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BODY:

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EDITOR-NOTE:

[Editor's Note: Marc Mayerson is a partner at Washington, D.C.'s Spriggs & Hollingsworth, where he leads its national practice representing corporate policyholders. This article is adapted from commentary published originally on his Insurance Scrawl blog, www.insurancescrawl.com. Copyright 2006. Replies welcome.]

W. Mark Felt or Hal Holbrook playing him said to "follow the money," which has proven difficult in the instance of Lloyd's of London, and a task made all the more important as asbestos and environmental liabilities continue to fall upon corporate policyholders in the US that purchased broad insurance in the 1950s, 60s and 70s through the London market and American insurers that purchased reinsurance in the same period. While lawyers, policyholders, and insurance companies may be familiar with Equitas, the reinsurance runoff and claims-handling vehicles set up in the late 1990s to deal with liabilities arising under historical Lloyd's policies, they are less familiar with something called Lioncover, a reinsurance vehicle originally set up to bailout important players at Lloyd's who were involved in Peter Cameron-Webb's "managed" syndicate years of account. Lioncover, a wholly owned subsidiary of the Corporation of Lloyd's and which houses the PCW business, initially was not reinsured into Equitas when Equitas was set up as part of the "Reconstruction and Renewal" of the Lloyd's operation. It was later poured into the Equitas structure in 1997 but also is explicitly backed by the Lloyd's enterprise itself. Lioncover is a lever litigators will use to uncover the financial vehicles backing old Lloyd's policies (which contra to popular myth are not backed solely by the assets of Equitas and the original "names" or even only by the trust funds in the US).

Some background on Lioncover: Peter Cameron-Webb's underwriting activities collapsed in 1982. In 1987, the Council of Lloyd's agreed to a settlement with participants who alleged fraud in the various PCW years of account (including the Feltrim Syndicate). While these "names" contributed additional monies to buy out their liabilities, and the brokers and auditors too chipped in, Lloyd's put in cash (40 million) and committed the Central Fund to the losses.¹ Reinsurance-to-close for the PCW syndicate years of account was provided by syndicate 9001, which in turn was reinsured by Lioncover. The affected syndicate years of account traded between 1968 and 1980.² The way Lloyd's

worked in this period is that each syndicate year of account venture was closed and rolled forward through "reinsurance to close," thus funneling all prior years' losses ultimately to the last year. Lioncover thus took on those obligations that carried forward and assumed any other prior years' losses.³ (Readers familiar with Equitas will see that Lioncover provided a template of sorts for the Equitas operation.⁴)

Equitas (or more strictly several different entities with Equitas in its name) was set up to deal in general with pre-1992 exposures under Lloyd's non-life businesses. Lioncover was not "reinsured" into Equitas initially but a short while after Equitas was up and running it was folded into the mix in exchange for a premium payment of 601 million.

Lloyd's annual report for 2005 (released last month and available at www.lloyds.com) contains a few interesting crumbs worthy of note for Lloyd's/Equitas watchers about Lioncover - and thus the entire Lloyd's and Equitas edifice.

First, Lioncover's liability payments in 2005 total slightly more than 525 million or roughly \$1 billion (US). These principally were attributable to asbestos, environmental, and health-hazard claims. (p. 114; note 14.)

Second, this amount is not reflected on Lloyd's net balance sheet because the directors of Lioncover conclude that, because Equitas says it will pay the claims, it can take that reinsurance recoverable as an offset on its balance sheet. (p. 120) As Lloyd's annual report states:

At present, ERL [Equitas Reinsurance Ltd.] and its subsidiary undertaking, Equitas Limited, which is responsible for the run-off of the reinsured business, continue to pay claims in full and the directors of ERL have stated that they believe that the assets should be sufficient to meet all liabilities in full. Accordingly, the directors of Lioncover have considered it appropriate to recognise the amounts recoverable from ERL in full. Should ERL ever cease to meet in full its obligations in respect of the PCW syndicates, Lioncover would be responsible to its policyholders for meeting any amounts remaining unpaid.

The establishment of Lioncover and its reinsurance into Equitas does not cutoff the original policyholder's right to make claim under the policy as against the Lloyd's enterprise, the backing of the Central Fund, or the appropriate trust fund,⁵ but here Lloyd's annual report may be referring not to the original policyholder but more likely to the holders of reinsurance from Lioncover, that is, the participants in syndicate 9001.

Third, in the event Equitas does fail to perform, then Lioncover may seek to obtain payment from the "Central Fund," which helps back the policies issued through Lloyd's. As part of the Reconstruction and Renewal process, there is an "old" Central Fund and a "new" Central Fund, and Lioncover can claim under both, though the Council of Lloyd's purports to have discretion not to pay under the new fund unless the current membership agrees. As the report explains:

Following the implementation of 'Reconstruction and Renewal', Names underwriting in respect of 1992 and prior years, Lioncover and Centrewrite were reinsured into Equitas. If Equitas were unable to discharge in full the liabilities which it has reinsured, any resulting shortfall in respect of Lioncover or Centrewrite could be met out of both the 'Old' Central Fund and the New Central Fund under the terms of their respective Lloyd's bond. Both the 'Old' Central Fund and the New Central Fund would also be available to meet the claims of policyholders of Names who are party to hardship agreements executed before 4 September 1996, to the extent that such an event resulted in a shortfall. However, unless the members of the Society resolve in a general meeting to make the New Central Fund available, only the 'Old' Central Fund would be available to meet the claims of policyholders of Names who are not party to hardship agreements executed before 4 September 1996. The Council has determined that any losses resulting from such indemnities will be met by the Lloyd's Central Fund. (p. 132, note 29)

There certainly is an open question whether there really is discretion not to pay under the new Central Fund, but the reason we care about this is that it is the current membership of Lloyd's that would be responsible for topping up the fund in the event of a shortfall (and that there would be a shortfall is a likely result if the new fund were tapped).

Note that simultaneously Lioncover's liabilities would need to be shown on Lloyd's balance sheet and the capital of

the members would be hit, thus doubly impairing the financial ratings of the Lloyd's enterprise.

Fourth, if Equitas stops making payments or determines that it has more mouths to feed than money (or owns up to that reality), following what happened with Lioncover and how it has been intermingled with "new" Lloyd's will be a key focus for discovery and trial when policyholders or cedants seek payment on their old Lloyd's policies (direct and reinsurance) and are shunted off to the admittedly penurious Equitas. The story of insiders being bailed out through Lioncover and new Lloyd's assumption of those liabilities and seeming manipulation of its own financial statements (by taking the reinsurance recoverable as a full, undiscounted offset while Equitas otherwise is proclaiming its own credit risk) will be the stuff of trial. The promises Lloyd's makes when selling policies are supposed to be backed up by the vaunted "chain of security," which means the assets of the current membership of the Lloyd's enterprise. Compare *Industrial Guarantee Corp. v Lloyd's* (1924) 19 Lloyd's List Law Reports 78 (Bailhache J).

The Lloyd's enterprise's efforts to "ringfence" the historic liabilities and to protect the current corporate members through the Equitas ploy may yet prove successful, aided by policyholders (including cedants) cooperation in obtaining less than the full value of their insurance⁶ - which last year Equitas estimated as yielding close to 100 million in profit to it.⁷ It is becoming increasingly plain that the chain of security will back the policies US companies purchased only once those companies bring litigation to force the Lloyd's enterprise to honor the promises made in the broad insurance policies sold to American companies (or in the unlikely event that regulators step in). Certainly, the halcyon days of Cuthbert Heath saying "pay all our policyholders in full" are long, long gone.

Endnotes

1. See Adam Raphael, *Ultimate Risk: The Inside Story of the Lloyd's Catastrophe* (1995) at 187.
2. Chatset Guide to Syndicate Run-Offs 1995 at 338.
3. Richard J. Astor, *Astor's Equitas Re Handbook* at 149-50 & nn. 462, 466 (2002).
4. See generally Phillip Hertz, *The Lloyd's Reconstruction And Renewal: A Success Story or Is the Jury Still Out?* (1998) available at <http://library.findlaw.com/1998/Nov/1/128995.html>
5. See generally Astor's, *Equitas Re Handbook*.
6. Steven Fiedler, *Will Equitas Come Back to Haunt the Big Companies?* *Financial Times* (Nov. 8, 2004), at 15; Richard Astor, *Equitas Re: Shortchanging of Corporate America Made Easy -- Part I: How Equitas Re Gets Away With It*, 25 *American Bankruptcy Institute Journal* (May 2006).
7. See Marc Mayerson, *Equitas Financial Reports - 2005 Version*, *Insurance Scrawl* (June 29, 2005), available at http://www.insurancescrawl.com/archives/2005/06/equitas_financi_1.html

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