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The Insurance Scandal Shakes Main Street

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LIKE many doctors in private practice, Andrew A. Slemp Jr. figured that he could earn enough from the small surgical group he started in Roanoke, Va., to enjoy a comfortable retirement. But Dr. Slemp, who is in his early 60's, recently dissolved his practice after running into financial trouble when his malpractice insurer collapsed.

In Kansas City, Kan., another doctor, Joel N. Schroeder, is considering filing for bankruptcy. He is unable to pay a \$750,000 malpractice claim that a state judge levied against him on behalf of survivors of an elderly stroke victim. Before the case went to trial, Dr. Schroeder, who contested the accusation, learned that his malpractice insurer, the same as Dr. Slemp's, had imploded.

Both men had coverage from a company called **Reciprocal of America**. Their lives, and those of thousands of other doctors and lawyers in the South and the Midwest, have been in flux since **Reciprocal cratered about two years ago amid a tangled web of business transactions that regulators describe as fraudulent**.

Tremors from the Reciprocal investigation would soon reverberate in the boardrooms of much bigger insurers. But as the inquiries into esoteric insurance practices spread, making their way around Wall Street, the fallout from some of the industry's abuses was already becoming apparent on Main Street. People who relied on Reciprocal, and held malpractice policies that evaporated without warning, say they feel betrayed by convoluted financial dealings that they barely understand.

"All of a sudden your lawyer calls you and tells you: 'Guess what? Your insurer just went under,'" said Dr. Schroeder, 41, a father of two. "You panic, because you have no idea what's going to happen."

Reciprocal, which was based in Richmond, Va., once claimed to do what all insurers do: soften the impact of uncertainty, pain and financial damages that accompany life's misfortunes. Today, its demise has emerged as a signature case in a series of investigations of insurance abuses. Regulators contend that Reciprocal, aided by outside business partners - including General Re - used financial gimmicks to mask serious problems and benefit insiders for more than a decade, until the company foundered.

Patrick H. Cantilo, a lawyer who is helping Virginia regulators liquidate Reciprocal, said he was still gathering information about how many doctors, lawyers and institutions were entangled in litigation over malpractice cases involving the company. But Reciprocal had sold about 50,000 policies through its units in Tennessee alone, according to regulators there. Mr. Cantilo estimates that claims against Reciprocal and its units have risen to more than \$770 million, for which liquidators may initially pay less than 20 cents on the dollar.

Reciprocal's former chief executive, Kenneth R. Patterson, and a former executive vice president, Carolyn B. Hudgins, have already pleaded guilty to federal fraud charges. The Justice Department has been investigating other managers of the company and outside advisers since 2003. Insurance commissioners in Tennessee and Virginia, as well as former policyholders, have also sued the company and its advisers, accusing it of engaging in a protracted conspiracy to inflate the company's weakening accounts and to allow management to speculate with corporate funds.

In motions to dismiss the lawsuits, lawyers for General Re, which helped Reciprocal manage its financial risks, said it had done nothing wrong in any of its interactions with the company. A person familiar with the deals in question said that General Re had never engaged in any cover-ups or financial shell games with Reciprocal.

Executives involved in the dizzying matrix of offshore accounts, secret transactions and financial sleight of hand that defined Reciprocal's business often struck deals in luxurious surroundings, even as Reciprocal itself was falling apart, according to the lawsuits. Executives, the lawsuits say, sometimes convened at fancy resorts and on other occasions cemented deals while cruising Chesapeake Bay aboard the Scottish Lass, a yacht owned by a Reciprocal executive. Reciprocal managers referred to the summer boating excursions as "Chesapeake Audits," according to one lawsuit.

Regulators say that in a 1994 outing aboard the Scottish Lass, General Re executives gave Mr. Patterson a \$1 million check. The money, according to the Virginia regulator's lawsuit, was related to funds that General Re agreed to return to Reciprocal under the terms of a complicated insurance contract between the two companies.

But regulators have been unable to find evidence that the check was deposited into Reciprocal's accounts, Mr. Cantilo said. "We have turned the books upside down," he said, "and found no trace of the money."

Charles F. Witthoefft, a lawyer for Mr. Patterson, would not comment on the incident but said his client denied any misuse of the money. J. Jonathan Schraub, a lawyer representing several Reciprocal executives, including one of the company's co-founders, John William Crews, also denied any wrongdoing by his clients. Mr. Crews is also a lawyer, and his firm, Crews & Hancock, received at least \$63 million in fees from Reciprocal and related entities over the years, according to one suit against the company. "The government has post-Enron blood lust," Mr. Schraub said. "Everybody is guilty until proven innocent."

IN a startling turn of events, the Reciprocal investigation produced information that led to the ouster of Maurice R. Greenberg, the iron-fisted chairman and chief executive of American International Group, the insurance giant.

Berkshire Hathaway, the holding company of Warren E. Buffett, acquired General Re in 1998. This January, as Berkshire lawyers scoured General Re's accounts to respond to Justice Department queries about Reciprocal, they disclosed a questionable insurance transaction that A.I.G. used to improperly spruce up its books.

Securities and Exchange Commission officials and Eliot Spitzer, the New York attorney general, were already investigating A.I.G. But the Berkshire disclosures led them to issue a fresh round of subpoenas to the company. The subpoenas, and evidence of financial manipulation that surfaced later, prompted A.I.G.'s board to ask Mr. Greenberg to step down.

Mr. Greenberg has not been charged with wrongdoing, but the investigation of his company has pummeled its stock price, caused a \$1.7 billion financial restatement and uncloaked a murky skein of suspect offshore dealings. Mr. Buffett is not a target in any of the investigations, and he has told regulators that he had no knowledge of the structure of any of General Re's suspect dealings before the transactions occurred.

Mr. Greenberg initiated the deals with General Re's former chief executive, Ronald E. Ferguson, according to investigators and federal regulators. Mr. Ferguson was also enmeshed in questionable transactions with Reciprocal, Virginia regulators said, including the approval of suspect contracts cloaked in language stating that they were intended for Mr. Crews's "eyes only." Mr. Ferguson did not return phone calls seeking comment.

Doctors, lawyers and hospitals, meanwhile, are wading through the emotional wreckage and financial devastation caused by Reciprocal's collapse.

Seven years ago, Bertha Walker's children rushed her to the emergency room of Bethany Medical Center in Kansas City, Kan., convinced she had suffered a stroke. Dr. Schroeder, who supervised her care, disagreed and ordered a brain scan. A few hours later, Ms. Walker, 71, was unconscious; 10 days later she was dead.

Ms. Walker's children sued Dr. Schroeder, arguing that he had failed to treat her adequately for a stroke. Although Reciprocal collapsed before the case was tried, Dr. Schroeder wanted the opportunity to clear his reputation in front of a jury. "I felt there was no negligence and I really thought that a fair trial with a jury would be in my favor," he said in an interview. "If there had been coverage in place, I'm sure it would never have gone to trial."

But Reciprocal's demise has left Ms. Walker's children uncertain that they will get the money awarded to them. It also left Dr. Schroeder with huge bills he had never anticipated as he worked with his wife, a

pediatrician, to build a comfortable life for themselves, their 10-year-old daughter and 6-year-old son.

Dr. Schroeder remains liable for \$650,000 of the \$750,000 owed to Ms. Walker's children, and the Walkers' lawyer, Michael L. Hodges, is asking a Kansas state insurance fund to make that payment. While that effort is pending, Dr. Schroeder has retained Tom Mullinix, a lawyer specializing in bankruptcy and financial planning.

"He's a young man and he has a nice annual income," Mr. Mullinix said of Dr. Schroeder. But "he's got kids and mortgage payments and he doesn't have \$650,000. If hard pressed, he might come up with \$50,000 or \$75,000."

Dr. Schroeder isn't the only one confronting problems like this. "You have people with claims having to take nickels on the dollar," said B. K. Christopher, a Kansas City, Mo., lawyer who represents several former Reciprocal policyholders. "You have doctors having to personally take out loans to pay money they don't have."

Without insurance backing a doctor or a hospital, Ms. Christopher said, lawyers, working on a percentage basis, often will not consider representing patients and their families. "Even if you get a jury verdict, it's not worth the paper it's printed on unless you want to garnishee the doctor's wages for the rest of his life," she said. "That takes a lot of time and effort, and it really doesn't happen in Kansas and Missouri."

Many hospitals that were insured by Reciprocal face millions of dollars in unexpected costs. Since the company's demise, they have postponed renovations and purchases of new equipment. Smaller hospitals worry that the extra costs of securing new insurance and resolving pending lawsuits may overwhelm them.

"We could be wiped out financially," said Patrick A. Romano Jr., chief executive of Gateway Regional Health System, a nonprofit company that operates a 63-bed hospital in Mount Sterling, Ky., and a clinic in Owingsville, Ky., in farm country east of Lexington. "It's depleted what minimal capital reserves we had."

He said Gateway would probably be able to "stave off bankruptcy" by taking on loans and appealing for contributions from residents of surrounding towns that depend on the hospital and clinic for care.

President Bush is still trying to persuade Congress to limit payments to victims of malpractice, contending that doing so would reduce premium costs for doctors and hospitals. After Reciprocal collapsed, replacement coverage bought by doctors and hospitals often cost more than their old policies.

Founded in 1977, Reciprocal once operated in more than a dozen Midwestern and Southern states. Mr. Crews, a Richmond lawyer and a former assistant Virginia attorney general, was instrumental in starting the company, and he directed much of its business over the years, regulators said. His law firm served as

general counsel to Reciprocal.

Mr. Crews's lawyer, Mr. Schraub, said his client "never had day-to-day operating responsibility for the company." But, he said, Mr. Crews and other Reciprocal executives "did their level best to make this company work."

Law enforcement officials have a different view. According to charges filed against Mr. Patterson by David T. Maguire, an assistant United States attorney in Richmond, Reciprocal routinely misrepresented its weakening financial condition - to regulators, its board and its policyholders - starting as early as 1995.

Among the devices Reciprocal used to cloak its problems, regulators say, were arcane reinsurance products. General Re is one of the biggest reinsurance vendors in the world, and its products play important roles in helping insurers themselves soften the blows from unexpected waves of large claims - like hefty malpractice awards. But some policies can also be engineered to function more like short-term loans than actual insurance policies, and unethical companies can use the funds to artificially enhance their financial statements.

Virginia regulators say they have uncovered improper transactions between General Re and Reciprocal dating back to 1990. But the most significant deals, they said, began in early 2000, after General Re determined that Reciprocal had underpriced its malpractice coverage and was going to be slammed with heavy losses.

Through a series of financial maneuvers from 2000 to 2002, regulators say, Reciprocal and General Re made it seem as if the reinsurer would manage a large portion of Reciprocal's potential losses. In reality, regulators say, the two companies were secretly working to reduce General Re's risk.

"General Re said, 'We want out,' " as the potential for losses mounted, said Mr. Cantilo, the lawyer assisting Virginia regulators. "The problem became: 'How do we take General Re out of the loop and not all of a sudden make it look like Reciprocal of America has a ton of unprotected risk?' "

One device, Mr. Cantilo said, was an undisclosed side letter that limited General Re's losses. In an amended version of its 2001 financial statement to Virginia authorities, regulators say, Reciprocal reported it had more than \$337 million in reinsurance from General Re, but because of the undisclosed side letter, Reciprocal could count on General Re for only \$135 million. Mr. Ferguson, the General Re chief, had earlier approved a similar side letter between his company and Reciprocal, regulators say.

A person with direct knowledge of the accusations against General Re disputed that the reinsurer had used undisclosed side letters in its dealings with Reciprocal. This person also said that regulators and auditors were apprised of the transactions, and that the lawsuit inaccurately described the level of risk General Re assumed from Reciprocal.

Regulators say Reciprocal and General Re also used offshore accounts and companies to play financial shell games. For example, regulators say, Reciprocal shifted \$112 million through a Bermuda company to General Re to pay claims. In a typical transaction like this, General Re would have been taking a risk that the cost of paying the claims over several years would exceed \$112 million and the company's investment returns on the money would not make up the difference.

But the risk to General Re was eliminated by a promise from the Bermuda company, First Virginia Reinsurance Ltd., to reimburse it for any losses over \$112 million, regulators say. The person familiar with the deal said, however, that General Re lost more than \$20 million in that transaction.

Reciprocal executives incorporated First Virginia in Bermuda in 1984, but regulators said the company was largely run out of Reciprocal's Richmond office. It is unusual for a company of Reciprocal's size to have an offshore entity like First Virginia, and the company made heavy use of it.

A long series of deals between Reciprocal and General Re from 1990 to 2002 were simply loans masquerading as reinsurance contracts, regulators say. They say that some of these transactions were devised to deceive General Re's regulators by artificially inflating First Virginia's ability to make good on transactions with General Re, and that Reciprocal itself guaranteed those loans.

When stealth loans did not do the trick, regulators say, Reciprocal simply went for old-fashioned cover-ups, by arbitrarily reducing estimates on potential claims and reporting some liabilities as assets.

In the fall of 2001, Reciprocal was confronting nine-month losses totaling \$90 million. So the company made its computer programmers work overtime, regulators say. On Nov. 7, 2001, they say, the programmers spent an entire night reducing scores of anticipated claims by about \$19 million and then backdated the doctored accounts.

MOST of Reciprocal's policyholders noticed nothing amiss until the whole company imploded a little more than two years ago.

Reciprocal's downfall has forced some doctors to give up private practice and to join hospital groups as salaried employees at lower pay. Dr. Slemp, in Roanoke, said that he and the two partners in his practice were so staggered by the costs of securing new malpractice insurance and other coverage that they dissolved their partnership. "I had a lot of benefits coming to me, but because of the insurance company going defunct, the other physicians in the group were forced to join up with the hospital group here," Dr. Slemp said. "They weren't able to afford the insurance premiums. And there was an unwillingness of some companies to take us on no matter what the cost."

When Reciprocal collapsed, Dr. Slemp was also grappling with a \$550,000 malpractice lawsuit. He said he would have preferred a trial so he could clear his name. But he said his lawyer reached a modest settlement that released him from future liability and gave the plaintiff the right to pursue a claim against Reciprocal's liquidators.

Even so, Dr. Slemo said, "that left a bad taste in everyone's mouth, especially mine, including the fact that I couldn't defend myself in court because of the extreme expense I would have encountered."