

CIRCULAR

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CIRCULAR NO. 14/04

TO MEMBERS OF THE ASSOCIATION

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Dear Member:

CHANGING THE CLUB'S DISCRETIONARY PRACTICE OF REIMBURSING MEMBERS IN RESPECT OF UNKNOWN AND UNRESERVED CLAIMS ARISING IN CLOSED POLICY YEARS PRIOR TO 1989

At a Special Meeting held in New York on May 25, 2004, your Board took important decisions in regard to the reimbursement of unknown and unreserved claims in policy years prior to 1989 which hitherto have been paid by the Club on a discretionary basis.

The purpose of this Circular is to explain those decisions and the positive effect they will have on the Club's financial outlook. Since many Members of the Club are – comparatively speaking – newcomers to its affairs, the remainder of this Circular seeks to place the Board's decisions in the historical context necessary fully to appreciate the reasons for them.

The recent past – growth, diversification and reform

As Members will be aware, the American Club has undergone great change in recent years. The driver of this change was the realization, emerging in the early 1990s, that the Club needed to grow and diversify to secure its future as a global player able to compete as effectively as any of its market counterparts.

Conducted in parallel with the commercial elements of implementing growth and diversification was the reform of the Club's systemic procedures, particularly after it became a member of the International Group of P&I Clubs in February 1989. The overall goal of the strategy was broadly to conform the American Club's business profile and practices to International Group "norms" – with appropriate market differentiation – so that it would become as natural a P&I option for international shipowners and charterers as any other P&I club in London, Scandinavia or elsewhere.

As a consequence, the American Club of today is completely different by reference to its size, membership and the characterization of its tonnage by vessel type from that which it was in the past. A decade ago, 95% of its tonnage (made up of only about 30 Members) was US-flag or US-domiciled and amounted to about 4 million gross tons in total. In 2004, the Club's nearly 400 Members are drawn from all over the world: about 60% are from Europe, 25% from the US, 11% from Asia and 4% from other regions of the globe and total some 20 million gross tons.

The more distant past – a small, homogeneous collegiality

By contrast with the Club of today, for the greatest part of its history the membership of the American Club was overwhelmingly US-flag and mainly engaged in deep-sea trades. From the 1940s through to the 1980s these Members formed a largely stable and homogeneous group collectively operating the Club in a manner consistent with the most rigorous application of the mutual principle. The practices of those years bear directly on the decisions made at the end of May.

Each policy year stood entirely on its own in financial terms and, as each came to be closed, assessments were made, or dividends returned, simply and exclusively on the basis of claims known and reserved for at the time of closure. Specifically, until the closing of the 1977 policy year in 1988, the Club made no allowance in closing years for claims Incurred But Not Reported (IBNR).



The rise of occupational disease – principally asbestos – claims

In about the early 1980s, seamen and others working on or about Members' vessels began to assert that they had been injured by exposure to asbestos many years earlier – in some cases going back to the 1940s. By the mid-1980s the assertion of such claims was accelerating.

Despite the fact that, as described earlier, prior to the closure of the 1977 policy year the Club had made no allowance for IBNR in prior years, nor levied any assessments to deal with such unforeseen claims, its then Board decided, in about 1980, on a discretionary practice to deal with them.

The practice was *discretionary* – and remains so – insofar as it is not provided for in the Club's Charter, By-Laws or insurance policies (Rules as evidence of cover were adopted in 1997) or under the principle of full mutuality in New York law. The practice was to indemnify Members from the Club's general reserves, irrespective of the fact that such reserves were not the property of the Members in the closed policy years.

The mechanics of the discretionary practice and establishing IBNR for 1977 and later years

The discretionary practice included allocating each seaman's or other party's claims over the year in which he worked on or about a Member's vessels, applying the Member's deductibles for each of those years and reimbursing the Member for the balance, if any. However, and as previously mentioned, prior to the closure of the 1977 policy year in 1988, no arrangements were made to establish any reserves for the continuing reimbursement of these claims either by way of assessment or otherwise.

In 1988, in closing 1977, the then Board decided to assess that policy year's Members the sum of \$100,000 as an IBNR allowance for that year and future years (except for the 1978 year which had already by then been closed). This amount has proved to be inadequate to cover these unpredicted claims.

In 1989, as mentioned above, the American Club became a member of the International Group and, by way of reinsurance, a party to the Pooling Agreement (it became a full pooling member in 1998). Accordingly, for exposure to seamen occurring entirely after February 20, 1989, it was decided that the Club would conform to International Group practice to which it continues – and will continue – to adhere. **This is why the Club will continue to respond to unknown and unreserved claims arising in 1989 and subsequent policy years.**

Current International Group practice is to apply a single deductible from the most recent period of coverage held by the Member even if the alleged exposure overlapped more than one policy year. Since deductibles tend to increase over time, the most recent deductible is likely to be the largest deductible applying to the relevant coverage of a Member.

Why the change to the former discretionary practice is necessary and what it means

As of the end of 2003, reimbursements to (largely former) Members of the Club under the application of the discretionary practice in relation to closed years amounted to almost \$6 million. The bulk of that sum relates to alleged exposures of seamen to asbestos on Members' vessels prior to 1977 in respect of which years no premium or assessments for such claims were ever received.

Indeed, between 1946 and 1976, Members eligible for the exercise of the discretion enabling them to receive reimbursement of these claims collectively received dividends from the Club of more than \$16 million in total.

Under New York law, the Club's reserves, including case reserves for closed years, are the property of the Members in the open years. Those Members have an obligation to indemnify closed years' Members for their settlements of reported claims from the case reserves. But Members in open years have no legal obligation to indemnify Members in closed years for unreserved or inadequately reserved claims.

Over 6,000 seamen's asbestos cases are pending in the courts of Cleveland and Detroit alone. Many other such cases are pending in other courts around the United States. Other forms of occupational disease claims have been asserted by seamen and will likely continue to be asserted in the future. They include claims in respect of hearing



loss; benzene-related leukemia; other chemical-related diseases; illnesses arising from exposure to lead and sandblasting grit; long-term welding injuries; and no doubt other types as yet unknown.

Given the sea-change which has taken place in the Club's membership in recent years, there is no justification for continuing a discretionary practice which threatens the erosion of current Members' funds for the benefit of those who made negligible, if any, contribution to the claims they are seeking to recover and many of whom, even if still trading with the same corporate identity they had when they were originally Members of the Club, if still trading at all, are no longer Members.

Those Members, both present on and represented by the Club's Board over the many years during which the issue of individual policy year funding came to be determined, consistently resolved to close relevant years without allowance for unknown or unreserved claims, often electing to make returns of premium by way of dividend. To continue the discretionary practice described herein by using funds belonging to Members of open years is plainly inequitable and inconsistent with the principles which were applied to the closure of those earlier years at relevant times in the past.

Prompted by recent developments on certain specific claims, your Board met on May 25 in New York and, as recommended by the Finance Committee, passed the attached Resolutions. At present, in conjunction with terminating as a practical matter the reimbursement of unknown and unreserved claims in accordance with these Resolutions, the Club's attorneys have also filed a Complaint in the United States District Court for the Southern District of New York seeking, *inter alia*, a Declaratory Judgment, the intention of which is to formalize the Club's legal position and, as a matter of procedural convenience, consolidate litigation which might otherwise arise piecemeal in other jurisdictions across the United States.

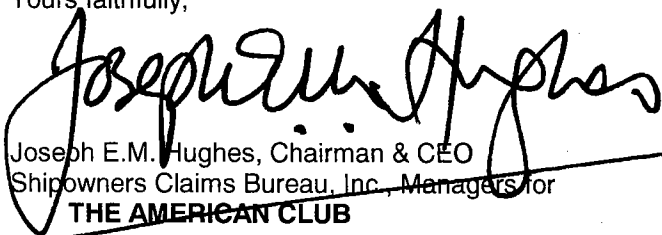
Summary

The decisions which your Board has reached are among its most important of recent years. They have not been taken lightly, and only after extensive consultation and debate. Above all, they have been taken with the Members' best interests at heart.

They are designed to end an inequitable erosion of the Club's assets, create a "ring-fence" around them and bring to an end the uncertainty attendant on the future vicissitudes of litigation associated with claims for occupational disease. Your Board has taken a decisive step forward which promises to have a positive effect on the Club's financial outlook over the years to come.

As always, the Managers will be pleased to answer any questions Members may have in relation to this Circular, or generally.

Yours faithfully,


Joseph E.M. Hughes, Chairman & CEO
Shipowners Claims Bureau, Inc., Managers for
THE AMERICAN CLUB



APPENDIX TO CIRCULAR NO. 14/04

RESOLUTIONS OF THE BOARD OF DIRECTORS TO:

(A) DECLARE CHANGES IN THE CLUB'S DISCRETIONARY PRACTICE OF REIMBURSING MEMBERS WITH RESPECT TO UNKNOWN AND UNRESERVED CLAIMS ARISING IN CLOSED INSURANCE YEARS BEFORE FEBRUARY 20, 1989;

(B) AS INSURANCE YEARS AFTER FEBRUARY 20, 2000, COME TO BE CLOSED, PURCHASE ADDITIONAL INSURANCE AND/OR INCREASE AND/OR OTHERWISE ADJUST MEMBERS' CONTRIBUTIONS TO THE YEARLY RESERVE FOR IBNR IN SUCH AMOUNT AND IN SUCH MANNER AS SHALL THEN BE CONSIDERED APPROPRIATE; AND

(C) AUTHORIZE COUNSEL TO PREPARE AND FILE A DECLARATORY JUDGMENT ACTION AGAINST ALL PRESENT AND FORMER MEMBERS OF THE CLUB WHO MAY BE AFFECTED BY THE CLUB'S NEW PRACTICE AND THE COURT'S DECISIONS WITH RESPECT THERETO

WHEREAS, the Association is a non-profit mutual insurance association, operated by the Members for their exclusive benefit; and the Members are both insureds and insurers, who through their fully assessable indemnity insurance policies collectively pay all claims against the Members, except for catastrophic claims covered by reinsurance; and

WHEREAS, prior to about 1989, Insurance Years were typically closed up to ten years after their terminations, and the only reserves retained by the Club at each closing, until the closing of Insurance Year 1977, were those sufficient to meet the Members' remaining known but unresolved claims; i.e., prior to the closing of Insurance Year 1977, no reserves were established for any unknown and unreported claim; and between 1946 and 1982 refunds of assessments to the Members exceeded \$17 million; and

WHEREAS, the law in New York is that the closing of an Insurance Year is the equivalent of a final settlement of accounts between the Members and the Club; accordingly, the Club is not entitled to seek any further sums from the Members and the Members are not entitled to seek any additional sums from the Club with respect to any



closed years; after an Insurance Year is closed, the reserves from that year become the property of the Members in the open years, who then have an obligation to pay the previously known but unresolved claims from such reserves; and the Members in the Open Years have no obligation to pay the unknown and unreserved claims of Members in Closed Insurance Years; and

WHEREAS, in or about 1980, after the assertion of asbestos related and other occupational diseases, in many cases arising from alleged exposure to asbestos, etc. by seamen on the Members' vessels, in some cases going back to the 1940s, 50s and 60s, at the request of the Members, the Club then adopted a discretionary practice of reimbursing the Members for occupational disease claims, even if unreserved; the practice was and still is to allocate the claims over the seamen's employment on the Members' vessels in each of the Insurance Years, apply the Members' deductibles for each such Insurance Year and reimburse the Members for the balance; in the beginning the reimbursements were fairly modest;

WHEREAS, in or about 1988, in connection with the closing of Insurance Year 1977, the Club's Members and Directors recognized the possibility that the number of claims and the amounts to be paid for asbestos and other occupational diseases would likely increase; the Board of Directors discussed providing a reserve for "IBNR" claims for occupational diseases; the Managers strongly recommended reserving \$250,000 or more per closed Insurance Year; the Board decided that \$100,000 per year would be reserved for IBNR; the refund of assessments for the 1977 year was over \$1.4 million; the reserve for IBNR beginning with the closing of Insurance Year 1977 and 1979 through the closing of the most recent year, 1999 has been \$100,000; and insurance Year 1978 was closed before this practice was established, thus, no contribution to the reserve for IBNR was made by the Club's Members for 1978;

WHEREAS, notwithstanding that the Members in the closed Insurance Years before 1977 had not paid even \$1 in premiums or assessments in regard to occupational disease claims, since about 1980 the Club has reimbursed those same members for millions of dollars in settlements of various occupational disease claims arising in those years, in accordance with the Club's Discretionary Practice, which had been approved by the Board in September 1989; the total amount paid in reimbursements to the Members to date is almost \$6 million; in addition, the known case reserves and IBNR total a further \$3 million and claims continue to be asserted; in Cleveland and Detroit alone, over 6,000 seamen's claims are pending in the Courts; other such claims are pending in other Courts;

WHEREAS, no one can predict what the final costs of all of the present and future occupational disease claims may be, however, if the present practice of reimbursing the Members for such claims while requiring them to absorb only multiple deductibles is continued, the Club's reserves, at least those accumulated from the Insurance Years before that beginning on February 20, 1989 will certainly continue to diminish, if not disappear; and



WHEREAS, the Finance Committee has unanimously approved of these Resolutions.

NOW, THEREFORE, be it

RESOLVED, that all present and future requests for reimbursement by present and former Club Members regarding occupational disease and other claims allegedly occurring in the closed Insurance Years before February 20, 1989 be denied; and

FURTHER RESOLVED, that for the Insurance Years between February 20, 1989 and February 20, 2000, the procedure required by the International Group Pooling Agreement will be followed; and

FURTHER RESOLVED, that as insurance years after February 20, 2000 come to be closed, the Club will either purchase additional insurance on behalf of the Members and/or the Members in those years will self-insure by increasing and/or otherwise adjusting their contributions to yearly reserves for IBNR, which contributions will be reviewed at the closing of each subsequent year; and

FURTHER RESOLVED, that counsel be authorized to immediately prepare and file a Declaratory Judgment Action against all present and former Members of the Club who may be affected by the Club's new practices described above, and the Court's decisions with respect thereto;

FURTHER RESOLVED, that the Association's Managers be and hereby are authorized and instructed to do all things necessary and proper to carry out the purposes and intent of the foregoing resolutions.