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Bankruptcy Ahoy!

Reliance's Big Dividends

On August 14, Reliance Group Holdings announced a second-quarter loss of $504.5 million, reducing the company's reported shareholders' equity to $455 million (down from $1.03 billion at year end). As of June 30, 2000, Reliance Group had $735.1 million of debt, including $237.5 million of bank borrowings coming due on August 31, 2000 and $291.7 million of senior notes maturing on November 15.

"Reliance [Group Holdings] does not expect to be able to obtain regulatory approval for dividends from Reliance Insurance Company sufficient to fund the repayment at maturity of the bank debt and the senior notes," the company noted in a 10-Q filing.

In addition to providing details of how the company managed to lose so much money, the filing stated that Reliance Group might "seek protection under the Federal Bankruptcy Code."

It's unlikely that long-time readers of *Schiff's Insurance Observer* are shocked by the turn of events at Reliance. (If anything, they are probably surprised that Reliance has hung on this long.) Way back in February 1992, we commented on Reliance Group's "Milkenesque balance sheet," "mountain of debt," negative tangible net worth, and "holding-company structure that relies on dividends from the insurance company to meet debt requirements." Over the ensuing years, we've commented regularly on Reliance's precarious finances and vulnerability to a rating downgrade. It's a testament to Saul Steinberg's extraordinary financial creativity that we could write about Reliance so often without repeating ourself. Indeed, it's rascals like Steinberg that make being a professional insurance observer so much fun. Almost every year he seemed to come up with some new scheme that was too clever by half. There were speculative investments, a rapidly growing book of dubious business, and financial re-engineering. Assets were sold, portfolios were rejiggered, and there were constant changes in the company's direction. Although Reliance lacks something every good business ought to have—solvency—Steinberg was such a whirlwind of activity that it's hard to begrudge him the majestic compensation he hauled in each year (courtesy of a board of directors packed with cronies).

Observing Saul Steinberg perform his financial high-wire act was horrifying and repulsive, yet strangely entertaining—like watching Jerry Lewis on his annual Labor Day telethon. Could any insurer other than Reliance have created Sable Insurance Company, which in a press release billed itself as the first African-American-owned property-casualty insurance company? (Sable was owned and controlled by Reliance, albeit through preferred stock rather than common stock.) Sable summed up Steinberg's *chutzpah*: a white man owning an insurance company that passed itself off as being owned by blacks. The reason for Sable was simple: to write business that was earmarked for minority-owned insurance companies.

The Steinberg Touch—a combination of brilliance, hubris, and madness—was what defined Reliance. It was hard to take your eyes off Steinberg's performance, awful as it was. As a speculator, leveragemeister, and stock tout he was an unabashed recidivist. Although he was known for his quick wit and good sense of humor in private, in front of an audience he was a pompous ass. Steinberg, when you get right down to it, was an artist whose metier was flaming bafflegab, bunk, and hokum.

"We are succeeding in what is generally considered a soft market," he wrote in his 1996 annual report, "by growing and investing in those segments where opportunities are most rewarding, while cutting back business in segments that are unattractive. It's a simple strategy, but its successful execution requires discipline, the willingness to say 'No' to business that yields inadequate risk-adjusted returns for shareholders."

By God that sounds impressive. (One can only shudder to think how poor Reliance's results would have been had it said "Yes" to business that yielded "inadequate risk-adjusted returns.")

In the 1998 annual report (published in 1999), Steinberg told shareholders that "we are fast and flexible. We move rapidly when we see a growth opportunity and are just as quick to back away from business that does not meet our risk-reward criteria." He stated that Reliance was a "disciplined underwriter" and even managed to get in the phrase "our growing e-commerce capabilities."

Alas! If only it had all been true. If only Reliance hadn't expanded so rapidly and recklessly. If only it hadn't been underreserved and overleveraged.

Actually, if it hadn't been *overleveraged* it might not be in such terrible trouble today, and Saul Steinberg might still be

$2 Billion in Dividends

Dividends upstreamed from Reliance Insurance Company to Reliance Group Holdings

	millions
2000	$ 50.4
1999	175.7
1998	271.0
1997	115.6
1996	111.5
1995	112.3
1994	114.1
1993	133.7
1992	143.7
1991	160.6
1990	144.9
1989	140.9
1988	146.6
1987	130.5
1986	108.5
TOTAL	**$2,060.0**

Sources: Reliance Group, Reliance Insurance Company, A.M. Best living in his 34-room Park Avenue apartment surrounded by old master paintings. Although Reliance's execution of its business plan was poor, it could have survived that had it eschewed debt and chosen to build its surplus over the years.

But that wasn't how Saul Steinberg did things. He was a glutton for leverage and, apparently, could only see its upside. Because Reliance Group Holdings (the parent company) carried so much debt, Reliance Insurance Company upstreamed large cash dividends each year. Between 1986 and 1999, Reliance Insurance Company paid \$2.09 billion in dividends, an average of \$143 million per year. During that long period, Reliance's statutory surplus only grew from \$577 million to a reported—but questionable—\$1.247 billion. The dividends from the insurance company were used primarily to pay the interest on Reliance Group's debt and, secondarily, to pay dividends to shareholders, of which Steinberg was by far the largest. (During these years, the Steinbergs received about \$125 million to \$150 million in dividends.)

Even when Steinberg "fired" his brother, it was on terms so generous that virtually every Reliance employee would like to be fired that way: a \$1.5 million payment and a \$2.25 million consulting contract.

Sue the Bastards

As a result of Reliance's woes, the company's shares have collapsed to about 25¢. The senior debt and subordinated debt are at 30¢ and 10¢ on the dollar, respectively. Not surprisingly, class-action lawsuits have been filed at a furious pace against Reliance, Steinberg, and other officers and directors. Here's an excerpt from a press release put out by a law firm representing shareholders:

> As alleged in the complaint, on March 31, 1999, defendants, in their financial statement filed with the SEC for its fiscal 1998 operations, stated that [Reliance's] reinsurance contracts were valid, and that it expects to recover the full amount of such coverage. This statement was false and misleading, and defendants knew, or recklessly disregarded its falsity, because [Reliance] was notified, prior to making the statement, that several reinsurance companies terminated their obligations to [Reliance]...Because [Reliance's] obligations to its insureds remained intact, [Reliance's] expected losses exceeded \$150 million. Furthermore, this \$150 million loss should have been reflected as a charge to income, under Generally Accepted Accounting principles, and was not, thereby masking [Reliance's] true, and impaired, financial condition and prospects.

Lawyers representing bondholders put out this missive:

> The complaint alleges that Reliance and certain of its senior officers...violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 by issuing materially false and misleading information regarding Reliance's liquidity and its ability to repay or refinance its debt, causing the price of Reliance Bonds to be artificially inflated...

Reliance Group Holdings, for its part, said it doesn't believe that its probable aggregate liability from these legal actions will have a material adverse effect on its financial position.

We agree. In the words of Bob Dylan, "When you got nothing, you got nothing to lose."

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