AIG and Gen Re: Helping One Another or Reinsurance Fraud—Case A

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The Transactions: Introduction

General Re Corporation (Gen Re) was involved in sham transactions with American International Group (AIG) from 2000 to 2005. In the fourth quarter of 2000, the first of two $250 million transfers of loss reserves was made. AIG booked $250 million in loss reserves and reported a $106 million increase in loss reserves. Without this transaction for the fourth quarter of 2000, AIG would have reported a reduction in loss reserves of approximately $144 million. In the first quarter of 2001, the second of two $250 million transfers of loss reserves were made. As a result, AIG reported a sixty-three million dollar increase in loss reserves for the first quarter of 2001. Without this transaction, AIG would have reported a reduction in loss reserves of approximately $187 million for the first quarter of 2001. (Securities and Exchange Commission, 2006) The following describes the events that led to these transactions and explains reinsurance.

Gen Re Corporation and American International Group

Owned by famed-investor Warren Buffett’s Berkshire Hathaway Inc., Gen Re was one of the largest reinsurers worldwide and the market leader in the U.S. The company had solid financial strength ratings, Aa1 by Moody’s Financial Strength Rating and AAA by Standard & Poor’s Claims Paying Ability Rating. It was present in all of the major reinsurance markets with a global network of over forty-five locations worldwide. Gen Re worked closely with clients to develop risk transfer solutions tailored to individual clients’ needs.

One of Gen Re’s largest clients, AIG was started in the early 1900s. American entrepreneur C.V. Starr founded AIG’s earliest predecessor company in Shanghai. AIG began as a small insurance company and grew to become one of the world’s largest businesses. By the end of 2000, AIG had assets of approximately $306 billion, $17.5 billion in annual revenues and 61,000 employees in seventy countries. (AIG, 2016)

On October 26, 2000, AIG watched its stock price drop six percent, down $6.06 from $99.37 to $93.31 per share. The decline was a reaction to AIG’s third quarter earnings release showing a fifty-nine million dollar decline in its insurance reserves. Loss reserves are a key measure of an insurer’s overall health. (Supreme Court of the State of New York, 2005) Several analysts downgraded AIG after their earnings release.

Concerned about this negative reaction, AIG’s longtime chief executive officer Maurice R. Greenberg called Ronald E. Ferguson, General Re Corporation’s chief executive officer, to ask for help organizing a transaction that would transfer $500 million in loss reserves to AIG from General Re through a reinsurance arrangement. Greenberg specified that he wanted to increase AIG’s loss reserves without taking on additional risk. AIG was Gen Re’s largest client, and Ferguson appeared eager to help. (Supreme Court of the State of New York, 2005)

Background on the Reinsurance Industry

Although a relatively unknown segment of insurance, reinsurance encompassed almost every aspect of the modern insurance market. Reinsurance was essentially insurance for insurance companies. Reinsurance protects a company from losses by spreading risk to other insurance companies. Insurers usually purchase reinsurance for one of four reasons: to limit the liability associated with specific risks; to stabilize loss experience; to protect against catastrophes; or to increase capacity. Depending on a company’s goals, different types of reinsurance contracts are available to facilitate a desired result.

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In a typical reinsurance contract, the reinsurer (the company providing and selling insurance) charges a reinsurance premium to the ceding company (the company purchasing and receiving the insurance) for the risk they assume in the transaction. The reinsurance industry was global and participated in covering losses in markets around the world. Foreign reinsurance companies wrote approximately forty percent of U.S. property casualty reinsurance premiums and two-thirds of U.S. property catastrophe reinsurance premiums.

Based on its needs, an insurer negotiates with a reinsurer to determine the terms and costs of the reinsurance contract. Under a reinsurance contract, an insurer was indemnified for losses on its insurance policies that are covered by the reinsurance contract. There was a large amount of uncertainty concerning the risk associated with reinsurance. The level of risk was dependent on the individual circumstances and the nature of each particular reinsurance transaction. In addition to the specific risk being underwritten, reinsurers had to consider the overall stability of the ceding insurer. (Reinsurance Association of America, 2012)

**The Deal**

**The AIG-General Re Team**

In response to AIG’s CEO Hank Greenberg’s call for help due to the company’s dropping share price, Ron Ferguson pulled together a team of General Re’s executives to work out the details of the AIG transaction. Those working for Gen Re on the arrangements included: Gen Re’s Chief Financial Officer Elizabeth Monrad, CPA; Senior Vice President and Assistant General Counsel Robert D. Graham; and Senior Vice President; and Chief Finite Reinsurance Underwriter Christopher P. Garand. For AIG, Vice President of Reinsurance Christian Milton was asked by Greenberg to take the lead role in the negotiations. As the deal developed, two people were added to the team. The first person was Senior Vice President Richard Napier, who was responsible for General Re’s customer relations with AIG. His role was to act as the General Re liaison with AIG. Since a General Re subsidiary in Ireland would be used for completing the transaction, the second person added to the team was Chief Executive Officer John Houldsworth of Cologne Re Dublin (CRD). Exhibit I contains the conversations recorded by John Houldsworth, CEO of Cologne Re Dublin (CRD) with Gen Re's Corporate Headquarters from November 14, 2000 to March 7, 2001. Although John Houldsworth knew the calls were being recorded, he still spoke freely. (Supreme Court of the State of New York, 2005)

**The AIG-General Re Transactions**

The financial expert on the team was Elizabeth Monrad who was named chief financial officer of General Re in June 2000. In October 2000 she received a call from her CEO, Ron Ferguson, asking her to help structure the AIG deal. Between October and December, 2000, the group worked together to create retrocession contracts between CRD, a General Re subsidiary in Ireland, and National Union Fire Insurance Company (National Union), an AIG subsidiary in Pittsburgh, PA. A “retrocession” is a transaction in which the reinsurer transfers to another reinsurer all or part of a reinsured risk.

The $500 million deal was structured in two parts so that AIG could add half of the premiums to its loss reserves for the fourth quarter of 2000 and the other half for the first quarter of 2001. AIG planned to account for the deal as reinsurance and increase their loss reserves, while General Re planned to account for the transaction as a deposit, not as reinsurance. The main constraint on the plan from AIG’s perspective was that they did not want to assume any real risk. They wanted to use the contracts to boost AIG’s “apparent” financial health that would hopefully result in a favorable reaction from analysts. General Re, on the other hand, did not want to risk their reputation or put any cash at risk.

By the beginning of December, the contracts were ready. National Union reinsured CRD for up to $600 million in losses. In return for the reinsurance, CRD was responsible for paying $500 million in premiums. As the contract was written, National Union appeared to assume the $100 million risk over and above the $500 million premium that CRD was to pay. Also attached to the deal were three factors that were not written as part of the main deal. First there was an agreement that $490 million of the $500 million in premiums was to be kept on a “funds withheld” basis, which meant that the cash was to be retained by CRD to cover claims. AIG was to “prefund” the ten million dollar difference that CRD was obligated to pay to National Union. Finally, AIG agreed to pay General Re five million dollars plus interest for putting the deal together. (Supreme Court of the State of New York, 2005)
Case A Questions

1. Review the GAAP for reinsurance. What is the substance of the AIG-Gen Re transaction? Were these transactions reinsurance or loans?

2. For each company, how should the transactions have been recorded if the transactions were for reinsurance? For a loan? What are the problems with the transactions?


4. While eight people worked on this deal, Elizabeth Monrad was viewed as the financial expert. As a previously licensed CPA, she should have been aware of the AICPA Code of Ethics? Did the transaction violate the AICPA Code of Ethics in any way?

5. Review AIG’s and Gen Re’s codes of conduct. Does this transaction violate AIG and Gen Re codes of ethics?
   - Read Gen Re Code of Business Conduct from the parent company's Berkshire Hathaway: http://www.berkshirehathaway.com/govern/govern.html

6. What safeguards were lacking and could have been implemented?

7. When should an employee say ‘no’ to doing something they know is unethical or wrong?
Case A*

Exhibit 1: Recorded Conversations

Court records revealed the following conversations recorded by John Houldsworth, CEO of Cologne Re Dublin (CRD) with Gen Re's Corporate Headquarters from November 14, 2000 to March 7, 2001. It is unclear why Houldsworth recorded most, but not all, of the calls between Gen Re's corporate headquarters and CRD. These tapes were admitted as evidence in the trial. Although John Houldsworth knew the calls were being recorded, he still spoke freely.

Conversations Recorded On November 14, 2000

Houldsworth: The story I got from Betsy…She was basically saying to me is it possible for CRD to charge to give AIG $500 million of reserves for a $500 million premium on a funds withheld basis for a couple of years.

Garand: It has to come from outside the U.S. It would be apparent in our numbers if we ceded it.

Houldsworth: If you do it in the States it's just going to stand out like a sore. It's going to look very odd in our numbers.

Garand: …the issue over here is we can't do it over here so she is looking for where in the group we can find something….

Houldsworth: I think basically they were sitting in the office last night and she just thought, “Oh god, who can I call that might be able to help. Who has got $500 million in reserves outside of the States without too much regulatory oversight that would cause, you know, those sorts of problems.”

Later the Same Day

Monrad: So let's assume they take the deposit liability I will tell you any way we structure it yes it's got to look more like deposit because they are not really looking to take risks! Well I think if we spend a lot of time trying to figure out how to transfer $500m of risk, we won't get this deal done in the time they want.

Houldsworth: Yeah, I mean as you say, if there's enough pressure on their end, they'll find ways to cook the books won't they?! [Monrad laughs] It's no problem there, it's up to them! We won't help them to do that too much. We'll do nothing illegal!

Still Later the Same Day

Houldsworth: There is clearly no risk transfer. You know there is no money…changing hands.

### Case A

**Exhibit 1: Recorded Conversations (continued)**

<table>
<thead>
<tr>
<th>Monrad:</th>
<th>[AIG] may have a tough time getting the accounting they want out of the deal that they want to do... They are not looking for real risk...</th>
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<tr>
<td>Houldsworth:</td>
<td>You know we can charge $500m for a $500m limit and get them to book that as a reserve, but I would be staggered if they get away with that.</td>
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<tr>
<td>Napier:</td>
<td>Then the way to do this, if there is risk in this, the way to become whole requires [AIG's chairman] and Ron [Ferguson] to have a handshake.</td>
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**Conversations Recorded On December 8, 2000**

<table>
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<tr>
<th>Monrad:</th>
<th>We told AIG that there would not be symmetrical accounting here. We told them that was one of the aspects of the deal they would have to digest.</th>
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<tr>
<td>Houldsworth:</td>
<td>That's fine then. That should do it, shouldn't it? It's so unlikely to be an issue so…</td>
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<tr>
<td>Monrad:</td>
<td>We haven't heard any push back from them in terms of can you change this, change that, so…</td>
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<tr>
<td>Napier:</td>
<td>It's quite the contrary. When Chris [Milton] called he said we're going to take it.</td>
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**Later that day Napier reported his conversation with Milton to Graham, Monrad and Houldsworth:**

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<tr>
<th>Napier:</th>
<th>Chris felt we should establish a traditional paper trail for this transaction. Rob's [Graham] work on the contract should complete the trail.</th>
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<tr>
<td>Monrad:</td>
<td>I think for the paper trail purposes...you need to have a wire transfer that shows $10 million at some point left your [CRD's] account…</td>
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**In a Follow-up Conversation About the Paper Trail**

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<tr>
<th>Houldsworth:</th>
<th>I'll be happy for [the contract] to go straight off to AIG today. When they put the real question out for Rick [Napier] as to who's gonna send that, do we send that again with another [offer] letter?</th>
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<tr>
<td>Graham:</td>
<td>I think the answer is you need to send the [contract]. What you want is, is for all of the deal correspondence on this thing really to come from you because it's your company that is doing the deal. It's okay for our guys [in Stanford, CT] to have meetings and conversations but any paper trail ought to really lead to Dublin.</td>
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### Case A

#### Exhibit 1: Recorded Conversations (continued)

#### Conversations Recorded On December 11, 2000

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<td>Houldsworth:</td>
<td>We're going to ask…Ron [Ferguson] to sign off on the reputational risk. I think it's Ron's deal so he's the one that ought to. I mean he's effectively done that by being involved but we may as well follow the rules.</td>
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<td>Garand:</td>
<td>Sure. Make him sign in blood.</td>
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<tr>
<td>Houldsworth:</td>
<td>Well, I don't care what he signs in as long as I know it's him.</td>
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#### Conversations Recorded On March 7, 2001 Reflecting On The Transaction

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<tr>
<td>Graham:</td>
<td>I personally would have been a lot more comfortable if the deal had been inked before 12/31, and this is gray area stuff for large zeros.</td>
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<tr>
<td>Houldsworth:</td>
<td>Yes, it's quite shocking actually.</td>
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<tr>
<td>Graham:</td>
<td>There's folk at pay grades higher than mine that have made the business decision they're willing to do that.</td>
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<tr>
<td>Houldsworth:</td>
<td>Well I think the AIG situation more than ours—I mean from our view point, you know, this is Cologne Re Dublin, we haven't closed our accounts. And to be quite frank, this route does not make a difference to our accounts. You know, there's no risk transfer in it. Its deposit accounting. But they're the ones who you really look at and think wow, this is impressive.</td>
</tr>
<tr>
<td>Graham:</td>
<td>Well, and their [AIG's] organizational approach to compliance issues has always been pay the speeding ticket, so, which is different than our [Gen Re's] organization approach to compliance. So, I'm pretty comfortable that our own skirts are clean but they [AIG] have issues.</td>
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#### Additional Conversations Recorded On November 14, 2000

Court documents revealed a further conversation Monrad had with Houldsworth where she stated to Houldsworth that she wanted CRD’s assistance because there were “transparency” issues with Gen Re providing the transaction to AIG in the United States. Because CRD was not subject to United States regulatory oversight and the same financial reporting requirements as Gen Re and its domestic subsidiaries, using CRD as a party further helped conceal the secret, unwritten side agreement. Monrad confirmed in the recorded conversation with Houldsworth that the loss portfolio transfer would not show up in any public filings in Ireland.
AIG and General Re: Helping One Another or Reinsurance Fraud—Case B

Trial and Convictions: Introduction

The following covers: several court cases brought against Gen Re and its management; review of events from 2000 to 2005; initial court findings; the 2012 federal appeals court throwing out the criminal convictions for five of the defendants; and the subsequent signing of a deferred prosecution agreement that allowed the defendants to avoid a retrial and possible prison time.

Trials and Findings

This fraud was tried in several courts. In 2005, John Houldsworth, former chief executive officer of Gen Re's affiliate CRD, and Richard Napier, one of General Re's senior vice presidents and the individual responsible for General Re's relationship with AIG, pleaded guilty to conspiring to commit securities fraud. Both faced up to five years in prison and $250,000 in fines under the plea deal. They each received lighter sentences because they provided crucial information to investigators to help them win convictions against the other five executives. Both were sentenced to only two years of probation and subjected to minimal fines. (McCarthy, 2009)

In February 2006, the SEC said in a complaint in Federal court in Manhattan that General Re was involved in sham transactions with AIG from 2000 to 2005 and a Prudential division from 1997 to 2002 that helped the two companies manipulate financial statements. For the fraudulent financial reporting, the SEC determined that the two companies simultaneously struck "secret, unwritten side deals" taking out all the risk of the transaction for AIG, thereby making the transaction fraudulent. (Securities and Exchange Commission, 2006) The transactions had no economic value as the funds just took a round trip between the two companies that led to false accounting on their financial statements. The sham transactions improperly boosted AIG's loss reserves by $500 million (Securities and Exchange Commission, 2006) and artificially propped up AIG's stock price ultimately costing shareholders as much as $597 million. (Mills, J. and D. Voraceos, 2009)

In 2005, the fraudulent nature of the deal was revealed through a tip from Warren Buffet. In a supposed attempt in an unrelated case to win leniency for Berkshire Hathaway, Buffett directed his lawyers to turn over documents describing a suspicious transaction between General Re, a Berkshire unit, and AIG. The documents led regulators to examine whether General Re and AIG manipulated their books and falsified accounting records. (Pullman, S., 2005) Around the same time, AIG acknowledged accounting improprieties and restated $3.9 billion in earnings from 2000 to 2004 and reclassified the $500 million of supposed loan reserves as deposits. (Securities and Exchange Commission, 2006) In 2006, AIG settled with federal and state probes for $1.64 billion (Powell, 2006) and in 2010, $725 million (Bloomberg News, 2010) to settle shareholder suits.

As a result of the ensuing investigations, in 2008, the United States District Court of Connecticut charged the named defendants, Ronald Ferguson, Elizabeth Monrad, Christian Milton, Robert Graham, and Christopher Garand, with sixteen felony counts. The charges included one count of conspiracy to violate the federal securities laws and to commit mail fraud; seven counts of securities fraud; five counts of making false statements to the Commission; and three counts of mail fraud. (United States District Court District of Connecticut, 2008) By the early months of 2009, the five defendants were all found guilty of conspiracy, securities fraud, making false statements to SEC and mail fraud. Elizabeth Monrad, the former CFO at General Re Corporation, was sentenced to eighteen months in prison with supervised release for three years and fined $250,000. Ronald E. Ferguson, former CEO of General Re from 1987–2001, was sentenced to two years in prison and fined $200,000. Christopher P. Garand, former senior vice president of Gen Re, was sentenced to one year and one day in prison and fined $150,000. (AlexandriaNews.Org., 2009) Robert D. Graham, former senior vice president and assistant general counsel of Gen Re from 1986–2005, was sentenced to twelve months and one day imprisonment followed by twenty-four months of supervised release and ordered to pay a fine of $100,000. He was also permanently suspended from practicing law. All defendants appealed their convictions. (Securities and Exchange Commission, 2009)

When Monrad and the others filed Motion to Sever in May 2008, the U.S. District Court of Connecticut, States Assistant Attorney Eric Glover stated that, “Her basic claim was that she didn't know AIG would book this improperly, but she knew from the start. This case is not about policing the books of another company. It's about the fact that Ms. Monrad...
helped create a sham transaction and deceived the investing public.” (Mills, J. and D. Voreacos, 2009) U.S. District Judge Christopher Droney said that, “There were many opportunities for her to come to her senses and shake this shady deal, but she never did.” (Mills, J. and D. Voreacos, 2009)

General Re admitted it helped AIG overstate loss reserves by $500 million. In January 2010, General Re agreed to pay more than $92.2 million to settle investor claims and end U.S. investigations over its role in sham transactions with AIG and Prudential Financial Inc. The company agreed to pay $19.5 million to the U.S. Postal Inspection Service Consumer Fraud Fund, $12.2 million to the Securities and Exchange Commission and $60.5 million to AIG shareholders in a class-action settlement. General Re previously forfeited the five million dollars in fees linked to the AIG scheme. The deal let General Re avoid prosecution by the U.S. Justice Department and resolved an SEC lawsuit. (Securities and Exchange Commission, 2010)

Court of Appeals and Deferred Prosecution Agreement

Court of Appeals
On August 1, 2011, the U.S. Court of Appeals in New York ordered a new trial for the five parties convicted in the 2008 trial. The panel of three judges’ decided that prosecutors use of three charts showing AIG stock price data suggested that this transaction caused AIG’s shares to plummet twelve percent during the relevant time period, which was without foundation. They said that it prejudicially cast the defendants as causing an economic downturn that was affecting all of America. (United States Court of Appeals for the Second Circuit, 2014)

Deferred Prosecution Agreement
In June 2012, rather than be retried at a new trial in January 2013, the five defendants made an agreement to pay fines and after twelve months of probation the prosecutor would file a motion to dismiss the criminal charges against them. The defendants admitted that aspects of the transaction were fraudulent and that many “red flags” should have alerted them to the fraud. Mr. Ferguson and Mr. Milton each agreed to a $200,000 fine that they had already paid. Fines were imposed on Ms. Monrad of $250,000, on Mr. Garand for $150,000 and on Mr. Graham of $100,000. (Strumpf, D., 2012A)

Case B Questions

Trial and Convictions
1. What were the charges filed against Ferguson, Garand, Graham, Milton, and Monrad by the U.S. District Court of Connecticut?
2. Do you think the sentences and fines initially imposed on the defendants were appropriate in this case considering those sentences that are suggested under the federal sentencing guidelines? Review U.S. District Court of Connecticut, Government Memorandum, Crim. No. 3:06CR137(CRD), September 5, 2008 for the courts discussion on how the sentencing was determined: https://www.yumpu.com/en/document/view/36825376/united-states-of-america-workcompcentral/7.

Convictions Overturned and the Deferred Prosecution Agreement
1. What was the U. S. Court of Appeals in ordering a new trial? Review the court of appeals opinion about the chart and why it was considered prejudicial to the defendants: http://www.ca2.uscourts.gov/decisions/isysquery/8d345d75-3ea4-4d3e-9766-ad91d83665a7/1/doc/08-6211_opn.pdf.
2. What are the ramifications of the “deal” for other executives who might consider committing financial statement fraud on a large scale in a corporation?
3. Did the parties receive any personal gain from the transactions?
References


