Insurance Giant Found to be Partner in Operation of Bankrupt Nursing Home Chain – Liability May Exceed One-Half Billion Dollars

June 24, 2004

1. A recent decision by a Texas bankruptcy judge represents a precedent-setting ruling of note to lenders, sureties, and insurance companies involved in structured finance transactions.

2. On April 22, 2004, Steven A. Felsenthal, Chief United States Bankruptcy Judge for the Northern District of Texas, Dallas Division, entered a declaratory judgment against ZC Specialty Insurance Company ("Zurich"), a subsidiary of Zurich Financial Services Group, ruling that Zurich was a partner in the ownership and operation of 87 nursing homes located in Texas and Illinois. The nursing home chain, which did business as Senior Living Properties, L.L.C. (SLP), filed for bankruptcy protection on May 14, 2002. As a partner in the enterprise, Zurich now finds itself liable for all debts incurred by the bankrupt nursing home chain. According to a subsequent lawsuit filed by the court appointed post-confirmation trustee, Dan B. Lain, Zurich is responsible for debts in excess of $500 million.

3. The seminal decision arose out of a lawsuit styled *Dan B. Lain, Trustee of Senior Living Properties, L.L.C., Trust vs. ZC Specialty Insurance Company*, Adversary Proceeding No. 03-3262, which was brought after SLP filed for protection under Chapter 11 and the details of the unusual relationship between Zurich and SLP surfaced. When the venture failed, Zurich denied responsibility for the debts of the enterprise, asserting that its relationship with SLP was no more than that of a surety.

4. In a detailed 110-page Opinion, notable for its penetrating examination of Zurich's relationship with SLP, Judge Felsenthal determined that Zurich was not only a partner under Illinois and Texas law, but also affirmatively attempted, during the litigation of the case, to conceal its true role in the transaction. Terming portions

of Zurich's testimony as "Clintonesque" and "evasive," the court found that Zurich's witnesses and their explanation of the insurance company's involvement in the enterprise were not credible.

5. The transaction in question grew out of Zurich's desire to enter into the nursing home business in 1998, yet avoid the potential liabilities. To accomplish this goal, a special purpose vehicle, SLP, was created to serve as the "nominee owner" in a highly leveraged financial structure involving the purchase of an 87 unit chain of nursing homes for $246 million. Although SLP had no assets, Zurich arranged for the "nominee owner" to borrow the purchase price for the nursing home chain ($226 million of the $246 million being a loan from GMAC), with only $200 of invested capital in the enterprise. Accordingly, as of February 6, 1998, the financial structure of this acquisition was virtually 100% debt.

6. The question of how a company could borrow $246 million with no capital or down payment became the lynchpin in the trustee's case against Zurich. An examination of the transaction revealed that the principals of SLP were originally brought into the deal to serve as independent directors for an unnamed buyer. Significantly, the buyer remained unnamed through almost the entirety of the pre-purchase negotiations and closing. The buyer/owner of the nursing homes was to be an entity formed by Zurich for the purpose of acquiring all of the seller's rights, title, and interest in the 87 homes. As closing negotiations progressed, however, the idea of SLP serving as the special purpose vehicle and buyer/owner emerged. Surprisingly, it was not until the eleventh hour of closing between the seller (Park Associates); the management company (Complete Care Services); and Zurich, that SLP emerged as the "nominee owner" for the transaction. Although SLP became the licensed operator of the nursing homes, the SLP principals assumed no financial risk for the enterprise. The SLP principals testified that they were only "nominee owners" or "titular owners," with Complete Care Services assuming the responsibility for managing the homes. SLP's view of their role in the transaction is evident from the sworn deposition of one of its principals, who testified as follows:

Q: And were the members prepared to invest additional capital over and above their $200 into Senior Living Properties?

A: The members were never asked to invest in the company. The members never said they would invest in the company. We were not prepared at closing, we were not prepared then, and we're not prepared now. That was never the intent of the nominee owner.

. . .

Q: Now, who in the transaction—well, what down side, economic downside did the members have in the deal?

A: We didn't have a down side in the deal.

. . .

Q: So against that $200, ya'll were able to borrow $246 million; is that correct?

A: That's about right. I'd have to look at the numbers to make sure, but yes . . .

Q: Okay. Well, if you weren't—if the members were only at risk for $200, who was at risk for losing money in the transaction?

A: Creditors.

7. Given the absence of capital in the venture, the glue that held this highly leveraged structure together was a surety bond provided by Zurich on approximately $146 million of GMAC's total exposure of $226 million. Without Zurich's surety, the purchase could not have been financed. Zurich's bond was guaranteed by another Zurich/Centre entity, Centre Reinsurance (US) Limited, ("Centre Re (US)"), a Bermuda exempted company. Under this surety arrangement, Zurich's bond acted as a form of credit enhancement for a portion of the SLP mortgage to GMAC. Zurich's compensation for providing the surety bond was a complex structure of fixed surety premiums which included 100% of the first $4 million in profits, plus an "equity kicker" of 70% - 90% of all free cash flow generated by the venture after all operating expenses and debt service payments. The "nominee owners" (SLP's principals), on the other hand, received fixed fees, salary and 10% of any profit remaining after Zurich took the first $4 million in profits and its additional 70-90% share. Based on a profit distribution of $5 million under the

compensation program devised by Zurich, Zurich would receive $4.7 - $4.9 million (94-98%) while the "nominee owners" would receive $100,000 (2%).

8. Zurich contended that it was not a partner but merely provided a surety bond guaranteeing the payment of a substantial portion of SLP's mortgage to GMAC. Moreover, Zurich claimed that since the transaction documents explicity identified and labeled Zurich as a "surety," not a "partner," no partnership relationship was intended. As a result, Zurich insisted it held merely a surety-debtor relationship with SLP. Importantly, the insurance company denied that it: a) held an equity position in the transaction; b) held the right to receive 70-90% of the profits from the venture; and, c) assumed the role of the owner in doing such things as dictating the structure of the transaction, selecting the lender for the transaction as well as negotiating all key deal documents, in the shoes of the owner.

9. Zurich's denials became the focus of a lengthy trial which began December 15, 2003 and ended January 29, 2004. In seeking a declaration from the bankruptcy court that Zurich was jointly and severally liable for the debts of SLP, the trustee for the bankrupt estate introduced evidence contradicting Zurich's denials. The trustee contended that: a) Zurich's structured scheme created a partnership; b) Zurich expected to receive the lion's share of profit generated by the partnership, for which it undertook the risk of losses; c) Zurich contributed capital, disguised in the form of a surety arrangement to the enterprise; d) Zurich exercised substantial management control over the operation; and, e) none of these acts were consistent with the role of a mere surety.

In closing statements on behalf of the trustee, attorney David Marks argued: "Zurich, and its coventurers, created a partnership and purposely sought to avoid the legal consequences of doing so by calling it something else. In an attempt to hide the true nature of its relationship, Zurich seeks to constrain and to bind this Court to the self-serving labels that were part of a sophisticated scheme to disguise the entirety of the transaction. These labels were not inadvertently placed nor were they accidentally used in the operative deal documents, but rather were strategically deployed in an effort to protect the beneficial owner, Zurich, from the

downside risks which were shifted to the unknowing trade creditors and helpless nursing home residents."

10. The Bankruptcy Court agreed, determining that the trustee "established by clear and convincing evidence that Zurich is a partner in the SLP business." In arriving at this conclusion, Judge Felsenthal specifically found that: "Zurich contracted to share in the profits of SLP's business, which is the essential term for a partnership under Illinois law. Zurich contracted to obtain a residual interest of seventy to ninety percent of the fair market value of SLP as a going concern; that is, Zurich contracted for a distribution of the equity. Zurich acted as an owner in contracting for the payment of all operating expenses, debt service and capital improvement expenditures before distribution of profits. Zurich contracted to cover debt service if SLP's revenue would not pay operating expenses and the mortgage. Zurich contracted to assure that creditors were paid before excess cash was distributed to equity level interests. Zurich had ultimate control of the hiring and termination of the management of the nursing homes. Zurich took control of the cash management system of SLP and could dictate the priority of payments of expenses and debt obligations, with a level of control over SLP's operations extending to dictating deviations from the contractual provisions of the waterfall. Zurich had the authority to extend the mortgage maturity date and to control the disposition of SLP's capital assets, both to protect its interest in equity. Zurich controlled the prepayment of the mortgage, not as a surety, but to protect its interest in equity. Zurich hired professional persons for SLP. Zurich exercised a degree of control as an equity holder in negotiating credit for SLP without SLP involvement in the negotiations. Zurich controlled the distribution of profits and controlled the salary of the members of SLP. Zurich negotiated indemnification of managers and members working at SLP. Zurich shared in the risk of loss. The parties actually implemented the SLP transaction, with SLP engaged in the nursing home business. As a partner in the business, Zurich is liable for SLP's debts. The Court will enter a declaratory judgment for the trustee."

11. The ruling represents not only a significant financial loss to Zurich but, more importantly, raises serious questions about other transactions by the insurance giant.

12 In its 1998 annual report entitled "Out of Our Minds", Zurich Financial Services Group, through its wholly owned subsidiary "Centre Group", prominently promoted the unique and "unconventional customized financial solutions" it offered customers. Advertising that it "assumed risk others preferred to shed" and "reinvented capital" by providing alternative approaches to conventional financing, Zurich publicly announced that in 1998 it completed over 75 transactions, "more than in any previous year." Significantly, one such transaction described in the annual report was the SLP venture:

> "We provided cash flow support for the $234 million acquisition of nursing homes in the United States by Senior Living Properties, L.L.C., thereby assuming the occupancy and operational risks associated with this business."

13. In ascertaining Zurich's role and intent, these published words were not lost upon the attorneys representing the trustee. Nor was Zurich's own characterization of the financial solution it offered customers, forgotten:

> "When the phrase 'out of our minds' is used in connection with us, the state of the environment often dictates how the reference is meant to be taken..... Many companies would be uneasy granting this much control to external forces. But for us, this approach represents an invigorating challenge...While at times we might feel a little vulnerable, we have found no better way to operate.... In this way, we are reinventing capital."

14. Appearing for the trustee for the bankrupt estates in the trial were:

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