

Enstar Group LTD  
Form 10-K  
March 16, 2007

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-K**

**FOR ANNUAL AND TRANSITION REPORTS  
PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

- þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the fiscal year ended December 31, 2006
- or**
- o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from            to

**Commission File Number 001-33289**

**ENSTAR GROUP LIMITED**  
*(Exact name of registrant as specified in its charter)*

**BERMUDA**  
*(State or other jurisdiction of incorporation or organization)*

**N/A**  
*(I.R.S. Employer Identification No.)*

**P.O. Box HM 2267  
Windsor Place, 3<sup>rd</sup> Floor, 18 Queen Street  
Hamilton HM JX  
Bermuda**  
*(Address of principal executive offices, including zip code)*

**Registrant's telephone number, including area code: (441) 292-3645**

**Securities registered pursuant to Section 12(b) of the Act:**

<b>Title of Each Class</b>	<b>Name of Each Exchange on Which Registered</b>
Ordinary shares, par value \$1.00 per share	The NASDAQ Stock Market LLC

**Securities registered pursuant to Section 12(g) of the Act:**  
**None**

Indicate by check mark if the registrant is a well known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

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Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is large accelerated filer, and accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2) of the Exchange Act. Yes  No

The aggregate market value the voting and non-voting common equity held by non-affiliates, computed by reference to the closing price as of the last business day of The Enstar Group, Inc.'s, the registrant's predecessor, most recently completed second fiscal quarter, June 30, 2006, was approximately \$353,351,916.54.

As of March 12, 2007, the registrant had outstanding 11,779,335 ordinary shares, \$1.00 par value per share.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A relating to its 2007 annual meeting of shareholders are incorporated by reference in Part III of this Form 10-K.

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Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities and Exchange Act of 1934

Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350

Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350

Description of Share Capital

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**PART I**

**ITEM 1. BUSINESS**

**Background**

Enstar Group Limited (formerly Castlewood Holdings Limited), or Enstar, was formed in August 2001 under the laws of Bermuda to acquire and manage insurance and reinsurance companies in run-off, and to provide management, consulting and other services to the insurance and reinsurance industry. On January 31, 2007, Enstar completed the merger, or the Merger, of CWMS Subsidiary Corp., a Georgia corporation and wholly-owned subsidiary of Enstar, or CWMS, with and into The Enstar Group Inc., a Georgia corporation, or EGI. As a result of the Merger, EGI, renamed Enstar USA, Inc., is now a wholly-owned subsidiary of Enstar. Prior to the Merger, EGI owned an approximately 32% economic and 50% voting interest in Enstar.

In addition, immediately prior to the closing of the Merger, Enstar completed a recapitalization pursuant to which it: (1) exchanged all of its outstanding shares of Enstar; (2) designated its initial Board of Directors immediately following the Merger; (3) repurchased certain of its shares held by Trident II, L.P. and its affiliates; (4) made payments totaling \$5,076,000 to certain of its executive officers and employees as an incentive to remain with Enstar following the Merger; and (5) purchased, through its wholly-owned subsidiary, Castlewood Limited, the shares of B.H. Acquisition Ltd., a Bermuda company, held by an affiliate of Trident II, L.P.

**Company Overview**

Since its formation, Enstar, through its subsidiaries, has completed several acquisitions of insurance and reinsurance companies and is now administering those businesses in run-off. Enstar derives its net earnings from the ownership and management of these companies primarily by settling insurance and reinsurance claims below the recorded loss reserves and from returns on the portfolio of investments retained to pay future claims. In addition, Enstar has formed other businesses that provide management and consultancy services, claims inspection services and reinsurance collection services to Enstar affiliates and third-party clients for both fixed and success-based fees.

In the primary (or direct) insurance business, the insurer assumes risk of loss from persons or organizations that are directly subject to the given risks. Such risks may relate to property, casualty, life, accident, health, financial or other perils that may arise from an insurable event. In the reinsurance business, the reinsurer agrees to indemnify an insurance or reinsurance company, referred to as the ceding company, against all or a portion of the insurance risks arising under the policies the ceding company has written or reinsured. When an insurer or reinsurer stops writing new insurance business, either entirely or with respect to a particular line of business, the insurer, reinsurer, or the line of discontinued business is in run-off.

In recent years, the insurance industry has experienced significant consolidation. As a result of this consolidation and other factors, the remaining participants in the industry often have portfolios of business that are either inconsistent with their core competency or provide excessive exposure to a particular risk or segment of the market (i.e., property/casualty, asbestos, environmental, director and officer liability, etc.). These non-core and/or discontinued portfolios are often associated with potentially large exposures and lengthy time periods before resolution of the last remaining insured claims resulting in significant uncertainty to the insurer or reinsurer covering those risks. These factors can distract management, drive up the cost of capital and surplus for the insurer or reinsurer, and negatively impact the insurer's or reinsurer's credit rating, which makes the disposal of the unwanted company or portfolio an attractive option. Alternatively, the insurer may wish to maintain the business on its balance sheet, yet not divert

significant management attention to the run-off of the portfolio. The insurer or reinsurer, in either case, is likely to engage a third party, such as Enstar, that specializes in run-off management to purchase the company or portfolio, or to manage the company or portfolio in run-off.

In the sale of a run-off company, a purchaser, such as Enstar, typically pays a discount to the book value of the company based on the risks assumed and the relative value to the seller of no longer having to manage the company in run-off. Such a transaction can be beneficial to the seller because it receives an up-front payment for the company, eliminates the need for its management to devote any attention to the disposed company and removes the

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risk that the established reserves related to the run-off business may prove to be inadequate. The seller is also able to redeploy its management and financial resources to its core businesses.

Alternatively, if the insurer or reinsurer hires a third party, such as Enstar, to manage its run-off business, the insurer or reinsurer will, unlike in a sale of the business, receive little or no cash up front. Instead, the management arrangement may provide that the insurer or reinsurer will share in the profits, if any, derived from the run-off with certain incentive payments allocated to the run-off manager. By hiring a run-off manager, the insurer or reinsurer can outsource the management of the run-off business to experienced and capable individuals, while allowing its own management team to focus on the insurer's or reinsurer's core businesses. Enstar's desired approach to managing run-off business is to align its interests with the interests of the owners through both fixed management fees and certain incentive payments. Under certain management arrangements to which Enstar is a party, however, it receives only a fixed management fee and does not receive any incentive payments.

Following the purchase of a run-off company or the engagement to manage a run-off company or portfolio of business, it is incumbent on the new owner or manager to conduct the run-off in a disciplined and professional manner in order to efficiently discharge the liabilities associated with the business while preserving and maximizing its assets. Enstar's approach to managing its acquired companies in run-off as well as run-off companies or portfolios of businesses on behalf of third-party clients includes negotiating with third-party insureds and reinsureds to commute their insurance or reinsurance agreement for an agreed upon up-front payment by Enstar, or the third-party client, and to more efficiently manage payment of insurance and reinsurance claims. Enstar attempts to commute policies with direct insureds or reinsureds in order to eliminate uncertainty over the amount of future claims. Commutations and policy buy-backs provide an opportunity for the company to exit exposures to certain policies and insureds generally at a discount to the ultimate liability and provide the ability to eliminate exposure to further losses. Such a strategy also contributes to the reduction in the length of time and future cost of the run-off.

Following the acquisition of a company in run-off, or new consulting engagement, Enstar will spend time analyzing the acquired exposures and reinsurance receivables on a policyholder-by-policyholder basis. This analysis enables Enstar to identify a target list, based on the nature and value of exposures, of those policyholders and reinsurers it wishes to approach to discuss commutation or policy buy-back. Furthermore, following the acquisition of a company in run-off, or new consulting engagement, Enstar will often be approached by policyholders or reinsurers requesting commutation or policy buy-back. In these instances Enstar will also carry out a full analysis of the underlying exposures in order to determine the viability of a proposed commutation or policy buy-back. From the initial analysis of the underlying exposures it may take several months, or even years, before a commutation or policy buy-back is completed. In a number of cases, if Enstar and the policyholder or reinsurer are unable to reach a commercially acceptable settlement, the commutation or policy buy-back may not be achievable, in which case Enstar will continue to settle valid claims from the policyholder, or collect reinsurance receivables from the reinsurer, as they become due.

Insureds and reinsureds are often willing to commute with Enstar, subject to receiving an acceptable settlement, as this provides certainty of recovery of what otherwise may be claims that are disputed in the future, and often provides a meaningful up-front cash receipt that, with the associated investment income, can provide a source of funds to meet future claim payments or even commutation of their underlying exposure. As such, subject to negotiating an acceptable settlement, all of Enstar's insurance and reinsurance liabilities and reinsurance receivables are able to be either commuted or settled by way of policy buy-back over time. Many sellers of companies that Enstar acquires have secure claims paying ratings and ongoing underwriting relationships with insureds and reinsureds which often hinders their ability to commute the underlying insurance or reinsurance policies. Enstar's lack of claims paying rating and its lack of potential conflicts with insureds and reinsureds of companies it acquires provides a greater ability to commute the newly acquired policies than that of the sellers.

Enstar also attempts, where appropriate, to negotiate favorable commutations with reinsurers by securing the receipt of a lump-sum settlement from the reinsurer in complete satisfaction of the reinsurer's liability in respect of any future claims. Enstar, or the third-party client, is then fully responsible for any claims in the future. Enstar typically invests proceeds from reinsurance commutations with the expectation that such investments will produce income, which, together with the principal, will be sufficient to satisfy future obligations with respect to the acquired company or portfolio.



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### **Strategy**

Enstar's corporate objective is to generate returns on capital that appropriately reward it for risks it assumes. Enstar intends to achieve this objective by executing the following strategies:

*Establish Leadership Position in the Run-Off Market by Leveraging Management's Experience and Relationships.* Enstar intends to continue to utilize the extensive experience and significant relationships of its senior management team to establish itself as a leader in the run-off segment of the insurance and reinsurance market. The strength and reputation of Enstar's management team is expected to generate opportunities for Enstar to acquire or manage companies and portfolios in run-off, to price effectively the acquisition or management of such businesses, and, most importantly, to manage the run-off of such businesses efficiently and profitably.

*Professionally Manage Claims.* Enstar is professional and disciplined in managing claims against run-off companies and portfolios it owns or manages. Enstar's management understands the need to dispose of certain risks expeditiously and cost-effectively by constantly analyzing changes in the market and efficiently settling claims with the assistance of its experienced claims adjusters and in-house and external legal counsel. When Enstar acquires or begins managing a company or portfolio it initially determines which claims are valid through the use of experienced in-house adjusters and claims experts. Enstar pays valid claims on a timely basis, and looks to well-documented policy exclusions and coverage issues where applicable and litigates when necessary to avoid invalid claims under existing policies and reinsurance agreements.

*Commutation of Assumed Liabilities and Ceded Reinsurance Assets.* Using detailed analysis and actuarial projections, Enstar negotiates with the policyholders of the insurance and reinsurance companies or portfolios it owns or manages with a view to commuting insurance and reinsurance liabilities for an agreed upon up-front payment at a discount to the ultimate liability. Such commutations can take the form of policy buy-backs and structured settlements over fixed periods of time. Enstar also negotiates with reinsurers to commute their reinsurance agreements providing coverage to Enstar's subsidiaries on terms that Enstar believes to be favorable based on then-current market knowledge. Enstar invests the proceeds from reinsurance commutations with the expectation that such investments will produce income, which, together with the principal, will be sufficient to satisfy future obligations with respect to the acquired company or portfolio.

*Continue Commitment to Highly Disciplined Acquisition, Management and Reinsurance Practices.* Enstar utilizes a disciplined approach to minimize risk and increase the probability of positive operating results from acquisitions and companies and portfolios it manages. Enstar carefully reviews acquisition candidates and management engagements for consistency with accomplishing its long-term objective of producing positive operating results. Enstar focuses its investigation on the risk exposure, claims practices, reserve requirements, outstanding claims and its ability to price an acquisition or engagement on terms that will provide positive operating results. In particular, Enstar carefully reviews all outstanding claims and case reserves, and follows a highly disciplined approach to managing allocated loss adjustment expenses, such as the cost of defense counsel, expert witnesses, and related fees and expenses.

*Manage Capital Prudently.* Enstar manages its capital prudently relative to its risk exposure and liquidity requirements to maximize profitability and long-term growth in shareholder value. Enstar's capital management strategy is to deploy capital efficiently to acquisitions, reinsurance opportunities and to establish (and re-establish, when necessary) adequate loss reserves to protect against future adverse developments.

### **Acquisition of Insurers or Portfolios in Run-Off**

Enstar specializes in the negotiated acquisition and management of insurance and reinsurance companies and portfolios in run-off. Enstar approaches, or is approached by, primary insurers or reinsurance providers with portfolios of business to be sold or managed in run-off. Enstar evaluates each opportunity presented by carefully reviewing the portfolio's risk exposures, claim practices, reserve requirements and outstanding claims, and seeking an appropriate discount and/or seller indemnification to reflect the uncertainty contained in the portfolio's reserves.

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Based on this initial analysis, Enstar can determine if a company or portfolio of business would add value to its current portfolio of run-off business. If Enstar determines to pursue the purchase of a company in run-off, it then proceeds to price the acquisition in a manner it believes will result in positive operating results based on certain assumptions including, without limitation, its ability to favorably resolve claims, negotiate with direct insureds and reinsurers, and otherwise manage the nature of the risks posed by the business.

With respect to its U.K. and Bermudian insurance and reinsurance subsidiaries, Enstar is able to pursue strategies to achieve complete finality and conclude the run-off of a company by promoting a solvent scheme of arrangement whereby a local court-sanctioned scheme, approved by a statutory majority of voting creditors, provides for a one-time full and final settlement of an insurance or reinsurance company's obligations to its policyholders.

## **Acquisitions to Date**

In November 2001, a wholly-owned subsidiary of Enstar completed the acquisition of two reinsurance companies in run-off, River Thames Insurance Company Limited, or River Thames, based in London, England, and Overseas Reinsurance Corporation Limited, or Overseas Reinsurance, based in Bermuda. The total purchase price of River Thames and Overseas Reinsurance was approximately \$15.2 million.

In August 2002, Enstar purchased Hudson Reinsurance Company Limited, or Hudson, a Bermuda-based company, for approximately \$4.1 million. Hudson reinsured risks relating to property, casualty and workers' compensation on a worldwide basis, and Enstar is now administering the run-off of its claims.

In March 2003, Enstar and Shinsei Bank, Limited, or Shinsei, completed the acquisition of The Toa-Re Insurance Company (UK) Limited, a London-based subsidiary of The Toa Reinsurance Company, Limited, for approximately \$46.4 million. Upon completion of the transaction, Toa-Re's name was changed to Hillcot Re Limited. Hillcot Re Limited underwrote reinsurance business throughout the world between 1980 and 1994, when it stopped writing new business and went into run-off. The acquisition was effected through Hillcot Holdings Ltd., or Hillcot, a Bermuda company, in which Enstar has a 50.1% economic interest and a 50% voting interest. Hillcot is included in Enstar's consolidated financial statements, with the remaining 49.9% economic interest reflected as minority interest. J. Christopher Flowers, a member of our board of directors and one of our largest shareholders, is a director and the largest shareholder of Shinsei. Enstar's results of operations include the results of Hillcot Re Limited from the date of acquisition in March 2003.

During 2004, Enstar, through one of its subsidiaries, completed the acquisition of Mercantile Indemnity Company Ltd., or Mercantile, Harper Insurance Limited (formerly Turegum Insurance Company), or Harper, and Longmynd Insurance Company Ltd. (formerly Security Insurance Company (UK) Ltd.), or Longmynd, all of which were in run-off, for a total purchase price of approximately \$4.5 million. Enstar recorded an extraordinary gain of approximately \$21.8 million in 2004 relating to the excess of the fair value of the net assets acquired over the cost of these acquisitions.

In May 2005, Enstar, through one of its subsidiaries, purchased Fieldmill Insurance Company Limited (formerly known as Harleysville Insurance Company (UK) Limited) for approximately \$1.4 million.

In March 2006, Enstar and Shinsei, through Hillcot, completed the acquisition of Aioi Insurance Company of Europe Limited, or Aioi Europe, a London-based subsidiary of Aioi Insurance Company, Limited. Aioi Europe has underwritten general insurance and reinsurance business in Europe for its own account from 1982 until 2002 when it generally ceased underwriting and placed its general insurance and reinsurance business into run-off. The aggregate purchase price paid for Aioi Europe was £62 million (approximately \$108.9 million), with £50 million in cash paid upon the closing of the transaction and £12 million in the form of a promissory note, payable twelve months from the

date of the closing. Upon completion of the transaction, Aioi Europe changed its name to Brampton Insurance Company Limited. Enstar recorded an extraordinary gain of approximately \$4.3 million, net of minority interest, in 2006 relating to the excess of the fair value of the net assets acquired over the cost of this acquisition. In April 2006, Hillcot Holdings Limited borrowed approximately \$44 million from a London-based bank to partially assist with the financing of the Aioi Europe acquisition. Following a repurchase by Aioi Europe of its shares valued at

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£40 million in May 2006, Hillcot Holdings repaid the promissory note and reduced the bank borrowing to \$19.2 million, which is repayable in April 2010.

In October 2006, Enstar, through its subsidiary Virginia Holdings Ltd., or Virginia, purchased Cavell Holdings Limited (U.K.), or Cavell, for approximately £31.8 million (approximately \$59.5 million). Cavell owns a U.K. reinsurance company and a Norwegian reinsurer, both of which wrote portfolios of international reinsurance business and went into run-off in 1993 and 1992, respectively. The purchase price was funded by \$24.5 million borrowed under a facility loan agreement with a London-based bank and available cash on hand.

In November 2006, Enstar, through Virginia, purchased Unione Italiana (U.K.) Reinsurance Company Limited, or Unione, a U.K. company, for approximately \$17.2 million. Unione underwrote business from the 1940 s through to 1995. Prior to acquisition, Unione closed the majority of its portfolio by way of a solvent scheme of arrangement in the U.K. Unione s remaining business is a portfolio of international insurance and reinsurance which has been in run-off since 1971. The purchase price was borrowed from a subsidiary of Enstar s equity owned affiliate, B.H. Acquisition Ltd.

Enstar recorded an extraordinary gain of \$26.7 million in the fourth quarter of 2006 relating to the excess of the fair value of the net assets acquired over the costs of Cavell and Unione.

On January 31, 2007, Enstar completed the Merger of CWMS with and into EGI and, as a result, EGI, renamed Enstar USA, Inc., is now a wholly-owned subsidiary of Enstar. Prior to the Merger, EGI owned approximately 32% economic and 50% voting interests in Enstar. As a result of the completion of the Merger, B.H. Acquisition Limited, or B.H. Acquisition, is now a wholly-owned subsidiary of Enstar.

On February 23, 2007, Enstar through Oceania Holdings Ltd, its wholly-owned subsidiary, completed the acquisition of Inter-Ocean Holdings Ltd. ( Inter-Ocean ). The total purchase price was approximately \$57 million, which was funded by \$26.8 million borrowed under a facility loan agreement with a London-based bank and available cash on hand. Inter-Ocean owns two reinsurers, one based in Bermuda and one based in Ireland. Both of these companies wrote international reinsurance and had in place retrocessional policies providing for the full reinsurance of all of the risks they assumed.

On June 16, 2006, a wholly-owned subsidiary of Enstar entered into a definitive agreement with Dukes Place Holdings, L.P., a portfolio company of GSC Partners, for the purchase of a minority interest in a U.S. holding company that owns two property and casualty insurers based in the United States, both of which are in run-off. Completion of the transaction is conditioned on, among other things, governmental and regulatory approvals and satisfaction of various other closing conditions. As a consequence, Enstar cannot predict if or when this transaction will be completed.

**Management of Run-Off Portfolios**

Enstar is a party to several management engagements pursuant to which it has agreed to manage the run-off portfolio of a third party. Such arrangements are advantageous for third-party insurers because they allow a third-party insurer to focus their management efforts on their core competency while allowing them to maintain the portfolio of business on their balance sheet. In addition, Enstar s expertise in managing portfolios in run-off allows the third-party insurer the opportunity to potentially realize positive operating results if Enstar achieves its objectives in management of the run-off portfolio. Enstar specializes in the collection of reinsurance receivables through its indirect subsidiary Kinsale Brokers Limited. Through Enstar s subsidiaries, Castlewood (US) Inc. and Cranmore Adjusters Limited, Enstar also specializes in providing claims inspection services whereby Enstar is engaged by third-party insurance and reinsurance providers to review certain of their existing insurance and reinsurance exposures, relationships, policies

and/or claims history.

Enstar's primary objective in structuring its management arrangements is to align the third-party insurer's interests with those of Enstar. Consequently, management agreements typically are structured so that Enstar receives fixed fees in connection with the management of the run-off portfolio and also typically receives certain incentive payments based on a portfolio's positive operating results.

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### **Management Agreements**

Enstar has entered into approximately 11 management agreements with third-party clients to manage certain run-off portfolios with gross loss reserves (as of December 31, 2006) of approximately \$3 billion. The fees generated by these engagements include both fixed and incentive-based remuneration based on Enstar's success in achieving certain objectives. These agreements do not include the recurring engagements managed by Enstar's claims inspection and reinsurance collection subsidiaries, Cranmore Adjusters Limited and Kinsale Brokers Limited, respectively.

### **Claims Management and Administration**

An integral factor to Enstar's success is its ability to analyze, administer, manage and settle claims and related expenses, such as loss adjustment expenses. Enstar's claims teams are located in different offices within its organization and provide global claims support. Enstar has implemented claims handling guidelines and claims reporting and control procedures in all of its claims units. To ensure that claims are handled and reported in accordance with these guidelines, all claims matters are reviewed regularly, with all material claims matters being circulated to and reviewed by management prior to any action being taken.

When Enstar receives notice of a claim, regardless of size and regardless of whether it is a paid claim request or a reserve advice, it is reviewed and recorded within its claims system reserving Enstar's rights where appropriate. Claims reserve movements and payments are reviewed daily, with any material movements being reported to management for review. This enables flash reporting of significant events and potential insurance or reinsurance losses to be communicated to senior management worldwide on a timely basis irrespective from which geographical location or business unit location the exposure arises.

Enstar also is able to efficiently manage claims and obtain savings through its extensive relationships with defense counsel (both in-house and external), third-party claims administrators and other professional advisors and experts. Enstar has developed relationships and protocols to reduce the number of outside counsel by consolidating claims of similar types and complexity with appropriate law firms specializing in the particular type of claim. This approach has enabled Enstar to more efficiently manage outside counsel and other third parties, thereby reducing expenses, and to establish closer relationships with ceding companies.

When appropriate, Enstar negotiates with direct insureds to buy back policies either on favorable terms or to mitigate against potential future indemnity exposures and legal costs in an uncertain and constantly evolving legal environment. Where appropriate, Enstar also pursues commutations on favorable terms with ceding companies of reinsurance business in order to realize savings or to mitigate against potential future indemnity exposures and legal costs. Such buy-backs and commutations eliminate all past, present and future liability to direct insureds and reinsureds in return for a lump sum payment.

With regard to reinsurance receivables, Enstar manages cash flow by working with reinsurers, brokers and professional advisors to achieve fair and prompt payment of reinsured claims, taking appropriate legal action to secure receivables where necessary. Enstar also attempts where appropriate to negotiate favorable commutations with its reinsurers by securing a lump sum settlement from reinsurers in complete satisfaction of the reinsurer's past, present and future liability in respect of such claims. Properly priced commutations reduce the expense of adjusting direct claims and pursuing collection of reinsurance receivables (both of which may often involve extensive legal expense), realize savings, remove the potential future volatility of claims and reduce required regulatory capital.

### **Reserves for Unpaid Losses and Loss Adjustment Expense**

Applicable insurance laws and generally accepted accounting practices require Enstar to maintain reserves to cover its estimated losses under insurance policies that it has assumed and for loss adjustment expense, or LAE, relating to the investigation, administration and settlement of policy claims. Enstar's LAE reserves consist of both reserves for allocated loss adjustment expenses, or ALAE, and for unallocated loss adjustment expenses, or ULAE. ALAE are linked to the settlement of an individual claim or loss, whereas ULAE reserve is based on the Company's estimates of future costs to administer the claims.



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Enstar and its subsidiaries establish losses and LAE reserves for individual claims by evaluating reported claims on the basis of:

its knowledge of the circumstances surrounding the claim;

the severity of the injury or damage;

the jurisdiction of the occurrence;

the potential for ultimate exposure;

the type of loss; and

its experience with the line of business and policy provisions relating to the particular type of claim.

Because a significant amount of time can lapse between the assumption of risk, the occurrence of a loss event, the reporting of the event to an insurance or reinsurance company and the ultimate payment of the claim on the loss event, the liability for unpaid losses and LAE is based largely upon estimates. Enstar's management must use considerable judgment in the process of developing these estimates. The liability for unpaid losses and LAE for property and casualty business includes amounts determined from loss reports on individual cases and amounts for losses incurred but not reported, or IBNR. Such reserves, including IBNR reserves, are estimated by management based upon loss reports received from ceding companies, supplemented by Enstar's own estimates of losses for which no ceding company loss reports have yet been received.

In establishing reserves, management also considers actuarial estimates of ultimate losses. Enstar's actuaries employ generally accepted actuarial methodologies and procedures to estimate ultimate losses and loss expenses. In addition, a loss reserve study is prepared by an independent actuary annually in order to provide additional insight into the reasonableness of Enstar's reserves for losses and loss expenses.

Enstar's loss reserves are largely related to casualty exposures including latent exposures primarily relating to asbestos and environmental, or A&E, as discussed below. In establishing the reserves for unpaid claims, management considers facts currently known and the current state of the law and coverage litigation. Liabilities are recognized for known claims (including the cost of related litigation) when sufficient information has been developed to indicate the involvement of a specific insurance policy, and management can reasonably estimate its liability. In addition, reserves are established to cover loss development related to both known and unasserted claims.

The estimation of unpaid claim liabilities is subject to a high degree of uncertainty for a number of reasons. Unpaid claim liabilities for property and casualty exposures in general are impacted by changes in the legal environment, jury awards, medical cost trends and general inflation. Moreover, for latent exposures in particular, developed case law and adequate claims history do not exist. There is significant coverage litigation involved with these exposures which creates further uncertainty in the estimation of the liabilities. As such, for these types of exposures, it is especially unclear whether past claim experience will be representative of future claim experience. Ultimate values for such claims cannot be estimated using reserving techniques that extrapolate losses to an ultimate basis using loss development factors, and the uncertainties surrounding the estimation of unpaid claim liabilities are not likely to be resolved in the near future. There can be no assurance that the reserves established by Enstar will be adequate or will not be adversely affected by the development of other latent exposures. The actuarial methods used to estimate ultimate loss and ALAE for Enstar's latent exposures are discussed below.

For the non-latent loss exposures, a range of traditional loss development extrapolation techniques is applied. Incremental paid and incurred loss development methodologies are the most commonly used methods. Traditional cumulative paid and incurred loss development methods are used where inception-to-date, cumulative paid and reported incurred loss development history is available. These methods assume that cohorts, or groups, of losses from similar exposures will increase over time in a predictable manner. Historical paid and incurred loss development experience is examined for earlier underwriting years to make inferences about how later underwriting years losses will develop. Where company-specific loss information is not available or not reliable, industry loss development information published by reliable industry sources such as the Reinsurance Association of America is considered.

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The reserving process is intended to reflect the impact of inflation and other factors affecting loss payments by taking into account changes in historical payment patterns and perceived trends. However, there is no precise method for the subsequent evaluation of the adequacy of the consideration given to inflation, or to any other specific factor, or to the way one factor may affect another.

The loss development tables below show changes in Enstar's gross and net loss reserves in subsequent years from the prior loss estimates based on experience as of the end of each succeeding year. The estimate is increased or decreased as more information becomes known about the frequency and severity of losses for individual years. A redundancy means the original estimate was higher than the current estimate; a deficiency means that the current estimate is higher than the original estimate. The first table shows, in the first section of the table, Enstar's gross reserve for unpaid losses (including IBNR losses) and LAE. The second table shows, in the first section of the table, Enstar's reserve for unpaid losses (including IBNR losses) and LAE net of reinsurance. The second section of each table shows Enstar's re-estimates of the reserve in later years. The third section of each table shows the cumulative amounts of losses paid as of the end of each succeeding year. The cumulative redundancy line in each table represents, as of the date indicated, the difference between the latest re-estimated liability and the reserves as originally estimated.

**Gross Loss and Loss Adjustment Expense**

<b>Reserves</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
	<b>(in thousands of U.S. dollars)</b>					
Reserves assumed	\$ 419,717	\$ 284,409	\$ 381,531	\$ 1,047,313	\$ 806,559	\$ 1,214,419
1 year later	348,279	302,986	365,913	900,274	909,984	
2 years later	360,558	299,281	284,583	1,002,773		
3 years later	359,771	278,020	272,537			
4 years later	332,904	264,040				
5 years later	316,257					

<b>Gross Paid Losses</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
1 year later	\$ 97,036	\$ 43,721	\$ 19,260	\$ 110,193	\$ 117,666	
2 years later	123,844	64,900	43,082	226,225		
3 years later	142,282	84,895	61,715			
4 years later	160,193	101,414				
5 years later	174,476					
Reserve Redundancy/ (Deficiency)	\$ 103,460	\$ 20,369	\$ 108,994	\$ 44,540	\$ (103,425)	

**Net Loss and Loss Adjustment Expense**

<b>Reserves</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
	<b>(in thousands of U.S. dollars)</b>					
Reserves assumed	\$ 224,507	\$ 184,518	\$ 230,155	\$ 736,660	\$ 593,160	\$ 872,260
1 year later	190,768	176,444	220,712	653,039	590,153	
2 years later	176,118	178,088	164,319	652,195		

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3 years later	180,635	138,251	149,980
4 years later	135,219	129,923	
5 years later	124,221		

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