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Name Game

Trouble in the House of Lloyd's

By Stev llivan

Once a pillar of the insurance business, a venerable institution, and symbol of the British Empire, Lloyd's of London now faces allegations of fraud and a difficult financial future.

AMERICANS ARE SUCKERS FOR A BRITISH ACCENT. You can tell us practically anything—even the most outrageous nonsense. And as long as you do it in a plummy drawl, we'll buy it every time.

Joe Silversmith wasn't buying it, though. Joe had spent most of his life in the insurance business, as had his father and father-in-law. He was no neophyte. So when a pair of tony Englishmen came through Denver back in 1982 selling membership in Lloyd's of London, he was skeptical at first.

It certainly wasn't Lloyd's reputation itself that aroused his suspicion. For more than three centuries, Lloyd's of London has been known around the world as a venerable institution, synonymous with probity, rectitude, reliability, and financial soundness. Though Lloyd's had long been renowned for insuring glamorous risks such as Betty Grable's legs, Bruce Springsteen's voice, and the Cutty Sark whiskey company when it offered £1 million to anyone who could capture the Loch Ness monster alive, it was also renowned for never reneging on a claim.

An invitation to become a Name, a member of a Lloyd's syndicate, was like receiving an invitation from the queen herself.

"My father and my father-in-law would have thought that the sun had just risen in the West if they knew that I'd been invited to join Lloyd's," says Silversmith. "Lloyd's had that kind of a reputation."

No, it wasn't reputation but a little something called an unlimited liability clause that kept Joe Silversmith at arm's length. Unlimited liability not just for him but for his wife as well. That meant that if the syndicate he participated in were to go south (something that, they assured him, had never happened in 300 years) he could lose everything—even if it was in his wife's name.

So Joe Silversmith politely declined.

But only until a short time later, Lloyd's changed the rule. Now, they told him, even though there was still no limit to Joe's liability, his wife's assets couldn't be touched.

That sounded a little better. Enough so that Silversmith made the trip to London, where he met with more smooth-talking sales types who definitely did not reassure Joe's conservative nature. It wasn't until he met a respected international insurance broker with long-standing Denver connections—and himself a Lloyd's Name—that he began to feel a little better.

The broker introduced Silversmith to the underwriters of several of the syndicates he belonged to. And the insurance pro from Denver knew just what questions to ask them, because unlimited liability is nothing to sneeze at, no matter what your track record.

What he asked was: Are you sure your reserves are adequate to handle anything that might come down the pike?

"The standard answer I got was: `Why certainly sir, we've been doing this for three hundred years; we know exactly what we're doing'."

And they told him once again, with a nod and wink, that he'd be liable "down to his last collar button," if something went wrong. And what could possibly go wrong?

Joe Silversmith ended up losing his house. Joe is 77, living in a rented apartment with his wife. He's ill with cancer and continues to run his one-man insurance agency because he can't afford to retire anymore.

And Lloyd's says he still owes them $750,000—which he doesn't have.

Elizabeth Luessenhop, a Washington, D.C., matron and divorcee who was looking for a safe investment for her settlement, was told the same thing—with similar devastating results. She wrote about it in a book called *Risky Business: An Insider's Account of the Disaster at Lloyd's of London*.

What they didn't tell Joe or Elizabeth was that, when it came to the adequacy of their reserves, some of the people at Lloyd's had been less than forthcoming. Many Americans just like Joe Silversmith and Elizabeth Luessenhop have alleged that the men who ran Lloyd's in the 1980s and 1990s used deliberate deception to recruit them into a losing proposition, perpetrating a fraud the likes of which has seldom been seen. The result? Ruined lives and blasted fortunes, an institution's reputation in tatters, and a cacophony of lawsuits that will reverberate for years to come.

The story of Lloyd's fall from grace is simple in its trajectory, complex in its details, horrifying in its implications. It involves not just wealthy, sophisticated investors who might have known better but who can nevertheless absorb substantial losses. It also involves a number of ordinary folks who can't. They —teachers, electricians, widows, damaged recipients of court settlements—were told that participation in a Lloyd's syndicate was the safest of bets, a conservative way to protect their retirement.

Was there risk? Sure, they were told. There's always risk. But Lloyd's syndicates hardly ever lose money, and there are plenty of reserves in case of unforeseen disasters. What they weren't told, they allege, was that not only had such a disaster been foreseen, it was already there, waiting like an iceberg, ready to sink them the minute they signed their name to the contract.

Spreading the Risk

Lloyd's of London is not an insurance company in the usual sense. In fact, were Lloyd's to happen today, it might be called Starbucks of London. But it was Edward Lloyd's coffeehouse on Tower Street, near the Thames, that in 1687 became the place where gentlemen of means could make a killing in the insurance business.

This, admittedly oversimplified, is about how it worked.

Let's say that Lord Greystoke, a wealthy shipowner, walks into Ed Lloyd's coffeehouse one morning and announces that his ship, the Tarzan, is on its way back from the West Indies, its hull and cargo worth an estimated $50,000. Greystoke will pay an agreed-upon premium to anyone willing to cover the risk of its loss, should the Tarzan happen to go down anywhere between Jamaica and London.

In the early days, it was well-heeled individuals who agreed to take on the risk, and they were usually good for the loss. Later, the larger risks were often spread among a number of individuals, known as Names because they would sign their name to a note agreeing to pay a portion of the loss.

Greystoke assures the interested Names that the captain of the Tarzan runs a tight ship—skilled, experienced, unflappable, and not one to take unnecessary risks. One of the Names, Sir Geoffrey, thinks it sounds like a good risk: stout ship, good captain, happy crew. Count Sir Geoffrey in.

Mr. Boswell, on the other hand, isn't so sure. He's well aware of the activity of pirates in the area. And besides, it's October—hurricane season—and there's a good possibility the Tarzan may founder in one, regardless of how good the captain is. Too risky for Boswell's blood; count him out.

Eventually, Greystoke is able to find five individuals willing to put both their money and their names on the line. They form a syndicate and divide the risk as well as the premium. That means that if the Tarzan sails up the Thames intact and delivers her cargo safely, the syndicate makes a profit. For Lord Greystoke the premium is just a cost of doing business.

But if the Tarzan is unlucky and goes down or gets hijacked by pirates, the syndicate has to pay Greystoke's claim. If they've calculated the premiums right, they should more than cover the claim on the Tarzan, with plenty to spare. At the end of the year, that surplus carries over into the next year of account to cushion whatever business is written then. And at the end of three years, when the books are closed, whatever is left after paying claims reverts to the Names as profit. Some might be left in reserve, of course, but the larger the reserve, the smaller the profit for the Names.

If, however, the underwriters have undercalculated the premium, and claims exceed the premium, the money has to come from somewhere.

In an insurance company, the money would come from reserves specified by law for just that purpose. At Lloyd's, however, that money would have to come from the personal assets that Sir Geoffrey and the other members of his syndicate had pledged as their entry fee.

With luck and prudence, the potential for profit outweighs the risk, and for 300 years that's just the way it worked. Prudent underwriting and diversifying risk enhance the chances of realizing a profit. Undercutting the competition to insure a fleet sailing through dangerous waters could be dicier. Because the Names' liability is unlimited, one rogue squall in the South Atlantic could ruin everybody.

As luck would have it, just such a rogue squall hit many Lloyd's Names late in the 20th century. But it wasn't bad weather that sank them; it was a curious, deadly, and ultimately expensive ailment called asbestosis.

A Dormant Virus

Apparently nobody saw it coming. Certainly not the shipyard workers in the 1930s and '40s who worked with asbestos and breathed in great quantities of the stuff as they fueled the country's massive war effort in World War II.

Not the insurance companies that sold liability policies to the companies that mined the asbestos and manufactured the products it contained.

Nor the Lloyd's syndicates that reinsured that business in the 1930s and 1940s at a tidy profit, or sold surplus lines policies to the manufacturers because nobody else would.

virus just waiting to come to life and cause trouble.

Nor did they fully understand that these unlimited liability policies carried unimagined consequences. Partly because no one fully understood what the American court system was about to do, and partly because of an archaic system peculiar to Lloyd's called "reinsurance to close."

"It isn't really reinsurance," says Jeff Peterson, executive director of the American Names Association in Rancho Santa Fe, Calif. "Reinsurance-to-close is how Lloyd's wrote nonmarine insurance starting in the late 1800s. Before that, they'd been writing ship-risk liability. The ship would always come back, or the disposition of the voyage would be determined, within three years. So, you'd write the policy and wait two more years to figure out the outcome, then pay the losses or divide up the profit."

But with nonmarine risks, at the end of three years, there would still be contingent liabilities—policies that were still in effect but hadn't yet been exercised. So using the marine model, the underwriters would quantify those contingent liabilities, and the next year of account would assume them for a fee.

In that way, liabilities could be carried forward for years, like a dormant virus just waiting to come to life and cause trouble.

"There were some syndicates that had started in the 1920s or 1930s that were still in business in the '60s, '70s, '80s," says Peterson. "So their book of business had a long-tail exposure to a lot of nasty garbage."

What made the garbage particularly nasty was that there was no cap on the amounts that would have to be paid (unlimited liability), and there were no diseases that were not covered.

The other thing nobody anticipated was the major shift that took place in the U.S. tort law system. Beginning in the 1960s, American juries were awarding ever increasing amounts in compensatory and punitive damages to plaintiffs who had been hurt by the negligence of major companies. Prominent among these vindicated plaintiffs were the victims of asbestosis.

"By the beginning of 1982," says attorney David Shaw of New Haven, Conn., "it was beginning to become clear that the asbestos-related legal liabilities of the American construction products industry and their insurance companies were going to be mind-boggling."

Major asbestos manufacturers, such as Johns-Manville, went bankrupt. Tort lawyers got so rich, at least one of them was able to buy a major-league baseball franchise.

And Lloyd's Names, whose syndicates had insured or reinsured these risks, were on the hook for billions of dollars. In fact, it was estimated that if the lords and ladies and other British gentry who were underwriting Lloyd's syndicates had to pay these staggering claims that were appearing in these formerly profitable enterprises, most of them would quickly go bankrupt.

Profits Above Reserves

According to an exhaustive investigative article in *Time* magazine by David McClintick, the men who ran the Lloyd's operation in London were not unaware of the situation. One who had an early inkling of what was coming down the pike was Ralph Rokeby-Johnson, who told his close friends in 1973 to get out or face inevitable bankruptcy. Something had to be done.

The first thing Lloyd's did was change the rules. In 1970, it modified its liability policies to exclude environmental claims, unless the damage resulted from an accident, such as the Exxon Valdez oil spill. But that still wasn't going to help the Names who were trapped in syndicates with unlimited liability. American insurers were reserving billions of dollars in anticipation of these claims. Lloyd's hadn't done that.

According to Elizabeth Luessenhop in her book *Risky Business*, "for so many years the profits of the fat years were distributed to the Names rather than salted away in reserves to meet possible demands in the lean years."

So in the absence of reserves, the claims would have to be paid from the personal assets of the syndicate's participating Names. As daunting as such a risk sounds, it's also what made participating in Lloyd's so attractive to investors—particularly investors who didn't have a lot of cash to invest. Rather than having to put up a large lump sum up front, they merely had to sign a letter of credit, pledging that they would be good for whatever losses they might have to pay. And they'd already been assured that as real as the risk might be, it had never happened in Lloyd's 300-year history.

After all, who in his right mind is going to buy a ticket on a ship he knows is headed full-speed for an iceberg? The answer, of course, is no one. So, according to those who allege conspiracy, Lloyd's recruiters chose simply not to mention it.

In 1972, for the first time in its history, Lloyd's opened its membership to Americans. Recruiters fanned out across the United States, dazzling the Yanks with Lloyd's impeccable reputation, its mystique, and its promise of modest but steady profits—modest returns of between 8 percent and 12 percent per year.

According to Joe Silversmith, his Lloyd's contacts told him that "I could be looking at a middle-five-figure number each year as profit. There could be some bad years, of course, but the incentive was the fact that they were showing substantial profits. Again, what they didn't say was that they had this whole big mess of asbestos and pollution, and they knew their reserves were totally inadequate."

Was this simply a matter of ignorance and oversight, as Lloyd's claims, or something else? In 1995, a dissident British Name hired Memery Crystal, a firm of London solicitors, to investigate Lloyd's system of operation and disclosure during the time when the asbestos problem was making itself known. The report concluded that "Names recruited to Lloyd's after 1982 were misled as to the level of asbestos claims ... and the level of reserves necessary to meet such claims. These matters have the appearance of fraud, malpractices or misconduct."

The recruiting succeeded. Figures compiled by the American Names Association show Lloyd's membership rising to 10,622 in 1977, 23,436 in 1984, and peaking at 32,433 in 1988.

Best of all, you no longer had to be a millionaire to join Lloyd's. As long as you were willing to stake everything you had on what, for 300 years, had been a sure thing, you could join with assets of half that or less. Retirees put up their nest eggs, pledged their homes.

"People making $80,000 or $90,000 a year were becoming Names," says Peterson, "and there's no way people like that could stomach the cash calls."

Big-name Names like stockbroker Charles Schwab, Supreme Court Justice Stephen Breyer, and pundit Robert Novak answered the call. According to *Time* magazine, Schwab stands to lose $2.3 million, Novak $1 million, and Breyer $140,000 before it's all over.

Jack Shettle was another Lloyd's American Name who lost big. He was a savvy investor, president of two insurance companies, and worked as an insurance broker in Baltimore before he retired. And he had worked closely with Lloyd's for 20 years before finally becoming a Name himself.

"I wasn't solicited like many of the others," says Shettle, now president of the American Names Association. "I became a Name because of my long-standing relationship with Derek Walker, underwriting manager of an aviation syndicate in London. Aviation was my specialty, so on his recommendation I joined one of the syndicates he managed. What I didn't know was that Walker's syndicate had written extensive excessive loss business."

The burgeoning claims bankrupted not only Walker but his wife and son too. Shettle was hit for $900,000, which he plans to challenge in court.

Easier said than done.

Last year, Sir William Jaffray, a dissident British Name, sued Lloyd's in British court for criminal fraud. He lost, because he was unable to prove, to the court's satisfaction, Lloyd's criminal intent. Gross negligence and incompetence were rampant, said the judge who heard the case, but none of it descended to the level of outright fraud.

Ironically, the reason the bar was so high in the Jaffray case was a 1982 ruling by Parliament, granting Lloyd's immunity from all lawsuits involving anything but the most blatant criminal wrongdoing. In court, Jaffray asserted that Lloyd's not only misled prospective Names so it could recruit them into a bankrupt enterprise; it misled Parliament in the same way.

"That's the only thing you can sue Lloyd's for in England," says Jeff Peterson. "It's the equivalent of only being able to charge premeditated murder; no second-degree, third-degree, manslaughter. Either they're guilty of the grossest criminal negligence and bad faith, or they're not guilty of anything."

In addition, buried in every Lloyd's American contract is the provision that Lloyd's can only be sued in a British court, a Catch-22 that would have scared off most American Names had they been aware of it. The ANA is now trying to get around it by suing Lloyd's legal counsel instead. According to Peterson, they'll be able to present the same evidence they would have presented if they had been able to get Lloyd's into a U.S. court, but Lloyd's itself is not the named defendant. These cases are expected to go before juries in the next year or two.

The dissident Names may have lost in London, but the U.S. Attorney's office in New York is actively investigating Lloyd's for wire fraud and mail fraud. There have been no indictments so far, but the level of activity and interest has increased as the investigation continues.

"They weren't too keen to begin with," says Jack Shettle, "but the more they got into it they realized there was a case here. When they started three years ago, one U.S. attorney and one postal inspector devoted one-eighth of their time to it. Today, eight people are working on it full time."

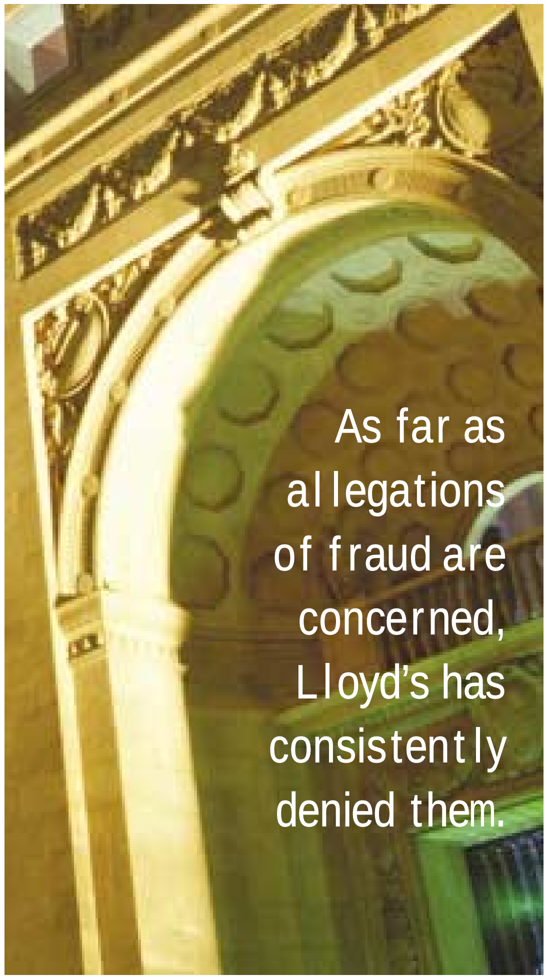
Reconstruction and Renewal

By 1994, Lloyd's could no longer find enough prospects willing to take on the steadily accumulating liabilities from asbestosis and other disasters. Something had to be done, and that something, known as "reconstruction and renewal" by Lloyd's insiders, resulted in the formation of a new entity called Equitas in 1996.

Basically, Equitas was created solely to pay off the pre-1993 liabilities and would write no new business of its own. It was capitalized by the assets of the pre-1993 underwriting syndicates. (Lloyd's itself restructured, too, depending less on individual Names and for the first time allowing corporations to become Names.)

But since Equitas' liabilities already exceeded the assets, the existing Names were expected to pony up. Approximately 95 percent of them, hoping to cut their losses and limit their liability, did just that. These Names, known as "settled Names," also signed a release pledging never to litigate against Lloyd's again. Around 250 holdouts, known as "nonsettled Names," pledged to fight Lloyd's to the bitter end.

But does Equitas have enough money to pay the claims? Hard to say. Lloyd's and Equitas say it does. In July last year, Equitas reported that it paid claims totaling $3.23 billion in the first quarter of 2000, a decrease of $100,000 for the same period last year. Then, two months later, Equitas warned that despite strengthened reserves (from $1 billion to more than $12.78 billion), analysts believed new claims may exceed the amount of the additional funds, putting further pressure on reserves.



In 1997, A.M. Best, the insurance rating service, said that Equitas was funded with "$588 million of surplus to support gross liabilities of $20.9 billion, or $10.4 billion net." Though Best's did not formally rate Equitas at the time, it did call it a "source of uncertainty."

"It's very difficult to be sure you have enough set aside to cover these long-tail liabilities, especially when you have a dead company paying them out," says J. Robert Hunter, actuary and director of the Insurance Consumer Federation of America in Alexandria, Va. "On asbestos, actuaries have been under on their reserves over the last two decades by significant amounts. They kept doubling them almost every year, and they still were behind all the time."

"Equitas was basically a reinsurance to close mechanism where Lloyd's retroceded to Equitas the pre-1993 liabilities," says Debra J. Hall, general counsel of the Reinsurance Association of America in Washington. "A certain amount of reserves went with Equitas. Some people feel that won't be sufficient to cover the liabilities there. So when that happens, that still leaves Lloyd's holding the bag because this was just reinsurance to close. The liabilities will come back to haunt Lloyd's."

And there's even some question of whether Lloyd's would be able to handle it if such an event were to happen. In 1995, the New York State insurance department audited Lloyd's American trust fund at Citibank and discovered a deficit of $18 billion in the fund. Lloyd's maintains the deficit has been rectified, but according to Jeff Peterson, the fund has not been audited since. "The adequacy of the reserves in the Equitas trust fund is a function of the outstanding liabilities of Equitas," he says.

In addition, according to Jack Shettle, when New York State insurance commissioner Ed Muhl permitted Lloyd's to use Equitas to assume pre-1993 liabilities, he insisted that the new trust fund indemnify the old one. So once again, institutional investors in Lloyd's seem to be unknowingly on the hook for Equitas liabilities.

Lloyd's continues to face challenges. Last year, Chatset, insurance analysts based in London, projected that Lloyd's total losses for the 1997-99 years of account would be approximately £900 million and at least six syndicates would not have sufficient funds to pay claims. What had been projected for 1997 as a £314 million profit turned into a £68 million loss. The anticipated break-even in 1998 became a projection of a £479 million loss.

As far as allegations of fraud are concerned, Lloyd's has consistently denied them. Though the plaintiffs in the Jaffry trial in London presented convincing evidence of negligence by Lloyd's agents and brokers, they were unable to prove that Lloyd's itself had committed fraud. According to Justice Peter Cresswell who tried the case, "the catalog of failings and incompetence in the 1980s by underwriters, managing agents, members' agents, and others. . . is staggering."

Meanwhile, the lawsuit brought by 250 dissident American Names against Lloyd's law firm of LeBoeuf, Lamb, Greene & MacRae is expected to go to court later this year. And the U.S. Department of Justice investigation of Lloyd's for mail fraud continues.

"We absolutely co-operate with the U.S. Attorney's office," Lloyd's current chairman, Max Taylor, told *Time* magazine late last year after the Jaffray verdict. "They are pursuing some of the same issues as were being pursued in the Jaffray case. They are, of course, getting the same information as was presented in the Jaffray case. We are co-operating with them fully and we will certainly expect them to come to the same conclusion as Judge Cresswell has come to given that they are dealing with the same facts."

Steven Sullivan is editor of *Contingencies*. Angie Moore assisted in the preparation of this article.