

# business insurance

update

## Plane crash victims' widows can sue, despite releases

NEW YORK—Several widows of Texasgulf Inc. employees killed in a 1981 plane crash were misled by Texasgulf and its corporate aviation subsidiary's insurer, United States Aircraft Insurance Group, into signing releases that gave up their right to sue, a federal court jury has ruled.

In addition, the jury ruled that Texasgulf Aviation, the corporate aviation subsidiary, is a "separate corpo-  
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## IRS proposals would kill FSAs as cost-control tool

By JERRY GEISEL

WASHINGTON—Proposed Internal Revenue Service rules on flexible spending accounts would knock out FSAs as weapons in employers' battle to control health care costs, consultants say.

FSAs were first dealt a blow in February when an IRS news release suggested that most forms of FSAs were invalid and that employers and employees would be retroactively liable for possible penalties and back taxes (BI, Feb. 20).

But the proposed rules, published May 7 in the Federal Register and reprinted beginning on page 56 of this issue, may be the punch that send FSAs to the canvas, where they will be counted down and out as cost-containment tools, experts say.

"(The proposal are) the death of cost containment for FSAs," says Philip Alden, a vp at consultant Towers, Perrin, Forster & Crosby in New York.

"Employers that considered setting up these plans are less likely to because their (cost-containment) objectives won't be met," adds Thomas Butterworth, a consultant with Hewitt Associates in Rowayton, Conn.

Under the proposals, which explain what the IRS considers as a valid flexible or cafeteria benefit plan under Section 125 of the Internal Revenue Code:

- Participants in FSAs must forfeit unused benefits in a flexible spending account or benefit bank at the end of the year.

For example, if an employee had his salary reduced during the year by \$500 to pay for uncovered medical expenses, like health care deductibles, and \$250 remained in the account at the end of the year, that \$250 must be forfeited if the plan is to be considered valid.

Similarly, if the employer contributed \$500 to the employee's account and \$250 was left at the end of the year, the employee must forfeit the money.

Balances in an employee's account cannot be carried over for use during the next year, rolled over into a 401(k) savings plan or returned to the employee as cash, according to the proposals.

- Employees enrolled in FSAs must, prior to the start of a plan year, make irrevocable benefit selections.

The proposals say that an employee must elect at the beginning of the plan year a specific amount to be allocated for each type of benefit offered—health care, dependent child care and legal services.

An employee's decision at the start of the plan to allocate specific amounts to the three major benefit categories must also be his final decision.

For example, an employee, who elected in January to have his salary reduced by \$1,000 to pay for health care costs, could not decide in June to have that \$1,000 medical care account transferred to an account to pay for legal services.

In addition, if a 401(k) plan is offered as part of an FSA, contribution schedules must be established at the start of the plan year.

It is the "use it or lose it" approach insisted upon by the IRS that could sound the death knell for FSAs as health care cost-containment tools, TPF&C's Mr. Alden says.

FSAs funded through employer contributions often have been  
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## Monsanto and Dow paying 65% of Agent Orange pact

By STEPHEN TARNOFF and STACY SHAPIRO

NEW YORK—Monsanto Co. and Dow Chemical Co. are responsible for the largest share of the \$180 million class-action settlement agreed to last week by manufacturers of the herbicide Agent Orange and attorneys representing Vietnam veterans.

Monsanto of St. Louis has paid 45.5%, or \$81.9 million, and Dow of Midland, Mich., has paid 19.5%, or \$35.1 million, of the \$180 million trust fund, sources told *Business Insurance*.

In settling the litigation, none of the chemical companies admitted liability.

The trust fund, which will compensate an estimated 40,000 to 60,000 Vietnam veterans and their families for injuries suspected to be related to Agent Orange, is expected to grow to at least \$250 million as interest accumulates. How much the veterans and their families will receive has not been determined.

The other defendants and their shares of the \$180 million fund are: Diamond Shamrock Corp. of Dallas, 12% or \$21.6 million; Hercules Inc. of Wilmington, Del.,

10% or \$18 million; T.H. Agriculture & Nutrition Co. of Kansas City, Kan., 6% or \$10.8 million; Uniroyal Inc. of Middlebury, Conn., 5% or \$9 million; and the now-defunct Thompson Chemical Corp., which will contribute 2% or \$3.6 million.

Two of the defendants, Hercules and Dow, say they will continue to pursue their claims against the government since Agent Orange was made to government specifications. The other defendants are expected to follow.

How much insurance—and from which insurers—will ultimately cover the contributions to the fund was not known last week.

A study by a special master in the litigation found that the seven defendants had between \$3 billion and \$4 billion of liability insurance.

Some observers expect the defendants and their insurers will have to ask the courts to determine which of the defendants' insurers will pay defense and indemnification costs. The disputes are expected to focus on the manifestation versus exposure theories of insurer lia-  
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## AIG unit covers subcontractor in massive Philadelphia blaze

By CAROL CAIN

PHILADELPHIA—The subcontractor whose worker's torch is believed to have started a nine-alarm blaze in the center of historic Philadelphia May 3 is insured by an American International Group company.

Geppert Brothers of Colmar, Pa., whose workers were cutting steel beams in a building under renovation when the fire broke out, is insured by AIG, President William Geppert said. However, he is uncertain which AIG unit underwrote the policy. AIG confirmed it is on the risk, but would provide no details.

The fire apparently started when sparks from a worker's propane torch being used to cut steel on the third floor apparently went down an elevator shaft and ignited lumber and debris on the first floor, said Capt. Robert Drennen of the Philadelphia Fire Department.

Sparks from the workers' torches also started small fires on April 6, Capt. Drennen said. Geppert was cited for safety violations April 18 and the morning of the fire, according to the city's Department of Licenses & Inspections.

But the conditions cited in those violations—no watchman on duty and unsafe conditions of propane torches cutting steel near wood—have not been linked to the May 3 fire, said a spokesman from the mayor's office.

A fire department investigation is pending.

The subcontractor could be sued by other property owners—or their insurers in subrogation actions—charging that the fire was the result of the subcontractor's negligence.

The subcontractor's general liability insurance would then respond, unless, of course, the subcontractor's general liability insurer denied coverage on the grounds that the subcontractor could have expected the fire and so the coverage is  
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Photo: Wice World  
The nine-alarm fire in downtown Philadelphia may have been caused by a welder's torch.

The proposed regulations

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## update

## Crash victims' widows can sue

Continued from previous page  
rate entity" from Texasgulf Inc., thus allowing the widows of the six Texasgulf employees killed in the crash to sue Texasgulf Aviation, says plaintiffs' attorney Milton G. Sincoff of Kreindler & Kreindler in New York. However, widows of the plane's pilots, who were Texasgulf Aviation employees, cannot sue, he said.

In addition to Texasgulf Aviation, suits have been filed against Lockheed Corp., the maker of the plane, and the federal government, he says, adding that the trial is set for August.

USAIG wrote a \$20 million liability policy for Texasgulf Aviation, Mr. Sincoff says (BI, Feb. 16, 1981).

Officials at Texasgulf and United States Aviation Underwriters, which manages USAIG, could not be reached for comment.

## Punitive damages not covered

MIAMI—Underwriters will cover compensatory damages assessed against Miami's Highland Park General Hospital in a medical malpractice judgment, but will not cover \$3.5 million in punitive damages, says a spokeswoman for Guaranty National Insurance Co., the hospital's lead underwriter.

A jury May 4 awarded \$766,420 in compensatory and \$3.5 million in punitive damages to Joseph Anderson, whose 33-year-old pregnant wife died in December 1982 after hospital employees allegedly gave her 10 times the prescribed dose of the mood-altering drug Thorazine, and then waited an hour to seek help to revive her.

Guaranty National, based in Englewood, Colo., retained only \$150,000 of the risk, the spokeswoman said, adding that North American Reinsurance Corp. would cover the rest of the claim.

A Dade County Circuit Court judge is now considering a motion to dismiss or reduce the punitive damage award.

## Court reverses helmet judgment

NEW YORK—An appellate court has reversed a \$3 million product liability award against Bell Helmets Inc. of San Marino, Calif.

Bell had appealed the October 1982 verdict by a New York Supreme Court jury in the Bronx that apportioned 75% of the responsibility for damages from a 1977 motorcycle accident to Bell, 15% to the motorcycle driver and 10% to the driver of a car that collided with the motorcycle (BI, Oct. 25, 1982).

Plaintiff Denise Cornier, a passenger on the motorcycle who was wearing a Bell Super Magnum helmet, now suffers permanent coordination and memory difficulties.

The appellate court said Ms. Cornier was obligated to prove that the helmet had a specific defect that made a particular difference in her condition, explained George Van Setter, Bell's attorney with Martin, Clearwater & Bell in New York. A new trial date has not been set.

## GE unit to buy Employers Re

FAIRFIELD, Conn.—General Electric Credit Corp. has agreed to pay \$1.075 billion in cash to acquire Employers Reinsurance Corp., a Getty Oil Co. subsidiary.

GECC, a unit of Fairfield-based General Electric Co., may form a financial services holding company to operate the reinsurer. The sale, subject to regulatory approval, is expected to close by July.

Employers Re of Overland Park, Kan., one of the three largest property/casualty reinsurers in the United States, reported net written premiums of \$639 million in 1983.

Separately, investors led by Merrill Lynch Capital Markets have proposed a leveraged buyout of New York-based City Investing Co. for \$50 a share in cash and securities, or about \$2.3 billion.

A City Investing spokesman said it is too early to tell if The Home Insurance Co., a City Investing unit, would be included in the deal.

## Insurer sued over MET claims

LOS ANGELES—The bankruptcy trustee of American Benefits Ltd., a huge California-based multiple employer health care trust that collapsed in September 1982, has filed a \$120 million lawsuit against Security Assurance Co., charging that the insurer is not paying claims incurred during the trust's last two months of operation.

The suit, filed in Los Angeles Superior Court by trustee Lawrence Diamant, seeks actual damages for unpaid claims for \$10 million, an additional \$10 million for breach of contract and \$100 million in punitive damages from Security Assurance, a member of the Central National Group of Omaha.

But Art Karma, an attorney with Karma & Coleite in Torrance, Calif., which represents Security Assurance, denies that Security ever insured the trust.

Elliot Lisnek, an attorney representing Mr. Diamant, said some 10,000 participants in the MET have unpaid health claims that may exceed \$10 million (BI, Oct. 4, 1982).

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## Injured buffalo herder cashes in chips

By CAROL CAIN

DENVER—Robert Warner, a 55-year-old buffalo herder, is not your typical worker—but then neither is the job-related injury he sustained last year.

Mr. Warner, who was a manager at B.J. Acres in Longmont, Colo., was jabbed in the jaw last April by the horn of a half-ton buffalo while he was trying to attach an identification tag to its ear. The injury left Mr. Warner without the ability to whistle for his partner, Stubby, a 60-pound dingo that helped keep the buffalo away from the herder in the corral.

"When you put buffalo in a corral for branding, they're wilder than cattle. He needed Stubby to help keep control," said Marshall Fogel, Mr. Warner's Denver attorney.

Mr. Fogel explained that Mr. Warner kept Stubby at his heels while inside the corral. If the buffalo started to get nasty, Mr. Warner whistled once and Stubby went to the other end of the corral to distract the buffalo. If Mr. Warner whistled twice, the dog returned to his side.

B.J. Acres has workers compensation coverage with the state's Compensation Insurance Fund, which paid Mr. Warner's medical bills.

But, Mr. Warner asked for additional permanent partial disability benefits of \$26,292. At a hearing in March determine the degree of disability, Mr. Warner told a hearing officer of the Division of Labor of the Department of Labor and Industries that without Stubby he couldn't practice his profession.

Mr. Warner, who has been herding buffalo for 19

years, continued to work at the ranch for a time after the accident, but he was fearful every time he had to go into the corral, Mr. Fogel explained.

Mr. Warner told the hearing officer that without the ability to whistle and use Stubby, he had no transferable skills. Before taking up buffalo herding, Mr. Warner was a roustabout and ranch hand.

"I haven't got the confidence in myself anymore. I've been to the doctor more times in the last six months on account of my heart beating, my head and stress," Mr. Warner reportedly told the officer.

The hearing officer suggested the herder train Stubby to respond to a voice command rather than to a whistle, but Mr. Warner noted that it took three years to train the dog initially.

Late last month, the hearing officer awarded Mr. Warner a lump sum of \$2,881 for a partial injury, Mr. Fogel said. Mr. Warner also received \$500 for bodily disfigurement.

But Mr. Warner, who had told the hearing officer that he would find another profession no matter what benefits he received, has quit his job and is heading for greener pastures in Wyoming.

In his new job, it appears that Mr. Warner will remain a true aficionado of buffalo, but instead of herding them, he'll cook them.

Mr. Warner is planning to cater meals—featuring buffalo—for riders who come to Hole-in-the-Wall, a spot in the Bighorn Mountains near Kaycee, Wyo. Both Mr. Warner and his attorney are members of a small band of modern adventurers known as the "Hole-in-the-Wall Gang."

## Chevron, its insurers paying \$15 million in fatal 1980 fire

By STEVE TARAVELLA

HONOLULU—Chevron USA Inc. and its liability insurers are paying \$15 million to settle two personal injury claims arising from a 1980 fire at a Shell Oil Co. facility that was caused by fumes from an adjacent Chevron plant.

## Communication seminar set

The Grand Hyatt Hotel in New York City will be the site of the 1984 *Business Insurance* Dollars and Sense of Communicating Employee Benefits Conference, to be held July 30 and 31.

Registrants at this year's conference will be guided through the entire benefit communications process, from strategic planning to maximizing the impact of a communications program.

The program includes general sessions for all conference participants, plus three concurrent sessions that will delve into how three different companies successfully met three benefit communications challenges. These concurrent sessions will be held three times, allowing all registrants to attend all three.

For program details and a registration form, contact Ann Vazquez, *Business Insurance* Conference Registrar, 220 E. 42nd St., New York, N.Y. 10017; 212-210-0137.

## ABC not anticipating Olympic claim

By JIM DAVIS

LOS ANGELES—Although the Soviet Union has announced it will not participate in the Summer Olympics, ABC-TV says it is too early to tell if it will collect on a non-appearance clause in the coverage it purchased to protect its investment in the Games.

The non-appearance coverage, led by Fireman's Fund Insurance Cos., will indemnify ABC for up to \$75 million if the network loses money on its coverage of the Olympics, which begin July 28 (BI, April 30).

The coverage can be triggered if one of 10 key nations named in the policy—including the Soviet Union—does not participate in the Games.

Late last week, East Germany, another of the 10 key nations, also pulled out of the Games.

But, ABC currently does not expect the Soviet boycott to affect its ratings so substantially that it will lose money, an ABC spokesman said last week after the boycott was announced.

Some observers predict that, without the Soviets, viewership of ABC's coverage would be significantly smaller. If its audience ratings declined sufficiently, the network probably would have to give either free advertising time or refunds to contracted advertisers.

Before the Soviet announcement, ABC had sold 98% of the commercial time available during the Olympics.

As part of the settlement, Chevron is dropping the February 1983 suit it filed in a Honolulu court against its liability insurers, which had refused to cover a \$27.7 million judgment against the oil company because of questions over the coverage of punitive damages.

The insurers—about 45 U.S., London-based and other foreign underwriters, including Lloyd's of London syndicates—are also dropping the suit they subsequently filed against Chevron in a San Francisco court.

The insurers argued in their suit that the wording of the Chevron policies relied upon California law, which prohibits insuring punitive damages, rather than on Hawaii law, which is silent on the issue, observers say.

London underwriters represented by H.S. Weavers (Underwriting) Agencies Ltd. led the coverage.

Robert C. Mussman, Chevron's regional counsel in San Francisco, says that following the judgment Chevron informed its broker, Marsh & McLennan Inc. in San Francisco, of the claim. M&M, in turn, put Chevron's underwriters on notice. When the insurers refused payment, Chevron sued in state court in Honolulu, Mr. Mussman explains.

The families of the two men killed in the accident will settle for a total of \$15 million, instead of the \$27.7 million ordered by the court.

Chevron, the domestic oil and gas subsidiary of Standard Oil Co. of California, is paying \$12 million to the families of Tony Lozano and Herman Ah Yat, the two Shell employees who died from injuries sustained when a vapor cloud from an overflowing Chevron gas

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A network official said revenues from Olympic advertising total \$428 million.

The ABC spokesman said last week that it is much too early to speculate whether ABC would have to reimburse advertisers.

"We're not changing plans for coverage," the ABC spokesman said. "We're going ahead with the hope that the Soviets will participate."

ABC, though, will receive a reimbursement on what

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## Brokers' questionnaires due

Agents and brokers who want to be listed in *Business Insurance's* 13th annual Agent/Broker Profiles issue, to be published June 25, must complete a questionnaire and return it to *Business Insurance* by May 18.

The directory of commercial insurance agents and brokers contained in the issue is published as an editorial service; there is no charge to be included.

If you have not received a questionnaire, please contact Diane Kastiel immediately at 312-649-5398.

# Financial guarantees

By DOUGLAS McLEOD

NEW YORK—Many insurers and brokers paint a rosy picture of the developing financial guarantee insurance marketplace.

Some of the roses are healthier than others, though, and even the healthiest of the current crop could prove difficult to cultivate in the long run, experts suggest.

The guarantees cover a variety of risks from bond defaults to bad weather. They are aimed at companies of various sizes in a variety of industries, and present varying degrees of risk to underwriters.

While some insurers do not call some of these products financial guarantees, all do insure financial loss for specific reasons.

Relatively well-established products, such as surety bonds and municipal bond guarantees, continue to be major premium generators for insurers, though the growth of surety bonds hasn't been nearly as explosive as that of some newer products (see stories on this page and page 24).

At least one new entry—limited partnership guarantee bonds—has grown spectacularly, producing \$120 million in premiums in 1983. The bonds were first offered in 1981 (see story below).

But growth among other new financial guarantees hasn't been as impressive, either because the products have attracted little interest from buyers or because the number of available markets is limited.

The future of some of these products—even fast-selling ones—is uncertain, insurers and brokers add. Many financial guarantees were a response to particular economic and legislative conditions, and changes in those conditions could limit their growth, they suggest.

Meanwhile, a few products are breaking through the already crumbling wall separating banking and insurance. The melding of the two disciplines is reflected in the addition of banking and financial experts to insurance company underwriting staffs.

While guarantees like residual value insurance are frequently used by large banks and corporations, many of the new products are intended for investors in smaller, less secure ventures.

For example:

- Motion picture completion bonds—which assure a movie company's backers that a production will be delivered on time and within budget—are typically bought for smaller, independent production companies. The major studios are assumed to have the resources to absorb a loss if a picture goes over budget (see story, page 33.)

- System performance insurance—which covers against the failure of a mechanical system to meet a designated level or quality of production—is most often written for small, alternative energy plants. Large industrial companies in most cases are able to finance construction of their plants without such assurances, experts say (see story, page 12).

- Limited partnership bonds assure a bank granting a development loan on real property, for example, that the various partners in that property will pay off promissory notes they have issued to secure their shares of the partnership. Partners are wealthy individuals rather than corporations.

Some of the less exotic forms of financial guarantee—notably surety bonds—have been around for years, allowing more or less solid underwriting standards to develop along with experience.

But many of those familiar with the newer guarantee forms concede that risk assessment and rating are often a "seat-of-the-pants" proposition.

"There are no set rules as to the rating," said Thomas Germani, a Johnson & Higgins vp in New York, of system performance coverage.

Fireman's Fund Insurance Cos. stopped writing limited partnership bonds in January after accumulating

*Continued on next page*



## Default of WPPSS boosts municipal bond coverage

By JIM DAVIS

Holders of slightly more than 10% of the Washington Public Power Supply System's defaulted bond issues received their regular semiannual interest checks in January.

Unlike the anguished investors in almost 90% of the \$2.25 billion in bonds, who saw no payments and are holding bonds whose market value has plummeted to about 15 cents on the dollar, holders of \$23.725 million of WPPSS securities had insured them with American Municipal Bond Assurance Corp., a subsidiary of MGIC Indemnity Corp. in New York.

Most of these insured bonds—\$22.2 million—are held in funds and trusts. The remaining \$1.525 million are in individual portfolios.

AMBAC will continue to make payments through the year 2018, when the bonds mature. This year, the insurer will make about \$1.6 million in payments to cover interest due.

Municipal bond insurance, such as that written on the WPPSS bonds, was

pioneered by AMBAC in 1971, when it insured a \$650,000 revenue bond issue by Greater Juneau Borough Medical Arts Building Co. in Juneau, Alaska.

In the 1970s, the product was relatively exotic. As late as 1979, less than 3% of new municipal bond issues totaling \$42.3 billion were insured. Today, about 21% of new municipal bond issues are insured, said Lauren M. Miralia, executive vp at Municipal Issuance Service Corp. of White Plains, N.Y., managing general agent for Municipal Bond Insurance Assn., another market that began underwriting coverage for municipals in 1974.

More than \$81.2 billion in new municipals came to market in 1983, almost twice as many as were recorded just two years earlier.

Both defaults and the growing volume of municipal bonds are increasing demand for the insurance and inviting more insurers to offer the product.

"There's no question the WPPSS default had a positive effect on our business," Mr. Miralia said. "Every time

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## Limited partnership bonds meet burgeoning demand

By DOUGLAS McLEOD

NEW YORK—One of the fastest-growing products in the nascent world of financial guarantees is the guarantee bond for limited partnerships.

Insurers issuing such bonds guarantee that the dozens or even hundreds of individual partners in an investment vehicle will make timely payments on the promissory notes they've issued to finance their shares in the investment.

The investments themselves can run the gamut from office buildings to cable television systems to racehorses.

Some limited partnerships have even been formed to finance research and development costs, though underwriters are more cautious about insuring this sort of risk.

In a limited partnership, individual investors buy shares or "units" of a larger investment vehicle. For example, a syndicator may finance the development of a \$10 million shopping center through the sale of 50 partnership units at \$200,000 each.

The partnerships developed as a tax-

sheltered vehicle in the mid-1970s, when the Securities and Exchange Commission ruled that investors could leverage equity. This meant that investors could make a cash down payment for their partnership unit—perhaps 20%—and issue a promissory note payable in yearly installments for the balance.

Throughout the 1970s, investors backed up these promissory notes with bank letters of credit. On the strength of the letters of credit, the partnership's syndicator would then take out a bank loan to buy and develop the partnership's property.

Meanwhile, having made relatively small cash down payments, investors were able to take their pro rata share of the partnership's tax deductions for depreciation on the property, interest due on development loans and mortgages and other fees and costs incurred by the partnership.

But as interest rates began to rise, banks became reluctant to reduce their overall lending capacity by issuing let-

*Continued on page 10*

# Guarantee products hard to underwrite

Continued from previous page  
a sizable book of the business over the previous eight months.

Among the company's reasons for discontinuing the line was the increasing difficulty of assessing the quality of new submissions, according to Michael Djordjevich, vp of the financial insurance department in Novato, Calif.

"It became a question of how well can you underwrite this business and control it from a risk management viewpoint," Mr. Djordjevich said, adding that the company is satisfied with the quality of its present risks.

Other guarantee products presenting special underwriting problems:

- "Change of law" insurance, which covers an insured's extra ex-

The future of some financial guarantee products is uncertain, insurers and brokers add. Many products were a response to particular economic and legislative conditions, and changes in those conditions could limit their growth.

penses if a government body changes regulations affecting a building project or other business operation that is already under way. The risk is especially tough to gauge in areas like environmental regulation, where laws may change quickly (see story, page 47).

- Residual value insurance, which guarantees the future value of a leased asset. The underwriting

problem is deciding what that future value should be (see story, page 29).

- Retroactive liability insurance, such as that placed by MGM Grand Hotels after its 1980 Las Vegas hotel fire, intended to cover known future losses. Here the problem is determining the amount of the future losses and the timing of their payment (see story, page

22.)

Underwriters already have suffered losses in some of the newer financial guarantee lines, including system performance insurance, where one loss hit \$375,000; motion picture completion bonds, where one loss hit \$1.9 million; and limited partnership bonds, where losses have been minimal.

With the exception of some underwriters in the motion picture completion bond line, though, most insurers say their business is profitable.

Meanwhile, other guarantee lines have yet to produce their first losses. These include change-of-law coverage; lease guarantees, which insure that municipalities will appropriate money to make payments on leased equipment (see story,

page 36); and industrial development bond guarantees, which insure against a default on the tax-exempt bonds issued by municipalities to fund private development projects (see story, page 19.)

Brokers say the survival of some of these products will depend on how the losses develop over the next few years.

**Most insurers** and brokers are optimistic about the growth potential for financial guarantee products.

"I think the whole field will take off," says Roger H. Kahn, assistant vp with Alexander & Alexander Inc. in New York.

One indication of the enthusiasm is the fact that most major brokers and several major insurance companies have formed separate departments to handle financial risks.

The relative old-timers of the field—surety bonds and municipal bond guarantees—continue to produce the largest premium volumes of the various guarantee products, experts say.

Surety underwriters say their premiums were flat in 1983 and will probably not improve much this year, mainly because of continued slow growth in non-residential construction.

But demand for municipal bond guarantees, first written in 1971, has skyrocketed, thanks to tremendous growth in the volume of new municipal bond issues and to the fears instilled by the massive \$2.25 billion Washington Public Power Supply System default.

The perceived growth in the line has led to the formation of two new insurers to compete for bond business, one of them a joint venture between American International Group Inc. and Phibro-Salomon Inc.

Commercial credit insurance, which also has been underwritten for many years, is expected to grow, depending on the volatile economy.

Some of the newer guarantee products have also produced large volumes of premium in a hurry.

MGIC Indemnity Corp. of Milwaukee wrote the first limited partnership bond in 1981, and last year took in about \$25 million in premiums. National Union Fire Insurance Co. of Pittsburgh, Pa., an AIG affiliate, wrote an estimated \$6 million in premiums in 1982, the first year it offered the bonds; last year, that volume jumped to \$36 million.

However, others of the new products, for a variety of reasons, have not fared quite so well. These include:

- Money market mutual fund insurance, intended to cover mutual fund deposits in the same way that the Federal Deposit Insurance Corp. and the Federal Savings & Loan Insurance Corp. cover bank and thrift deposits (see story, page 38).

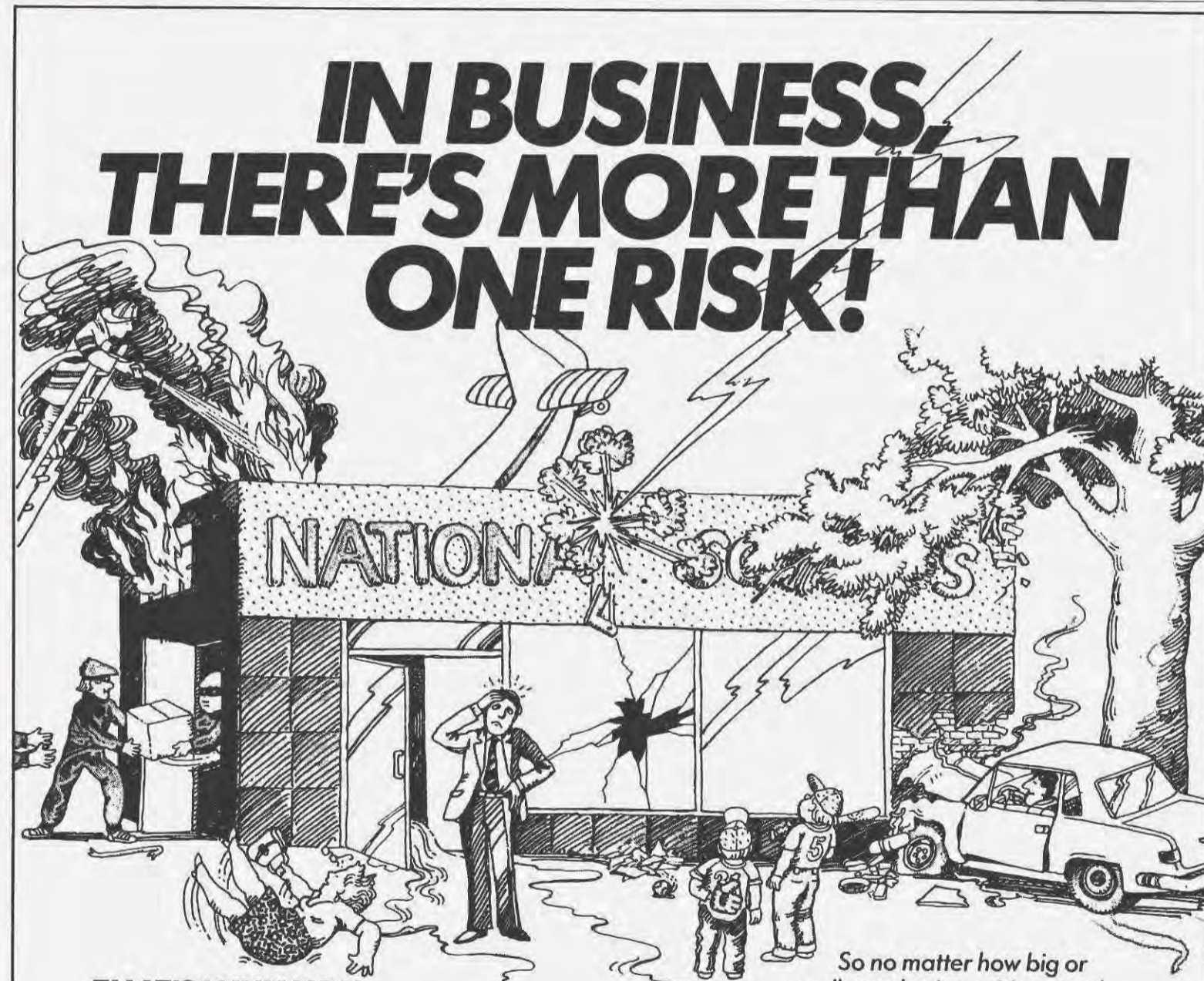
Most fund managers found the coverage too expensive to be practical, and only a handful of funds have such insurance.

- "Excess FDIC" insurance, which is intended to cover deposits in excess of FDIC's \$100,000 guarantee in case a bank fails. Brokers report little demand for the coverage (see story, page 39).

- Industrial development bond guarantees, first issued in 1980. Less than 1% of all IDBs issued are covered by insurance.

- Retroactive liability insurance. Litigation surrounding the MGM coverage may be scaring potential buyers away, some say. MGM hasn't yet collected on its retroactive policy.

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## IN BUSINESS, THERE'S MORE THAN ONE RISK!

### THAT'S WHY YOU NEED A MORE-THAN- ONE-COMPANY INSURANCE AGENT.

Fire. Theft. Vandalism. Liability. Computer Crash. Pollution Liability. Product Recall. D&O Liability. Business Interruption Losses. Product Liability. Key Person Losses. These are just some of the many risks that businesses must face every day. What's the best way to manage these risks? Many risk managers turn to their Independent Insurance Agent. They know that an

Independent Agent is a true professional who can recommend creative programs that utilize traditional insurance, self-insurance, co-insurance, captives, or a combination that best suits the special needs of your business. And because Independent Agents represent several insurance companies not just one, they can help you select the best business coverages at the best price.

So no matter how big or small your business, it's a good idea to consult an Independent Insurance Agent. They're the more-than-one-company agents ...and helping you manage your business risks is their business.

Contact your Independent Insurance Agent today. You'll find one wherever you find this symbol.



THE MORE-THAN-ONE-COMPANY  
INSURANCE AGENT.

# Strength upon strength. The Atkinson idea, reinforced by Wausau.

Guy F. Atkinson Company has a global reputation in the construction industry. The firm has been responsible for some of the most ambitious building projects in the world.

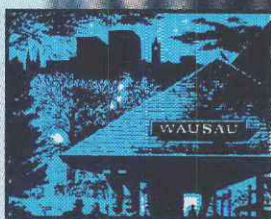
Today, Atkinson is actually in 12 separate businesses from construction to manufacturing and electronics. It's a company of strength added to strength — each part reinforcing the whole — and the total entity bringing stability and resourcefulness to all the parts.

Wausau has served as workers compensation insurer to Atkinson for 35 years. Atkinson Chairman, George T. McCoy, says, "Wausau has done everything expected of them. They're on our projects — in our offices. If we develop an insurance problem, Wausau's *there*, paying attention.

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# Growth expected in some lines

Continued from page 4

Lease guarantees for municipalities and private companies have gotten off to a slow start, though insurers and brokers expect interest to pick up as more potential policyholders become aware of the coverage.

Brokers also hope for growth for change-in-law and residual value coverages, though the limited number of available markets could hinder expansion for both products.

Weather-related insurance covering financial losses from foul

weather is another product insurers hope will flower (see story, page 50).

But even for the products that are currently selling well, bright futures are far from guaranteed, insurers and brokers concede.

Several financial guarantees were developed to take advantage of specific economic and regulatory conditions, and if those conditions change, the guarantees could become less attractive.

For example:  
 • Limited partnership bonds

took off after the Securities and Exchange Commission ruled in the late 1970s that investors could finance shares in property-owning partnerships with debt. This allowed investors relatively large tax deductions for interest payments and depreciation while requiring only small initial cash outlays.

**A bill now pending** in Congress, though, would eliminate some of these tax advantages, which could change the character of partnerships and reduce the sale of partnership bonds, experts say.

• System performance insurance is most frequently written for alternative energy projects, such as waste-to-energy plants. The spread of such projects—and hence of the insurance—was spurred by the high energy costs of the 1970s and by federal law, which grants tax breaks to the projects and requires larger utilities to buy their production.

Communities faced with environmental laws limiting the use of landfills may also find the plants a convenient way of disposing of waste.

Any change in these laws—a change, for example, that would allow the use of a cheaper disposal alternative like a landfill—could shrink the demand for system performance guarantees.

Likewise, brokers add, another oil crisis could stimulate demand.

• Commercial paper bonds were created to reduce a corporation's borrowing costs by guaranteeing its short-term debt, reducing its interest expense by raising its debt rating. The value of the guarantee depends on the spread in interest rates associated with various debt ratings.

Currently, that spread is too narrow to justify the expense of the insurance, experts point out. Though corporations may have other reasons for buying the guarantee, future growth may depend on a change in credit market conditions, they say (see story, page 54).

**Whatever their prospects** may be, several financial guarantee products are notable for their extension of insurance companies into what had earlier been bank business. Among these products:

• Limited partnership bonds, which replaced bank letters of credit as security on partners' debt. Letters of credit are still used, though, in cases where underwriters are nervous about a particular type of risk, such as the financing of research and development costs through a partnership.

• Coverage to cap interest payments due on floating-rate loans. Banks first offered this coverage in 1981, and were followed last year by Interest Guard Managers Inc., a new company formed by Frank B. Hall & Co. Inc. and General Reinsurance Corp. (see stories, pages 45 and 46).

**This confluence** of banking and insurance has produced a new type of insurance professional: insurance companies and brokerages have added staff members with banking, financial, accounting and legal backgrounds.

"We think that what we're dealing with is a financial risk exposure. The only way to deal with it is to have a staff that has financial background," said Clifton Brown, a director in the financial services department at Continental Corp. in New York.

"The term 'underwriter' as we perceive it is not an insurance person as might have been defined in the property/casualty industry several years ago," observed Joseph P. DeAlessandro, National Union's president.



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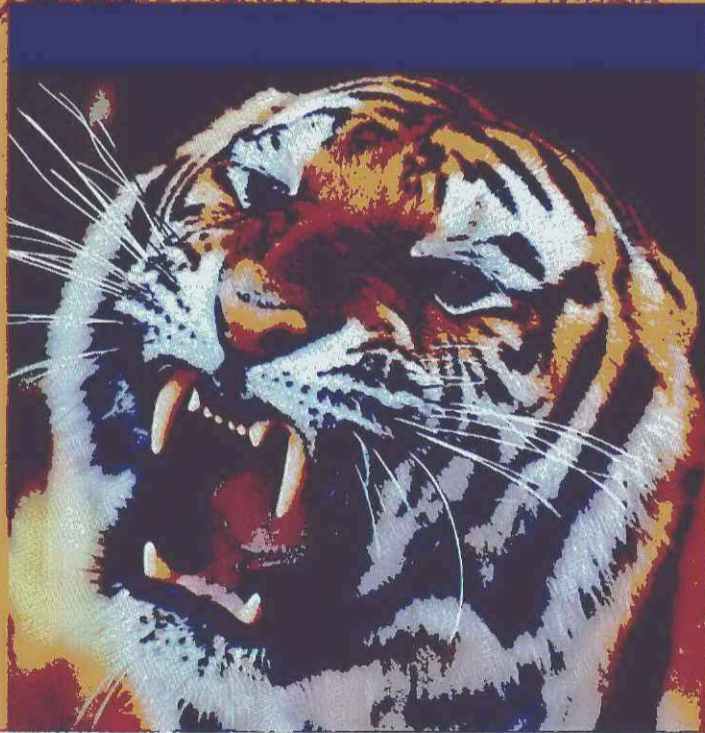
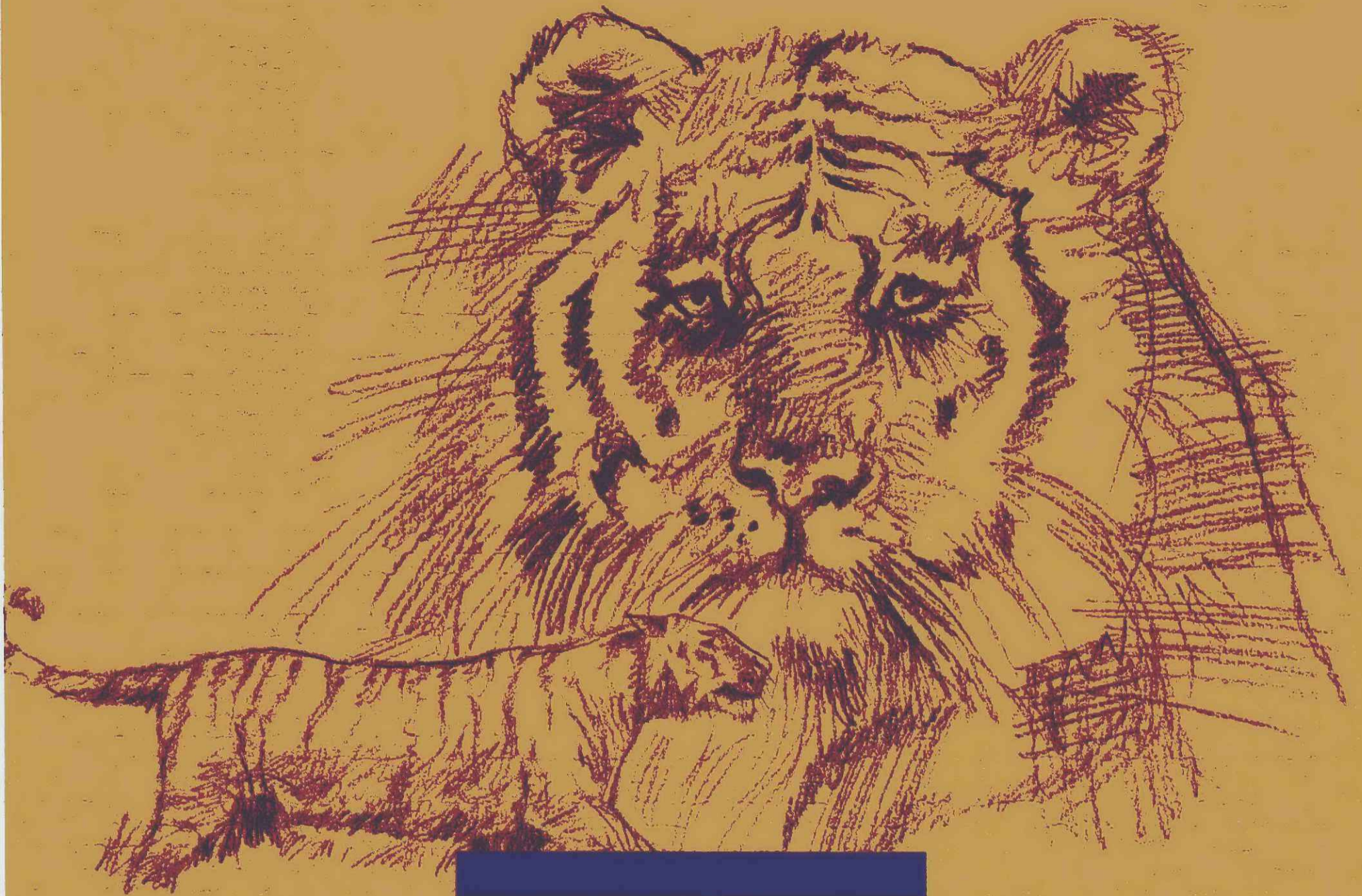


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## opinions

# More classic blunders

THE INTERNAL REVENUE SERVICE attack on flexible spending accounts is a series of classic bureaucratic blunders.

The IRS dillydallied for five years issuing regulations so many employers proceeded to act on what they thought were reasonable assumptions.

In the absence of any regulations, some employers got a littled carried away in their assumptions, with the likes of Zebra accounts and allowing wealthy employees to pay for their children's expensive summer camps with pretax dollars under the guise of child care.

When the IRS didn't like some employers' assumptions, it pulled the rug out from under all the employers with onerous regulations.

But, the IRS' biggest blunder is in its cost-benefit analysis.

The Treasury Department arrived at the absolutely ludicrous figure of \$11.5 billion in lost income tax revenues and lost FICA taxes over the period 1985 to 1989 if FSAs were allowed to continue in place.

We can't believe that the government will even recover in taxes the money it has wasted in staff time writing these overbearing and burdensome regulations and printing them in the Federal Register.

And, by killing a promising tool for controlling the

rising cost of health care, the federal government may well in the long run spend more money than the marginal tax revenues it will collect by killing FSAs.

Consider the savings possible in the years ahead under federal health care programs if people were to be wiser consumers of health care. Granted, flexible spending accounts have not been in place long enough to prove conclusively that they will encourage people to be better consumers of health care. But, giving employees an economic reward for staying healthy and for not squandering money on health care is a powerful incentive. We think that people exposed to this incentive would not only respond now but also would carry into the years ahead a new attitude toward spending money on health care.

The IRS has overreacted to the problem, has spent an inordinate amount of time and effort on the issue and as a result has stolen from employers a very promising tool for controlling rising health care costs.

The only solution is for employers to rally behind Rep. Barber Conable, R-N.Y., who has a reasoned solution to the problem: Cap the value of benefits offered in a flexible spending account to control abuses and roll over unused benefits into a benefits bank for the next year.

## letters

### Cost of risk survey statistics just don't add up

To the editor: You reported on the third biennial "Cost of Risk" survey (*BI*, April 16). Following the previous survey, you printed an article wherein I explained reasons why the figures used were so unreliable as to be useless and misleading (*BI*, Oct. 4, 1982). The response was not that the figures were reliable (no one can claim that), but that it was the best available information, so why not use it. Such an argument is analogous to the man on the life raft saying that ocean water is the only water available so why not drink it.

The cost of risk figures are not only misleading, but detrimental to the risk management community. The numbers cited are much too low, giving the impression that risk costs are a smaller component of corporate expenses than they really are. This is the case because the survey omits intangible and unmeasurable—yet very real—aspects of risk.

Consider the first (and least accurate) component: insurance premiums. Such figures lump together a firm having high limits, a low retention and broad coverage with a firm with low limits, a high retention and limited coverage.

Quite obviously, comparing insurance premiums of these two companies would be unfair, yet management of the latter company might praise its risk manager for doing a great job of controlling the

cost of risk.

Now in theory, these inequities should be offset by the second component of risk: uninsured losses. If a company's insurance is inadequate, it will pay the piper eventually in retained losses. But how many firms keep records of losses that don't happen? Or put a figure on the books to represent actuarially determined uninsured losses?

Estimates are often made for losses of high frequency, like workers compensation and auto physical damage, but who calculates the probable annual cost of such losses as earthquakes, claims in excess of policy limits, product recall, pollution, product guarantee, professional liabilities not insured, currency fluctuations, political risks, punitive damages and other losses not covered by insurance?

These losses are significant aspects of the risk manager's job that are not measurable and, therefore, sometimes overlooked by management. It is important for the risk manager to communicate to management approximately what they mean to his firm's financial picture.

This is made more difficult if these aspects of risk management don't appear in what seems to be a total cost of risk figure.

And there are uninsured aspects of insured losses that may be many times the

direct costs. Heinrich's 4-to-1 ratio of indirect costs to every direct employee injury cost is widely quoted, but no one knows exactly what it should be. We do know, though, that it is several times the direct cost. So if you pay \$100,000 in direct workers compensation payments, the actual cost may be two or 10 times that amount.

As for the most inaccurate component of the study, loss control costs, this, too, has to be stated at an amount far less than real-world figures. No one knows all the costs of safety programs, guard services, welding standby, fire walls, fire brigade and safety committee training and so on *ad infinitum*. The risk manager's judgment plays a large role in these costs so when they are overlooked, the scope of his work appears less than it really is.

For these reasons, the immeasurable aspects of risk costs are grossly understated, so the final figure will be far too low—possibly by factors of from two to 20.

The "Cost of Risk" study has many valuable parts to it, but reporting on the total cost of risk is not one of them. Because it so grossly understates total risk costs, it would be a service to risk management if this aspect were discontinued.

**David Warren**  
Risk management consultant  
Orinda, Calif.

### Allendale may not participate on American Can

To the editor: James River Corp., being a policyholder of Protection Mutual Insurance Co., does not necessarily guarantee Allendale Insurance participation on the risk (*BI*, April 30). Each individual company in the Factory Mutual system has the opportunity to reject a risk subscribed to by one of its sister companies. Since it has become apparent that Allendale believes pulp and paper operations are non-profitable, I am sure they are not participating on the James River Corp. property program placed with Protection Mutual.

Regarding the fact that American Can's risk management department believes Allendale Insurance made money on the account, I am sure there are many expenses that American Can does not realize. The engineering costs associated with the pulp and paper risk are tremendous. By nature of the risk, engineering must be done on an extensive basis. Combine that with the fact of large losses occurring, and it is possible this account was

not profitable. The problem here is that the insured sees a check issued to them in a loss settlement as the only cost of doing business with an insurance company. This is simply not the case. The engineering costs and the cost of settling a large loss

can eat up to 75% of the earned premium of an account such as this.

**James C. Hays**  
Account executive  
Reed Stenhouse Inc. of Minnesota  
Minneapolis

### A vote for 'Insurance Person of the Year'

To the editor: Tucked away on page 23 of the April 30 issue is the report on an event worth more than end-of-magazine reporting.

Myra Tobin has been named "Insurance Woman of 1984." Having worked with Myra, I believe she could easily receive the award of "Insurance Person of 1984"—or of any year. Her modesty is apropos of her total professionalism. She has worked at a level of competence and energy of which I have never seen an equal—male or female. She is truly amazing, and Marsh & McLennan Cos. Inc. is truly lucky to have her.

In making the award to Myra for her

"characteristics as a role model," the Assn. of Professional Insurance Women could not have chosen better.

**Beth Kravetz**  
Associate Counsel  
Home Owners Warranty Corp.  
Washington, D.C.

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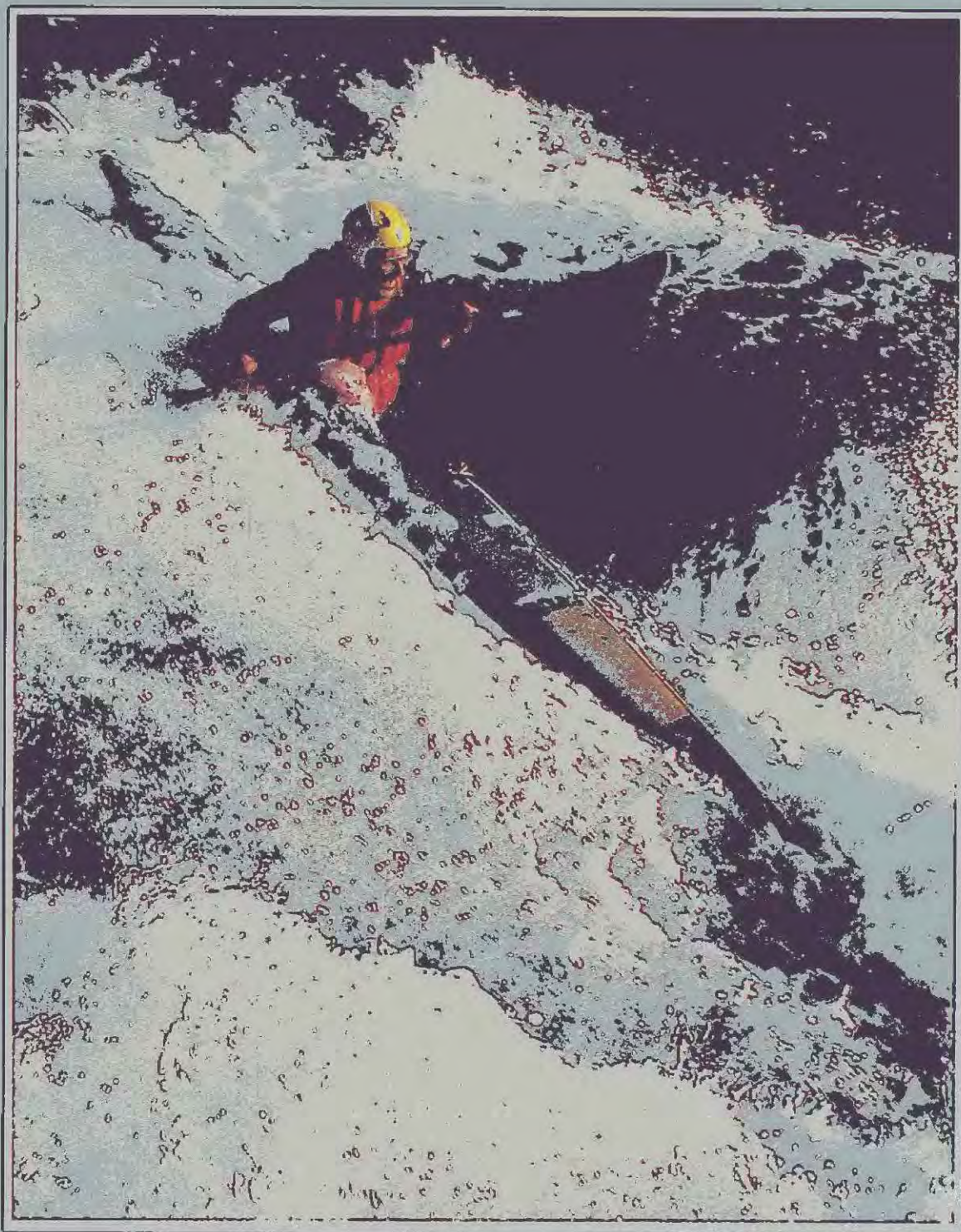


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## Partnership bonds

Continued from page 3

ters of credit to individuals. Banks providing development loans also found it increasingly cumbersome to deal with dozens of letters of credit from the investors' banks.

The limited partnership bond thus appeared as an alternative to the bank guarantees. Under the bonds, which are non-cancelable, the insurer guarantees that individual investors will make good on their promissory notes.

Since MGIC Indemnity Corp. of Milwaukee wrote the first limited partnership bond in 1981, total premium volume for the product has ballooned to an estimated \$120 million in 1983.

Proponents of the bond predict that this volume could triple in the next five to six years, though one dark cloud has appeared on the horizon to threaten this bright prospect. A House-Senate confer-

ence committee will soon consider proposed legislation that would:

- Extend depreciation schedules on non-residential property from 15 years to between 18 and 20 years, depending upon when the contracts for the property are bound. This would reduce investors' annual tax deductions.

- Amend accrual accounting procedures to limit the extent to which investors can write off accrued interest on the partnership's loans. Currently, many partnerships deduct interest they owe but have not actually paid during a given tax year. Under the proposed rule, investors would be able to deduct interest payments only when those payments are actually made.

If adopted, these changes would eliminate some of the limited partnership's tax advantages, and could change investors' reasons for entering into these partnerships in the first place, experts say.

Insurers agree that most of the

limited partnership bonds written so far contain indemnity agreements that allow the insurer to take over a defaulting partner's share in a project and resell it to recoup a loss. If the proceeds from the sale don't cover the partner's obligation, the insurer can sue the defaulting partner for the balance.

However, losses in the line have been minor, involving only individual investors, insurers report. A catastrophic loss—the failure of an entire project—hasn't yet occurred.

Most insurers issue a "master bond" to a syndication's general partner, with a schedule listing the various individual investors involved in the partnership. But some—including MGIC—issue separate bonds to each investor.

Insurers say that in underwriting a partnership risk, they look first at the track record and financial stability of the syndicator putting the partnership together; then at the soundness of the project itself; and

finally at the financial strength of each individual investor.

Bonds are typically issued for terms of four or five years—reflecting the repayment schedule on investors' promissory notes—though in some cases the term may extend to seven years.

Premium rates generally range between 1% and 2%, and are applied to the principal and interest due each year on the notes covered by the bond. Premiums are normally paid in full up front.

For example, if a two-year bond is written at a 1% rate to cover \$4 million the first year and \$2 million the second year, premiums would amount to \$40,000 for the first year and \$20,000 for the second. The total premium of \$60,000 would be due when the bond is issued.

Most bonds cover real estate partnerships, insurers say.

For example, MGIC wrote a bond to cover International Business Machines Corp.'s sale of its

Armonk, N.Y., headquarters to a limited partnership, which then leased the building back to IBM, according to Vp Randall Kastner.

The partnership's gains included appreciation of the property's value, cash flow from the lease and the standard tax advantages. IBM, meanwhile, received cash for the property and had the option of buying it back later at fair market value, he explained.

But bonds are often written to cover other types of partnership investments.

MGIC also wrote an \$80 million bond covering New York-based Metromedia Inc.'s sale of its billboard operations to 250 limited partners, Mr. Kastner said. In that deal, Metromedia continues to operate the 35,000 billboards for the partnership, he explained.

National Union Fire Insurance Co. of Pittsburgh, Pa., an American International Group Inc. unit, is now looking at a \$12 million bond to cover a horse breeding partnership, says James P. Cullinan, president of Coverage Consultants Inc. of New York, a brokerage involved in the placement.

In a horse breeding partnership, investors buy one or more mares in foal, hoping to make a profit by raising the mares' offspring until they are sold at yearling auctions.

In addition to other tax advantages, the costs of caring for the horses are deductible, Mr. Cullinan explained.

Other insurers—including Continental Corp., Fireman's Fund Insurance Cos., National Union and United States Fidelity & Guaranty Co.—report either writing or considering bonds for partnerships investing in cable television systems, equipment leasing and alternative energy plants.

Most insurers say interest in limited partnership bonds has run high.

**Fireman's Fund**, which started writing the bonds in May 1983, found when it consolidated its financial guarantee operations last December that it had already written more of the business than it wanted.

In eight months, the company issued bonds covering 8,000 individual investors in 46 separate projects.

"We can open the door and it's like a floodgate opening. The business just poured in," said Michael Djordjevich, vp in the financial insurance department at Fireman's Fund's Novato, Calif. headquarters.

Deciding that its portfolio of financial guarantee risks was "skewed" by the abundance of limited partnership bonds, Fireman's Fund stopped underwriting the bonds in January and will probably not resume writing them for some time, Mr. Djordjevich said.

Premium volume at National Union, which started writing the bonds in 1982, shot from \$6 million that year to \$36 million in 1983. The company now has about 400 bonds in force, according to President Joseph P. DeAlessandro.

MGIC, whose bonds are fronted by Industrial Indemnity Co., a Crum & Forster affiliate, generated about \$25 million in bond premiums last year, Mr. Kastner said. The company has written 10,000 bonds covering \$1 billion in equity in 150 projects since 1981.

USF&G, which started writing the bonds last December, has already generated about \$3.2 million in premiums, according to Robert Ungerleider, president of Financial Risk Underwriting Agency Inc. in New York, underwriting manager for USF&G.

Continuing explosive growth is by no means certain, however.

"This is a very dynamic area, subject to a lot of potential changes," observes Clifton Brown, a director in Continental's financial services department.

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**Q: Who is likely to have an insurance coverage dispute?**

**A:** Any business that buys insurance.

**Q: Who is more likely to have an insurance coverage dispute?**

**A:** The insured who has been able to affect unrealistic savings on their insurance programs.

**Q: Who does not need Insurance Coverage Dispute—  
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**A:** The insured who is a professional clairvoyant with an unblemished record.

**Q: How much can the legal expenses run for an insured who has a coverage dispute?**

**A:** Believe it or not, \$1,000,000. or more, is not unusual. Remember, the larger the claim, the more likely the chance for a dispute.

**Q: Is there any insurer who will not create an insurance coverage dispute?**

**A:** We do not believe there is any insurer who can state they have not been involved in a coverage dispute.

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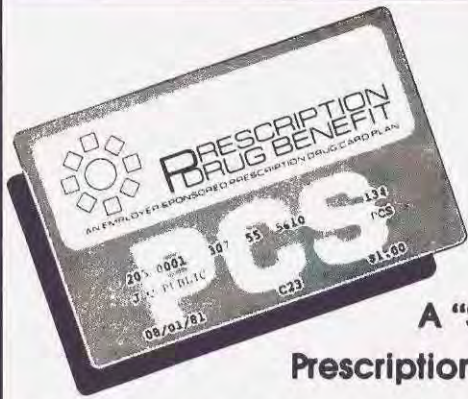
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## System performance cover not growing as expected

By DOUGLAS McLEOD

NEW YORK—Brokers are uncertain about the future of system performance insurance, one of the hot new products in the marketplace a few years ago.

System performance, or "efficacy," insurance is purchased to cover the failure of a mechanical system to meet technical performance standards and has been written mainly for energy-related projects, such as waste energy plants.

But the coverage is expensive as well as being complex and time-consuming to underwrite. Though insurers report growth in the line,

brokers say sales of system performance policies haven't met early expectations.

The future of the product, brokers say, will depend on a number of factors, including the availability of financing for energy projects; restrictions imposed by waste disposal laws; and the cost effectiveness of alternative energy technologies.

"There's been a lot more discussion about this than there has been action," said Alburn Blankenship, a regional risk management director with Fred S. James & Co. Inc. in Boston.

"In three years, system performance insurance could be a very

common thing... or markets may decide to pull back because they aren't getting enough premium, they're spending too much time underwriting it or they could be hit with significant losses," said Thomas Germani, a vp in the Energy Group at Johnson & Higgins in New York. "I don't think anybody can predict which way it will go."

Demand for system performance coverage first developed among investment bankers, bond underwriters and others involved in financing energy projects. These lenders wanted some assurance that the projects—which often rely solely on operating revenues to meet debt obligations—would work.

"Investment bankers were most worried about not understanding the technologies they were dealing with," explains Paul H. Staulcup, an underwriting manager with American International Underwriters, an American International Group Inc. affiliate and a major market for the coverage.

The coverage has been used for energy plants more often than manufacturing plants because the energy projects often involve alternative technologies that haven't been widely developed in the United States.

"In most other businesses, the technologies are more common and the need for a technology guarantee isn't there," Mr. Germani noted.

The spread of small alternative energy plans has also been encouraged by the federal government, which has granted tax credits and favorable depreciation schedules while requiring larger utilities to buy power from them, he added.

Even where manufacturing plants use relatively untried technology, the builders are often large corporations that understand the risks and can finance the project with corporate funds without a guarantee, Mr. Blankenship added.

Such manufacturing plants may also involve proprietary processes, details of which the manufacturing company may not want to release as part of a prospectus for outside financing.

The focus of the system performance policy differs somewhat from one underwriter to another. AIU's policy is a third-party liability form intended to cover a project's general contractor or engineering firm rather than the project owner itself.

CIGNA Corp., another major market for the coverage, offers a first-party policy covering the project owner.

The AIU policy covers the insured's liability for repair or replacement of defective parts that result in a system's failure to meet the level or quality of production specified for it. Performance standards are decided on before construction and should be in line with industry standards for similar systems, Mr. Staulcup explained.

The policy also covers liability for certain extra expenses. For a waste energy plant, these may include extra costs of complying with environmental laws the plant was designed to meet (the policy won't cover extra expenses resulting from stricter environmental laws adopted after the policy is bound); the costs of disposing of excess garbage fuel while the plant is out of operation; or interest payments due during the period the plant is down.

Projects hurt by a drop in energy  
Continued on page 14



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## System performance cover

Continued from page 12

prices couldn't look to the policy for help, though.

"We aren't going to guarantee that they will get a profit from the sale of electricity," Mr. Staulcup explained. "Some things are still business risks."

The policy is generally bound before construction of a project and terminates when the insured contractor or engineer has turned the plant over to its owner, after it has passed performance tests.

AIU also offers a related policy, called a "component risk" policy, that covers an insured's liability for failure of a component that it supplies for use in a larger system.

Buyers of this coverage have included makers of gas turbines, marine engines, heat exchangers, smokestack liners and cables, Mr. Staulcup said.

The coverage is available only to suppliers of components for commercial use, he added. AIU will not write policies for manufacturers of consumer goods, paints or coatings, aviation parts or products or on pure contracting risks or buildings and property.

AIU requires a minimum deductible of \$250,000 on system performance policies, and deductibles may range up to \$3 million, Mr. Staulcup said. In addition, AIU requires the insured to take a loss participation of 10% to 20%.

Premiums are generated by applying a rate to the value of the insured's contract rather than to policy limits. Rates can range as high as 5%, he said, adding that the largest premium generated by a system performance policy was \$1.5 million for a \$300 million project.

The largest loss so far—a compo-

nent risk loss—hit \$375,000.

For one project, AIU wrote liability limits of \$37 million, Mr. Staulcup said, though limits are typically in the \$10 million to \$20 million range.

The company has a \$10 million reinsurance treaty exclusively for system performance and component risk policies, led by Bavarian Re with participations from Lloyd's of London and Munich Reinsurance Co., he said. For additional capacity, the company must negotiate facultative reinsurance treaties.

AIU retains 25% of the first \$1 million layer on each risk, and another \$5.556 million of the \$9 million layer excess of \$1 million. Other AIG facilities take further "substantial" portions of each risk, he explained.

In the three years since AIU started writing the coverage, business has grown about 60% each year, Mr. Staulcup said. The company wrote 23 policies last year,

about eight of which were system performance and the rest component risk policies.

CIGNA's system performance policy is intended to insure a project owner's ability to cover debt service costs if plant operations are slowed by a technical failure and revenues temporarily dry up (BI, April 16.)

The policy, which CIGNA first offered in 1981, covers only debt service costs that can't be met because a plant's production falls below an agreed-upon level of output; the policy doesn't cover operating or maintenance expenses, according to Akos Swierkiewicz, a vp with CIGNA's special risk facilities unit in New York.

At the insurer's discretion, the policy may also cover "rectification costs": the costs of repairing or replacing defective equipment.

CIGNA also requires a deductible and a loss participation of between 2.5% and 10%, he said. In-

sured losses are further reduced by a debt service reserve fund established by the project owner for meeting loan payments.

The policy also contains a "recapture" provision, under which the policyholder must reimburse CIGNA for any losses it pays as soon as the plant resumes normal operations, replenishes its debt service reserve fund and is able to meet operating expenses and debt service costs.

CIGNA has written six policies so far and has experienced no losses, Mr. Swierkiewicz said.

The biggest problem in selling the system performance coverage is the complexity of financing and underwriting energy projects, insurers and brokers agree.

Insurance coverage is easier to arrange than project financing, according to Mr. Germani. But most policies still take at least six months to put together, he said.

Mr. Blankenship said he spends up to a year and a half on projects that eventually are insured, and has spent up to two years on projects that never panned out.

System performance risks are "expensive acquisitions," Mr. Staulcup noted, adding that AIU prefers component risks.

Whether these difficulties will be worth overcoming for future projects may be affected by several factors, brokers add. These include:

- The availability of financing. A House revenue-raising bill now before Congress would limit issues of tax-exempt industrial revenue bonds to \$150 per capita in any one state, a development that would reduce available financing for energy projects, notes William Duggan, a managing director with Marsh & McLennan Cos. in New York.

- Government regulations on waste disposal. If communities are allowed to continue operating landfills, they may find it cheaper to dump their garbage than to build a garbage-burning power plant, Mr. Blankenship observes.

- Energy prices. If energy costs rise, alternative power plants will look more attractive. ■

# Alphabet Scoop

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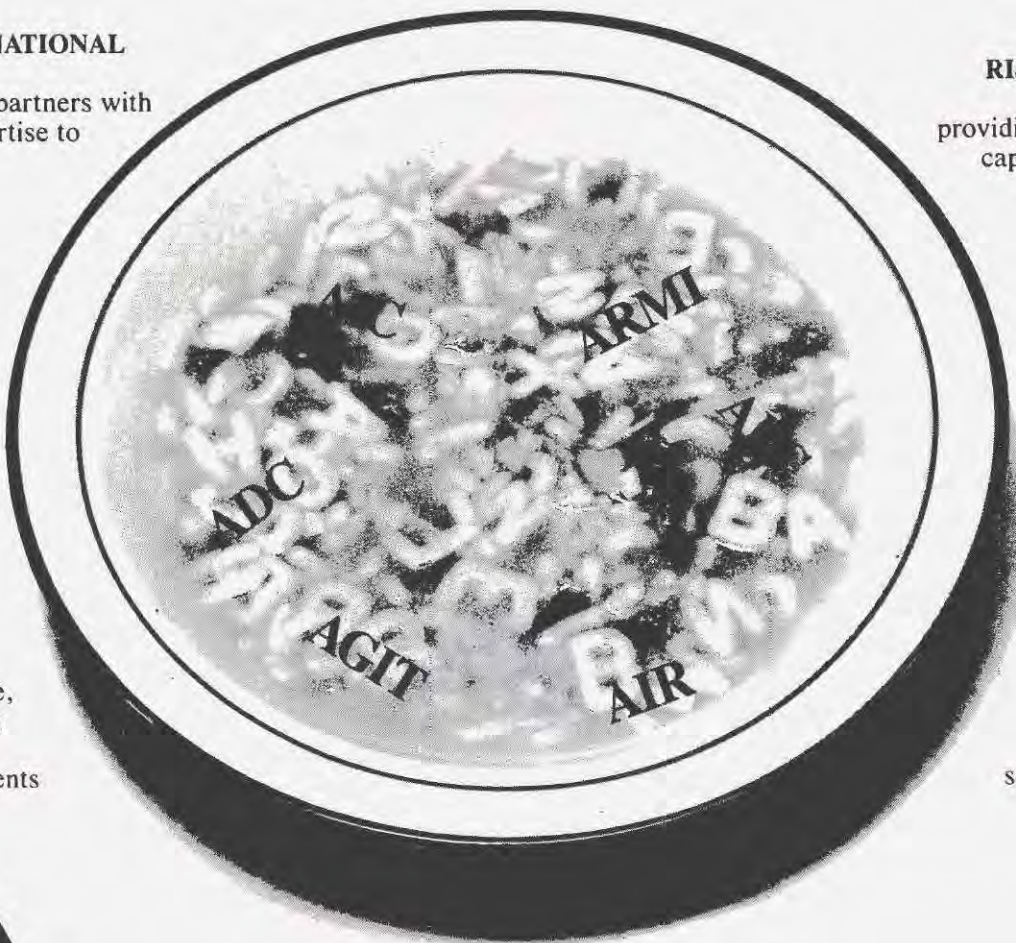
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# Market is growing for bond insurance

Continued from page 3

there's an attack on municipal bonds' safety, investors' confidence is shaken. And when this happens, they turn to insurance."

The financial difficulties encountered by New York City and Cleveland in the 1970s spurred growth, too, he said.

The growth in municipal bonds has been fueled by the decline in federal revenue sharing funds that has placed a larger portion of the financing burden for infrastructure improvements on state and local governments, as well as the drop in interest rates from the historic high levels in 1980 and 1981.

Municipal bond insurance is available in two forms. The first is directly purchased by the issuer, which buys the coverage before the

bonds are offered for sale. The second form is purchased by the buyers of bonds after they are issued.

Savings to the issuer that buys bond insurance far exceed premium costs, according to insurers, because the issuer can lower the yield with the protection of insurance. MBIA, for example, estimated its coverage produced interest cost savings of \$330 million on premiums of \$86 million in 1983.

When an issuer buys insurance on its bonds, the protection increases the bonds' marketability, especially to institutional investors, who often are constrained to buying high-quality debt instruments. Investors also will be willing to buy insured bonds at lower yields than uninsured bonds of similar quality.

Once a municipal bond is insured, Standard & Poor's Co., a leading national investment rating firm, upgrades its rating to the highest "triple-A" level, on the theory that the issue is backed not only by the issuer's resources but also by the insurer's.

Moody's Investors Service Inc., the other leading rating firm, does not upgrade insured bonds' ratings, because it contends the coverage does not improve the bonds' intrinsic value.

Bond insurers are choosy about the issues they'll underwrite. To qualify for coverage, bonds already have to be solidly backed.

"We're not in the business of bringing bonds with a significant default risk up to investment grade," Mr. Miralia said.

He contends that municipal bond insurance is designed for high-caliber obligations that might be issued for unusual purposes or for those local government borrowers who enter the market infrequently, especially those that do not have established relationships with investment banking houses that arrange these financing packages.

When investor interest in municipal bonds is thin or buyers are demanding high credit ratings, insurance also can make the bonds more attractive. Similarly, insurance can make complex bonds and negotiated issues more attractive.

About two-thirds of all municipal bond insurance is purchased by issuers. Premiums, which range from 0.1% to 2.5% of bonds' face values, are payable before the

bonds are issued. This coverage, which stays in effect for the bonds' lives, has no deductibles or cancellation provisions. And the bonds' tax-exempt status isn't changed.

If an issuer defaults and later can't resume payments, the issuer must first reimburse its insurer for payments made on its behalf.

The remainder of municipal bond insurance is bought by purchasers—either individually or by trusts or funds—after the securities are issued.

Premiums on bond fund, trust or portfolio insurance are paid periodically: monthly, quarterly or semi-annually.

MBIA is the largest insurer of municipal bonds. Since opening in 1974, the insurer has collected \$257 million in premiums. And none of its more-than-2,500 issues has defaulted.

MBIA is a consortium of five insurance companies: Aetna Casualty & Surety Co., Fireman's Fund Insurance Co., The Travelers Indemnity Co., Aetna Insurance Co. and The Continental Insurance Co. These companies have combined assets of more than \$21.1 billion.

The largest new municipal bond issue that MBIA has insured was a \$180 million New York state general obligation bond issue in 1983.

Most of the bonds MBIA insures are general obligation issues, backed by the issuer's full faith and credit. But it also covers revenue bonds, backed only by funds generated by the financed project, when they are issued by monopoly public utilities like power services.

Said Mr. Miralia, "We're looking to establish long-term relations with medium-sized issuers in growing communities that can benefit from the marketing credibility we can add. Central cities are not our primary clientele."

The company only protected new issues through 1983, when it began covering municipal bond trusts.

Since then, MBIA has insured trusts worth \$588 million. Included in this number is the largest bond trust ever insured, with municipals worth \$214 million, marketed last year by Merrill Lynch, Pierce, Fenner & Smith Inc.

MBIA also insures municipal bond trusts offered by John Nuveen & Co. Inc., an investment banking house in Chicago. Nuveen packaged its first insured trust, worth \$30 million, in February.

"As a result of WPPSS, individuals have a strong desire for safety in whatever form they can get it," said Steven D. Beligratis, Nuveen's research vp. "There was a clamor for insured trusts, and it would have been silly for us to ignore it."

Through mid-April, Nuveen had packaged six insured trusts worth \$175 million; during the same period, it offered uninsured trusts worth \$179 million. The insured trusts' yields are slightly lower than the uninsured's.

MBIA obtains quota-share reinsurance from seven companies that share 10% of all risks. Their maximum exposure on a policy is \$11 million, according to John W. Rindlaub, senior vp at Municipal Issuers Service Corp.

After this limit is reached, these reinsurers provide \$66 million of excess-layer coverage. MBIA can solicit additional reinsurance on a facultative basis from these or other reinsurers.

Unlike MBIA, AMBAC's record is not blemish-free. Prior to its first WPPSS payment, AMBAC had paid \$2.8 million in claims on 10 defaulted issues. Two of those issues have resumed payments and AMBAC has been able to recoup its payments, so that its net claims on

Continued on page 18



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# Bond insurance attracting more firms

Continued from page 16  
issues that remain in arrears are \$2.2 million.

Only one of these claims involved a new issue, and none included general obligation bonds.

Even with these losses, AMBAC's business remains hugely profitable. In 1983 alone, the insurer collected almost \$95 million in premiums. Thus, AMBAC officials contend they're not too upset about their WPPSS exposure.

"We don't plan to do anything different as a result of WPPSS," said Phyllis F. Smyczek, AMBAC's customer relations vp. "Writing insurance means you're going to have to pay claims."

More than half of AMBAC's insurance is written on bonds that already have been purchased.

These issues are in funds and trusts, as well as bond portfolios worth more than \$500,000 that are held by individuals or institutions. This individual and institutional portfolio coverage accounts for about 2% of AMBAC's business.

AMBAC and MGIC Indemnity Corp., a sister company, have combined assets of \$415 million. AMBAC has insured new issues as large as \$110 million and trusts up to \$128 million.

To provide this capacity, the company shares 18.75% of all exposures on a quota-share basis with three reinsurers.

Then, its first layer of stop-loss reinsurance, provided by 14 reinsurers, adds \$75 million of protection to pay claims. For this coverage to be triggered, AMBAC has to pay claims equal to more than 125% of its earned premiums.

If claims still remain unpaid, a second layer of stop-loss coverage will provide an additional \$50 million in funds to fulfill obligations.

Two new underwriters of municipal bond insurance have opened this year in response to the growing bond market.

The first, Financial Guaranty Insurance Co. of New York, opened in January. The second, a joint venture backed by American International Group Inc. and Philbro-Salomon Inc., parent of investment banker Salomon Bros., expects to start writing coverage this month.

Financial Guaranty Insurance Co. has insured 27 municipal bond trusts and funds and four new issues with a combined par value of about \$850 million since January.

Executive Vp Roger K. Taylor would not say how much in premiums this business has generated.

The company, headed by former AMBAC Chairman Gerald Friedman, has targeted trusts and funds rather than new issues, Mr. Taylor said, because, "There was good demand, and sufficient service wasn't being provided."

Indeed, today 90% of all bond issues are purchased by individuals, either individually or as investors in bond trusts and funds.

Financial Guaranty was funded with \$75 million from five investors: Merrill Lynch, GEC Credit (a General Electric subsidiary), Lehman Brothers Kuhn Loeb Inc., Kemper Corp. and General Reinsurance Corp. The company has signed on reinsurers, but Mr. Taylor would not reveal their identity.

Later this month, the municipal bond insurance field is due to become even more crowded when the Philbro-Salomon/AIG joint venture starts writing policies.

AIG is negotiating with two other financial institutions to join the venture, according to Douglas A. Paul, an AIG vp.

While municipal bond insurers' loss records have been enviable, the consensus among industry observers and participants is that

there are not enough high-quality issues coming to market to support additional entrants.

The field probably will not become more crowded, they say, because start-up costs are high for insurers and the insurance, which can run the life of 30-year bonds,

has a long term.

These factors could squeeze insurers' resources if the financial security of the underwritten municipal obligations were threatened.

Such a situation developed in 1933, the fourth year of the Great Depression, when municipal de-

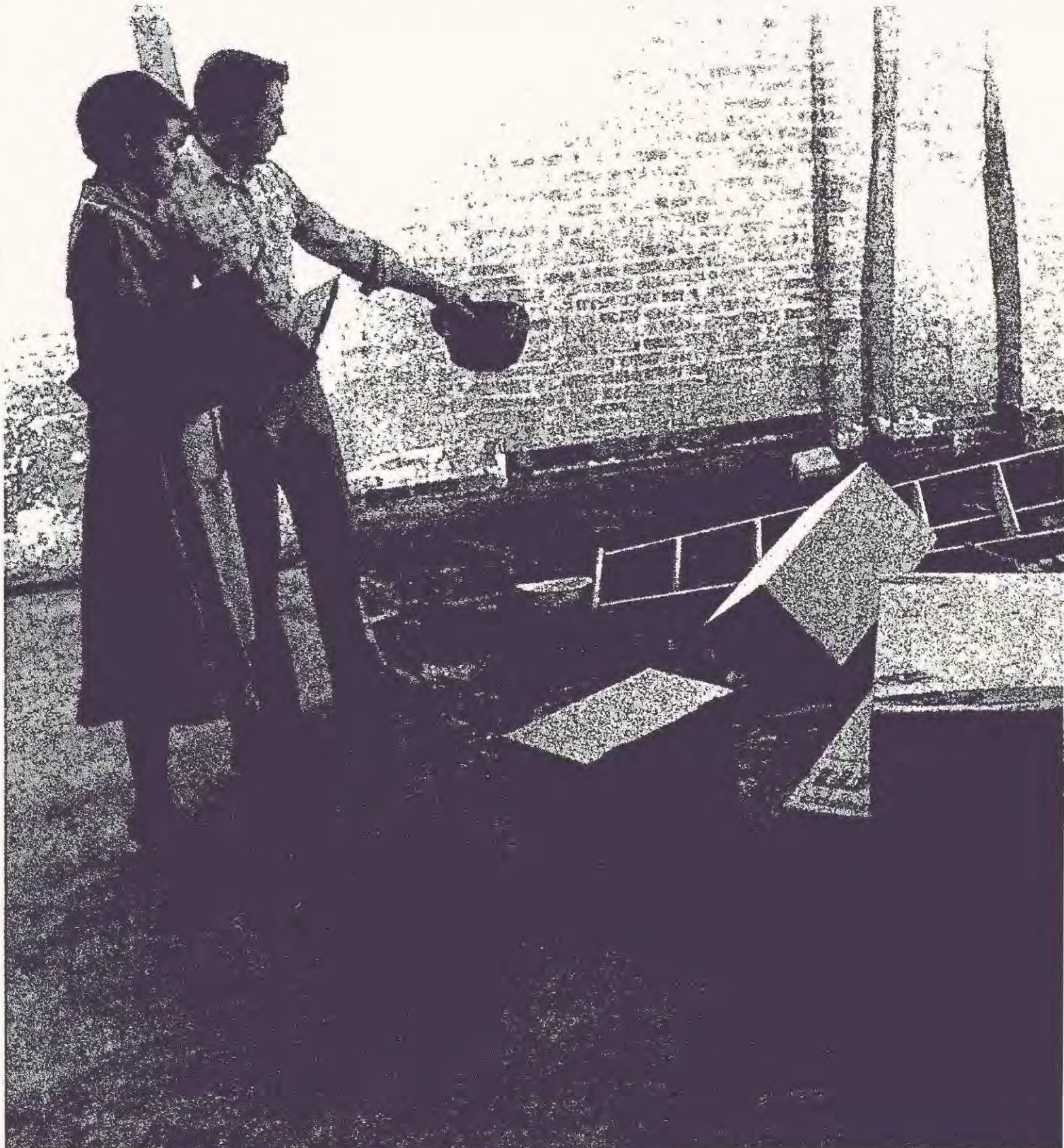
faults peaked at 16% of the total annual debt service.

"The field looks attractive," Mr. Miralia said. "But new companies should look carefully before they leap in. This is still a fairly exotic product."

Still, established insurers are

looking for ways to expand their business. MBIA, for example, has begun insuring municipal bonds that already have been purchased and are later sold on the secondary market. Because the bonds are insured, they can fetch higher prices upon resale.

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# Few industrial development bonds insured

Less prevalent than municipal bond insurance is the even more specialized product of insuring industrial development bonds.

Only about \$125 million of the more than \$110 billion of industrial development bonds issued since 1980 have been insured for premi-

ums totaling some \$9 million.

More than 99% of all IDBs are sold without insurance, compared with 79% of all municipal bonds.

IDBs are tax-free securities issued by municipalities to finance private development that strengthens a community's econ-

omy. Interest and principal payments are made from revenues generated by the funded project.

First issued in Mississippi in 1936, IDBs are available for construction of manufacturing plants, distribution and industrial facilities and other projects. They are designed to

provide low-cost financing for companies that otherwise would have no access to the bond market.

Because insured bonds are more secure, this coverage can further reduce the yield. Whether insurance is purchased will depend on if the average premium of 6% to 7.5%

of the issues' par value, payable in advance, is more than offset by reduced interest charges.

For example, a 20-year, \$1 million bond with a 10% interest rate could be charged a \$75,000 premium. This charge would raise the effective cost of the company's borrowing to 11.08%, according to IDBI Insurance Managers Inc., one managing general agent providing the product. Insurance would not be purchased if the bonds could be floated without insurance at a lower interest rate.

Because insured IDBs automatically receive a "triple-A" rating from Standard & Poor's Corp., this coverage is particularly useful in promoting their sale to a national market. Without this backing, many of the issues, especially those from smaller municipalities, would be limited to local buyers, because they would not be rated by S&P.

IDB insurance was first provided by S&B Insurance Services Co. of White Plains, N.Y., in 1980, targeting issues with par values of \$5 million to \$10 million.

Since then, the brokerage unit of Municipal Bond Insurance Assn. has placed insurance on IDBs with a par value exceeding \$50 million for premiums of about \$3.75 million.

S&B places coverage with more than a half-dozen insurers, including Aetna Life & Casualty Co., The Travelers Indemnity Co., Fireman's Fund Insurance Co., Old Republic Insurance Co., St. Paul Fire & Marine Insurance Co. and Industrial Indemnity Co.

Smaller offerings, with face values of up to \$4 million, have been insured since June 1982 by IDBI Insurance Managers Inc. of New York, a subsidiary of Corroon & Black Corp.

"We're for the little guy," said an IDBI spokeswoman. "the company that's making its first big move."

IDBI has placed insurance on 41 bond issues with a face value of about \$75 million, generating about \$5.6 million in premiums for Firemen's Insurance Co. of Newark, N.J. Firemen's, a Continental Insurance Co. unit, is IDBI's sole market for this insurance.

IDBI retains a portion of the premium and gives the remainder to its parent. A spokeswoman wouldn't disclose the amount or percentage of premiums it keeps.

No insured IDB issue has defaulted. "It's really still too soon," noted a spokeswoman for IDBI, "especially since most of the exposures are for 20-year bonds."

## ON THE SCENE, YOU BEHIND THE SCENE.



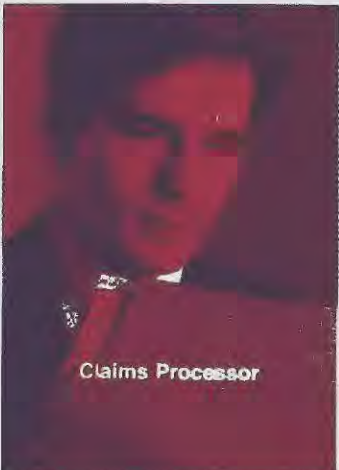
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### Market covers hospital bonds

Bond insurance also is offered to the health care industry.

American Health Capital Inc. of New York has written 16 policies on hospital construction bonds with a total value of about \$625 million since September 1983.

Company officials would not disclose the amount of premiums this business has generated.

While only insuring hospital issues, AHC protects both tax-exempt and taxable issues.

Premiums for the new issue coverage, which is provided by Industrial Indemnity Co., a wholly owned subsidiary of Crum & Forster, range from 0.7% to 1.4% of the debt issue's total value. As with other forms of new issue coverage, premiums are payable in advance.

# Demand for retroactive insurance lacking

By STEPHEN TARNOFF

CHICAGO—More than a year after litigation erupted over the widely publicized MGM Grand Hotel's retroactive liability insurance policies, some insurers are willing to underwrite policies covering corporations' known losses but there are few deals closed.

The demand for retroactive insurance isn't there, say underwriters and insurance brokers. They suggest risk managers may not understand the coverage.

And, when buyers do seek the coverage, they often find it too expensive or not suited to their needs.

Insurers underwriting retroactive liability insurance to cover a known loss charge a premium today that they expect will gen-

erate enough investment income to cover the loss when it comes due.

The most widely publicized retroactive liability insurance written was for MGM Grand Hotel's after the company discovered that its \$50 million of insurance was inadequate to cover losses stemming from a November 1980 fire at its Las Vegas hotel (*BI*, Feb. 9, 1981).

Losses have not been paid under the retroactive policies and suits and countersuits have been filed over the coverage (*BI*, Jan. 2 and Feb. 13).

The breakdown of the MGM coverage is one reason the product has not become popular, some say.

"It's available," says Fred Angely, vp for Alexander & Alexander in New York. "We've put together proposals, but can't say they

have actually been formalized."

Frank B. Hall & Co., which brokered the MGM retroactive insurance, has had three requests for retroactive known-loss coverage during the past year but did not make any placements because the insured decided not to purchase the coverage, said Roger Wade, vp for Frank B. Hall & Co. Inc. and head of the broker's financial guarantees activity.

Inquiries by insureds are not as frequent as one might expect because some risk managers and brokers haven't realized the role retroactive coverage should play, says Larry Drake, managing director at Marsh & McLennan Inc. in New York.

Retroactive liability insurance can be purchased when a company

is underinsured or uninsured for a known loss. The company knows it will someday have to pay a loss, but it doesn't know when or how much.

By purchasing retroactive liability insurance that will pay a certain amount when the loss comes due, the company can protect its earnings in the year the loss finally is owed. And, the company can possibly take a tax deduction for the premiums paid for the retroactive insurance while a self-funded reserve for the loss generally is not considered tax-deductible.

"There is a surprisingly large market for known-loss retroactive coverage as distinguished from IBNR," notes Mr. Drake.

IBNR coverage is written for prior accident years to cover in-

currant-but-not-reported losses. It is more common than coverage for known losses and is purchased by companies that want to beef up prior limits, either their own or those of an acquired company.

"As many as 17 markets consider all types of retroactive coverage, although they are somewhat erratic in terms of response," Mr. Drake adds.

On any given risk, perhaps five will want to respond, five might consider it and five will reject it, he notes.

But retroactive insurance is not cheap.

Known-loss coverage may require a premium very close to the limit of liability covered by the policy, explains Angus Robinson, senior vp of Trenwick Ltd. in Bermuda.

If an insurer can quantify within a reasonable, verifiable statistical basis when the payments will be made and what size they will be, the insurer can consider discounting the amount of the premium needed today, he said.

But, "in most cases there is neither a statistical basis to quantify the risk of payment nor the timing of the payment," he adds. "You're dealing in an environment close to a crapshoot."

Trenwick will consider requests for retroactive liability insurance, "but with a rather jaundiced eye," Mr. Robinson said. "Most underwriters who try to apply imagination to products will look at it," he adds. "Anything is insurable at a price."

James Pearce, vp for American Reinsurance Co., said at least one large insured with substantial legal problems that sought such coverage finally rejected it because of the price. "The cost of the transfer of dollars was so high they couldn't afford it."

The high price reflects another difficulty for insurers underwriting the product: They get little if any reinsurance support.

Since the MGM coverage was written, reinsurers have specifically excluded retroactive insurance for known losses from coverage under their treaties, fearing that they could end up paying twice for the same loss—once under a conventional insurance policy and then again under a retroactive policy.

Lacking reinsurance support, insurers that want to write retroactive coverage must do so on a net line basis, limiting capacity.

And, there is increasing reluctance on the part of domestic markets to get involved with this type of transaction as well as a movement by insurance regulators to look at accounting practices involving these transactions, says Mr. Wade of Hall.

"The transfers are going to the offshore markets. The Bermuda markets are inclined to take these types of arrangements," he says.

Shippan International Insurance Co. Ltd. in Bermuda is specifically targeting corporate needs for retroactive liability insurance and has written two policies in the last year.

Shippan is owned by nine financial and insurance institutions including General Re Corp. and managed by Gen Re's Bermuda subsidiary, General Re Service Ltd.

Shippan made its big push into financial insurance products in 1983 after its original black lung risk-funding products were no longer needed by coal mine operators due to changes in the black lung law (*BI*, April 25, 1983).

In addition to retroactive liability insurance, Shippan also writes loss

Continued on page 22

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## Bermuda firm targets market

*Continued from page 20*  
portfolio transfers from insurance companies and prospective catastrophe treaties for insurance companies.

Shippan can capitalize on the tax and regulatory advantages offered by its Bermuda domicile when underwriting these programs because Shippan is not a controlled foreign corporation, its shareholders are free of current tax on the company's operations. As a result, investment income on premiums accumulates tax free.

In addition, because Shippan is not subject to U.S. statutory insurance accounting, it can discount loss reserves.

Shippan's annual report cites as one of its "unique products," the "insuring for a known or expected loss, with the added benefits of a current premium payment and the

tax-exempt accumulation of funds to pay the loss."

In 1983, Shippan underwrote \$11 million in premiums against capital and surplus at year-end of \$36.2 million. All but \$1 million of the premium was related to financial products. Of the four policies, one was a retroactive liability insurance policy with a premium in excess of \$1 million, according to General Re Services Vp and General Manager William M. Kinney.

Shippan also is also currently negotiating several other retroactive policies, he added.

When underwriting a retroactive liability insurance policy, Shippan considers the insured's motivation in purchasing the coverage, what the insured is trying to protect, the amount of insurance required, how soon the insured needs to recover under the policy and what investment vehicles and rates are available in the investment market.

"Shippan assesses the liability and the litigation process and reaches a policy limit," Mr. Kinney explains. The corporation then pays the premium to Shippan in one of several ways.

It can be paid upfront and Shippan will guarantee a interest rate on that premium. The premium, plus interest that has accrued tax-free, will be available to pay the loss when it comes due.

Or, if the policyholder prefers, Shippan can structure the premiums payments over any number of years with the policy limit available to be called upon at any given time established in advance.

"It doesn't take a genius to discount a known loss," Mr. Kinney notes. "But there are other tax and investment vehicles that can be incorporated" in writing the coverage.

The premium payment could possibly include stocks, bonds or other securities, Mr. Kinney adds. "It's something we could think of," he adds. "We'd look at it."

But whether fixed securities would be acceptable would depend on answers to other questions including the investment risk of accepting them and what the investment value will be a number of years in the future, he adds.

It would be tough to determine what the value of the shares will be in the future and to determine a policy's limits based on the value of the share, he said.

Shippan also can fashion policies with a commutation clause so that if there is no loss at a certain period of time, the premium can be returned, Mr. Kinney says.

With the insurer's \$38 million capital and surplus, Shippan theoretically could write five or ten times that amount in retroactive coverage under Bermuda regulations, Mr. Kinney adds.

"Shippan is only limited by imagination and its strong sense of marketplace ethics to be sure we are not contributing to the delinquency of someone else," he says.

Mr. Kinney adds that premiums paid to Shippan should be tax deductible to the policyholder because there is risk transfer.

But he adds that every situation is different and that no insurance company guarantees tax and accounting treatment. That determination is up to the client and his tax advisers.

"It's a very unsettled area of the law. You can't be definitive."

There have been some suggestions that Congress may declare that retroactive liability insurance isn't insurance for tax purposes, but those suggestions are not yet part of any legislation.

Shippan's marketing force is Herbert Clough, the wholly owned brokerage subsidiary of General Re Corp., based in Greenwich, Conn.

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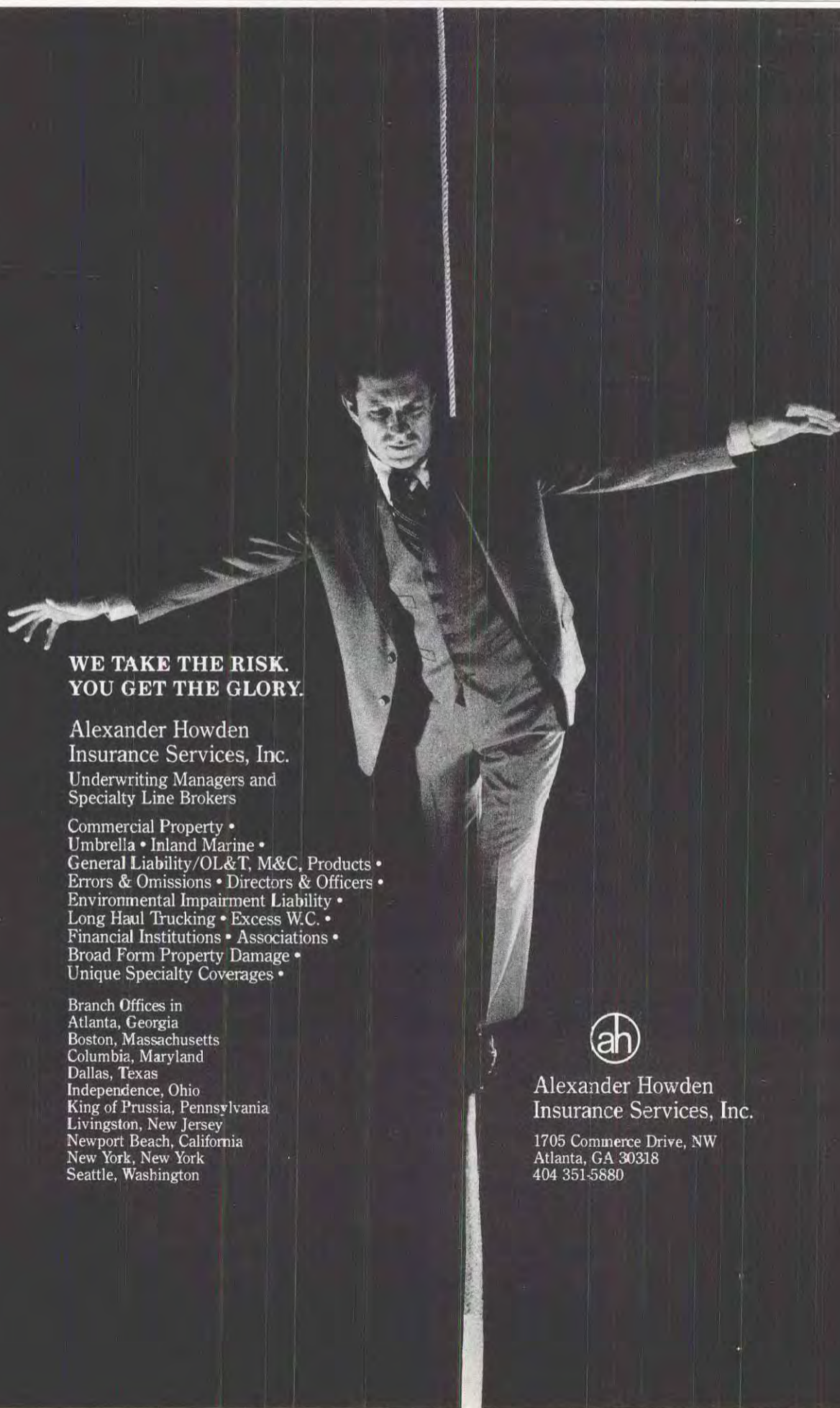
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# Construction slowdown hinders surety growth

By STEPHEN TARNOFF

The recent improvement in the nation's economy is sparking some increased interest in surety bonds, one of the oldest forms of financial guarantees, but not nearly as much as underwriters had expected.

The construction industry, especially companies that work on the road and highway projects that are a major source of contract surety bonds, is not yet making the comeback that had been anticipated.

Many contractors are still hard-pressed to find work and are lowering their bids on construction projects. This, in turn, affects surety underwriters, whose premiums are based on the contract cost.

In addition, the lower the contract bid, the lower the contractor's

profit margin, which increases the likelihood that the contractor may not be able to complete the project.

Unlike some of the more exotic forms of financial guarantees, surety bonds have been an essential part of the insurance industry for years. Basically, a surety bond guarantees monetary payment or completion of a project should a party fail to perform specified acts within a stated period.

Most surety bonds that are underwritten are contract bonds that guarantee the contractors will complete their jobs and comply with all the requirements of a project.

However, surety insurers also write miscellaneous risks, including non-contract obligations and financial guarantees.

And, the growth of financial

guarantee coverages, like lease guarantee insurance, could have a big impact on the surety industry.

"The (financial guarantee) market is still undetermined but is growing very fast," says Lloyd Provost, president of the Surety Assn. of America in Iselin, N.J., the surety industry's trade association. "We do know it is a major component of the surety line."

"There are new premiums coming into the surety line," he adds. "The problem is that these financial guarantees must be underwritten very carefully."

Robert L. Mills, assistant vp of the bond department at Aetna Casualty & Surety Co., notes the impact of financial guarantees on the surety industry is uncertain, though it may affect the split in

premiums between contract and non-contract bonds.

Traditionally, contract bonds have garnered two-thirds of the premium, while non-contract bonds, including financial guarantees, generated just one-third of the business.

"Those numbers are beginning to be influenced by new financial guarantee products," Mr. Mills says. "Some people project that eventually financial guarantees will become as large as contract income."

"It's an area where we're going slowly, he adds. "I don't feel the industry in general at this time fully recognizes the risk which exists in some of those types of guarantees."

Although the construction industry has not rebounded as much as underwriters had hoped, some

surety underwriters project an 8% to 10% increase in premium volume in 1984.

Although official 1983 underwriting results have not yet been published by the Surety Assn. of America, 1983 premium levels for traditional surety lines will show a slight increase, according to the SAA's Mr. Provost.

But, overall underwriting experience "has been a little worse" than 1982, Mr. Provost says, estimating that the industrywide 1983 combined ratio is about 100%, compared with 96% in 1982.

The increase in the combined ratio is largely due to higher losses. Preliminary SAA figures put the loss ratio for total surety at 38% for 1983, compared with 33.2% in 1982.

"The contract line appears to be marginally profitable," he adds.

Surety underwriters note that although the construction industry has begun to improve during the past year, most of the recovery has been in the housing market, which is not traditionally bonded.

Meanwhile, non-residential construction for the federal and state governments, for which virtually all work is bonded, has lagged.

For instance, the 5-cent-a-gallon federal gasoline tax that went into effect last year to finance road and highway construction has not developed as much work as was anticipated.

"We thought it would generate more activity than it appears to have generated," says Robert Sener, assistant vp in the bond department at Hartford Insurance Co. in Hartford, Conn.

"There does seem to be more work coming out," adds W.R. Holley, assistant vp in charge of contract surety bonds with USF&G Corp. in Baltimore. "But, by and large, there is not a major uptick. Even if there were, it would not be sufficient to absorb the unused capacity in the market right now."

Most underwriters didn't see much improvement in volume during 1983 and don't expect much in 1984.

"Premium volume was just about flat" in 1983, says Hartford's Mr. Sener. He expresses a "cautious optimism" for 1984, which will depend on the availability of government funds for construction and no major increase in interest rates.

"We don't see a tremendous increase in available work for contractors, perhaps a 2% increase in real dollars for work that is overall bid," Aetna's Mr. Mills adds.

"That's not a great increase, but it means it will be as good as last year, although last year was depressed."

Mr. Holley of USF&G says, "We have not seen material changes and don't expect to see any in 1984."

Mr. Holley points out that there is a substantial lag between the time the economy picks up and the time its effect is felt on non-residential construction.

"It's the last thing to be picked up in an upturn."

Underwriters also agree that their loss ratios could increase again in 1984, as they did in 1983.

The lack of a construction boom means that contractors will fiercely compete for the work available, cutting their profit margins as low as possible.

The low margins, however, make it more likely that contractors will not be able to finish the job if something goes wrong. It also means that underwriters must be more careful about the contractors they insure and will be more likely to tighten their underwriting requirements, some insurers say.

"The very, very competitive construction market places pressures  
Continued on page 26



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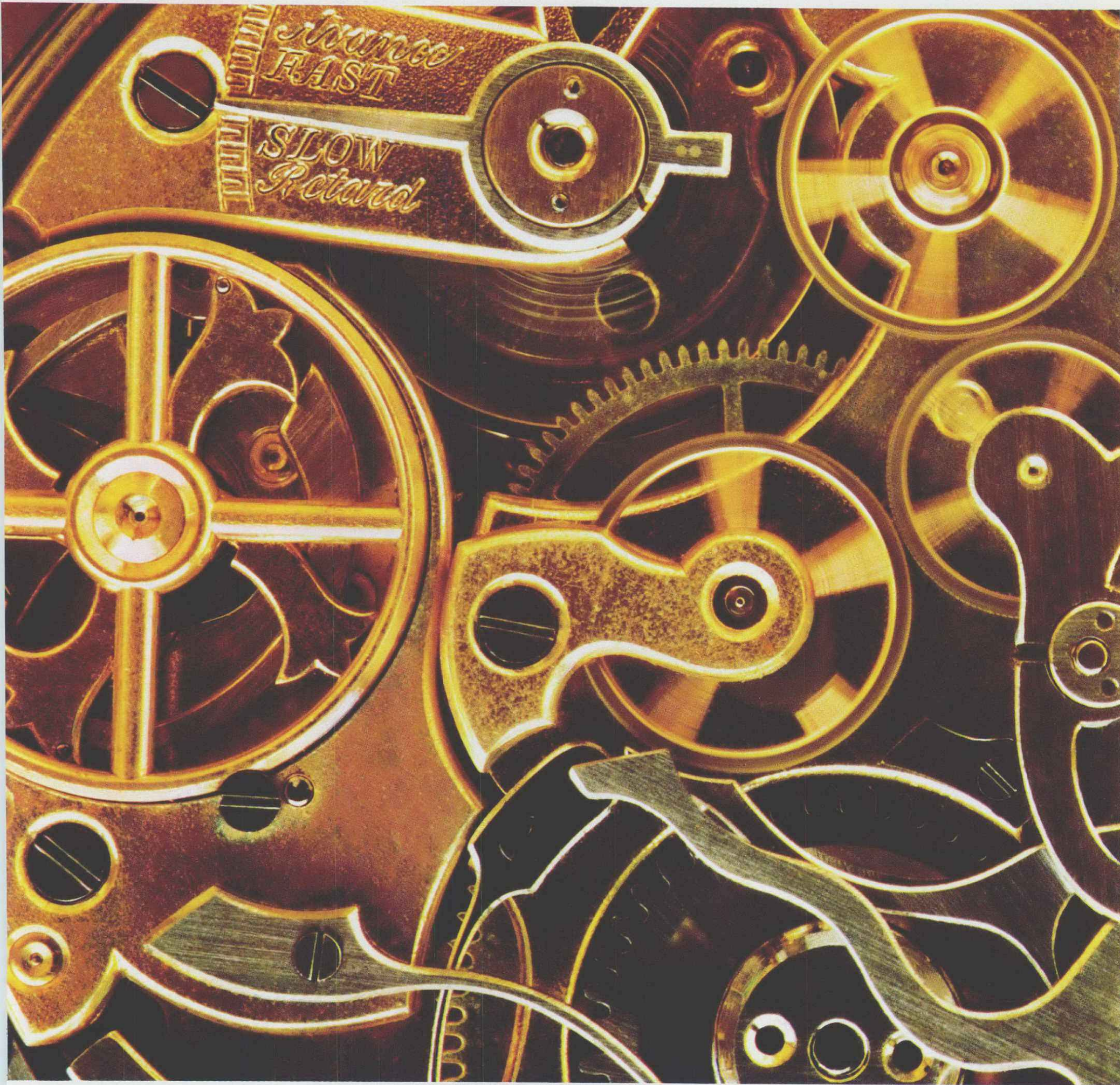
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## Surety bond demand slow

Continued from page 24

on contractors in terms of margin," Mr. Mills adds. "The lower the margin the greater the risk for the contractor."

Among the items underwriters take into consideration when writing a surety bond is the contractor's ability to manage and finance the work program.

According to Mr. Mills, the underwriter must evaluate the quality of the contractor's employees, equipment and organization, including the types of contracts the contractor has completed in the past.

"They also must be able to forecast several years down the line, because when the underwriter writes the bond, he is not relieved from liability until the job is completed," Mr. Mills adds. "You must be able to look ahead and anticipate the contractor's financial growth as well as deterioration."

Despite the widespread competition in most commercial insurance lines, the rates charged by surety underwriters don't fluctuate very much, underwriters say, adding that surety bonds have not been subject to the intense rate cutting that hit other types of property/casualty insurance.

Most surety underwriters say they compete in the service they can provide, the credit limit they can provide and the quality of their bonds.

But rates can be a factor if the job is a particularly large one, involving millions of dollars of contract price, says Glenn Montgomery, assistant vp at Chubb Corp. in New York.

The Surety Assn. of America recommends its member companies charge a base rate of \$12 per \$1,000 of contract value, up to the first \$500,000. After that, the rate drops to \$7.50 per \$1,000 of contract value for the next \$2 million, Mr. Provost says. Some underwriters, though, deviate slightly from the recommended rates.

No matter what rate they charge, most underwriters don't see a change in rates during 1984.

"It's still a very, very competitive market and there will be no increases in the rate level," says the SAA's Mr. Provost. "We don't see rates necessarily climbing in 1984 in the surety areas."

"From an industry standpoint, rates haven't really changed, and I don't think they will," adds Jerome H. Noldin, senior underwriting officer for contract bonds for St. Paul Fire & Marine Insurance Co. in St. Paul, Minn.

## More companies express interest in credit coverage

By JUDY GREENWALD

NEW YORK—The volatile economy is prompting new growth in old-time credit or accounts receivable insurance, say the two underwriters of this coverage.

The insurance, which indemnifies a company for unpaid debts due to the bankruptcy or insolvency of its customers or slow payment on their part, is of most interest to smaller companies that cannot absorb a large bad-debt loss, but both underwriters say more large

firms are becoming interested.

The only two markets currently underwriting accounts receivable insurance are Baltimore-based American Credit Indemnity, a subsidiary of Control Data Corp., and New York-based London Guarantee & Accident Co., an affiliate of Continental Insurance Co.

American Credit Indemnity, which was founded in 1891 by a group of New Orleans businessmen, generated 76% of the \$52 million in credit insurance premiums recorded last year, according to Chairman and President H.A. Legge Jr.

London Guarantee, founded in 1879, was an outgrowth of factoring in the clothing manufacturing business, although the firm is no longer involved in the clothing industry, says Kenneth C. Lee, a special agent for the firm. In factoring, a third party helps the seller collect accounts receivable and, when they aren't collected, helps finance the debt. This is particularly common in the clothing industry.

This summer, Baltimore-based Fidelity & Deposit Co. of Maryland, a subsidiary of Swiss Reinsurance Co. and Zurich Insurance Co., will enter the market on a limited basis, says Louis Calucci, resident vp in the firm's Bloomfield, N.J., office.

London Guarantee's Mr. Lee anticipates a 30% increase in premium this year, primarily generated from major companies that will be insuring their accounts receivable for the first time.

Previously, Mr. Lee says, the typical buyer of credit insurance had sales of \$5 million to \$10 million. Now, firms with sales of \$500 million or more are seeking to insure all or part of their accounts receivable.

He attributes the increased interest to "volatile economic conditions. We're going from inflation to recession, to good times to bad times."

This creates the need for proper planning by many companies to protect themselves in the event of "strategic bankruptcies," such as those entered into to avoid an expensive labor contract, he says.

According to Dun & Bradstreet, there were 31,334 bankruptcies last year, or 110 for every 10,000 businesses, the highest rate since 1932.

The \$52 million in premiums written last year "could easily be \$200 million as soon as the uninitiated companies and insurance brokers find out what's available," Mr. Lee says.

Mr. Legge, who says his company's business has been growing at a 13% to 16% annual rate, also perceives a trend toward larger companies with sales of more than \$50 million buying accounts receivable coverage. "There has been a tendency to slow down payments, and thus the outstanding (accounts) are much greater."

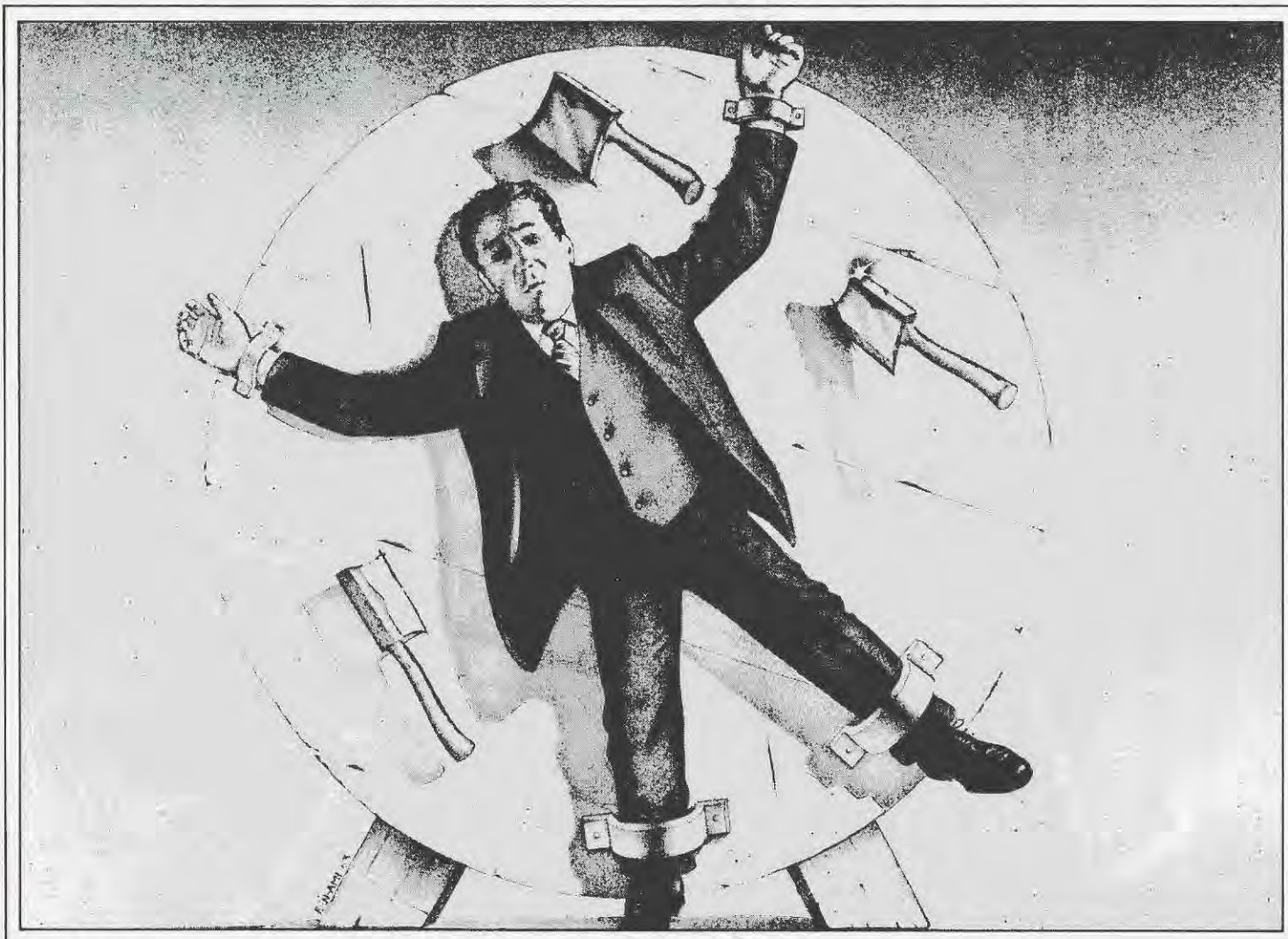
Despite this trend among the large companies, Mr. Legge believes the smaller businessman will still be the one most interested in this coverage.

"The interest in credit insurance is primarily coming from the entrepreneur who is a small businessman to whom any substantial credit loss could be devastating, in that it could wipe out the entire net worth of the company."

"I think the application of credit insurance for the most part is (among companies) in the \$1 mil-

Continued on page 28

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# Credit insurers say business is increasing

Continued from page 26

lion to \$20 million annual sales volume category," he says.

For a manufacturer with \$5 million to \$10 million in annual sales, premiums would run from one-tenth to one-fifth of 1% of annual sales, Mr. Legge says.

The exact rate would depend on the credit rating of the firm's customers. If its accounts were equally divided between well-rated accounts and those without a credit rating, the final cost would be closer to one-tenth of 1%, Mr. Legge says. "If the mix is more toward the unrated accounts, it would be closer to one-fifth of 1%."

Mr. Lee, who estimates his policies cost about one-twelfth to one-third of 1% of sales, also notes that a firm that sells \$1 million worth of

merchandise to an account once a year will pay more for insurance than one that makes several different sales during the course of the year that total \$1 million.

Both ACI and London Guarantee base deductibles on the losses a firm is expected to sustain within any given 12-month period. These could range from \$35,000 to \$100,000 annually.

Under both the ACI and London Guarantee policy, the policyholder determines how much of his accounts receivables should be covered. He can select a general coverage policy, under which the majority of his receivables will be covered, or a specific coverage policy, under which a select number of his largest accounts will be insured separately, Mr. Legge says.

For instance, a manufacturer with hundreds of \$10,000 accounts and a dozen \$500,000-plus accounts would probably only cover the larger accounts. Any limits on coverage are determined by the policyholder himself, Mr. Legge says.

Neither ACI nor London Guarantee, however, permits "adverse selection," Mr. Lee says.

"If someone gives us the five worst accounts and asks us to insure those, we will not."

A policyholder could also decide to self-insure part of the risk.

ACI and London Guarantee permit endorsements to their policies to cover particular accounts. One, for instance, applies to specially processed or purchased merchandise, like private-label items.

"Anything manufactured to

order that wound up in the policyholder's warehouse at the time of (the accounts) bankruptcy would be covered by the policy," Mr. Legge says.

If the policyholder is financing his receivables through a bank, a bank endorsement would give the bank the same rights as the policyholder, Mr. Legge says.

Another endorsement eliminates the deductible in the event of a customer's insolvency.

Still another permits the policyholder to continue to ship to an account even though its credit standing has deteriorated.

At both firms, claims are generally paid on an annual basis, although an endorsement can be purchased for more-frequent claim settlements.

Both insurers are seeing their loss ratios improve. ACI's loss ratio in 1982 was more than 61%. In 1983, it was slightly above 44%. And this year, it has improved even further, Mr. Legge says.

"The loss ratios were quite high in 1982, and in 1983 they were quite a bit better because, despite the continuation of bankruptcies, most of them were taking place on accounts that were having problems prior to that time and we were careful on," says Steve Taylor, assistant secretary of London Guarantee. So far, he adds, the loss ratio has improved even further in 1984.

For the first 43 years that Dixie Yarns, a Chattanooga, Tenn.,-based textile manufacturer, was insured by ACI, it filed claims only twice for a total of \$5,000, says credit manager Joe Eaves.

But in 1979, a customer went bankrupt and Dixie tapped the insurer for \$400,000, Mr. Eaves says. ACI was able to recover only 12 cents on the dollar, he notes.

Dixie, which supplies its yarn to the carpet industry, insures about \$200 million of its \$283 million in sales through ACI. The remaining \$83 million in accounts receivables is handled by factors.

About \$196 million of the \$200 million in accounts receivables insured through ACI is covered under a general policy. The other \$3.6 million is insured through endorsements and five special policies, Mr. Eaves says.

For example, \$200,000 of a \$300,000 account might be covered by an endorsement, with the remaining \$100,000 covered by a special policy.

There is a \$75,000 deductible on the general policy, while deductibles for the special policies vary, Mr. Eaves notes. The total cost for the general policy and the five special policies is \$120,000.

The 20 endorsements on Dixie's policy also cover accounts not rated by Dun & Bradstreet.

Having a credit policy is an effective sales and marketing tool because "we can go in and sell to people who would not be the best of credit risks," says the credit manager for an apparel manufacturer with \$100 million in annual sales.

About 50% of the firm's accounts receivable are covered by an ACI policy, says the credit manager. "If we wanted all the accounts covered, I imagine the insurance premiums would be astronomical."

A total of 505 accounts are covered by special endorsements added to one general policy, which costs "in the low six figures" annually, the credit manager says.

He notes that because companies are constantly being added and subtracted from the list of special endorsements, the total premium paid by the company at any one time is difficult to determine.

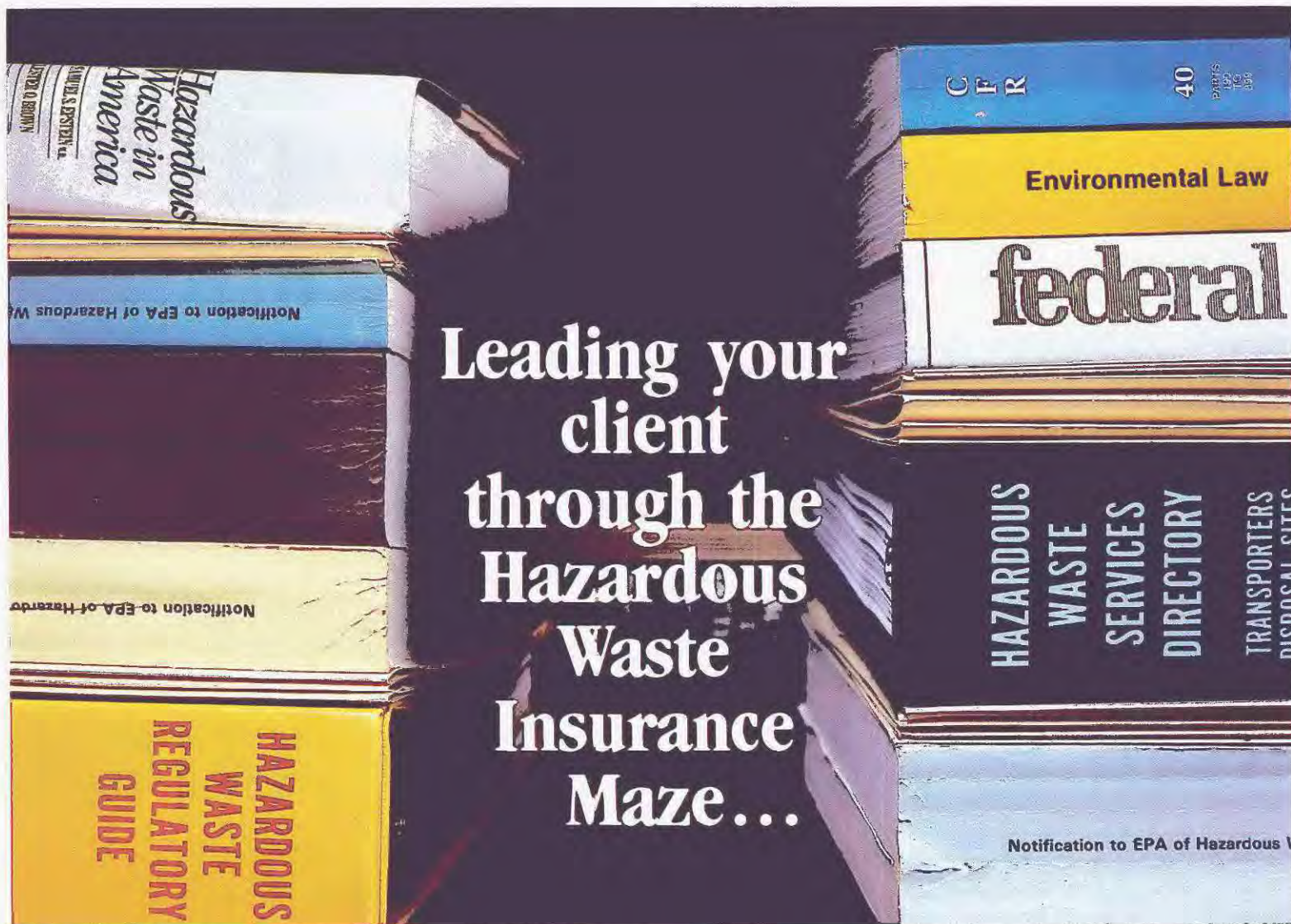
As of March 15, the company had filed \$119,000 in claims this year toward its \$350,000 annual deductible, says the credit manager. ACI has paid claims five times over the past 10 years, for a total of about \$500,000.

Lucille Farms, a Yonkers-based cheese producer, has never filed a claim in the six years it has had its London Guarantee policy.

The firm renews it each year, though, "just in case. I sleep better that way," says Vp Alfonso Falivene. The firm has about \$30 million in annual sales, with about 75% of its accounts receivable covered by the policy.

The policy covers "concentrated accounts," which are the accounts that represent at least 10% of company sales, and has a \$35,000 deductible.

The policy costs about 0.1% of receivables, Mr. Falivene says.



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# N.Y. residual value insurers threatened by state regulator

By JUDY GREENWALD

NEW YORK—For a brief dozen days it looked like residual value insurance was, for all intents and purposes, condemned to death in New York state.

It has since been granted at least a temporary reprieve, and permanent rescue may be on the way.

Residual value insurance guarantees an asset's worth in the future, with insurers indemnifying the policyholder if the asset's value falls below a specified level during the policy period.

New York Insurance Superintendent James P. Corcoran notified New York-licensed insurers March 29 that they could not write residual value insurance after April 15, and policies now in force could not be renewed or continue in force after April 14, 1985.

Many of the insurers writing residual value insurance are licensed in New York, notes Richard H. Napier, second vp at General Reinsurance Corp. in Greenwich, Conn.

However, vice chairman of Clarendon Group Services in New York, which arranges residual value insurance, said, "People will figure out how to work around it." There are insurers not licensed in New York that could issue the coverage, he notes.

Such alternatives may not be necessary because Mr. Corcoran has delayed the deadline for writing residual value insurance and legislation permitting the product has been written.

Mr. Corcoran's March 29 letter said residual value insurance falls into the category of "insurance of life of property." As such, he said, to underwrite it, insurance companies must be organized pursuant to Section 401 of the insurance law. But, he added, no insurance company has the license to write this type of insurance in New York.

The ban on underwriting residual value insurance also applied to the New York Insurance Exchange and New York's Free Trade Zone, whose specially licensed insurers can write insurance for special risks without any rate or form regulation by the state Insurance Department.

The March 29 letter, in effect, would have killed residual value insurance in New York because the law stipulates that life-of-property insurers must set up a reserve equal to the limit of each policy, says Mr. Napier of General Re.

The reserve could be discounted by no more than 3% annually, so in practical terms, Mr. Napier explains, to issue a 10-year residual value policy with a \$10 million limit, the insurer would have to immediately reserve \$7,440,939. This would result in a prohibitively high premium. "Nobody in their right mind would pay for that coverage," he said.

On April 10, however, Mr. Corcoran said in a supplement to his original letter that he had given "further consideration" to the effect his policy would have on New York banks and leasing companies and its "sudden negative impact" on the state's economy.

As a result, he extended the deadline for writing residual value policies to July 15 and said any policies that expire before that could be renewed. He also said any policies now in effect could continue until their expiration date.

In the meantime, legislation that would permit insurers to underwrite residual value policies has been written, and sponsors in both houses are now being sought.

Patrick Foley, vp and associate

general counsel for American International Group Inc., who helped write the legislation, is optimistic it will pass. AIG is among the insurers that occasionally underwrite residual value policies.

The New York department's concern with residual value insurance may be just another bump in the road to growth for the product, which has recovered from a stum-

bling start and is now running along at a swift pace.

It stumbled on a \$388 million loss suffered by Lloyd's of London syndicates on policies they issued in the late 1970s to computer leasing companies guaranteeing the value of their leases.

Even though the policies were not residual value per se, the losses

*Continued on next page*



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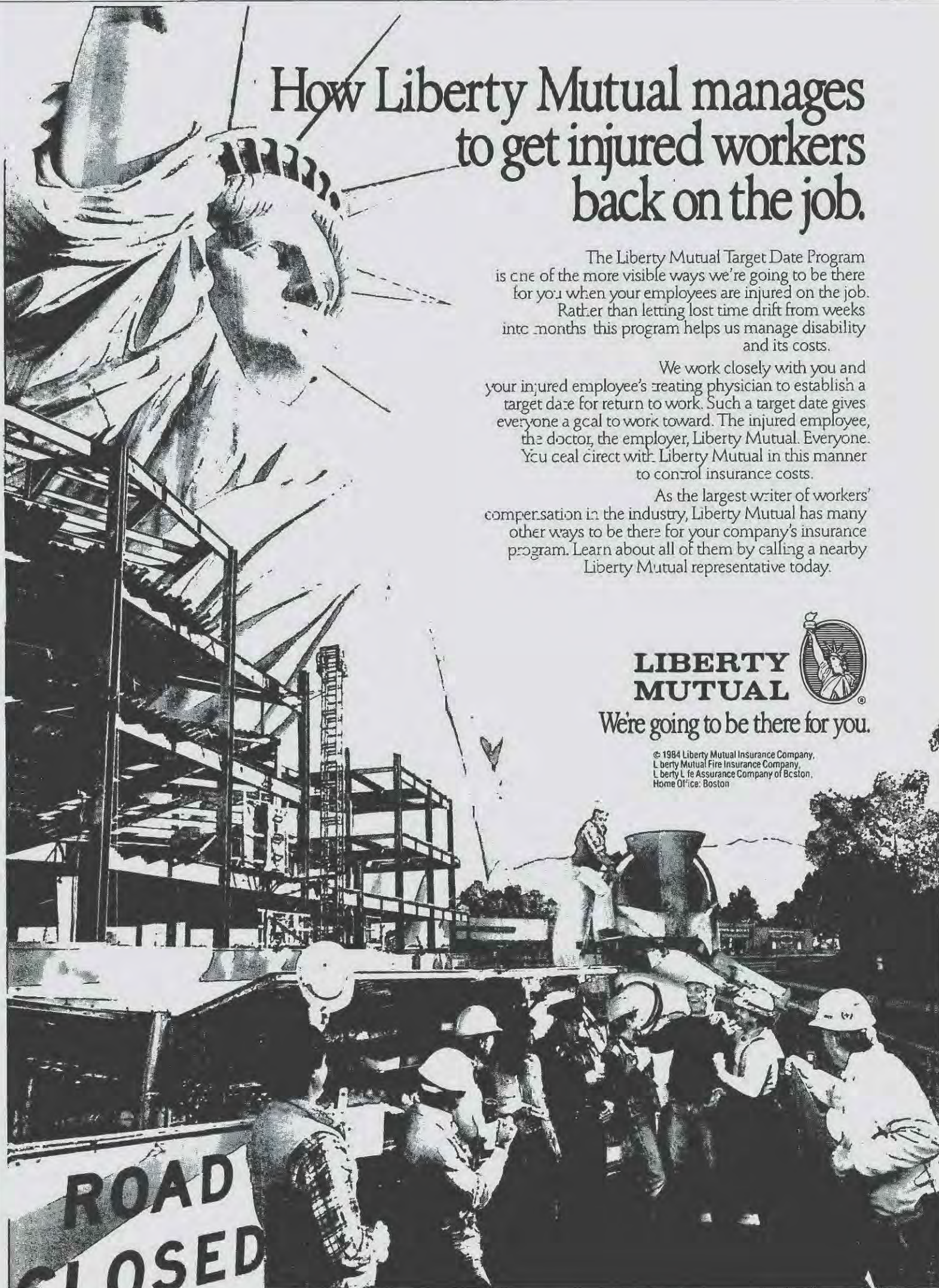
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## Residual value

Continued from previous page  
scared some underwriters away.

True residual value insurance guarantees the value of the equipment in the future.

Residual value coverage permits financial institutions in particular to price leases more competitively and all companies in general to strengthen their balance sheets by carrying equipment at the insured residual value rather than at the book value, which is normally lower.

Insurers and brokers estimate that more than \$30 million in premiums were written in residual value insurance last year.

"It is clearly expanding rapidly," says Douglas G. Morris, president of D.G. Morris Inc. in New York, a subsidiary of Corroon & Black Corp. Mr. Morris has been involved in underwriting residual value insurance for several years.

The assets most commonly insured under residual value insurance policies are commercial and corporate aircraft and railroad rolling stock, but machine tools, automobiles, telephone systems and computer equipment have been insured as well.

The biggest users of residual value insurance to date have been financial institutions.

Under the Federal Reserve Board's Regulation Y, bank holding companies cannot assume at the end of a lease that an asset is worth more than 20% of the acquisition cost. Similarly, under Regulation 7.3400, the controller of the currency says that bank leasing subsidiaries are limited to assuming 25% of the acquisition cost.

The insurance permits leasing subsidiaries of bank holding companies and banks to assume a higher value on their books for leased assets, making higher-risk, short-term operating leases feasi-

ble.

For instance, to price a lease competitively, a bank holding company may be able to recover just 60% of an asset's cost in leasing income. It is allowed to assume an additional 20% of the value, and the other 20% would be covered by residual value insurance.

Without the insurance to recover its cost, the holding company would have to charge rates that would permit it to recover 80% of the asset's value, and, perhaps, price itself out of the market.

The coverage is used by financial institutions in other ways.

Vince Kolber, president of Residual Based Finance Corp. in Chicago, which sets up deals involving residual value insurance, says he recently worked with two banks that were each partners in 450 leased railroad cars.

The banks wanted to sell their equity position in the lease. The 15-year lease had seven years remain-

ing, but because it was a leveraged lease, all the leasing income went to retire the remaining debt on the cars. "Consequently," Mr. Kolber says, "for a new investor, there was no immediate cash return for the next seven years to the lease expiration point."

Mr. Kolber found an investor willing to purchase the cars. Residual value insurance bought by the investor insured that the cars would have a value of \$2,500 per unit, or \$5,625,000, seven years in the future.

A 14.5% interest rate was agreed upon. The net present value of \$5,625,000 seven years from now, with a 14.5% interest rate, is \$2,075,000. The new investor paid the \$2,075,000 to the banks. This permitted him to book as income one-seventh of the \$2,075,000, plus 14.5% interest, every year for the next seven years. This will net out to \$5,625,000 at the end of seven years, when he will be able to take

possession of the cars.

The insurance means the investment is protected in the event the cars are worth less than \$5,625,000 at that time. The banks, in turn, were able to book the entire \$2,075,000 as income immediately.

While banks continue to be major users of residual value insurance, "right now we're almost in a transitional period" with other types of companies becoming interested as well, says J. Francis Sinnott, a vp with Johnson & Higgins in San Francisco.

"Pretty sophisticated, larger companies" are buying residual value insurance as a means to write up their assets, cutting back on the need for borrowing and enhancing their credit, Mr. Sinnott says.

The "most consistent players" in the residual value field, Mr. Roberts says, include Clarendon, which has an underwriting services agreement with General Reinsurance Services Corp., a subsidiary of General Re Corp., and Old Republic International Corp., through its White Plains, N.Y.,-based Residual Value Managing Co. Other major insurers, he says, are involved on an "in and out" basis.

For instance, a spokesman for Prudential Reinsurance Co. in New York says, "We do have some existing contracts, but we're not what you'd call a big player in this area."

In December, Traveler's Insurance Co. became involved in the field in an indirect way as well, when it agreed to provide coverage for \$100 million on guarantees written by International Capital Equipment Ltd. in Chicago, says Robert G. Clark, ICE's chairman and president. ICE will continue an ongoing relationship with Employers Reinsurance Corp. as a reinsurer as well.

ICE guarantees the future value of capital equipment through a commercial contract, called an Equipment Purchase Agreement, under which it agrees to buy the equipment at a certain date and at a particular price, Mr. Clark says. ICE is not an insurance company. While its product is similar to insurers' residual value policies in its concern with equipment's future value, he says it is more of an extension of the futures market.

But, behind ICE stand its reinsurers, guaranteeing ICE will pay.

Residual value underwriters tend to have various specialties, Mr. Morris notes. Clarendon, for example, handles aircraft of all types, railroad cars, automobiles, trucks, real estate and, under "very special circumstances," certain types of peripheral computer equipment. But, it does not underwrite oil rigs or barges, which are handled by other companies.

Mr. Sinnott says residual value generally costs 2% to 10% of the asset's residual value, although he has handled contracts that have been as high as 16%.

Total market capacity is estimated at \$2 billion by Mr. Roberts.

"On capital assets like airplanes, \$15 million is probably the higher per unit per capacity," says Mr. Morris, adding, that this could be increased by facultative insurance.

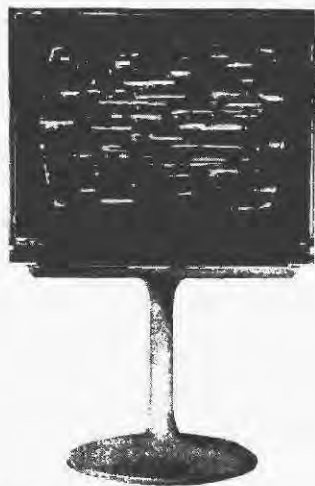
Major brokers who handle residual value accounts include Alexander & Alexander Services Inc., Marsh & McLennan, Johnson & Higgins, Rollins Burdick Hunter Co. and Corroon & Black, notes Mr. Napier of Gen Re.

While there are no figures available on the overall loss ratio for residual value insurance, Mr. Roberts says it has been low.

The primary risk in underwriting a residual value policy, especially with aircraft, is that of an economic downturn, Mr. Roberts says.

A secondary worry, he says, is technological obsolescence of the equipment. This concern, he says, explains why no coverage has been written for medical technology. ■

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**JUNE 12. New England Employee Benefits Council** meeting in Boston; \$25 for members, \$55 for non-members. Judy Stevens, New England Employee Benefits Council, P.O. Box 2594, Boston, Mass. 02208; 617-423-6146.

**JUNE 12-13. Product Safety and Liability Prevention** workshop in Madison, Wis., sponsored by the University of Wisconsin-Extension; \$495. Prof. Richard A. Moll, Engineering Department, 432 N. Lake St., Madison, Wis. 53706; 608-263-4712.

**JUNE 13-15. Advanced Safety Management** seminar in Atlanta, sponsored by the International Loss Control Institute; \$350. Also **Sept. 17-19** in Atlanta. Richard Jump, International Loss Control Institute, Highway 78, P.O. Box 345, Loganville, Ga. 30249; 800-554-6001 or 434-466-2208.

**JUNE 13-15. Risk Management Information Systems** course in San Francisco, sponsored by the Risk & Insurance Management Society; \$545 for members; \$645 for non-members. Claudia

Shnider, Administrator-Continuing Education Program, RIMS, 205 E. 42nd St., New York, N.Y. 10017; 212-286-9292.

**JUNE 17-20. 17th Annual Loss Prevention** seminar in Dallas, sponsored by the National Retail Merchants Assn.; \$295 for members; \$435 for non-members. Tomi Block, National Retail Merchants Assn., 100 W. 31st St., New York, N.Y. 10001; 212-244-8780.

**JUNE 18-19. Practical Law & the Security Manager** seminar in Arlington, Va., sponsored by the American Society for Industrial Security, Education & Seminar Programs Department, Suite 1200, 1655 Fort Myer Drive, Arlington, Va. 22209; 703-522-5800.

**JUNE 18-20. 1984 Food Industry Institute Employee Benefits** program in Lake Tahoe, Nev., sponsored by the International Foundation of Employee Benefit Plans; \$420 for members; \$495 for non-members. IFEBP, P.O. Box 69, Brookfield, Wis. 53005; 414-786-6700.

**JUNE 18-20. Planning an EDP Disaster Recovery Program** seminar in Atlanta, sponsored by the Computer Security Institute; \$750 for members; \$795 for non-members; group discounts are available. Computer Security Institute, Educational Resource Center, Department ERC, 43 Boston Post Road, Northborough, Mass. 01532; 617-845-5050.

**JUNE 18-22. Industrial Ventilation Fundamentals** course in San Diego, sponsored by the University of Southern California; \$650. University of Southern California, Institute of Safety and Systems Management, Office of Extension and In-Service Programs, Los Angeles, Calif. 90089; 213-743-6523/24.

**JUNE 18-22. Loss Control Management** seminar in Atlanta, sponsored by the International Loss Control Institute; \$625. Also **Aug. 6-10** in Atlanta. Richard Jump, International Loss Control Institute, Highway 78, P.O. Box 345, Loganville, Ga. 30249; 800-554-6001 or 404-466-2208.

**JUNE 19-20. Health Agenda 1984-85: Public and Private Strategies** conference in Washington, co-sponsored by the Washington Business Group on Health and the National Assn. of Manufacturers; \$350 for members, \$450 for non-members. Washington Business Group on Health, 922 Pennsylvania Ave. S.E., Washington, D.C. 20003; 202-547-6644.

**JUNE 19-21. Risk Management in Environmental Health and Protection** summer institute in New York, sponsored by New York University's Graduate School of Public Administration; \$525. Charles Nicolson, Summer Institute in Risk Management in Environmental Health and Protection, Graduate School of Public Administration, New York University, 4 Washington Square N., New York, N.Y. 10003; 212-598-3133.

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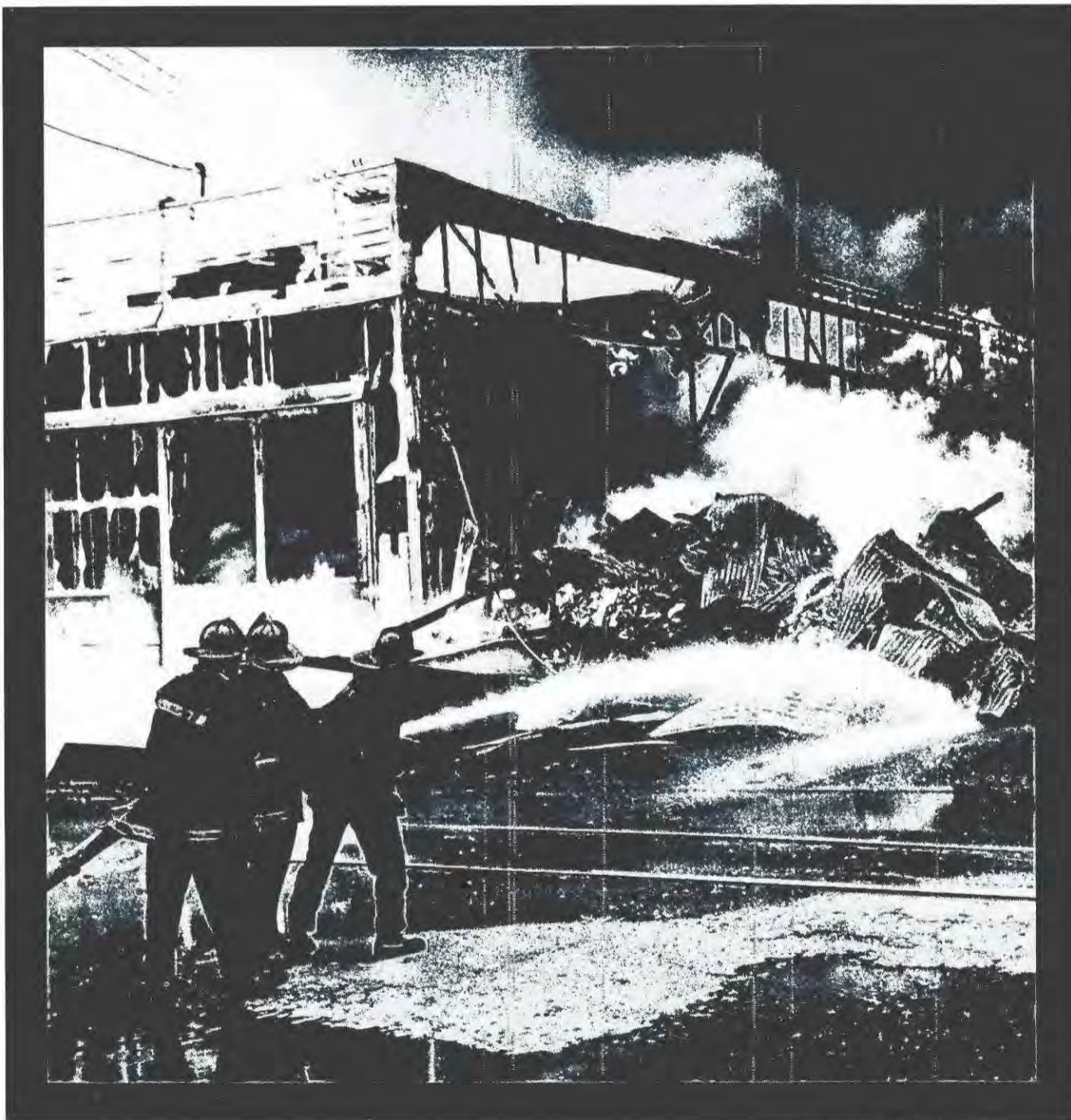
**JUNE 20-22. Reinsurance Concepts** course in New York, sponsored by Risk & Insurance Management Society; \$495 for members; \$595 for non-members. Also **Oct. 1-3** in San Francisco. RIMS, 205 E. 42nd St., New York, N.Y. 10017; 212-286-9292.

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**JUNE 22-26. Second Annual Health Promotion Strategies** conference in Portland, Ore., sponsored by Kaiser-Permanente; \$285; \$260 before May 15; group discounts are available. Kaiser-Permanente Department of Community Medicine, 3600 N. Interstate Ave., Portland, Ore. 97227; 503-280-2050, ext. 2359.

**JULY 30-31. Dollars and Sense of Communicating Employee Benefits**, conference in New York City, sponsored by Business Insurance; \$545; 10% discount for additional registrants from same company. Ann Vazquez, Registrar, Business Insurance, 220 E. 42nd St., New York, N.Y. 10017; 212-210-0137.

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# Movie producers buy bonds to guarantee film completion

By STEVE TARAVELLA

LOS ANGELES—While cameras focused on actors Michael Douglas and Kathleen Turner careening through a mudslide in the smash-hit movie "Romancing the Stone," Film Finances Inc. was watching closely from the sidelines.

Film Finances is one of several markets for motion picture completion bonds, which guarantee a film's investors that the movie they're sinking money into will be finished.

Film Finances guaranteed delivery of "Romancing the Stone" and monitored progress on the \$10 million romantic adventure daily throughout its production.

Completion bonds are not commonly purchased by major movie studios, like 20th Century-Fox Film Corp. or Paramount Picture Corp., which have the financial resources to absorb the loss if a project doesn't make it off the studio lot.

Rather, the bonds are most frequently purchased by independent production companies that can't lure financial backing without guaranteeing investors that the project will be completed—an unfinished film has no value.

Bond guarantors say they are experiencing a marked increase in the number of films seeking completion guarantees. But, the increase is not due to a greater number of films being produced. Major studios and independent production companies release a consistent number of films annually, about 140.

The increase, instead, is attributed to a shift in the players. More films are being made by the independent production companies that lack big-studio support. And, these films are being financed by investors outside of the traditional film community, who are leery of pouring funds into a project they're not certain will ever see the screen. Ever-increasing film budgets also are causing investors to clamor for completion bonds.

The major studios themselves are occasionally turning toward the guarantees to ensure completion of films they are "picking up" from independent producers to meet studio distribution contracts.

Lindsley Parsons Sr., executive vp at Film Finances, says the head of a major studio recently told him, "We have to have about 20 pictures a year to satisfy our distribution requirements. Here on the lot, we have the capacity to make six or seven—we just don't have the manpower to go beyond that. The other 12 or 13 have to be outside, independent productions, so it's worth a million dollars a picture for us to have a guarantee on them."

As recently as two years ago, about 20% of the films produced in the U.S. were guaranteed with completion bonds, estimates C. Scott Milne, president of Albert G. Ruben & Co. Inc., a brokerage subsidiary of Alexander & Alexander Services Inc. that specializes in entertainment-related risks.

Mr. Milne estimates that in the next year or two that fig-

ure may rise to 35%.

Until only a few years ago, American films that sought completion guarantees purchased them from what may have been the only available market—Film Finances Ltd., the London-based parent of Film Finances Inc.

But in the early 1980s, particularly in the wake of "Heaven's Gate," the market opened up.

"Heaven's Gate," a critical and box office failure released in 1980 by United Artists, went way beyond its budget and nearly brought the studio to ruin. UA did not have a completion guarantee on the film, which is reported to have exceeded its \$18 million budget by some \$27

million. Some say it was the severe loss on this picture that forced UA to merge with Metro-Goldwyn-Mayer a year later, forming MGM/UA Entertainment Co.

Today more than a dozen companies issue the bonds worldwide.

The market is dominated by The Completion Bond Co. in Beverly Hills, which wrote its first bond in March 1981 and expects to issue 25 more this year, and by Film Finances, which opened its U.S. office in Hollywood in June 1982 and has since issued bonds on about 80 films.

In its simplest form, a completion guarantee assures that a film will

*Continued on next page*



Photo: 20th Century-Fox Film Corp.

Film Finances Inc. guaranteed completion of 'Romancing the Stone,' starring Michael Douglas and Kathleen Turner.

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Photo: Ladbroke Entertainments Ltd.

Completion Bond experienced a sizable loss on Barbra Streisand's recent film, 'Yentl,' from MGM/UA Entertainment.

## Bonds guarantee film completion

Continued from previous page

be finished, that its producers will not have to spend more than a certain amount above their budget, and, often, that the completed film will be delivered by a certain date.

"Whether we budget a film at \$5 million or at \$15 million, that's what we expect it to come in at. If it comes in at \$20 million (and was expected to come in at \$15 million), that's a \$5 million overage. The price of the bond is minimal compared to the potential there for loss," says Linda S. Hunt, insurance administrator for Lorimar Productions Inc. in Culver City, Calif.

In a typical scenario, a production company that is denied backing for a \$10 million film by cautious banks or private investors turns to a completion guarantor.

When deciding whether to issue

a completion bond on a picture, guarantors examine its script and its shooting and production schedules to determine if the project can be completed within the confines of the budget.

Guarantors also review the track records and past work performances of the major people involved, including the director, producers, cinematographer, art director and chief of special effects.

Guarantors nearly always require that all insurable risks associated with the film be covered appropriately. The standard production package includes cast insurance, third-party liability, faulty (film) stock and camera coverage, negative insurance, props coverage, errors and omissions coverage and workers compensation insurance.

The bonding company, once sa-

tisfied that the film's chances for safe completion are good, issues a letter of intent to guarantee completion, dependent on the producer's attaining financing. The investors, now reassured that their money will yield something tangible, provide the funds.

A production is allowed a certain overage—generally 10% of the budget—before the bond can be tapped. The fee for the bond is a percentage of the film's budget; the going rate is 6%.

These percentages, however, are negotiable and vary according to the size of the project. On large-budget films, guarantors will frequently take a smaller fee if the production company will assume a larger contingency.

But the producers of a film with a \$10 million budget would typically need \$11.6 million—the \$10 million budget, the \$1 million contingency, and the \$600,000 fee.

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When a bonded film is completed within budget, the guarantor returns to the production company between 20% and 50% of the fee it paid for the bond. On a \$10 million picture, that bonus could vary from \$120,000 to \$300,000.

El Corazone Producciones S.A., the production company organized by producer/actor Michael Douglas for "Romancing the Stone," received a bonus of "less than a quarter of a million dollars," Mr. Parsons notes. The film went over its budget, but did not pierce its contingency, he says.

Mr. Parsons says he took a survey of 44 recent films by various production companies, and found that only three exceeded their budgets: one by 22%, one by 18%, and one by 10%. "Most films come in (within budget) but the runaways can be disastrous," he notes.

If a film exceeds the budget and pierces the contingency, the guarantor is responsible and generally has two options: providing the producer with the funds needed to complete the film or stepping in and taking over production.

The guarantor can take full control of a production as soon as it senses things running awry, and even has authority to fire anyone involved in the project, including the producer and director.

The situation rarely gets to this point. Guarantors watch progress on a film closely and periodically pitch in to keep production flowing smoothly. Completion Bond, for example, has a representative on location for most of the films the company guarantees.

Film Finances, which estimates it has assumed control of less than 3% of the films it has guaranteed in 34 years, prefers to monitor its pictures through daily telephone or telex communications with someone on the set, generally the production coordinator.

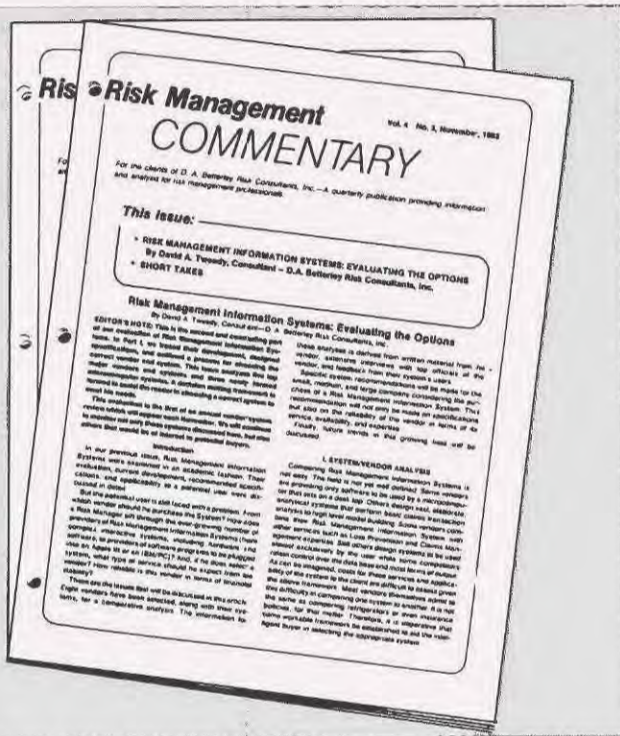
Mr. Parsons points out that weather problems and hazardous filming conditions involved in "Romancing the Stone"—an action and adventure story shot almost entirely in the Mexican wilds—made that film an exception, and someone from Film Finances was on the set throughout production.

"Very seldom do we put anybody on the set. But if we saw that a picture was running into trouble, we might send somebody out," says Mr. Parsons, who points out that he is often "that somebody."

If both the producer and the bond company fail to keep the film within its budget, chances are that the funds needed to complete production will be paid by the guarantor's insurance, frequently referred to as "reinsurance" by the parties involved because of the coverage's backup nature.

Continued on facing page

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Continued from facing page

Completion Bond, for example, insures all of its bonds with Fireman's Fund, generally for the amount of the original budget. The bond company, now a policyholder, pays a premium for the coverage but is not subject to a deductible.

"Since we get the major part of the risk, we get a pretty good percentage of the total premium charged (to the production company by the guarantor)," says Richard T. Barry, manager of the entertainment division at Fireman's Fund in Beverly Hills.

He declined to discuss current rates, but says Fireman's Fund has taken in more than \$2 million in premium on this line since it began its relationship with Completion Bond more than two years ago.

Guarantors and insurers say if the business is handled properly and a good film makes it onto the screen, there is little room for losing money because when the guarantor puts up money, it is reimbursed if the film is profitable.

"You're always in a recoupment position, (although) it's at the mercy of the box office," explains Bette L. Smith, president of Completion Bond.

Completion Bond experienced a sizable loss recently on MGM/UA's "Yentl," but expects to recoup from the film's profits after ancillary rights to the picture are sold.

"Yentl" is the first substantial loss of the 55 films the company has guaranteed, Ms. Smith says.

While she will not specify how much money it had to kick in after the film's contingency was pierced, she says it was more than \$1 million. The film operated with a budget of more than \$15 million.

"We knew it (the film) would either go very well or the bottom would slightly go out of the barrel, and it did," she says. "But we're projecting that we'll get the money back." Completion Bond's recoupment is about a year down the road, she adds. Guarantors generally recoup after the investors.

She says "Yentl" was an unusual risk for a number of reasons:

- Unlike most of the films the company bonds, this was backed by a major studio, MGM/UA.
- It was a musical, which tends to take longer to complete than other production forms.
- The producer, director and star were the same person, Barbra Streisand and it was Ms. Streisand's first time out as a director.

Although Completion Bond insured its "Yentl" guarantee with Fireman's Fund, the guarantor did not tap the insurer for the loss, but rather absorbed it itself.

"I was very protective of my market, and want to work with that market for many years to come. We feel our bond is the strongest in the marketplace because of Fireman's Fund," Ms. Smith explains.

Completion Bond did, however, tap Fireman's Fund when "Heart Like a Wheel" required an additional \$80,000 to complete.

Both Ms. Smith and Completion Bond's executive production administrator, Alan Wilson, acknowledge that the company has not been profitable in the past, partly because competition has thrust it into some costly concessions.

"We spend a lot of our fee helping directors bring films in within budget, only to turn around and give away 50% (in no-claim bonuses)," Ms. Smith says. She says that the company will be profitable in a few years, "but right now we're having to spend an awful lot of money."

Mr. Wilson says the company, which has guaranteed about 55 films with a total production budget of more than \$500 million, expects to bond an additional 25 productions in 1984.

Film Finances self-insures most of its completion guarantees, and

absorbed a \$1.9 million loss in 1980 on "Bear Island," a film released by Taft International Pictures.

Film Finances maintains a \$20 million cast catastrophe policy at Lloyd's of London to guard against severe, unexpected losses, but Mr. Parsons says Film Finances has never tapped the insurance.

Film Finances purchases insurance from Lloyds on only 5% to 10% of its completion bonds, generally on those pictures with large budgets or difficult locations, he adds.

Although most completion guarantees also specify a date by which the film will be completed, investors and studios rarely take issue if a film is late.

"I don't know of any claim based on non-delivery-on-time. Financiers have no objection to extending time as long as the project is sound," says Albert Rieder, executive vp at Howard-James Co., an underwriting manager for Lloyd's based in Sherman Oaks, Calif. ■

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# Insurers guaranteeing lease payments

By STEPHEN TARNOFF

Lease guarantee insurance is beginning to carve itself a niche alongside other types of financial guarantee coverages, insurers and brokers say.

The insurance, which so far has predominantly covered leases of heavy equipment to municipalities and other public entities, guarantees that payments will continue to be made if the lessee defaults.

Because municipalities and corporations are becoming more interested in leasing—rather than purchasing—capital equipment, some insurers and brokers say they expect the coverage to become much more widespread in the future.

The coverage is purchased by, for example, an investment banker on behalf of individuals, banks or other financial institutions that invest in certificates of participation issued by an equipment-leasing company. The certificates are used to help finance the lease.

Currently, lease guarantee insurance is still a relatively new and not widely sought product, though brokers and insurers are reporting an increasing number of inquiries.

Most of the lease guarantee policies that have been sold are for municipal leases, though some commercial lease coverage is being written on a manuscripted basis. Municipalities are generally thought to be a better risk.

"We expect it (municipal lease insurance) to be very much a growing market," says Benjamin Veit, manager of financial products for Continental Insurance Co. in New York, which has just begun to write the coverage.

"They are very valuable instruments and open the market to institutional investors who have restrictions on the quality of investments they might make."

Municipalities leased equipment valued at \$2 billion in 1982 and \$3 billion in 1983, points out Peter Livaich, vp of Municipal Lease Insurance Managers Inc. in Nashville, Tenn., which writes municipal lease insurance as the exclusive managing general agent for Fireman's Fund Insurance Cos.

"It is expected to continue to grow."

In a typical scenario, a municipality leases capital equipment because it costs too much to purchase outright, but the cost of the equipment is not high enough to warrant a bond issue, explains Douglas Morris, president of D.G. Morris Inc., a New York subsidiary of Corroon & Black Corp. that brokers lease insurance.

Such equipment might include a fleet of fire trucks, street sweepers, other rolling stock, electronic data processing equipment or telephone systems.

Municipal lease insurance will cover the payment if the municipality fails to appropriate money for the equipment. The failure can occur for a number of reasons—like an incoming administration's opposition to the lease or a city's financial problems.

Under the terms of the policy, the insurer will step in and pay the principal and interest to the investors if the municipality for any reason fails to make payments.

The insurer can then repossess the equipment for the term of the lease and re-lease the property.

"If the municipality in the course of the transaction becomes insolvent, the investors lose money," explains Joel Aronchick, national manager for Chubb's Corp.'s commercial marine department in Short Hills, N.J.

"We guarantee the money that is not paid back and the interest up to

the time of default, subject to policy terms. This is state-of-the-art financing as far as municipalities are concerned," Mr. Aronchick adds.

So far, the major admitted companies involved in lease guarantee coverage in addition to Chubb are Continental Insurance Co., Old Republic Insurance Co. and Fireman's Fund. Southampton Insurance Co. Ltd., a surplus lines underwriter based in Bermuda, also offers the coverage on a non-admitted basis.

The newest player is Continental, according to Mr. Veit. "It's so new we are just now beginning to entertain submissions," he says, noting the company is working on a few deals right now.

Rates depend on such factors as the size and complexity of the risk, the kind of property involved, the term of the lease and the credit rating of the municipality.

Municipal leases often run for three- to five-year terms, but the length of the leases can last longer

depending on the useful life of the equipment. But, generally, the leases do not run less than two years nor more than 10, brokers and insurers say.

Generally the average lease term is about five years, says Mr. Aronchick. "The shorter the better."

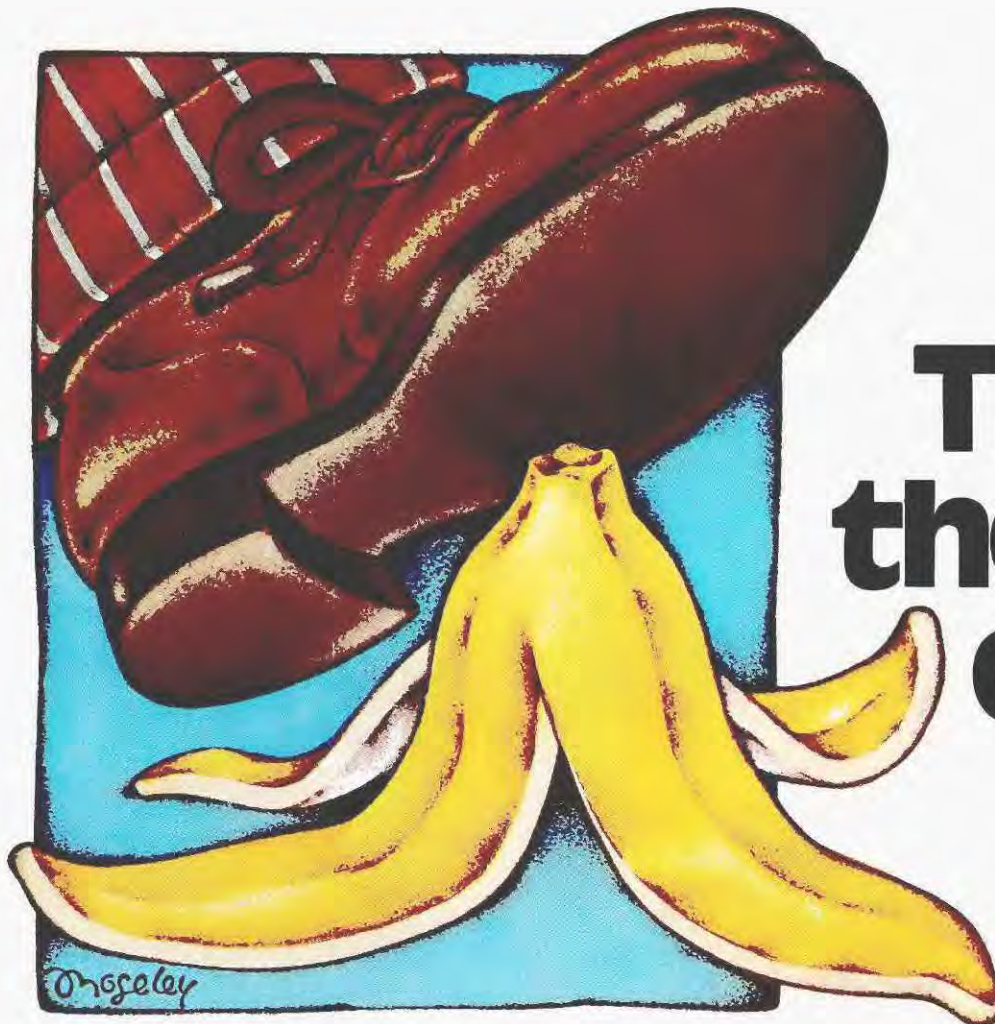
According to Mr. Morris, the average premium rate is 2% to 3% of the cost of the equipment. Thus for a piece of equipment valued at \$100,000 with a five-year lease, the average premium for a lease guar-

antee policy might be \$2,500, he adds.

The leased equipment must have a value of at least \$100,000 for his agency to consider the risk, Municipal Lease's Mr. Livaich says. But where certificates of participation are used, the agency will usually limit coverage to equipment with a value of \$1 million or more to substantiate the additional costs.

The coverage has virtually no limit, he adds, noting that insur-

*Continued on facing page*



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Continued from facing page  
ance has been written on a lease of \$40 million of equipment, including rolling stock and computer equipment, to a major city.

In addition, insurance can also be issued on a portfolio of several leases, Mr. Livaich says, noting that some of the portfolios have had equipment values of \$50 million or \$60 million.

Mr. Aronchick, however, says that the largest lease he has seen on capital equipment alone is \$4 million.

He adds that Chubb will only market this type of insurance for "essential" items, like ambulances, where there is greater likelihood

that the city will not walk away from the lease.

"Leases with municipalities aren't backed by the full faith and credit of the community," he explains. "It's completely different from general obligation bonds. It's far riskier."

"We've been very careful and very, very selective," he adds, noting that the company is not writing all the risks it sees, even though it receives many requests.

So far, there have been few if any losses.

"There's been very few defaults," says Raymond K. O'Neil, senior security analyst at Fireman's Fund. "But the real question is

what kind of losses there will be in bad economic times.

"Even in the worst times, public agencies make an effort to pay debts, but this is different from debt. This is something that municipalities can walk away from."

Even so, Mr. O'Neil says that the public necessity of the equipment often makes it less likely that the municipality will fail to pay.

Although relatively few policies guaranteeing municipal leases have been written, even fewer policies guaranteeing equipment leases to private companies are in force.

"Except for the occasional 'one-off,' it's almost a non-product right now" says one broker. "It is a prod-

uct area that people will look to, but it is far from a developed product."

"It will definitely develop, but the question is when."

"The potential market is unknown," Mr. Aronchick says, pointing out that no one has yet approached Chubb for this coverage.

He notes that many large companies that lease equipment investigate the credit of the lessee and may not feel a need for such insurance.

Richard A. Erlanger, manager of financial services for Alexander & Alexander in New York, agrees that commercial lease guarantee insurance is not fully developed.

"It's not a standard product, but that doesn't mean you can't get insurance for it," he says.

"They (insurers) are looking at deals," he says. "They're not as interested in product areas as the quality of deal produced before them."

While Mr. Erlanger says that the cost of the coverage is variable, insurers generally won't look at a lease for equipment valued at less than \$1 million or \$1.5 million, he says.

"We're getting a lot of calls," he adds, but notes that only one in 10 are high-enough quality that they will try to place it.

Alexander & Alexander only began placing lease coverage within the past year, but has already placed three or four policies, a mix of commercial and municipal business, not naming the underwriters.

One company that currently underwrites lease guarantee insurance for private companies and municipalities as well as other financial guarantee products is Southampton Insurance Co. Ltd. in Bermuda, an affiliate the Ivanhoe Insurance Group of Toronto.

"I feel especially comfortable with lease guarantee business," says Southampton President Warren H. Larson. "It's good business with low probability of losses."

Mr. Larson agrees that a policy written for equipment leased to private companies is being done on a manuscript basis.

"We have an aggressive interest in looking at almost anything," he explains. "Our book of business tends to be the one-off type."

But he says that it does not take much more effort to write commercial lease coverage than it does to write insurance for a municipal lease.

"Very often if it's a fleet of trucks, trailers or copy machines, very minor adjustments in a manuscript form is all it takes," he says.

Furthermore, because Southampton is an approved non-admitted insurer in 40 states, Mr. Larson contends that the company has more flexibility than the larger insurers to deal with this type of insurance.

"We can act quicker and have freedom from rate and form regulation," compared with admitted insurers, he adds, noting that Southampton is also willing to take more risks.

Mr. Larson notes that many insurers turn over this type of insurance to the surety department, which tends to look for an insured with a zero probability of loss and thereby come up with a lower premium.

For the right price, however, Southampton will write a risk that is lower-quality than a surety risk, he says. "I think there's an opportunity for writing business above pure surety."

Every rate is negotiated, with the premium paid up front, he says. On certain lease contracts there may be a split with one-half upfront and one-half on the first anniversary, although in these cases there's an extra charge for the delayed payment.

Mr. Larson says he usually requests a rate of about 7.5% to 8% of the insurer's maximum liability on the risk, because of the higher risks involved in commercial leasing, but lower rates are possible.

Southampton will write policies on leases of up to five years in length, he says, adding that it will write both direct coverage and reinsurance for the risk.

To write more than the \$640,000 per risk that Southampton has immediately available, it must obtain facultative support, he notes.

Mr. Larson says that Southampton has seen "one possible claim" and has been alerted to a second possible loss, although he adds that the company has never completely "processed" a claim. ■

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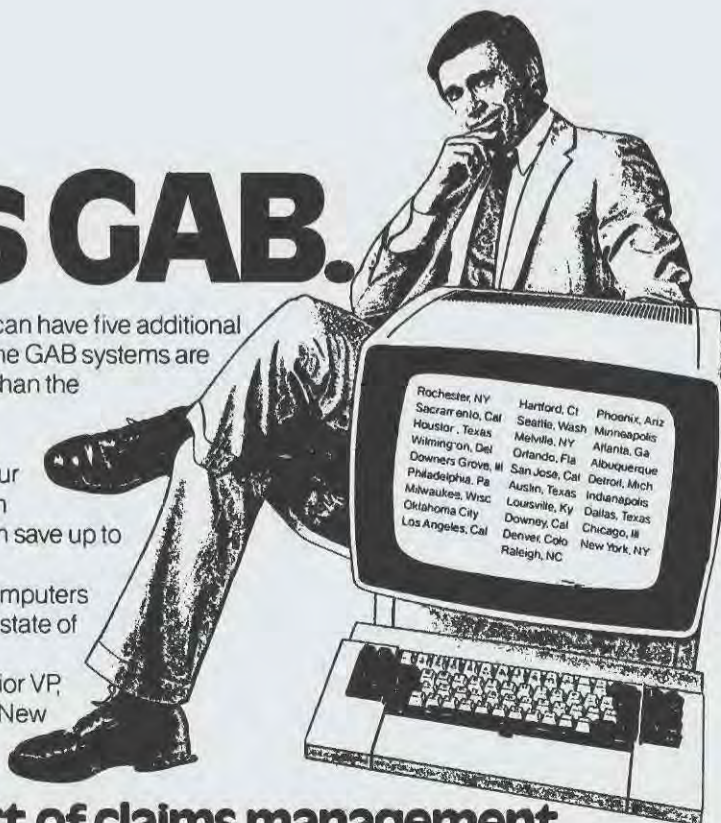
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# Few money market funds buying coverage

By JUDY GREENWALD

NEW YORK—About a year and a half ago, guaranty insurance for money market mutual funds looked like it would be a "hot" new insurance product (BI, Dec. 20, 1982).

Today, only two of the more than 330 existing money market funds have coverage guaranteeing deposits, and no efforts are being made to market the coverage.

Observers say fund managers decided the insurance was not worth the cost.

Interest in money market fund guaranty insurance was sparked by the passage in 1982 of the Garn-St. Germain Act, a federal banking law that permitted banks and thrifts to offer high-interest money

market accounts and compete directly with money market mutual funds beginning Dec. 14, 1982.

The Federal Deposit Insurance Corp. and the Federal Savings & Loan Insurance Corp. automatically guarantee banks and thrift deposits for up to \$100,000 per account.

No similar commercial insurance existed for money market funds in 1982, but when the Garn-St. Germain Act was passed, the fund managers believed they needed such coverage to compete effectively with the banks and thrifts whose customers knew their deposits were protected by federal insurance.

A major push for an insurance product to serve the money markets came from the Washington-

based Investment Company Institute, a trade group that represents mutual funds. In October 1982, ICI began working with Johnson & Higgins, Aetna Casualty & Surety Co. and CIGNA Corp. to develop a money market fund insurance product.

The discussions ended in April 1983, without a product being developed, says Richard Pogue, senior vp of management for ICI.

During the discussions, it became clear that the final product would have been too expensive and offered too little capacity, Mr. Pogue says, adding that a policy was never even proposed.

"What they wanted and what they wanted to spend did not coincide. The client lost enthusiasm," agrees a CIGNA spokesman.

A main reason for the lost of interest in the coverage was the sharp drop in short-term interest rates in 1982 and 1983 that narrowed the gap between the interest rates earned on government securities and mutual funds' yields.

Mike McAteer, vp of the financial institutions divisions for New York-based broker Marsh & McLennan Inc., points out that if short-term government securities have a 9% yield and commercial AAA-rated funds have only a 10% yield—and then the cost of insurance lowers the commercial funds' yields by 0.75%—customers will pick the safer government securities.

"It just did not make a heck of a lot of sense" to introduce an insurance policy, says Mr. McAteer, who

also worked with a number of money market funds on the insurance issue.

Mr. McAteer notes that a series of new money market funds, including ones that offer government securities or invest only in insured municipal bonds, also have been introduced.

"There are ways of doing it (protecting funds) outside of out-and-out guaranteeing the market fund," Mr. McAteer says. Financial guarantee insurance is only one way of solving the problem of security.

The two money market policies that do exist are one underwritten by St. Paul Fire & Marine Insurance Co. for a fund managed by Vanguard Group of Valley Forge, Pa., and one Travelers Corp. underwrites for a money market fund managed by Capital T, a Travelers' subsidiary.

The Vanguard Group has coverage for the full value of its \$22 million no-load money market fund and the limits could increase to \$500 million if the fund grows that much, says Jerald Stevens, president of Vanguard Group. The premium paid was one-third of 1% of the fund's assets.

The policy indemnifies the fund if any individual bond within the portfolio defaults or if a flurry of (investor) redemptions necessitates the fund cashing out on a loss.

"We step in and make up that difference," says James L. Boudreau, treasurer of St. Paul. No losses have been paid to date.

Mr. Stevens says Vanguard bought the insurance to interest investors who were attracted by bank money market accounts, which have FDIC coverage.

Vanguard started trying to obtain insurance coverage in 1982, notes Mr. Stevens, in the hopes of introducing an insured money market product before Dec. 14, 1982, when banks and thrifts were permitted to introduce money market deposit accounts.

"We wanted to be ahead of them," he says. The product, though, was not ready until February. Still, Mr. Stevens says the fund was able to attract some attention from the insurance-conscious segment of the public. "We're pleased with the product," he says.

Vanguard has no immediate plans, however, to purchase insurance for any other of its funds, Mr. Stevens says. It already operates funds, such as a fund that invests in government-backed mortgages, that appeal to investors who wanted a fixed, secure investment, he notes.

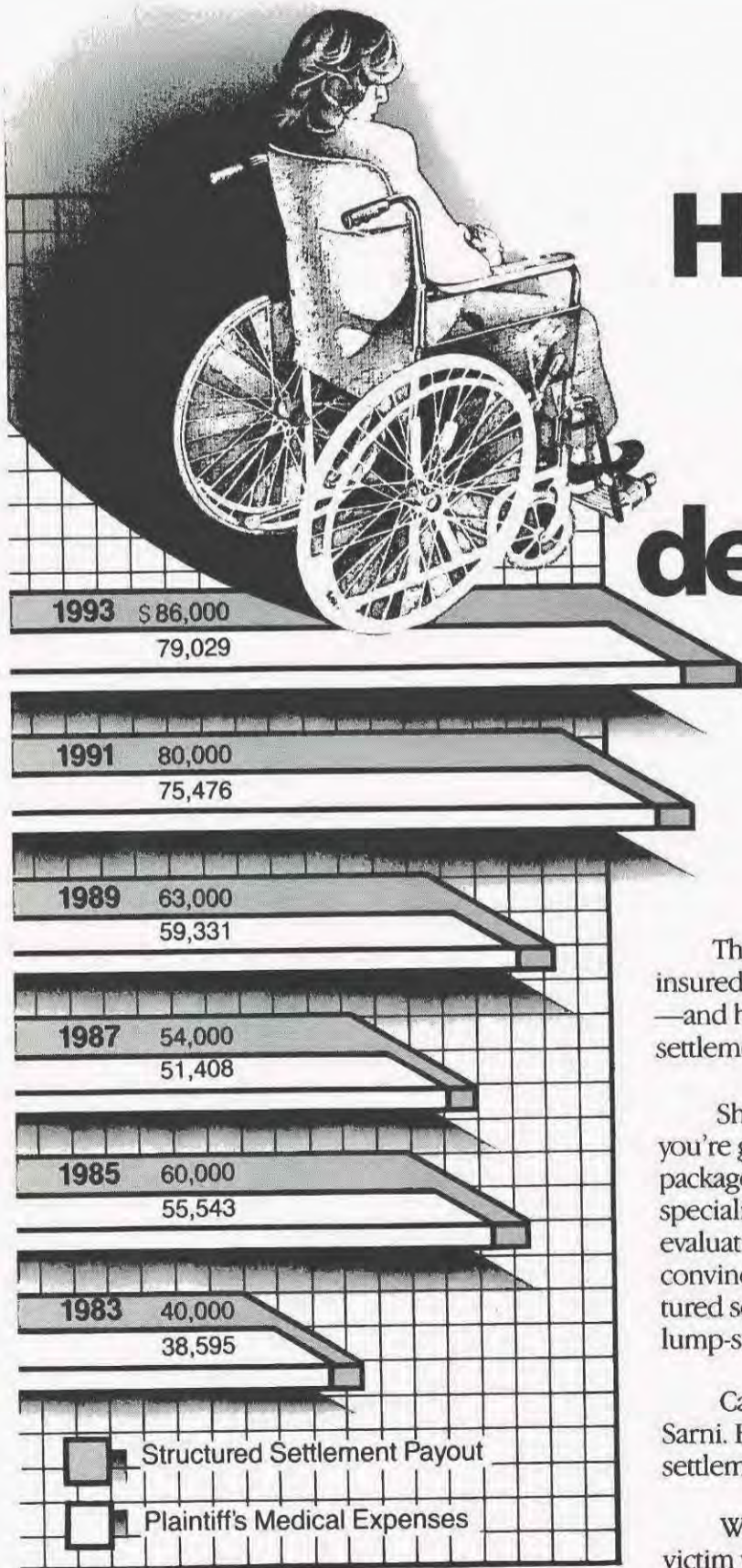
Mr. Boudreau says St. Paul does not believe there is any market for the product. Growth in money market funds overall has slowed and the additional cost of insurance would not be feasible, he said.

"The economics of the situation haven't been as good as anticipated," he says. "I would be surprised if we would do any more. I'm not saying we wouldn't, but we're not knocking on any doors."

Travelers insures one of two-money market portfolios managed by Capital T. Both funds were introduced only a few weeks ago and no data is available on their size, a spokeswoman says.

Like the St. Paul policy, the Travelers' policy would indemnify the fund if a particular bond defaulted or if there were a sudden rash of redemptions. The fund passes the cost of the insurance on to its investors, charging them between 0.3% and 0.5% of their investment to pay for the coverage, depending on the type of investments held in the portfolio.

The fund is insured for up to \$300 million, says the spokeswoman. "As the fund grows, we would get more (insurance) for it."



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# Insurers' stockbrokerage units purchasing account coverage

By JUDY GREENWALD

NEW YORK—The new financial services networks are taking care of their own.

Insurers with stock brokerage affiliates are issuing special insurance policies to their affiliates to protect the brokerage customers' accounts above the federal Securities Investor Protection Corp. coverage.

And, one insurance company with a bank affiliate is insuring the affiliated bank's customers' deposits above the Federal Deposit Insurance Corp. coverage.

SIPC coverage kicks in when a brokerage house fails, compensating accounts holding up to \$100,000 in cash and \$400,000 in securities.

FDIC coverage pays bank depositors up to \$100,000 per account when a bank fails.

Excess SIPC coverage has been available for about 10 years and all the major stockbrokers buy it for their largest accounts, according to a spokeswoman for Prudential-Bache Securities Inc. The policies will cover losses associated with securities, not cash, exceeding the SIPC limits.

Aetna Casualty & Surety Co. is the only insurer offering a standard policy, but other insurers do manuscript the form.

Excess FDIC coverage is less in demand and little has been written, say insurance brokers.

At Prudential Insurance Co. of America, subsidiary Prudential Reinsurance Co. underwrites an excess-SIPC policy for Prudential-Bache. The excess SIPC policy provides coverage of up to \$9.5 million above SIPC coverage on the securities held in the Prudential-Bache "Command" accounts, which have minimum assets of cash and securities totaling \$10,000. The policy does not cover cash above \$100,000, but such a large cash holding is unlikely in these accounts which are designed to invest—not to hold—cash.

Gibraltar Casualty Co., a subsidiary of Prudential Reinsurance Co., is about to issue an excess-FDIC policy for Prudential Bank & Trust Co. in Hapeville, Ga., another subsidiary of Prudential Life Insurance Co. of America. The policy would provide coverage of up to \$900,000 beyond the \$100,000 of FDIC coverage, says a Prudential Re spokesman.

At Sears, Roebuck & Co., subsidiary Allstate Insurance Co. has underwritten a policy for affiliate Dean Witter Reynolds Inc. An Allstate spokesman refused to provide details on the policy.

And, American Express Co.'s Fireman's Fund Insurance Cos. unit is also known to insure Shearson/American Express above the SIPC limits, but requests for details were denied.

Aetna's standard excess-SIPC coverage provides coverage of \$2 million per account for accounts with securities exceeding the \$400,000 insured by SIPC, according to a knowledgeable source who asked not to be identified. Cash deposits are not covered.

Individual account holders, however, can insure their accounts up to an additional \$7.5 million with Aetna for an additional premium paid through their stockbroker.

Aetna's rates for the stockbrokers' coverage vary depending upon the total number of accounts with a stockbroker and the number of accounts with assets exceeding SIPC limits.

More than 25 brokerage houses have purchased the policy.

One Aetna policyholder, for ex-

ample, is Merrill Lynch, Pierce, Fenner & Smith Inc., which promotes its \$2 million of excess-SIPC coverage in a pamphlet. While Merrill Lynch pays for the first \$2 million in extra coverage, its customers also can purchase the extra \$7.5 million in coverage themselves at a two-year rate of 50 cents per \$1,000, in incremental amounts of \$500,000.

The few other insurance companies that manuscript excess-SIPC policies generally do it for an aggregate amount, rather than on a per-account basis, explains Mike McAteer, vp of financial institutions divisions for Marsh & McLennan. The policies, whose rates are

determined on a sliding scale basis, generally cost a minimum of \$20,000, he notes.

There have been no losses in the 10 years that excess SIPC coverage has been offered, sources agree.

There is no formal excess-FDIC policy, but it can be manuscripted on an individual basis, Mr. McAteer says. But, insurers accept only highly qualified banks, he notes. Banks with assets of at least \$1 billion probably are eligible, he says, or only about 50 of the 1,400 banks in the country.

American International Group Inc. is one market for the coverage that confirmed its willingness to write the insurance. ■

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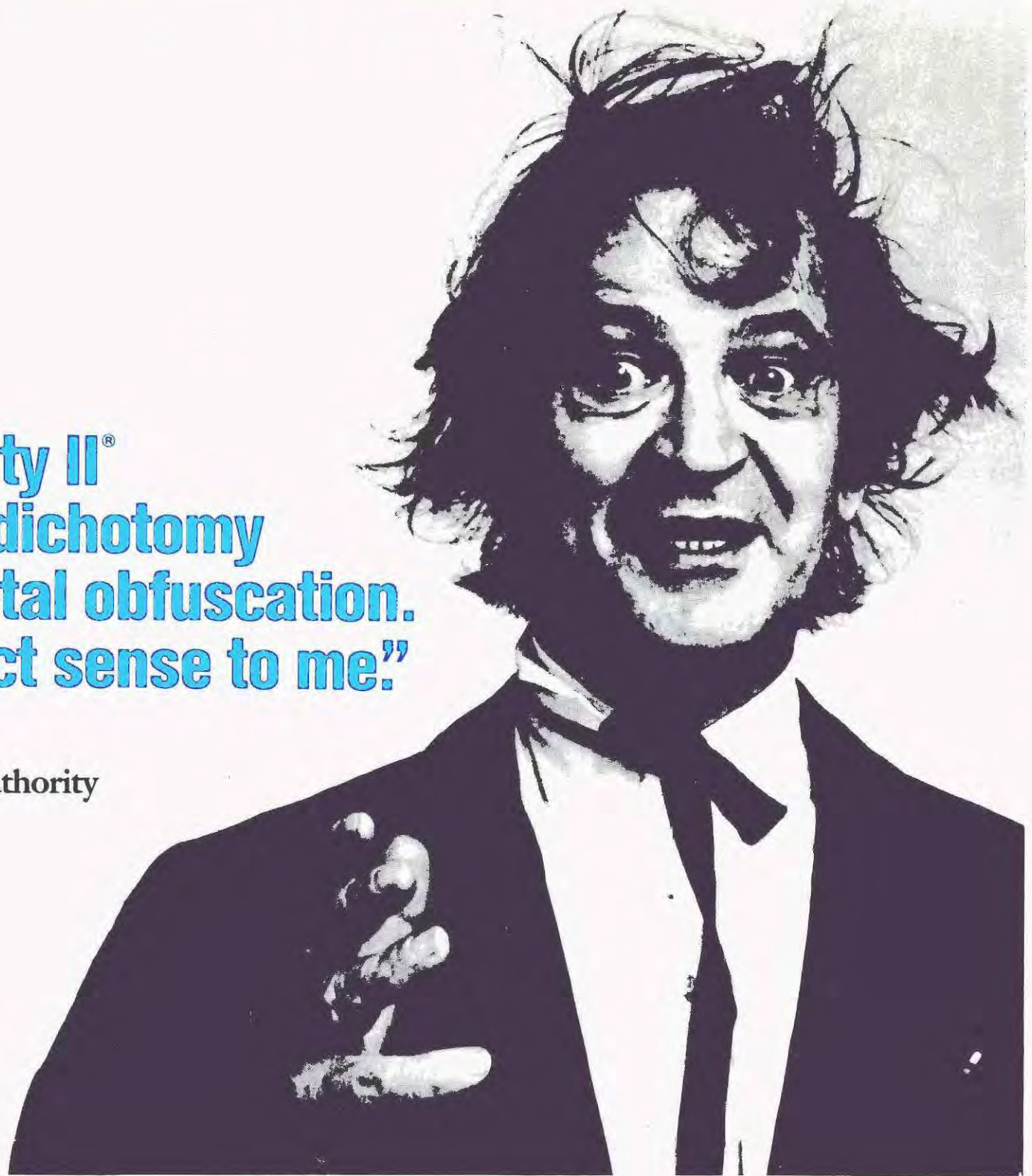
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# ANSWERED QUESTIONS

How can a company keep communications costs low?

By Joseph W. Duva

**Q:** *We are planning certain changes in our benefit program in the near future. However, the costs we have been given by our consultant to communicate these changes to employees, including an audiovisual presentation, seem very high. How can we reduce these costs or keep them to a minimum?*

**A:** You can keep these costs to a minimum by competitive bidding, full use of your company's in-house staff and effective management of the project. I assume that the consulting firm that helped you redesign your benefits program has quoted the cost to communicate it to employees. There is no reason, however, why you cannot separate the communications effort and ask other consulting firms to quote on the project on a competitive bidding basis.

Before you ask outside consultants to bid on the project, however, you should determine what you can accomplish by fully utilizing your own staff capabilities and, depending upon the timing and confidentiality of the project, other internal resources of your company.

In this regard, many companies have corporate communication departments and some even have used communications or advertising specialists to develop sales and training presentations.

By fully utilizing your company's internal resources, you not only keep outside charges to a minimum, you also gain a wider endorsement of the proposed changes by involving other managers and departments in your company in communicating these changes.

Lastly, an effective benefits manager must demand high-level services from outside consultants and must

## ask a benefit manager



be in a position to evaluate what services are needed, why they are needed and how much they cost.

Don't hesitate to meet periodically with your employee benefits consultants to review costs and to ask the tough questions, such as what services are worth.

How can coordination-of-benefit efforts be toughened?

**Q:** *How do you get Blue Cross/Blue Shield organizations to effectively "police" a coordination-of-benefits provision? We are having a great deal of difficulty in this regard, and although the coordination-of-benefits provision has been in effect for many years, we have not yet realized any substantial savings.*

**A:** Some Blue Cross/Blue Shield organizations have adopted "pay-then-pursue" procedures in respect to the coordination-of-benefits provisions under their plans. This means that they initially pay benefits to the hospital or doctor where assignments have been made, then seek reimbursement from the employee if other insurance is involved.

The problem is that there is no incentive for the employee to respond to demands for reimbursement if the hospital and medical bills already have been paid by the insurer.

In addition, Blue Cross/Blue Shield plans usually rely on the provider of services (the hospital or doctor) to obtain duplicate coverage information, since their main concern is with being paid for their services.

There are several things you can do to correct this situation. They are:

- Insist that the Blue Cross/Blue Shield plans involved amend their procedure to a pursue-then-pay

procedure. This means that they will not pay a claim unless they are satisfied that no other coverage is involved, or that they are liable for the initial payment of the claim.

This may involve a re-enrollment of employees with the requirement to provide specific data on any other insurance coverages. This data can be maintained by the Blues and updated as necessary.

- Suggest that employee contributions, however modest, be introduced if the Blue Cross/Blue Shield plan involved is non-contributory. This would be a requirement to participate in the plan. Many employees will waive coverage if they are required to contribute for it and are covered by another plan.

- Consider canceling the Blue Shield coverage and have it underwritten by a private insurance company if the Blue Cross/Blue Shield plans refuse to amend their procedures.

Although Blue Shield plans generally receive a discount from private physicians, an insurance company may well be able to underwrite the same coverage at the same level of cost because of better administration, especially as it relates to the coordination-of-benefits provision.

You may also have the insurance company make its COB information available to your local benefits administrators, who in turn would use it to monitor the Blue Cross plan's administration of this provision. This way, you will also be able to retain the usually more sizable Blue Cross discount on hospitalizations that is presently available in some Eastern states.

Be sure, however, that cancellation of the Blue Shield coverage does not result in a change in your Blue Cross coverage (for example, from a community-related to an experience-related basis) that may not be financially advantageous to your corporation.

Do unemployment taxes affect acquisitions or sales?

**Q:** *I have heard that unemployment tax liabilities can be a factor in negotiating the acquisition or sale of a business. I understand the pension and group insurance liabilities that may be involved in such situations, but how do unemployment insurance taxes—which are determined by each state—affect these negotiations?*

**A:** The taxes to support unemployment insurance benefits are paid almost exclusively by each employer under various state rating formulas. The formulas are designed to assess each company a tax rate that primarily depends on a ratio of the benefits paid to its former employees to the company's taxable payroll.

In effect, each company is penalized for the unemployment charges attributed to its former employees; the higher these charges are, the higher the company's tax rate will be.

Because each company's experience differs, opportunities for tax rate reductions or increases are inherent in corporate situations involving acquisitions, mergers or spinoffs. For example:

- Where the unemployment insurance experience of the company being acquired is good, the buyer may be able, in some states, to lower its tax rate if the seller agrees to a transfer of its unemployment insurance reserves to the successor company.

- Where the unemployment insurance experience of the company being acquired is not favorable or is in a deficit, under certain conditions, the buyer may refuse the transfer of experience and take the more favorable "new business" tax rate assigned to the company by the state.

- Where the business being acquired is a separate legal entity or where it is mandated by law, in some situations, it may not be possible for the buyer to avoid the transfer of an unemployment insurance deficit and a resulting increase in its unemployment insurance taxes in that state.

In these cases, the buyer should negotiate with the seller to recognize this additional liability in the purchase agreement.

Because each state is given broad latitude under federal statutes to enact its own unemployment compensation laws, these laws are complex, diverse and are changed frequently. Tax savings often depend on compliance with the law.

*Do you need advice on a benefit management problem? Would you like suggestions from a colleague on a risk management question? Two new features in the Perspective section of Business Insurance can give you some answers.*

*Ask a Benefit Manager and Ask a Risk Manager will answer written questions from readers on risk management and benefit management issues.*

*Ask a Benefit Manager debuts this month.*

*The first Ask a Risk Manager will appear in June.*

*Ralph F. Perry Jr., vp and director of risk management at Amfac Inc. in San Francisco, will field the risk management questions. Mr. Perry holds ARM, CPCU and CLU designations. He also is the chairman of the education committee of the Risk & Insurance Management Society Inc. Mr. Perry has been in risk management for 14 years, was a consultant for three years and in the insurance industry for 16 years.*

*Mr. Perry's and Mr. Duva's columns will appear alternately on the second Monday of each month.*

*Address your questions to ASK, Business Insurance, 740 N. Rush St., Chicago, Ill. 60611. Please give us your name, title and employer; however, Business Insurance will consider unsigned letters.*



Joseph W. Duva is director-employee benefits and compensation at SCM Corp. in New York. Mr. Duva's next Ask A Benefit Manager column will appear in July.

# SHIFT IN WORKERS COMP

## Insurers must adapt to meet buyers' needs

By Arthur E. Parry

**W**ORKERS compensation accounts for more than \$15 billion in annual premiums in the United States.

Twenty companies write two-thirds of the business with another 500 or more companies accounting for the other one-third. No one company has 10% of the market and only three have 5%.

In certain states, local companies have become leaders. For example, Texas Employers' Insurance Assn. has a 14% market share in Texas, Pennsylvania Manufacturers' Assn. Insurance Co. has 12% in Pennsylvania and New Jersey Manufacturers Insurance Co. has 24% in that state.

As a result, with no one company dominating the market, risk managers find a maturing market, one that is, in fact, declining because of new types of external competition. The changes in market size and market share have created different responses by the leading insurers that affect the choices a risk manager has.

Severe competition exists from self-insurers, as well as from other insurers.

For example, in Ohio, more than 800 employers self-insure. And captive companies are another competitor. One estimate is that more than 1,000 captives have been formed in Bermuda and elsewhere to write workers compensation and property/casualty insurance solely or primarily for their parent company.

As a result, double-digit premium increases—15% in 1980, 18% in 1979 and more than 20% in 1978 and 1977—have been reduced to 3% in 1981 and just more than 4% in 1982. This reduction reflects both external competition as well as the changing responses within the industry to recapture or retain market share.

This movement of premium out of the conventional market may weaken a risk manager's available statistical bases for loss measurement and prediction. It may create regulatory concerns because of loss of taxable premiums and control. Lastly, it could eliminate some insurer solvency and actuarial controls.

What are insurers doing to adapt to changing market conditions?

Twenty-one leading insurers were examined in a Wyatt Co. survey conducted earlier this year to see what methods they used to compete with self-insurers and captives that have created eroding premium volume pressures. Consultants, intermediaries and in some cases, company representatives were questioned.

Each company was examined for

participation in one or more of the following activities (see chart):

- Offering unbundled services—in effect, accepting both self-insurance and captive insurance, but providing a different product to these segments.

- Fronting. Again, this service recognizes the new captive/self-insurer approach and legitimizes it by use of the insurance company contract backed up by reinsurance from the captive or self-insurer.

- New rating approaches. These services represent the responses created to directly compete with self-insurance and further restrict the number of companies moving to self-insurance.

Insurers that fell into each category

They did not compete solely for unbundled or fronting services. Such companies:

- Could offer an equivalent price only if the risk manager purchased the various services as a unit.

- Could not offer an equivalent price whenever individual services could be purchased separately at lower prices.

The approach by these companies may be classified as middle-of-the-road. In one respect, their services are a contradiction because they sell unbundled services only on a new "bundled" basis.

### New rating approaches

All 21 insurers offered a variety of new rating approaches to reduce the price of the workers compensation product.

unbundled and captive services, but on a limited basis.

They include: Travelers Corp., Aetna Life & Casualty Co., Hartford Casualty Insurance Co., Fireman's Fund Insurance Cos., Crum & Forster, Commercial Union Insurance Co., Wausau Underwriters Insurance Co. and Texas Employers' Insurance Assn.

- Market leaders. These are aggressive companies, seeking to retain or increase market share by actively utilizing all methods.

These companies are: American International Group Inc., CIGNA Corp., Continental Insurance Co., The Home Insurance Co., Kemper Group, Mission Insurance Co. and Northwestern National Insurance Co.

These classes show how insurers respond to the market change. Some continue to do "business as usual," but cut the price. Another group, while not active in offering newer, lower-cost products, will do so, yet only under highly favorable conditions. A third group recognizes the changing market and the need for new products and aggressively offers them.

However, some of the more aggressive companies, within the last few months, have shown a more conservative trend.

The observation that has emerged is that despite the outgo of premium income with a potential loss of millions of dollars, only one-third of the leading companies are apparently determined to respond aggressively.

Another one-third, while aggressive, will compete only in selected situations and, possibly, for specific accounts.

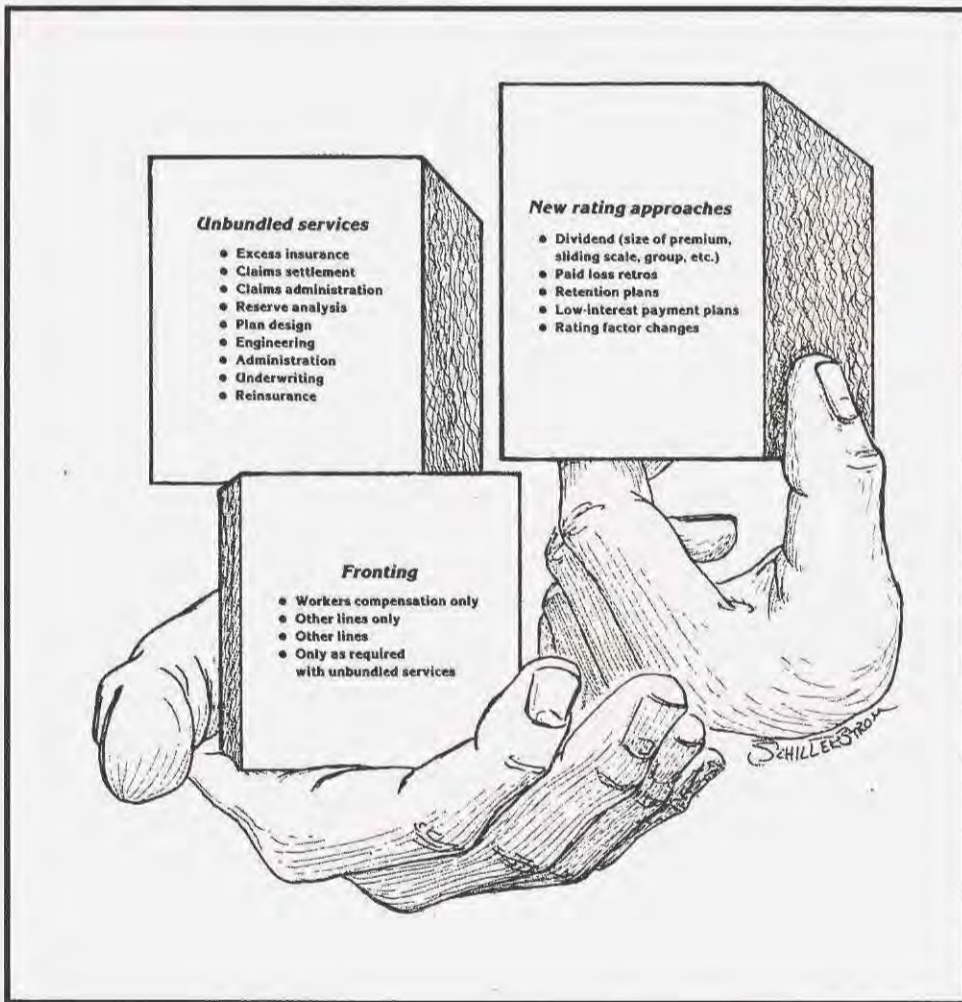
Still another third is apparently using conventional tools to compete without recognizing perhaps that such an approach will be inadequate.

Therefore, while the conventional marketplace provided insurance for many years, apparently satisfactorily, the market does not now nor will not change rapidly to respond to buyers' needs. This may be due to a lack of awareness of changing needs, an inability to quickly respond or an unwillingness to respond.

Risk managers should consider these factors not only as they apply to a company, but to other companies in the same business or in the same states.

It may be that risk managers need to collectively establish a stronger dialogue with representatives of the conventional marketplace, perhaps through the National Council on Compensation Insurance, the American Insurance Assn. or the Risk & Insurance Management Society, in order to consider appropriate positive responses to this changing market.

What is being done or not done by major insurers does have a long-term impact on buyers. Efforts should be made now to assure a viable market for the future. ■



exhibited certain traits.

### Aggressive unbundled/ fronting activity

In this group, six companies aggressively offered various services and fronting in whatever manner the risk manager requested.

These companies apparently recognized new products and the competitive marketplace and competed by responding in an aggressive manner. Most companies formed or had acquired separate engineering and claims adjusting firms to permit unbundling of such services for efficient handling.

This group contains market leaders in pricing, innovation and response.

### Limited unbundled/ fronting activity

In this group, eight companies were active in providing both unbundled services and fronting, provided that all such services were purchased from them.

However, seven companies used no other method. Such companies:

- Did not offer an equivalent price to the risk manager already buying self-insurance or a captive approach.

- Did not have a price equal to the total price for self-insurance to a risk manager comparing both options.

These companies tended to be status-quo conservatives on pricing policies.

Based on responses to the survey, companies may be divided into three general classes:

- The status-quo conservative. These companies employ only rating techniques.

Companies in this group include: Liberty Mutual Insurance Cos., United States Fire & Guaranty Co., CNA Insurance Cos., Argonaut Insurance Co., Royal Insurance Cos. and American Financial Group.

- Middle-of-the-road group. These insurers are willing to offer both



Arthur E. Parry is manager of risk management services with The Wyatt Co. in Dallas.

The Perspective section, which is a forum for readers' opinions, is compiled and edited by Assistant Copy Editor Claudette Dampier. She can be reached at 312-649-5282.

# Banks, insurer both offering coverage to cap interest costs

By JIM DAVIS

CHICAGO—The cold war between banks and insurance companies is erupting into real competition over one product:

Coverage to cap interest payments due on floating-rate loans.

Even before the prime rate soared as high as 21.5% in 1980, borrowers with floating-rate loans anxiously watched the movement of the prime rate, the rate that banks charge their most credit-worthy customers.

And, although the prime lending rate now stands at 12%, some borrowers fear another surge in interest rates.

Since 1981, borrowers have been able to purchase insurance-type products that will cap the payments they must make. These products will pay interest charges accrued above an agreed amount on a floating-rate loan.

First offered by banks, the coverage also has been written by one insurance concern since September 1983 (*BI*, May 9, 1983).

The total amount of protection provided is uncalculated, but banks agree that the majority of this coverage has been purchased by commercial and residential real estate developers, commercial property rehabilitators, limited tax-advantaged investment partners and operators, financiers and dealers involved with "rolling stock"-related industries, such as autos, trucks and over-the-road machinery.

And, as the number of leveraged buy-out transactions has exploded during the past few years, these investors that purchase publicly held companies and take them private have generated about one-quarter of the demand for interest caps, participants say (see story, page 46).

The first products that placed a lid on the interest rates borrowers had to pay were offered in the early 1980s, after interest rates became more volatile in the late 1970s. Investment bankers, like Merrill Lynch, Pierce, Fenner & Smith Inc., and commercial banks, like Citicorp, began providing this service.

While the product is not called insurance, it behaves in much the same fashion.

By hedging in interest rate futures markets, first established in 1975 at the Chicago Board of Trade, traders hope to realize gains that will compensate for interest rate increases.

When this coverage is tied to the U.S. prime rate or the London interbank offered rate (LIBOR is the rate at which banks in London offer Eurodollars in the placement market), Merrill Lynch charges an annual rate equal to 1% of the loan amount for the first 15 months of protection and 0.75% for coverage beyond that time, for terms up to 30 months.

When the coverage is tied to banks' short-term certificate of deposit rates or U.S. Treasury bill rates, the annual cost is 0.875% for the first 15 months and 0.75% for the second 15 months.

Fees must be paid when the coverage is arranged. Then, interest rates are computed quarterly; if they are above the unprotected level, the borrower receives the difference.

Merrill Lynch began providing this coverage in September 1981, said David E. Driver, manager of Merrill Lynch's Chicago financial instruments office. It has protected

about 25 loans totaling about \$1.9 billion, Mr. Driver said.

Although he declined to disclose the amount of fees this business has generated, multiplying the lowest rate times the loans suggests this coverage represents at least \$35 million in fees.

The average protected loan has been \$75 million, Mr. Driver said. Capacity is limited only by Merrill

Lynch's desire to do the business, he adds.

Actual interest rate insurance coverage was first offered last September by Interest-Guard Managers Inc., a joint venture of Frank B. Hall & Co. Inc. and General Reinsurance Corp., based in White Plains, N.Y.

Interest-Guard remains the only

*Continued on next page*

## IS THERE A TAIL TO A SALE?



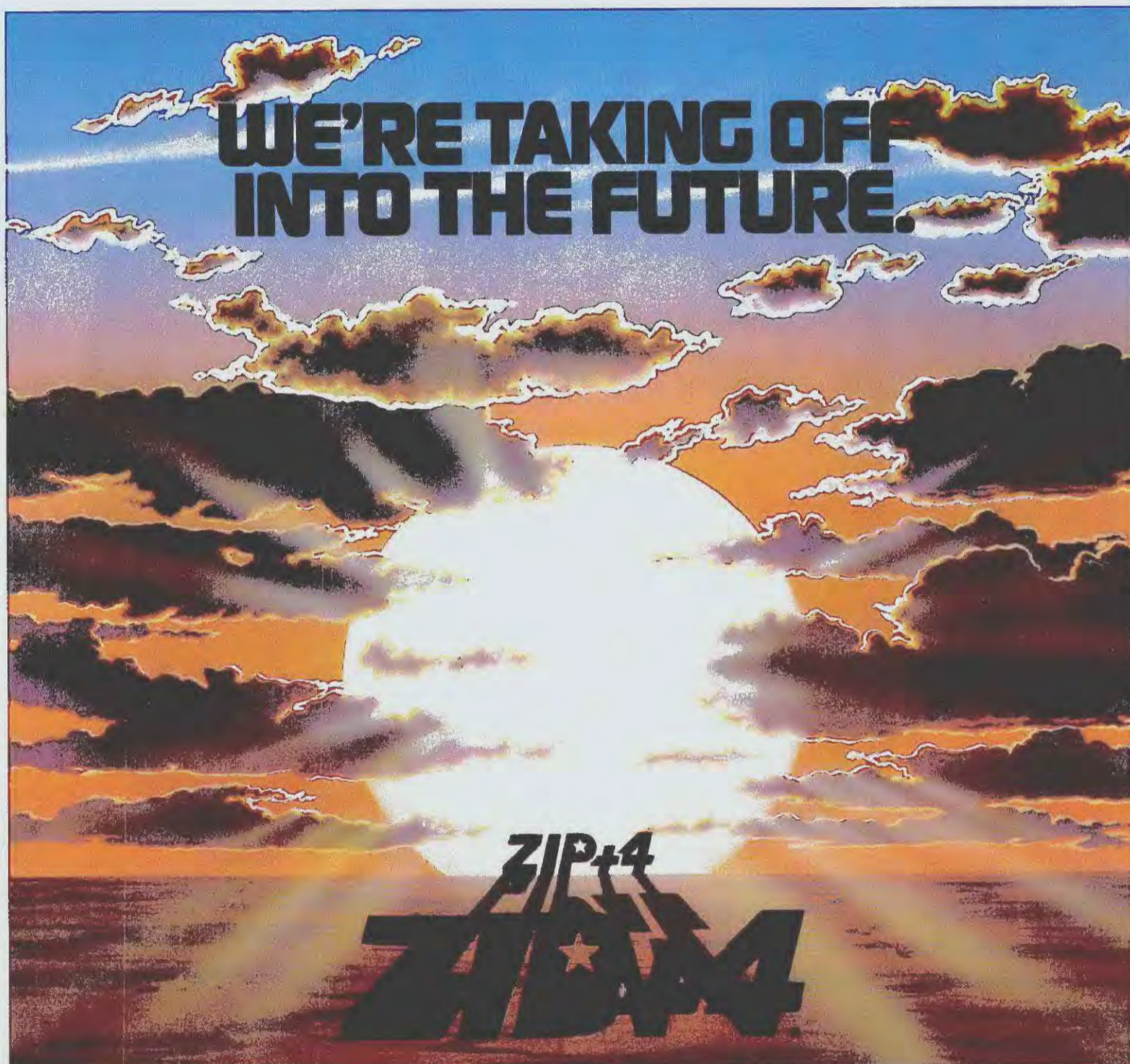
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## Interest rate coverage

*Continued from previous page*

Insurance on these policies is provided on an excess and surplus lines basis by North Star Excess Insurance Corp., a unit of General Reinsurance Corp. in Stamford, Conn., and Safety Mutual Casualty Corp. of St. Louis.

Interest-Guard has capacity to write insurance on \$1 billion in loans. Its clients are borrowing from \$1.5 million to \$75 million, said Executive Vp Franklin Montross IV.

The company has insured about 15 loans totaling some \$200 million, which have generated about \$2 million in premiums, Mr. Montross said. Four of these policies have been for leveraged buy-outs.

Policies run as long as two years. Premiums depend on terms and are due in advance.

All policies have a self-insured retention of at least a half-point increase in the prime. However, the amount of this retention can be as much as seven points, reducing the cost.

And, all coverage is capped at from five to 10

points.

For example, one year of coverage on a \$1 million floating prime rate loan with a half-point retention and a five-point cap would cost \$12,000—1.2% of the loan amount.

The annual premium for a two-year policy with a four-point retention and a five-point cap would be less: 0.5% of the loan amount.

Interest-Guard pays borrowers for any day on which the prime rate rises above the unprotected limit. Settlements are made monthly.

The insurer had to make its first payments at the end of April, on three loans, one of which had been taken out for an LBO. Claims totaled slightly more than \$40,000.

Mr. Montross said he wasn't alarmed by those payments. Besides, he said, the two-year premiums, equal to about 2.16% of each of the loans, were designed to allow the insurer to make such payments for several months and still earn a profit.

Generally, banks and Interest-Guard charge similar rates for comparable protection.

The most significant difference between insurance and futures protection is that Interest-

Guard's policies are tied to the prime rate, which banks tend to avoid because prime rate futures contracts are not traded, while other rate futures contracts are.

Most U.S. companies' loans are tied to the prime, but very large companies, especially those with operations in other countries, are not confined to depending on domestic markets. They can tap other countries' financing sources, if their rates are more favorable. The LIBOR rate is one of the most widely used.

Whether interest rate protection is provided by investment banks, commercial banks or Interest-Guard, Mr. Montross said he believes the product will become more widely used, "as companies come to accept what we're offering as a standard financial tool."

Also, he said, the coverage should make lenders more willing to provide credit to companies that have bought the protection, because it reduces the chance of default.

Shortly after he said this, several large banks announced they had raised their prime rate 0.5%. "That should get our phones ringing off the wall," Mr. Montross said.

## Cover protects leveraged buyout

A group of investors took on a huge debt load when they purchased part of a publicly held company late last year and engineered a leveraged buy-out transaction to take it private.

So early this year, they arranged coverage that puts a cap on the interest rate they will have to pay.

The protection, provided by a large bank that had not been involved in providing the initial \$100 million floating-rate loan, will be triggered if the prime rate, currently 12%, rises above 14%.

Running two years, the coverage cost less than \$500,000, according to the executive of the Midwestern industrial conglomerate who discussed his experience only on the condition that he and the company not be identified.

"We're looking to protect ourselves in case the roof falls in," the executive said, explaining the decision to cover interest rate hikes. "We fervently hope we won't have to collect; it's like life insurance."

In an LBO, management or another party acquires a company—or more commonly a division of a company—largely with loans secured by the target firm's assets. Usually, the amount of debt taken out in these deals is from four to eight times the amount of equity provided.

LBOs have been around for about two decades, but it has only been in the past few years that their popularity has exploded. Thirty-six public companies went private in 1983 via LBOs, up from just 13 in 1980.

**Financing comes from** a variety of sources, including commercial banks and venture-capital firms. Another major source has been insurance companies, like Allstate Insurance Co., Connecticut General Corp., Prudential Insurance Co. and Northwestern Mutual Insurance Co.

With interest rates more volatile, lenders are reluctant to provide long-term fixed-rate loans. As a result, most of the debts LBO firms have acquired have a floating rate.

If interest rates soar as they did earlier this decade, then these borrowers' interest payments would also rise. This burden could wreck many LBOs' already delicate financial structures, especially immediately following the buy-out, when debt loads are heaviest.

After the Midwestern industrial conglomerate's officials decided to cap their floating rate loan, they solicited quotes from several banks and Interest-Guard Managers Inc., the only insurer providing interest-rate protection (see story, page 45).

The bank won, the company executive said, because Interest-Guard would have charged more than \$20,000 more for the same protection.

"This is the first time they (the banks) have offered this service," he said, "so they might have been willing to charge less to establish themselves in the market."

Another attractive feature of the bank's coverage, the company executive said, is that it will cover all increases in the prime rate above 14%, the level up to which the company must pay. Interest-Guard would only provide protection up to a 19% prime rate.

"If the prime went back over 20%," the company executive said, "we decided we'd be kicking ourselves if we weren't covered."

Another alternative the company rejected was entering the interest-rate futures market on its own.

Said the executive, "We don't have the time or expertise to hedge on our own. This way, the bank manages the risk."

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# 'Change-in-law' coverage draws growing interest

By CAROL CAIN

Insurers are beginning to manuscript policies to cover a company's losses, including extra costs, if a governmental entity changes regulations while a building project or business operation is under way.

The coverage—referred to as change-in-law, force majeure or U.S. "political risk" coverage—is especially attractive to the nuclear energy and waste recovery industries.

But while interest in the coverage is growing, it is not easy to find insurers willing to write coverage for an exposure that often is hard to define, brokers say. And, the cost can be prohibitive.

Fred S. James & Co. Inc. of New York and wholesale brokerage MacLean, Oddy & Associates Inc. in Dallas, a subsidiary of Sedgwick Group P.L.C., appear to be the leaders in marketing such coverage. Both offer it as part of a package that covers builders risks.

James officials say Lloyd's of London is the only market the brokerage has found for this coverage, and James has placed only one policy that includes coverage for costs arising from regulation changes.

Meanwhile, MacLean, Oddy says it has placed four such policies and expects to place 10 more. Its markets include Lloyd's, other alien insurers and both admitted and non-admitted U.S. insurers.

"At present there is limited capacity available," said Roy Oddy, chairman of MacLean, Oddy.

"It's very difficult to get, if at all," said a spokesman from broker Johnson & Higgins, which has not placed any such coverage.

Marsh & McLennan Inc. has had inquiries for the coverage, but doesn't know of any markets, says William Duggan Jr., a managing director in New York who coordinates financial guarantees.

One problem appears to be defining the exposures to be insured because in some areas regulations are still developing.

"From a risk standpoint, it's not definable yet, not formalized," said Michael T. Tilton, a James executive vp. He noted the environmental area, which "is embraced by a very dynamite situation. There are plenty of laws in place, some desirable, some not. And there's pressure for more regulations."

And because each risk can be different, no one policy is being marketed to respond to buyers' needs.

"None of this (coverage) is standard; it's all manuscript," said Mike Dinstein, president of the financial research and planning division with James' corporate office. And so far, he says, demand has been minimal. However, that appears to be changing.

"We are optimistic about the future of this type of coverage and see the demand increasing as the financing aspects and contractual obligations in the projects become more and more sophisticated and innovative," Mr. Oddy said.

"Every day a potential client realizes an exposure from a change in law, and we are receiving more and more inquiries," Mr. Tilton said.

For instance, one recent potential client was concerned about a local municipality changing its building condemnation law.

"This client was buying a building from the government with a 10-year mortgage, and it perceived a potential change in the law to be an exposure. They want us to look

into it," Mr. Tilton said.

M&M also has had similar inquiries.

"Someone was buying old utility facilities and wanted to guarantee that there wouldn't be a loss if the buildings were condemned," Mr. Duggan said.

"Some (insurance) markets are interested in that, but you have to be very specific. Underwriters are zeroing in to see if they can identify a specific contingency or change in law," he said.

Continued on next page

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# Changing laws concern waste energy companies

Continued from previous page

A major area of concern for waste energy companies today is the possibility of new laws covering dioxins, said Alburn E. Blankenship, senior vp and Northeast regional risk management director for James in Boston.

"There are no standards yet," he explained, adding that companies that are building now may be concerned that they will be precluded from operating if certain dioxin standards are adopted.

"In the past our government has 'grandfathered' those (plants), if they had a permit," he said. But they may not be left off the hook in the future, he warns.

The majority of change-of-law risks that have been written have been for cogeneration and waste-

to-energy type facilities, explains Terry Jacobson, an account executive for MacLean, Oddy.

However, chemical plants and nuclear plants are also interested, and MacLean Oddy is working with risks ranging from ethanol plants to a paper mill, he says.

Cogeneration is the production of electricity and some other form of energy, like heat or steam, from the same facility. Waste-to-energy facilities are those in which agricultural or other types of waste is converted to electricity and steam.

A Lloyd's underwriter made a quote on change-in-law coverage for a waste-to-energy project in Massachusetts during the past year, says Jay Greer, a partner with Le-Boeuf, Lamb, Leiby & MacRae, counsel for Lloyd's in New York.

The policy was designed especially for this energy project, a proposed joint venture among several municipalities, Mr. Greer said. The municipalities involved were concerned about law changes by one of several federal agencies, the Massachusetts Department of Environmental Quality, the local municipal governments and/or the courts.

"The concern was on the part of the (municipalities) that were building the plant, which would take three years to complete," he said.

The policy would have had a \$47 million limit and at one point, the premium was around \$1.2 million, Mr. Greer said. However, the project did not go through for non-insurance reasons, he said.

"I think the concept is an interesting one. The biggest problem in

drafting the wording is trying to make sure there is no misunderstanding between the underwriter and the insured. It's a product that you have to tailor to the particular facility in question."

A year ago, a James' client in the resource-recovery industry purchased a policy underwritten by Lloyd's that includes change-of-law coverage, Mr. Blankenship said.

The policy covers any additional costs in bringing the company up to the new standards or regulations set by the government, he said.

The premium was 4% of the \$40 million limits, or \$1.6 million.

Because no one fully understands the exposures involved in this type of coverage, rates are based on what the policyholder is willing to

pay, he said.

"You have to ask, 'What can you charge not to ruin the economic viability of the project?'" he added.

And generally speaking, such coverage will have a very large deductible or coinsurance, or a combination of both, he said.

The coverage was sold as part of a builders risk package policy.

"We are recommending that rather than fragment this coverage, you keep it together with builders risk," Mr. Blankenship said.

MacLean, Oddy also markets this type of coverage as part of a broad builders package policy and calls it "force majeure" coverage, or coverage for an event that cannot be reasonably anticipated or controlled.

The overall policy, which is written by U.S. admitted and non-admitted companies, Lloyd's underwriters and overseas companies, includes four separate coverages:

- All risks of direct damage, including boiler and machinery.
- Indemnification (force majeure).
- Errors and omissions.
- Project warranty.

The force majeure portion indemnifies the policyholder for liability assumed by contract and arising out of business interruption and/or continuing expenses of force majeure exposures, Mr. Oddy says.

Among the force majeure exposures listed in the policy are: "Any law, order, directive or regulation of any governmental authority or agency thereof or order of any court of competent jurisdiction."

This section of the policy also covers fire or other physical destruction or damage including, but not limited to, lightning, explosion, flood, earthquake, hurricane, storm or action of the elements, riots, civil commotions or malicious or other acts intended to cause loss or damage; strikes, lockouts and labor disputes, except if they occur between the insured and its own employees; and any other cause beyond the control of the insured.

The cost for the force majeure portion of the package policy varies according to the project, but would range from 3% to 5% of the policy limits, Mr. Jacobson said. Factors considered include the type of project, the number of days for completion, deductibles, the experience of the contractors, the type of equipment used, safety factors and the financial performance.

The policy is tailored to the contract, and the buyer can purchase any combination of the four parts of the broad policy, Mr. Oddy said.

The policies are subject to certain exclusions and the limits vary according to the size of the project, he said, adding that limits of up to \$25 million are not uncommon.

Although brokers and underwriters are beginning to hear more about this specialty coverage, many potential clients are unaware of its existence and fear it might be too costly.

"It sounds interesting, but how could anyone afford it? It must have lots of restrictions," said Linda Hodge, general counsel who sits on the insurance committee of the Atomic Industrial Forum in Washington, a trade association for the nuclear power industry.

"Sounds like a good idea, but it could cost a substantial amount of money," said Walter G. Holberg, manager of insurance with Philadelphia Electric Co.

James' Mr. Blankenship agrees that cost is a major concern.

"What will it cost? That depends on how well the risk can be described and to what extent the sponsor and the underwriter can agree on the quantification of severity and probability," he said. ■

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# Few companies buy coverage for coupon over-redemption

By STACY SHAPIRO

LONDON—Product manufacturers that offer discount coupons to consumers can be clipped.

Manufacturers can be hit for millions of dollars if coupons are fraudulently redeemed. And, they can end up with an unexpected loss if zealous consumers redeem more coupons than predicted.

However, coupon over-redemptions is a risk that is seldom insured.

Underwriters have been generally wary about offering insurance to manufacturers to cover this risk, notes Geoffrey Fox, director of Adam Brothers Contingency Ltd., a Lloyd's of London broker.

"It is more of a trade risk than an insurable risk," he pointed out, though he said that Lloyd's has issued some policies.

A Lloyd's spokesman said that underwriters will look at the risk on a "one-of-a-kind basis."

Union Atlantique S.R. in Brussels, Belgium, a subsidiary of American International Underwriters Ltd., part of American International Group Inc., says it has underwritten several coupon over-redemption policies.

The coverage written by UNAT usually resembles stop-loss coverage, according to Simon Humphries, manager of underwriting operations for UNAT. If a company estimates that 5% of the coupons issued will be redeemed, the policy will kick in only after 15% of the coupons issued are redeemed.

However, Mr. Humphries could not say what limits UNAT provides or what rates it charges since each risk it writes is individually manuscripted.

However, at least one U.S. market research firm is eager to offer over-redemption insurance to its clients and has asked broker Fred S. James & Co. Inc. to help it place the coverage.

Thomas Whitehead, president of the Merrill & Whitehead in New Caanan, Conn., notes that there could be great demand for the coverage if it is offered on a wide-scale basis.

About 150 billion coupons will be issued by U.S. companies this year, Mr. Whitehead notes. With an average value of about 35 cents apiece, this will represent total available discounts of about \$50 billion, he says.

In addition, U.S. companies will conduct about 3,000 cash refund or rebate programs—offers through which a consumer can receive money from a manufacturer if he or she mails in proof of purchase of a product. These offers will cost about another \$1 billion or \$2 billion, he said.

"Historically, (coupon and rebate) offers are made on certain assumptions," he said. "One of the assumptions is that only a certain percentage of the exposure will be redeemed."

For example, a cereal company or its marketing firm may estimate that only 1% of the coupons or refund offers that are distributed, either through newspapers or magazines or on the product carton itself, will be returned. Thus, the company will budget 1 cent in redemptions for every \$100 of coupons printed.

But, such budgeting can be short-circuited by an "educated public" and "chicanery," Mr. Whitehead said, adding that over-redemption can cost a company millions of dollars on a single series of coupons.

For instance, consumers have formed "coupon clubs" with a

membership of almost 2 million people.

Members trade coupons on products they do not use to get additional coupons for items they do normally buy, and this can significantly boost the redemption rate, Mr. Whitehead said.

And, millions of dollars in coupon refunds emanate from the fraudulent redemption of coupons.

For instance, retailers may buy unsold newspapers, cut out coupons and redeem them, even though the product was never sold to a consumer, Mr. Whitehead said.

And, sometimes coupons are reprinted and then redeemed.

In fact, coupon fraud is such a big-ticket item that the Federal Bureau of Investigation is probing the problem.

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# Weather insurers see sunny days ahead

By SALLIE J. DRURY

Some businesses change with the weather.

In fact, a number of businesses could suffer severe financial loss as a result of rain, wind and snow—or the lack thereof.

But, to soften Mother Nature's blow, insurers have developed a number of weather-related products.

The main markets for this type of coverage are Lloyd's of London and two affiliates of American International Group Inc.: Good Weather Inc., a 25-year-old company specializing in weather risks, and National Union Fire Insurance Co. of Pittsburgh, Pa., which underwrites a snow removal policy for municipalities and other enti-

**'I think the biggest growth area for this type of coverage is for outdoor recreation and vacation insurance. Industrial use is fairly limited,' says Monte J. Gollub of Marsh & McLennan Group Associates Inc.**

ties whose snow removal costs exceed their budgets due to a harsh winter.

Brokers say insurance against foul weather has existed on a case-by-case basis for a number of years, but recently there has been a move toward specialization and expansion in this market.

However, there has not been a storm of requests for the coverage.

"Many people consider it, but often after pricing it they won't buy it," said Charles McAlear, chairman of McAlear Associates Inc., a surplus lines broker in Grand Rapids, Mich. "The number of accounts we handle for (weather-related insurance) is very, very low."

"I don't think it's a huge book of business," said Jack Chutuk, vp at

Albert G. Ruben Inc., a Beverly Hills, Calif., subsidiary of Alexander & Alexander Services Inc. and the exclusive broker for the entertainment division of Fireman's Fund Insurance Co.

"I represent about 75 concert promoters and there's just not a big demand (for weather-related insurance). The premium is off the record, but it's rather high."

However, others see growth down the road.

"We have been writing weather insurance for special events for several years, and with Good Weather we have seen vacation insurance getting heavy in the last 12 months," said Monte J. Gollub, vp for Marsh & McLennan Group Associates Inc. in New York.

"I think that as the American

public gains more free time, through computerization, perhaps a four-day work week and flex time, there will be more outdoor events and more vacations, increasing the demand for weather insurance," he continued.

"I think the biggest growth area for this type of coverage is for outdoor recreation and vacation insurance. Industrial use is fairly limited."

However, Harold Mollin, director of programs and marketing for Good Weather, disagrees. "I think we're just scratching the surface," he said.

"There is the energy industry, which depends on winds, and air conditioners, which depend on hot days, and fireplaces, which depend on cool days. And there are risks all over the world."

Good Weather, in particular, is aggressively seeking to expand its specialty market.

"In the last three or four years, we have grown about 100 times over," Mr. Mollin said.

One area in which Good Weather is involved, and which has received much press lately, is insuring a sales promotion for weather-related products and services.

For example, last year The Toro Co. offered the buyers of its snowthrowers a refund if snow accumulation was less than average. Any money Toro loses on the offer is insured by Good Weather (see story, page 52).

Travel agents, airlines, rent-a-car companies and other travel-related vendors can also insure a weather-related promotion, Mr. Mollin said. These usually involve guaranteeing travelers a certain number of sunny days—or in a ski area, a certain amount of snow.

Clothing retailers also have shown interest in weather-related insurance.

Retailers selling seasonal merchandise—for example, winter boots or overcoats—can suffer financial loss if a mild winter forces the store to mark down the price of merchandise earlier than planned.

**For example,** a chain of shoe stores in the Toronto area that normally sells \$1 million in boots during October, November and December might also as a rule mark down all remaining boots to half price if there is no snow before Dec. 15.

To cover such a loss, the company could purchase a policy from Good Weather that would pay the chain store a certain amount, say \$500,000, if it did not snow by Dec. 15. The chain's "deductible" would pay for any sales lost before Dec. 15 due to snowless days.

For such a policy, the company might pay about 10% of the \$500,000 face value of the policy, or \$50,000. However, the premium would vary by location and the "deductible" assumed by the buyer.

Seasonal businesses—like summer restaurants, beach clubs, boardwalk arcades and ski resorts—also can lose if there is too much or too little rain, too much or too little snow, too many cool or cloudy days or too many warm and sunny ones.

They, too, can find coverage from Good Weather.

Each business would determine its deductible in terms of the number of inches of rain (or lack of rain) or snow it would withstand before a claim could be made. Once that deductible is met, the business receives the face value of the policy it has purchased.

Other types of businesses that have weather-related exposures include promoters or sponsors of outdoor events—like athletic events,

*Continued on facing page*

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Continued from facing page  
concerts and fairs—and suppliers for outdoor events—caterers and lessors of rental furniture like picnic tables.

A rained-out event, like a concert by a big-name star, could be quite a risk.

"Imagine if Michael Jackson gave an outdoor concert at the Los Angeles Coliseum, which seats 90,000, and it got rained out," one broker said. "Reimbursing the ticket price would cost a fortune—you could have several million dollars at risk."

(The site of Michael Jackson's concert later this year in Los Angeles has not yet been determined.)

"Last year we paid \$100,000 on a Johnny Cash concert, and we might have paid \$1.5 million on a Diana Ross concert (held in New York's Central Park, which was rained out the first night)," Mr. Mollin said. "But, we didn't have to pay anything on that because it only rained the one night, and their policy was for rain two nights in a row."

"They had thought about the one-night policy," he said, "but decided it was too expensive to buy."

Producers of movies, commercials and music videos also purchase insurance to cover extra costs if weather holds up production.

"We do a lot of music videos," Mr. Mollin said. "We did Billy Joel's 'Uptown Girl' when they were shooting at a gas station in Manhattan and didn't want it to rain."

For this project, Good Weather insured that between midnight and 8 a.m., six of the eight hours of shooting would be rain-free. The deductible would be the two hours that could be rained out without reimbursement.

A one-day shoot may cost as much as \$100,000, Mr. Mollin said. "If the policy specifications were similar to those for 'Uptown Girl,' the value of the policy were for \$100,000 and the shoot took place in May, the premium would be around 15% to 20% of the face value of the policy, he said.

A producer of such a film would ordinarily purchase a policy to cover the cost of reshooting if weather caused a cancellation.

"There's a big risk when you're filming," added M&M's Mr. Gollup. "Production expenses for a one-day shoot are astronomical."

But so far, it has been pretty smooth sailing for Good Weather.

The company now handles a premium volume of about \$10 million annually with a loss ratio "safely around 33%," Mr. Mollin says.

To assess the weather risks it assumes, Good Weather gathers rainfall, snowfall, wind, temperatures and other weather records from 7,000 weather stations around the world.

"We collect the data back as far as we can get it," Mr. Mollin explains. "For some cities, we have the last 100 years of snowfall."

"The risk we specialize in is weather; it doesn't make any difference to us what the product (or service) is that may suffer the loss," he continued. "And it doesn't matter to us where it is—1/100 inch of rain is the same in Duluth or Paris or anywhere."

"The founder of Good Weather (Henry L. Fox) had a penchant for this kind of risk and developed an underwriting technique," Mr. Mollin said. "When that technique was transferred to computers, we really grew."

Patents are pending on its software used for underwriting the weather coverages.

Meanwhile, National Union is prepared to underwrite snow removal insurance for any entity that budgets for snow removal—municipalities, counties, states, even airports—and that could blow a year's snow removal budget if it were hit with a winter of blizzards.

**'The risk we specialize in is weather; it doesn't make any difference to us what the product (or service) is that may suffer the loss. And it doesn't matter to us where it is—1/100 inch of rain is the same in Duluth or Paris,' Mr. Mollin says.**

"A very severe winter might end up costing a municipality \$2 million for snow removal, when it had budgeted only \$500,000," said Carl H. Luecke, vp at Johnson & Higgins, managing general agent for National Union for this program.

"When that happens, the municipality has to raise property taxes, sell bonds or otherwise raise money to pay for the extra cost." However, the extra cost would be fully covered by National Union if the entity purchased snow removal insurance.

This policy was developed about

a year ago, and J&H is in the marketing stage now. "I think there's quite a demand for this type of coverage," Mr. Luecke said. "I would think if a municipality knew it were available, it would buy it."

"Whenever you think of excess or catastrophe coverage, you think of a policy that doesn't pay," he continued. "This policy will pay. There will be a year in which (a greater than normal snowfall) will happen."

Lloyd's of London has handled some weather-related risks, but one broker says the coverage is expen-

sive and "frankly, not very salable."

"One underwriter once said 'Don't ask me to bet against the Almighty,'" said Geoffrey S. Fox, director of Adam Brother Contingency Ltd., a Lloyd's broker. With weather-related risks, "you are just trying to bet against statistics and it just doesn't work."

However, one underwriter in London, Eagle Star Insurance P.L.C., does specialize in "pure pluvious insurance," as its called in Britain, in which the insured does not have to prove loss to collect on the policy if an event is rained out, Mr. Fox said.

For example, a church may plan an outdoor bazaar and expect to raise 2,000 pounds sterling. But, if it rains, there is no way to prove how much money would have been made.

"Eagle Star will issue a policy which pays an agreed-upon sum in the event that you get an agreed-

upon amount of rainfall between certain specified hours," he said.

Other Lloyd's syndicates handle "a tremendous amount of abandonment insurance," Mr. Fox said, which is a regular indemnity policy in which loss must be proved.

"Excess rainfall can cause the cancellation of a football or tennis match; excess heat may cause the cancellation of a grouse shoot because the brush could be set alight," Mr. Fox said.

And, Lloyd's has begun to receive Toro-like inquiries for weather-related promotions in Britain, he said.

"The U.K. distributor of Polaroid sunglasses has inquired about insuring a certain amount of sunshine," he said. "And holiday companies and ski resorts have inquired."

"But it's very difficult to come up with any satisfactory quote for them. This type of insurance is very expensive." ■

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# Insurer protects against blizzard of refunds

By SALLIE J. DRURY

MINNEAPOLIS—Spring is nudging out the last traces of winter, and The Toro Co. of Minneapolis is busy tallying the inches of snow that fell this past season.

The tally will show how much will be paid in claims to purchasers of Toro snowthrowers, who were guaranteed a full or partial refund of the price of a snowthrower if winter brought below-average accumulations of snow.

The tally also will show how much Mother Nature will cost the insurer that guaranteed Toro's promotion.

The refund was offered to customers that purchased a Toro snowthrower between May 1, 1983, and Dec. 10, 1983.

They were guaranteed that if less than 20% of the average annual snowfall fell between July 1, 1983, and May 31, 1984, they would receive a 100% rebate on the purchase price of the snowthrower. If less than 30% of the average fell, they would receive 70% of the purchase price; less than 40% of the average would bring a 60% rebate; and less than 50% of the average would bring a 50% rebate.

Snowfall measurements are tallied by the National Oceanic and Atmospheric Administration of the U.S. Department of Commerce.

"Right now it looks like two or three cities had less than 50% of the annual average," said Dick Pollick, Toro's director of marketing. "If so, we would have some partial reimbursements there."

But, nowhere was there less than 20% of the annual average snowfall this season, so Toro will not have to reimburse anyone for the full purchase price.

As a result of the promotion, Toro's actual sales exceeded projections by more than 20%. However, without insurance coverage the promotion would never had gotten off the ground, said Mr. Pollick.

"I doubt that we would have gone ahead with the promotion if we didn't have the insurance backup," Mr. Pollick said. "The exposure is really too great."

Before Mr. Pollick joined Toro, he had worked in the recreation industry.

"We depended on snow, and offered a similar promotion which we self-insured," he said. "When I came to Toro I thought we could do a similar type of promotion, but self-insurance wasn't practical."

Toro first approached Lloyd's of London for the coverage, "and they weren't interested," Mr. Pollick said.

But a Lloyd's broker said, "It's not fair to say Lloyd's refused to quote a rate for Toro."

"We received a tentative inquiry from Toro, and asked them to supply us with voluminous weather statistics so we would have adequate underwriting information," said Geoffrey S. Fox, director of Adam Brothers Contingency Ltd. "We never got them, however, and we couldn't place the business without the weather statistics."

"Since we're in the U.K., weather statistics in the States are not readily available," he continued. "It's absolutely correct to say we didn't want to accept (the Toro risk), but we may have if we'd received the statistics."

After it pitched Lloyd's, Toro brought the idea to Good Weather Inc., a subsidiary of American International Group Inc. that specializes in weather-related risks. Good Weather agreed to underwrite the coverage, which was brokered through Marsh & McLennan Group Associates Inc.

Toro's premium, which Mr. Pol-

**'I doubt that we would have gone ahead with the promotion if we didn't have the insurance backup. The exposure is really too great,' says Dick Pollick, Toro's director of marketing.**

lick would not disclose, was based on the number of snowthrowers sold.

Good Weather assumed a \$25 million risk on the Toro policy.

"But that was really less of a risk to us than a \$2 million, one-day concert cancellation policy because the risk was spread around the country," said Harold Mollin, director of programs and marketing for Good Weather.

While Toro's snowthrower promotion received a lot of media coverage, it is by no means the only company insuring financial loss from weather-related risks.

Steiger Tractor Inc. of Fargo, N.D., also insured a similar promotional effort.

The company promised purchasers of its farming equipment that it would redeem a certain percentage

of the purchaser's annual payment if rainfall was a certain percentage below average.

"This was a kind of drought insurance," said Keith Dickelman, retail finance marketing manager for the company. And the risk was assumed by Good Weather.

According to the promotion, a purchaser will be reimbursed 10% of his annual payment if it rains less than 70% of the average; 20% if it rains less than 60% of the average; 40% if it rains less than 50% of the average; 60% if it rains less than 40% of the average; and 100% of the payment if it rains less than 30% of the average.

Annual payments on Steiger equipment ranges from \$10,000 to \$20,000.

Once Steiger pays the premium,

which is based on the number of units financed during the promotional period from April 1 to the end of May, it pays nothing toward any claims triggered by a lack of rain.

"We would like to see someone collect on the program," Mr. Dickelman said. "It would be good publicity for us."

But, Steiger will have to wait and see what weather summer brings.

Steiger paid a premium deposit, based on expected sales before the promotional period began. When actual sales are tallied, additional premium will be paid or an amount will be reimbursed, depending on how forecasts compare to actual sales.

Steiger's idea to offer a weather-  
*Continued on facing page*

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Continued from facing page  
insured promotion was inspired by Toro and Republic Airlines, which offered vacation rebates in case of bad weather in "sun spct" cities, Mr. Dickelman said.

"Everybody is familiar (with those plans), so we talked with (broker) Credit International Associates and researched the idea to see if we could do the same in our business." But, Steiger purchased the policy directly from Good Weather rather than through the broker.

There is no aggregate limit on Steiger's policy. For instance, the largest annual payment for a piece of Steiger equipment is \$20,000. If rainfall were less than 30% of the average, the policy would pay that \$20,000 for every piece of that kind of equipment sold during the promotion period.

Because the rebates could be so large, "We never would have gone ahead with the promotion without

the insurance coverage," Mr. Dickelman said. "We're not in the business of taking risks.

"But the promotion does catch a lot of people's eyes," he added. "I think a lot of people are interested as a result of the promotion. It's doing something for us by making people aware of our name, but it's hard to say in dollars what that means."

Virginia Harvestore Inc., in Louisa, Va., is another producer of farm equipment that wanted to combat customers' fear of a drought. The company sells airtight corn storage structures; if this season brings a drought, farmers may not have any corn to store.

Here again, Toro planted the idea for an insured promotional program.

"We saw an article in The Wall Street Journal and we called up Toro," said Kim Schrum, secretary-treasurer for the company.

Because Virginia had suffered a

drought in the 1983 growing season, the company had to combat the attitudes of farmers who were skeptical of another bad harvest year, he said.

"Toro gave us the name of Good Weather, and we bought a policy through TD&R Insurance Brokers in Richmond," Mr. Schrum said. "Most of the sales are in May and June, so we'll see how the idea works out. There has been a good response from farmers just talking to them about it."

Premiums and limits for Virginia Harvestore are arranged like those of Steiger Tractor. Premium is a percentage of gross sales and there is no aggregate limit. "We projected about \$1 million in sales, but if we actually have \$5 million in sales, we'll just pay more in premium (and the rebates will be covered)," Mr. Schrum said.

Virginia Harvestore is not offering a scaled rebate, but if it rains less than 50% of the average be-

tween May 1 and Sept. 16, purchasers will receive back 50% of what they paid for the storage structure.

Simpson-Sears Ltd. in Toronto, the Canadian division of the giant retailer, also has begun a snowthrower promotion insured through Good Weather.

Simpson-Sears offers a scaled rebate program with a maximum rebate of \$1,500, or 100% of the purchase price of a snowthrower if it snows less than 20% of the average. The insurance premium is also based on sales, with a premium deposit based on sales forecasts.

"Others were (offering a similar promotion) and, in order to be competitive, we had to do it," said J. Gordon Hird, national manager of risk and insurance for the company.

The idea was sparked by the retailer's buyer of snowthrower equipment. The company then purchased the insurance through Perdi Insurance Brokers Inc. in Toronto. ■

## A&A gambling on bookie policy

By SALLIE J. DRURY

British bookies now have another factor to weigh when they set odds: Will it rain enough to make foul weather insurance a "profitable" investment?

Most bookmakers are gambling that it won't, and that's the trouble Alexander & Alexander Ltd. has encountered in marketing its new coverage for Britain's legalized bookmaking operations, which lose income when foul weather cancels horse racing.

"The problem with the book-making fraternity is that they take everything as a gamble," said Eric Carr, an account executive with the Liverpool office of A&A Ltd. "They calculate the risk themselves, and figure how many days of racing will have to be lost for them to make a profit on their premium investment. For them, it's a bet on the weather."

A&A introduced the policy late last year. It is written by Sun Alliance & London Insurance Group.

However, the company was not able to sell a single policy during the last racing season, which runs from November to March. "We need to make it more attractive from a bookmaker's point of view," Mr. Carr said.

A&A is also "rethinking the idea actuarially," as well as from a marketing perspective, he said.

"We went back about 10 years looking at the number of lost racing days due to weather." The worst year yielded 40 days lost. In 1978, 20 days were lost; 33 were lost in 1979; while 20 were lost in 1981.

The policy will pay bookmakers an agreed-upon daily rate equal to 10% or 12.5% of the bookmaker's average net turnover, depending on the amount of premium the bookmaker wants to pay, after 14 days of racing are canceled.

"If a bookmaker were paying a 100-pound premium and earned an average of 50 pounds a day, the break-even point for him would be more like 19 days," Mr. Carr said. "In an average year you are going to break even, but it's difficult to convince (the bookmakers) of the catastrophe risk."

Another actuarial problem, Mr. Carr pointed out, is that all of the policyholders are liable to collect at the same time. "It's not just the one unfortunate collecting from the pot subsidized by everyone else."

A&A is considering changes in the number of canceled days needed before the coverage takes effect. It also may include a provision for payment if a certain number of consecutive days are canceled. But, despite the changes, Mr. Carr says A&A will continue to offer the coverage.

"It's a good idea, and I don't think anyone else has thought of it. We've had inquiries on it from other parts of the world—South Africa and Australia, all sorts of places. We had a racing newspaper asking us about it," Mr. Carr said.

A&A does not plan to expand its market just yet, he said. "At the moment, we are trying to get the U.K. horse racing sorted out." ■

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# More insurers begin writing commercial paper guarantees

By DOUGLAS McLEOD

NEW YORK—As they would with almost any new product, underwriters are approaching the relatively new area of commercial paper guarantees with caution.

While one insurer—Aetna Life & Casualty Co.—has been writing commercial paper guarantees for 10 years, many major underwriters and brokers are only taking steps toward offering the product.

Commercial paper is a term used to describe short-term corporate promissory notes that have specific values and mature on specific days.

Most agree that, given the right economic conditions, the growth potential for commercial paper guarantees is strong.

Some, however, say that the guarantees cannot reduce borrowing costs significantly enough to make them clearly preferable to bank financing of commercial paper issues.

An insurance company issuing a bond covering commercial paper guarantees that the insured corporation will be able to meet payments on the short-term debt. Such a guarantee has the effect of raising the insured company's Standard & Poor's or Moody's debt rating to the same level as the insurer's.

Higher debt ratings normally translate into lower interest rates, so an insured company may substantially reduce its borrowing costs with a guarantee bond, depending on the interest rate spread between its own debt rating and the insurer's.

A single bond may cover multiple commercial paper issues, which by Securities & Exchange Commission definition must mature in fewer than 270 days.

Commercial paper bonds may be written for up to five years, though

they more typically cover terms of one or two years.

The bonds may also contain cancellation provisions, allowing the insurer to back out of covering future issues if the insured company's financial performance falls below certain standards measured by debt-to-equity ratios, cash flow, income and other factors, according to Michael Djordjevich, vp in the financial insurance department of Fireman's Fund Insurance Cos. in Novato, Calif.

Fireman's Fund started writing corporate bond and commercial paper guarantees last December, Mr. Djordjevich said.

Guarantee transactions can take two forms, according to Marc Knapp, financial products director in the financial services department of Continental Corp. in New York. Continental is now gearing up to write its first commercial paper guarantee bond, and expects premium volume to hit \$2 million to \$3 million this year.

In one form, the insurer issues a bond directly to the insured company, which puts up no collateral to cover the debt issues. The insurer thus bears the risk of a default by the insured company.

Few insurers say they are eager to write this type of bond.

More commonly, Mr. Knapp said, a company will set up a "special purpose corporation" to issue its commercial paper. This special purpose corporation then puts up some form of collateral—a bank letter of credit, for example—to cover its debt issues.

The special purpose corporation is generally insulated from the parent company, so that if the parent company goes bankrupt, the assets of the special purpose corporation will still be available to cover the debt issues, he explained.

Most insurers writing guarantee bonds require this or some other form of collateral, says Roger H. Kahn, an assistant vp at Alexander & Alexander Inc. in New York.

"They like to be in a zero loss position," he noted.

"Without collateral our capacity would be strained. We couldn't take it," Mr. Djordjevich said.

In underwriting the coverage, insurers perform a review of a company's creditworthiness, concentrating on its liquidity and ability to meet short-term obligations. Insurers also evaluate the collateral being offered, which in some cases may consist of receivables.

Premiums are generated by applying a rate either to the average amount of outstanding commercial paper covered by the bond or to the bond's limit.

Aetna does both, according to Conrad Chanzit, an assistant vp in the financial guarantee department.

The company first applies a rate to outstanding balances. Then it charges a "standby fee" on the unused portion of the insured company's bond. The standby fee is calculated using a separate rate, usually lower than the rate applied to outstanding balances, Mr. Chanzit explained.

Aetna's rates on outstanding balances have ranged up to 1.25%, though the average rate ranges between 0.375% to 0.75%, he said.

Companies that buy commercial paper guarantees are typically those that either have low debt ratings or no ratings at all because they've never gone to the commercial paper market to finance items like inventory build-up or interim construction, experts say.

By moving from an average debt rating to a top one, a company might cut the interest rate on its

debt issue by 50 basis points, or half a percentage point, Mr. Djordjevich said.

"It may not seem big, but if a company is issuing \$300 million to \$400 million annually, it amounts to some money," he observed.

On a \$300 million commercial paper issue, for example, a drop in the interest rate of 50 basis points would translate to a savings of \$1.5 million annually.

Others, however, say that the current spread between Standard & Poor's A1-plus and A2 commercial paper ratings is narrow, and that companies often have reasons other than interest savings alone to justify using the guarantee bond.

A1-plus is Standard & Poor's top commercial paper rating, and there isn't much of a market for commercial paper rated below A2, experts say.

The current spread between A1-plus and A2 issues may be as little as 20 to 40 basis points, while in 1982 the spread was as great as 75 basis points, according to James Penrose, a vp with Lehman Commercial Paper Inc., a subsidiary of Lehman Brothers Kuhn Loeb Inc. in New York.

"The spread in the marketplace... is insufficient in many situations to make it worthwhile to get the insurance," said Mr. Chanzit.

Continental likes to see some "transactional benefit" for clients in addition to the cost benefits of using commercial paper guarantees, Mr. Knapp noted.

Such transactional benefits may include:

• **Confidentiality.** Privately held companies may use commercial paper guarantees to avoid releasing financial data that Standard & Poor's or Moody's would require to issue a debt rating.

• **Name recognition.** Foreign corporations that are financially strong but relatively unknown in the United States might use a guarantee bond to back up their initial entry into U.S. markets.

Commercial paper guarantees have other specialized uses, Mr. Chanzit added. Aetna, for example, acts as a fronting company for some bank clients, issuing commercial paper in its own name on behalf of the banks.

While the banks indemnify Aetna with letters of credit, they avoid having to back up large volumes of their own short-term debt with letters of credit that would be more visible in the marketplace, Mr. Chanzit explained.

"In effect, it's a quiet form of reinsurance," he observed.

Other insurers—including CIGNA Corp. and National Union Fire Insurance Co. of Pittsburgh, Pa.—are looking at commercial paper guarantees on a selective basis, and several insurers say the growth potential is considerable.

That growth will depend to a large extent on the condition of credit markets, though.

"If there's a generous spread between (the interest paid by) unrated credits and rated credits, there will be a need for credit enhancement," said William Duggan, a managing director with Marsh & McLennan Cos. in New York.

Meanwhile, though, underwriters appear to be proceeding cautiously.

Guarantee bonds could be a self-defeating product for insurers that try to turn too many corporate "dogs" into financial "racehorses," Mr. Djordjevich warned.

"In my opinion, you can do this just so many times before you become a dog yourself," he said. ■

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## Bermuda insurers refuse to write coverage for 'golden parachute'

By **KATHRYN J. McINTYRE**  
and **STACY SHAPIRO**

No one will admit to writing it, but several underwriters in Bermuda say they were offered the opportunity.

The Bermuda underwriters were asked to underwrite portions of a \$30 million policy that would pay the financial benefits promised to 10 senior officers of St. Regis Corp. in New York if their "golden parachutes" didn't open after a takeover.

There has been considerable interest in St. Regis stock recently but the company appears to have thwarted any takeover attempts.

The financial benefits promised select senior officers under so-called golden parachutes that soften the blow of losing one's job are paid when the company is taken over by another and the covered officers lose their jobs or "for good reason" resign.

The officers apparently were concerned that new management might not honor the promise.

St. Regis, however, refused to answer questions regarding the policy or to even confirm it exists.

Bermuda-based underwriters that were offered an opportunity to write a portion of the policy say it was structured in three layers to a \$30 million limit. The premium mentioned by underwriters ranged from \$3 million to \$5 million, which one underwriter said was to be paid by St. Regis.

The first layer was said to have been completed in London, but London underwriters who may have been involved with the policy were unavailable for comment.

Bermuda underwriters said they refused to write the policy because it verged too closely to a financial guarantee for their tastes.

One underwriter said he regretted turning down the policy because it appeared to be an excellent risk. The provisions of the golden parachutes had been disclosed in filings with the Securities and Exchange Commission by St. Regis so an acquiring company would not have grounds for violating the contract, he reasoned.

The golden parachutes were first promised eight St. Regis officers in 1981 and were amended this February to include, among other things, two more officers, the documents filed with the SEC say.

The benefits will be paid if there is a "change in control" of the company and the covered officers are terminated for any reason other than disability within five years after the change or if they voluntarily terminate their employment for "good reason."

The benefits provided for termination of employment other than for disability include:

- Salary, bonuses and incentive awards under the management incentive compensation plan accrued through the date of termination.
- Three times the sum of the officer's annual base salary at the date of termination plus the highest amount awarded to the officer in any of the five years immediately preceding the date of termination under the company's management incentive compensation plan.
- Cash equal to the aggregate spread between the exercise price of all stock options, whether or not fully exercisable, and the higher of the then current market price or the highest price paid in connection with any change in firm control.
- Minimum pension of 35% of the sum of base salary plus the highest bonus in the five years preceding termination.
- Maintenance in full force of all life, health, disability and medi-

cal programs until the first day of the month the officer turns 65.

The officers also are promised compensation for certain taxes, which may be payable as a result of receiving the benefits and for legal expenses incurred.

Sources at Lloyd's confirm that officers covered by golden parachutes can purchase insurance to pay the benefits if the acquiring company doesn't honor the agreement. But, it is written on a select basis and for high premiums.

The coverage limits can range from \$200,000 to \$30 million to \$40 million, said Simon Harrup, managing director for Lloyd's broker Stewart Wrightson North America Ltd. He would not identify premiums.

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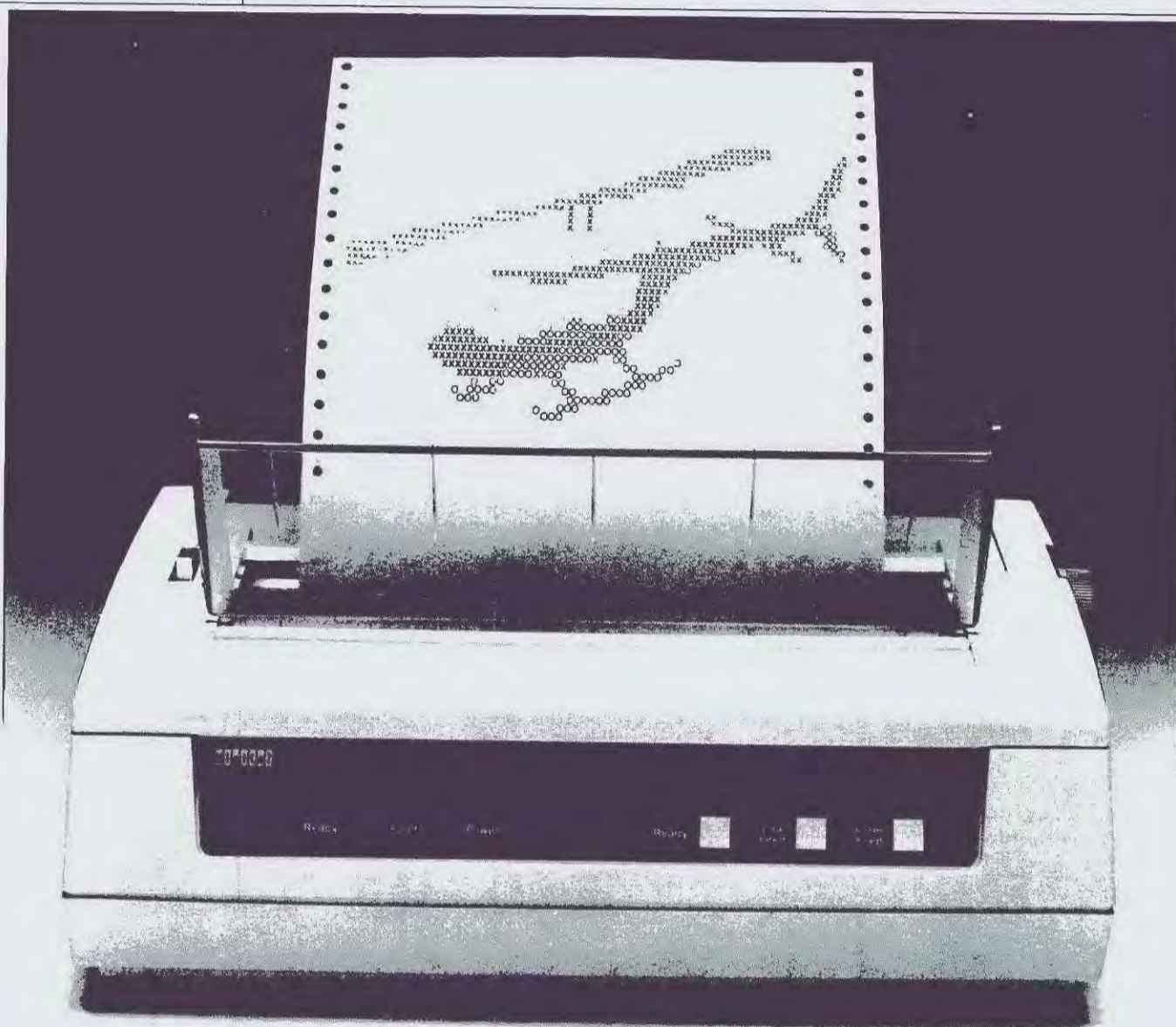
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# Proposed rules governing cafeteria plans, FSAs

The following is the list of 21 questions and answers published by the Internal Revenue Service regarding tax treatment of cafeteria benefits and flexible spending account programs.

The proposed benefit regulations were published in *The Federal Register* on May 7.

The IRS will hold a public hearing

July 26 on the proposed rules. The hearing will begin at 10 a.m. at IRS headquarters in Washington at 1111 Constitution Ave. N.W.

Comments and requests to speak should be sent by July 12 to the Commissioner of the Internal Revenue, Attention: CC:LR:T (EE-16-79), Washington, D.C. 20224.

## Q-1: What does Section 125 of the Internal Revenue Code provide?

A-1: Section 125 provides that a participant in a non-discriminatory cafeteria plan will not be treated as having received the taxable benefits offered under the plan solely because the participant has the opportunity, before the benefits become currently available to the participant, to choose among the taxable and non-taxable benefits offered under the plan.

## Q-2: What is a "cafeteria plan" under Section 125?

A-2: A "cafeteria plan" is a separate written benefit plan maintained by an employer for the benefit of its employees, under which all participants are employees and each participant has the opportunity to select the particular benefits that he desires. A cafeteria plan may offer participants the opportunity to select among various taxable benefits and non-taxable benefits, but a plan must offer at least one taxable benefit and at least one non-taxable benefit. For example, if participants are given the opportunity to elect only among two or more non-taxable benefits, the plan is not a cafeteria plan.

## Q-3: What must the written cafeteria plan document contain?

A-3: The written document embodying a cafeteria plan must contain at least the following information: (i) a specific description of each of the benefits available under the plan, including the periods during which the benefits are provided (i.e., the periods of coverage), (ii) the plan's eligibility rules governing participation, (iii) the procedures governing participants' elections under the plan, including the period during which elections may be made, the extent to which elections are irrevocable and the periods with respect to which elections are effective, (iv) the manner in which employer contributions may be made under the plan,

such as by salary reduction agreement between the participant and the employer or by non-elective employer contributions to the plan, (v) the maximum amount of employer contributions available to any participant under the plan and (vi) the plan year on which the cafeteria plan operates.

In describing the benefits available under the cafeteria plan, the plan document need not be self-contained. For example, the plan document may include by reference benefits established under other "separate written plans," such as coverage under a qualified group legal services plan (Section 120) or under a dependent care assistance program (Section 129), without describing in full the benefits established under these other plans.

But, for example, if the plan offers different maximum levels of coverage under a dependent care assistance program, the descriptions must specify the available maximums. In addition, an arrangement under which a participant is provided with coverage under a dependent care assistance program for dependent care expenses incurred during a period of coverage up to a specified amount (e.g., \$500) and the right to receive, either directly or indirectly in the form of cash or any other benefit, any portion of the specified amount that is not reimbursed for such expenses will be considered a single benefit and must be fully described as such in the plan document. This is also the case with other benefits, such as coverage under an accident or health plan and coverage under a qualified group legal services plan. See Q&A-17 and Q&A-18 regarding the taxability of such benefit arrangements.

## Q-4: What does the term "employees" mean under Section 125?

A-4: The term "employees" includes present and former employees of the employer. All employees who are treated as employed by a single employer under subsections (b), (c) or (m) of Section 414 are treated as em-

ployed by a single employer for purposes of Section 125. The term "employees" does not, however, include self-employed individuals described in Section 401(c) of the Code. Even though former employees generally are treated as employees, a cafeteria plan may not be established predominantly for the benefit of former employees of the employer.

In addition, even though the spouses and other beneficiaries of the participants may not be participants in a cafeteria plan, a plan may provide benefits to spouses and beneficiaries of participants. For example, the spouse of a participant may not be permitted to participate actively in a cafeteria plan (i.e., the spouse may not be given the opportunity to select or purchase benefits offered by the plan), but the spouse of a participant may benefit from the participant's selection of family medical insurance coverage or of coverage under a dependent care assistance program. A participant's spouse will not be treated as actively participating in a cafeteria plan merely because the spouse has the right, upon the death of the participant, to select among various settlement options available with respect to a death benefit selected by the participant under the cafeteria plan or to elect among permissible distribution options with respect to the deceased participant's benefits under a cash or deferred arrangement that is part of the cafeteria plan.

## Q-5: What benefits may be offered to participants under a cafeteria plan?

A-5: With the exception of benefits that defer the receipt of compensation (see Q&A-7), a cafeteria plan may offer participants the opportunity to select among certain taxable benefits and non-taxable benefits described in the plan document. The term "taxable benefit" means cash, property or other benefits attributable to employer contributions that are currently taxable to the participant under the Internal Revenue Code upon receipt by the participant. The term "non-taxable benefit" means any benefit attributable to employer contributions to the extent that such benefit is not currently taxable to the participant under the Internal Revenue Code upon receipt of the benefit. Thus, a cafeteria plan may offer participants the following benefits, which will be non-taxable when provided in accordance with the applicable provisions of the Internal Revenue Code: group-term life insurance up to \$50,000 (Section 79), cover-

age under an accident or health plan (Section 105), coverage under a qualified group legal services plan (Section 120) and coverage under a dependent care assistance program (Section 129). Also, amounts received by participants under one of these benefits may or may not be taxable depending upon whether such amounts qualify for an exclusion from gross income. See Q&A-17 and Q&A-18 regarding the inclusion of an accident or health plan, dependent care assistance program or qualified group legal services plan in a cafeteria plan. Also, see Q&A-7 regarding the inclusion of deferred compensation benefits in a cafeteria plan.

In addition, a cafeteria plan may offer benefits that are non-taxable because they are attributable to aftertax employee contributions. For example, a cafeteria plan may offer participants the opportunity to purchase, with aftertax employee contributions, coverage under an accident or health plan providing for the payment of disability benefits. A participant's receipt of coverage under such an accident or health plan would not trigger taxable income because the coverage would be purchased with aftertax employee contributions. Similarly, any amounts paid to a participant under such an accident or health plan on account of disability incurred during the year of coverage may be non-taxable under Section 104(a)(3).

## Q-6: May employer contributions to a cafeteria plan be made pursuant to a salary reduction agreement between the participant and the employer?

A-6: Yes. The term "employer contributions" means amounts that have not been actually or constructively received (after taking Section 125 into account) by the participant and have been specified in the plan document as available to a participant for the purpose of selecting or "purchasing" benefits under the plan. A cafeteria plan document may provide that the employer will make employer contributions, in whole or in part, pursuant to salary reduction agreements under which participants elect to reduce their compensation or to forgo increases in compensation and to have such amounts contributed, as employer contributions, by the employer on their behalf. A salary reduction agreement will have the effect of causing the amounts contributed thereunder to be treated as em-

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 employer contributions under a cafeteria plan only to the extent the agreement relates to compensation that has not been actually or constructively received by the participant as of the date of the agreement (after taking Section 125 into account) and, subsequently, does not become currently available to the participant. In addition, a plan document also may provide that the employer will make employer contributions on behalf of participants equal to specified amounts (or specified percentages of compensation) and that such non-elective contributions will be available to participants for the selection or purchase of benefits under the plan.

**Q-7: May a cafeteria plan offer a benefit that defers the receipt of compensation?**

A-7: No. A cafeteria plan does not include any plan that offers a benefit that defers the receipt of compensation, with the exception of the opportunity for the participants to make elective contributions under a qualified cash or deferred arrangement defined in Section 401(k). Thus, employer contributions made at a participant's election to a profit-sharing plan containing a qualified cash or deferred arrangement will be treated as non-taxable benefits under a cafeteria plan.

In addition, a cafeteria plan does not include a plan that operates in a manner that enables participants to defer the receipt of compensation. Generally, a plan that permits participants to carry over unused benefits or contributions from one plan year to a subsequent plan year operates to enable participants to defer the receipt of compensation. This is the case regardless of whether the plan permits participants to convert the unused contributions or benefits into another benefit in the subsequent plan year. For example, a plan that offers participants the opportunity to purchase vacation days (or to receive cash or other benefits under the plan in lieu of vacation days) will not be a cafeteria plan if partici-

pants who purchase the vacation days for a plan year are allowed to use any unused days in a subsequent plan year. This is the case even though the plan does not permit the participant to convert, in the subsequent plan year, the unused vacation days into any other benefit.

In determining whether a plan permits participants to carry over unused vacation days, a participant will be deemed to have used his non-elective vacation days (i.e., the vacation days with respect to which the participant had no election under the plan) before his elective vacation days. For example, assume that an employer provides a participant with three weeks of vacation for a year and, under the plan, the participant is permitted to receive cash or other benefits in lieu of one of those three weeks. Assume that the participant elects not to exchange the one elective week of vacation for another benefit. If the participant uses two

weeks of vacation during the year, he will be treated as having used the two non-elective weeks of vacation. Thus, if the participant is permitted to carry the one unused week over to the next year, the plan will be treated as operating to enable participants to defer the receipt of compensation. Thus, the plan will fail to be a cafeteria plan and the Section 125 exception to the constructive receipt rules will not apply.

In addition, a plan that allows participants to use employer contributions for one plan year to purchase a benefit that will be provided in a subsequent plan year operates to enable participants to defer the receipt of compensation.

**Q-8: What requirements apply to participants' elections under a cafeteria plan?**

A-8: A plan is not a cafeteria plan unless the plan requires that participants make elections among the benefits offered under the plan. A

plan may provide that elections may be made at any time. However, benefit elections under a cafeteria plan should be made in accordance with certain guidelines (see Q&A-15) in order for participants to qualify for the protections of the Section 125 exception to the constructive receipt rules. An election will not be deemed to have been made if, after a participant has elected and begun to receive a benefit under the plan, the participant is permitted to revoke the election, even if the revocation relates only to that portion of the benefit that has not yet been provided to the participant. For example, a plan that permits a participant to revoke his election of coverage under a dependent care assistance program or of coverage under an accident or health plan after the period of coverage has commenced will not be a cafeteria plan. However, a cafeteria plan may permit a participant to revoke a benefit election after the period of coverage has commenced

and to make a new election with respect to the remainder of the period of coverage if both the revocation and the new election are on account of and consistent with a change in family status (e.g., marriage, divorce, death of spouse or child, birth or adoption of child, and termination of employment of spouse).

**Q-9: What is the tax treatment of benefits offered under a non-discriminatory cafeteria plan?**

A-9: A participant in a non-discriminatory cafeteria plan will not be treated as having received taxable benefits offered under the plan and thus will not be required to include the benefits in gross income solely because the plan offers the participant the opportunity, before the benefits become currently available to participant, to elect to receive or not to receive the benefits. Section 125 thus provides an exception to the constructive re-

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cept rules that apply with respect to employee elections among non-taxable and taxable benefits (including cash). These constructive receipt rules generally provide that an individual will be required to include in gross income the taxable benefits that he could have elected to receive if the individual had the opportunity to elect to receive or not to receive the benefits even though both the opportunity to make this election occurs and the actual election is made before the benefits become currently available to the individual.

Section 125 does not, however, alter the application of the constructive receipt rules to a situation in which benefits become currently available to an individual even though the individual elects not to receive and does not actually receive the benefits. Thus, if taxable benefits become currently available to a participant in a non-discriminatory cafeteria plan, the participant will be taxable on the benefits, even though the participant has elected or subsequently elects not to receive the benefits and does not actually receive the benefits.

#### Q-10: What is the tax treatment of benefits offered under a discriminatory cafeteria plan?

A-10: The Section 125 exception to the constructive receipt rules is not available to the highly compensated participants in a cafeteria

plan that is discriminatory for a plan year. Thus, a highly compensated participant in a cafeteria plan that is discriminatory for a plan year will be taxable on the combination of the taxable benefits with the greatest aggregate value that he could have selected for the plan year. The Section 125 exception to the constructive receipt rules remains available to participants who are not highly compensated without regard to whether the cafeteria plan is discriminatory.

#### Q-11: How are the amounts taxable to a highly compensated participant because a cafeteria plan is discriminatory for a plan year to be allocated among the benefits actually selected by the participant for the plan year?

A-11: A highly compensated participant in a discriminatory cafeteria plan is taxable on the maximum taxable benefits that he could have selected for the plan year. For example, assume that a cafeteria plan provides a highly compensated participant with the opportunity to select, for a plan year, benefits costing \$1,300 from among the following: up to \$300 in cash, coverage under an accident or health plan providing medical expense reimbursement (cost of \$600), coverage under an accident or health plan providing disability benefits (cost of \$200), coverage under a qualified legal services plan (cost of \$400) and coverage under a dependent care assistance program (cost of \$400). For the plan year in question, the participant elects to receive \$100 in cash, coverage under both of the accident or health plans (\$600 and \$200) and coverage under the dependent care assistance program (\$400). If the cafeteria plan is discriminatory for the plan year, the participant will be taxable on the \$100 cash benefit actually selected and on the \$200 cash benefit that the participant could have selected. This \$300 will be allocated, first, to the taxable benefits actually selected by the participant and, second, on a pro rata basis to the non-taxable benefits actually selected by the participant. Thus, \$100 is allocated to the \$100 cash benefit actually received and the \$200 is allocated as employee contributions among the non-taxable benefits actually selected as follows: \$100 to coverage under the accident or health plan for medical care, \$33.33 to the coverage under the accident or health plan for dis-

ability benefits, and \$66.67 to the coverage under the dependent care assistance program. This allocation would not affect the non-taxable status of any of these benefits—the purchase of coverage under any of these plans with employee contributions would not trigger taxable income—but it may affect the taxability of amounts received under any of the plans. In addition, depending upon whether other conditions are satisfied, the participant may be able to deduct under Section 213 some or all of the employee cost of coverage under the accident or health plan for medical care. Thus, reimbursements received by the participant for medical care expenses incurred during the year of coverage may be non-taxable under either Section 104(a)(3) or Section 105(b), depending upon whether the reimbursements are attributable to aftertax employee or pretax employer contributions. Also, if the participant became disabled during the year of coverage, benefits provided under the accident or health plan would be non-taxable to the participant under Section 104(a)(3) to the extent that the benefits were attributable to the portion of the coverage purchased with the aftertax employee contributions. Finally, any reimbursements received under the dependent care assistance program for the year of coverage will be non-taxable under Section 129 if the requirements of that section are satisfied.

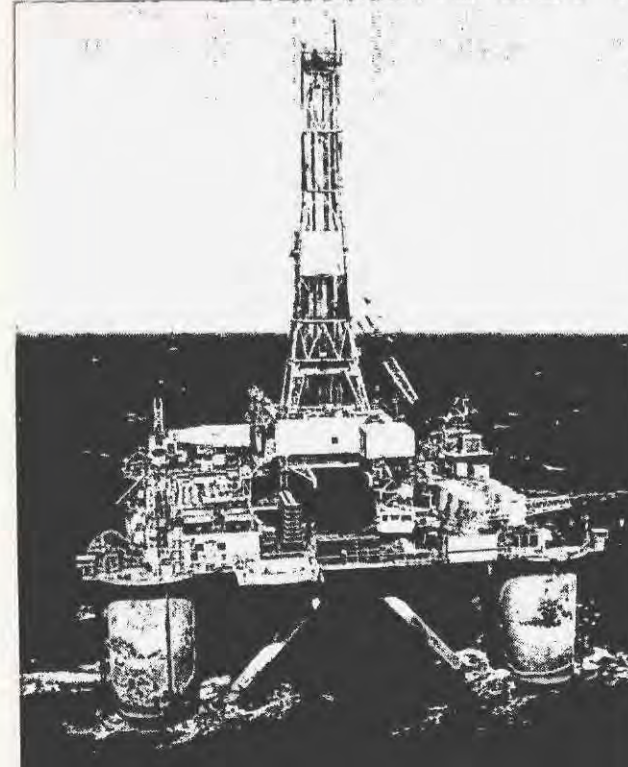
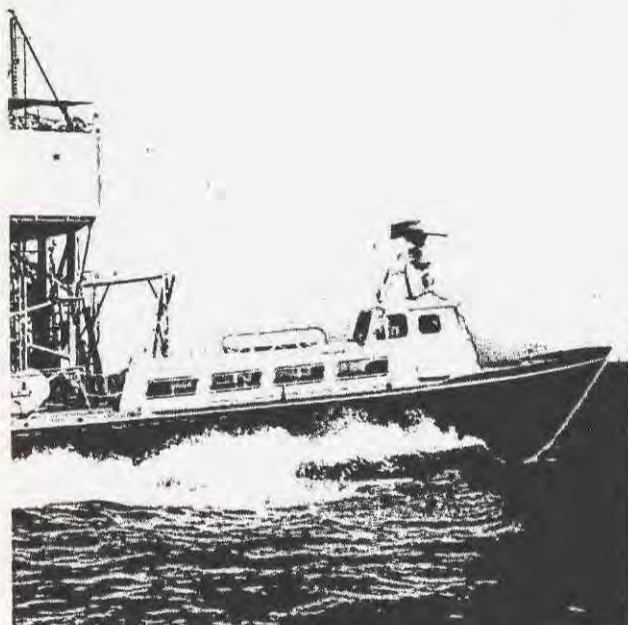
#### Q-12: When must a highly compensated participant in a discriminatory cafeteria plan include in gross income amounts attributable to the taxable benefits that the participant could have selected, but did not in fact select?

A-12: Amounts required to be included in gross income by a highly compensated participant because a cafeteria plan does not satisfy the applicable non-discrimination standards for a plan year will be treated as received or accrued in the participant's taxable year within which ends the plan year with respect to which an election was or could have been made.

#### Q-13: Who are highly compensated participants under Section 125?

A-13: The term "highly compensated participant" means a participant who is an officer, a share-

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**Q-14: When will a benefit be treated as currently available to a participant in a cafeteria plan?**

A-14: A benefit is treated as currently available to a participant if the participant is free to receive the benefit currently at his discretion or the participant could receive the benefit currently if an election or notice of intent to receive the benefit were given. A benefit will not be treated as not currently available merely because of a requirement that the participant must elect or give notice of intent to receive the benefit in advance of the receipt of the benefit. However, a benefit is not currently available to a participant if there is a substantial limitation or restriction on the participant's receipt of the benefit. A benefit will not be treated as currently available if the participant may under no circumstances receive the benefit before a particular time in the future and there is a substantial risk that, if the participant does not fulfill specified conditions during the period preceding this time, the participant will not receive the benefit.

**Q-15: What procedures with respect to benefit elections should a cafeteria plan adopt in order to assure that participants are not subject to tax, under the constructive receipt rules, on taxable benefits that the participants have elected not to receive?**

A-15: Generally, in order for participants to avoid constructive receipt with respect to taxable benefits offered under a cafeteria plan, the taxable benefits must at no time become currently available to the participants. Thus, a cafeteria plan should require participants to elect the specific benefits that they will receive before the taxable benefits become currently available. A benefit will not be treated as currently available as of the time of the election if the election specifies the future period for which the benefit will be provided and the election is made before the beginning of this period.

In addition, after the beginning of the specified period for which the benefits are provided, the taxable benefits must not become currently available to the participants. After the commencement of this period, taxable benefits will be treated as currently available if participants have the right to revoke their elections of non-taxable benefits and instead to receive the taxable benefits for such period, without regard to whether the participants actually revoke their elections.

For example, assume that a cafeteria plan offers each participant the opportunity to elect, for a plan year, between coverage under a dependent care assistance program for up to \$2,000 of the dependent care expenses incurred by the participant during the plan year or a cash benefit of \$2,000 for the year. If the plan requires the participants to elect between these benefits before the beginning of the plan year and, after the year has commenced, the participants are prohibited from revoking their elections, participants who elected coverage under the dependent care assistance program will not be taxable on the cash benefit of \$2,000. But if, after the beginning of the plan year, participants have the right to revoke their elections of coverage under the dependent care assistance program and thereby to receive the cash benefit, the participants will be treated as having received the \$2,000 in cash even though they do not revoke their elections. The same result would obtain even though the cash benefit

is not payable until the end of the plan year. See Q&A-8, however, regarding the revocation of elections on account of changes in family status.

**Q-16: Do the rules of Section 125 affect whether any particular benefit offered under a cafeteria plan is a taxable or non-taxable benefit?**

A-16: Generally, no. A benefit that is non-taxable under the Internal Revenue Code when offered separately is treated as a non-taxable benefit under a cafeteria plan only if the rules providing for the exclusion of the benefit from gross income continue to be satisfied when the benefit is offered under the cafeteria plan. For example, if \$50,000 in group-term life insurance is offered under a cafeteria plan and the rules under Section 79(a) governing the exclusion of the cost of this benefit from gross income are satisfied, the rules of Section 79(d) still apply to determine the status of the benefit as taxable

or non-taxable for key employees who participate in the plan. See Q&A-17 and Q&A-18, however, regarding the inclusion of coverage under an accident or health plan, dependent care assistance program or qualified group legal services plan in a cafeteria plan.

Similarly, if a cafeteria plan offers benefits that are non-taxable under the Internal Revenue Code when offered outside of a cafeteria plan, but are prohibited from inclusion in a cafeteria plan, the benefits will be treated as taxable benefits under the cafeteria plan. Thus, coverage under a qualified transportation plan (Section 124) and coverage under an educational assistance program (Section 127) will be treated as taxable benefits if offered under a cafeteria plan. Also, any benefits (either reimbursement for expenses or in kind benefits) received by a participant under a qualified transportation plan or an educational assistance program will be taxable if the benefits are pro-

vided under a cafeteria plan.

Finally, if a benefit that is taxable under the Internal Revenue Code when offered separately is offered under a cafeteria plan, the benefit will continue to be a taxable benefit under the cafeteria plan. For example, if a cafeteria plan offers a participant the opportunity to direct the employer to make charitable contributions or contributions to an individual retirement account on behalf of the participant, such contributions must be included in the participant's gross income for income and employment tax purposes without regard to whether the plan satisfies Section 125 and without regard to whether the contributions are deductible by the participant.

**Q-17: How are the specific rules of Section 105, providing an income exclusion for amounts received as reimbursement for medical care expenses under an accident or health plan, to be applied when coverage under an**

**accident or health plan is offered as a benefit under a cafeteria plan?**

A-17: Section 105(b) provides an exclusion from gross income for amounts that are paid to an employee under an employer-funded accident or health plan specifically to reimburse the employee for certain medical care expenses incurred by the employee during the period for which the benefit is provided to the employee, i.e., the period during which the employee is covered under the accident or health plan. Section 105(h) provides that the exclusion provided by Section 105(b) is not available with respect to certain amounts received by a highly compensated individual (as defined in Section 105(h)(5)) under a discriminatory self-insured medical reimbursement plan. Several rules are of particular importance when coverage under an accident or health plan is a benefit offered under a cafeteria plan.

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First, in order for medical care reimbursements paid to a participant under a cafeteria plan to be treated as non-taxable under Section 105(b), the reimbursements must be paid pursuant to an employer-funded "accident or health plan," as defined in Section 105(e) and S 1.105-5. This means that, although the reimbursements need not be provided under a commercial insurance contract, the reimbursements must be provided under a benefit that exhibits the risk-shifting and risk-distribution characteristics of insurance. A benefit will not exhibit the required risk-shifting and risk-distribution characteristics, even though the benefit is provided under a commercial insurance contract, if the ordinary actuarial risk of the insurer is negated either under the terms of the benefit or by any related benefit or arrangement (including arrangements formally outside of the cafeteria plan).

Second, a cafeteria plan benefit under which a participant will receive reimbursements of medical expenses is a benefit within Sections 106 and 105(b) only if, under the benefit, reimbursements are paid specifically to reimburse the participant for medical expenses incurred during the period of coverage. Amounts paid to a participant as reimbursement are not treated as paid specifically to reim-

burse the participant for medical expenses if, under the benefit, the participant is entitled to the amounts, in the form of cash (e.g., routine payment of salary) or any other taxable or non-taxable benefit, irrespective of whether or not he incurs medical expenses during the period of coverage, even if the participant will not receive the amounts not used for expense reimbursement until the end of the period. A benefit under which participants will receive reimbursement for medical expenses up to a specified amount and, if they incur no expenses, will receive cash or any other benefit in lieu of the reimbursements is not a benefit that qualifies for the exclusions under Sections 106 and 105(b). See S 1.105-2. This is the case without regard to whether the benefit was purchased with contributions made at the employer's discretion, at the participant's discretion (such as pursuant to a salary reduction agreement), or pursuant to a collective bargaining agreement.

For example, if a cafeteria plan offers participants coverage under an employer-funded plan that provides for the reimbursement of medical expenses incurred during the plan year up to a specified amount (e.g., \$1 000) and the participants are entitled to receive, in the form of any other taxable or non-taxable benefits (including deferrals under a cash or deferred arrangement), any portion of the specified amount that is not paid as reimbursement for medical expenses, the employer contributions used to purchase the coverage will not qualify for the Section 106 exclusion and any reimbursements paid to participants for expenses incurred during the year of coverage will not be eligible for the Section 105(b) exception. Arrangements formally outside of the cafeteria plan that provide for the adjustment of a participant's compensation or a participant's receipt of any other benefits on the basis of the expenses incurred or reimbursements received by the participant will be considered in determining whether the reimbursements are provided under a benefit eligible for the exclusions under Sections 106 and 105(b).

Third, the medical expenses that are reimbursed under an accident or health plan must have been incurred during the period for which the participant is actually covered

by the accident or health plan in order for the reimbursements to be excluded from gross income under Section 105(b). For purposes of this rule, expenses are treated as having been incurred when the participant is provided with the medical care that gives rise to the medical expenses, and not when the participant is formally billed, charged for or pays for the medical care. Also, for purposes of this rule, medical expenses that are incurred before the latter of the date the plan is in existence and the date the participant is enrolled in the plan will not be treated as having been incurred during the period for which the participant is covered by the plan. Thus, in order for reimbursements to be excluded from gross income under Section 105(b), the accident or health plan must provide a participant the right to reimbursement for medical expenses incurred during a specified period of plan coverage. Reimbursements of expenses incurred prior to or after the specified period of coverage will not be excluded under Section 105(b). However, the actual reimbursement of covered medical care expenses may be made after the applicable period of coverage.

Fourth, in order for reimbursements under an accident or health plan to qualify for the Section 105(b) exclusion, the cafeteria plan may not operate in a manner that enables participants to purchase coverage under the accident or health plan only for periods during which the participants expect to incur medical care. For example, if a cafeteria plan permits participants to purchase coverage under an accident or health plan on a month-by-month or an expense-by-expense basis, reimbursements under the accident or health plan will not qualify for the Section 105(b) exclusion. If, however, the period of coverage under an accident or health plan offered in a cafeteria plan is 12 months (or, in the case of a cafeteria plan's initial plan year, at least equal to the plan year) and the plan does not permit a participant to select specific amounts of coverage, reimbursement or salary reduction for less than 12 months, the cafeteria plan will be deemed not to operate to enable participants to purchase coverage only for periods during which medical care will be incurred. See Q&A-8 regarding the revocation of elec-

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Continued from facing page  
tions during a period of coverage  
on account of changes in family  
status.

Fifth, in order for reimbursements to a highly compensated individual under a self-insured accident or health plan to be treated as non-taxable under a cafeteria plan, the discrimination rules of Section 105(h) must be satisfied. For purposes of these rules, coverage under a self-insured accident or health plan offered by a cafeteria plan will be treated as an optional benefit (even if only one level and type of coverage is offered) and, for purposes of the optional benefit rule in S 1.105-11(c)(3)(i), employer contributions will be treated as employee contributions to the extent that taxable benefits are offered by the plan. In addition, the accident or health plan offered by the cafeteria plan must provide for the non-discriminatory reimbursement of expenses on a per capita basis, rather than on a proportion of compensation.

**Q-18: How are the specific rules of Section 129, providing an income exclusion for dependent care assistance provided under a dependent care assistance program, to be applied when coverage under a dependent care assistance program is offered as a benefit under a cafeteria plan?**

A-18: Section 129(a) provides an employee with an exclusion from gross income both for employer-funded coverage under a dependent care assistance program and for amounts paid or incurred by the employer for dependent care assistance provided to the employee if the amounts are paid or incurred under a dependent care assistance program. A program under which participants receive reimbursements of dependent care expenses up to a specified amount and are entitled to receive, in the form of any other taxable or non-taxable benefits, any portion of the specified amount not used for reimbursement is to be treated as a single benefit that is not a dependent care assistance program within the scope of Section 129. Thus, dependent care assistance provided under a cafeteria plan will be treated as provided under a dependent care assistance program only if, after the participant has elected coverage under the program and the period of coverage has commenced, the participant does not have the right to receive amounts under the program other than as reimbursements for dependent care expenses. This is the case without regard to whether coverage under the program was purchased with contributions made at the employer's discretion, at the participant's discretion or pursuant to a collective bargaining agreement.

For example, assume a cafeteria plan allows participants to elect to receive, for a particular plan year, either the right to reimbursements of dependent care expenses incurred during the year up to \$2,000 or a cash benefit of \$2,000. If the participant elects the right to receive reimbursements of dependent care expenses, the reimbursements will not be treated as made under a dependent care assistance program if, after the period of coverage has commenced, the participant has the right to revoke his election of this benefit and instead to receive the cash or if, under the terms of the program itself, the participant is entitled to receive, in the form of cash (e.g., routine payment of salary) or any other benefit, any amounts not reimbursed for dependent care provided during the period of coverage. Arrangements formally outside of the cafeteria plan that provide for the adjustment of a participant's compensation or a participant's receipt of any other benefits on the basis of the assistance or reimbursements received by the participant will be

considered in determining whether a dependent care benefit is a dependent care assistance program under Section 129.

Moreover, in order for dependent care assistance to be treated as provided under a dependent care assistance program eligible for the Section 129 exclusion, the care must be provided to or on behalf of the participant during the period for which the participant is covered by the program. For example, if a participant elects coverage for a plan year under a dependent care assistance program that provides for the reimbursement of dependent care expenses, only reimbursements for dependent care expenses incurred during that plan year will be treated as having been provided under a dependent care assistance program within the scope of Section 129. For purposes of this rule, dependent care expenses will be treated as having been incurred when the dependent care is provided, and not when the

participant is formally billed, charged for or pays for the dependent care. Also, for purposes of this rule, expenses that are incurred before the latter of the date the program is in existence and the date the participant is enrolled in the program will not be treated as having been incurred during the period for which the participant is covered by the program. Similarly, if the dependent care assistance program furnishes the dependent care in kind (e.g., under an employer-maintained child care facility), only dependent care provided during the plan year of coverage will be treated as having been provided under a dependent care assistance program within the scope of Section 129.

In addition, in order for dependent care assistance under a cafeteria plan to be treated as provided under a dependent care assistance program eligible for Section 129 exclusion, the plan may not operate in a manner that enables participants

to purchase coverage under the program only for periods during which the participants expect to receive dependent care assistance. If the period of coverage under a dependent care assistance program offered by a cafeteria plan is 12 months (or, in the case of a cafeteria plan's initial plan year, at least equal to the plan year) and the plan does not permit a participant to select specific amounts of coverage, reimbursement or salary reduction for less than 12 months, the plan will be deemed not to operate to enable participants to purchase coverage only for periods during which dependent care assistance will be received. See Q&A-8 regarding the revocation of elections during the period of coverage on account of changes in family status.

Finally, if coverage under a dependent care assistance program is a benefit offered under a cafeteria plan, the rules of Section 129 will determine the status of the benefit

as a taxable or non-taxable benefit.

As a result, coverage under a dependent care assistance program in a cafeteria plan will be non-taxable for a plan year only if, among other requirements, the principal shareholder and owner discrimination test contained in Section 129(d)(4) is satisfied with respect to employer contributions actually used to provide participants with dependent care assistance during the plan year. In addition, amounts paid or incurred by the employer under a dependent care assistance program are excludable from gross income only to the extent that these amounts do not exceed the lesser of the participant's earned income or the participant's spouse's earned income.

Rules similar to the rules applicable to dependent care assistance programs apply with respect to coverage under a qualified group legal services plan (Section 120) offered as a benefit under a cafeteria

Continued on next page

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Continued from previous page plan.

**Q-19: What are the rules governing whether a cafeteria plan is discriminatory?**

A-19: The applicable discrimination rules under Section 125 provide that, in order to be treated as non-discriminatory for a plan year, a cafeteria plan must not discriminate in favor of highly compensated participants as to benefits and contributions for that plan year. Generally, this discrimination determination will be made on the basis of the facts and circumstances of each case. Section 125(c) provides that a cafeteria plan does not discriminate where either (i) total non-taxable benefits and total benefits or (ii) employer contributions allocable to total non-taxable benefits and employer contributions allocable to total benefits do not discriminate in favor of highly compensated participants. A cafeteria plan must satisfy Section 125(c) with respect to both benefit avail-

ability and benefit selection. Thus, a plan must give each participant an equal opportunity to select non-taxable benefits, and the actual selection of non-taxable benefits under the plan must not be discriminatory, i.e., highly compensated participants do not disproportionately select non-taxable benefits while other participants select taxable benefits.

In addition to not discriminating as to either benefit availability or benefit selection, a cafeteria plan must not discriminate in favor of highly compensated participants in actual operation. A plan may be discriminatory in actual operation if the duration of the plan (or of a particular non-taxable benefit offered under the plan) coincides with the period during which highly compensated participants utilize the plan (or the benefit).

**Q-20: May non-taxable benefits provided under a cafeteria plan be counted as "compensation"**

**under Section 401(a)(5) for purposes of determining whether a qualified pension, profit-sharing or stock bonus plan discriminates under Section 401(a)(4), or under Section 415 for purposes of the limitations contained in that section?**

A-20: A qualified pension, profit-sharing or stock bonus plan will not be treated as discriminatory within the meaning of Section 401(a)(4) merely because, for purposes of allocating contributions to the participant or calculating the participant's benefit under the plan, the plan considers non-taxable benefits provided to a participant as compensation. For example, if a participant in a cafeteria plan elects coverage under an accident or health plan, the value of such coverage may be considered as compensation under a qualified plan for purposes of calculating the participant's allocation or benefit under the qualified plan. Non-taxable reimbursements under the accident or health plan, however, generally may not be treated as compensation under a qualified plan. Similarly, the value of coverage under a dependent care assistance program may be counted as compensation under a qualified plan for allocation and benefit purposes, but non-taxable reimbursements of dependent care expenses under the program generally may not be treated as compensation for these purposes. On the other hand, a qualified plan will not be treated as discriminatory under Section 401(a)(4) merely because the plan does not consider non-taxable benefits, such as coverage under an accident or health plan or coverage under a dependent care assistance program, as compensation for allocation or benefit purposes under the plan.

For purposes of Section 415, "compensation" does not include amounts that are excluded from gross income, such as premiums for group-term life insurance under Section 79 or employer contributions to an accident or health plan excluded under Section 106.

**Q-21: What are the effective dates of the rules contained in these questions and answers?**

A-21: These rules contained in questions and answers relating to Section 125 generally shall apply to plan years of cafeteria plans beginning after Dec. 31, 1978. However, a cafeteria plan that failed to satisfy one or more of the following rules

for plan years beginning before (the date of publication of this document in the Federal Register) will not be deemed thereby to have failed to satisfy Section 125 for such plan years if, by (the date that is 120 days after the date of publication of this document in the Federal Register), the plan is amended to operate in accordance with these rules: (i) the rules requiring certain information to be included in the cafeteria plan (Q&A-3), (ii) the rules governing the active participation of a participant's spouse in a cafeteria plan (Q&A-4), (iii) only in the case of a plan under which participants were permitted neither to carry over unused benefits for more than one plan year nor to convert, into any other benefits, any unused benefits that had been carried over to a subsequent plan year, the rules prohibiting the carryover of any unused contribution or benefit from one plan year to a subsequent plan year (Q&A-7), and (v) the rules limiting the revocability of benefit elections (Q&A-8). A cafeteria plan may treat the portion of its current plan year remaining after (the date that is 120 days after the date of publication of this document in the Federal Register) as a new period of coverage for the purposes of satisfying the rules governing benefit elections (Q&A-8). Also, a benefit offering participants the opportunity to make elective contributions under a qualified cash or deferred arrangement may be included in a cafeteria plan only in plan years beginning after Dec. 31, 1980.

The rules contained in Q&A-17 governing the taxability of coverage and benefits under an accident or health plan relate specifically to Sections 105 and 106 and thus generally are effective with respect to all taxable years beginning after Dec. 31, 1953. The rules contained in Q&A-18 governing the taxability of coverage and benefits under a dependent care assistance program relate specifically to Section 129 and thus generally are effective with respect to all taxable years beginning after Dec. 31, 1981. The rules contained in Q&A-18 governing the taxability of coverage and benefits under a qualified group legal services plan relate specifically to Section 120 and thus generally are effective with respect to all taxable years beginning after Dec. 31, 1976.

However, if coverage under an

accident or health plan, dependent care assistance program or qualified group legal services plan was offered as a benefit under a cafeteria plan and such benefit failed to satisfy, before (the date of publication of this document in the Federal Register), the rule prohibiting a plan from operating to enable a participant to elect coverage under an accident or health plan, a dependent care assistance program, or a qualified group legal services plan only for periods during which the participant expects to receive medical care, dependent care or legal services (Q&A-17 and Q&A-18), such benefit will not be deemed solely on account of such failure to have failed to satisfy the statutory rules providing for the income exclusion of such coverage or of any benefits provided thereunder, if, by (the date that is 120 days after the date of publication of this document in the Federal Register), the cafeteria plan is amended to operate in accordance with such election of coverage rule. A cafeteria plan may treat the portion of its current plan year remaining after (the date that is 120 days after the date of publication of this document in the Federal Register) as a new period of coverage and as an initial plan year for purposes of satisfying the rule prohibiting a plan from operating to enable participants to elect coverage under an accident or health plan, dependent care assistance program or qualified group legal services plan only for periods during which they expect to receive medical care, dependent care or legal services (Q&A-17 and Q&A-18).

In addition, if the conditions set forth below are satisfied, employer contributions (including elective and non-elective contributions) made before June 1, 1984, under an arrangement described in the next sentence which is part of a cafeteria plan, will not be treated as having been made to an accident or health plan, dependent care assistance program or qualified group legal services plan that fails to satisfy the rules contained in the second and third paragraphs of Q&A-17 and the first paragraph of Q&A-18, merely because, under the arrangement for a plan year, a participant was entitled to receive, in the form of cash or any other taxable or non-taxable benefit, amounts available for reimburse-

Continued on facing page

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## Chicago-area PPO, administrator formed

CHICAGO—A new preferred provider organization and a PPO third-party administrator have been established in the Chicago area.

Health Management Group Pro-Net is the PPO. Since January, it has enlisted five Chicago-area companies: Colborne Manufacturing Co., The Ball Co., Sound & Stagecraft, Milton Johns/Spring Air and Precision Carbide Tool Co. Inc.

About 500 employees and dependents are eligible for coverage under the PPO program. Those enrolling receive discounts of from 5% to 25% on services offered by five hospitals in Chicago and its suburbs, 30 optical centers, 17 dentists and eight other providers of health maintenance-related products and services, including sporting goods and vitamin stores, where members receive discounts.

"Our whole intention is to cover all aspects of employees' health," said Ruth A. Kalish, vp at Health Management Corp. of America, the PPO's sponsor. "We don't want to penalize the

person who is healthy."

Employees and covered dependents are not obligated to use designated providers, although member companies can provide additional financial incentives to those who do, such as wellness bonuses and higher coinsurance rates, Ms. Kalish said.

Pro-Net provides employers with utilization reviews on a prospective, as well as a retrospective, basis. The prospective reviews allow employers to monitor and limit forthcoming health costs, Ms. Kalish said.

Companies can obtain retrospective reviews of their individual costs separately, as well as in comparison to the costs incurred by other PPO companies. Also, Pro-Net provides aggregate reviews comparing the cost of health services provided by PPO hospitals to those provided by non-PPO hospitals.

Bunch Self-Funded Administrators, the third-party PPO administrator, has arranged with a Chicago-based PPO headed by Dr.

Gerald M. Berkowitz to provide negotiated-fee medical services to employees of self-insured companies. It offers the services of doctors practicing 50 specialties, most of whom are at Chicago's Louis A. Weiss Memorial Hospital.

The PPO was established in early 1983 and has provided services to a variety of motion picture and theater productions.

The PPO contracted with BSFA, Dr. Berkowitz said, to widen the scope of its business. "Before, there were times when we had hundreds of people under contract, and other times that were dead," he said.

Located in Park Ridge, Ill., BSFA is a subsidiary of National Accident Insurance Underwriters, an underwriting manager for six insurance companies.

BSFA will pay employees' benefit claims, provide utilization reports, arrange excess loss insurance and perform other administrative functions for member companies. It has not yet contracted with any employers. ■

Continued from facing page  
ment under the arrangement without regard to whether covered expenses are incurred. An arrangement is described in this sentence only if, under the arrangement,

(i) an account was actually established on behalf of the participant by the employer, by an entry on the employer's books or in similar fashion, prior to the beginning of the plan year (or prior to the date on which an individual first becomes eligible to participate under the arrangement in the case of an individual who first becomes eligible to participate, on account of years of employment, during the plan year);

(ii) the amount (or specific rate) of contributions to the account under the arrangement was fixed prior to the beginning of the plan year;

(iii) neither the participant nor the employer possessed the right to increase or decrease contributions to the account during the plan year (but a plan may provide that contributions could be terminated during the year on account of the participant's (a) separation from service or (b) cessation of participation under the arrangement for the remainder of the plan year);

(iv) contributions were actually deposited in or credited to the account before being made available for reimbursement; and

(v) distributions were not available for reasons other than reimbursement of covered expenses until the end of the plan year (but a plan may provide that a single distribution of the unreimbursed balance may be made on account of the participant's (a) separation from service or (b) cessation of participation under the arrangement for the remainder of the plan year).

A cafeteria plan may operate on a plan year other than the calendar year for purposes of this transitional rule, so long as terms of the plan permit contributions to a plan to be fixed only once during, and a distribution of the unreimbursed amount to be received, only once for any plan year, provided that contributions may be fixed for a short plan year of the plans first period of operation. This transitional rule does not affect or alter the requirement of Q&A-17 and -18 that expenses that are reimbursed under an arrangement must have been incurred during the period for which the participant actually is covered by the arrangement. ■

### OSHA may approve Alaska safety plan

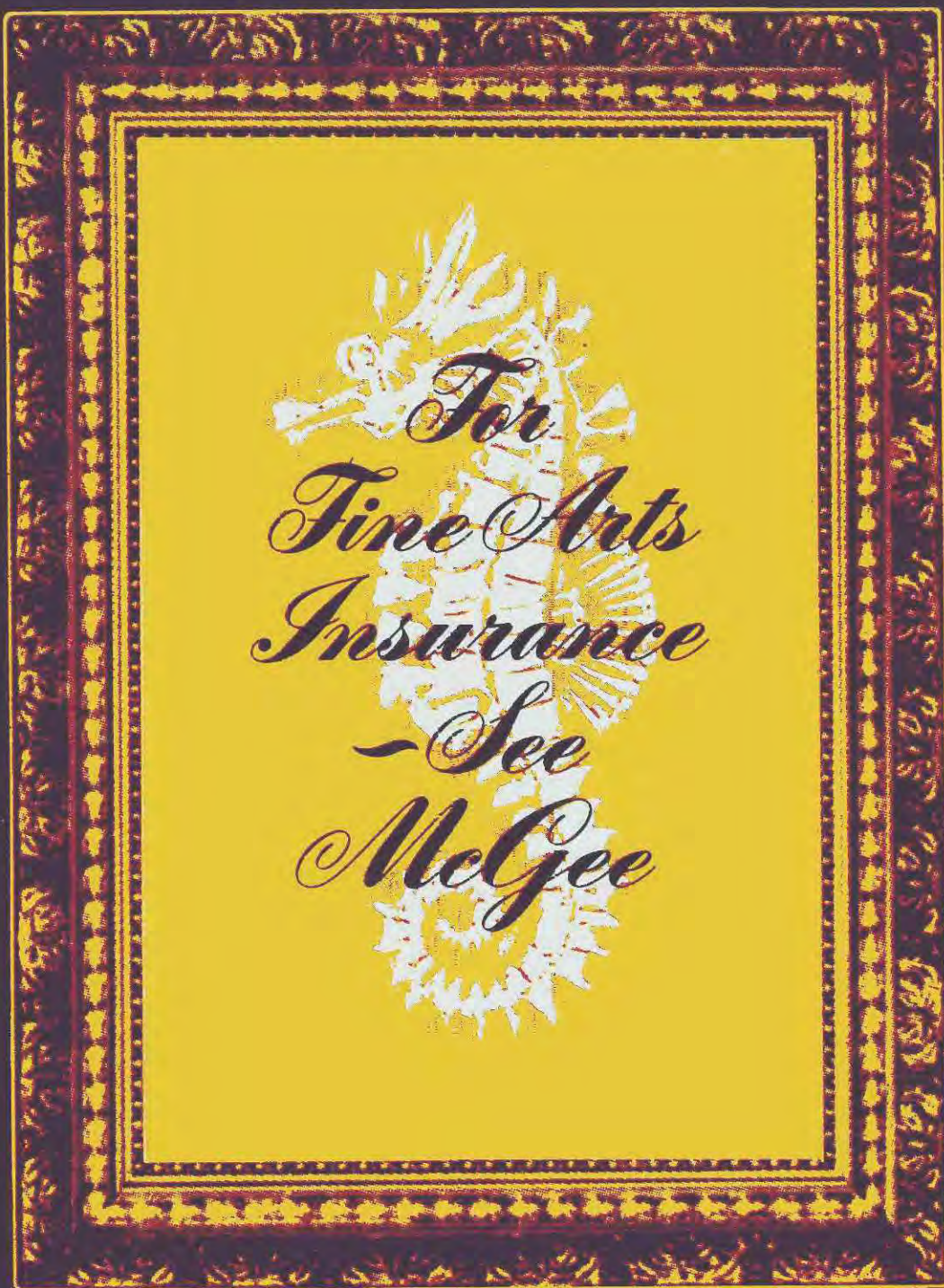
WASHINGTON—Alaska's state job safety and health program is eligible for final approval by the federal Occupational Safety and Health Administration, the federal Labor Department has announced.

If granted, final approval would mean that federal standards and enforcements would be formally relinquished in areas covered by the Alaska plan.

That program covers safety and health for private sector workers and for state and local government employees. Alaska's plan does not include safety and health in the private sector maritime industry, which is covered by federal OSHA.

States and territories are permitted to establish their own job safety and health programs, subject to federal approval and monitoring, under the Occupational Safety and Health Act of 1970. The Virgin Islands and Hawaii are the only other jurisdictions that currently meet requirements.

Public comment on whether final approval should be granted to Alaska's program will be accepted by OSHA through May 22. An informal public hearing on the issue is scheduled for June 7 in Anchorage, Alaska. ■



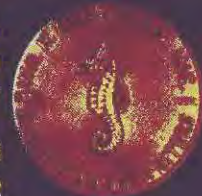
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## APPWP Washington conference

# Packwood asks employers to help battle benefit threats

By JERRY GEISEL

WASHINGTON—Employee benefit managers: Sen. Robert Packwood needs your support.

"I desperately need your help during the next two to three months" to stave off the ongoing assault on employee benefit plans, the Oregon Republican told benefit managers earlier this month.

Speaking at the Washington meeting of the Assn. of Private Pension & Welfare Plans, Sen. Packwood said a defeat of current proposals to restrict employee benefit plans could buy "benefit tranquility" in Congress for many years.

**That's because** Senate Finance Committee Chairman Robert Dole, R-Kan.,—who favors, among other things, taxing health care benefits—is expected to resign as committee chairman next year if he replaces Sen. Howard Baker, R-Tenn., as Senate majority leader. Sen. Baker will retire from the Senate at the end of the year.

Sen. Packwood, who was described by APPWP Executive Director Ed Davey as "our only friend in Congress," would become chairman of the Finance Committee if the Republicans maintain control of the Senate. He is now the ranking majority member.

Sen. Packwood said that—as chairman of the Finance Committee, which controls much benefit legislation—he would do everything he could to protect employee benefits.

If a victory is won in the conference committee that is finalizing tax legislation that would restrict funding of benefit plans, such as 501(c)(9) trusts, "We will be over the hurdle," he said.

For starters, Sen. Packwood said, there would be a major staff shakeup if he became Finance Committee chairman.

Staff members of the Finance Committee, as well as the House Ways and Means Committee and

the Treasury Department, do not like tax preferences now enjoyed by employee benefit plans, the senator said.

"You are up against a philosophy that every benefit should be taxed," Sen. Packwood said. "That is anathema to me" and should be to everyone else who wants to keep government off their backs, he said.

Benefit managers should realize that there is a "cult" that wants to take benefits away, he added.

There are sound public policy reasons why Congress years ago decided to give tax preferences to employee benefit plans, Sen. Packwood said.

**These preferences**, such as allowing employers to deduct as a business expense the cost of group health insurance premiums, have encouraged companies to expand their benefit programs to meet their employees' health care needs, he said.

The growth in corporate health care plans is a major reason that Congress hasn't passed a costly national health insurance program, Sen. Packwood said.

And those who think the federal government can provide health care benefits at a lower cost than employers are "out of their minds,"

'You are up against a philosophy that every benefit should be taxed. That is anathema to me,' Sen. Robert Packwood, R.-Ore., told employers.

he noted, citing cost overruns in the Medicare program, which provides health care for the elderly (see story, page 65).

A current tactic used by those who oppose tax preferences for benefit plans is to say that the plans are being abused by the highly compensated, Sen. Packwood pointed out.

In fact, such "abuse" usually is an isolated example that benefit opponents falsely describe as representative of all plans, he explained.

Although some say employer plans have become too generous and thus have reduced employees' incentive to use health care services wisely, Sen. Packwood rejected that argument.

Employers, he said, are "not going to give away the ship" by providing every conceivable employee benefit.

Sen. Packwood also said that placing a cap on the amount of tax-free health insurance coverage an employee can receive is not likely to control health care costs.

Such a cap would not ease health care inflation, but it would reduce benefits to workers.

It should be up to employers and employees and competitive market pressures, and not the federal government, to determine the scope of coverage, Sen. Packwood said.

## Senator says caps on fees won't control hospital costs

WASHINGTON—Placing caps on hospital charges will not control the soaring costs of health care, a U.S. senator contends.

Limiting hospital charges, such as specifying how much a hospital will receive for a particular surgical procedure, may cut costs by only 2%, says Sen. David Durenberger, R-Minn.

Although such cost controls are in vogue because they can be quickly implemented, they don't offer much promise in putting a dent in the current 12% to 15% annual health care inflation rate, he said.

Instead of treating hospitals like they have treated the utility industry, with massive regulation, legis-

lators need to cool the demands for health care services, Sen. Durenberger said at the Assn. of Private Pension & Welfare Plans conference in Washington.

Currently, he said, health care consumers lack incentives to stay healthy. First-dollar coverage means "you can get sick for free," he said.

"People need choices to stay healthy," Sen. Durenberger said.

**For example**, if limits were placed on the amount of tax-free health insurance employers could provide, employees would become more conscious of the cost of health care and use services more wisely, he suggested.

Sen. Durenberger said he favors a cap that would require employees to pay taxes on health-related insurance premiums paid by employers that exceed \$300 a month for family coverage.



Sen. Durenberger

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## APPWP meeting draws big crowd

WASHINGTON—The Assn. of Private Pension & Welfare Plans, a major benefits trade group, brought together about 250 employee benefit managers, consultants, attorneys, pension plan sponsors, actuaries and guests at its Washington conference April 30-May 2 to discuss "Politics & Deficits: The Squeeze on Benefits."

This year's attendance was up more than 20% from last year, said Ed Davey, the APPWP's executive director. The increased attendance, Mr. Davey said, is a reflection of benefit managers' need to stay on top of breaking benefit developments in Washington.

"People are overwhelmed by what is going on (in the benefits arena)," he said.

The APPWP is located at 1201 Pennsylvania Ave. N.W., Suite 340, Washington, D.C. 20004; 202-737-6666.

# Retiree benefits seen as major issue

By JERRY GEISEL

WASHINGTON—Funding and providing post-retirement health care benefits may become one of the hottest benefit issues of the 1980s, a consultant predicts.

As more companies go out of business and can't pay the health care benefits they promised to retirees, employers will face legislative pressures to fund those benefits, says David Glueck, a vp at Towers, Perrin, Forster & Crosby, a New York-based management and financial consultant.

Speaking before the Assn. of Private Pension & Welfare Plans conference in Washington, Mr. Glueck said that employers that don't believe that regulatory standards for funding post-retirement benefits are on the horizon should recall what happened in the pension arena.

The collapse during the 1950s of companies that failed to fund their pension plans, including Studebaker, the Indiana-based automaker, led to the passage of the Employee Retirement Income Security Act. That 1974 law sets minimum funding standards for pension plans.

If a major recession forces large companies to fold and not pay promised post-retirement health care benefits, legislators in Washington may get involved and set funding standards, Mr. Glueck predicted.

"We could get another ERISA if promises to provide medical benefits to retirees are broken," Mr. Glueck said.

In addition, legislators are bound to take more of an interest in post-retirement health care plans as more costs are shifted from the federal Medicare program onto employers, Mr. Glueck said.

Post-retirement plans are set up to supplement Medicare which has, among other things, high deductibles and high co-

"We could get another ERISA if promises to provide medical benefits to retirees are broken," says David Glueck.

insurance requirements. Currently, few companies have set specific reserves to pay for post-retirement benefits, and that is practice Mr. Glueck says he finds puzzling.

Companies decline to set reserves because they believe—incorrectly—that post-retirement benefits are not a fixed promise, like pension benefits, Mr. Glueck noted.

In fact, courts have ruled that companies are responsible for paying the post-retirement benefits they promised, the TPF&C consultant noted.

Although there may be no statutory law in the area, employers can expect unfavorable court decisions if they drop post-retirement benefits.

"If you promised to provide the benefits indefinitely, then courts probably will rule against you if you cut back," Mr. Glueck said.

**Companies that are concerned about the post-retirement benefits can take several steps, Mr. Glueck said. Those steps include:**

- Measure the liabilities
- Some employers believe that the cost of post-retirement health care benefits can't be calculated.
- In fact, Mr. Glueck advises, the cost of post-retirement health care can be measured just as companies have been estimating their future pension expenses.
- Decide how you will communicate the promise to provide the benefits.
- Employers that say they always will provide post-retirement health care benefits are

especially vulnerable to legal actions if they later attempt to reduce the benefits.

• Fund the benefits.  
But funding post-retirement benefits, which most employers currently handle on a pay-as-you-go-basis, could prove difficult if the House of Representatives has its way, Mr. Glueck said.

The House has passed tax legislation that would deter employers from using tax-exempt 501(c)(9) trusts to fund post-retirement health care benefits.

A 501(c)(9) trust, named for the section of the Internal Revenue Code authorizing it, allows employers to receive tax deductions for contributions to the trust, which are used to fund a variety of employee benefits. The trust assets and the interest they earn are not taxed.

However, the House bill, H.R. 4170, would cap the reserves held by a trust at 75% of the average benefits paid out during an employer's previous and current tax years (BI, April 16). The Senate tax bill, H.R. 2163, lacks this restriction.

Both House and Senate bills will be considered by a congressional conference committee, possibly starting May 15. The congressional conference committee will iron out this and other differences.

The proposed 75% limit compares with a level of reserves consultants recommend that prudent employers establish for post-retirement benefits: 10 to 15 times what a company paid out in its most recent year.

The level of reserves should be high because the promise to pay health care benefits can extend for years after an employee has retired.

By contrast, the liability to cover an active employee in a group health insurance plan ends shortly after the worker leaves the company.

If the House provision on 501(c)(9) trusts gains congressional approval, employers will have lost an important vehicle to fund post-retirement health care benefits, Mr. Glueck said.

## Medicare ailing, committee says

By JERRY GEISEL

WASHINGTON—The federal Medicare program must be overhauled to prevent the program from running out of money, says the executive director of a national commission.

Medicare's financial problems are serious because of an aging population, according to Thomas Burke, executive director of the Advisory Council on Social Security.

More older people are living longer, which means Medicare costs continue to increase.

While costs are rising, the ratio of workers—who support the pay-as-you-go program through Social Security taxes—to beneficiaries is slipping, Mr. Burke told the Assn. of Private Pension & Welfare Plans conference in Washington.

Today, there are 3.8 workers paying Social Security taxes for every retiree eligible for Medicare benefits. By the year 2000, that ratio of workers to beneficiaries will decline to 2-to-1.

The Advisory Council, whose 14 members were appointed in 1982 by the secretary of the Department of Health and Human Services, has made dozens of recommendations to Congress to put the Medicare program on a sound financial footing.

Perhaps the most controversial recommendation by the council in its 310-page report, Medicare Benefits and Financing, is that a portion of employers' contributions to group health insurance

Continued on next page



Mr. Glueck



Mr. Burke

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## Medicare system ailing, panel says

Continued from previous page  
ance plans should be counted as taxable income to the employee.

The council specifically endorsed the Reagan administration's proposal, S. 640, to tax employees on employer-paid health insurance premiums that exceed \$70 a month for individual coverage and \$175 a month for family coverage, Mr. Burke said.

A portion of the revenue from the health care tax would be funneled to the Medicare Hospital Insurance Trust Fund, which is now supported by part of the FICA tax.

That health care tax, which is opposed by most employers, insurers and unions, "will make employees more conscious of and concerned about the effectiveness of the services they receive," according to the council.

Another of the council's recommendations to raise revenue is a boost in federal excise taxes on alcohol and tobacco, with the additional revenue earmarked to support Medicare.

Such a tax is justified because a good portion of health care costs is due to abuse of alcohol and tobacco, Mr. Burke explained.

The council also recommended that the eligibility age for Medicare, now 65, should be gradually increased, starting on Jan. 1, 1985, until it reaches 67 on Jan. 1, 1990, Mr. Burke said.

After 1990, the eligibility age for

Medicare coverage would be indexed to increased life expectancy.

In its report, the council noted that average life expectancy has increased significantly since 1966 when Medicare began. Today, the life expectancy for women is 77.5 years, up from 73.9 years in 1966, while males' life expectancy has climbed to 69.8 years, compared with 66.7 years in 1966.

"With increased longevity, an expanding Medicare population will place even greater fiscal burdens on the program," the council said. Setting the eligibility age at 65 is based more on custom than on an assessment of health care needs, the council added.

Perhaps the most unusual council recommendation is its proposal that workers be allowed to set up accounts, known as Individual Medical Accounts or IMAs, which would pay catastrophic health care bills. Medicare currently does not cover all catastrophic expenses.

Under this proposal, an individual, starting at age 52 or 55, would begin contributing to an IMA, which would be administered by the federal government. These contributions would be tax deductible, and funds in the IMA would be shielded from taxes. The maximum contributions would be either

a flat amount or based on income.

When an individual became eligible for Medicare, money could be withdrawn from the fund to pay for catastrophic medical expenses—those expenses that exceed 15% to 20% of one's aftertax income.

If an individual died and did not exhaust all the funds in his or her IMA, the contributions would accrue to the estate. However, accumulated interest in the IMA would be transferred to a government "catastrophic health care bank."

This health care bank would fund catastrophic expenses of those individuals whose catastrophic health care costs exceeded the value of their IMAs.

The IMA approach would ensure that "elderly Americans who have adequate financial means to pay for a greater portion of their health care expenses would do so without unreasonable hardship," the council said.

"Those with lesser means would pay a lesser share of their costs both would be protected through their IMA and the government health bank against catastrophic illness cost," the council reported.

Mr. Burke said he expects Congress will analyze and discuss the council's recommendations next year.

## NCSI to discuss workers comp

LOUISVILLE, Ky.—Nitty-gritty issues facing employers that self-insure their workers compensation risks will be discussed May 20-23 during the annual meeting of the National Council of Self-Insurers in Louisville.

Among topics currently on the agenda are:

- Occupational diseases—Are the states doing enough?
- Deducting the loss reserve—cash-flow impact.
- The status of the exclusive remedy doctrine.
- The workers compensation system in Minnesota.

Lincoln M. Alexander, chairman of the Ontario Workers' Compensation Board and president of the International Assn. of Industrial Accident Boards & Commissions, will be among the featured speak-

ers. Kentucky Gov. Martha Layne Collins also will address the NCSI meeting.

Registration for the event, to be held at the Hyatt Regency Louisville, is \$225 for members, \$275 for non-members, \$100 for member spouses and \$125 for non-member spouses.

The NCSI, which was organized in 1945, promotes the interests of self-insurers and their employees in matters of legislative and administrative activity affecting workers compensation coverage and related issues.

Information about the NCSI or its annual meeting is available from Executive Director Douglas A. Stevenson, 10 S. Riverside Plaza, Suite 1530, Chicago, Ill. 60606; 312-454-5110.

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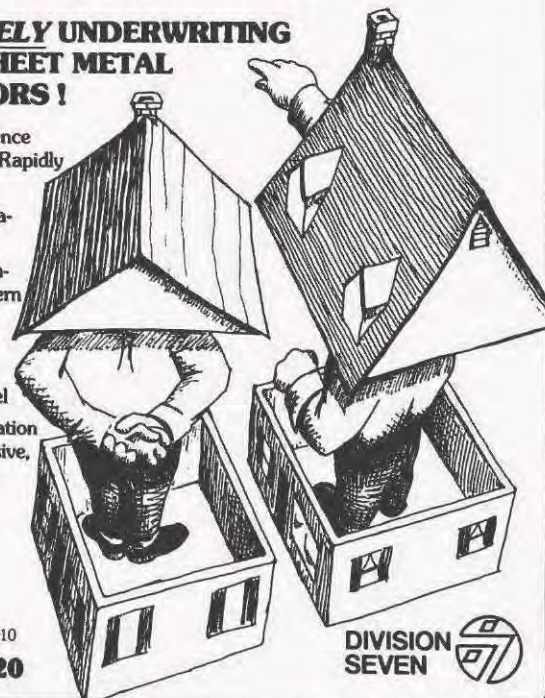
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DIVISION SEVEN

## British Insurance Brokers' Assn. conference

**Bank, insurer ties worry British regulators**

By STACY SHAPIRO

BRISTOL, England—New government regulations probably will be needed to cope with the financial services conglomerates formed as banks and insurers merge, the governor of the Bank of England says.

"We will have to consider such controls as the retention of corporate distinctions between the different parts of a new group, the preservation of the independence of the separate managements and the erection of barriers preventing cross-infection through exposure to the same risks," Robin Leigh-Pemberton told the annual meeting of the British Insurance Brokers Assn.

"Where there is more than one supervisory authority, as with banking and insurance, this will clearly require cooperation and coordination among the (government) officials concerned," he added.

Unlike in the United States, British banks are now allowed to purchase insurers. But, Mr. Leigh-Pemberton noted that British regulators are worried, as are regulators in the United States, that if banks become players in the insurance industry, they could coerce borrowers into buying their insurance from the bank.

"I must say that I never encountered such a practice when I was a commercial banker," the governor told the brokers. "I would have condemned it then as an anti-competitive restrictive practice and

have no hesitation in doing so now."

The governor of the Bank of England is considered to be one of the most powerful men in the British financial sector.

Although the bank has no official control over the British insurance market, it wields considerable clout in the affairs of underwriters and brokers.

For instance, the governor of the Bank of England approves the selection of three non-Lloyd's of London members who sit on the Council of Lloyd's and was instrumental in the appointment of an accountant, Ian Hay Davison, as Lloyd's chief executive.

The Bank of England is very interested in the growth of the "financial supermarkets," in which one company provides a variety of financial services, including insurance, the governor said.

"Linkages between banks and insurance companies... present a major problem for the supervisory authorities—that is the Bank of England and the Department of Trade and Industry, respectively," Mr. Leigh-Pemberton told the audience.

"The core of the problem is that both kinds of institutions are highly geared in the sense that their capital is low in relation to their other liabilities. Both are vulnerable to changes in asset valuations which are, moreover, quite likely to occur at the same stage of the economic cycle, and both depend on maintaining the confi-

dence of their investors, which could be put in jeopardy by a failure in a related company."

As a result, supervisory bodies require both industries to maintain adequate capital and other solvency ratios, the governor pointed out. But, if these ratios threaten to fall below acceptable levels, the authorities have the power to see more capital from shareholders.

Mr. Leigh-Pemberton noted that during a banking crisis in Britain in the mid-1970s, some interconnected banks and insurance companies ran into trouble, creating a crisis where one division of a con-

glomerate was aggravated by the need to meet the solvency requirements of the other.

Now, he said, "We have to consider how best to respond to proposals to develop new forms of financial institutions encompassing previously separated activities. In all probability, we will have to devise new safeguards to cope with new structures."

In this vein, the governor applauded the "self-regulation" approach that Professor Emeritus Jim Gower of Southampton University took in his recent report on investor protection, which will be the basis

for legislation (see related story).

As more banks and insurers merge, the governor sees the need for "the construction and enforcement of a robust regulatory framework."

But, Mr. Leigh-Pemberton pointed out, "I want to emphasize equally strongly that I would resist any style of regulation which needlessly frustrated innovation, impeded the flow of funds to those raising new capital or stifled the capacity of the financial services industry quickly to respond to competitive and technological challenge."

**Speakers' list reflects BIBA's clout**

By STACY SHAPIRO

BRISTOL, England—The British Insurance Brokers' Assn. annually attracts Britain's top financial and governmental officials to its conference, and the 1984 meeting was no exception.

Among the notables who addressed the brokers this year were Lloyd's of London Chief Executive Ian Hay Davison (*BI*, May 7), Industry Minister Norman Lamont and Robin Leigh-Pemberton, the governor of the Bank of England (see related story).

This year's speakers, though, had a tough act to follow: Prime Minister Margaret Thatcher addressed the BIBA conference in 1983.

The brokers attending the conference are heavyweights in their own right.

Among the 380 delegates that attended this year's meeting, held April 26-28, were the chairmen of the large Lloyd's brokers, including Sedgwick Group P.L.C., Willis Faber P.L.C., Stewart Wrightson

Group P.L.C. and Alexander Howden Group P.L.C.

BIBA is well-respected in the British financial community because of the large role the insurance industry plays in the nation's economy, association officials note.

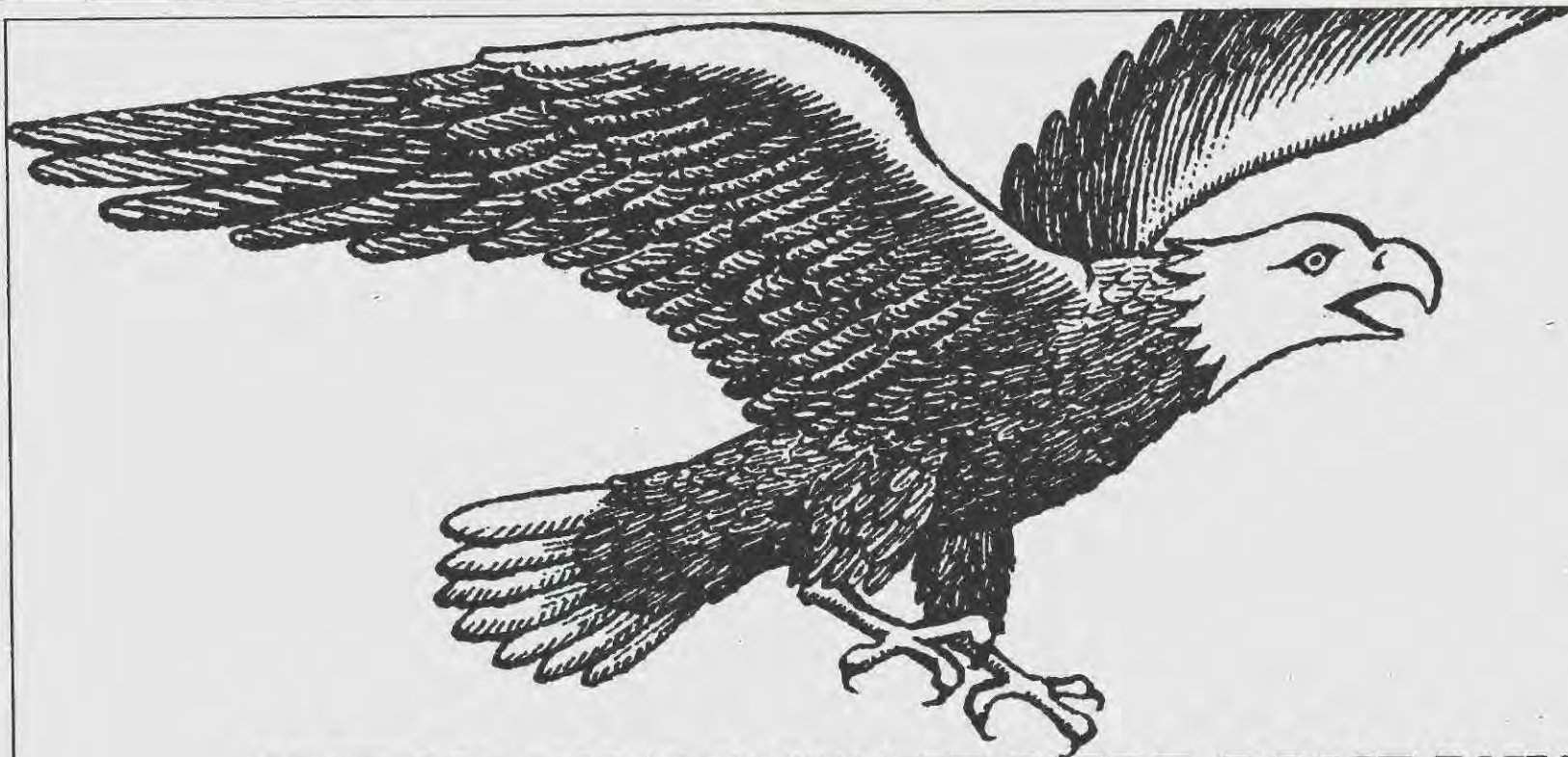
"It can fairly be said that in 1982 the activities of the British insurance broking industry benefited (Britain's) invisible earnings and balance of payments by some 600 million pounds (\$900 million)," said BIBA's Director General Michael Morris.

"This achievement is well-recognized and enables the association to carry more weight in discussion with government," he said.

However, BIBA's clout also stems from six years of active lobbying with government and the financial industry, points out A.V. "Dickie" Alexander, the group's chairman.

"Really excellent progress has been made in establishing close and effective links with the Department of Trade and Industry."

*Continued on next page*

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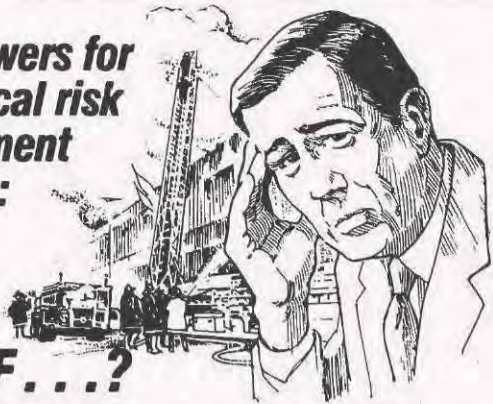
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## BIBA's clout draws top officials

Continued from previous page  
ment of Trade and Industry, which is both our sponsor and our monitor, with government ministers and with the Bank of England," he said. "These links will have deep and lasting benefits for our industry because they are immensely valuable in helping toward a better comprehension of our affairs on the part of those who are outside our community but have a part to play in influencing the shape and behavior of insurance broking."

Paradoxically, BIBA and its members are struggling to improve their relations with underwriters, and officials note that it hasn't been easy.

Insurers and BIBA member brokers are at odds over a 1982 law that states that any intermediary calling itself an "insurance broker" must be registered with the government's Insurance Brokers Registration Council. In addition, BIBA members must also be registered with the council.

However, many insurers are still accepting business from non-registered intermediaries, which BIBA says undermines attempts to regulate the nation's brokers.

"The fact is that, in general, insurers have shown little inclination to actively support the concept of registration and to discriminate positively in favor of registered brokers," Mr. Alexander said.

"You have long been urging us to get together under the umbrella of one association and to set about improving standards. We have

done precisely that. Our members would like to see some tangible recognition from the market for those who have submitted themselves to the quite onerous test of registration."

But, BIBA members also have to upgrade their own standards of practice, both Mr. Morris and Mr. Alexander agreed.

"Our standards are not sufficiently high and we must not be complacent," Mr. Morris said, adding that many brokers need more formal education.

BIBA is also worried about the security that insurers offer, especially as capacity shrinks and the market hardens, Mr. Morris and Mr. Alexander pointed out.

To protect its members and their clients from an insurer insolvency, BIBA may help its member brokers

assess insurers' security.

Although BIBA is perceived to have a lot of clout in the insurance industry, it could gain even more.

A recent report by Professor Emeritus Jim Gower of Southampton University on the protection of British private investors, which is expected to result in legislation, suggests that life insurance intermediaries be regulated by an industry body, which could be BIBA, Mr. Alexander said.

As a result, BIBA has contacted the Department of Trade and Industry and the Bank of England to advise how to best self-regulate life insurance intermediaries.

"This legislation will provide possibly a once-and-for-all opportunity to dispose of the running sore of non-regulated intermediaries," Mr. Alexander said. ■

### info

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• H.M. Bates, a leading Australian-owned insurance broker, publishes a quarterly newsletter on the Australian insurance market. For a free copy, write Sandy Ross, H.M. Bates, 140 Arthur St., North Sydney 2060, Australia.

• "The 1984 Information Booklet" provides information on all aspects of the International Foundation of Employee Benefit Plans, including dates of the group's 1984 educational programs; titles of books, periodicals and research reports recently published; and a description of its objectives, functions, history and membership services. The 28-page booklet also lists names of the foundation's officers, directors, committee members and key staff personnel. For a free copy, write the IFEBP, P.O. Box 69, Brookfield, Wis. 53005.

• "Public Officials at Risk" traces the development of public officials' professional liability through landmark court decisions. The authors, two Illinois attorneys whose primary practice is defending local governments in civil rights litigation, discuss the extent of civil rights liability under federal law and describe methods for handling potentially libelous situations. This 24-page booklet costs \$6, with discounts available for multiple-copy orders. To order, write Public Risk & Insurance Management Assn., 1120 G St. N.W., Suite 707, Washington, D.C. 20005.

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# St. Paul Cos. name Haugh chairman, chief executive

**Robert J. Haugh** has been named chairman and chief executive officer of The St. Paul Cos. Inc. in St. Paul, Minn.

Mr. Haugh succeeds **Carl B. Drake Jr.**, who is retiring after 43 years with the company. Mr. Drake will remain as a director and vice chairman of the St. Paul board.

Mr. Haugh has been president of The St. Paul Cos. since 1982, and he will retain that title. In addition, he is chairman, president and chief executive officer of St. Paul Fire & Marine Insurance Co., the major operating division of the holding company.

He had been executive vp of the insurance operation for the holding company before he was named president.

#### Other insurer changes:

**Robert D. Kilpatrick**, president and chief executive officer of CIGNA Corp. in Philadelphia, elected chairman, succeeding **Ralph S. Saul**, who is retiring from active management. Mr. Saul will continue to serve on the CIGNA board.

**David M. Klein** elected senior vp at Hartford Insurance Group in Hartford, Conn. He will continue as director of North American property/casualty insurance marketing. Mr. Klein is responsible for the maintaining the ties between Hartford and its 10,000 independent agents. He had been vp and director of actuarial research.

**James L. Anderson** appointed vp at Fremont Indemnity Co. in Los Angeles. Mr. Anderson will head the newly formed Fremont

## comings & goings: industry

Insurance Services Division, which supervises the Fremont underwriting agencies and special risk and services division. He will continue as president of Hospital Insurance Services Inc., a Fremont hospital malpractice insurer.

**Robert A. Anker** promoted to executive vp of American States Insurance Co.'s property/casualty agency companies. The field operations, agency development, product management, actuarial and market research and planning divisions will report to Mr. Anker, who had been a senior vp at the company.

**Robert L. Degner** appointed vp of commercial lines sales for Transamerica Insurance Co. in San Francisco. He had been vp of special accounts at Transamerica Insurance, a unit of Transamerica Corp.

**Walter M. Schroeder** promoted to vp at United States Life Insurance Co. in New York. He had been assistant vp of sales. Mr. Schroeder will manage group business for the company's New England sales office in Newton, Mass. He joined U.S. Life in 1982.

**Howard Lichtenstein** appointed senior vp of Mutual of America in New York. Mr. Lichtenstein is responsible for the company's field offices, consulting services, actuarial consulting services and direct mail operations. He had been vp in charge of the company's consulting services division.

### Reinsurers

**Anthony L. Lupo** elected president and chief executive officer of the Monarch Insurance Co. of Ohio in New York. He succeeds **Kenneth W.I. Fletcher** in the posts. Mr. Fletcher will continue as president of the parent holding company, Pearl American Corp. Mr. Lupo had been executive vp and chief reinsurance underwriter for



Mr. Hall



Mr. Blanchard

Unity Fire & General Insurance Co. and General Security Assurance Corp. of New York. Monarch specializes solely in treaty reinsurance.

**Robert F. Hall** and **John A. Blanchard Jr.** named senior vps at American Re-Insurance Co. in New York. Mr. Hall had been a vp and head of the company's claims department. He joined American Re in 1974. Mr. Blanchard had been a

vp for planning, financial and data processing functions. He joined the company in 1981.

**William R. Coleman** appointed senior vp of domestic treaty production with Thomas A. Greene & Co. in New York. Mr. Coleman had been vp and manager of U.S. treaty operations with Wilcox Inc. before joining Thomas A. Greene. The company is the reinsurance subsidiary of Alexander & Alexander Services Inc.

**Robert B. Naeny Jr.** joined Brooks-Shettle Co., a managing general agency and reinsurance intermediary, in charge of mass marketing the company's specialty programs. Brooks-Shettle is a wholly owned subsidiary of AVEMCO Corp. Mr. Naeny had been manager of special risks for Monumental General Mass Marketing Inc. ■

### Wyoming names new commissioner

CHEYENNE, Wyo.—**Robert W. Schrader**, an attorney and justice of the peace from Buffalo, Wyo., is scheduled to take over as insurance commissioner in Wyoming on June 15.

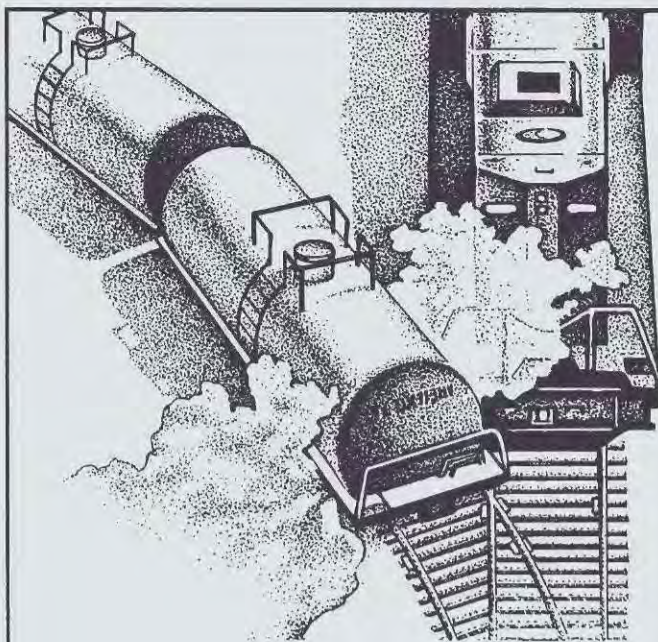
He will replace J.T. Langdon, who is stepping down from the post he's held for nearly 10 years to become a state district judge in northern Wyoming.

Mr. Schrader, 40, who has an undergraduate degree in business administration and a law degree from the University of Wyoming in Laramie, is also a licensed mortician.

Before attending law school, Mr. Schrader worked for the Equitable Life Assurance Society of America and has received the Certified Life Underwriter designation.

While in law school, he also served as a deputy sheriff.

Mr. Langdon, who was a city judge, U.S. magistrate and a justice of the peace before being named insurance commissioner in January 1975, plans to leave that post June 15 after clearing his hearing docket. ■



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# State regulation works best, agents' group tells legislators

By JERRY GEISEL

WASHINGTON—Congress should keep its hands off the McCarran-Ferguson Act, an insurance agents' trade association says.

State regulation of the insurance industry, which the McCarran-Ferguson Act provides, "is most compatible with the public interest and most suitable to the types of regulatory issues associated with insurance," according to the Independent Insurance Agents of America.

Testifying earlier this month on behalf of the 220,000-member IIAA before the House Judiciary Subcommittee on Monopolies and Commercial Law, Frank Patterson, chairman of the IIAA's federal affairs committee, said state regulation is working to protect consumers.

"I would anticipate that this subcommittee will conclude that local regulation facilitates the flow of consumer information and that the state insurance departments are particularly sensitive to such matters," said Mr. Patterson, who also is president of Patterson & Associates, a Chevy Chase, Md., insurance agency.

The Judiciary subcommittee plans more hearings this year on McCarran-Ferguson.

## Social Security

Congress may want to consider overhauling the Social Security program yet again, says Treasury Secretary Donald Regan.

Social Security was set up in the 1930s to provide a floor of benefits for needy retirees, but benefits now go to the wealthy who don't need them, Mr. Regan said this month.

"At some cutoff point, we may want to ask why a person such as that (wealthy) should receive Social Security," Mr. Regan said.

Congress last year made its first move to reduce Social Security benefits for middle- and upper-income people.

Under the Social Security Amendments Act of 1983, up to one-half of Social Security benefits are taxed for retirees who file an individual tax return and have at least \$25,000 in annual income, while those who file joint returns are taxed on their Social Security benefits if their annual incomes exceed \$32,000. Mr. Regan expects more changes may be considered by Congress by the end of the decade.

## Health insurance

More employees are paying a portion of their group health insurance premiums, the Labor Department says.

Last year, some 31% of employees who work for companies with more than 100 employees shared premium costs with their employers, up from 26% in 1982, according to a Bureau of Labor Statistics survey.

The survey, which provides representative data for 20 million employees, also found that 50% of employees who opt for family health care coverage pay part of the premium, up from 47% in 1982.

Other survey findings include:

- Between 1979 and 1983, the percentage of workers covered by dental insurance climbed to 71% from 48%. During the same period, employee participation in vision care plans grew to 27% from 17%.

- Last year, 55% of employees were enrolled in pension plans that give credit for employment after age 65. In 1982, some 48% of employees received pension credits for

their post-65 employment.

- Some 71% of employees in 1983 were covered by group health insurance plans that had a stop-loss feature that limits an employee's out-of-pocket expense for claims in a year. By contrast, just 46% of employees were protected by a stop-loss provision in 1979.

Detailed results from the BLS survey will be published this summer in a report, "Employee Benefits in Medium and Large Firms, 1983."

## Pension terminations

Employers must disclose in the summary plan descriptions they distribute to employees the conditions under which the company may terminate its pension plan, the Labor Department says.

A technical bulletin issued May 4 by the department's Office of Pension and Welfare Benefit Programs says an SPD will not comply with the standards set by the Employee Retirement Income Security Act unless it contains this information:

- A summary of any plan provision governing the benefits, rights and obligations of participants if the plan is terminated.

- A summary of how participants' benefits are accrued and vested if the plan is terminated.

- An explanation that the employer has the right to terminate the pension plan.

## washington

The Labor Department technical bulletin was triggered by the wave of pension plan terminations by employers seeking to recapture excess assets. In some cases, employees, when they joined the company, were not informed that the company had the right to fold the pension plan.

## Oil spill liability limits

The House Merchant Marine and Fisheries Committee has approved legislation to create a single system to establish liability and provide compensation for damage caused by oil spills.

Under the legislation, H.R. 3278, also known as the Comprehensive Oil Pollution Liability and Compensation Act, these liability limits would be set:

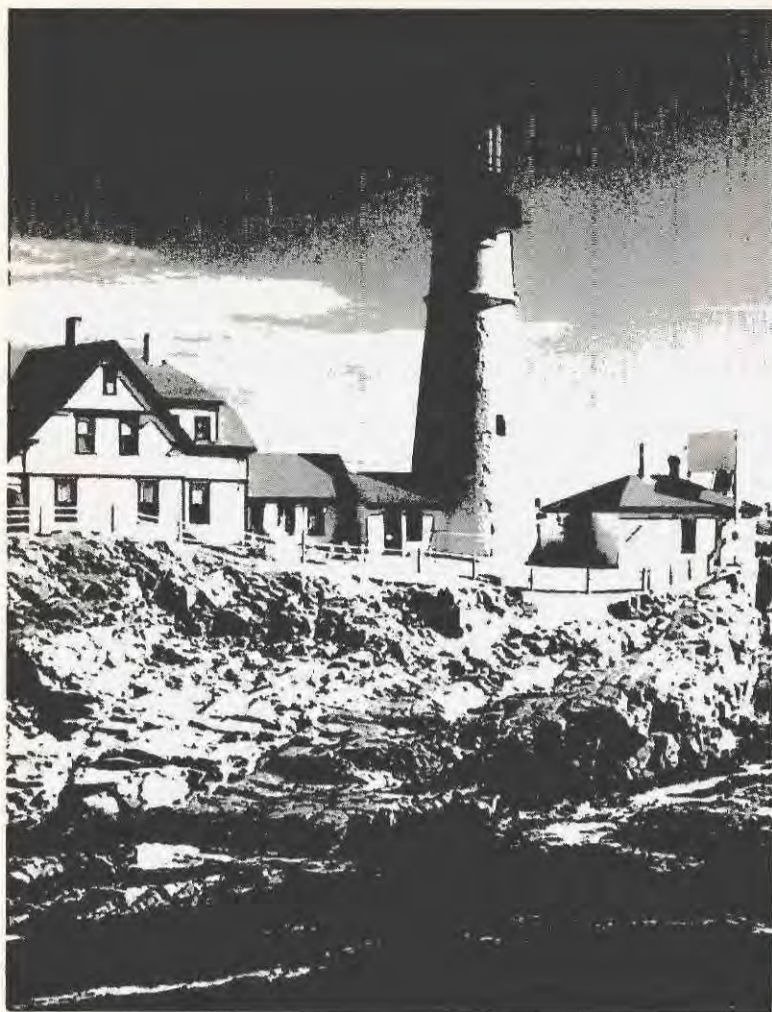
- \$150 per gross ton for vessels other than a ship or an oil barge.

- The greater of \$1 million or \$400 per gross ton, up to a maximum of \$40 million, for ships.

- The greater of either \$150,000 or \$150 per gross ton for inland oil barges.

- \$50 million for Outer Continental Shelf structures and deep-water ports.

Although the Reagan administration likes the general concept of the bill, it favors increasing liability limits for ships and barges to \$1,000 per gross ton, with a maximum limit of \$75 million.



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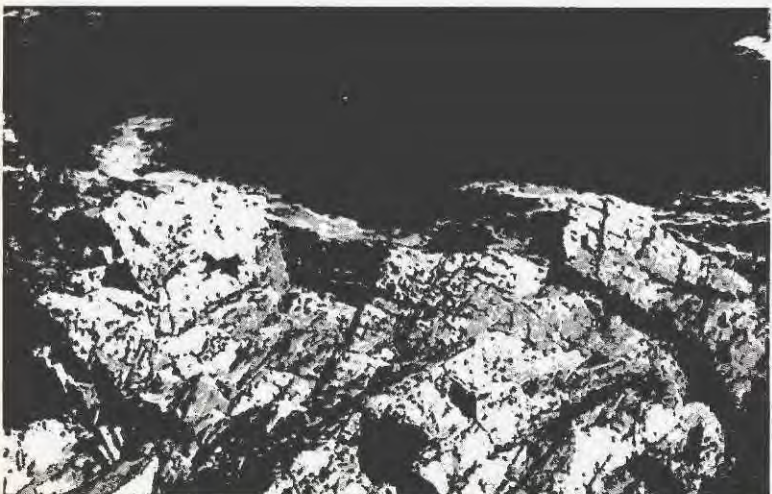
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## FSA proposals

Continued from page 1

installed at companies to win employee acceptance of higher health care deductibles. Employees participating in FSAs are more willing to accept higher deductibles because they can collect any unused money in the account at the end of the year.

Since employees know they can "cash out" a balance in an FSA or roll the excess over into a savings plan, they have a powerful financial incentive not to overutilize health care services.

Even in FSAs funded solely through salary reduction, in which employees contribute pretax dollars to an account, workers also have an incentive to use health care services wisely because employees can collect the balance left over in the account or roll it over into a 401(k) plan.

Such an incentive is lacking in traditional first-dollar health insurance plans, where all medical bills are paid and employees don't receive a "dividend" for prudent use of health care services.

"FSAs have made the transition from first-dollar coverage to higher deductibles less painful," Hewitt's Mr. Butterworth says.

But if employees must forfeit FSA balances at the end of the year, employer contributions to the plans actually could be counterproductive to corporate cost-containment goals.

For example, if an employer contributes \$500 to an FSA to induce employees to accept higher health care deductibles, employees will spend all the money rather than forfeit the balance at the end of the year, said Lance Tane, manager of the flexible compensation team at The Wyatt Co. in Washington.

Unless the IRS rules are changed, "I would not recommend that employers contribute to the plans," one consultant added.

Requiring employees to make irrevocable advance benefit selection will cool employee acceptance of the plans, consultants note.

Employees will be reluctant to have their salaries reduced by large amounts if the proposals are approved because they would end up playing Russian roulette: They could lose their contributions if they choose the "wrong" benefit.

For example, an employee would be a loser if he agreed to have his salary reduced in January by \$1,000 for legal expenses because he anticipated buying a house later that year. Under the proposals, he could not get the contribution back or use it for another benefit if he failed to buy a house and, thus, did not incur any legal expenses.

"Will employees feel comfortable with the risk?" asked Albert Cole, director of group consulting at Buck Consultants Inc. in New York.

"It's a tragedy. We had a useful tool to control costs and it is being taken away," said Mr. Tane.

Experts say FSAs can survive the proposed IRS rules, but they will take different forms, none of which will control costs.

FSAs, for instance, might be set up to cover very predictable benefit expenses where there is little risk that the benefit would have to be forfeited, said Peter Hutchings, a partner with benefit consultant Kwasha Lipton in Fort Lee, N.J.

A diabetic might have his salary reduced and use the funds in the FSA to pay for prescription drugs. Using pretax dollars, which reduces an employee's taxable income, to pay for insulin would be more tax advantageous than paying for the drugs with aftertax dollars.

In addition, FSAs might be used under an arrangement in which employees would have their salaries reduced by a fixed amount to pay for a share of the employer's

health insurance premium.

Rather than raising a deductible, employers might require employees to pay more premium costs through salary reduction to an FSA.

This also would have a tax advantage to the employee since pretax dollars would be used to pay for the premium, while aftertax dollars would be used to pay for expenses that fall under the deductible.

"Contributory health insurance plans will grow through FSAs," says Mr. Alden of TPF&C.

But using FSAs as vehicles to require employees to pay a bigger share of the health insurance premium doesn't give employees an incentive to use benefits wisely. The premium contribution will be made—without any chance of getting anything back—regardless of the amount of services used.

Such an arrangement would really be cost shifting to the employee, not cost containment, said Mr. Alden.

In addition, many employers that now have "invalid" FSAs could be hit with back taxes and penalties under the proposed rules, as suggested in the February IRS news release.

On the surface, the proposed rules do offer protection from retroactive penalties, but few plans will qualify for this protection, consultants note.

An employer sponsoring an FSA that allowed cash-outs of unused benefits at the end of the year will not be liable for retroactive penalties so long as the it required employees to make advanced irrevocable benefit selections, a provision not found in most FSAs.

Many FSAs, for example, allow employees to periodically stop or change the amount of contributions to 401(k) plans. Such plans will not qualify for retroactive relief.

Employers with plans that fall in the safe harbor cannot make contributions to the FSA after May 31.

The plan must be amended by Sept. 4, 1984, according to the IRS proposed rules.

"The IRS 'safe harbor' is very shallow and full of shoals," said Buck Consultants' Mr. Cole.

Other consultants recommend caution for those employers that do not qualify for the safe harbor.

"My advice would be inaction at least for the next couple of weeks," said TPF&C's Mr. Alden notes.

There is a chance, according to Mr. Alden and other experts say, that Congress could pass legislation to supersede the IRS rules.

A House-Senate conference committee that will draft a uniform tax package may consider a proposal by Rep. Barber Conable, R-N.Y. that would offer retroactive relief for most FSAs and allow unused benefits to be rolled over into a benefits bank for use the next year (BI, May 7).

Mr. Conable wants to attach his proposal to the tax package, which the conferees are expected to con-

sider this week, possibly on May 15.

The IRS also says it will hold a hearing July 26 in Washington on its proposed rules. But few experts expect the IRS to make drastic changes after the hearings.

The IRS, Mr. Alden says, had the opportunity to be a hero and say 'let bygones be bygones, but you (employers) better get your act together in the future.' The fact that the IRS failed to offer substantive retroactive relief does not bode well for the future.

"It is my guess that the IRS will be unlikely to change any important provision unless directed to do so by Congress," said Hewitt's Mr. Butterworth.

As a result, experts agreed, employers must begin a vigorous lobbying campaign.

"Employers, concerned with the future direction of flexible compensation, can still have tremendous impact by contacting congressmen and senators as quickly as possible," Hewitt Associates said. ■



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# Firms with FSAs hoping for congressional relief

By SALLIE J. DRURY

Employers with flexible spending accounts are pinning their hopes on Congress to provide relief from the Internal Revenue Service's proposed regulations governing FSAs.

Meanwhile, the immediate strategies taken by employers differ. Some are starting to revise the FSAs to comply with the IRS specifications, while other employers refuse to accept the IRS interpretation of Section 125 of the Internal Revenue Code and are standing firmly beside plans that will not be valid if the proposals are approved.

"Right now we are just holding tight for a few more weeks to see if anything does evolve out of Congress," said Albert C. Worrell, manager of employee benefits for

Armco Inc. in Middleton, Ohio. "We are hoping the Conable proposal will be accepted."

That proposal, which Rep. Barber Conable, R-N.Y., hopes to attach to the tax legislation now before a conference committee, would—unlike the IRS proposals—allow employees to roll over unused funds into a benefits bank to be used the next year (BI, May 7).

In addition, under the Conable proposal, employers whose FSAs are not considered valid would not be retroactively liable for back taxes and penalties and would have until the end of the year to redesign their plans.

"I think every benefit manager should get something to Washington" in support of the Conable proposal, noted Mary Jane Klansky, director of employee benefits for

Educational Testing Service in Princeton, N.J. "I've sent letters, and if they asked me to testify, I would be delighted. This 'use it or lose it' stuff makes me crazy."

Although the IRS proposed regulations say that some companies with "invalid" FSAs will not be liable for back taxes and penalties and will be given time to redesign their plans, the majority of employers with FSAs will not fall into this "safe harbor" (see story, page 1).

Armco Inc. is one company that will not be allotted a grace period to redesign its plan. Although its FSA was not begun until January and would thus not be liable for back taxes, the IRS proposals would not give the company any time to renegotiate a new benefit plan with its union employees, who now take part in the FSA.

"The way we understand it, the (proposed regulations) throw us in the same category as ZEBRAs," Mr. Worrell said, referring to Zero Balance Reimbursement Accounts, a form of FSA that most consultants agree are abusive. "And the reason is we let employees change the amount they want to contribute through salary reduction quarterly."

Armco established its FSA program to make more palatable employee health care cost sharing. Employees can take as cash any funds left in an FSA at the end of a plan year, which employers say promotes health care cost containment. However, these "cash-outs" would not be allowed under both the IRS and the Conable proposals.

For now, Armco is not planning any changes until Congress acts, but it has told employees that the

government is scrutinizing FSAs. But, if the proposals are approved, Armco might have to scrap its FSA program, Mr. Worrell said.

"In a worst-case situation we would have to go back and renegotiate (with unions)," Mr. Worrell said. "The IRS has pretty much destroyed FSAs. We would stick to our flexible benefits, but not the FSA. And, I think one of the things the unions would insist on is going back to first-dollar coverage."

Dallas-based LTV Corp. would be in a similar situation, but says it would not abandon its FSA altogether.

"We would probably continue with our FSA, but we might have to go back and rethink our whole health care program," said Peter Biggins, LTV's director of personnel planning. "We might have to resort to first-dollar coverage."

But, not all companies involved with unions are willing to go back to swallowing the entire cost of an expensive first-dollar health plan.

"We would keep our FSA (as it is now designed), but go to a 'use it or lose it' (plan)," said Bob Sjogren, manager of benefits planning for Xerox Corp. in Stamford, Conn., another company that credits FSAs for its success in negotiating health cost sharing with unions.

"We would have to make changes in (the complete benefits) plan and design around the regulations, but we will never go back to first-dollar coverage."

Xerox is one company that qualifies under the safe harbor provisions in the IRS proposals. But, it is hoping that the Rep. Conable's proposal will include a special provision for collectively bargained em-

ployee groups, so Xerox union employees can continue in the plan as it is now designed through the end of its contract period in 1986.

"I think there's a good chance that (will be added in)," Mr. Sjogren said.

Some companies are preparing to alter their FSAs should the IRS proposals be approved.

"I am not sure what we are going to do just now," noted Educational Testing Service's Ms. Klansky. "As soon as we can, we are going to communicate to the staff that unless they know they are going to use the money they put in the account, don't opt for it."

"We only allow employees to set aside \$100 for a physical examination or to take cash for unused vacation, and we are talking about three employees (taking cash), not 150. We are not the ones the IRS is looking for, but we don't want to be considered invalid anyway."

Frank M. Sterner, vp of human resources management and strategic planning for Johnson Controls Inc. in Milwaukee, said, "We are talking with our consultant and are still deciding what to do. We will know by the end of May."

Like Armco, Johnson Controls allows employees to take cash at year-end and to make changes in the plan during the year and will not receive a grace period to redesign its plan under the proposals.

"I would like to see the Conable proposal accepted," Mr. Sterner said, "but we are going to have to make some changes before we know what happens in Congress."

All the benefit managers interviewed by *Business Insurance* expressed their exasperation with the IRS action, and repeatedly said the action runs counter to their health care cost-containment goals.

"When the (February) news release came out, we communicated the results of our first year in the health incentive plan to employees," said Robert Penzkover, director of employee benefits at Quaker Oats Co. in Chicago, "and told them how much they saved, how much the dividend would be, and we congratulated them. Then we said, 'And by the way, here's what the government thinks.'"

"We don't agree with the Q's and A's any more than we agreed with the news release," he said. "It's the same garbage."

However, if the regulations as they are now written become final, "obviously we intend to comply with anything that becomes law," Mr. Penzkover said.

Although he would not reveal what Quaker intends to do as a result of the proposed regulations, Mr. Penzkover said "just because the dollars put in these plans become taxable doesn't necessarily mean you change your plan design, any more than you would increase every employee's pay if Congress increased the income tax. This (action) is just taxing benefits to scratch up revenue."

Said another benefit manager, "It would be interesting to see what it has cost for the IRS to take so long in issuing these regulations." ■



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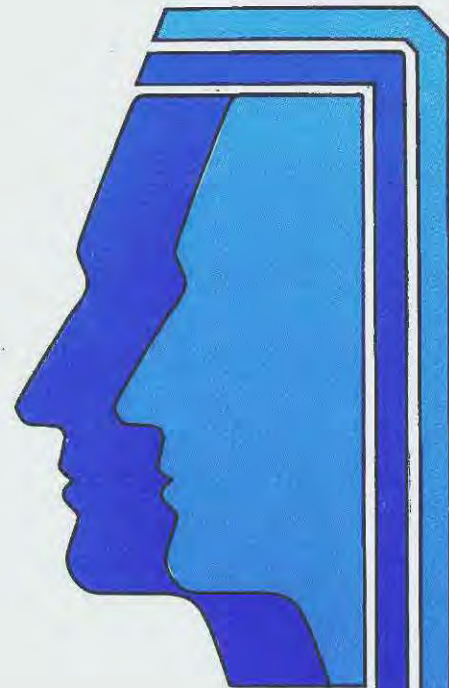
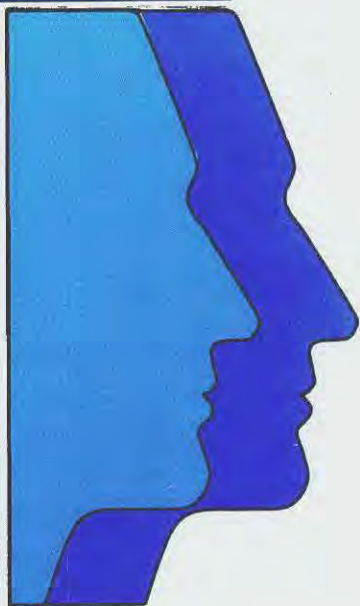
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## Agent Orange

Continued from page 1  
bility for long-latent injuries.

Attorneys point out that most if not all the insurers have been paying defense costs but have reserved their rights to deny coverage.

Some insurers, including Fireman's Fund Insurance Cos. and Travelers Insurance Cos., participated in the two-day settlement negotiations during the weekend of May 4.

Already, the litigation has spurred two coverage lawsuits. One has been settled, and settlement is imminent in the other.

For the past three years, Travelers and Liberty Mutual Insurance Co., Monsanto's primary insurer prior to 1978, have been litigating who should pay the company's defense costs in the Agent Orange litigation. The suit, brought by Travelers, also names Monsanto.

Liberty Mutual insured Mon-

santo from 1961 through 1970, and Travelers insured the company from 1971 through 1978. Insurance Co. of North America, which insured Monsanto after 1978, had been named in the litigation but is expected to be dismissed.

Attorneys say a settlement between Travelers and Liberty Mutual is imminent, but they were uncertain what impact the recent settlement with veterans will have on the litigation.

For the last several years, Monsanto has put on notice its excess insurers going back to the 1960s, an insurance source said.

Hercules and its primary insurer Aetna Casualty & Surety settled in 1982 a suit over defense costs in U.S. District Court in Washington.

The chemical companies all say that the settlement will not significantly impact their earnings, citing their insurance coverage. They say they are adequately reserved.

Other primary insurers for the

defendants include Fireman's Fund for Dow Chemical from at least 1956 to 1976; Aetna, also for Diamond Shamrock; Travelers, also for T.H. Agriculture and Thompson Chemical; and Hartford Insurance Co. for T.H. Agriculture.

Peter Wilson, managing director of H.S. Weavers (Underwriting) Agencies Ltd. in London, confirmed that Weavers is a leading underwriter for the excess insurance of five of the defendants—Dow, Monsanto, Uniroyal, Diamond Shamrock and Hercules.

"I have played a leading role in those accounts for many years," Mr. Wilson said.

Brokers for the defendants include Marsh & McLennan Inc. of Detroit for Dow; M&M of Stamford, Conn., for Uniroyal; M&M in Dallas for Diamond Shamrock; Thomas E. Sears in Boston for Monsanto; and Johnson & Higgins in Wilmington, Del., for Hercules.

London brokers include C.T.

Bowring for Dow, Uniroyal and Diamond Shamrock; Sedgwick Group for Monsanto; and Willis Faber for Hercules, sources in London said. Prior to 1980, Sedgwick was broker for Dow and also previously brokered insurance for Diamond Shamrock.

Attorneys for plaintiffs and defendants reached the settlement after meeting around the clock during the weekend of May 4.

The settlement, which is considered the largest class-action settlement ever, came just hours before jury selection was to begin May 7 in the class-action trial.

The trial, which would have focused on the charges of nine representative plaintiffs of the estimated 15,000 veterans and family members in the class, would have addressed several major issues involving Agent Orange.

The jury would have been asked to decide whether Agent Orange caused the injuries claimed by the

veterans and their families and the government's role in its use.

The trial was expected to last five months, adding to the estimated \$50 million to \$75 million already spent on defense costs.

Details of the settlement are expected to be determined within 90 days, including the establishment of a mechanism for determining who will be compensated and how amounts will be disbursed.

The settlement still must be approved by the U.S. District Court for the Eastern District of New York, the court in which the class-action suit was filed. Those veterans opposing the settlement will be able to voice their objections at a hearing in early July.

Veterans who opt out of the class can pursue their claims against the companies individually. However, observers speculate that few will pursue claims individually because of high legal costs.

Continued on facing page

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vps of finance, secretaries,  
treasurers, etc. 10,202

Insurance Management:  
vps, directors, managers of  
insurance, risk, benefits,  
compensation, safety,  
security, etc. 6,604

Associations 1,133

Government, Unions,  
Educational Institutions 799

#### Commercial Consumers

Sub-total 24,376

Insurance Agents  
& Brokers 9,655

Insurance Cos. 5,461

Financial Institutions 441

Actuaries, Attorneys,  
Adjusters, Appraisers  
& Consultants 2,977

Others allied to the field 1,083

TOTAL 43,993

\*Source: Business/Occupational  
breakdown of qualified circulation,  
November 7, 1983 issue, as submitted  
to BPA for December 1983, BPA  
Publisher's Statement.

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Continued from facing page

Each defendant's share in the trust fund was based on a formula that considers the total gallons of Agent Orange that each defendant delivered to the government and the percentage of dioxin in each manufacturer's product, one insurance industry source said.

Mr. Wilson of Weavers, however, points out that the settlement was reached between the chemical companies and the plaintiffs, but no agreements have been reached between the chemical companies and their insurers.

"Underwriters have been kept unaware of what has been going on, but the settlement was achieved by the assureds themselves," Mr. Wilson said.

Insurers and chemical companies say that the issue of when bodily injury caused by Agent Orange occurs for determining which insurance policies apply is the same as the coverage issue in asbestos litigation—or even more complex.

When did the veteran suffer bodily injury—when he was exposed to Agent Orange in Vietnam, when he became aware of the injury 20 years later or sometime in between?

Similarly, when did bodily or emotional injuries occur to the wives of veterans, or to a deformed child?

What insurance policy applies when a veteran is exposed to Agent Orange in 1967, his wife conceives a child in 1972 and the child is born in 1973 with defects or later develops diseases linked to Agent Orange?

"How do you fit that into the rubric of bodily injury sickness or disease" as defined in the policy? the insurer asks.

"It is the old exposure-manifestation problem," agrees John Tyndall, executive director of Bowring Union-Marine Insurance brokers, which brokers insurance for Dow, Uniroyal and Diamond Shamrock in the London market.

If the injury manifests itself years after exposure, would a policy today that excludes injuries related to Agent Orange, as many now do, cover the settlement costs Mr. Tyndall added.

But not everyone expects coverage litigation, and, in fact, one source says some of the insurers already have indemnified defendants for their contributions to the fund.

"I don't think there will be the coverage problems here that solved in asbestos," said Otis Hess, senior vp and claims counsel for Fireman's Fund. "Nobody wants war."

He notes that the policies that would apply are modern policies dating from the 1960s, unlike the 1940s policies that have been applied in some asbestos cases.

The chemical companies were reluctant last week to divulge insurance information, but said that their financial condition would not be materially affected by the settlement.

"We have product liability insurance in excess of the settlement amount," said a spokesman for Uniroyal. The company has hundreds of millions of dollars of insurance coverage, he added. "It won't have any material effect on our business financial condition."

Uniroyal supplied just 5.4% of the Agent Orange to the government, the spokesman said.

A spokesman for Monsanto, which BI learned has contributed the largest share to the trust fund, \$1.9 million, said its business will not be affected and that "insurance is involved." The company has not yet determined if it will sue the government.

At Dow, whose share is believed to be \$35.1 million, general counsel Wayne Hancock said, "We're in an insured position and worked with our carriers. Certainly, we are very comfortable

with our position from an insurance standpoint."

Robert Stauffer in the risk management department of Diamond Shamrock, whose share is believed to be \$21.6 million, said that Aetna has been the company's primary insurer for decades including the whole Vietnam era. The company had various excess insurers in the U.S. and London markets.

"We believe we have more than ample coverage to address the situation," Mr. Stauffer said.

A spokesman for Hercules, whose share is believed to be \$18 million, said that two-thirds of its contribution would be covered by insurance. Its insurers include Aetna and Lloyd's of London.

Hercules said that its contribution will have no material adverse effect on the company's financial position and will cost about six cents a share. Hercules earned \$1.04 per share in the first quarter of 1983.

"At the appropriate time, we will

sue the government and probably join in a collective suit with the other major defendants," the spokesman added.

All the chemical companies' insurers contacted said that they had reserved for the claims and that their earnings would not be significantly affected by the claims.

They include Travelers, insurer for three of the defendants; Fireman's Fund, primary insurer for Dow and high-excess insurer for others; Hartford, primary insurer for four years for T.H. Agriculture; and Aetna, primary insurer for Diamond Shamrock.

A spokesman for CIGNA said the company did not have a significant exposure with the Agent Orange defendants. "The layers are very high up," the spokesman said. CIGNA does not expect to make any payments on behalf of Monsanto, which became an INA primary policyholder in 1978.

Commercial Union Insurance Co. in Boston said it has no involve-

men: with any of the defendants.

American International Group was only a "minor participant," involved only in high excess layers, a spokesman said.

Both defendants and plaintiffs say that the settlement was in everyone's interests, although each claimed it had the better case and would have prevailed if the case had been tried.

"This case was a case of enormously weak causation," said David Gross, an attorney for Thompson Chemical with the New Jersey firm of Budd, Larner, Kent, Gross, Picillo & Rosenbaum.

The defendants settled based on an "economic judgment," in part because of the enormous litigation costs, Mr. Gross added.

The defendants settled when they finally realized that the plaintiffs could put together a case and stay together, said plaintiffs' attorney Dean Trafelet, a Chicago attorney with the firm of Schlegel & Trafelet.

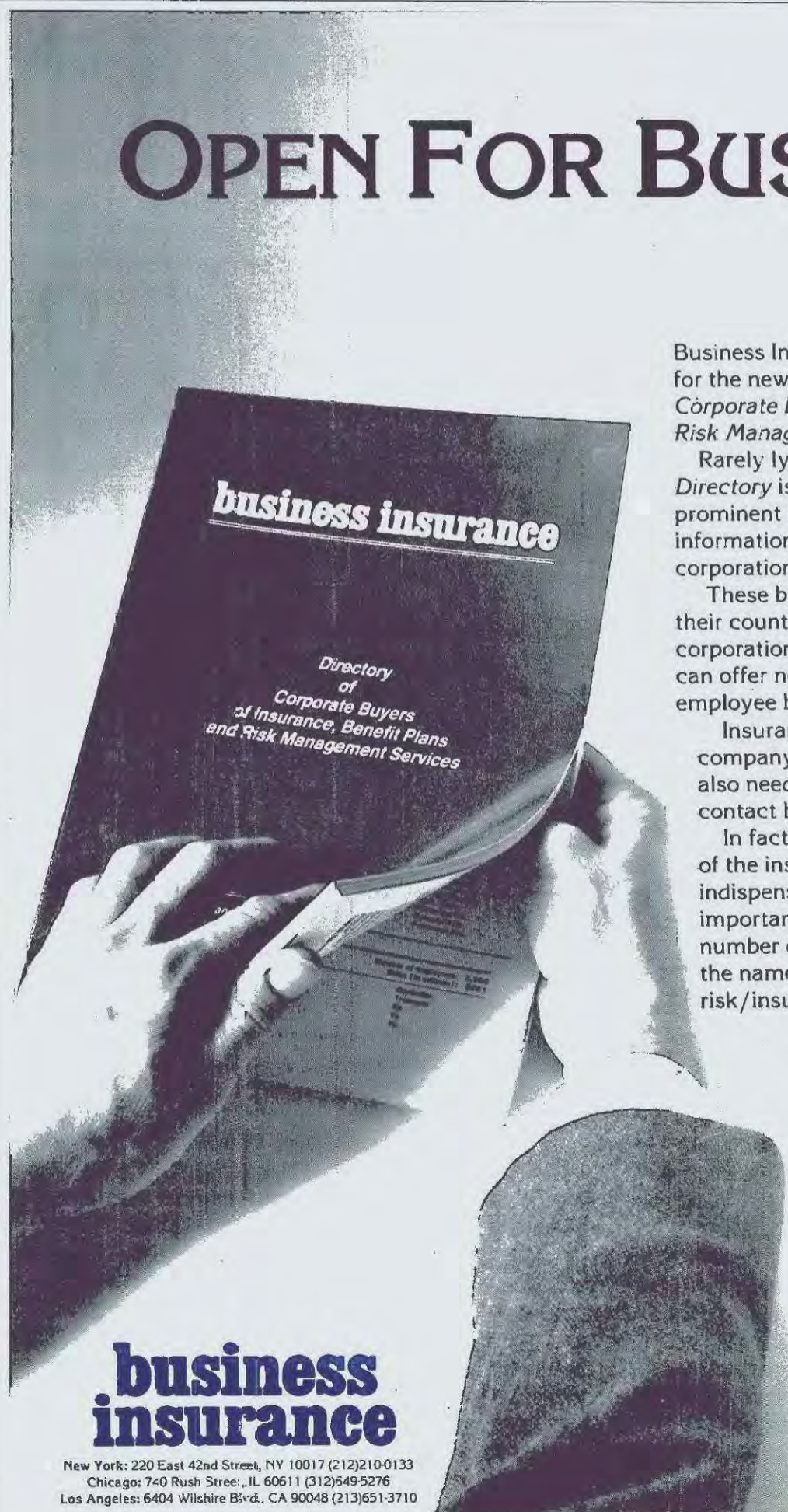
Plaintiffs' attorney Stanley M. Chesley of the Cincinnati firm of Waite, Schneider, Bayles & Chesley suggests that the chemical companies also feared that the case would result in the application of some form of enterprise liability. That theory would have allowed the plaintiffs to recover damages from all the makers of Agent Orange without identifying the particular manufacturer whose product injured them.

The settlement itself is based on market share and how much dioxin was in each manufacturer's product.

"It is a model for the resolution of toxic tort litigation," contends Victor Yannacone, the plaintiffs' attorney who rallied the veterans in the late 1970s to sue the chemical companies. In the last year, however, he was edged out of the litigation by other plaintiffs' attorneys.

"It is a milestone in the administration of justice—the legal system's finest hour," he said.

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## Damages covered in Philadelphia fire

Continued from page 1

not triggered under the definition of occurrence in the policy.

"We did not realize there were any violations until the day after the fire (May 4). We heard about them on the radio," said Edward C. Driscoll, chairman of the board and chief executive officer of L.F. Driscoll, the general contractor on the project.

Apparently, notice of the violations were sent to Geppert and copies were sent to Driscoll, but at an incorrect address.

Driscoll, however, was aware of the smaller fires earlier last month, and since then instituted additional safety measures.

In fact, Mr. Driscoll says it was one of the safety watchmen who noticed the fire of May 3.

Driscoll could have a contingent liability for the damages.

Driscoll and the owner of the building, Carley Capital Group,

combined have about \$90 million of insurance covering the project, half of which is liability insurance. The coverage is more than enough to cover any losses, one of Carley's attorneys said.

Carley's insurance package is underwritten by Fireman's Fund Insurance Cos. in Novato, Calif.

**The blaze damaged** 18 buildings and affected 44 businesses, including the popular Gallery shopping mall, which had to be evacuated.

No total damage estimates were available for the office and commercial buildings damaged.

Forty of the 44 businesses affected have property and business interruption insurance that will cover any losses, said Charles Pizzi, deputy director of commerce for the city.

The four businesses that have no coverage include a pharmacy and three Chinese restaurants. The fire

occurred on the fringe of Philadelphia's Chinatown area.

"We are still putting together our numerous policies, but we expect the total insurance (along with the general contractor's) will be in excess of \$90 million," said Mark Kaufman, general counsel in Washington, D.C., for Carley, a real estate developer based in Madison, Wis.

Carley Group owned the seven-story Harrison Court building on Filbert Street, which was built in the late 1800s and had been vacant for several years. The developer purchased the building last year and was renovating it for office space. The building was razed after the fire.

Carley's builders risk policy and general liability policy are underwritten by Fireman's Fund, both with first-dollar coverage, Mr. Kaufman said.

Details on Driscoll's insurance were unavailable.

Besides the damage to the Harrison Court building, flames also leaped to adjacent buildings and

across the narrow street, scorching the large indoor Gallery shopping mall, which houses more than 200 shops.

Police officers have been credited with evacuating an estimated 30,000 people from the Gallery in less than 10 minutes.

"We will have somewhere around \$1 million in damage just to the structure," said Steven Sachs, corporate risk manager for Rouse Co. in Columbia, Md., which manages or owns 60 shopping centers throughout the nation, including the Gallery.

**Rouse has an** all-risk property policy with Arkwright-Boston Insurance Co. in Waltham, Mass., a member of the Factory Mutual System, Mr. Sachs said.

The policy, which covers all of Rouse's property, has a \$500,000 deductible, according to a source.

A metal outside curtain wall on the Gallery with insulation behind it "buckled, melted, tore and came apart" but saved the Gallery from greater damage, Mr. Sachs said.

The wall, which faced the fire, was adjacent to the Gallery's mechanical rooms and service corridors.

The night of the fire, Rouse had plywood and plastic smoke barriers constructed along the service corridors to seal off the inside of the center.

"We hired a contractor, who worked through the night fogging the building to get the smoke out," Mr. Sachs said. The company also spent \$8,000 to advertise in print and on the radio that the Gallery would open the next day, he added.

"And we did open, after approval from the health department and fire department—only 20 minutes late," Mr. Sachs said.

Damage to individual stores in the Gallery was expected to be minor, city officials said.

J.C. Penney Co. Inc., one of the anchor retail stores of the mall, was closest to the fire. The only damage it sustained was some water damage to the back of the building, said an operations manager in Philadelphia.



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## ABC not anticipating claim on Olympic cover

Continued from page 2

it paid for the television rights. The spokesman said that ABC will receive a partial refund of the \$225 million it paid the Los Angeles Olympic Organizing Committee for the U.S. television rights for the Games, though he said the exact amount of the refund had not yet been figured.

In addition, the spokesman said that Soviet broadcasters already have paid ABC in full for the facilities the Soviets would use at the Summer Olympics broadcast center in Hollywood, Calif. This payment is non-refundable, the ABC spokesman said, although he would not reveal the amount.

"Because they've already spent

this money, we'd hope this would encourage them (the Soviets) to come to the Olympics," the ABC spokesman said.

**The non-appearance** coverage is part of a larger, \$200 million policy led by Fireman's Fund that will indemnify ABC should it lose money if the Games are canceled or postponed until next year. This coverage insures against a variety of risks, including acts of God, a change in location of Olympic events, riots, satellite malfunctions or pre-emption of the broadcasts due to an emergency.

The Soviet Union announced May 8 that its athletes would not take part in the Summer Olympics

because the United States was "flouting...the ideals and traditions of the Olympic movement" and could not assure the safety of Soviet athletes.

However, the Soviets have until June 2 to change their minds should they decide to compete.

If ABC's policy, which cost less than \$10 million for the cancellation and non-appearance coverages, is triggered, it would mark the second consecutive time a U.S. broadcaster has collected on insurance covering the broadcast of the Summer Olympics.

**In 1980,** NBC-TV, which had purchased the U.S. rights to the Moscow Games, received \$76.5 million from Lloyd's of London and U.S. underwriters to compensate for the fees the network paid the Russians for the television rights after NBC aborted its coverage because the U.S. team boycotted the competition (BI, Jan. 14 1980; May 31, 1982).

NBC had paid \$4 million for \$80 million in coverage.

## Chevron and insurers pay \$15 million

Continued from page 2

storage tank traveled to Shell's terminal and exploded in the facility's electrical switchroom.

Chevron admitted it was negligent in monitoring the level of gas in the tank and paid Shell \$1 million for its property losses, Mr. Mussman says.

Chevron also paid \$9 million to family members last spring, bringing its payments from the accident to \$10 million, which satisfied the company's self-insured retention, he says.

Mr. Mussman would not divulge policy limits, but he did say that Chevron had more than \$27 million in liability coverage.

When Chevron made the initial \$9 million payment to the plaintiffs, it also assigned them the company's rights in its suit against the insurers, he adds.

The remaining \$6 million owed to the families in the settlement is being divided between Chevron and its liability insurers. The entities are each giving the families \$3 million, though the underwriters will pay Chevron an additional \$500,000, according to the settlement.

"In effect, Standard Oil and the insurance companies are splitting the punitive argument 50-50," explains Paul F. Cronin, plaintiffs' attorney with Cronin, Fried, Sekiya & Kekina in Honolulu.

A six-week jury trial in Honolulu concluded in January 1983 that Chevron was responsible for the deaths of the two men and assessed damages totaling \$27.7 million, \$20.5 million of which were punitive damages. The families of the men had filed suit in Hawaii's Circuit Court of the 1st Circuit shortly after the Aug. 16, 1980, fire.

Chevron appealed that ruling in the Hawaii State Supreme Court after its request for a new trial was denied. That appeal, however, has

now been dropped.

Shell, which self-insures its workers compensation risks, paid work comp death payments to the families of the two men. It will now be reimbursed by the families from the settlement, Mr. Cronin notes. ■

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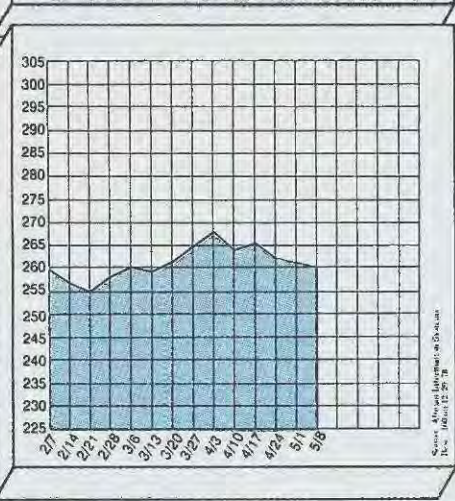
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BI Insurance Index



# Brokers' annual reports offer peek at managements' plans

By LEONARD M. WILSON  
Special to Business Insurance

THIS IS THE season of annual reports, recapitulations of the past year's achievements. In tone and content, annual reports often offer insights into how corporate managements are thinking about the future as well as highlights of corporate directions.



Mr. Wilson

For the publicly owned insurance brokers, the 1983 annual reports exhibit several common denominators. Managements were hopeful, but cautious, on pricing in commercial lines. Considerable space was devoted to new product initiatives, while success in consulting and diversification of services received some emphasis. Finally, internationalization was again in the limelight.

Marsh & McLennan Cos. Inc. noted its acquisition of a 100% interest in its Belgian affiliate. This step probably presages a longer-term strategy with respect to other partially owned affiliates. Minority ownership of foreign affiliates may turn out to be an interim stage, appropriate during the period of learning how to manage on a global scale.

The company's international scope was also enunciated by a discussion of the Arabian American Oil Co.'s business. Coverage was placed with 150 underwriters drawing upon the capabilities of offices in a number of countries. Marsh & McLennan is far along the path of internationalization. Taking in the aggregate consolidated and unconsolidated operations, foreign revenues now just about equal domestic revenues.

With the acquisition of Meidinger Inc., the company now claims the No. 1 position in worldwide employee benefits consulting. A low-profile acquisition program, implemented over the past few years, has given the company significant positions in special-

ized areas of consulting. Further moves in that direction seem likely.

lized areas of consulting. Further moves in that direction seem likely.

Alexander & Alexander Services Inc.'s annual report was generally constructive, though conceding the disappointing necessity of bolstering reserves of underwriting subsidiaries. Remedial actions beyond the reserve boosts, the annual report affirmed, included cancellation of bad business and a winding down of Bermuda operations. Clearly, A&A wants to reassure stockholders that underwriting problems are being contained.

Most of the report is devoted to a discussion of Alexander & Alexander's wide-ranging capabilities as an insurance broker—accentuating the positive, one might say. Energy, transportation, entertainment and financial guarantees are areas discussed in vignettes that are, in effect, brief case studies.

Even the brokerage operation of A&A's British subsidiary, Alexander Howden Group P.L.C., receives a fair share of attention. The firm handled \$1.2 million in premiums in 1983 and is now equipped with a new top management team, some of whom were drawn from Alexander & Alexander's ranks.

Acquisitions continue to be a feature of growth. Two acquisitions, Clifton & Co., based in San Francisco, and O'Brien, Russell & Co. in Boston, attest to A&A's prowess in making solid acquisitions. Both are leading firms. Their willingness to join the Alexander & Alexander fold is quiet but effective testimony to the company's unimpaired position in the insurance brokerage business.

Frank B. Hall Cos. Inc. has coined the acronym "DISCO" to place itself in the ranks of what it calls diversified financial services companies. The company continues to stress its diversity. We counted 50 discrete services tabulated in the annual report. By way of one example, claims services are now provided at 150 offices across the country.

Internal organization is also a focus of development. The report alludes to a new delivery system for deploying the firm's range of services and insurance expertise more effectively. This issue is a real one for all the public brokers.

In the realm of new business, the company claims significant gains in insurance brokerage for small to medium clients as well as in the area of jumbo accounts. Future progress in market share for public brokers is likely to occur as a result of penetration of

this small to medium-sized account base.

Corroon & Black Corp.'s letter to shareholders contains the sobering observation that direct writing of commercial lines may be on the increase. This and other structural changes, like bank deregulation, could confront insurance brokers with serious challenges. Notwithstanding these comments, management seems optimistic.

Corroon & Black has a strong new product thrust, judging by the tenor of the annual report. Cited in the report are financial guarantees, a package of services for group medical programs, computerized systems for small groups and self-insurance and wider capabilities in employee benefits.

Reinsurance brokerage is also on the march at the company. Internal growth was helped by the opening of two new offices and appreciable expansion of the staff devoted to treaty reinsurance.

The public brokers probably have just about passed through the worst competitive environment in their operating histories. Annual reports convey the impression that despite austerity programs, progress was recorded on virtually all fronts important to competitive positions.

## Financial briefs First-quarter earnings

CIGNA Corp. is blaming its first-quarter operating loss on continued rate competition in the property/casualty insurance industry, while two other large commercial insurers have reported sharply decreased earnings.

CIGNA reported a \$23.7 million operating loss for the first quarter, compared with a \$76.6 million gain in the first quarter of 1983. Robert Kilpatrick, chairman, president and chief executive officer, noted that most of the company's operating groups reported "strong growth" in the first quarter, but added that the loss sustained by the property/casualty group outweighed the other divisions' gains.

The property/casualty losses were due to continued rate competition and increased claims, especially weather-related losses, the company said. CIGNA's combined ratio ballooned to 137.2% for the first quarter, compared with 113.1% in 1983.

Last week, CIGNA also announced that its National Producer Council, a group of independent agents from around the nation, endorsed CIGNA management's intention to "selectively and responsibly price" property/casualty business.

Aetna Life & Casualty Co. reported that first-quarter operating earnings plummeted 84% to \$19 million, compared with \$119 million in the first quarter of 1983. The combined ratio for Aetna's commercial insurance division rose to 124.9% from 107.9%.

The St. Paul Cos. Inc.'s first-quarter operating earnings declined 79.8% to \$9 million from \$44.6 million. Its combined ratio jumped to 126.7% from 108.7%.

## Bayly, Martin & Fay

Members of the oil-rich Bass family have increased their interest in broker Bayly, Martin & Fay International Inc. to 50% (BI, Aug. 8, 1983; Oct. 3, 1983).

A transaction that took effect April 30 forms a new holding company for the brokerage. The holding company, Bayly, Martin & Fay Services Inc., will be owned equally by Bass interests and by BMF officials, says Donald Connors, the brokerage's counsel. BMF will still be headquartered in Newport Beach, Calif., he notes.

The Bass family increased their holding in the broker by assuming a substantial portion of the \$60 million debt that BMF owed its parent company, financially troubled Baldwin-United Corp., according to Mr. Connors. However, he would not disclose how much the Bass interests had invested in BMF.

It's not known either how much the Bass interests had previously invested in BMF or their previous share of its ownership.

Mr. Connors says the acquisition severs all ties between Baldwin-United and BMF.

8 May	Price	P/E	Div.	Yield	High—Low
Companies	pence	N/A	pence	%	pence
Comml Union	213	N/A	16.86	8.0	218—210
Genl Accident	468	12.6	27.14	5.8	472—468
Gdn Royal Exch	565	13.3	32.85	5.8	575—565
Phoenix	435	15.7	28.29	6.5	435—434
Royal	545	12.8	40.72	7.5	553—537
Sun Alliance	1475	15.8	80.00	5.4	1475—1450

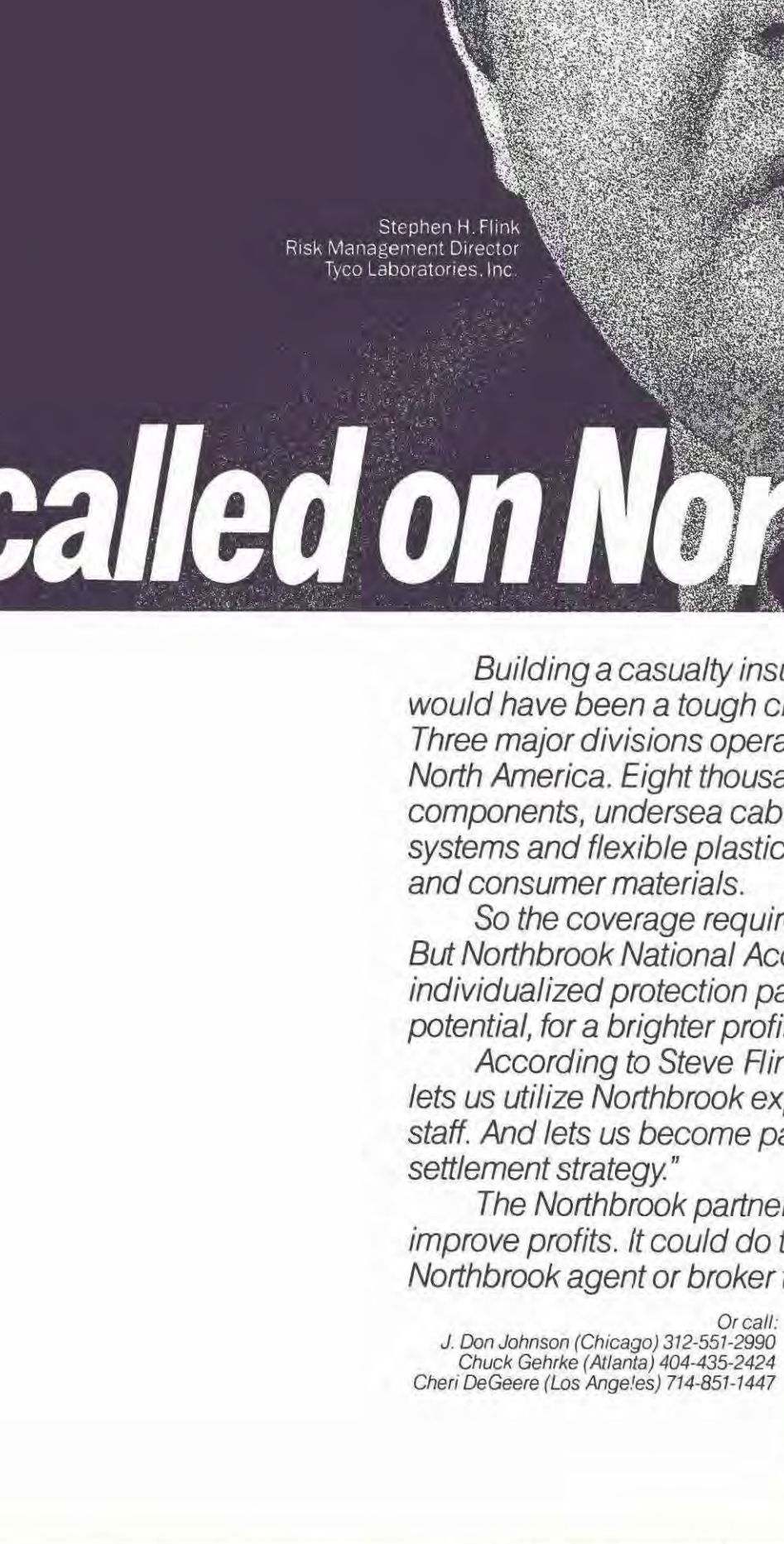
Brokers	Price	P/E	Div.	Yield	High—Low
	pence	N/A	pence	%	pence
CE Heath	395	9.9	22.86	5.8	398—395
Hogg Robinson	204	15.7	9.43	4.6	208—204
JH Minet	162	12.5	7.57	4.6	168—162
Sedg Grp	262	14.2	11.43	5.4	270—262
Stew Wrightson	398	13.5	21.43	5.4	406—398
Willis Faber	812	17.2	30.00	3.7	812—807

Source: Philip Olsen/Alan Clifton, Insurance Industry Specialists Kitcat & Aitken Stockbrokers, London

## BI Industry Stock Report

	MAY 8, 1984							5/2/84 THRU 5/8/84							MAY 8, 1984							5/2/84 THRU 5/8/84							
	Price	% Chg.	P/E	\$ Div.	% Yld.	High	Low	Vol. (000)	Price	% Chg.	P/E	\$ Div.	% Yld.	High	Low	Vol. (000)	Price	% Chg.	P/E	\$ Div.	% Yld.	High	Low	Vol. (000)					
<b>Insurance Cos.</b>																													
Aetna Life & Cas Co	NYSE	33.88	-4.9	16.6	2.64	7.8	35.50	33.88	871.3	United Fire & Cas Co	OTC	28.75	0.0	21.5	1.60	5.6	28.75	28.75	0.8	United States Fid & Gty Co	NYSE	51.25	-1.7	7.7	4.16	8.1	52.63	51.25	590.7
American Bankers Ins Group	OTC	13.63	-0.9	9.6	0.50	3.7	13.75	13.63	91.8	United Svs Life Ins Co	OTC	28.38	4.6	8.3	1.00	3.5	28.75*	28.13	26.8	USLife Corp	NYSE	26.50	0.0	7.1	0.96	3.6	26.88	26.50	149.0
American General Corp	NYSE	22.25	-4.3	7.5	0.90	4.0	23.13	22.25	757.5	Washington Natl Corp	NYSE	20.00	-3.6	11.6	1.08	5.4	21.50	20.00	44.0	Zenith Natl Ins Corp	OTC	13.00	-1.9	8.7	0.60	4.6	13.50	13.00	17.9
American Indty Finl Corp	OTC	18.50	-1.3	132.1	1.12	6.1	18.75	18.50*	19.4	<b>INSURANCE COMPANIES</b>						AVERAGE	11.3	4.0											
American Intl Group Inc	OTC	59.50	0.4	10.3	0.44	0.7	59.50	59.25	638.4	<b>Agents/Brokers</b>																			
American Natl Ins Co	OTC	24.63	2.1	7.2	0.96	3.9	24.63	24.13	101.8	Alexander & Alexander Svcs	NYSE	21.63	4.2	0.0	1.00	4.6	21.63	21.25	292.0	Hall Frank B & Co Inc	NYSE	22.75	-1.1	30.7	1.35	5.9	23.13	22.13	173.3
Aneco Reins Ltd	OTC	2.88	0.0	8.5	0.00	0.0	2.88	2.88	1.3	Baldwin & Lyons Inc	OTC	37.00	0.0	616.7	0.80	2.2	37.00	37.00	2.7	Integrated Res Inc	AMEX	24.75	7.0	7.3	0.00	0.0	24.75	23.13	107.2
Avenco Corp	AMEX	18.00	-0.7	11.5	0.58	3.2	18.13	17.88	1.8	Corroon & Black Corp	NYSE	24.75	4.2	15.6	1.00	4.0	24.88	24.13	78.7	Marsh & McLennan Cos Inc	NYSE	39.50	-5.1	11.3	2.20	5.6	40.50	39.50*	2,324.4
Banks Iowa Inc	OTC	51.50	0.0	19.1	1.52	3.0	51.50	51.50	2.2	Crump E H Cos Inc	OTC	12.38	0.0	15.5	0.40	3.2	12.50	12.38	32.4	Poe & Assoc Inc	OTC	5.00	0.0	0.0	0.00	0.0	5.00	5.00	0.2
Bitco Corp	OTC	13.00	-17.5	0.0	1.33	10.3	15.50	13.00*	39.7	Emett & Chandler Cos Inc	OTC	9.00	0.0	128.6	0.00	0.0	9.00	9.00	0.8	Reed Stenhouse Cos Ltd	OTC	13.00	-3.7	17.0	0.60	4.6	13.50	13.00	317.7
Carolina Cas Ins Co	OTC	4.25	-10.5	0.0	0.00	0.0	4.75	4.25	7.4	<b>AGENTS/BROKERS</b>						AVERAGE	22.0	3.5											
Chubb Corp	OTC	71.50	-1.0	13.0	3.12	4.4	73.50	71.50	212.8	Alexander & Alexander Svcs	NYSE	21.63	4.2	0.0	1.00	4.6	21.63	21.25	292.0	Hall Frank B & Co Inc	NYSE	22.75	-1.1	30.7	1.35	5.9	23.13	22.13	173.3
Combined Intl Corp	NYSE	33.38	-1.5	8.6	2.08	6.2	34.88	33.38	286.6	Baldwin & Lyons Inc	OTC	37.00	0.0	616.7	0.80	2.2	37.00	37.00	2.7	Integrated Res Inc	AMEX	24.75	7.0	7.3	0.00	0.0	24.75	23.13	107.2
Continental Corp	NYSE	28.75	-1.7	151.3	2.60	9.0	29.88	28.75	481.3	Corroon & Black Corp	NYSE	24.75	4.2	15.6	1.00	4.0	24.88	24.13	78.7	Marsh & McLennan Cos Inc	NYSE	39.50	-5.1	11.3	2.20	5.6	40.50	39.50*	2,324.4
Crawford & Co	OTC	15.25	0.0	10.4	0.66	4.3	15.50	15.00	45.7	Crump E H Cos Inc	OTC	12.38	0.0	15.5	0.40	3.2	12.50	12.38	32.4	Poe & Assoc Inc	OTC	5.00	0.0	0.0	0.00	0.0	5.00	5.00	0.2
Crown Life Ins Co	OTC	130.00	8.6	8.5	3.20	2.5	130.00*	119.75	0.0	Emett & Chandler Cos Inc	OTC	9.00	0.0	128.6	0.00	0.0	9.00	9.00	0.8	Reed Stenhouse Cos Ltd	OTC	13.00	-3.7	17.0	0.60	4.6	13.50	13.00	317.7
Employers Cas Co	OTC	30.75	0.0	6.9	1.20	3.9	30.75	30.75	2.0	Hall Frank B & Co Inc	NYSE	22.75	-1.1	30.7	1.35	5.9	23.13	22.13	173.3	Integrated Res Inc	AMEX	24.75	7.0	7.3	0.00	0.0	24.75	23.13	107.2
Equifax Inc	NYSE	25.75	4.6	11.4	1.60	6.2	25.75	25.00	41.3	Marsh & McLennan Cos Inc	NYSE	39.50	-5.1	11.3	2.20	5.6	40.50	39.50*	2,324.4	Poe & Assoc Inc	OTC	5.00	0.0	0.0	0.00	0.0	5.00	5.00	0.2
Farmers Group Inc	OTC	40.38	0.9	9.5	1.52	3.8	40.38	39.75	230.5	Reed Stenhouse Cos Ltd	OTC	13.00	-3.7	17.0	0.60	4.6	13.50	13.00	317.7	<b>AGENTS/BROKERS</b>						AVERAGE	22.0	3.5	
Foremost Corp Amer	OTC	25.75	10.8	14.1	0.96	3.7	26.00	25.25	95.5	<b>Conglomerates/Holding Cos.</b>																			
Fremont Gen Corp	OTC	14.38	4.5	0.0	0.48	3.3	14.38	13.00	607.2	American Express(Fireman's Fd)	NYSE	31.50	4.1	13.9	1.28	4.1	31.50	30.63	3,218.4	City Investing Co. (Home Ins.)	NYSE	43.13	25.0	10.3	2.00	4.6	43.13*	33.00	1,894.8
Great West Life Assurn Co	OTC	300.00	3.4	9.6	12.00	4.4	300.00	290.00	0.0	Anderson Clayton(Ranger/PanAm)	NYSE	27.00	-3.6	30.3	1.32	4.9	28.75	27.00*	33.0	CNA Finl Corp (CNA)	NYSE	26.50	0.0	9.9	0.00	0.0	26.50	26.13	39.9
Hanover Ins Co	OTC	27.25	-3.1	9.1	0.44	1.6	28.75	27.25	151.0	Arco Inc	NYSE	18.88	-1.3	0.0	0.40	2.1	19.63	18.75	582.0	Control Data (Comm. Credit)	NYSE	31.13	0.0	7.5	0.66	2.1	32.13	30.88	1,283.8
Hartford Steam Boiler Inspnt	OTC	51.50	-2.8	12.9	3.00	5.8	53.00	51.50	29.0	Baldwin Utd Corp	NYSE	1.50	20.0	0.0	0.00	0.0	1.50	1.25	183.1	General Re Corp	NYSE	57.00	-0.2	15.2	1.44	2.5	58.00	56.50	661.0
Jefferson Natl Life Ins Co	OTC	40.75	-0.6	18.5	0.76	1.9	40.75	40.75	2.0	CIGNA Corp	NYSE	39.13	-1.6	9.6	2.60	6.6	39.63	38.38	982.0	ITT (Hartford Group)	NYSE	37.00	-1.0	8.2	2.76	7.5	37.00	36.13	1,764.0
Kemper Corp	OTC	35.50	5.2	11.6	1.80	5.1	35.50	34.38	253.9	City Investing Co. (Home Ins.)	NYSE	43.13	25.0	10.3	2.00	4.6	43.13*	33.00	1,894.8	Optimum Hlcp Corp	OTC	4.00	0.0	30.8	0.00	0.0	4.00	4.00	7.6
Lincoln Natl Corp Ind	NYSE	32.75	1.9	8.0	1.68	5.1	32.75	31.75	383.9	CNA Finl Corp (CNA)	NYSE	26.50	0.0																

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Stephen H. Flink  
Risk Management Director  
Tyco Laboratories, Inc.

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