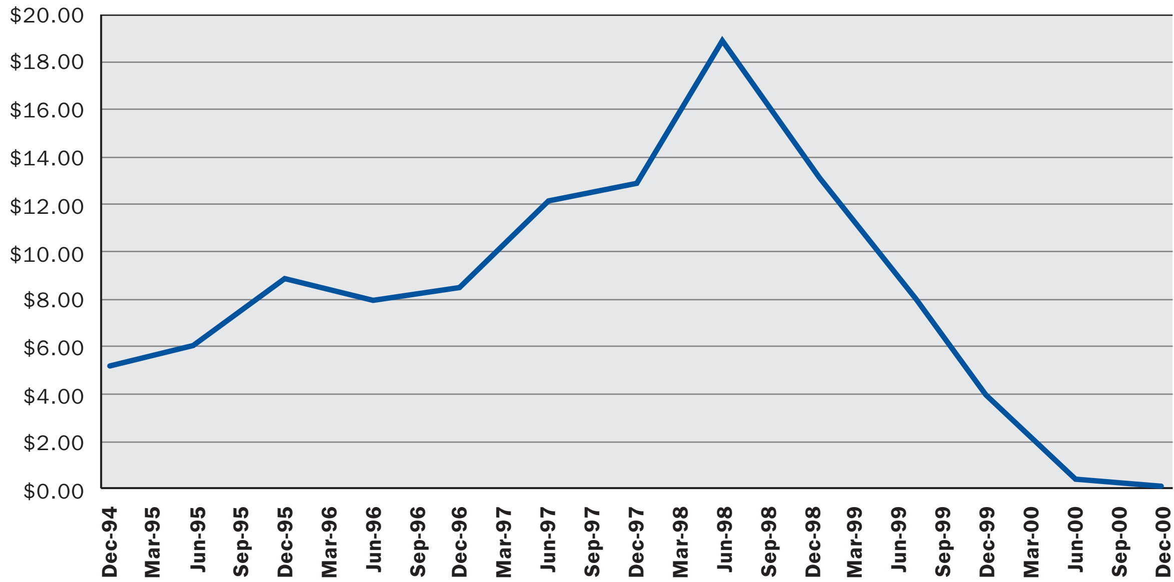
In February 2000, Reliance also reported a net loss of over $300 million for 1999. The company was in deep trouble. In early 2000, Mr. Steinberg agreed to sell Reliance to Leucadia National Corporation ("Leucadia") for $359 million – a loss of some $1.941 billion since mid-1998, when Reliance was valued at $2.3 billion. The deal fell through in July, however, because of Reliance's continuing poor financial health. Leucadia feared that Reliance would be unable to pay debts coming due the next month. A.M. Best reduced Reliance's credit rating to "very good", citing looming debt obligations that Reliance was unlikely to meet.

PID ordered a financial examination of Reliance on March 2, 2000, just one day after its 1999 Annual Statement was filed. It also asked Reliance for an action plan to address its declining capital position. In May 2000, Reliance reported $36 million in operating losses in the first quarter. Its stock continued to drop as institutional investors dumped their shares and Wall Street support disappeared. "The company is in a fire sale right now," said Matthew Coyle, a director of insurance ratings for Standard & Poor's. "It has to sell key businesses or lose them."[31] RGH was at the mercy of its creditors, who were refusing to extend short-term debt maturities.

[31] Ibid.

Figure 4 shows a free fall decline in Reliance's share price, beginning in 1998. This coincided with the collapse of the Long-Term Capital Management hedge fund and the beginning of the Asian financial crisis. The classification of its debt as "junk" caused problems for Reliance as it tried to refinance upcoming maturities in 2000. Investors opted instead for higher-quality investment products.

Figure 4 – Monthly Closing Stock Prices (1995-2000) – Reliance



Source: Dow Jones Interactive, Dow Jones and Company, Inc., 2000.

Table 7 shows Reliance's 12 NAIC Insurance Regulatory Information System (IRIS) test ratios for the period 1995 to 1999. Failing scores are highlighted in red.

Table 7 – IRIS Ratio Testing – Reliance Insurance Company

Test #	IRIS Ratio Test %	1995 %	1996 %	1997 %	1998 %	1999 %
1	Gross Premiums to Policyholders' Surplus (Fail if > 900)	231.0	239.0	250.0	229.0	344.0
2	Net Premiums to Policyholders' Surplus (Fail if > 300)	126.0	138.0	143.0	125.0	180.0
3	Change in Net Writings (Fail if > 33 or < -33)	-1.3	14.2	14.3	17.4	2.1
4	Surplus Aid to Policyholders' Surplus (Fail if > 15)	4.7	8.0	8.7	8.9	12.9
5	Two-Year Overall Operating Ratio (Fail if > 100)	89.5	90.4	90.6	90.1	106.1
6	Investment Yield (Fail if > 10 or < 4.5)	6.7	5.9	6.1	5.1	6.1
7	Change in Policyholders' Surplus (Fail if > 50 or < -10)	21.3	6.1	11.6	30.7	-23.8
8	Liabilities to Liquid Assets (Fail if > 105)	122.4	116.3	117.1	99.9	141.3
9	Gross Agents' Balances to Policyholders' Surplus (Fail if > 40)	3.1	0.0	2.7	3.4	21.7
10	One-Year Reserve Development to Surplus (Fail if > 20)	0.9	9.4	-3.4	-2.1	9.3
11	Two-Year Reserve Development to Surplus (Fail if > 20)	0.0	9.3	9.3	-7.8	-0.8
12	Estimated Current Reserve Deficiency to Surplus (Fail if > 25)	0.0	10.0	30.7	32.6	34.7

Source: NAIC Annual Statements, 1995-1999.

It is not clear why test results in the above table did not attract more regulatory attention. While Reliance solvency tests did not fall below the "Company Action Level" until late 1999, the company repeatedly failed Test #8 (Liabilities to Liquid Assets), which the NAIC IRIS Guide flags as a key indicator of financial trouble. The Guide notes, "Analysis of insolvent companies have shown that many insurers who later became insolvent reported an increasing liabilities to liquid asset ratio in their final years…In general, further analysis of an insurer with a high ratio of liabilities to liquid assets should focus on the adequacy of reserves and on proper valuation, mix and liquidity of assets to determine whether the company will be able to meet its obligations to policyholders"[32]

There were other early warning signs that perhaps warranted further enquiry. The late 1990s were characterized by a soft market for insurance products. Reliance had been found to be underpricing its products in order to gain market share. It is intuitive that rapid growth in a soft market is more likely a result of writing policies at inadequate rates than it is from

[32] Insurance Regulatory Information Systems (IRIS) Manual, Property/Casualty Edition (Washington, D.C., National Association of Insurance Commissioners, 2002).

applying rate increases on renewal business. The results of Test #3 (Change in Net Writing) – sudden and sustained double-digit increases in policies written – was another possible early warning sign of trouble. It is not clear why the shareholder dividends requiring regulatory approvals were not questioned further. After years of writing commercial accounts, Reliance was experiencing larger and more frequent claims in certain high-risk lines. The claims it was incurring required an increase in loss reserves. Reliance failed Test #12 (Estimated Current Reserve Deficiency to Surplus) from 1997 onward, with results worsening each year.

Reliance stopped writing virtually all lines of business in June 2000. A.M. Best and Standard & Poor's both downgraded their ratings, citing concerns about the company's ability to pay claims. A deal that Reliance had to sell its European operations to London's Candover Investments fell apart in September 2000. Cash flow was critical, as RGH had almost $240 million of bank debt maturing in August 2000 and $290 million of bonds maturing in November 2000.

Regulatory intervention (supervision, rehabilitation and liquidation)

In August of 2000, Reliance agreed not to pay dividends or make other disbursements without PID's approval, and to file reports with PID detailing financial information, business plans and proposed material transactions.[33] September 30, 2000 was the last date that Reliance's financial information was made public.

Table 8 shows elements of Reliance's statutory year-end surplus. Reliance had an aggressive investment strategy and very risky investment portfolio. A much smaller percentage of its portfolio was invested in bonds, compared to most of its competitors. Non-investment grade (junk) bonds accounted for at least 30 percent of Reliance's bond portfolio between 1996 and 1999 – multiples higher than its peers. Reliance's stock portfolio was highly concentrated in only a few stocks. Its investment in Symbol and Zenith grew from 22 percent of statutory year-end surplus in 1996 to 48 percent in 1999. Junk bonds accounted for up to 88 percent of RGH's total equity between 1995 and 1999. This was problematic, as junk bonds had higher interest rate risks (market rate increases driving down bond values), higher default risks and higher yield-spread risks (loss of value due to investors' flight to quality). Table 8 shows that RGH's investments were extremely risky by 1999 – a full 92 percent of the portfolio was invested in junk bonds, and just one technology stock.

[33] Susanne Sclafane, "Reliance Dividend Payments Under Pennsylvania's Scrutiny", National Underwriter Property & Casualty/Risk & Benefits Management Edition online (United States, August 28, 2000. Archived Web Site. https://www.loc.gov/item/lcwaN0021517/), Pg. 1..

Table 8 – Reliance Statutory Year-End Surplus

Investments	Percentage of Year-End Statutory Surplus				
	1995	1996	1997	1998	1999
Non-Investment Grade Bonds*	23	41	39	32	44
Symbol Technologies Stock	10	11	13	26	48
Zenith National Insurance Stock	12	15	13	9	
Ceding Commission on Unearned Ceded Premium (Surplus Aid)	5	8	9	9	13
Reserve Discounting	13	14	12	8	3
Two-Year Adverse Reserve Development**	12	-	-	-	66**

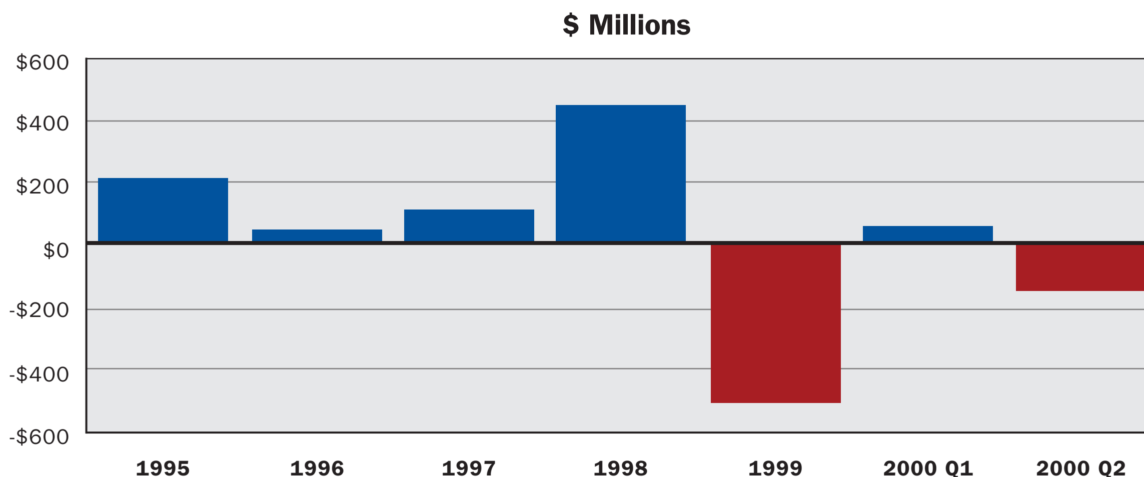
*NAIC classes 3 through 6.

**This is based on one year of development.

Source: Reliance Group Holdings, Inc. 10-K U.S. SEC Reports, 1995-2000.

Reliance had a debt strategy that saw maturities spread out over five years. It created a debt crisis for itself by increasing its short-term debt and loans, and having all this come due in 2000. Figure 5 shows changes in statutory capital for Reliance between 1995 and 2000. Very significant surplus deterioration occurred in 1999. Growth in Reliance's statutory surplus was always constrained by dividend payments to RGH. Surplus generation was significant in 1998, but this was because of the sale of title insurance operations.

Figure 5 – Reliance – Changes in Statutory Capital



Source: Reliance Group Holdings, Inc. 10-K U.S. SEC Reports, 1995-2000.

Mr. Steinberg was eventually forced to cede control of major expenditures to PID. Having twice strengthened its claims reserves in 2000, on November 16, 2000 Reliance filed with PID a copy of its 2000 third-quarter financial statements showing a surplus of $624 million (as at September 30, 2000). Given that the company's reported surplus had decreased sharply, PID advised Reliance that supervision would be required. The surplus was further reduced, however, as insureds worried about Reliance's unstable financial position suddenly came forward with new claims. In November 2000, RGH defaulted on loan payments totaling $538 million. A.M. Best subsequently downgraded its rating to "poor." On December 6, 2000, Reliance was delisted by the New York Stock Exchange. It had been trading at less than a penny a share, down from its 1998 peak of $19.[34]

Based on Reliance's compromised financial position, PID placed Reliance under formal supervision on January 29, 2001. It also installed permanent overseers to manage the company's operation. On April 4, 2001, Reliance advised that its 2000 year-end financial statements were incomplete and its surplus was now negative $220 million (as at December 31, 2000). On May 29, 2001, the Commonwealth Court of Pennsylvania issued a Rehabilitation Order for Reliance. Despite being more than halfway through its second quarter of 2001, the company had not yet completed its 2000 financial statements. Its failure to deliver timely financial information prevented PID from evaluating Reliance's true financial condition. PID discharged Reliance's auditors and directed the company to immediately complete the 2000 financial statements.

The company's true financial health would be far worse than PID realized when it issued the Rehabilitation Order in May. In mid-August, 2001, Reliance produced unaudited financial statements showing a negative surplus of $730 million (as at December 31, 2000) – some $510 million worse than was reported in April. PID directed Reliance to prepare 2001 first-quarter financial statements for the period ending March 31, 2001. This was completed on September 28, 2001.

The 2001 first-quarter financial statements showed continued deterioration in Reliance's financial position. It had a negative surplus of $1.053 billion as of March 31, 2001. Total assets of $8.8 billion were exceeded by total liabilities of $9.9 billion, leaving a shortfall of more than $1 billion.[35] Table 9 shows Reliance Insurance Company's Consolidated Domestic Statement of Assets and Liabilities, as at March 31, 2001.[36]

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[34] Joseph N. DiStefano, "Saul P. Steinberg and Reliance Insurance Co." (Three Parts), *The Philadelphia Inquirer* (Philadelphia, Pennsylvania, The Philadelphia Inquirer, LLC, December 2001), Pg. 28.

[35] M. Diane Koken, *Petition for Liquidation* (Pennsylvania, Insurance Commissioner of the Commonwealth of Pennsylvania vs. Reliance Insurance Company, Docket No. 269 MD 2001, October 3, 2001), Pg. 12.

[36] Ibid., Pg. 12.

The Rehabilitation Order gave PID an opportunity to perform independent, in-depth financial analysis of the company's claims exposure, claims reserve adequacy and reinsurance assets. PID's rehabilitation team took control of Reliance and analyzed its financial condition to determine whether rehabilitation was feasible, or if liquidation was necessary. On June 11, 2001, PID demanded that RGH repay $95 million in dividends that it had received from Reliance. The next day, RGH filed for bankruptcy. Its bankruptcy filing revealed estimated underwriting losses at Reliance of between $1.9 and $2.2 billion, with an additional loss estimate of between $110 million and $150 million for the first quarter of 2001.

Figure 6 – Bad Math Adds Up to Failure for Reliance

On October 3, 2001, the Commonwealth Court of Pennsylvania ordered Reliance into liquidation, as per Article V of the *Insurance Department Act* of 1921. Three factors contributed to a quick decision to liquidate Reliance:

1. The terrorist attack on the World Trade Center on September 11, 2001 caused significant cash flow problems for Reliance. Reinsurance recoverables accounted for almost 60 percent of Reliance's cash flow. However, payments slowed significantly after the World Trade Center attack.[37]
2. First-quarter 2001 financial statements for Reliance that were completed in September showed a negative surplus of $1.05 billion – much worse than the $220 million negative surplus reported on May 29, 2001 when the Rehabilitation Order was first issued.
3. Financial modelling results (as at September 29, 2001) prepared for PID by Ernst & Young indicated that Reliance would be unable to pay policyholder claims as early as the fourth

[37] Swiss Re, "A History of US Insurance" (Zurich, Switzerland, Swiss Reinsurance Company Ltd., 2013/2017), Pg. 47.

Table 8 – Reliance Insurance Company Consolidated Domestic Statement of Assets and Liabilities

Excluding Canada; Unaudited, as at March 31, 2001; Figures in $ Millions

	Domestic Consolidated Gross Basis
Assets	
Cash and bank deposits	50.5
Bonds and short-term investments	1,154.1
Preferred stocks	122.8
Symbol Technologies C/S	285.3
LandAmerica	13.7
Other common stocks and options	22.8
Real estate related investments	135.2
Other invested assets	17.1
Invested assets excluding affiliates	**1,801.4**
Reliance Life	11.0
Garnet – at market	46.0
Reliance Consulting Group	81.6
Foreign Insurance Affiliates	248.6
Non Consolidated Affiliates	26.6
Investments in affiliates	**413.9**
Total Invested Assets	**2,215.3**
Premium balances	142.2
Accrued retrospective premiums	165.3
Accrued interest and dividends	30.9
Reinsurance recoverables – paid losses/LAE	852.9
Reinsurance recoverables – Direct	4,673.8
Reinsurance recoverables – Assumed	385.8
Other Assets	345.0
Total Admitted Assets	**8,811.2**
Liabilities and Surplus	
Losses and loss adjustment expenses – Direct	7,219.3
Losses and Loss adjustment expenses – Assumed	1,293.5
Unearned premiums	327.1
Unauthorized reinsurance	201.1
Reinsurance funds held	553.0
Other liabilities	270.9
Total Liabilities	**9,864.9**
Total Policyholders' Surplus	**(1,053.7)**
Total Liabilities and Surplus	**8,811.2**

Source: Petition for Liquidation, Commonwealth Court of Pennsylvania, Docket NO. 269 MD 2001, Exhibit A, October 3, 2001.

quarter of 2001. The company had a deficit of $31 million in September 2001. Most of its non-reinsurance assets were not liquid. Reliance's weekly cash need for claims and expenses were between $35 million and $40 million. Reinsurance receipts averaged between $12 million and $18 million per week. Residual premium income would shrink from $17 million to $5 million in the coming months. Despite requests from PID, many states refused to release Reliance's statutory capital ($400 million) to pay claims. The company's lack of access to statutory capital and the $95 million dividend paid to RGH left it with a serious liquidity problem.

PID noted, "These factors forced the difficult decision to place Reliance into liquidation immediately. Any further attempts to rehabilitate the company's 'insolvent and financially hazardous condition' would be futile and would substantially increase the risk to creditors, policyholders and the public."[38]

[38] M. Diane Koken, *Petition for Liquidation* (Pennsylvania, Insurance Commissioner of the Commonwealth of Pennsylvania vs. Reliance Insurance Company, Docket No. 269 MD 2001, October 3, 2001), Pg. 2.

Reliance was one of three similarly-sized commercial insurers to be declared insolvent in 2001. Australia's HIH Insurance Limited (subject of PACICC's 2018 *Why Insurers Fail* study) collapsed in March 2001 with an asset deficiency of between $3.6 billion and $5.3 billion. The U.K.'s Independent Insurance went into liquidation in June 2001, after irregularities were uncovered in its claims accounts. In a July 2001 *Insurance Journal* article, Charles Boyle noted the similarities with the Reliance, HIH and Independent Insurance failures, including:

- Each company being led by an industry maverick;
- Each CEO exerting undue influence over his company's operations;
- All three companies gaining market share at the expense of larger competitors; and
- All three companies having flawed business strategies.[39]

Some critics said the fate of Reliance was entirely predictable. Former Reliance Manager Robert Battaglia noted, "I've been in this business 20 years, and I realize this is radical, but it's absolutely ridiculous that insurance companies can be traded on the New York Stock Exchange. Insurance companies have to put money aside to pay claims. A public company has to report to Wall Street investors…And where the major stockholder of a big company is one individual, they're naturally going to do things that satisfy the investor, not the long-term health of an organization."[40]

Joseph DiStefano wrote in *Inquirer Magazine*, "The chairman and his family collected hundreds of millions of dollars from Reliance, lavishing the money on art and philanthropy, while driving the company deep into debt. Critics questioned how regulators responsible for ensuring that Reliance remained solvent could allow Mr. Steinberg and his family to take millions in dividends, stock options and executive pay from the company (more than $150 million during the 1990s alone), even though the company was hundreds of millions of dollars in debt."[41]

[39] Charles E. Boyle, "Reliance Insurance 1871-2001 – RIP", *Insurance Journal* (San Diego, California, Wells Media Group, Inc., July 23, 2001).

[40] Op. cit., Pg. 31.

[41] Ibid., Pg. 3.

Aftermath in the U.S.

To support his dream of creating a financial juggernaut, Mr. Steinberg pushed Reliance heavily into debt and into high-risk lines of coverage that eventually caused the company to fail. In the space of just three years, Reliance saw its net worth tumble by $3.4 billion – from $2.3 billion in mid-1998 to a negative surplus of $1.1 billion in October of 2001. PID moved to liquidate Reliance when the money ran out in the Spring of 2001, in order to protect policyholder interests. Mr. Steinberg's greed and ambition cost many people very dearly, including: employees who lost jobs and severance pay, stockholders left with worthless investments, banks and bondholders that Reliance stopped paying in 2000, insurers hit with industry-funded bailout costs and policyholders left to pay higher premiums because of reduced competition in the market place.

Many Reliance claims were never paid, including those of smaller insurers who purchased reinsurance from Reliance to cover their own future losses. Major banks and bondholders lost a significant portion of their $700 million in investments. Approximately 7,000 former Reliance employees had their pensions reduced, learning later that Reliance's pension fund was underfunded by about $100 million.[42]

At the time Reliance was declared insolvent, it had 187,000 outstanding claims. Three years later, the number stood at 144,000 (almost twice the number expected), worth some $8.7 billion. Reliance had insufficient assets ($5.9 billion) to ensure that all policyholders and creditors would be paid in full. The estate was in a significant deficit situation. The 2001 insolvency of Reliance stands as the largest insurance company failure in U.S. history. The National Conference of Insurance Guaranty Funds estimates that over 80,000 claim files were transitioned to the P&C guaranty funds. As of June 2019, the U.S. Liquidator had approved guaranty fund payouts (including claims payments and administrative expenses) of over $4 billion. The next largest insurance company failure (Legion Insurance Company), which occurred in 2002, was approximately one-quarter that size (approximately $1.2 billion).[43]

Given that the firm had operations in every U.S. state, the impact of the Reliance insolvency was felt across the country. State life and health insurance guaranty associations arranged for the payment of claims. States that were most severely impacted included California, New York and Texas. The insolvency costs were passed along to competing insurers, and would ultimately find their way back to policyholders through higher future premiums.

[42] Ibid., Pg. 32.

[43] Lynch Ryan, "Workers' Comp Insider" (Maryland, Lynch Ryan Weblog, October 25, 2004), Pg. 1.; and NCIGF.

PID committed to carefully reviewing its own oversight, to see what lessons government regulators could learn from Reliance's demise. It said it was aware that the business of insurance is complex, and that complexity will only increase as sectors of the financial services marketplace continue to converge. PID subsequently moved to enhance its scrutiny of loss reserves and reserving practices and to increase its monitoring of the financial condition of holding companies. It urged the NAIC to continue to take steps to adopt a model framework for improved the monitoring solvency of holding companies. PID filed a civil action in June 2002 against various Officers and Directors of Reliance, alleging breach of fiduciary duties, professional negligence and the recovery of preferential transfers. It noted that funds were used to support their "lavish lifestyle." A $100 million settlement was announced in 2005, with those funds flowing to Reliance policyholders in the U.S. Another $31 million was recovered for RGH creditors.[44]

On January 13, 2016, the U.S. Liquidator received approval to pay a cumulative distribution of 65 percent on allowed claims. A Claims Bar Date was set for March 31, 2016. The cumulative distribution on allowed claims was increased to 100% on December 4, 2019.

[44] Doug Simpson, "Unintended Consequences", Weblog, www.dougsimpson.com, February 26, 2005.

Act II: The liquidation of Reliance (Canada)

The October 3, 2001 failure of Reliance in the U.S. marked the end of Act I of this drama. Act II would begin two days later in Canada, with OSFI commencing the wind-up of the company's solvent Branch, Reliance (Canada).

As a result of financial difficulties encountered in the U.S., in October 2000 Reliance initiated the voluntary run-off of its insurance business in Canada. Reliance (Canada) had been in operation in Canada since 1918 and was approved to sell the following lines of insurance: property, accident and sickness, automobile, boiler and machinery, fidelity, liability and surety. It specialized in: professional liability for lawyers, engineers, architects, dentists and hospital programs; directors and officers liability; pollution and environmental liability; and product liability. Reliance (Canada) arranged reinsurance to cover a significant portion of its liabilities. Reliance (Canada) had 16 employees, including its Chief Agent.

While some of its policies were "claims-made" (covering a specified period), many were "occurrence-based" (covering liabilities that might not yet be known, manifest or reported). There were 16 active policies and more than 1,400 outstanding claims when the liquidation formally began in December 2001, not including "incurred but not reported" ("IBNR") claims. A timely run-off of the business would prove challenging, given the nature of some of the long-tail policies and other reinsurance issues. Reliance (Canada)'s last occurrence-based policy expired in March 2004. Its last claims-made policy expired in March 2007.

Canadian branches of foreign insurers are regulated by OSFI and are governed by the *Insurance Companies Act* (*Canada*). A Canadian branch can be placed into supervision and ordered wound-up under the *Winding-up and Restructuring Act* (*"WURA"*). OSFI had frozen Reliance (Canada)'s assets in August 2000 and directed it to stop writing new business in early 2001. On October 5, 2001, OSFI seized control of the assets of Reliance (Canada) under the *Insurance Companies Act*, due to its financial difficulties. OSFI moved quickly to build a ring fence to keep Reliance (Canada)'s assets in Canada to pay Canadian policyholders and creditors. OSFI's early intervention prevented these assets from leaving the country – the U.S. Court was likely to have otherwise forced the transfer of these funds to the U.S.

OSFI cited several concerns at that time to justify the need for immediate action, including:

- As of June 30, 2001, Reliance (Canada) had assets of $171 million and liabilities of $167 million. The company lacked capital to cover any material increase in gross liability.
- Historical company returns showed that claims and adjustment expenses were understated by 20 percent to 40 percent. Its current liabilities could thus be understated by $28 million to $57 million.

- The bulk of Reliance (Canada) underwriting was generating low-frequency high-severity claims, with a high degree of volatility and uncertainty. There was concern that liabilities could be understated.
- There was uncertainty concerning the collectability of reinsurance, given concerns about reinsurer solvency in light of the catastrophic claims arising from 9/11 and the interconnectedness between the U.S. and Canadian reinsurance.

Wind-Up Order

On December 3, 2001, the Ontario Superior Court of Justice ("Court") ordered Reliance (Canada) to be wound-up, pursuant to the provisions of the *WURA*. KPMG Inc. was appointed as Provisional Liquidator ("Liquidator") to pay any valid policy loss claims in full (without cancelling policies) and to collect any reinsurance owed, separate from the estate in the U.S. in liquidation. PACICC and the U.S. Liquidator were appointed as Inspectors. Reliance (Canada)'s projected estate surplus was $85.3 million. PACICC Board Minutes (November 14, 2001) noted support for a "novel approach" to the wind-up of Reliance (Canada).

PACICC signed a *Loan and Services Agreement* with the Liquidator (backed by a pledge of PACICC's assessment power) whereby PACICC would borrow money from the Canadian estate of Reliance (Canada), with the funds repayable only if dividends from the estate were less than 100 percent. PACICC was only required to provide a $50 million covenant (via its Compensation Fund or assessment capacity) to secure agreement from the Liquidator. PACICC had made similar requests to other liquidators in the past to resolve other company failures, but those requests had been rejected. In the case of Reliance (Canada), the Liquidator was prepared to enter into the agreement because, notwithstanding the uncertainties surrounding the estate, the Liquidator was of the view there was a reasonable possibility there would be sufficient assets in the estate ultimately to allow full payment to policyholders. This enabled the Liquidator to enter into settlement with PACICC.

In the absence of an agreement that PACICC would provide coverage, the Liquidator would be unable to simply pay out claims to PACICC limits, since the Liquidator could potentially be held personally liable for preferential payments if the estate were unable to pay policyholder claims in full.[45] The precedent-setting agreement with PACICC took pressure off the assignment of claims and facilitated faster payment of policyholder claims. Because in the end the recovery on claims was 100 percent, PACICC was not required to advance funds and Members were thus spared the time and expense of a traditional assessment.

[45] Similar agreements were used in the case of several liquidations of life insurance companies in the early 1990s; the agreements being between the Liquidator and CompCorp, as it then was.

Extended protection

PACICC was able to add to its resolution "toolkit" by showing flexibility in responding to claims in the Reliance (Canada) liquidation. For instance, to enable the Liquidator to secure regulatory and Court approval for the transfer of the Meridian Warranty Program to London Guarantee, PACICC's Board agreed to several extensions of policyholder protection beyond the 45-day coverage period provided in PACICC's Consolidated Memorandum of Operation ("Memorandum"). PACICC cited provisions of Article 30 of the Memorandum, allowing the Board to pass a unanimous resolution that claims be paid in hardship cases. PACICC agreed to seven extensions over the next two-and-a-half years to enable the Liquidator to continue to run off the business and secure the transfer of non-warranty policies to another insurer. Reliance (Canada)'s 18,000 vehicle warranties were non-transferrable, as they were only available to original purchasers of the vehicles.

Sale of a portfolio

On May 9, 2003, the Liquidator advised the PACICC Board that an agreement had been reached with a new insurer to be incorporated for the assumption of Reliance (Canada) business, other than the vehicle warranty business. The Liquidator encountered difficulties in concluding the *Transfer and Assumption Agreement* because of reinsurer reluctance to accept assignment of the reinsurance. The reinsurers either wanted to have the reinsurance commuted, or took the position they were entitled to termination or set-off because of the interconnection with the U.S. reinsurance portfolio. It was proposed that the warranty business be rolled into the other book of business that would be assumed by the prospective insurer, and that the commuted reinsurance would be worked into that transaction. In such case, the Liquidator would ask PACICC to extend its protection until the transaction closed. If an agreement could not be reached, then the Liquidator would likely run-off the business. The agreement fell through.

Reinsurance claims

Prior to its insolvency, Reliance had entered into certain reinsurance contracts and treaties that reinsured Reliance, Reliance (Canada) and other affiliates. Reliance (Canada) experienced difficulties and delays in the collection of reinsurance proceeds under these treaties. Some reinsurers claimed set-off for amounts owing to Reliance (Canada) against amounts that they claimed were owed to them by Reliance. On February 29, 2008, the Court ruled on claims of two reinsurers that had entered into agreements with Reliance. The reinsurers were seeking to offset or reduce the amounts they owed to Reliance (Canada) (totaling CDN$1.7 million) by amounts that were owed to them by Reliance (totaling US$35 million).

No parties challenged the constitutional validity or applicability of the *International Commercial Arbitration Act* or the *Model Law on International Commercial Arbitration* (adopted by the United Nations Commission on International Trade Law in 1985) in the context of a *WURA* proceeding, and which were referenced in the case. The reinsurers were ordered to pay to the Liquidator most of the amounts due and owing.

Claims payments

The Court approved six separate distributions to policyholders for valid loss claims, resulting in a cumulative 100 percent payment. Distributions were approved on: December 3, 2001 ($25,000); June 26, 2003 (25%); September 2, 2004 (25%); December 21, 2005 (15%); December 15, 2006 (15%); and April 8, 2008 (20%). With 100 percent of policyholders having been paid in full (including interest), the Liquidator applied to the Court for approval to pay ordinary creditor claims up to $100,000. Court approval was granted on December 17, 2008.

On August 3, 2010, the Court approved a process under the *WURA* calling for policy loss claims, with December 17, 2010 set as the filing deadline. A total of 3,732 claims were received, potentially costing $1.7 billion – 37 claims were already on the books. On December 31, 2017, the Liquidator determined that there were 30 open claims for 61 policies from 19 policyholders. It had resolved 18,600 claims (in full) worth $189 million, with a post-liquidation interest where appropriate. The projected estate surplus was $104.7 million – $122.9 million of total assets less $18.2 million in total liabilities.

RBH and ITCAN

Pursuant to the Liquidator's earlier call for claims, Rothmans, Bensons & Hedges Inc. ("RBH") filed 168 contingent claims and an additional 19 claims relating to various class and provincial government actions commenced against it between 1995 and 2015 (exceeding its $110 million policy limits). On May 7, 2015, Reliance (Canada) entered into an agreement with RBH, absolving it of all claims (reported or unreported) for 12 excess liability policies for a one-time sum of $9 million, subject to Court approval. Similarly, Imperial Tobacco Company Limited ("ITCAN") filed 18 contingent claims and an additional 10 claims relating to various class and provincial government actions commenced against it between 1997 and 2015 (far exceeding its $173 million policy limits). On June 17, 2015, Reliance (Canada) entered into an agreement with ITCAN, absolving it of all claims (reported or unreported) for 11 excess liability policies for a one-time sum of $10 million.

The ITCAN and RBH agreements were immediately opposed by Quebec class action representatives who had obtained a $15.5 billion judgement against RBH, ITCAN and JTI-MacDonald. Eight provincial Crowns (B.C., Saskatchewan, Manitoba, Ontario, Quebec, New Brunswick, Nova Scotia and PEI) also opposed the ITCAN and RBH agreements – each was seeking up to $50 billion from the tobacco manufacturers. The Crowns were suing RBH and ITCAN directly to recover tobacco-related healthcare costs, under the *Tobacco Damages and Health Care Costs Recovery Act, 2009*. They opposed any settlements with RBH and ITCAN that would release Reliance (Canada) from the Crowns' claims against the company or its reinsurers.

The Crowns argued that they were not subject to the *WURA*. The *Act* provides a framework to address the failures of federal corporations and financial institutions, ensuring orderly and expeditious distribution of assets among a failed institution's creditors, under Court supervision. The *WURA* requires that any claims against a company in liquidation be pursued through a recovery process conducted by a Court-approved Liquidator. Section 38 of the *Act* gives the Liquidator the power to compromise claims, which was the basis for the conditional settlement of the RBH and ITCAN claims. The Crowns noted that, even if they were found to be bound by the *WURA*, there was no basis for the Court to release Reliance (Canada) from their litigation. Given that they were not making any claims under the *WURA*, the Crowns felt that the *Act* did not come into play.

The Liquidator expressed concern that any decision that Crowns were not bound by the *WURA* would create uncertainty about possible claims from Crowns in future. The Liquidator would be left questioning whether it was protected by the Court's authorization to distribute surplus funds from the estate. It could conceivably create a situation where an estate might never be finalized, and assets never fully distributed to address outstanding claims. The Liquidator expressed concern that it could later be sued by a Crown for having distributed Reliance (Canada) surplus funds to the U.S. parent after all claims were paid in full.

Court decision

On December 2, 2015, the Court ruled that Crowns were not bound by the *WURA*. The RBH and ITCAN settlements, which were supported by PACICC as an Inspector, were therefore not approved. The Court did not rule on whether policy exclusions prevented coverage for cancer or other diseases stemming from the use of tobacco products. The decision stated, "If the Crowns do not all participate in the winding-up being carried out

by the Liquidator and file no claims with the Liquidator, the Liquidator can apply to Court and be authorized to make distributions to those claimants who have filed claims and have had them accepted by the Liquidator…If the Liquidator applied to Court for such approval, and the Crown had not filed any claims with the Liquidator, I fail to see how the Liquidator could somehow be liable for ignoring a non-claim from the Crowns once the payment was authorized by the Court."[46]

Following this Court ruling, the Liquidator continued its efforts to bring closure to the Reliance (Canada) estate and proceeded to attempt to find a viable Canadian insurance company of sufficient size to absorb Reliance (Canada)'s outstanding book of business. The new firm would have to satisfy the Liquidator that all affected policyholders would be as well off with the transfer as with dealing with Reliance (Canada) in liquidation. Success would come years later.

By September 30, 2018, the Liquidator had collected $135 million in reinsurance for the Reliance (Canada) estate. On November 8, 2018, the Liquidator entered into an *Assumption Reinsurance Agreement* with Westport Insurance Corporation – Canada Branch ("Westport"). The Agreement was supported by the U.S. Liquidator and PACICC. OSFI took no position on the transaction. On December 6, 2018, the Court approved the transfer of all outstanding Reliance (Canada) claims and policy liabilities to Westport, discharge of the Liquidator, termination of Inspector appointments and the release of surplus assets ($104.7 million) to the U.S. Liquidator. Westport assumed all outstanding Reliance (Canada) claims and policies as a going concern carrier.

The Reliance (Canada) experience exposed an important discrepancy between the wording of the *WURA* and Canada's other insolvency legislation – the *Act* does not contain any language expressly binding the Crown to any liquidation procedure under the *WURA*. The Crowns sought to recover health care costs from RBH and ITCAN directly through the *Tobacco Damages and Health Care Costs Recovery Act, 2009*, rather than through Section 132(1) of the *Ontario Insurance Act*. Throughout the litigation, Ontario maintained that any judgement it obtained against Reliance (Canada) would target the assets of Reliance (Canada) – refusing to accept that these were ever assets of the Liquidator. The Crowns successfully argued that the Court lacked authority to bind the Crown to the Liquidator's proposed settlement agreements. The Court decision that the *WURA* was non-binding on the Crown avoided the need for a ruling on Reliance (Canada) policy exclusions (for cancer

[46] Canada (Attorney General) v. Reliance Insurance Co., 2015 ONSC 7489, 2015 CarswellOnt 18299, 261 A.C.W.S. (3d) 307…Pg. 8.

or other diseases caused by tobacco products) or which party may recover costs under Section 132(1) of the *Ontario Insurance Act* (the injured party vs. a third party paying health care costs for damages caused to the injured party).

The Liquidator encountered some significant hurdles in bringing closure to the Reliance (Canada) estate given the complexity of both its liabilities and its reinsurance. This stands in contrast to another liquidation of a solvent Canadian branch that occurred in 2003 – the liquidation of The Home Insurance Company ("Home Insurance" – discussed in the following Case Study) which did not have such complexities,. Again, policyholder interests were protected by PACICC's pledge to cover claims, and by the subsequent transfer of the business to another viable insurance company. While it took 17 years to resolve the Reliance (Canada) liquidation, it took only four months to resolve the Home Insurance insolvency.

The case for expanding PACICC's resolution "toolkit"

PACICC's Priority Issue for 2020 is to expand its resolution "toolkit" to deal with troubled insurers, including possible early intervention in the absence of a Court-ordered wind-up. Section XI, Paragraph 40 of PACICC's Memorandum of Operation permits the PACICC Board to take "reasonable steps" prior to a Member being ordered into wind-up, if such steps are consistent with the Corporation's objectives. The Memorandum clarifies that these steps include, "without limitation, assisting in the sale, transfer or reinsurance of a book of business written by a Member company," and/or "issuing guarantees or otherwise providing financial support." PACICC is seeking to define these pre-insolvency resolution powers more clearly – and to better understand what it will need to do to support them (e.g. additional financing mechanisms, staffing, external resources and direct support from regulators).

PACICC has been involved with the failure of two Canadian Branches – Reliance (Canada) and The Home Insurance Company of Canada. Actions taken by PACICC to deal with these two insolvencies differed from traditional approaches taken in the past. They can be viewed as early launch points for a closer examination of creative new resolution options (early resolution vs. traditional liquidation) that can enhance consumer protection, reduce costs to the industry and strengthen policyholder confidence in Canada's P&C insurance industry.

The Home Insurance Company of Canada: Sold!

On June 26, 2003, a Winding-up Order was issued for The Home Insurance Company of Canada ("Home Insurance Canada"), a Member company of PACICC. The U.S. parent company was insolvent (having been ordered into liquidation two weeks earlier). In fact, the Canadian branch had been winding down its operations since the mid-1990s. Deloitte was appointed by OSFI as the Provisional Liquidator of Home Insurance Canada.

It was clear from the information available at the time that Home Insurance Canada, unlike its parent company, was in a solvent position. For example, the Company's P&C-2 filing as at December 31, 2002, reported net assets of CDN$39.0 million (see Table 10). The estimate of total unpaid claims of $8 million was further verified by an independent actuary's report prepared in February 2003.[47] The Company was writing only commercial insurance at the time of the wind-up, having sold its personal lines business in Canada some 14 years earlier.

Table 10 – Financial Position of Home Insurance Canada
(as at December 31, 2002)

Assets and Liabilities	$ Millions CDN
Vested assets (mostly government bonds)*	$49.6
Reinsurance receivable/recoverable	0
Other assets (cash, receivables, etc.)	0.4
Total Assets	**50.0**
Unearned premiums	0
Unpaid claims (including IBNR) and adjustment expenses	7.9
Other liabilities (mostly income taxes)	3.1
Total Liabilities	**11.0**

*At the time of the Winding-up Order (June 26, 2003), these assets were under the control of OSFI.

Source: P&C-2 filing of Home Insurance Canada, as at December 31, 2002.

Despite the apparent solvent position of Home Insurance Canada, there were concerns about the possibility of "non-booked claims" when the Winding-up Order was issued. These concerns were due in part to Home's status as a Canadian branch, but mainly to the insolvency of the U.S. parent company. To mitigate those concerns, PACICC entered into a *Loan and Services Agreement* with the Canadian Liquidator – whereby $10 million of PACICC's general assessment capacity was reserved to cover possible claims

[47] David J. Oakden, "The Home Insurance Company – Canadian Branch Policy Liabilities as of December 31, 2002" (Toronto, Tillinghast-Towers Perrin, February 24, 2003).

contingencies. This Agreement was in place when the Winding-up Order was issued. Discussions had been under way between Home Insurance Canada and Lombard Insurance Company of Canada (a unit of Fairfax Financial) regarding a possible sale of Home Insurance Canada's business. Following the Winding-up Order, the discussions were continued by the Liquidator, resulting in the conclusion of an *Assumption Reinsurance Agreement* by both parties in October 2003 – only four months after the formal winding-up. (The Agreement was also signed/supported by the U.S. Liquidator for Home – who had a claim on at least part of Home Insurance Canada's surplus).

When the *Assumption Agreement* came into effect on February 24, 2004, Home Insurance Canada's policyholders were informed that, "…Lombard General Insurance Company of Canada has assumed, with effect as of January 1, 2003, the insurance business in Canada of The Home Insurance Company including your current policy. The transaction was completed pursuant to an agreement which received the approval of the Minister of Finance, Canada. Lombard will continue to provide benefits to you and will administer your policy, according to its terms and conditions, as they existed prior to the assumption of the business…All payments, notices or claims in respect of your policy should be made and sent directly to Lombard as though Lombard had originally issued the policy."

The prompt winding-up and sale of Home Insurance Canada illustrates how the process of liquidation can, at times, be shortened to achieve good commercial results for all stakeholders. Most important, the interests of Home's policyholders were protected in the short-term by PACICC's guarantee – and in the longer-term by the assumption of business by another viable insurance company. The transfer process was relatively quick and seamless. In some respects, PACICC's guarantee (to policyholders) was an early form of what is now being referred to among "resolution experts" as "preparing the runway" for the successful sale of Home Insurance Canada. The sale avoided a potentially lengthy and expensive liquidation for PACICC and its Member companies. And the outcome allowed regulators to focus their attention on other more urgent policy and supervisory issues. (The U.S. Regulator/Liquidator had a strong incentive to be supportive, as they stood to gain from the transfer of surplus Canadian assets to help address a shortfall in Home's U.S. estate).

While the result in this case was facilitated by Home Insurance Canada's solvent financial condition, the outcome was nonetheless a "win-win" for all stakeholders, at least in part attributable to the creative utilization of PACICC's non-insolvency "resolution" powers.

Causes of the Reliance insolvency

Primary causes of the insolvency:

1. Business Strategy of Growth and Diversification

Reliance's net written premiums grew by an average of 16 percent from 1996-1998. Given that this growth was in riskier lines and the fact that new business often has a higher loss ratio, this was a big gamble for Reliance.

2. Pricing

Reliance priced products aggressively to support an ambitious growth strategy. This was especially problematic, given its expansion into markets with high risk (e.g. construction defects and asbestos) and long-tail claims (e.g. workers' compensation) where true costs became apparent only years later. Rapid growth in a soft market is likely a result of underpriced products rather than rate increases on renewal policies.

3. Governance Structure

Following its takeover, Reliance was led by a dysfunctional Board of Directors that was stagnant, conflicted, passive and lacking independence. Decisions were often made to benefit key investors (principally the Steinberg family) rather than company interests.

4. Reserving

Reliance shifted its focus to riskier lines of business, such as workers' compensation. Constantly deteriorating results in the company's last few years of operations were a sign that its reserves were inadequate, or overly optimistic. Reliance significantly underestimated future claims costs.

5. Investments

Reliance took a very aggressive approach to investments. A large percentage of its investments were in below investment-grade bonds and stocks. Also, its stock holdings were highly concentrated in individual stocks. RGH's worsening credit and a deteriorating market for lower-grade debt made it difficult for the parent to re-finance its debt.

6. Capital Management

Reliance had difficulties in managing its capital. Surpluses were continually depleted by shareholder dividends. The settlement of the Unicover exposure and investment losses on below investment-grade bond and stock portfolios placed further demands on capital. This drain of surplus constrained Reliance's ability to handle adverse business developments as they arose.

Possible contributing factor:

Regulatory Supervision

While PID acted decisively when it was clear that Reliance was in deep trouble, there were early warning signs that may have been overlooked (e.g. consistent failure of the Liabilities to Liquid Assets Test, falling stock prices, large capital depletions via shareholder dividends, increasing short-term debt with loans coming due in the same year, rapid growth in a soft market, etc.). Earlier regulatory engagement may have mitigated or even averted the scope of the failure.

Lessons learned from the Reliance insolvency

For insurers:.

- **Reserving –** *Adequate provisions for outstanding exposure are critical to the financial health of any insurer*. Reliance did not set aside adequate reserves for its aggressive entry into riskier lines of business. Its failure to set aside adequate reserves to cover future claims costs proved fatal to the company.
- **Underwriting –** *Assessing and properly pricing risks is vital to an insurance company's long-term success*. Reliance used aggressive underwriting to seize market share from established competitors to support an ambitious growth plan. Trouble ensued when capital was not available to pay higher claims costs.
- **Entry into new markets and new lines of business –** *Companies must exercise caution when entering new markets and new lines of business*. Reliance shifted its focus to riskier lines of business and new international operations. Its lack of underwriting discipline in a soft market and inexperience abroad would prove fatal in the end.
- **Acquisitions and joint ventures –** *Acquisitions and joint ventures should support the strategic objectives of the organization*. Reliance used heavy debt financing to support acquisitions and investments that were not related to the business of insurance. The parent company's debt load was fatal when cash flow became an issue.
- **Financial statements –** *A company's financial statements must accurately reflect its true financial position*. Reliance was unable to produce timely and accurate financial statements when losses were mounting. Shareholders suffered from a lack of accurate information to make informed investment decisions.
- **Director responsibilities –** *Boards of financial institutions must demonstrate independent judgement*. The Reliance Board was conflicted and self-serving, remaining largely unchanged for years. It lacked the necessary independence to challenge management decisions regarding strategy and performance.
- **Capital management –** *Maintaining capital strength is important for the success of any insurer*. While Reliance was able to generate relatively steady surpluses, they were routinely depleted through dividends to the parent company. Reliance lacked available funds to handle unexpected claims costs.

For regulators:.

- **Regulatory supervision –** *Regulators must show healthy suspicion and be prepared to intervene at the first sign of trouble*. While Reliance solvency tests did not fall below minimum levels until late 1999, there were much earlier signs of poor corporate governance, financial weakness and significant change in the company's risk appetite.
- **Discrepancy between the *Winding-up and Restructuring Act (WURA)* and other Insolvency Legislation –** *The WURA lacks language to bind the Crown in WURA proceedings.*This has consequences for the priority of claims, and to seek various relief binding the Crown.

Timeline of key events

1817	The (volunteer) Fire Association of Philadelphia is established – eventually becomes Reliance.
1871	The City of Philadelphia establishes its own paid fire department.
January 1, 1958	The Fire Association of Philadelphia changes its name to Reliance Insurance Company.
1961	Saul Steinberg establishes Ideal Leasing Company, a computer-leasing company.
1965	Ideal Leasing Company becomes Leasco Data Processing Equipment Corporation.
August 21, 1967	Edward Netter publishes his report, "*The Financial Services Holding Company.*"
June 21, 1968	Saul Steinberg launches an unsolicited takeover bid to acquire Reliance.
August 1, 1968	Steinberg takes over Reliance, issuing $400M of stock to fund the deal.
August 1969	Reliance issues $52M in dividends to shareholders, up from $10M in 1968.
1971	Reliance Financial is established.
December 1973	Leasco Data Processing Equipment Corporation becomes Reliance Group, Inc.
1981	Reliance Group Holdings, Inc. is established, replacing Reliance Group.
1987	Reliance National is established to help Reliance enter new markets and expand sales.
1991	Reliance exits personal line coverages.

1995	Saul Steinberg suffers a stroke. Brother Bobby takes over as CEO.
1996	Reliance expands rapidly into non-standard auto.
August 1997	Reliance establishes Cybercomp to offer workers' compensation via the Internet.
February 27, 1998	Reliance sells its title operations to LandAmerica for $657M.
February 1999	Cologne Re's $275M loss exposes widespread problems with Unicover.
June 14, 1999	Reliance announces losses of up to $250M on its non-standard auto business.
January 21, 2000	Reliance takes a $170M loss on its Unicover exposures.
February 2000	Reliance sells its surety business to Travelers Property Casualty Group for $580M. It also reports a net loss of over $300M for 1999.
March 2, 2000	PID orders a financial examination of Reliance.
June 2000	Reliance stops writing virtually all lines of business.
June 8, 2000	A.M. Best downgrades Reliance's rating due to poor performance.
July 14, 2000	S&P downgrades Reliance, raising questions about its ability to meet financial obligations.
September 30, 2000	Reliance's financial information is made public for the last time.
November 16, 2000	Reliance files its Q3 2000 Quarterly Statement showing a surplus of $624M.
January 29, 2001	PID places Reliance under formal supervision, installing managers to oversee its operation.
April 4, 2001	Reliance's 2000 financial statements are incomplete, with a $220M negative surplus likely.

May 29, 2001	PID secures a Rehabilitation Order for Reliance.
August 2001	Reliance submits 2000 financial statements showing a negative surplus of $730M.
October 3, 2001	PID secures a Liquidation Order for Reliance.

Events in Canada

October 5, 2001	OSFI takes control of Reliance (Canada) assets, even though the Branch is solvent.
December 3, 2001	Ontario Superior Court orders the solvent wind-up of Reliance (Canada).
November 14, 2001	PACICC Board takes a "novel approach" to wind up Reliance (Canada) operations, borrowing funds from the estate rather than assessing Members, speeding payment of policyholder claims.
January 28, 2002	PACICC Board extends policyholder protection beyond the 45-day period (to April 30, 2002) to enable the Liquidator to transfer policies (other than vehicle warranty) to another insurer.
April 19, 2002	PACICC Board extends policyholder protection to December 31, 2002.
November 29, 2002	PACICC extends policyholder protection to March 31, 2003.
February 19, 2003	PACICC Board extends policyholder protection to December 31, 2003.
November 18, 2003	PACICC Board extends policyholder protection to June 30, 2004.
March 2004	Last occurrence-based Reliance (Canada) policy expires.
March 2007	Last claims-made Reliance (Canada) policy expires.
February 29, 2008	The Court rules on claims of two reinsurers that had entered into agreements with Reliance.

December 17, 2008	The Court approves payment of ordinary creditor claims.
December 31, 2008	PACICC receives a special one-time payment from the estate for direct liquidation expenses related to PACICC's role as the Court-appointed Inspector.
April 15, 2009	PACICC makes available up to $50,000 from its operating surplus to fund future non-recoverable liquidation expenses incurred in resolving the Reliance (Canada) liquidation.
August 3, 2010	The Court approves a process calling for policy loss claims under the *WURA*.
December 17, 2010	Deadline for filing policy loss claims with Reliance (Canada) under the *WURA*.
May 7, 2015	Reliance (Canada) enters into conditional $9M claims settlements agreement with RBH.
June 17, 2015	Reliance (Canada) enters into conditional $10M claims settlements agreement with ITCAN.
December 2, 2015	The Court rules that Crowns are not bound by the *WURA*, and rejects the conditional deals.
March 31, 2016	A Claims Bar date is established for Reliance policyholders in the U.S.
November 8, 2018	Westport Insurance Corporation agrees to assume Reliance (Canada)'s outstanding claims.
December 6, 2018	The Court approves the transfer of all outstanding Reliance (Canada) claims to Westport. The transfer of Reliance (Canada)'s $104.7M surplus to the U.S. Liquidator is approved.
June 2019	U.S. Liquidator-approved guaranty fund payouts related to the Reliance insolvency (including claims payments and administrative expenses) total over USD $4 billion.

Abbreviations

CBW	Carter, Berlind & Weill, Inc. (investment brokers)
Home Insurance Canada	Home Insurance Company of Canada
IBNR	Incurred but not reported
IRIS	Insurance Regulatory Information Systems
ITCAN	Imperial Tobacco Company Limited
LandAmerica	LandAmercia Financial Group, Inc.
Leasco	Leasco Data Processing Equipment Corporation
Leucadia	Leucadia National Corporation
Liquidator	KPMG Inc.; Provisional Liquidator (Canada)
Memorandum	PACICC Consolidated Memorandum of Operation
NAIC	National Association of Insurance Commissioners
NCIGF	National Conference of Insurance Guaranty Funds
OSFI	Office of the Superintendent of Financial Institutions
PACICC	Property and Casualty Insurance Compensation Corporation
PID	Pennsylvania Insurance Department; Provisional Liquidator (U.S.)
P&C	Property and casualty insurance
RBC	Risk-based capital
Reliance	Reliance Insurance Company
Reliance (Canada)	Reliance Insurance Company – Canadian Branch
Reliance Consulting	RCG International, Inc.
Reliance Development	Reliance Development Group, Inc.
Reliance Financial	Reliance Financial Services Corporation
Reliance Group	Reliance Group, Inc.
Reliance National	Reliance National Insurance Company
RBH	Rothmans, Bensons & Hedges Inc.
RGH	Reliance Group Holdings, Inc.

Unicover	Unicover Managers, Inc.
U.S. Liquidator	Pennsylvania Insurance Department; Provisional Liquidator (U.S.)
Westport	Westport Insurance Corporation – Canada Branch
WURA	*Winding-up and Restructuring Act*

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