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SURPLUS-LINES REQUIREMENTS AND LLOYD'S: BACKGROUND ON THE RECENT CHANGES IN THE NAIC'S TRUST REQUIREMENTS,

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At its March 16, 1998 meeting in Salt Lake City, Utah, the NAIC's Surplus Lines (E) Task Force, subject to certain conditions discussed below, reduced the NAIC's trust requirements for Lloyd's U.S. surplus-lines policies from 100% to 50% of liabilities gross of reinsurance. The decision applies not only to new business, but also to policies that incepted between August 1, 1995 and January 1, 1998. This article reviews the background of the trust requirements imposed upon Lloyd's and of the NAIC's conditional decision to reduce those requirements.

Lloyd's Trusts and Surplus-Lines Eligibility

Lloyd's of London is a marketplace in which various syndicates of individuals, or "Names," agree to underwrite insurance and reinsurance. (As used herein, "Lloyd's" refers to the syndicates collectively.) For most purposes, a Lloyd's syndicate functions as an insurance company. In Lloyd's view, however, a syndicate is only an unincorporated association of its Names. The Names are not "jointly and severally" liable for the obligations of the syndicate as a whole. Rather, each Name is responsible only for his or her share of losses. In the United States, Lloyd's is licensed only in Illinois and Kentucky. In all other U.S. jurisdictions, Lloyd's issues insurance policies on a surplus-lines basis.

To qualify as a surplus-lines insurer in most states, a non-admitted alien insurer must maintain a trust account for the protection of U.S. policyholders. In many instances, this trust requirement is a function of state adoption of the Quarterly Listing of Alien Insurers of the International Insurers Department ("IID") of the NAIC as a determinant of alien-insurer eligibility. In approximately 14 states, statutory provisions base alien-insurers' eligibility on the Quarterly Listing. In 21 additional states, regulations or insurance department policy make inclusion on the Quarterly Listing either a requirement or one method for alien insurers to become eligible to write surplus-lines business. Thus, Lloyd's syndicates have become eligible surplus-lines insurers in many states through inclusion on IID's Quarterly Listing.

The IID's Plan of Operation, approved by the NAIC membership, establishes a number of criteria for inclusion on the Quarterly Listing, including maintenance of an appropriate trust. Lloyd's has maintained the requisite trusts in New York. In practice, the New York Insurance Department ("NYID") has acted as the principal regulator of Lloyd's duty to maintain U.S. trust funds. For example, each trust requires the approval of the NYID in order to change the trust terms; neither the approval of the NAIC nor of other state Departments is required.

The Recent History of Lloyd's Trust Requirements

The history of the requirements applicable to Lloyd's U.S. trust funds is closely tied to the financial problems Lloyd's experienced in the late 1980s and early 1990s. From 1988 to 1992, Lloyd's suffered about 8 billion in losses. Many Names became insolvent and sued for fraud and other claims. At the time, Lloyd's was required only to maintain $50 million in trust for its surplus-lines liabilities; these funds formed part of the Lloyd's American Trust Fund ("LATF"). *See*, e.g., 11 N.Y. Code Reg. 27.27.5(b)(1) (1993).

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The LATF was the original Lloyd's trust fund in the U.S., first established in 1939 to assure that the impending Second World War would not impede Lloyd's ability to meet its U.S. obligations. The LATF is actually not a single trust fund. Instead, it consists of multiple trusts that secure the liabilities of individual Names. Further, the LATF applies to all U.S. dollar-denominated policies, including policies issued to non-U.S. policyholders.

In 1993, Lloyd's established two "Joint Asset Trust Funds" ("JATF"), one applicable to reinsurance and one to surplus-lines insurance. These trust funds were meant to meet the requirement of U.S. regulators that Lloyd's maintain in trust a minimum surplus over its liabilities and this surplus be held on a joint and several basis. The LATF failed this test because each Name's trust assets are held severally, not jointly. Thus, both JATFs now hold the mandated surplus in a single account, rather than a series of accounts for each Name.

In 1994, New York amended its surplus-lines regulation to require Lloyd's to fund its trust based on total liabilities plus $100 million. 11 N.Y. Code Reg. 27.13(g) (1994). The regulation did not clearly indicate whether "liabilities" were gross or net of reinsurance, although an opinion by the NYID at the time indicated that the funding obligation was *net of reinsurance*. N.Y. Ins. Gen. Coun. Op. 1-24-94. The liability portion of this requirement is funded by the LATF and several other trust funds noted below. The surplus portion of the requirement is funded by the JATFs.

In 1994 and 1995, the NYID conducted a limited examination to determine whether the LATF complied with New York's requirements. The NYID concluded that the LATF was underfunded by approximately $7 billion *net* of reinsurance and by approximately $18 billion *gross* of reinsurance. Notwithstanding the prior Nyid General Counsel Opinion, the NYID also stated that Lloyd's funding requirement was *gross of reinsurance*. In addition, the NYID questioned the application of the LATF to all dollar-denominated liabilities, since that feature means that the funds may be drawn down by the many non-U.S. policyholders whose policies are denominated in dollars.

Following the audit, Lloyd's executed a stipulation with the NYID effective on May 24, 1995. Lloyd's agreed, among other things, that as of August 1, 1995, it would fund a trust dedicated to U.S. surplus-lines liabilities 100% gross of reinsurance. Further, this fund (and a parallel fund applicable to reinsurance) was to secure policies covering U.S. risks, rather than all dollar-denominated policies. In December 1995, the IID amended its Plan of Operation to conform to the funding requirement in the stipulation. The fund established pursuant to this agreement was the Situs Trust. The Situs Trust (and its reinsurance counterpart) effectively replaced the LATF as the trust for liabilities on contracts incepting August 1, 1995, and later. Like the LATF, the Situs Trust actually consists of multiple trusts for individual Names; these trusts are held on a several, not joint, basis.

In 1996, Lloyd's "Reconstruction and Renewal" ("R&R") plan went into effect. The R&R plan was meant to rescue Lloyd's from the crisis of the late '80s and early '90s. Its cornerstone was the 100% reinsurance of Lloyd's 1992 and prior liabilities into Equitas. Equitas was established as a limited-liability English reinsurance company whose sole function was to run off the pre-1993 liabilities. Lloyd's Names remained ultimately liable for losses on policies, but (assuming its continued solvency) Equitas became responsible for the pre-1993 liabilities. The Equitas reinsurance was a form of "good bank/bad bank" strategy, by which Lloyd's older obligations were isolated in Equitas, and the on-going market was at least partially freed of those obligations.

As part of R&R, Lloyd's restructured its trusts. Assets in the LATF relating to 1992 and prior business were transferred to a new Equitas American Trust Fund ("EATF"). For claims on pre-1993 Lloyd's business, the LATF is the beneficiary of the EATF.

In sum, the chain of security offered by the Lloyd's U.S. trust funds now varies depending on the inception date of the policy secured. For 1992 and prior policies, liabilities are secured by the LATF, which in turn draws on the EATF. For policies incepting from 1993 to August 1, 1995, liabilities are secured by the LATF alone. For policies incepting on or after August 1, 1995, liabilities are secured by the Situs Funds.

For all years, the surplus held in addition to liabilities is held in the JATFs. As noted, these funds, which now contain roughly $100 million each, are held on a joint-and-several basis and are available as a last resort to secure *all* claims on Lloyd's U.S. business.

business.

NAIC Regulation of the Lloyd's Trusts

To appear on the IID Quarterly Listing, Lloyd's must maintain a trust "at an appropriate level."[1] The NAIC Surplus Lines (E) Task Force has defined "appropriate" to be 100% of gross liabilities before 1998 and 50% of gross liabilities thereafter. [2]

In approving Lloyd's for the Quarterly Listing, the IID considers the liabilities of both the current syndicates and of syndicates in previous accounting years. Thus, IID effectively requires funding based on the liabilities both of active Names and of those Names who are no longer participating in any Lloyd's syndicates.

Lloyd's Proposal to Change the Surplus-Lines Funding Requirements

In 1997, Lloyd's complained that the NAIC trust-fund requirements could impair its ability to close accounts on 1995 syndicates and its ability to underwrite new business.[3] Consequently, Lloyd's proposed amending the terms of the Situs Trust to bring Lloyd's security requirements more in line with those imposed on alien insurance companies. Specifically, Lloyd's proposed reducing the requirements for the Situs Trust to 50% of Lloyd's gross U.S. surplus-lines liabilities, with no cap, and increasing the JATF for surplus-lines liabilities from $100 million to $200 million. By way of comparison, under section 5(e) of the NAIC Non-admitted Insurance Model Act, alien surplus-line insurance companies must fund trusts based on 30% of liabilities gross of reinsurance, subject to a floor of $5.4 million and a cap of $60 million.

In December 1997, before the NAIC determined whether to accept Lloyd's proposal, the NYID unilaterally agreed to it, both with regard to business underwritten after January 1, 1998 *and with regard to business underwritten after August 1, 1995*.[4] The NYID determined that this reduction was prudent in light of Lloyd's increasing financial strength following the R&R program, as well as "new internal controls and enhanced periodic financial reporting requirements." *Id*.[5]

The NAIC's Response

At its December 1997 meeting, the NAIC approved Lloyd's proposal for business written after January 1, 1998. Due to concerns about the proposed reduction in trust funds and its effect upon in-force policies, the NAIC deferred its decision on the reduction of security for prior years of account until March 1998, to permit its on-site review of Lloyd's and to permit a legal analysis of the proposed reduction.[6] At that time, the NAIC approved the reduction for prior years of account subject to four limitations:

Before reducing the amount held in trust:

- Lloyd's must increase the funds held in the JATF from $100 million to a minimum of $200 million (as Lloyd's had proposed).

- The aggregate value of the Situs Trust must not fall below $600 million.

- Lloyd's must warrant that it has no contractual obligations to affected policyholders or other parties regarding the level of trust funding or maintenance thereof.

  Within 90 days of the Task Force's adoption of a standard-form trust agreement modified for Lloyd's:

- Lloyd's must conform its trust deed to the modified form or else return to a 100%-of-gross-liabilities funding level for *all* years of account.

The last condition on the NAIC's approval may prove significant. Lloyd's current trust agreements permit modification of the trust terms with the consent of the NYID and do not require the consent of the NAIC or other state Commissioners. While the Task Force has not yet approved a standard-form trust agreement modified for Lloyd's, the NAIC's standard-form agreements typically require the NAIC's consent to amendment of the terms of the trust. The NYID to date has not agreed to agreements typically require the NAIC's consent to amendment of the terms of the trust. The NYID to date has not agreed to the proposals that Lloyd's trust agreements be modified to give this power to the NAIC. If further discussions fail to resolve this issue, Lloyd's could once again be required to fund the surplus-lines Situs Trust based on 100% of its liabilities.

Endnotes

1. NAIC Int'l. Insurers Dep't., Plan of Operations for Listing of Alien Non-Admitted Insurers, (as Amended December 1997).

2. Minutes of the Surplus Lines (E) Task Force at 3 & attach. 3, Dec. 8, 1997.

3. National Underwriter, Nov. 10, 1997.

4. N.Y. Ins. Dep't. Press Release, Dec. 2, 1997, (available on NYID web site).

5. *Id.*

6. Provided by Chadbourne & Parke LLP.