CHAPTER 24

1975 Perimeters and Parameters

Premium levels in general and medical malpractice in particular

With the poor results of 1974 fresh in their minds, many of those in the insurance industry went into 1975 believing it to be a year in which to raise premiums, convinced that only higher levels could offset the fall in investment income consequent on the current global recession. Meanwhile the incidence of litigation by medical patients in the United States, coupled with the size of malpractice claims and awards, had risen so high as to bring on a crisis of acute proportions. Doctors faced huge insurance cost increases as American insurers raised their rates dramatically in an effort to recover lost premiums. Some insurers were so unnerved by the increase in the number of malpractice suits that they began to pull out of the business altogether. Senate Health Subcommittee hearings in mid-March were prompted to call for federal government solutions. Finally, in desperation at the lack of affordable medical malpractice coverage, the doctors themselves decided to take matters into their own hands by forming their own medical malpractice mutual. They sought collectively to set up a captive that would insure their needs in a common pool.

Bermuda demurs

Because Bermuda was considered to be the best jurisdiction for captives, it was naturally the first choice of the Harvard Medical Group's doctors as the place in which to locate their own new captive. They also used the services of insurance broker Johnson & Higgins (J&H). The Group applied through its coordinator, Dan Creasey and J&H Bermuda, to form Medical Centre Insurance Company Limited (MCIC) as an association captive. Their goal was to provide medical malpractice coverage to the resident doctors of their medical schools, as well as to private practice (part-time) doctors.

An *ad hoc* committee was set up, headed by Steven Chamberlain, President of Intercontinental Reinsurance Company Ltd., and formerly a Vice President of Home Insurance Company, Mr L.H. Longley-Cook, a consulting actuary residing in Bermuda, and Mr Bill Lishman, a retired Bermuda insurance executive, were appointed to this committee. Prior to the Insurance Act of 1978 this committee reviewed all applications for entry to Bermuda. It set up requirements for the formation of companies writing medical malpractice and products coverage. Once the committee approved a company to come to Bermuda, the Bermuda government was then free to allow the company to operate there.[207]

The Committee had a problem with the inclusion of private practice physicians under a captive scheme and advised Creasey that it would require some modification to the language of the policies. Without a moment's discussion, Creasey took the business plan to the Cayman Islands, where it was accepted on the spot.

[207] J.H. Blades, Chairman of Blades Group of Companies, 'The Bermuda Insurance Market', speech to the Insurance Institute of London, 8 February 1977

MCIC thus became the first captive of any significance to be established in the Caymans. As a result of their readiness to accept this first medical malpractice captive without modifications, the Caymans in due course developed a reputation for specialised skills in the management of such captives, and these later broadened into professional liability programmes. In fact MCIC, though introduced by J&H to the Caymans, was managed by the Bank of Nova Scotia, because J&H did not yet have a presence in the Caymans. J&H subsequently acquired the Bank of Nova Scotia portfolio when Brian Hall went to the Caymans with a commitment to establish a presence there.[208]

The establishment of MCIC marked the beginning of the captive era in the Cayman Islands. Bermuda's refusal to accept MCIC paved the way for the Caymans to become a very important domicile for captives, second in the world only to Bermuda as far as numbers were concerned.

Bermuda sets criteria for health care captives

Although those involved behind the scenes of the Bermuda insurance industry were disinclined to accept MCIC as a captive, they did not want to shut the door on what appeared to be a lucrative market for Bermuda if the programme was handled correctly. Chamberlain's *ad hoc* committee set very high standards for allowing health care captives to set up on the island, because the committee realised just how volatile the whole medical malpractice situation was in the United States. Because of this volatility, the committee decided they would only allow captives owned by hospitals and would not accept any owned by physicians.

Business Insurance reported as follows—

> 'A special a*d hoc* committee was established in 1975 to evaluate applications for medical malpractice companies. The committee is headed by Steven Chamberlain, President of Intercontinental Reinsurance Co. Ltd. "We've only approved about 15 malpractice insurance companies," Mr Chamberlain said, "All of them hospital owned. Our standards are high enough so we don't get many applicants." The committee will not approve physician-owned malpractice insurers.'[209]

Bob Clements seeks alternative markets

At the same time as medical malpractice claims were creating an insurance crisis in the United States, Bob Clements, a broker within the Marsh & McLennan organisation, moved back to New York and got involved with the management of the company. Clements had gone to work for Marsh & McLennan in Toronto, Canada, back in 1959. All of his children were born there but most importantly his family enjoyed life in Canada and had no intention of moving back to the United States. In the past he had turned down opportunities to advance his career by being offered positions in the United States. However, Clements had just turned 40 years old and really wanted to find out if he could 'hurl curve balls in Yankee Stadium'. He did not want to go through the rest of his life wondering if he had it in him or not. As a result he moved back to New York in 1975, where he became Marsh's senior officer for casualty insurance. The business at the time was primarily North American.

As we have seen, by 1975 the insurance market was in dire straits. Rates had escalated and capacity had shrunk. Consequently, for the first time in its history, Marsh & McLennan was unable to complete placements of orders for its clients because there was just not enough insurance capacity available. It was then that Clements saw how essential it was that Marsh should never find itself in such a vulnerable position again. He set out to find a way for Marsh to provide constructive solutions to clients at all times.[210]

[208] Notes from Brian Hall, 29 May 2002

[209] *Business Insurance*, 7 March 1977, 'Registering a captive is painless, more are filing, says key official,' by Margaret LeRoux, p. 23

[210] Interview with Bob Clements, 10 December 2002

Kevin Stevenson of *Bermudian Business* reported the following comments by Clements—

> 'It was not a fun experience because first of all, you don't get paid for failing to fill an order, and second, we noticed the disturbing tendency to shoot the messenger...If you come back and say 275 insurance companies have refused to insure you, they don't remember the name of anybody but the person who told them that. We had always conceived that a broker's responsibility had been to execute the placement of insurance in the most cost-effective and professional manner possible. And it seemed that we had left a dimension out because there had been a call for it—and that dimension was to do something about creating a market if there wasn't one.'[211]

And so the seed was sown in Clements' mind. He could not know that a little over a decade later this seed would give rise to, a whole new playing field for insurance, not just in Bermuda but around the globe.

Insurance centres vie for market share

A wave of change was sweeping the insurance world, as companies exerted tremendous pressure to increase their profits by enlarging their market share. London was no longer the only insurance capital. Its underwriters began to experience competition from the Japanese and the US marine markets and from continental Europe, as well as from the United States in the non-marine and aviation markets. Conflicting reports came out of London as to how well the insurance market there was faring by comparison with worsening global insurance results.

Obviously concerned at losing market share in a line of business they had been accustomed to control, the London insurers sought to increase market share with lines of business that no one else was writing. They sought to find this in the growth of aviation and therefore began to concentrate heavily on this supposedly lucrative market.

OIL experiences rating conflicts with its members

As the oil industry expanded significantly and its technology became increasingly sophisticated, so its exposure also increased, along with the boom in oil well exploration and production.

Membership in the Bermuda based OIL had grown likewise, as a consequence of the attention being accorded to oil companies. Although OIL had still not managed to recruit the giants, such as Shell, Mobil, and Exxon, the members of OIL differed widely enough in size for there to be sharp disagreement within the mutual as to how premiums should be assessed and allocated among such a varied membership.

Then came a shock. Gulf Oil announced that it was pulling out of OIL. This seemed at the time to be a massive blow. Gulf had been one of the founding members. Rumours abounded. Was the withdrawal due to the fact that Gulf did not see the need for OIL to provide marine coverage, because Gulf felt it was so abundantly available in the traditional insurance marketplace? Was it displeasure at the way their former president, Roy Jackson, had been forced out of OIL? Gulf said that one of its major reasons for departure was that it could better manage exposures through INSCO, its own newly formed captive, based in Bermuda. Gulf was also planning to take advantage of the limits and coverages readily available in the conventional marketplace. In addition Gulf maintained that in the risk distribution plan whereby OIL assessed premiums there was an inherent imbalance that left the larger companies holding the bag for the smaller.

Despite such disparagement, the mutual flourished. Many dispassionate observers considered it to be the most progressive and sophisticated concept of its time in the field of risk management. They were of the view that such mishaps as the loss of Gulf were of only passing account and would prove to be of little financial consequence for OIL. Any sense of alarm could be quickly discounted.

[211] *The Bermudian*, Focus on Business, 'Fathers of Fortune', by Kevin Stevenson, pp. 2–4, 6–7, 12

Meanwhile, and shortly after incorporating, INSCO began to insure the risks of unrelated parties. Net premiums resulting from unrelated party business amounted to some two per cent of total premiums written by INSCO in 1975.[212]

Director's and Officer's (D&O) market shrinks

The D&O marketplace in London was reduced to one major player by the retirement of the Surge syndicate's John Huckstable. His book of business was transferred to Leslie R. Dew, chairman of the Merrett Group at Lloyd's, who thus became the sole provider of D&O coverage in London. Many in the industry saw this development as of major concern for the D&O market. Others did not think it would have any significant effect overall because of the growing D&O market in the United States.

Immediately after this announcement came the record US $13.8 million D&O payout by London in the Mattel case. This was more than four times the size of the US $3.3 million payout on the R. Hoe Co. case just one year previously. The total settlement in the Mattel case was a staggering US $30 million, as a result of Mattel having allegedly falsified its books between 1971 and 1972 in order to push up the value of its stock.[213] As a result the D&O market began to harden even further.

FASB #5 lies in wait

While the global insurance marketplace struggled to adapt to its rapidly changing environment, the international insurance industry in Bermuda suffered another blow from the United States regulatory authorities, when the Financial Accounting Standards Board (FASB) issued a statement establishing standards of financial accounting and reporting for contingencies (FASB #5).

Outwardly the intention of FASB #5 was to restrict the use of catastrophe reserves by insurance companies, but in essence its intent was to disallow a company from reserving against contingencies that had not yet occurred. The statement went further and clarified that a company could not reserve against future occurrences through internal accounting, or through a captive company, or through a banking arrangement with a totally disassociated insurance company. FASB #5 basically required that in order for insurers to establish a loss reserve, the losses had to be known and quantifiable. In that a contingency is by definition a future possibility and not a past or present actuality, FASB #5 was trying to do away with self-insurance altogether.

Ford challenges the IRS

The end of 1975 saw the captive insurance industry once again on edge. Ford had decided to sue the IRS. Ford took up the gauntlet when the IRS alleged that Ford owed it US $6.6 million in taxes, on account of premiums paid by foreign subsidiaries into Ford's Bermuda captive, Transcon Insurance Co. Ltd. This lawsuit was the first ever to be brought against the IRS by a United States company operating a captive. It was expected to set a precedent that would force the IRS at last to define its position towards captives. Many were those who keenly awaited the outcome and many were those who believed it would bring to an end the fast growing captive movement.

Sidney Pine was the New York lawyer who had made it his mission to prove that captives were more than just self-funding mechanisms. According to Pine the IRS looked upon Ford's decision to insure its risks in a wholly owned captives as a device whereby any financial loss would remain within the corporate family. That being so, the IRS would claim that the use of a wholly owned subsidiary to insure the risks of the parent corporation did not constitute a true transfer of risk but was

[212] *Captive Insurance Company Review*, February 1988: 'The Gulf Tax Decision—A New Direction for Captives?', pp. 1–4

[213] *Business Insurance*, 17 November 1975, 'Record D&O settlement in Mattel case', p. 1

merely a formalisation of self insurance. On the ground of this reasoning the IRS would maintain that the premiums paid into the captive were taxable.

However Transcon had been writing third party business since 1973, business that was not their own, and was active in property and casualty underwriting as well as in third party reinsurance. This brought into play the issue of exclusivity, which would have a bearing on whether Transcon was operating as an insurance company or as merely a formalised self-funding mechanism. The IRS was basing its argument on the contention that there was no risk transfer and this in turn on the assumption that the captive did not underwrite any substantial risks outside the affiliated group. However there was no test or measurement established to determine what the word 'substantial' meant. Nevertheless, Sidney Pine thought that once 'substantiality' had been defined it would be easy to determine whether the premiums paid to a captive would be tax deductible or not, according to whether the captive could show that it had substantial outside or unrelated insurance.

As reported by *Business Insurance*, Pine was of the opinion that a level of 25 per cent should qualify for 'substantiality'. In other words, if a captive derived at least 25 per cent of its annual premiums from outside parties that would be a substantial component of total income and risk. Furthermore he proposed that if there were a minority ownership of consequence then premiums paid to the captive should be tax deductible. 'As to what percentage of minority ownership of the captive would be sufficient to allow a deduction for premiums, Mr Pine stated that his reaction is that two or three per cent would not be enough.' In the matter of ownership *Business Insurance* reported that Pine maintained that by any standard ten per cent should be accepted as a 'substantial' minority interest.'[214]

Political troubles and an uncertain outlook

The end of the year also witnessed a significant change in Bermuda's political climate when the Black Caucus made its first report to the Premier about the state of the social environment and the sentiment of the community, while the press reported that there was a rift in the party. In the midst of the problems with his party, the Premier was also confronted with some 600 government employees, including those who ran the buses, ferries and garbage collection, going on strike just as the Royal Visit to Bermuda was about to begin. It was not a good year for Premier Richards.

Although the strike caused little interference with the Visit, the Premier met with yet another crisis when the murderers of Governor Sharples and Captain Sayers were apprehended. Because of the unprecedented nature of these assassinations, a debate ensued once the accused had been found guilty, as to whether they should be executed or given a life sentence. The House was divided on what to do until the end of 1976 when a decision was reached.

On top of these crises, Bermuda's economic outlook had not improved in any way and showed a deficit of US $3 million. Crime was up and inflation was a major threat to social stability. By the end of this turbulent year Bermuda's Premier—the first incumbent to hold that title—announced he was retiring from politics. Sir Edward cited his family as his main reason. Deputy Premier Jack Sharpe was elected as his successor, although without the unanimous support of the party.

Despite the civil unrest and as a mark of Bermuda's advancing technology, the Bermuda Telephone Company introduced direct dialling to the United States and Canada, prompted in part by the wish to keep pace with the business needs of the exempted companies.

[214] *Business Insurance*, 1 December 1975, 'Ford Motor skirmish with IRS over captive is landmark case', by Margaret LeRoux, p. 1

CHAPTER 25

1976
Dawn of a Golden Age

An international need for captives

According to Appleby Spurling & Kempe's *Guide to the Bermuda Insurance Market 2002*, the period beginning with 1976 and ending in 1982 was to become known as a golden age for business in Bermuda. 'No other market worldwide could keep up with the innovations pioneered by the new captives in Bermuda.'[215]

A fledgling global insurance marketplace was faced with critical problems that were in part of its own making. Bermuda took on the role of providing solutions. John Milligan-Whyte, partner at Milligan-Whyte and Associates, described the plight of the global insurance companies and explained why captives were so desperately needed.

> '(The) steep climb in the cost of commercial insurance and its ensuing negative impact on corporate profit and loss statements have encouraged some concerns to look to captives for relief.
>
> 'Because the overhead expenses of commercial insurers may consume 30% or more of premiums, some see potential savings in establishing their own insurers and reducing, if not eliminating, such expenses. Others, believing their rates excessive in relation to their actual losses—commercial premium charges tend to reflect average group experiences—have switched to captives to lower their premiums.
>
> 'But perhaps the most significant source of savings that sponsors perceive in captives is the direct avenue they provide to reinsurers…Because protection in reinsurance markets is devoid of services such as engineering, it costs less than in primary markets. By reinsuring some of their assumed risks, captives can reduce the insurance outlays of their sponsors—provided, of course, they are willing to forego the ancillary services built into most commercial policies or are able to obtain them inexpensively elsewhere. Captives may also earn credits and commissions from reinsurers that serve to contain costs further.
>
> 'Standard insurance arrangements sometimes call for the insurer to pay premiums in advance on the basis of estimated losses. Carriers subsequently pay claims from these accumulated funds. But the payout period, especially for non-property losses, may extend over a lengthy period, perhaps as much as five or 10 years. Claims with "long tails"—those taking considerable time to settle—provide carriers with investment opportunities. Premiums collected but not distributed as claims payments can be invested and earn interest—often in sufficient amount to more than offset any underwriting losses that may occur.
>
> 'By using captives, many sponsors seek cash-flow benefits similar to those enjoyed by commercial carriers. They expect to realize investment income on their captives' reserves. In addition, they intend to arrange less demanding premium payment schedules. For example, one of the reasons given by a responding company for establishing its captive was to obtain the advantage of having full use of the three-year advance premium which had been required in some instances by the commercial insurance companies.
>
> 'Not infrequently corporations acquire a variety of policies from carriers that contain deductibles, which, in

[215] Appleby Spurling & Kempe, *Guide to the Bermuda Insurance Market 2000*, 'Third Party Business', p. 3-3

aggregate, exceed their desired maximum levels of risk retention. By insuring through captives, however, companies are able to arrange reinsurance that places an acceptable cap on the total losses they can sustain.

'Captives, especially those of the association variety, can also help fill the bill, according to some of those surveyed, if commercial markets become too expensive or too thin. When coverages for professional or product liability, for example, are hard to come by, captives can sometimes assume them. The ready access the captives have to reinsurers helps in this respect.'[216]

Brokers begin to take a strong role in captives

By 1976, captives contributed fourteen per cent to Bermuda's GNP and thus were important to the island's economic welfare. There were also 30 management services companies, offering a range of services to organisations having subsidiaries or mutual insurance companies. Fred Reiss' captive concept had caught on and had taken off. Any mystery surrounding the establishment of captives had been dispelled and thenceforth everyone jumped on the bandwagon. Consequently, Reiss' International Risk Management was no longer the only game in town.

For years Reiss' company, International Risk Management, controlled the captive industry in Bermuda. In 1976 it had an estimated 55-60 captives under management. American International Co. Ltd., a subsidiary of American International Group (AIG), was next in line, with approximately 40 clients under its direct management. (American International also claimed to be involved in 'servicing close to 100 captives'.)

However the large United States brokerage houses, by way of local contacts in Bermuda, quickly closed in on the lucrative offshore captive management industry. Soon Johnson & Higgins (J&H), managed by Inter-Ocean Management, had 35 captives and was closely followed by Marsh & McLennan (M&M) with 34. Some US $2.5 billion in premiums were thought to be flowing through Bermuda captives.[217]

Brokers lured clients with the offer of more options outside the captive concept to help them satisfy their insurance shortfalls. The push towards alternative risk transfer led brokers to work hard in order to prove their worth. As a result clients began to receive much better service. The standard of insurance buying and selling continued to attain a higher degree of sophistication, yet again in direct response to market forces.

Bermuda captive charged with illegally soliciting business in the United States

Having passed the scrutiny of the *ad hoc* Committee, the newly formed Bermuda malpractice captive, Multihospital Mutual Insurance Co. (MMI), was charged by the California state insurance commissioner, Wesley J. Kinder, with illegally soliciting business from physicians at hospitals in the state of California, these being four Southern California hospitals, Memorial Hospital Centre of Long Beach, Daniel Freeman Hospital in Inglewood, Anaheim Memorial Hospital and Queen of the Valley Hospital in West Covina. The California Hospitals were among some 43 hospitals in 11 states insured by the captive.

MMI offered hospitals liability limits up to US $10 million per occurrence on a basis of one million primary and nine million in excess coverage. MMI made available to staff physicians at those hospitals coverages up to one million per occurrence and three million in annual aggregate. The captive was managed by Ebasco Services Inc. and its excess underwriters in the London market included Edinburgh General Insurance Co., Winterthur Swiss Insurance Co., Wallbrook Insurance Co., and Mutual Reinsurance Co.

[216] John Milligan-Whyte: *The Evolving American, Canadian and English Taxation of Offshore Insurance Companies as at April 1987*, pp. 11–12

[217] *Business Insurance*, 14 June 1976, 'Firms managing captives in fast race', by Margaret LeRoux, pp. 13 & 16

The basic allegation was that MMI was not an admitted carrier in the United States and therefore should not have been soliciting business within United States jurisdiction.[218]

It appeared to be the case that the only state causing problems for the Bermuda captive was California. MMI did not seem to run into problems with any of the other eleven states where it had business and despite the negative press surrounding this case another hospital joined the captive because of the horrendous malpractice rates that were being forced on the medical profession.

With another turn of the screw, and despite the dire medical malpractice crisis in the United States, the state of California in October of 1976 placed a temporary injunction blocking MMI from further soliciting business in California.

In April of 1976, with medical malpractice captives on the rise, the Ad Hoc Committee submitted a report to the Bermuda Minister of Finance as described by *Business Insurance*—

> 'The Ad Hoc (*sic*) Committee submitted a report to the Minister of Finance in April 1976 suggesting guidelines for malpractice insurance companies. The committee recommended that stock companies be preferred over "open-ended vehicles such as mutuals". As a result the committee now requires additional information from those insurance companies seeking to write malpractice insurance. "In no event will the Bermuda company commence any underwriting operation until an adequate catastrophe reinsurance program has been put into effect and the directors of the Bermuda company have submitted an agreement to any undertakings by the Minister of Finance," states one provision.'[219]

New malpractice captive set up in Bermuda to cover own excess coverage

As a result of these investigations and requirements, on 15 May 1976 a novel form of captive was created. The Hospital Underwriting Group (HUG) consisted of 100 proprietary hospitals in the United States and had as its primary purpose the underwriting of hospital malpractice insurance on an excess basis. *Business Insurance* reported as follows—

> 'This is one of the few captives—if not the only one—established to write excess liability insurance for its owners, who are American Medicorp, Philadelphia; Medenco Inc., Houston; Charter Medical Corp., Macon, Ga; and Hospital Affiliates Inc., Nashville.
>
> 'Policies written by HUG are provided on an occurrence basis covering losses above a minimum retention level of US $500,000 up to US $7.5 million per occurrence for malpractice. The accompanying umbrella general liability covers up to US $30 million. Both the malpractice and CGL policies are subject to US $30 million annual aggregate limits.
>
> 'Marsh & McLennan is managing the captive and Baker & McKenzie, a New York law firm, is acting as counsel.'[220]

Buffer layer market created

At the end of 1976, as markets disappeared, leaving a huge void in excess and surplus lines, premiums skyrocketed and risk managers had great difficulty finding coverages in professional and products liability and in excess workers' compensation for self-insurers. Pharmaceutical companies fared worst in finding insurance because of the restrictions imposed on products liability.

Another interesting need of the industry emerged as excess carriers moved to higher attachment points, in order to escape what they saw as the newly established working layers required for certain classes of business. This confronted clients with a problem in that few primary carriers wanted

[218] *Business Insurance*, 9 August 1976, 'Captive charged with illegal offer of physicians policies', by Margaret LeRoux, pp. 1 & 2

[219] op. cit., 7 March 1977, 'Registering a captive is painless, more are filing, says key official', by Margaret LeRoux, p. 23

[220] op. cit., 23 August 1976, 'Hospital chains use own insurer for excess covers', by Susan Alt, pp. 1 & 2

to offer high limits and many clients were faced with a gap between primary carriers and excess carriers. To bridge this gap the industry created an entirely new concept, to be known as the 'buffer layer market'.

This was composed of those excess underwriters who were willing to fill in the gaps between the upper limits of primary and the minimum requirements of excess. In some cases the cost of excess coverage was more than the cost of primary. *Business Insurance* sounded an early warning about buffer layer insurance and quoted a risk manager of an Eastern manufacturing company as saying, 'A lot of companies writing buffer layers don't know what they're getting into. They're burying themselves in paperwork so deeply that they don't understand the risks they're writing.'[221]

Several risk managers objected to the control that buffer layer insurers now exercised over the market but accepted them as a necessary evil. Nothing was to be gained by trying to argue with them. Ultimately the buffer layer concept found its way into the Bermuda insurance market place and soon Bermuda became a vital, though some might say naïve, player in this rapidly growing sector of the market.

Carnation v. United States rolls on

The end of 1976 saw the escalation of the Carnation case. This was to set the precedent for corporations that insured United States risks using their captives. Those involved in the rapidly growing Bermuda insurance industry monitored the proceedings very closely, knowing that Bermuda would be directly affected by the outcome of this landmark case.

In March 1976 the IRS notified Carnation that it was disallowing US $1,755,000 paid into the captive as premiums during 1972. Carnation objected but the US government held to its position. Some in the industry wanted the issue brought to trial in court, thereby forcing the IRS to make clear and public, once and for all, just what was its policy towards captives.

The background to the case was that in 1971 Carnation had set up a captive, Three Flowers Assurance Co. Ltd., to insure the first US $500,000 of loss on each of the 135 United States and Canadian facilities that Carnation owned at the time. *Business Insurance* recounted the history—

> 'The authorized capital of Three Flowers was US $500,000. However, Carnation purchased 120,000 shares of the captive's par value common stock for US $120,000 in cash and agreed to purchase on demand by Three Flowers up to 288,000 additional shares at US $10 per share.
>
> 'The captive was thus provided with total capital resources of US $3 million. Three Flowers has not paid any dividends since its establishment, Carnation stated in its petition to the IRS. The result has been to increase the fair market value of the captive net assets to approximately US $7 million as of December 31, 1975.
>
> 'American International Underwriters Overseas Ltd. of Hamilton, Bermuda manages Three Flowers. The captive contracted to reinsure 90% of a blanket property policy on Carnation facilities insured by American Home Assurance Co. The policy provided coverage of up to US $500,000 per loss arising out of any one event at any one location with a US $10,000 per loss deductible.'[222]

Although the allegations behind the Ford and Carnation cases were entirely different, with Ford's case involving premiums that foreign subsidiaries had paid into its captive and Carnation involving insurance of United States risks into its captive, the two cases shared a common characteristic in that both Ford and Carnation had taken the initiative against the IRS and not the other way round. This indicated just how important it was for the captive insurance industry that the IRS should be forced to declare its position.

[221] *Business Insurance*, 15 November 1976, 'Excedrin headache #11: the buffered layer pain', p. 27

[222] op. cit., 27 December 1976, '*Carnation* v. *IRS* in key captive case', by Margaret LeRoux, pp. 1 & 2

A search for balance

Contemporary accounts reflect 1976 as being the third worst year that the insurance industry had suffered to date. *Business Insurance* reported that—

> 'Best's estimates that during the fourth quarter of last year (1976), the industry recorded an underwriting loss of US $50 million or only about one-sixth of the loss of preceding three months. Experience continued to be bad in such major segments of the property/casualty field as general liability and workers' compensation.
>
> 'As the figures suggest, among the significant changes visited upon the industry in the last 10 years has been the switch from modest to deep business cycles, meaning a shift from short but, shallow downturns to longer and more devastating adversity.
>
> 'If there is one change of the last decade that has caused more consternation among insurance officials than the up-and-down economy it is what Mr DeRosa called "social inflation".
>
> 'Under the umbrella of social inflation he includes the swollen plaintiffs bar and the general propensity to litigate everything disputed. On the property side he included the huge increase in arson cases.'[223]

Some said that society had embraced the 'doctrine of entitlement', the belief that people are entitled to more than their forebears ever had known in the past. Many blamed the court system, for taking money from those who had it and giving it to those who thought themselves entitled to it. One effect of social inflation would be that eventually risk management could no longer adequately provide for the impact on reserves. The legal frenzy in the United States spread fear among those charged with setting reserves on liability losses, because there was no longer the ability to predict what courts would award when awards kept leapfrogging higher and higher.

Perhaps the traditions of the industry might not be keeping up with social change. The future of the captive movement seemed at times to be up in the air, casualty rates were skyrocketing and buffer layer insurance controlled the excess insurance market. Yet many looked to the captives in the belief that these alone could keep pace with the new demands. Bermuda waited to see what fate the future held.

In this same year Larry Tacklyn and Erskine 'Buck' Burrows were tried for the murders of Police Commissioner Duckett, Governor Sharples and Captain Sayers. The atmosphere in the court room was so charged with violent emotion that counsel for Tacklyn, lawyer Lois Browne Evans, was later to recall, 'The witness' eyes had the purest hatred she had ever seen.'[224] A great divide between the races had become apparent. The island held its breath.

At the end of 1976, not only was Bermuda seeking a balance in the turbulent world insurance market, it was also in desperate need of a way to defuse explosive discords at home.

[223] *Business Insurance*, 31 October 1977, 'It's a different industry a tough decade later', by Joanne Gamlin, pp. 21 & 24

[224] J. Randolf Williams: *Lois: Bermuda's Grande Dame of Politics*, Chapter 8, 'Advocate', p. 191

Chapter 26

1977
Yes I *'Dew'*

Leslie Dew

Although few if any imagined as much at the time, 1977 marked the beginning of a new era for the Bermuda international insurance industry. Insurance business came from Europe and not just from the United States, a sign that Bermuda had become a true insurance and financial centre for the world at large. *Business Insurance* remarked how, by 1977, Bermuda was being described as a 'miniature Lloyd's of London by its most enthusiastic boosters' while others thought of the island as a 'miniature Wall Street', because of the close proximity of the insurance companies each to the other, along with some 500 captives domiciled in one place and with an army of management companies, accountants, lawyers, and bankers, all in their service. Hamilton was bursting at the seams.

The captive industry had moved beyond just insuring the parents' risks and into providing third party business. Bermuda also attracted reinsurance business from major international reinsurers. The previous fall, Insurance Co. of North America (INA) had announced that it was setting up in Bermuda, Continental Insurance Co. transferred its international operations to its Bermuda subsidiary, Security Reinsurance Co., and American International Group reported strong earnings from its insurance operations in Bermuda. Yet the insurance community on the island remained a close knit one that wanted to preserve the reputation of the island and therefore kept quite a low profile, in an effort to keep out the 'riff raff'.

Then along came a notable man from London, who bolstered Bermuda's image more than some are willing to admit. Many believe that by choosing to come to Bermuda rather than to other jurisdictions, Leslie Dew showed the world just how important he thought Bermuda was going to be in the future of the insurance industry. On the other hand, his decision was not without controversy. Susan Alt described him in a commentary for *Business Insurance*—

> 'Mr Dew, as one of Lloyd's most colourful and controversial figure, almost instantly confers a status on Bermuda's insurance centre not achieved by gradual growth. The status accorded Bermuda by Mr Dew's move is attributable at the very least to the attention it draws to the island as a financial centre. At best, Mr Dew's power within Gulf's agency will attract more business to captives as bona fide insurers and to Bermuda generally. At worst, his outspoken and controversial underwriting reputation at Lloyd's of London will cast a shadow over the island's insurance community. Mr Dew, because of his vocal and often-disputed remarks about D&O insurance and fiduciary liability risks—coupled with his London syndicate's high premium charges for liability policies—is not universally well liked by insurance buyers and brokers.'[225]

Leslie Dew's arrival on the Bermuda scene heralded a new era for the insurance industry. He was a well-recognised name in the industry and brought with him a wealth of experience, which he was able to pass on to many who worked for him. Dew was the first high profile insurance execu-

[225] *Business Insurance*, 4 April 1977, editorial opinions, 'Bermuda, Mr Dew, and Gulf Oil', by Susan Alt, p. 6

tive from London to take up a position in Bermuda away from the major markets such as the United States and London. His decisions sparked speculation about why he would chose a tiny little island in light of his prestigious spot at Lloyd's. Susan Alt wondered as to why such a prominent man should take over a 'subsidiary underwriting operation, to develop a new business'....

> 'Why would a man like Leslie Dew want to leave Lloyd's of London after a lifetime in that body's foremost syndicates, and having risen to the pinnacle as senior deputy chairman of Lloyd's?'[226]

It did not take long for rumours to surface about why Dew left Lloyd's, suggesting anything from professional disappointment to irresistible offers elsewhere. Other commentators thought his ultimate mission was to lay foundations on which to build for the future in Bermuda as Lloyd's had once built in London. Then *Business Insurance* reported that—

> '...Sources very close to Mr Dew's base in London have now disclosed that an internal struggle within the Merrett syndicate at Lloyd's deposed Mr Dew. He responded to this information by saying he prefers to think he ended up on the winning end, judging from the sizeable financial settlement he received upon his departure from Merrett. He prefers not to use terms like "power struggle" in describing the kind of internal conflict that took place between him and members of the Merrett family. That conflict concerned the direction and control of the syndicate, however, Mr Dew acknowledged.'[227]

Whatever the motives behind his move, there need be no doubt that Leslie Dew's decision to come to the island magnified Bermuda's reputation as a credible place of business in which to evolve a career and thereby enhanced its appeal for many more senior executives yet to come.

Just two months after Dew had arrived on the Island, he spoke at a luncheon given by the Bermuda Insurance Institute, when he predicted that Bermuda would see an upsurge of international insurance. He forecast that the involvement of established international insurance brokers would stimulate growth and said he was accordingly very optimistic about Bermuda's future. He considered that the island was—

> '...an ideal place for a base for the intra-national insurance market, augmenting, not conflicting with, existing ties. The European market, he said, was becoming increasingly strangled bureaucratically. "Their outlook is more parochial and protectionist then ever," he said. And even the London market—for centuries the centre of the international market—was being seriously endangered with the encroachment of European regulations.'[228]

Dew held that Bermuda stood head and shoulders over other jurisdictions that vied to take the number one spot for captives because they lacked the infrastructure which Bermuda could offer for the smooth operations of international companies, such as good 'communications, banking, legal firms, accountants and the freedom to move capital.'[229] He predicted moreover that 'Bermuda can become the launching pad to meet the demands of the private insurance sector and its need for capital. This need had come about because for too long, regular insurers had ignored the need for underwriting profit, relying on their investments to pull them through.'[230]

Bermuda College dispute

While Leslie Dew was establishing his position on the island and the captive insurance industry continued to grow by leaps and bounds, the Bermuda College Executive Director, Mansfield Brock, expressed his frustration at the lack of support from the international insurance industry. *Business*

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226 ibid.

227 ibid., 16 May 1977, editorial opinions, 'Leslie Dew—Why he left Lloyd's and his goals', p. 6

228 *The Royal Gazette*, 22 June 1977, 'Upsurge in insurance seen, Institute told', pp. 13 & 15

229 ibid.

230 ibid.

Insurance recorded his protest that the exempted insurers continued to ignore the College—'Since 1974 when the college was created by an act of Parliament, we've invited members of the business community to tell us their needs so we can develop programs, turn out students that are qualified,' he said. 'Industry needs should determine what courses we offer.'[231]

He said he was tired of accusations that the College did not train graduates qualified to enter the insurance industry. The industry had itself to blame, for its own indifference, for ignoring his calls for help. The College needed the active involvement of industry to devise and implement a properly relevant curriculum, with which to shape the type of people the industry needed. Brock said the only business that had been responsive to his approach was the accounting community and that, as a direct result of its help, the first three qualified accounting professionals were about to graduate from the College.

Brock was not alone in his criticism of how little the new insurance industry was doing to help Bermudians get into the profession. Opposition leader Frederick Wade was quoted by *The Royal Gazette* as saying, 'we don't want an island of waiters and taxi drivers'. He challenged the insurance industry to get more Bermudians involved. The pressure was building.

IRS ruling 77-316

Some may say Dew was clairvoyant, others that it was serendipity or simply optimistic thinking come true, but shortly after Dew arrived and voiced his predictions, the rules of the game for the captive industry in Bermuda were fundamentally and, as it turned out, favourably changed. On 29 August 1977, with the issuance of IRS Ruling 77-316, the way that tax law was interpreted for captives shifted and suddenly they began writing unrelated business.

This ruling was a catalyst. It led to the demise of many opportunistic and sometimes greedy insurers, who had been more concerned with writing as much premium as possible than with underwriting the risks. Also, and perhaps ironically for its authors, this same ruling allowed the captive concept to be applied to many complex problems that confronted the industry. Kathryn McIntyre itemised the ruling for the readers of *Business Insurance*—

> 'The IRS ruling dated August 29 (1977 known as IRS ruling 77-316), deals specifically with the operation of an offshore captive—wholly owned by a US parent and insuring only risks of the US parent and its subsidiaries—under three different arrangements:
>
> 'The parent and its subsidiaries place their insurance directly with the offshore captive, which retains 100% of the risks. None of this premium is deductible.
>
> 'The parent and its subsidiaries contract with an unrelated insurance company for insurance, with the agreement that the insurer will immediately transfer 95% of the risk to the parent's subsidiary insurance company. Only the charge by the primary insurer for retaining 5% of the risk is deductible.
>
> 'The parent and its subsidiaries pay premiums directly to the captive for insurance, but the captive transfers 90% of the risk through reinsurance to an unrelated company. Only the portion of the premium paid for reinsurance is deductible.'[232]

Ms McIntyre went on to explain the IRS premise as told to her by an IRS staff member—

> '…An arrangement with a wholly owned insurance subsidiary cannot be insurance because there is no shifting of risk outside the economic family… The IRS is saying it considers a wholly owned insurance subsidiary as just setting up reserves for self-insurance. But when the wholly owned captive also insurers

[231] *Business Insurance,* 7 March 1977, 'Exempt insurers ignore Bermuda College—Director' p. 28

[232] op. cit., 19 September 1977, 'IRS axes deductions for premiums paid to captives: court test awaited', by Kathryn McIntyre Roberts

risks other than those of the parent and its subsidiaries, it "might" be beyond the scope of this ruling, she (the source) acknowledged.'[233]

However, instead of the IRS ruling 77-316 ruling killing the captive industry in Bermuda, it had the opposite effect. As a matter of fact, the ruling encouraged larger insurance companies in Bermuda to widen their focus and some started aggressively writing third party business.[234]

Years later Brian Hall recalled in a speech that when the IRS 77-316 ruling was passed, 'The (Bermuda insurance) industry stood still—for ten days—then, after analysis of the ruling, it was "business as usual". This was because the primary reasons for establishing a captive were still valid, and tax was still a secondary justification.'[235]

The arrival of Leslie Dew and the IRS ruling 77-316 paved the way for third party business to begin in Bermuda. Lisa Bergen of *The New York Times* wrote in 1978 that—

'Bermuda, of course, has seen plenty of insurance action for several years…In just four years the captive population on the island has swelled to more than 700 from 333, writing some US $2.5 billion in premiums. What is causing the captives to branch out?

'A ruling by the United States Internal Revenue Services has been the major spur. The captives ran into a giant problem last year when the IRS questioned their status as independent insurance companies and the right of their parent corporations to claim certain deductions as business expenses, including premiums paid to the captives.

'Instead of folding the tents of these Bermuda concerns, many corporations decided to meet the problem head-on by transforming them into bona fide insurers—actively competing in the business not just for the tax advantages, but for the profits. Whether the captives will successfully meld into the international insurance market depends on their ability to overcome a host of obstacles, including an uncertain American regulatory climate, their own lack of underwriting experience, dependence on their parent corporation for capital and the shaky political outlook for Bermuda. But they seemed determined to try.

'The reinsurance sector, particularly, seems a fertile field. The captives can provide fresh capital to the inflation strapped general insurance industry and take advantage of new markets in high-risk areas—including oil spills, nuclear accidents, malpractice and executive kidnapping and ransom coverage…'[236]

Joe Blades, chairman of the Blades Group of Companies in Bermuda, summed up the matter as follows—

'Because of the tight insurance market in America and the desire of corporations to use insurance as a tool in financial planning and the chronological stabilization of income, we will see the captive movement flourish regardless of the actions taken by the US government as respects the few remaining tax benefits.'[237]

Local businessmen began to worry about Bermuda's reputation

During this time David Lines, co-founder of Cooper & Lines, always accompanied by at least one lawyer and one banker, travelled extensively around the United States to promote the virtues of doing business in Bermuda. He became aware of a growing animosity on the part of US insurance regulators towards the Bermuda insurance industry and of an undefined sense of unease with respect to Bermuda in general.

[233] ibid.

[234] Brian Hall speech to the Paget Lions Club, 22 August 1980

[235] Brian Hall speech, 'A History of Captives', 1990

[236] *The New York Times*, 16 July 1978, 'Offshore Captive Insurers Slip Their Chains', by Lisa Bergson, pp. 1 & 3

[237] *Business Insurance*, 21 March 1977, 'Perspective, Government restrictions, insurance vacuum to stir more Bermuda growth', by J.H. Blades, p. 17 & 18

For fear that the island's prospects of international business might be threatened, Lines went to see Premier David Gibbons, told him of the animosity encountered on his travels, and voiced his concern that unless some type of formal regulation was put in place, Bermuda could be ruined by opportunists, especially in light of the ruling from the ongoing Carnation case, which could result in many new companies coming to Bermuda.

As a result of this warning the government gave priority to the formalisation of the insurance industry regulations. In collaboration with David Saul, Minister of Finance, and Mansfield Brock, the Financial Secretary, Lines put together a draft proposal. This included ways of regulating the legislative environment. Gibbons thought the draft could not be decided upon in isolation and that it needed wider discussion. He nominated a four-man committee, consisting of Hal Dale, Raymond Medeiros, and George Sandeman (who was in charge of Bluefield Bermuda, which was owned by Mobil Bermuda) with Lines as Chairman. For a year and a half the committee worked without compensation to put together the basic provisions of the Insurance Act.

Lines said that when they designed the Act they knew it had to be easy to read and follow because it was supposed to be self-regulatory. Within the Act he plagiarized many American filings but not their investment criteria because he thought these were too punitive and restrictive. He considered the Act a significant development because it set Bermuda apart from other jurisdictions.

The Act also contained the concept of 'principal representative', which had been put forward originally by George Sandeman. Lines called this a stroke of genius. Sandeman reckoned it was all very fine to have someone attest to the financial well being of a company but such testimony would be worthless unless there were a person within the company charged with the responsibility to monitor what was going on and that this person should be the sole person held accountable for the veracity and accuracy of the report. The penalties provided within the Act for failure on the part of the principal representative are very severe. The committee designed them specifically with the intent that insurance companies should not just stick anyone into that position but rather should appoint a responsible party with the capability and wherewithal to understand the company dynamics.[238]

All the while that it was designing the Act, the Committee worked closely with the Registrar of Companies, Shelton Burgess. According to Lines there had never been another Registrar with so much vision. Burgess was a very bright man.

Captives enter buffer layer insurance

As we have seen, buffers are layers of coverage that pick up the differences between the upper limits of primary policies, which by 1977 had shrunk dramatically, and the next limits where excess coverage begins. Not long after buffer layer coverage started to dominate the insurance market, Bermuda's captive companies began to see an opportunity in this new sector. Accordingly they decided to enter it, as demand for insurance continued to rise worldwide. Demand for buffer layer coverage was keen as casualty and product liability coverage had become so scarce that buyers were scrambling to buy almost anything they could get.

Business Insurance reported on the trend for captives seeking to write buffer layer coverage as follows—

> 'Tax avoidance or delay is the key to the captive interest in writing outside buffer layer business. That's because buffer layer business is the most vexatious area of insurance coverages. Predicted and catastrophic losses are easy. But casualty and product liability coverage is a different matter. Generally, the experts count on a loss event every five to 10 years. Thus, if a loss is insured in an offshore captive, it can be fully funded, and avoid taxation until the loss—in which case taxes would decrease proportionate to the loss—and still allow the firm to use its reserves.

[238] Interview with David Lines, 3 June 2002

'...There are only eight or nine captive concerns said to be underwriting buffer layers. One successful mechanism used to increase their capacity is to unite captives into a consortium pooling arrangement. The surprising profitability of captive insurance companies allows managers to use the combined assets in the highly profitable buffer layer business. In addition to allowing managers continued use of the money, it protects the members' income from taxation.'[239]

Many felt that they had to get into the buffer layer market because there was so much money to be made. Others shied away opting instead to take the 'wait and see' approach because they feared with the skyrocketing casualty payments in the US as a result of litigation gone mad, casualty was just too unpredictable, regardless of the amount of premiums that were on offer. For them, the cost of 'social inflation' was just too great to risk their entire book of business.

Yet another type of captive came to Bermuda when, as *The New York Times* reported, 'To help captives make the most of their new ventures, risk managers are experimenting with a variety of buying plans. Rather than go it alone, most Bermuda-based captives opt to join forces...The "pooling arrangement" allows captives to share the capital costs, underwriting and administrative staff required to write commercial treaties.'[240]

The Royal Gazette also reported on the new captive concept—

'Some 65 unaffiliated American companies are studying a preliminary report recommending the formation of a Bermuda captive to underwrite liability insurance. The group captive, representing a broad cross-section of risks, is reportedly most likely to reinsure the so called gap layers of casualty coverage extending between the top of a primary layer or risk—say US $500,000—and the bottom of an excess layer starting as high as US $5 million. ...The so call(ed) gap layers are areas of insurance from which underwriters have withdrawn in recent years, making less capacity available for coverage needed to link primary and excess layers. In addition, premiums have skyrocketed'[241]

Corporate Insurance and Reinsurance Company Ltd. (CIRCL) and R-Pool

With the news of group captives becoming a cost effective means to incorporate a captive, CIRCL was formed in December 1977 as a group-owned, captive insurance company designed to provide a reinsurance facility to its owners, with US $10 million in authorised capital. *The New York Times* reported on CICRL as follows—

'Membership (of CIRCL) consists of the National Steel Corporation, the Archer-Daniels-Midland Company, the Charter Oil Company, Emery Industries, the International Harvester Company, the Minnesota Mining and Manufacturing Company, Ideal Mutual and Hanna Mining.'[242]

Seeing the opportunities left in the market as a result of IRS 77-316, Fred Reiss decided to set up a company to deal with the shortfalls. *A.M. Best* reported on Reiss' solution to IRS 77-316 as follows—

'While the captives were entering the buffer layers to combat IRS 77-316, Reiss' organisation formed the R-Pool. United managed the R-Pool, formerly known as the United Surplus Relief Treaty. This pool comingled the reinsurance of working layer casualty risks so that unrelated business could be retroceded to the same participants. The R-Pool was designed to break the back of Revenue Ruling 77-316. As a result of the comingling of funds in the R-Pool, each company ended up with its subsidiary insuring mostly somebody else and was thus able to obtain a deductibility for premiums paid to the subsidiary.'[243]

[239] *Business Insurance*, 19 September 1977, 'Captives enter expanding buffer layer area', by Raymond Lane, p. 18
[240] *The New York Times*, 16 July 1978, 'Offshore Captive Insurers Slip Their Chains', by Lisa Bergson, p. 1 & 3
[241] *The Royal Gazette*, 10 October 1977, 'Group captive mooted'
[242] *The New York Times*, ibid.
[243] *Best's Review*, March 1984, 'Beyond Bermuda', by Doris Fenske, pp. 22, 24, 114, 115

Business Insurance explained the rationale behind Reiss' changes as follows—

> 'Reiss, seeing his monopoly of the captive insurance side being slowly eroded by the new players in the market, announced the formation of United Insurance Co. in Shannon Ireland with capital of US $100 million. According to Arthur Deters, Executive Vice President and director of ARM, United was to insure the so-called difficult areas, product liability, workers' compensation, buffer layers of casualty, and all-risks property covers.'[244]

Transatlantic Re

Seeing the opportunity left wide open in the reinsurance industry with captives beginning to write unrelated business, the American International Insurance Company joined with seven other insurance companies to form a US $100 million reinsurance firm to compete in the world's reinsurance markets. It was to be called Transatlantic Reinsurance Company and was backed by American Home Assurance Company, Swiss Re, Walton Insurance Limited, Bermuda, USF&G, *Compagnie Financîère et de la Réassurance de Groupe A.G.* of Belgium, and Daido Mutual Life and Nichido Fire & Marine, both of Japan. AIG held 47.2 per cent ownership in the company. A substantial share of AIG's treaties was made available to Transatlantic Re.[245]

Walton enters the third party business arena with Veere Palmer

IRS 77-316 was the subject of many Board meetings in Bermuda, and the Board of Walton Insurance Company (a captive owned by Phillips Petroleum) was no exception. Seeing this as a profitable opportunity on the horizon, they decided to enter the third party business arena. They advertised for an underwriter with experience in global insurance markets and decided that, rather than hiring someone who had seen the world cross their desk (as at Lloyd's), they wanted someone who had travelled the world, with established contacts. They hired Veere Palmer to do the job. Palmer had been underwriting in the Bahamas prior to being offered the position.

When Palmer came on board he was given the huge task of generating unrelated premium to match the parent related premiums, over $20 million, already on the books, in three years! An awesome task! As a result, Palmer was driven to write a significant volume of business in a short period of time. He was seen by London as someone "who could sign down on 30 submissions in half an hour, and still have time for a cup of coffee!"

Palmer rejoiced, as did other Bermuda underwriters, when Leslie Dew arrived because he felt he could ride Dew's coat tails and follow his lead. Anything that he saw that Dew had signed on, he would sign down proportionally. However, Palmer never knew if he was being shown everything that Dew was seeing and he was not aware of Dew's reinsurance protection. As a result, Walton's experience was totally different to Dew's, and it later emerged that Walton ultimately incurred significant losses.

When Palmer was asked what he would do once claims started coming in, he replied that he would go out and book more premiums! This underwriting approach later forced Walton into liquidation.

Other captives that entered into third party business did not fare any better. An unfortunate result of these moves was to eliminate (by liquidation) otherwise perfectly sound parent-related captive programmes that fell victim to the losses incurred by such adverse third party business.

Brian Hall recalls using the term "Friday night slip" which referred to the Bermuda captives giving the "pen" away to London underwriting agencies. Anything that was not placed in the London

[244] *Business Insurance*, 19 September 1977, 'ARM sets major move into excess', p. 35

[245] *The Royal Gazette*, Business Week Four, 'American International Group sets up reinsurance firm'

market by Friday afternoon, when the agency closed for the weekend, was likely to appear on the books of a Bermuda captive which had given away its underwriting authority. This was surely to lead to an adverse selection of risks.[246]

A Bill for disclosure

Seeing the increase in the number of captives on the island, many in both the public and private sectors became more concerned than ever about protecting Bermuda's image. After years of debate as to the pros and cons of putting together specific insurance legislation, Insurance Bill 1977 was publicised to let everyone know that there was a regulation in the works to regulate the insurance industry in Bermuda. It sought to police the operations of local and exempted insurance companies. All insurers, insurance managers and intermediaries were required to register with the Government and to give information to the Registrar of Companies, including annual accounts, audited independently except in the case of Non-Resident Insurance Undertaking (NRIUS) companies. These had to provide the Bermuda authorities with copies of the accounts filed in their parent countries, plus a certificate that they had met their liabilities there. The Bermuda minister had the power to seek more financial information from exempted companies 'in case of need'.[247]

Several local insurers were privately concerned about a proposed clause in the pending Insurance Bill, whereby offshore insurance firms needed to simply prepare statements signed by two company directors, affirming the company's solvency. The local sentiment was that offshore insurers could get away with falsifying records, while local insurers and agents representing firms underwriting business on the Island would have to disclose much more financial information for the protection of policyholders and shareholders. *The Royal Gazette* reported the concern of local businessmen—

> 'One local insurer told *Business Week*, "some of us have protested strongly about this certificate clause, because if something went wrong with a company it could have a detrimental effect on the Bermuda insurance industry as a whole—especially now that we have built up the Island as an insurance market to be reckoned with."'[248]

This last was if anything an understatement. Some would say that Bermuda was preparing itself to become the third largest reinsurance centre in the world.

Canary Islands jumbo jet collision

On 27 March 1977 two Boeing 747 jumbo jets collided on a runway in the Canary Islands, killing nearly 600 people. This disaster inflicted one of the biggest losses in the history of aviation, and had the effect of a seismic shift on risk management.[249] It opened the eyes of aviation insurers to the truly cataclysmic and catastrophic dangers latent in the aviation world.

At that time most aviation insurance was still transacted in the London market. Lloyd's and the other London underwriters had heavily insured the two airlines that were involved in the crash, Pan American World Airways and KLM Royal Dutch Airways.

In turn London had reinsured into the French and Dutch markets and also in the two largest aviation pools operating in the United States—Associated Aviation Underwriters (AAU) and United States Aircraft Insurance Group (USAIG). Faced with the devastation of its bottom line by aviation losses and the fact that the loss had exhausted the traditional reinsurance marketplace, the London market now sought additional capacity to reinsure its risks. The Bermuda captive reinsurance industry met that need by providing aviation capacity.

[246] Notes from Brian Hall, 29 May 2002

[247] *The Royal Gazette*, Insurance Companies to be 'policed'

[248] *The Royal Gazette*, Business Week Three, 25 May 1977, 'Proposed disclosure clause causes some concern', p. 10

[249] *Business Insurance*, Millenium Special Issue, A Timeline of Key Events in Risk Management

Offers of help with Bermuda's social problems

On Bermuda's social side, the cost of living had risen rapidly. As it was bound to do, this caused intense frustration for those whose incomes were not keeping pace. Meanwhile the international business community enjoyed a surging tide of prosperity but it was not a 'rising tide that lifts all boats'. On the contrary, average Bermudians themselves were not keeping pace with the cost of living.

Many Bermudians found it difficult to make ends meet in their own island home. This was not only dispiriting and stressful, it was infuriating when, at the same time, the rest of the world was beginning to think of Bermuda as a land of lavish, growing and boundless prosperity.

This disparity led to resentment. More and more non-Bermudians were coming to live in the island. Rightly or wrongly they were perceived as being successful, while Bermudians fell behind and they were blamed because Bermudians were not entering the international business sector fast enough to benefit from its growth. From there it was but a short step to perceiving the newcomers as outsiders whose sole intent was to get rich at the island's expense.

The international companies in Bermuda began to feel the heat from this volcano that was bubbling away beneath the growing financial sector. They publicly announced that they wanted to help in solving Bermuda's social problems. Mr Robert Lynch, chairman of the executive committee of the International Companies Division (ICD) of the Bermuda Chamber of Commerce said as much during an interview with *The Royal Gazette* —

> 'In the eyes of Government, the Opposition, members of the media and the general public, there still remains, perhaps unfortunately, an impression that international companies operate in Bermuda purely because of taxation. This is not the case. The basic reason is to be able to compete in international trade and business and manage their companies unfettered by the over-regulation of companies offshore. At a time of political evolution it is essential to project an image of our operations so people will recognise the value and scope of our contribution to the Island. It (is) important to identify the high proportion of Bermudians employed in the sector.
>
> 'The ICD calculated that exempted companies generated ten per cent of Bermuda's gross national product, or US $40,000 per employee, compared with US $14,000 per employee for the total workforce and US $13,000 per employee for local businesses.
>
> 'The public seems unaware of the way this expenditure is spread through all levels of the community. International companies more than pay their way, not only through company taxes but through personal taxes and contributions to charity, sports and other areas. The local company recoups its costs in Bermuda from its customers. The international company absorbs all its costs, so it does not become a burden to the Bermuda economy—and "we are significant customers of local business."
>
> 'He (Mr Lynch) recalled that the first issue of notes by the Bermuda Housing Corporation was over-subscribed by international companies for Bermuda's benefit, as "we are more than willing to share with you in the solution of the problems confronting all countries today." Four Bermudians were awarded grants from more than US $25,000 in scholarship funds raised by the ICD from its members.'[250]

Riots from hangings

Bermuda was once again thrown into a period of unrest when, in August of 1977, Premier Jack Sharpe announced he was resigning as the Premier. A retrospect was published years later in the *Mid Ocean News* (our notes in brackets)—

> 'He (Premier Jack Sharpe) placed too little emphasis on improving the lots of Bermuda's majority population—chiefly in the economic and educational spheres. Sharpe's failure to take the advice (of the UBP

[250] *The Royal Gazette*, 28 October 1977, 'International companies—more than willing to help solve our problems'

Black Caucus to improve the lot of Bermudians) on board led to Dr Stanley Ratteray (a silent force behind the UBP Black Caucus) becoming a founding member of the "Magnificent Seven", the rebel faction of UBP MPs (Members of Parliament) who engineered Sharpe's removal as Premier when the party lost fully one-fifth of its Parliamentary seats under his leadership. Sharpe had ignored the advice of Dr Ratteray and likeminded colleagues such as Jim Woolridge and Gloria McPhee; but neither he nor they could ignore the consequences of his decision to ignore them.

'Sharpe stepped down in 1977 after a protracted and bitter internal split in the UBP and, while naturally hurt by his fall from political grace, finally came to understand the underlying causes.'[251]

David Gibbons replaced Jack Sharpe as the new Premier of Bermuda. Gibbons came in at a very bad time for Bermuda because by November 1977 it had been decided that Larry Tacklyn and Erskine Buck Burrows would be hanged, despite the fact that there had been no hangings in Bermuda for 30 years. Britain's Foreign Secretary, Dr David Owens, announced, 'I am unable to ask Her Majesty to intervene.'

On Friday, 2 December 1977, despite the threat of unrest if the hangings took place, Burrows was executed at 4 am, followed by Tacklyn at 4:30 am. The island burst into flames—

'The rioting, looting and fire bombings continued for several nights. So did the curfew, the second in ten years. Some two hundred and fifty troops from the Royal Regiment of Wales and the Royal Fusiliers arrived, supposedly to give relief to exhausted police and Bermuda Regiment soldiers.'[252]

Many condemned the presence of the British troops, believing it would further incite the violence that was already taking place on the island.

A feeling of unrest swept over Bermuda. Workers, children, parents and adults were forced behind closed doors as dusk fell. Tourists cancelled their vacations, while international journalists swarmed the island, looking for stories about the supposedly stable and tranquil Bermuda. It was almost as if the island was silent, breathless and still waiting in darkness for the light of day to break. Many asked who had the power to stop the executions. Many were to look back on this dark period and question what could have been done to prevent the destruction that followed. But it was no use asking 'what if?' All that could be done from that point on was to move forward and try to ensure that such things should never happen again.

The insurance industry turns around

Bermuda was about to experience yet another change to its insurance industry when it emerged that on a global basis property and casualty insurers made nearly US $1 billion in 1977 on an underwriting premium volume totalling US $73.9 billion. This was a marked improvement over the underwriting loss in 1976. Not only was Bermuda grappling with the devastating effects of the riots, its international insurance industry found itself struggling to maintain its place in the global insurance industry as rates began to tumble across the board.

[251] *Mid Ocean News*, 14 February 2003, 'The Iron Duke…Tribute' by Tim Hodgson, p. 5

[252] J. Randolf Williams: *Lois—Bermuda's Grande Dame of Politics*, Chapter 8, 'Advocate', p. 197

CHAPTER 27

1978
Captives Surge

Captives Surge

Despite the civil unrest that hit Bermuda in December 1977, the following year saw a major influx of reinsurance captives. There were 750 insurance companies registered. It seemed as if international companies flew in by the planeload and that the economic barometer swung to 'set fair' yet again. Then, as if nature was warning the island, an earthquake measuring six on the Richter scale shook Bermuda on 25 March. Meanwhile, on the social level, both government and opposition feared that irreversible damage would be done unless the growing frustrations of the working class could somehow be relieved.

Therefore the Bermuda government decided to commission an enquiry and a report as to what was really happening on the island. Lord Pitt of Hampstead, Deputy Chairman of the Community Relations Commission in Great Britain and a former Chairman of the Greater London Council, was invited by the Bermuda government to chair a six person Royal Commission of Inquiry into the 1977 riots. Because Lord Pitt was a black West Indian, an elder statesman of the British Labour Party, and a highly respected Minister with broad experience, many in Bermuda saw him as the best choice to lead the Commission.

The reaction to the Pitt Commission varied from hope to ambivalence. There were those, including some members of the opposition, who looked on it as a memorial to Larry Tacklyn and Erskine 'Buck' Burrows, the two who had been hanged for the murders of Governor Sharples and Captain Sayers Aide. Other observers considered the inquiry to be long overdue, because the average Bermudian had been pushed too far, too fast. Yet others dismissed it as merely a reiteration of all the old qualms about Bermuda that the Progressive Labour Party had been mouthing already. Whatever may have been thought at the time, the fact remains that the Pitt Commission was the first formal attempt at an understanding of what was in the minds of ordinary working class Bermudians. Accordingly there were many who hoped it would usher in changes essential to the welfare and stability of the island, before it was all too late.

The growth of the international insurance sector did not seem to be in the least affected by all these social rumblings. A wide range of different captives had been set up on the island by 1978, especially group captives such as the American Greyhound Track Operators Association (AGTOA), Chem-Spec (formed by members of the Chemical Specialties Manufacturers Association), Farmco, the National Basketball Association (NBA) captive set up by Planet Insurance, US Industries Insurance, Hanna Mining, and Food Industry Insurance Co. Ltd. (FIICO), a captive of the frozen food industry. A principal reason why group captives were becoming so popular was that IRS ruling 77-316 specifically denied the admissibility of insurance between a parent and a wholly owned insurance subsidiary that insured only the risks of the parent.

One of the biggest coups in that year came when Arkwright-Boston, the second largest member of the Factory Mutual system, announced that it would set up a Bermuda subsidiary. Arkwright gave as its motive the need to remain responsive to the changing requirements of its customers.

Service providers flock to the island

The New York Times reported the following to be one result of the increase in the number of captives in Bermuda—

> 'A new crop of brokers, underwriters, risk managers, attorneys and insurance consultants has been attracted to the burgeoning business—and growing profits—centred in Bermuda....Now responsibility for the hundreds of captives in Bermuda is divided up among numerous professional managers and seven major insurance brokerage firms including the American International Group, Johnson & Higgins Ltd., and Marsh & McLennan Ltd.'[253]

Bermuda was without question becoming a marketplace that could cope with the rapidly changing business environment.

Attitudes and relationships

Yet, for all that Bermuda was on its way to becoming a worldwide market, an experienced professional newly arrived from overseas might still find attitudes within the Bermuda industry to be somewhat exclusive and insular. When Walton Insurance assessed the shortage in aviation capacity, consequent on the Canary Island disaster, they responded to the needs of the London market by bringing in Jill Husbands from Lloyd's. When Ms Husbands arrived in Bermuda to underwrite aviation risks for Walton she was surprised by the lack of professional camaraderie on the island.

Husbands said that one of the things she missed dreadfully in Bermuda was the ability to talk with others in the industry to find out what was happening in the market.

She thought the Bermuda international insurance market was strongly influenced by the American way of doing business, where everyone kept business dealings secret and no one shared information. She also said that when she first arrived she was shown a quality of business that was not of the calibre she had come to expect in London. However she did recognise that the Bermuda insurance market was still young.

For example, a decision would be made to write small lines of business, just to appear accommodating to the brokers overseas, in the hope that eventually one would build up relationships with them and would then be shown quality business. Many believed Bermuda would need time to establish solid relationships with overseas brokers, if ever it wanted to see the quality of business shown elsewhere.

Husbands quickly discovered that the aviation market was purely a matter of relationships and she had to work hard to build them so that she would get the better business. The aviation market is also very volatile, so that it might be completely clean in any one year, thus forcing rates to drop, but then while the rates were at their lowest all it would take was a couple of planes to go down for the aviation underwriters to find themselves devastated overnight.[254] It was all the more important to have solid and reliable long-term relationships.

New York developments

By 1978 the State of New York had become concerned about the volume of dollars it was losing in premiums to foreign jurisdictions. To stem the flow New York decided to restore its position as a premier insurance centre. Therefore a Bill was passed which would allow New York to become the first free trade zone in which qualified insurers could write large or unusual risks without seeking prior approval on rates or forms from the State insurance department.

[253] *The New York Times*, 16 July 1978, 'Offshore captive insurers slip their chains', by Lisa Bergson, pp. 1 & 3

[254] Interview with Jill Husbands, 12 November 2002

The biggest supporter of this initiative was American International Group. In an interview with *Business Insurance* AIG President and CEO Maurice R. Greenberg said—

> 'The regulatory climate doesn't move fast enough to deal with the large corporations. These corporations want to sit down and design a program and get it fast, rather than wait for departmental approval. A regulatory climate that is conducive to doing commercial business faster will aid New York insurers seeking to increase their business.'[255]

Later in the year AIG, through its subsidiary Insurance Company of Pennsylvania, became the first company to write a policy in the free trade zone. By then 17 companies had been granted licenses to operate in the zone. By signing into the zone these companies became exempt from filing policy forms or rate approvals on policies having US $100,000 premiums for one kind of insurance, US $200,000 premium for two or more kinds of insurance, or on unusual or hard-to-place risks approved by the superintendent of insurance.

In addition New York was successful in establishing an Insurance Exchange, which was dubbed the 'American Lloyd's'. Brokers put this together in order to compete directly with Lloyd's. It was pushed hard by the brokers but was strongly resisted by AIG, because the insurance giant did not want brokers to establish their own insurance network without using its services.

The Act was passed, the Exchange was established, and the brokers were elated and could not wait to get started. However the market reaction was lukewarm, as many elected to take a 'wait and see' approach. Come the end of the year, risk managers and captives were still not making any strides to enter the Exchange. They saw no point to it really. By the time the Exchange got underway, risk managers were comfortable with the scope that was given to the captives they had formed in Bermuda. They did not see how becoming a member of the New York Insurance Exchange would benefit them in any way.

The Exchange soon ran into big trouble. From having been an ardent promoter, the largest broker, Marsh & McLennan, soon became its biggest critic. There was a move on behalf of AIG to limit the powers of brokers within the Exchange. The brokers also discovered that the committee had decided that the board of governors would consist of five underwriting members, four public members and three broker members. This move made the Exchange heavily weighted by the underwriting community and not the brokerage community, as had been the original intention. As a result, the brokerage community no longer felt it was in their interest to support the Exchange and therefore it died almost as soon as it had been formed.[256]

Lloyd's says 'no' to Marsh & McLennan and Frank B. Hall

In a statement that shocked the insurance world, Lloyd's of London, acting almost as though it were a private club, refused to allow Marsh & McLennan and Frank B. Hall, two of the largest American brokers, to buy two of the Lloyd's brokers, Wigham Poland and Leslie and Godwin. Kenneth Fleet of *The Sunday Times* voiced the following opinion—

> '...Wednesday's rulings were a slap in the face with a dead fish for two of the leading figures in American insurance. By implication they were deemed not to be trusted to behave like members of the club are required to behave. Not, of course, because they are foreigners, although Lloyd's kept foreigners out until 1970. The issue was one of control, not simply control by foreign companies but control by "outside insurance interests", defined as an "insurance company, an underwriting agency, or non-Lloyd's broker".
>
> 'The Committee's principal fear was that if it opened the door wide to Marsh & McLennan and Frank B. Hall it would set a precedent that Lloyd's with all its flexibility could not then ignore. American brokers

[255] *Business Insurance*, 15 May 1978, 'NY ponders free trade zone to deregulate special risks', by Ellis Simon, pp. 1 & 36

[256] *Business Insurance*, 13 November 1978, 'M&M chairman threatens to oppose NY exchange', by Ellis Simon, p. 6

hitherto have not been internationally-minded but some of them are now gearing themselves to break their domestic mould and, like US bankers before them, invade foreign soil. And once the leaders have run up their flag abroad, the rest will assuredly follow the fashion. Acquiring a Lloyd's broker would be the method they would understand, and the road to instant international status. Lloyd's broking firms not taken over would stand to lose valuable American business that would inevitably be transferred to newly acquired subsidiaries.'[257]

Many thought that Lloyd's argument of keeping American brokers out to preserve their independence was nothing short of ludicrous. How could Lloyd's consider itself to be independent when the majority of Lloyd's brokers were owned by Lloyd's own underwriters or by the large merchant banks?

Business Insurance added this comment—

'Since the object of this move (Lloyd's blocking United States brokers from acquiring Lloyd's brokers) was clearly to protect their own flanks, the members of the committee at Lloyd's would have done well to come right out and say so. But to pretend that their decision was made in order to protect the buyer of insurance defies credibility.'[258]

In 1978, as a result of the state of the market, Bob Clements, senior officer for casualty operations at Marsh & McLennan, presented a position paper arguing that the definition of a broker's responsibility should be expanded to include the creation of market capacity when there were no other available solutions. Soon after he presented the position paper, the market began to soften so no one took it seriously anymore and it just collected dust.

Rent-a-captives become popular

While New York was trying to become a free trade zone and Lloyd's was rejecting giant brokers, Bermuda took the rent-a-captive concept to a new level. These captives had started in 1976 when Hugh Loader, group insurance manager for Associated TeleVision Corp. Ltd (ATV), began to promote the idea. ATV came to Bermuda in 1971 and opened up a pure captive, Marbach Insurance Co. Ltd., responsible for writing all of its parent company's insurance needs. It later expanded to include third party business.

In 1976 Loader saw an empty niche in the market. Some companies needed the services of a captive but did not necessarily want to establish one of their own. Loader decided to branch out and open a second company, Campton Insurance Co. Ltd., which others could use for their own insurance needs. This set in place for the first time a true rent-a-captive facility.

By 1978 the rent-a-captive concept was making quite a stir in the market. Many clients wanted access to such a facility but had little luck in finding one. However Clay Chambers, who had been instrumental in bringing J&H to Bermuda, was now retired from J&H and was looking for another opportunity in the market. Along with his colleague, William H. Green, he soon formed American-British Insurance & Annuity Co, the first company specifically designed to rent out its services.

Chambers and Green actively solicited middle market clients who wanted a captive but did not want to incur the capital expenditure or management responsibility themselves. The company was designed to treat each tenant's business as though that was an individual insurance company, with its premiums, profits and losses segregated from the business of other rentals. It was up to the tenants to decide if they wanted to cross-reinsure among themselves to spread the risks. Chambers was to do the underwriting and to handle the placement of reinsurance.

[257] *The Sunday Times*, Business News, 23 April 1978, 'For whom the bell tolls', by Kenneth Fleet, editor Business News, © NI Syndication, London, 1978

[258] *Business Insurance*, 15 May 1978, 'Lloyd's doesn't understand free trade', p.6

Crum & Foster acquires Blades

Despite Joe Blades' enthusiasm for Bermuda, his stay on the island was quite brief. By 1978 he had run into some financial problems and was looking for a way out of the business. He called on his good friend Bobby Russell, of Crum & Foster, at that time a very large US insurance company, for help. They decided to buy out Blades and this brought to an end the involvement of big Joe Blades with the Bermuda insurance industry. Robin Spencer-Arscott, at that time General Manager of the Blades Bermuda operation, resigned from Blades to take up the position of President of Frank B. Hall (Bermuda) Ltd. One of his missions with Hall was to bring Grumman Corporation's captive Paumanock Insurance Company Ltd into the world of third-party underwriting.

Cash flow underwriting

If we envisage the insurance market as a parabolic curve, it took a very deep dive in the late seventies. By the time IRS 77-316 was passed, interest rates had skyrocketed and because insurers realised they could earn more income from favourable investment returns they began to write more policies at premiums they would have considered unprofitable in the past, simply in order to generate premium dollars for investment. As a consequence insurance premiums were further deflated, as investment income became a larger portion of insurance earnings and underwriting income decreased, which in the end opened up underwriters to the 'cash flow underwriting principle.' This is simply the practice of pricing insurance premiums taking into account anticipated investment returns. Insurers needed more premium to generate the cash flow to invest. Thus began the era of cash flow underwriting in the global insurance industry.

Carnation case in United States

Against this backdrop of a changing market and the growing need for captives, the Carnation case was adjudged and decided. It came to be regarded as a landmark tax case in the United States. As a result of this case it was understood that in order to preserve the risk transfer rule, and thus for premiums to qualify as being tax deductible, the captive had to write a significant amount of third party business. This ruling created an incentive for captives to write third party business on their books if only to preserve the tax benefits.[259]

Carnation was the first captive test case to be decided.[260] It confirmed the Internal Revenue Services (IRS) ruling of 29 August 1977, which set the ball rolling for Bermuda to become known as the third largest reinsurer in the world. *Bermudian Business* reported on this landmark decision as follows—

> 'This ruling held that captives had to have a significant amount of third party business to preserve the tax status of the captive. Suddenly, there was a powerful economic incentive to put third-party business on the books of the "naïve captives" at almost any cost. The captives did so with a vengeance, resorting to cutthroat competition to pick up business. In time, captives were generating significant profits—and they changed from being cost control mechanisms to actual profit centres.
>
> In many ways, this was the golden age of creativity and growth in the Bermuda insurance market—even if the captives were planting the seeds for some serious problems later on down the road.'[261]

[259] *Historical Development of Insurance in Bermuda, Recent Developments,* compiled by the BII, Chapter 1, 'Captives and Tax Status', p. 9

[260] John Milligan-Whyte: *The Evolving American, Canadian and English Taxation of Offshore Insurance Companies as at April 1987,* p. 47

[261] *Bermudian Business*, Spring 1999, 'Bermuda ready for challenge', by Donald S. Watson, Alan M. Levin, Fred R. Loeloff, p. 42

Ford tax reversal in United States

Then to add to the snowball effect of Bermuda's growing importance in the reinsurance world, the Ford Motor case was settled by a decision that would have effects of the greatest importance. *The Journal of Commerce* reported as follows—

> 'Ford Motor Co. and the Internal Revenue Service have resolved a dispute tax observers say holds far reaching significance for hundreds of captive insurance companies maintained offshore, especially in Bermuda by multinational corporation. In negotiations concluded last week in Washington, IRS attorneys backed away from the contention that the premiums paid by operating subsidiaries of Ford to Ford's Bermuda-based captive insurance subsidiary were taxable dividends, rather than a non-taxable business expense.
>
> '...The Ford Motor case (and another involving Carnation Milk) also holds substantial meaning for the offshore captive insurance companies already operating in Bermuda, according to the President of Bermuda's Insurance Institute, Mr Clive Himsworth. In the past, he has said of the Ford Motor case: "I think many operations would seriously think about continuing here if the IRS ruling were upheld." Approximately 600 captives operate in Bermuda, contributing US $2.5 billion flow of funds through Bermuda's gross income.'[262]

Aneco Reinsurance, Andrew Barile and Edward Mallozzi

Looking for trends around the global insurance industry, two reinsurance brokers, Andrew Barile and Edward Mallozzi, came up with the concept of forming an investor-owned reinsurance company. Lacking the wherewithal to formalise their concept, they sought the expert advice of two lawyers, Gordon Werner and Francis Mulderig, in setting up Aneco Re.

Barile and Mallozzi needed help because Aneco Re was to be the first of its kind, the only company that would be publicly traded or completely independent of a foreign parent in Bermuda. It filed with the Securities Exchange Commission (SEC) to sell 1.7 million shares at six US dollars each. Mulderig was the natural person to head the organisation because of his prior association with the island. He had been chief legal counsel of American International Reinsurance Company (AIRCO) in Bermuda from 1956 to 1966, before being transferred to the company's New York headquarters, so he was very familiar with the way the island operated and knew at once that the best jurisdiction in which to establish the company would be Bermuda. Furthermore Barile, Mallozzi and Werner also recognised that the time was right to domicile this publicly traded reinsurance company in Bermuda, because of Bermuda's growing reputation as the place for offshore business.

It was also Mulderig's specific role to secure the financing for the new company. Part of the original concept was that the company should be investor-owned. However the four men knew that as a controlled foreign company it could not operate effectively in the United States, because each investor would be heavily taxed. A company was held to be a controlled foreign company if any one US investor owned more than ten per cent. So to get around the problem of US tax liability they would need at least 11 investors, each of whom would take up a share of less than ten per cent. They further decided to incorporate in Bermuda so that none of the earnings would be taxable unless repatriated to the United States.

The company was also the first to receive blanket permission from the Bermuda Monetary Authority (BMA) for share transfers to be effected, thus obviating the need to get the BMA's approval each time a share was transferred.

[262] *Journal of Commerce*, 12 May 1978, 'Offshore Tax Case Won by Ford Motor paves way for captives', by Christopher Elias, pp. 1–2

Andrew Barile, head of Andrew Edwards and Company Inc., and known as the reinsurance matchmaker, was instrumental in setting up this facility.[263] The underwriting of the reinsurance risks was to be handled by a subsidiary of theirs, AEC Professional Services Inc., through its local underwriter, Harry New.[264]

After the company was established, Barile told a financial management seminar attended by 200 corporate and insurance executives at the Waldorf Astoria in New York, 'We are entering a new era in the development of the offshore insurance company, commonly referred to as the captive insurance company.'[265]

Mulderig said that Aneco was set up to reinsure half the business it underwrote. He also expected captives to be among those looking for reinsurance from Aneco because the company was not being set up merely to funnel reinsurance from one source to another, nor to provide business to other companies owned by Aneco shareholders. Mulderig further stated, 'We are going to be a major international reinsurer.'[266]

AIRCO merges with AIG

In 1978 AIRCO, the publicly traded parent company, was merged into American International Group (AIG), thereby making the Bermuda companies wholly owned subsidiaries of AIG. Stempel became President and Chief Operating Officer in charge of all AIG's life insurance operations worldwide. Hal Dale retired. Joe Johnson became President and Chief Executive Officer and Treasurer of American International Company, Ltd., which managed all the other Bermuda operations.

When Greenberg asked Stempel to become his second in command, Stempel was enjoying his lifestyle so much that he told Greenberg he wanted to stay in Bermuda. Greenberg agreed to this but it meant that Stempel spent most of his time on planes back and forth to New York and all over the world, to oversee the operation. Stempel says he had to get up at four in the morning to catch his flight and was always the first at the airport on a Monday morning and yet would be in his New York office before his secretary got there! He would travel back to Bermuda on the Thursday and work in the office there on the Friday.

It was travel, travel, and travel, all around the world. He was logging 150,000 miles a year and not on the comfortable jumbo jets we know today. He says there was a contest once in Bermuda to see who was the most travelled person on the island. Not surprisingly he won. He'd even out-travelled the head of Pan Am.[267]

Also in 1978, long before finite risk (financial reinsurance) came into vogue, AIG saw an opportunity in creating financial vehicles for clients who needed them and formed Inter-Hemispheric Reinsurance Co. Ltd., as a joint venture by AIG. Inter-Hemispheric Reinsurance was the first Bermuda company devoted to finite risk insurance. It later changed to become Richmond Reinsurance Co. Ltd. (named for Richmond Road where American International had sited their office).[268] 'Inter-Hemispheric had a US$50 million capital base. It now operates as Richmond Insurance out of Barbados.'[269]

[263] *The Royal Gazette*, Business Week Four, 'Insurance chief speaks on the profit center angle'
[264] op. cit., Business Week Three, 'Investors' chance to jump on the insurance bandwagon'
[265] op. cit., Business Week Four, 'Insurance chief speaks on the profit center angle'
[266] *Business Insurance*, 13 November 1978, 'First public island company, Bermuda reinsurer to tap captive market', p. 56
[267] Interview with Ernie Stempel, 28 March 2002
[268] *The American International Group, 50 years in Bermuda, a brief history*, 1997
[269] *The Bermudian*, Focus on Business, April 1995, 'Inside the Powerhouse', by Kevin Stevenson, pp. B14–B17

The Insurance Act of 1978

The passage and provisions of The Insurance Act reflected a recognition by Government and by the insurance industry itself of the need for some measure of regulation. Bermuda insurance companies were transacting business with ever increasing frequency with their counterparts in regulated jurisdictions, and needed to demonstrate their accountability to a regulatory body. Therefore the Act was designed to serve the public interest by maintaining Bermuda's credibility as an internationally accepted insurance centre. The Act required that companies take two actions—appoint a principal representative and file a Statutory Financial Return, which had to be certified by the directors and auditors. The Act also granted explicit investigatory powers to the Minister of Finance. *Bermudian Business* gave the following explanation of the Act—

> 'The Insurance Act of 1978 was formed on the basis for the government supervision of the insurance industry for both domestic and international exempted companies. The purpose of the legislation was—
>
> 1. To protect the public interest.
> 2. To protect Bermuda's image as an insurance centre.
> 3. To increase Bermuda's credibility as a centre for international insurance and reinsurance
>
> 'The Act is administered by the Registrar of companies assisted by an advisory committee consisting of executives from within the industry.'[270]

The Act itself is unique as to insurance regulation because it was based on the concept of a partnership between government and the industry. In 1978 it was decided that Government would not create a bureaucratic structure to regulate the industry but rather that provision would be made in the act for the appointment of an Advisory Committee consisting of private sector representatives.[271] Brian Hall gives much credit for the 'partnership' that evolved between the business sector and the government to Shelton Burgess, former Registrar of Companies.

> 'Shelton worked hard to create the regulatory environment Bermuda enjoys today. He worked hard with the business people of Bermuda to ensure minimal government intervention. He recognised the importance of self-regulation and as such avoided the prospect of self-recognition by creating unnecessary bureaucracy. Shelton Burgess was the guy who if he wanted to be a stickler could have insisted on more compliance. Thankfully he did not.'[272]

Prior to the Insurance Act being passed, Brian Hall was running his own company, Inter-Ocean Management Ltd., and managing the affairs of Johnson & Higgins, Willis Faber, Tokio Marine & Fire, and Taisho Fire & Marine. Since Inter-Ocean was a local company he felt that his interests were not being adequately represented, because all the other captive insurance managers were international companies and represented by the International Companies Division (ICD) of the Chamber of Commerce. As a local company, though managing a large volume of international companies, he was prohibited from joining the ICD. He also felt that the captive managers interests generally were not being adequately represented, so he arranged a meeting of all management companies to discuss these concerns. As a result of this meeting it was decided to form the Association of Insurance Managers of Bermuda (AIM), which subsequently became the Bermuda Insurance Management Association (BIMA). At the end of the meeting all those present gave Hall their business cards so that he could document their attendance at the meeting. He subsequently

[270] op. cit.,, April 1991, 'Is Bermuda poised to fulfil its function during the 1990s?' by Cyril Rance

[271] Brian Hall speech, 'Bermuda's influence in the risk financing industry and government's role', 29 March 1983

[272] Interview with Brian Hall, 28 March 2002

left the Island on a business trip and on his return discovered that he had, in his absence, been elected the first President of the Association.[273]

During the entire drafting stage, to conclusion, there were different groups with different agendas, among them lawyers, accountants, auditors, bankers, local and overseas companies, all trying to reach a workable solution for the business sector. So it took a long time, some seven years, for the regulations to be finally agreed and enacted in 1978.

Cyril Rance, former head of Bermuda Fire and Marine and local business activist, believes that there should have been two sections to the Insurance Act—one for the international companies and the other for local companies. In the final draft, however, there was no split between the local and international sector. The Act was not something that happened overnight and by the time it was finalised most participants were relieved that they had managed to accomplish such a mammoth undertaking.[274]

The Financial Times reported on the Insurance Act as follows—

> '... Mr Shelton Burgess, who, while Company Registrar, will also double up as Regulator of the new Act, stresses that the new regulations are far from the rate, policy, market conduct restrictions imposed on insurance companies in the big onshore markets. Mr Burgess, who is a considerable fan of the cost efficiencies of "captive" and offshore insurance, says the main purpose of Bermuda's new insurance regulations, which come into effect later this year, is to ensure the solvency of the companies on the island. The guidelines set by the Registrar under the Act say that companies should not be writing business on which the premium income is more than five times their capital and surplus together.
>
> 'Two features unique to Bermuda in the insurance legislation, says Mr David Lines, a Bermudian accountant prominent in the drawing up of the new legislation, are the relatively slender paperwork that companies must submit to the Registrar and the role of the industry advisory committee in relation to the Finance Minister in dealing with any offenders under the Act.
>
> 'Essentially, the Act involves a characteristically Bermudian form of self-policing, with any defaulting insurers being judged by their peers. Though the new Insurance Act is aimed primarily at ensuring the solvency of companies, it does not stipulate, as legislation in many other countries does, specifically what insurers must invest in.
>
> 'Insurance companies obviously must be able to realise assets to meet claims. But "it would be impudent of the government of Bermuda to tell companies to invest in the mid-Atlantic," Mr Lines says. The Act requires only that a certain proportion of liabilities must be funded in a broad class of fairly liquid assets.'[275]

In designing the Bermuda regulations, the designers took features from a number of jurisdictions. The British system had the most influence, particularly in the early years. As the Act began to develop, many features were adapted from the United States regulatory systems, in particular the requirement for actuarial opinions on loss reserving and the National Association of Insurance Commissioners (NAIC) warning ratios. The designers borrowed the Canadian dividend tripping —features like ratios of loss reserves. Some of the solvency margins are drawn from the Canadian model. The conscience of the Bermuda companies was different from other markets. Bermuda was a market of captives that were more interested in self-insurance and reinsurance and not a market of direct writers. Bermuda companies typically did not issue policies to individuals but reinsured other insurance companies, which were sophisticated buyers and needed less regulatory protection.

The move proved to be the right one because, when there was a capacity shortage in the mid 1980s in the excess liability area, and again in 1993 and 1994 for the property and catastrophe mar-

[273] Interview with Brian Hall, 28 March 2002

[274] Interview with Cyril Rance, 4 March 2002

[275] *The Financial Times*, 9 March 1979, 'A Special report on Bermuda by David Buchan, A boom in insurance', p. 17

ket, not to speak of September 11, 2001, Bermuda was the jurisdiction of choice, and the force behind a substantial number of new start-up insurers with significant fresh capital.[276]

The Insurance Advisory Committee

In a speech given on 7 October 1985 Brian Hall explained how the Insurance Advisory Committee (IAC) was born out of the Insurance Act of 1978, which is

> '...appointed by the Minister of Finance to advise his Ministry on the needs of the industry and the implementation of responsive legislation to regulate the industry. All sectors of the insurance industry are represented on the Advisory Committee, which contains 12 members, all being senior insurance industry executives. These members give freely of their time in the interest of the industry and to avoid Government developing a bureaucracy. The partnership does work effectively and allows the industry to feel that they are well represented in the regulatory environment.'[277]

The Minister appoints the members of the Advisory Committee annually. They chair various subcommittees, dealing with international insurance matters. The original members of the committee were—Chairman Hal Dale, Deputy Chairman George Sandeman, Bob Baker, Leslie Dew, Stephen Chamberlain, Laurie Longley-Cook, Simon Everett, Allan Richardson, Glenn Titterton, William Rewalt, Registrar & Inspector of Companies- Shelton Burgess (ex-Officio), Controller of Foreign Exchange (Ex-Officio).

Insurance Admissions Committee

The most significant of the IAC subcommittees is the Insurance Admissions Committee, which vets all new insurance company incorporations and makes recommendations to the Minister of Finance. All Committee members are subject to and bound by the Official Secrets Act.[278]

Bob Baker, former Chairman of the Insurance Advisory Committee and Insurance Admissions Committee says that the Insurance Admissions Committee serves two purposes—

1) To keep the crooks out and
2) To try to make sure that no company admitted goes bankrupt or is under-capitalised, even though most of them were captive companies that were not insuring third party business. Baker says the main concern and focus of the Bermuda insurance marketplace during that time was "character over capacity."[279]

According to Bob Steinhoff, senior partner at KPMG Bermuda, it was fortunate for companies coming to Bermuda that the accounting rules and insurance regulations developed side by side. Initially these insurance companies did not come to Bermuda because there was an infrastructure in place. They came because of a willingness on behalf of Bermuda to work with them—and also for a small tax advantage. The accounting firms and captive management firms developed side by side also. Management firms did the accounting, investments, underwriting and policy issuance. The accounting/auditing firms provided the audit services and advisory services, including actuarial work. The accounting profession trained many of the accountants in the insurance industry, who then moved over to the management side of the industry. Accounting firms provided many resources for the captive management firms. People like David Ezekiel, Terry Powers and Nick Dove had all worked in the accounting profession before becoming leaders of the insurance industry.[280]

[276] Interview with Bob Steinhoff, 4 April 2002
[277] Brian Hall, speech on the 10th Anniversary of PMG Assurance Company Ltd., 7 October 1985
[278] Joe Johnson speech, January 1987, 'Alternative Domicile, Why Bermuda?'
[279] Telephone interview with Bob Baker, 26 April 2002
[280] Interview with Bob Steinhoff, 4 April 2002

All good things must come to an end

1978 proved to be the last of the best years for the captive reinsurers. At the local level the Bermuda international insurance industry, the Bermuda government, and local participants, all worked well together, to put in place an Insurance Act that would maintain quality control with respect to companies wanting to set up on the island. Yet on the global scale insurance markets underwent significant changes as rates tumbled and coverages expanded.

Buffer layer business boomed in Bermuda and the captives that wrote nonrelated business wrote as much of it as they could. Little did they know that as quickly as it had become an opportunity it would even more quickly become a drag. By mid 1978 the buffer layer was moribund. It had been hard to place and was an expensive layer of insurance, this link between the primary and the excess programmes. The demise of the buffer layer sent the clearest possible signal that the storybook growth of the excess and surplus markets in 1976 and 1977 was taking a different turn in 1978.

The market shifted, to become a buyer's market overnight. The major reason was that the primary underwriters woke up to the fact that they were missing out on some very good premiums and therefore went after the buffer layer with an aggressive underwriting policy, to attract this business back to their books. The biggest losers were the excess and surplus insurers, specialising in the buffer layer. These included a majority of the captives in Bermuda, who had sought this type of risk. This was the first significant sign to the Bermuda insurance industry that the times were in for a drastic change.

Group captives and IRS 78-338

While buffer layer business was on the verge of drying up in Bermuda, the group captives that had formed were by contrast rejoicing. Internal Revenue Service ruling 78-338 publicly declared for the first time that premiums paid by a United States company to an offshore, group-owned, or industry owned, captive were tax deductible as ordinary and necessary business expenses, provided that they were 'reasonable' and based on 'sound actuarial principles'.

US brokers find a way into Lloyd's

Towards the end of the year, brokers Marsh & McLennan and Frank B. Hall finally found ways to penetrate the Lloyd's blockade that had prevented United States brokers from entering that marketplace. First Frank B. Hall (FBH) gained access to Lloyd's through a compromise that allowed them to purchase London broker Leslie & Godwin (Holdings) Ltd and a subsidiary of Leslie & Godwin that handled Lloyd's business was spun off. Hall took 25 per cent ownership of this subsidiary while the remaining 75 per cent was to be owned by non-insurance interests at Lloyd's.

Shortly after this victory Marsh & McLennan (M&M) was allowed into Lloyd's by combining its operations with those of Lloyd's broker C.T. Bowring & Company Ltd. This was the only way that Marsh could circumvent Lloyd's rule whereby outside insurance interests could not own more than 20 per cent of a Lloyd's broker. M&M were happy with the merger because it allowed them access to the Lloyd's marketplace, something they had always wanted.

United Kingdom brokers did not take these entries into the Lloyd's club lightly. Many saw it as the forerunner of more United States brokers gaining entry into Lloyd's, especially since Lloyd's had approved the M&M and Bowring linkage as a means to strengthen the market's global position.

These concerns were soon justified when Alexander & Alexander Services Inc. announced that it planned to link up with Lloyd's brokers, Sedgwick Forbes Holdings Ltd. and Bland Payne Holdings Ltd, who were planning to merge.

The proposed link, between Alexander & Alexander, Sedgwicks Forbes Holding Inc. and

Bland Payne Holdings Ltd., caused a sensation in the Lloyd's market, because it was totally unexpected. Many feared that such huge mergers would allow the large brokers to become too strong a force and that business should be directed to other, smaller companies, so as to lessen the power of the new mega-brokers to control the marketplace. Not only did these mergers and relationships change forever the way Lloyd's operated, but they also changed the ways of the world market, because boundaries disappeared, as the forging of such relationships enabled brokerage houses to become more global.

It was as a result of one of these new partnerships that in 1979 the National Brokerage Agency (NBA), split off from Marsh & McLennan (Bermuda) Ltd. along with four employees. Johnnie Dobbs and his assistant Esterley Thomas headed up the operation, while Warren Larson and Donna Gaugain headed the underwriting division. NBA was initially formed as a wholesale operation to broker the business Marsh foresaw as a result of its dealings with Bowring in London and of Bermuda's growing reputation as an alternative marketplace.

Scrutiny from the National Association of Insurance Commissioners (NAIC)

By the end of 1978 the resounding success of the captive industry in Bermuda had caught the attention of yet another regulatory body in the United States, the National Association of Insurance Commissioners (NAIC), an organisation of insurance regulators from the 50 states, the District of Columbia and the four United States territories. The NAIC had been developed in 1871 to provide a forum for the development of uniform policy when appropriate. Given the growing concern about the number of companies forming offshore, the NAIC decided to create a task force to study the growth of non-admitted markets and the adequacy of a 1962 model law designed to govern them.

Although the NAIC task force did not specifically mention captives, it was widely believed that the NAIC considered them to be a part of the excess/surplus insurer category. Many in the United States were troubled by a seeming lack of regulation on the island and wanted to make sure that adequate controls were in place for captives that wrote business directly into the US, particularly those providing workers' compensation insurance.

The matter in question was the financial soundness of these captives because they were not required to carry letters of credit, which caused many to fear that they would be insufficiently capitalised to write significant amounts and limits.

The growth in the excess/surplus lines was a cause of anxiety for the NAIC. It wanted to make sure that all the players, including the Bermuda captives, would be able to meet their obligations whenever the need arose.

Scholarships and the College of Insurance

The Inter-Ocean Management/J&H companies were becoming a major insurance force on the island. As such, the need to get more Bermudians involved in the insurance industry was identified and J&H showed itself to be responsive to this challenge. The degree to which Bermudians were keen to get involved in the insurance industry was well illustrated when J&H offered its scholarships. There were 50 applicants for the two scholarships offered. The two successful candidates, Kathy Ball and Thelma Trott, returned to the island after completing their studies to work in the insurance industry.

Love Canal

In what was to be remembered as the worst pollution disaster of its time, the Love Canal crisis in New York State sent shock waves throughout the insurance industry, the government of New York, and the United States. It awoke them all to the correlation of low-level chemical exposures with birth defects, miscarriages, cancer, and health troubles in general, not to speak of the immense damage done by pollution to the economy.

Hooker Chemical and Plastics Corporation had used a site at Love Canal as landfill from 1947 until 1952. Buried there were 20,000 tons of chemical industrial waste. In 1952 Hooker donated the site to the City of Niagara as the location for a school. Most of the homes in the Love Canal area were also built in the early 1950s.

Although the full severity of the underground contamination did not reveal itself until two decades later, there were warning signs over the years. Residents complained of burns when walking across the site. Numerous dogs had died of tumours. Human miscarriages, birth defects and liver abnormalities were high. By the time the seepage reached disaster levels the soil in the backyards closest to the Canal was potentially lethal to pregnant women and young children.

Then the canal overflowed, after six years of abnormally heavy rains. In the spring of 1978 residents discovered that the dump was leaking out into their neighbourhood. On the second of August the State Department of Health declared a state of emergency at Love Canal. The 99th Street School was closed. Some 239 people were evacuated from their homes, especially women and the children under the age of two. It was recommended that a clean-up plan be implemented immediately.

Yet, while it was evident that Love Canal was a problem of immense proportions, no one was willing to admit fault. Even Hooker's parent, Occidental Petroleum, was pulled into the subsequent lawsuit, it being alleged that Occidental knew of the dangers present at the site. The Love Canal case was huge. It was the first of its kind and it changed forever the scale and nature of environmental and pollution coverage.

Captives reach their peak

By the end of 1978 captives had become a major part of the industry. They had changed the manner in which insurance was purchased, because of the newfound ways whereby they could be used. Risk managers had become influential in their companies for creating cost controls, and a possibility to produce profits, through creative captive utilisation. There was a proliferation of captive-related underwriting pools and services, with Bermuda hosting the bulk of them. Regardless of what might happen to the captives in the future, the insurance industry would never be the same again as it was before they came. This period helped insurance managers, underwriters, brokers, service providers, and all the ancillary operations to grow in ways that could not have been envisaged in the past.

Nevertheless and despite this surge of the captives, trouble loomed on the horizon for the young Bermuda marketplace, as rates began to plummet around the world and global capacity became far too abundant. Unknowingly, the captives that chose to write nonrelated business had reached their peak in 1978 and would change as the market continued to decline.

CHAPTER 28

1979
Claim to a Global Market

In the forefront

By 1979 there were 850 insurance companies registered in Bermuda[281] and the island was recognised as the third largest reinsurance market in the world. Of the nearly 900 so-called exempted insurers registered in Bermuda, 500 to 600 active companies generated gross premiums estimated at anywhere from US \$2 billion to US \$3 billion, with net premiums thought to be about US \$800 million. Not only were the numbers impressive in themselves but also brokers in other markets such as London began to recognise the worthiness of the Bermuda insurance marketplace and began to show the underwriters more 'quality business'.

Underwriters like Gulf's Britamco, Corporate Insurance and Reinsurance Company Ltd. (CIRCL) and Hopewell did exceedingly well and looked to pool their risks together. More established reinsurers such as General Reinsurance looked to set up on the island. Bermuda was buzzing with new as well as long established business.

Meanwhile Bermuda's oldest reinsurance company, Security Re, had changed its name to Continental Reinsurance Corporation (Bermuda), Robert Baker had resigned as President and Nigel Harley was named his successor.

Merger of J&H and Inter-Ocean Management

By the end of the decade, Johnson & Higgins decided their own presence on the island was needed in order to support their clients. Therefore the management looked at various options. According to Dick Meyer, Senior Vice President of J&H, New York, as a result of the activity in Bermuda they decided it was time to complete their relationship with the Island. In 1979, after being in business for ten years with Brian Hall, through his company Inter-Ocean Management, and mindful of his energetic, knowledgeable and independent capabilities, J&H decided to buy out Inter-Ocean Management.

This initiative resulted in J&H Limited becoming the largest insurance management operation on the island with more than 40 staff. Also at the same time, because J&H as captive managers were frequently seeking reinsurance protection for their captive clients, they formed a reinsurance brokerage facility in Bermuda which was called Johnson & Higgins Wilcox Baringer (Bermuda) Limited. Ultimately there were 12 employees and the company performed all insurance and reinsurance brokerage functions, not only in the Bermuda market but also on a worldwide basis.[282]

Mutual Risk formed

After Aneco Re had been established in 1979, Francis Mulderig saw another opportunity opening

[281] *The Financial Times*, 9 March 1979, 'A special report on Bermuda', by David Buchan, 'A boom in insurance', p. 17
[282] Brian Hall speech, mid 1983, 'Significant developments in captives and at J&H'

up for a facility to provide rent-a-captive services. Mulderig knew he needed a reputable company to issue policies for such a facility if it was to work properly. Instantly he thought of his friend John Cox, with whom he had worked at American International Company in New York. The two men had often exchanged ideas about how they could provide solutions to shortages they saw in the market. After Mulderig had made contact with Cox the two tossed the idea around for quite some time until they had refined the concept as much as they could.

Following on his conversations with Cox, Mulderig decided to form a new company called Aneco Mutual, to handle rent-a-captive business. The company was set up to provide services to captives rather than risk undertaking as a means of diversifying the portfolio of Aneco Re.

By 1979 Cox had moved to Insurance Company of North America (INA) and therefore became the ideal candidate to issue policies for the new Aneco Mutual, which later became known as Mutual Indemnity. John Kessock and Michael Grimer were hired to set up the new Aneco Mutual and the operation was opened for business. The first piece of business was written in January 1980.

Rob Mulderig, son of Francis Mulderig says it was Kessock and Grimer who marked out Aneco Mutual with the term Insurance Profit Centre Programme (IPC), because he believes Aneco Mutual was the first company to be in the business of successfully offering a rent-a-captive service for a fee. Mulderig continued that others may have tried but they did not attain the level of success of Aneco Mutual, as its IPC programme was the first widespread successful rent-a-captive facility.[283]

Trenwick Reinsurance

News quickly spread that Bermuda was the place to be for alternative risk transfer facilities. Five men from the established reinsurer, General Reinsurance, decided that it was time to break away from the traditional reinsurance market and create something new. They saw the opportunity to open a Bermuda company, to be called Trenwick Reinsurance, which would focus on reinsuring captives.

The first five employees of Trenwick were Brian O'Hara, Senior Vice President and Director, Jim Billett, President and Managing Director of Trenwick Reinsurance, Angus Robinson, Senior Vice President and Director, Mark Hinkley, Senior Vice President, Secretary and Director and Kent K. Winford, Senior Vice President. O'Hara became the Chief Underwriting Officer of Trenwick. Brian O'Hara told *Reactions Magazine* the following about coming to Bermuda—

> '...He (O'Hara) believes destiny has put him on the island because of its strong connections to his past—his parents were stationed there (in Bermuda) during World War II and his older sister was born there. When it (Bermuda) started to develop as a financial centre, O'Hara's interest was quickly drawn to the island. "I grew up hearing stories about Bermuda and when I saw the captive industry starting to develop it really got my attention," says O'Hara. "I really felt it was driven by fate. I thought Bermuda had a great future and there were great opportunities here for someone to come in and be part of that development. Fortunately, it seems to be working out that way. The island is in my blood."'[284]

According to Nancy O'Hara, who was the Controller of Trenwick at the time, when Angus Robinson, the founder of Trenwick, was trying to raise the US $25 million needed to put the Bermuda deal together in 1979, no one knew whether they would reach their target. Never before had anyone tried to raise this unprecedented amount of capital to form an insurance company. US $25 million was a lot of money in 1979, unlike in 2001 when insurance companies raised a billion in less than a week.

[283] Interview with Rob Mulderig, 5 February 2003

[284] *Reactions Magazine*, February 2002, 'Bermuda: Interview—Brian O'Hara, made of true Bermudian stuff', by Wyn Jenkins, pp. 30–32

While Angus was out doing the 'dog and pony show' to try to raise funds, the company had hired a temporary employee and an attorney to get the Bermuda office going. Consequently Trenwick had a payroll of US $11,000 due on the first of August for these Bermuda employees. Unfortunately all Nancy had on the books was US $4,000. She went to Angus to tell him the bad news and to ask him what they should do if they had not raised the money by the time payroll was due. Instead of being pessimistic about their predicament, Angus responded, 'If we don't get the money we throw a four thousand dollar party!'[285]

With Angus' optimism and the hard work of his staff they were able to raise the US $25 million, pay the employees and commence operations in Bermuda in 1979 as Trenwick Reinsurance Co. Ltd. According to Brian O'Hara US $25 million was the largest private formation in history to that date.[286]

In retrospect the timing was not great because, by the time Trenwick got its infrastructure up and running, the market was already beginning to show signs of softening, thereby reducing the need for alternative risk transfer. O'Hara says if they had started the business two to three years earlier, Trenwick may have been a different company.[287]

Enter Bala Nadarajah

Meanwhile although Bermuda's first Insurance Act had become law in 1978 and is therefore properly referred to as being of that date, it had not yet been formally drafted and implemented because the Bermuda Government lacked the specific and specialised expertise in wording that its novel provisions required. Hence the arrival of Bala Nadarajah in 1979.

After practicing law for sixteen years in his native country, Sri Lanka (formerly known as Ceylon), and being far from happy with the growing political and social problems there, Nadarajah left for the United States, to pursue a master's degree in comparative law at Georgetown University. When he graduated he was told by one of his professors that Shelton Burgess, an alumnus of Georgetown and the new Registrar of Companies in Bermuda, was looking for a legal advisor. Burgess had sent out feelers to certain professors at the university, hoping they could recommend suitable candidates.

Seeing that Nadarajah was well versed in English law, Burgess thought he might be a suitable choice. The two men had not yet met but once they did they hit it off immediately. Burgess was so keen to have Nadarajah in Bermuda that he brought his employment contract to Washington for Nadarajah to sign.

Nadarajah says that Burgess was unquestionably the 'architect' for insurance regulations in Bermuda and was an enlightened thinker. Burgess had some lofty ideas and was an idealist who wanted to make Bermuda not only the most credible jurisdiction but to make it a centre of insurance studies so that people would come from other parts of the world and benefit from the Bermuda experience. Nadarajah said the regulations in Bermuda became necessary because of the explosive captive growth experienced in the 1970s and that the clamour for regulation came not from government but from the industry itself. The industry was expanding fast, because of the hard global insurance market, and Bermuda had become the ideal fertile ground for captives. In the absence of statutory regulations there had been the various Companies Acts, but they did not deal specifically with the insurance industry.

Prior to the formal introduction of insurance law in Bermuda on 1 January 1980 there was an *ad hoc* Insurance Admissions Committee, which advised the Minister of Finance about the credibility,

[285] Telephone conversation with Nancy O'Hara, 14 February 2002
[286] Interview with Brian O'Hara, 18 February 2002
[287] Interviews with Brian O'Hara, 18 February 2002 and Bob Cooney, 13 March 2002

viability, and validity of new insurance and reinsurance companies wanting to incorporate in Bermuda and their respective business programmes. Because this committee worked so well, the committee system concept was enshrined in the Insurance Act of 1978. Nevertheless, in view of the exponential growth in captives, the industry was very concerned that there should be some formal regulation under the law.

At the same time, there were well-established companies operating captives in Bermuda, with the majority being *Fortune 500* companies. None of these wanted a bad apple to spoil the barrel. As a result of all these concerns a 'good working partnership developed between the government and the private sector—a shared regulatory system unique to Bermuda.'

Burgess' dream never became a reality for him, because of his early death, but Nadarajah says that before his death Burgess had it in mind to make Bermuda the greatest insurance centre in the world. Nadarajah concludes that Burgess' dream is being realised, despite the criticisms levied against Bermuda by other jurisdictions. 'Burgess would be proud.'

When Nadarajah came in 1979 his first task was to ensure that the private sector's input for the development of the regulatory system was properly harnessed and put into legal format to assist the legal draftsmen to draft the regulations. Nadarajah acted as a filter between the private and public sector. George Griffiths, now retired and living in Barbados, did the final legislative drafting. Nadarajah recalls that Griffiths was to his fingertips a gentleman of the old school, one who did not let modern technology influence him in any way. Griffiths used old-fashioned typewriters, which irritated those with whom he worked, both because of the noise and the fact that, when mistakes were made, entire documents had to be retyped.

Nadarajah believes that the reason why Bermuda's legislation is so effective is because it does not operate on the 'catch-me-if-you-can' premise but rather on the principle of disclosure in utmost good faith. After all, he asks, isn't this principle what insurance is all about in the first place? And it was for this reason that self-disclosure was incorporated into the Insurance Act. A Principal Representative of an insurance company must monitor continuously the company's solvency and compliance with requirements. Directors of companies have to vouch for the performance of companies and their compliance with the requirements of the law by signing the solvency certificates. He says that Bermuda's form of regulation is the more damaging to an offending party because if he is caught his action not only contravenes the law but harms as well his reputation of good faith. He will thus be seen as dishonest or fraudulent.[288]

A changed place

By the end of the 1970s Bermuda had undergone significant changes socially, politically and financially. 1979 alone saw many changes, large and small. Non-Bermudians lost the right to vote. Compulsory voter registration was introduced. 24 May was officially declared to be Bermuda Day. And for the first time, a Bermudian woman, Gina Swainson, was crowned 'Miss World' in London.

Meanwhile international business vied with tourism as the major contributor to gross domestic product. The government estimated that by 1979 international business was contributing 30 per cent of Bermuda's GDP. However, the Bank of Bermuda and Brian Hall, head of Johnson & Higgins (Bermuda) Ltd., estimated that contribution to be more like 50 per cent if earnings from lawyers, accountants, computer services and banking facilities, as well as the value of business visitors, were added into the total revenue from the growing international business sector.[289] By the end of the decade, ten years in which huge strides had been made, the lesson had been driven home that

[288] Interview with Bala Nadarajah, 21 May 2002

[289] Brian Hall, speech to the Lions Club 1981

stability meant everything to modern Bermuda, stability such as to assure the well being of those twin pillars, tourism and international finance.[290]

The world also experienced such changes as set in motion a train of events that fundamentally altered the insurance industry as well as international affairs. Margaret Thatcher became the first woman Prime Minister of England and radically transformed the economy of Great Britain. The Soviets invaded Afghanistan, setting in motion a force that would multiply and come back to haunt the financial world, including the insurance industry, until the present day. Three Mile Island, a nuclear power plant in Pennsylvania, suffered a partial meltdown in March 1979, as a result of a series of mechanical and human errors, raising doubts about the industrial use of nuclear energy, and at a local level leading in 1980 to the formation of Nuclear Energy Liability (NEIL), a captive in Bermuda.

The 1970s were a time of great uncertainty. Bermuda, along with the rest of the world, changed at a rapid and ever accelerating pace—a pace that was almost beyond comprehension and that seemed not to allow anyone the time to sit back and reflect on what these accumulating changes would ultimately cost.

[290] Gordon Phillips: *First, One Thousand Miles, Bermudian Enterprise and the Bank of Bermuda*, Chapter 6, 'Swings and Roundabouts', p. 191