

IN THE MONEY: Insurer Covers Corporate Financial Risks

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NEW YORK (Dow Jones)--Directors of public companies are under intense scrutiny these days.

Wrong decisions can lead to regulatory probes, shareholder angst and even costly lawsuits.

But, faced with a sophisticated financial decision such as whether a complex corporate tax write-off is kosher or what a company's liabilities are from a recent takeover, boards of directors can now take a more unorthodox option: Insure it.

In the past, the idea of insuring something as esoteric as the level of income tax reserves on a corporate balance sheet would have seemed far-fetched. But in the wake of accounting scandals at Enron Corp. (ENRNQ), Tyco International Inc. (TYC), and others, many directors and corporate executives are concerned that they have personal exposure to a company's financial decisions.

"Two of Enron's directors are good friends and a third one taught me," said Robert Williamson, chief financial officer for Therapy Review Systems in Miami and the former CFO of Equinox Systems Inc., a Sunrise, Fla., company that was acquired by Avocent Corp. (AVCT) in November 2000. He has spent 25 years on public and private boards and frequently lectures on the responsibilities of directors.

"They got led down the primrose path," Williamson said of the people he knows who were Enron directors. "And these are good people, honest people, smart people. They got misled by management, auditors and lawyers. It's a very difficult situation."

For directors staring at similar problems, insurance would seem to be a natural solution.

"In a post-Sarbanes-Oxley world directors are very concerned that their accounting be pristine," said Lewis Steinberg, an attorney who specializes in tax issues at Cravath, Swaine & Moore.

The insurance works like this: Say a company needs to set aside money for taxes in its year-end financial statements. The chief financial officer tells the directors that the company qualifies for \$100 million in tax credits. But the auditors warn that future changes to Internal Revenue Service rules may at some point disqualify the company from claiming those credits.

And that's the crux of the board's dilemma. Opting for the CFO's more aggressive treatment will boost the company's income statement, but the company might wind up with future tax liabilities that prove problematic. If the board heeds the auditors' more cautious approach, it risks using an accounting treatment that is unnecessarily conservative, making its results seem less attractive.

So here's where the insurance would come in. For a fee, an insurer could assume the risk of the potential liability, freeing up the company to use the more aggressive accounting treatment while knowing that its downside is covered.

"Basically what these policies do is transfer the problematic issues on your balance sheet to an insurance company," said Nemo Perera, principal and co-founder of Risk Capital Partners, a New York insurance boutique that has started writing these kinds of policies.

Perera said Risk Capital calculates the premium a company would pay based on a percentage of the liability involved, usually between 3% and 10%.

So using the \$100 million example above, the company would pay a one-time insurance premium of up to \$10 million and

its \$100 million tax credit would be insured. If the IRS never changes its ruling, Risk Capital would pocket the premium. But if the IRS eventually rules that the credits are illegal, Risk Capital would be on the hook for the \$100 million it indemnified.

These policies are different from the so-called "finite reinsurance" or financial reinsurance that have become so controversial lately for insurers like American International Group Inc. (AIG). Finite reinsurance enables a company to pay premiums to an insurer and then recoup those premiums at a later date, essentially transforming the insurance into a loan.

But Risk Capital's policies operate as traditional insurance, where the underwriter accepts a premium in return for taking on the risk of the potential liability.

As it stands now, there aren't too many of these kinds of policies in existence, largely because they're so new and few companies are selling them. Perera said Risk Capital has spoken to just 20 to 25 companies about the insurance, has signed up roughly five so far, and isn't aware of any other outfits pursuing these policies.

And many corporate finance experts said the concept was new to them.

"This isn't something I'm familiar with, but it sounds like could be an interesting idea," said Dennis Beresford, a professor at the University of Georgia's J.M. Tull School of Accounting and the former chairman of Financial Accounting Standards Board. "Companies are exposed if they've materially understated their liabilities. Companies get sued for those kinds of things all the time."

"I'm really intrigued by this product," said Cravath's Steinberg, who actually has worked with Risk Capital in evaluating the risk in one potential policy.

"A lot of my clients have this kind of exposure," he added. "Today the typical response is to be very conservative with your accounting, to err on the side of conservatism. But that may not be in the best interests of the company either."

(Eric J. Weiner is one of four "In The Money" columnists who take a sophisticated look at the value of companies and their securities and explore unique trading strategies.)

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