

Changes to Lloyd's U.S. Trust Funds: Considerable Improvement Noted⁽¹⁾

by Robert M. Hall⁽²⁾

For many years, Lloyd's of London has secured its U.S. liabilities for reinsurance and surplus lines business through the Lloyd's American Trust Fund ("LATF"). £8 billion in losses suffered by Lloyd's over the past five years⁽³⁾ have focused more attention on the efficacy of the LATF. Some have criticized the LATF as a poor security device.⁽⁴⁾ For example, an examination of the LATF by the New York Insurance Department revealed a number of deficiencies in the LATF, including \$18.5 billion in underfunding.⁽⁵⁾

In response to these criticisms, Lloyd's:

1. amended the LATF generally to apply to business July 31, 1995 and prior;
2. amended the surplus lines and reinsurance joint asset trust deeds which supply a \$100 million solvency margin on a joint basis; and
3. initiated two new trust funds generally for business effective August 1, 1995 and forward.

The purpose of this article is to examine the amendments to the existing funds and the new funds from the standpoints of: (1) the characteristics of the existing trusts; (2) the significant improvements in the new trusts; and (3) the compliance of these trusts with the latest draft of the National Association of Insurance Commissioners ("NAIC") Model Credit for Reinsurance Act ("Model Act") and Model Credit for Reinsurance Regulation ("Model Regulation").

I. Lloyd's American Trust Fund

The LATF secures the obligations of Names on American business written by Lloyd's prior to August 1, 1995. These obligations total nearly £20 billion.⁽⁶⁾ The LATF consists of the premiums which would otherwise be paid to Names. The security, proper use and investment of the LATF is critical to those U.S. entities (ceding insurers, policyholders and claimants) who may seek to collect from the LATF (collectively "claimants") and to the Names themselves.

In recent years, there has been growing criticism of the LATF as an adequate security device. For instance, the Examination Report concluded that: (1) the LATF was severely underfunded; (2) Lloyd's violated its own solvency tests in calculating the proper balance; and (3) there were no records to demonstrate the assets in the LATF on a Name by Name basis.⁽⁷⁾

Effective July 31, 1995, Lloyd's amended and restated the Lloyd's American Trust Deed which structures the LATF. The purpose of the amendment was to separate out the LATF from other funds being initiated for business written after August 1, 1995. Unfortunately, these amendments did not address a number of issues which are important to U.S. claimants and to Names.

A. Joint v. Several Liability

Just as trading at Lloyd's is "each for his own and not for any other," the LATF is established on a several basis. One Name is not liable for the obligations of others. This is troubling to creditors since the Names against which they have claims may not have sufficient assets in the fund when losses come due to be paid. Creditors lack the ability to determine which Names have sufficient assets in the LATF and which do not.⁽¹⁾ Although there may be billions of dollars in the LATF in the aggregate, these assets may not be available to unlucky creditors whose Names no longer have funds in the LATF.⁽²⁾ In addition, some of the funds in the LATF can be depleted by payment of various fees and commissions before claimants are able to recover.⁽³⁾

Names, on the other hand, are concerned that their assets have been loaned to other Names who have insufficient assets to pay their losses. Although such authority is not specified in the LATF, it appears that agents, or Lloyd's on their behalf, have the ability to make such loans.⁽⁴⁾ Initially intended to remedy brief cash flow problems, such loans have increased in size and duration because of difficulties encountered by some syndicates in collecting losses from Names and their reinsurers.⁽⁵⁾ This has led Names to complain about involuntary loans to insolvent syndicates.

B. Authority of Agents

When individuals became Names, they were required to appoint agents to represent them who would exercise very broad authority with respect to the Names' involvement with Lloyd's. No doubt this was a necessity from an operational standpoint since thousands of Names cannot be consulted on each policy matter, to say nothing of thousands of ministerial tasks. This has become troublesome, however, in recent years due to disastrous losses which have put some Names at odds with Lloyd's and their own agents.⁽⁶⁾ The nature of the agency relationship itself has become blurred since agents, in practice, delegate many of their functions to Lloyd's.⁽⁷⁾ Thus, parties with whom some Names are at odds have complete control of Names' assets in the LATF. This control is exercised in several ways.

The agent has broad authority over disbursements from the LATF to a wide variety of creditors, including claimants. The agent is not required to demonstrate to the trustee that the disbursements it orders are proper in amount or proper for their intended use. The trustee is authorized to pay the funds to the

agent and let the agent distribute them to the recipients chosen by the agent. The trustee is required to pay: "any salary, commission, or other remuneration payable to the agent or any other person, or any proper expenses of the agent or any other person, in connection with the conduct or winding up of [the Name's] American business; . ." ⁽¹⁵⁾ Theoretically, then, the agent can obtain its own fees and expenses regardless of: (1) the competing interests of other claimants; and (2) any grievance that a Name may have against its agent. This creates an uneasy tension among the interests of the agent, the agent's principal and the beneficiaries of the LATF.

While there is little evidence, other than loans to cash poor syndicates, that LATF assets have been invested poorly, there are no investment guidelines in the LATF. The LATF grants the agent complete control over the direction of investments and the trustee has no obligation to oversee the propriety of the investments directed by the agent. The agent may decide whether the assets of Names can be commingled. ⁽¹⁶⁾ This contrasts with the relatively strict control over investments of licensed insurers and those unlicensed insurers which post other types of trusts recognized by U.S. Credit for Reinsurance Laws.

The LATF is structured to allow the agent to screen the trustee from outside scrutiny. The trustee is required to submit to the agent on a periodic basis, "an account with respect to its acts and proceedings" ⁽¹⁷⁾ The trustee is not required to account for its activities with respect to LATF assets to claimants or Names. Moreover, if the agent approves of the trustee's account, this purports to bind all claimants and Names and to effect a complete discharge of any liability of the trustee for its own misconduct. ⁽¹⁸⁾

The result is that the trustee and the agent have complete power over, but little apparent accountability for, the funds of Names which are posted for the benefit of U.S. claimants. The appearance of power without accountability is troubling to both claimants and Names and is of questionable necessity to the trustee's proper functions.

C. Role of the Trustee

The trustee's role in the LATF is unusual in that it appears to have an extraordinarily low level of responsibility to claimants and Names. The trustee has a first lien against the trust for its remuneration and expenses, ⁽¹⁹⁾ unlike trustees who manage other types of credit for reinsurance trusts. ⁽²⁰⁾ This has the appearance of a conflict of interest with the trustee's duties to pay the Names' debts to U.S. claimants.

The trustee holds the funds of Names but is not required to:

1. question the agent with respect to transferring funds; ⁽²¹⁾

2. make sure the agent correctly applies funds it withdraws;⁽²²⁾
3. consult with Names before paying their assets to creditors;⁽²³⁾ or
4. determine whether the agent's investment instructions comply with the regulations of the Council of Lloyd's.⁽²⁴⁾

In the event of a dispute involving the trust or the trustee's conduct, the trustee shall "have an absolute protection . . . against all claims and demands whatsoever by the Name" if the Council of Lloyd's approves of the trustee's actions.⁽²⁵⁾ Thus, the trustee is absolved from liability to Names if the trustee handles the Names' funds in a fashion that is approved by Lloyd's.⁽²⁶⁾

Finally, the trustee is prohibited from providing information about assets in the LATF to any claimant. As a result, claimants must obtain a final judgment and wait 30 days to determine if there are available assets from relevant Names to pay a loss.⁽²⁷⁾

D. Lack of Documentation

There is no provision in the LATF that requires the trustee to maintain records documenting the assets of each Name in the trust. The Examination Report has shown that the trustee has maintained no such records in the past. This makes it impossible to determine, in a several trust, such fundamental matters as how much is available to pay a particular claimant and how a particular Name's assets have been applied.

E. Summary

Names are required to maintain assets with the trustee of the LATF to secure their obligations to U.S. claimants. Yet the trustee seems to have little responsibility to the Names or to U.S. claimants. The trustee takes its direction from agents and Lloyd's itself. To the extent that Names are at odds with agents and Lloyd's, the Names are at a considerable disadvantage in asserting their interests in the funds held in trust. In the final analysis, however, Names remain liable to claimants if assets in the LATF are insufficient after payment of the trustee's fees, agent's commission and other expenses deducted from the LATF.

The LATF is an important security device which supports the viability of the Names' obligations in the U.S. Nonetheless, U.S. claimants must compete with the trustee, agents and other parties for assets in the LATF, while not having sufficient information to know if the competition is worthwhile.

II. Purpose of the New Trusts

Lloyd's has established a Lloyd's United States Situs Credit for Reinsurance Trust Deed ("Reinsurance Trust") to secure U.S. reinsurance obligations and a Lloyd's United States Situs Surplus Lines Trust Deed ("Surplus Lines Trust") to secure U.S. surplus lines obligations for business written on and after August 1, 1995. The Reinsurance Trust is designed as a remedy for U.S. domiciled cedents who have not been able to get satisfaction on losses ceded to Lloyd's. As with the LATF, the cedent must obtain a final judgment, submit it to the trustee and wait for 30 days. Since the Reinsurance Trust is several, like the LATF,⁽²⁸⁾ questions continue about the sufficiency of assets in the trust to pay the claims, regardless of the aggregate balance of the trust. The Surplus Lines Trust works much the same way with respect to surplus lines policyholders and those asserting claims against policyholders.

The Credit for Reinsurance Joint Asset Trust and the Surplus or Excess Lines Insurance Joint Asset Trust are designed to provide a \$100 million solvency margin on a joint basis. In the event that the Reinsurance Trust and the Surplus Lines Trust are not able to fulfill their obligations,⁽²⁹⁾ these joint trusts pay them.

A. Significant Improvements in the New Trusts

While problems remain, the new trusts are significant improvements over the LATF. The Reinsurance and Surplus Lines Trusts are now gross of reinsurance, except for reinsurance to close which is secured by assets in trust.⁽³⁰⁾ This is intended to remove, at least on a going forward basis, the underfunding noted in the Examination Report.⁽³¹⁾

Should the trusts be inadequate to pay losses, the balance in the trusts, after deducting the trustee's share, is transferred to the New York Superintendent of Insurance who distributes them in accordance with New York Liquidation law.⁽³²⁾ This keeps such funds in the hands of a U.S. regulator.

Should there be a dispute over payment of a claim, once the claimant has obtained and filed a certified judgment, the New York Superintendent of Insurance can determine whether the claim is properly filed and should be paid.⁽³³⁾ This will allow some regulatory oversight of the procedural aspects of paying claims which have been reduced to judgment.

Investment of trusts assets must be made in accordance with New York law on investments for insurers or the laws of other states with substantially similar requirements.⁽³⁴⁾ Claimants no longer have to compete for assets with agents, employees and other creditors, other than the trustee.⁽³⁵⁾ Other improvements are noted in context below.

B. Remaining Problems with the Trusts

1. The Trustee

The trustee continues to have a first lien on trust assets for its compensation and expenses, including legal expenses, although this lien is now capped.⁽³⁶⁾ The apparent conflict of interest is nullified since the trust documents waive the trustee's conflicts of interest with respect to Names and policyholders.⁽³⁷⁾

The trustee continues to be prohibited from providing an accounting or other information concerning the trust to claimants,⁽³⁸⁾ which produces attendant difficulties for claimants seeking to assert their interests.⁽³⁹⁾ The trustee is now required⁽⁴⁰⁾ to maintain records of the administration of the assets in the trust to the extent such information is provided by the agent. Nonetheless, the trustee is not required to provide such information to the Names who have supplied these assets.⁽⁴¹⁾ This situation seems out of balance with the fact that claimants and Names have the biggest stake in the trust funds.

The trusts are replete with provisions intended to negate any liability on the part of the trustee to any relevant party. For instance, "it shall be an absolute protection . . . against all claims or demands whatsoever [by Names, policyholders or ceding insurers] that the Council [of Lloyd's] shall approve of such act or thing . . ." ⁽⁴²⁾ Although trustees commonly seek a measure of indemnification or to be held harmless for negligent acts, these Lloyd's trusts seem to reach an unusual level in this regard, e.g., conflicts of interest, self dealing and breach of fiduciary duty.

The trustee is required to provide to various parties, other than Names, policyholders and ceding insurers, periodic statements on assets in trust, their value and relevant liens and encumbrances. In the absence of a written objection by the agent within 60 days:

[T]he Trustee shall be released, relieved and discharged with respect to all matters set forth in such statement as though such account had been settled in a court of competent jurisdiction in a proceeding where all parties having a beneficial interest in the Trust were parties.⁽⁴³⁾

It would seem that the Names and claimants, are denied: (1) access to financial information about trust assets; and (2) the ability to protest the activities described in this information. The necessity for this is not apparent given the obvious interests of Names and claimants in such information.

If there is any exposure remaining after such negation of liability, the trustee is further exempted with respect to actions taken in good faith except for willful misconduct or gross negligence.⁽⁴⁴⁾ As a result, there is very little recourse for Names who post assets or for claimants, for whom the assets are posted.

2. The Agent

Agents continue to have broad authority to act on behalf of Names and Lloyd's is authorized to substitute agents for Names.⁽⁴⁵⁾ This is manifested in numerous provisions in the trusts which provide that:

the agent directs investments of assets;⁽⁴⁶⁾

the agent directs how much the trustee maintains in the trusts;⁽⁴⁷⁾

the agent purportedly absolves the trustee from liability for its handling of trust funds;⁽⁴⁸⁾

the agent and Lloyd's can control access to the records of the trustee concerning the trusts and can prevent access by claimants and Names;⁽⁴⁹⁾

the agent controls the data the trustee uses in keeping records on the trusts;⁽⁵⁰⁾ and

the agent controls commingling of Names' funds.⁽⁵¹⁾

As a result, Names appear to have no control over their assets in the trusts.

C. Summary

The new trust funds are significant improvements over the LATF. They: (1) are gross of reinsurance; (2) cap the trustee's remuneration; (3) require additional record keeping with respect to trust assets; (4) require investment of trust assets in accordance with New York law; (5) limit access to extraneous creditors; (6) allow regulatory involvement in procedural claim disputes; and (7) control disposition of assets upon insolvency of the trust. Nonetheless, the new trusts retain certain limiting features of the LATF such as limited access to trust funds by claimants. In addition, they limit information about such funds to agents, the trustee and Lloyd's at the expense of Names and claimants.

III. NAIC Model and Changes Thereto

The NAIC proposes various model laws and regulations to the states, many of which are adopted in part or in whole by the states. The NAIC Model determines the circumstances under which ceding insurers can take credit for reinsurance as an asset or deduction from liability and requires unlicensed insurers to post security for their obligations to cedents.⁽⁵²⁾ The Model is undergoing changes which may be finalized in 1996 for consideration by the various state legislatures.⁽⁵³⁾

There is some doubt that the LATF complied with the Model even prior to the amendments currently being considered.⁽⁵⁴⁾ Relevant issues included the fact that the LATF is net of reinsurance, it is relatively inaccessible to claimants and the

fact that claimants must compete with the trustee, the agent and other creditors for trust assets.⁽⁵⁵⁾ The LATF has not remedied any of these problems in its recent amendments and, therefore, a threat remains that one or more states will deny credit for reinsurance for cessions which are secured by the LATF. Since most of Lloyd's outstanding liabilities are secured by the LATF at this time, this would present a very significant problem to Lloyd's and to its cedents.

Practically, however, such a result seems unlikely. U.S. regulators have known of the limitations of the LATF for some time. Precipitous action now would throw the U.S. marketplace into a cataclysm over a situation which has been in place and unchallenged for many years. It would be virtually impossible for Lloyd's to change the structure retroactively (and increase the assets) of the LATF. To do so would jeopardize Lloyd's efforts to put its old year problems behind it. As a result, it is likely that U.S. regulators will exercise forbearance concerning security for past cessions and focus on improving security in the future.

The major amendments, from a Lloyd's standpoint, being considered for the next generation of the Model would provide that:

- the reinsurance and surplus lines trusts are separate;
- the reinsurance trust shall equal liabilities to U.S. cedents;
- the reinsurance trust shall be gross of reinsurance; and
- the trust shall be subject to investment guidelines.⁽⁵⁶⁾

As noted in **Section II**, these anticipated changes in the Model have been addressed in the new trust funds. As a result, it is likely that the new trust funds will be found to be in compliance with the new NAIC Model Credit for Reinsurance Act.

IV. Conclusion

Recent problems at Lloyd's have led to increased scrutiny of the security devices which support Lloyd's reinsurance writings in the U.S. Scrutiny of the LATF has revealed a number of weaknesses, from the standpoints of both claimants and Names and questions have arisen about its compliance with U.S. credit for reinsurance laws.

U.S. regulators are finalizing a strengthening of the NAIC Model which will be referred shortly to state legislatures for their consideration. Lloyd's has anticipated the major changes in the Model and has instituted new trusts on a going forward basis which appear to be in substantial compliance with the projected language of the Model.

Notwithstanding the improved nature of the new trusts, the LATF, in its original form, continues to secure the vast majority of Lloyd's obligations in the U.S. In addition, the new trusts contain a good deal of language from the LATF which inhibits oversight and accessibility to both claimants and Names, i.e., those who assert claims and those who pay them. Nonetheless, it is likely that U.S. regulators will not challenge the LATF or the new trusts under U.S. Credit for Reinsurance Laws as long as Lloyd's continues to pay its claims.

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ENDNOTES

1. This article was originally published in the International Journal of Insurance Regulation.
2. Mr. Hall practices insurance and reinsurance law, and is active in both arbitrations and mediations. The views expressed in this article do not represent the opinions of Mr. Hall's clients. Copyright 1996 Robert M. Hall. Comments and questions can be addressed to robertmhall@erols.com.
3. There are indications that this might rise to £11.4 billion (before double counting) when the next year of accounting is completed. *See Names' Committee Interim Report* at 5 (November 1995)
4. *See* Robert M. Hall, *Security Devices for Unlicensed Reinsurers*, 16 U. Pa. J. Int'l. Bus. Law 41, 49-61 (1995) ("Security Devices").
5. *See* New York Department of Insurance, *Report on Examination of Lloyd's of London as of December 31, 1993* (May 11, 1995) ("Examination Report").
6. *See* Examination Report at 20.
7. *Id.*
8. *See* note 25, *infra*, and accompanying text.
9. *See* Security Devices at 55-57.
10. *Id.* at 57-58.
11. *See* *Lloyd's American Trust Fund Manual, LATF - Operating Procedures* § 4.3.

12. *See* correspondence from underwriting agencies to Names in the author's possession.
13. There are 13,600 Names currently suing agents and others in London. Names Committee Interim Report at 12 (1995).
14. *See* LATF § 1 (G); *see also* *Lloyd's American Trust Fund Manual § 5, The Background and Overview of LATF*.
15. *See* LATF (B) § 5.
16. *See* LATF § 7.
17. *See* LATF § 11.
18. *Id.*
19. 17. *See* LATF § 14.
20. *See* Model Act § 2 and Model Regulation § 9 and § 10.
21. *See* LATF § 4 and § 5.
22. *See* LATF § 5 (H).
23. *See* LATF § 5 and § 6 (D).
24. *See* LATF § 7 (B).
25. *See* LATF § 10.
26. Since Lloyd's is immune from suit, Names are deprived of a remedy.
27. *See* LATF § 6.
28. *See* notes 6 to 10 and accompanying text, *infra*.
29. Prior to making a claim against the joint trusts, a claimant has an opportunity, and responsibility, to make claims against the two Central Trust Fund trusts in the U.S.
30. *See, e.g.*, Reinsurance Trust § 1.23 and § 1.24.
31. *See* note 3, *supra*.

32. *See, e.g.*, Reinsurance Trust § 5.4 and § 5.5.
33. *See, e.g.*, Reinsurance Trust § 2.3 (e).
34. *See, e.g.*, Reinsurance Trust § 2.6.
35. *See, e.g.*, Reinsurance Trust § 1.4 and § 2.3.
36. The lesser of \$50,000 or 10% of trust assets for the Surplus Lines and Reinsurance Trusts, *see* § 2.2, and the lesser of \$4 million or 10% of the Joint Surplus Lines and Joint Reinsurance Trusts. *Id.* The reason for the variation in caps is not evident.
37. *See, e.g.*, Surplus Lines Trust § 3.14.
38. *See, e.g.*, Surplus Lines Trust § 2.4.
39. *See* note 24, *supra*, and accompanying text.
40. *See Examination Report* at 11 (the trustee of the LATF maintains no records of "the individual Name's total assets held in LATF accounts"). This makes it very difficult to pay claims out of a several trust.
41. *See, e.g.*, Reinsurance Trust § 3.8.
42. *See, e.g.*, Reinsurance Trust § 3.15.
43. *See, e.g.*, Surplus Lines Trust § 2.13 (c).
44. *See, e.g.*, Surplus Lines Trust § 3.11.
45. *See, e.g.*, Reinsurance Trust § 1.1.
46. *See, e.g.*, Reinsurance Trust § 2.6.
47. *See, e.g.*, Surplus Lines Trust § 2.7.
48. *See, e.g.*, Reinsurance Trust § 2.13.
49. *See, e.g.*, Surplus Lines Trust § 3.8.
50. *Id.*
51. *See* Reinsurance Trust § 4.3.

52. *See generally*, Debra J. Hall and Robert M. Hall, *Changes In U.S. Credit for Reinsurance Laws*, [1995] IJIL 257 (hereinafter "Changes").

53. *Id.*

54. Security Devices at 42 - 66.

55. *Id.*

56. *See* Changes at 259 - 260.