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# Proposed Equitas Transaction with Berkshire Hathaway: What Does It Mean for Lloyd's Policyholders?

On October 20, 2006, Equitas Ltd. and Berkshire Hathaway Inc. announced a landmark transaction under which a Berkshire Hathaway entity would initially reinsure the pre-1993 Lloyd's coverage obligations that are currently being reinsured and run off by Equitas Ltd. Subsequently, those obligations would be transferred in their entirety to a new entity so that they were no longer the responsibility of Lloyd's Names.

In 1996, Equitas was established to address all 1992 and prior (non-life) insurance business that had been underwritten by Names participating in Lloyd's syndicates. At that time, because of a proliferation of long-tail claims, various internal scandals and other financial problems, the Lloyd's syndicates had been unable to respond fully to mounting policyholder claims being made against the pre-1993 Lloyd's policies. Equitas was formed to effectuate a market-wide reinsurance-to-close transaction in which Equitas reinsured the coverage obligations of the pre-1993 Lloyd's policies and agreed to act as the runoff agent to handle and resolve all pending and future coverage claims against those policies. Equitas was established with initial capital of about £16 billion, which was funded from assets of the reinsured Lloyd's syndicates, as well as from monies provided by other stakeholders in the Lloyd's Enterprise .

For the past ten years, Equitas has been running off coverage claims pending against the pre-1993 Lloyd's policies, many of which involved long-tail asbestos, pollution and health-hazard ("APH") claims. Equitas now proposes its two-phase transaction to implement its end-game strategy by entering into an agreement with Berkshire Hathaway, which would ultimately terminate the ongoing liability of Names who had invested in the Lloyd's syndicates that issued the pre-1993 Lloyd's policies. The first phase of the transaction is scheduled for completion by March 31, 2007, with the second phase targeted to be completed by 2009. This proposed transaction will require regulatory approvals both in the U.K. and the U.S. as well as approval by the High Court in England . Lloyd's policyholders should consider whether they wish to become involved in these legal and regulatory approval proceedings so as to protect their rights and interests under their Lloyd's policies.

## SUMMARY OF THE PROPOSED TRANSACTION

The key aspects of the proposed Equitas-Berkshire Hathaway transaction are as follows: In the first phase, the Berkshire Hathaway unit, National Indemnity Company, will provide reinsurance coverage to Equitas in an initial amount of $5.7 billion (£3 billion) over and above Equitas' March 2006 reserves of $8.7 billion (£4.6 billion) minus adjustments for payments and recoveries since that date. Thus, the total limit of the reinsurance being afforded to Equitas by National Indemnity would be approximately $14.4 billion (£ 7.6 billion), as adjusted. In exchange for receiving the $14.4 billion of reinsurance cover, Equitas will transfer to National Indemnity the entirety of its approximately $8.7 billion in assets, minus $319.2 million (£172 million), which amount Equitas will retain for continued operating expenses, severance payments, etc. The corporation of Lloyd's will also contribute a reinsurance premium to National Indemnity of $133.6 million

(£72 million) as additional consideration for the reinsurance being provided by National Indemnity. This first-phase transaction should operate like a traditional retrocession agreement.

The proposed second phase of the transaction, however, is quite different than the first phase. In the second phase, Equitas will seek approval of the English High Court to transfer (not just reinsure) the coverage obligations of the pre-1993 Lloyd's policies to Equitas or to a Berkshire Hathaway entity. Those obligations would be transferred away from the Names in the Lloyd's syndicates that presently retain the original coverage responsibility for these policies "down to their last cufflink." If such a transfer is permitted by the High Court, it would operate like a "novation," under which the reinsured Names would no longer have any responsibility for the coverage under the pre-1993 Lloyd's policies. Instead, a policyholder's only recourse for coverage would be the assets of the entity (whether Equitas or a Berkshire Hathaway company) to which the coverage responsibility has been transferred. Before the second phase of the transaction may be implemented, however, a change in English law must be enacted which would enable Names who ceased underwriting at Lloyd's prior to 1996 to take advantage of a 2000 Act that permits the transfer of insurance business, upon High Court approval.

If the second phase transfer is approved by the English High Court and other insurance regulatory bodies such that the transfer takes place before the end of 2009, National Indemnity will provide an additional $1.3 billion (£685 million) of reinsurance limits for the pre-1993 Lloyd's business in exchange for a further premium of $76 million (£40 million). Also at the time of such transfer, or on December 31, 2009, if a transfer has not occurred, the corporation of Lloyd's will pay an additional premium of $34 million (£18 million).

## SIGNIFICANCE FOR POLICYHOLDERS

This transaction is a significant development for all persons and entities who possess pre-1993 insurance policies issued by Lloyd's. The following is a brief summary of issues for policyholders to consider in deciding how to react to the proposed transaction.

### Security for Payment of Claims

On the surface, the proposed transaction appears to provide greater security for the ultimate payment of claims of Lloyd's policyholders given that Berkshire Hathaway, and its National Indemnity subsidiary, are much more financially stable entities than Equitas and given that Berkshire Hathaway is committing at least an additional $5.7 billion—and possibly as much as $7 billion—in assets to pay claims over and above the assets that otherwise are currently available to Equitas. Indeed, Equitas has always been a financially unstable entity. Its most recent financial statements, as of March 31, 2006, reported a surplus of only $870 million (£458 million), and it has a solvency margin of only 12%. Thus, a retrocession agreement between Equitas and a more stable and solvent Berkshire Hathaway entity, under which an additional $5.7 billion of assets are made available to Lloyd's policyholders—as contemplated under the first phase of the transaction—would seem to be a no-lose proposition for Lloyd's policyholders. After all, policyholders would have the benefit of an additional $5.7 billion of readily available cash as security for payment of claims, while still retaining recourse to Lloyd's Names if this amount of cash proved insufficient.

The more interesting question regarding security for payment of claims arises from the second phase of the proposed transaction, which purports to be a novation under which the ultimate liability of Lloyd's Names for the relevant Lloyd's coverage obligations would be extinguished and, thereafter, the only recourse available to the policyholders would be the assets of the corporate entity to which primary responsibility would be transferred and novated. If the second phase is completed, all of the Lloyd's Names—and indeed the entire Lloyd's enterprise—presumably would be legally released from any further coverage obligations under pre-1993 Lloyd's policies.

If the second phase of the proposed transaction is completed by 2009, Berkshire Hathaway has committed an additional $1.3 billion (£685 million) to pay policyholder claims over and above the $14.4 billion (£7.6 billion) made available through the first phase of the transaction. However, as a trade-off for that amount of additional readily available cash to respond to claims, Lloyd's policyholders would be giving up any recourse to Lloyd's Names and/or to the Lloyd's Enterprise if additional funds are needed to respond to future claims. Under the status quo, policyholders presently have the right to pursue the personal assets of the individual Lloyd's Names who underwrote (and reinsured-to-close) the coverage obligations under the pre-1993 Lloyd's policies to ensure full payment of their coverage claims. This right may be more theoretical than practical because those Names that are legally on the hook for these policy obligations "down to their last cufflink," to the extent they are still alive and possess any significant personal assets, have likely taken steps to shield those assets from attachment by creditors. Thus, in reality, a policyholder's loss of recourse against Lloyd's Names may not be as great as it might seem on the surface.

Nonetheless, a real loss of value to policyholders from the second phase of the proposed transaction—which must be weighed against the gain of an additional $1.3 billion (£685 million) in assets to be put forward by Berkshire Hathaway—is the potential loss of any recourse against the Lloyd's Enterprise if both the assets of Equitas and the $5.7 billion additional reinsurance limits offered by Berkshire Hathaway prove to be insufficient to pay claims. Specifically, although the coverage obligations of a Lloyd's policy purport to be the several responsibility of the individual Names who subscribe to the policy, there is a well-established tradition at Lloyd's that other members of the Lloyd's Enterprise would step in to pay a policyholder claim in the event of a default by the Names who are contractually obligated to provide coverage. Indeed, Lloyd's has historically advertised that it always pays claims in full. Thus, if a policyholder did not receive full payment on a pre-1993 Lloyd's policy because of the lack of sufficient funds available to Equitas or its reinsurers, a policyholder could bring an action against the Lloyd's Enterprise to enforce its promises of making full claims payments.[1] Yet, if the second phase of the proposed transaction is consummated, and thus the High Court consents to a complete transfer of coverage responsibility to a new entity—and a corresponding complete release of all prior obligors for such coverage responsibility—then presumably any possible recourse against the Lloyd's Enterprise in the event of a default under the relevant Lloyd's policies may be extinguished. Therefore, under the second-phase transaction, the capital of the new Berkshire Hathaway-controlled entity would be substituted for the capital of the Lloyd's Enterprise (as well as the capital of the relevant Lloyd's Names) as the ultimate security for the coverage obligations under pre-1993 Lloyd's policies. Policyholders should carefully consider this substitution of security in evaluating the proposed transaction.

[1] For a further discussion of this cause of action, *see* John M. Sylvester and Roberta D. Anderson, *Threatened Equitas Insolvency: Is the Lloyd's "Chain of Security" Really Secure?* Journal of Insurance Coverage, Vol. 5, No. 3 (Summer 2002) at 30-32.

## Impact on Claims-handling Practices Experienced by Policyholders

Under the proposed agreement, the National Indemnity unit of Berkshire Hathaway will take on the staff and operations of Equitas and handle the runoff of Equitas' liabilities. Accordingly, policyholders have a valid interest in the quality and integrity of claims handling to be provided by National Indemnity. At this stage, neither Equitas nor Berkshire Hathaway has given any indication that the claims-handling practices to be experienced by Lloyd's policyholders after the runoff responsibility is transferred to National Indemnity will be any different. Nonetheless, one must wonder whether policyholders will indeed realize a noticeable change in claims handling being implemented by National Indemnity once the first phase of the transaction is completed.

From the standpoint of Berkshire Hathaway, the presumed economic rationale for this proposed transaction is that, once National Indemnity obtains control over Equitas' $8.7 billion in reserves, it can earn substantial income on those reserves in the coming years such that it will have more-than-sufficient funds to pay out claims totalling as much as $14.4 billion, if necessary, over the life of the deal. Seemingly, the only way that National Indemnity will be able to earn significant income on the $8.7 billion reserves is to hold on to that money for a long time so that it can reap significant investment income. Presumably, Berkshire Hathaway believes that National Indemnity can earn double-digit returns on investment of the reserves—well in excess of the returns historically earned by Equitas through its conservative investment philosophy. Because National Indemnity can earn so much more on its investments, it will have a much greater economic incentive than Equitas to retain and invest money, rather than paying it out to policyholders. Given such incentives, policyholders should be wary that their claims may not be paid as promptly as they otherwise would be paid. In this regard, Lloyd's policyholders should insist that the courts and regulators reviewing this proposed transaction take steps to ensure that there will be no deterioration in the timeliness of claims payments experienced by policyholders if the transaction is approved and implemented.

## Jurisdictional Issues for U.S. Policyholders

Another claims-related aspect of the proposed transaction to consider is its effect on U.S. policyholders' rights to sue to enforce Lloyd's policy obligations. Should the second phase of the transaction be implemented, it is expected that the new entity to which coverage responsibility will be transferred will be an English-registered company. As a result, the High Court and insurance regulators should ensure that, notwithstanding this transfer, U.S. policyholders will retain the benefits afforded under the typical Service of Suit clause in their Lloyd's policies to sue the new entity in the United States over any coverage disputes arising from those policies. Specifically, under the Service of Suit clause contained in pre-1993 Lloyd's policies, Lloyd's Underwriters agreed to submit to the personal jurisdiction of any court in the United States chosen by the policyholder to bring suit under the policies. A typical version of this clause provides as follows:

It is agreed that in the event of the failure of Underwriters hereon to pay any amount claimed to be due hereunder, Underwriters hereon, at the request of the insured (or reinsured), will submit to the jurisdiction of any Court of competent jurisdiction within the United States and will comply with all requirements necessary to give such Court jurisdiction and all matters arising hereunder shall be determined in accordance with the law and practice of such Court.

Thus, in the event of a coverage dispute under a Lloyd's policy, the foregoing clause allows a U.S. policyholder to sue Lloyd's Underwriters in any court in the United States , regardless of whether that court would otherwise have personal jurisdiction over the Lloyd's Underwriters. Moreover, this provision ensures that a coverage dispute between a U.S. policyholder and Lloyd's will be adjudicated according to the laws of the United States , and not English law or some other less-favorable foreign law. For example, the laws of U.S. jurisdictions typically recognize causes of action for bad-faith insurance claims handling, which may not be legally recognized in a foreign jurisdiction. Lloyd's Underwriters have always been subject to such causes of action if they engaged in bad-faith claims-handling conduct in the United States . U.S. policyholders certainly would want the full panoply of U.S. legal rights at their disposal to enforce coverage obligations under the Lloyd's policies after any transfer takes place. Accordingly, it is critical to U.S. policyholders that their rights under the Service of Suit clause be maintained through both phases of the proposed Equitas-Berkshire Hathaway transaction.

Another important issue for U.S. policyholders is whether the funds currently being held in trust funds located in the United States for the payment of claims and judgments on Lloyd's policies will be maintained after the proposed Equitas-Berkshire Hathaway transaction is completed. These trust funds—most notably the Equitas American Trust Fund ("EATF")—are required by insurance regulators to be maintained in the United States to secure payment of claims to U.S. policyholders under pre-1993 Lloyd's policies. The public pronouncements of Equitas and Berkshire Hathaway regarding the proposed deal have not specified whether the assets currently held in these trust funds will remain. It is critical that U.S. insurance regulators ensure that these trust funds, or other suitable security, be maintained in the United States so that funds will be readily accessible to U.S. policyholders for payment of coverage claims and, if necessary, for enforcement of a court judgment rendered on a Lloyd's policy.

## Possibility of Subsequent Cut-off Scheme

Possibly the most significant impact of the proposed Equitas-Berkshire Hathaway transaction is one that has not been addressed by Equitas or Berkshire Hathaway in their public statements regarding the deal—namely, the possibility that, sometime after the transaction is completed, the entity to which coverage obligations have been transferred will enter into some type of Solvent Scheme of Arrangement, with a cut-off date for policyholders' claims submissions. These so-called "Cut-off Schemes" are familiar to Lloyd's policyholders because many English insurance companies that co-insure London Market policies along with Lloyd's have recently entered into such

Schemes. Under these Schemes, if approved by the requisite majority of creditors and the Court, a cut-off date is imposed for all policyholders to submit their coverage claims—regardless of whether those claims are ripe for resolution or, alternatively, are only based on underlying Incurred But Not Reported ("IBNR") claims which will manifest in the future but which are difficult to quantify. Under such a Scheme, all current as well as future, prospective coverage claims are assigned a value and are then liquidated within a short period of time with assets available to the company in the Scheme. Any assets that remain with the Scheme company after all claims have been paid are often distributed to the owners of the Scheme company, rather than being retained for payment of future claims.

Many policyholders with significant underlying IBNR claims have complained, with respect to certain solvent Schemes, that these Schemes should not go forward because they will be forced to commute their policy rights prematurely, at a time when those rights cannot properly be valued at the IBNR stage. Rather, these policyholders contend, their policies should remain in place in the future to address claims as they develop. Policyholder challenges in English Courts have met with some success,[2][2] but such schemes continue to be proposed and some of them continue to be approved.

In any event, if the policy obligations of all pre-1993 Lloyd's syndicates are transferred to an English company pursuant to the second-phase of the Equitas-Berkshire Hathaway transaction, presumably such English company will have the ability to take advantage of English law that allows companies to terminate their obligations through use of the Solvent Scheme mechanism. Such mechanism may not be available to Lloyd's Names who currently have coverage responsibility on these policies and, thus, this aspect of a policyholder's rights under pre-1993 Lloyd's policies may be materially affected by the Equitas-Berkshire Hathaway transaction. Accordingly, Lloyd's policyholders that have substantial IBNR claims should consider whether a transaction that could render their Lloyd's policies subject to an English Solvent Scheme of Arrangement is in their best interests.

## IMPORTANCE OF POLICYHOLDER PARTICIPATION IN THE PROCEEDINGS

The Financial Services Authority ("FSA"), which regulates insurance in the U.K. , must approve the proposed Equitas-Berkshire Hathaway transaction for it to proceed. The Financial Services and Markets Act 2000 ("FSMA 2000") permits insurers to transfer their insurance business (including liabilities), subject to having received the approval of the English High Court. An Amendment to FSMA 2000 will be necessary to permit the second phase of the transaction to go forward. Specifically, an Amendment will be required in order to permit those who ceased to be underwriting members of Lloyd's prior to December 1996 to participate in such a transfer because such Names are not legally entitled to engage in such a transfer transaction under the Act, as it currently stands. Currently, HM Treasury is seeking consultation on amendments to FSMA 2000 that would allow all Lloyd's Names to transfer their coverage responsibility to a new entity, as contemplated by the second phase of the proposed transaction. The deadline for submission of comments is January 26, 2007. Policyholders should consider whether they wish to submit comments to HM Treasury on this proposed Amendment.

If the Amendment is adopted, the transfer proposed by the second phase of the Equitas-Berkshire Hathaway transaction will be subject to Part VII of the FSMA 2000 and associated statutory instruments, which enable the High Court to approve the transfer of business carried on by certain members of Lloyd's, subject to the following conditions:

- the Council of Lloyd's must have, by resolution, authorized one person to act, in connection with the transfer for the members concerned, as transferor;
- a copy of the resolution must have been given to the FSA;
- the transferred business must be carried on from an establishment within an EEA state;

[2] This debate over the propriety of Solvent Schemes to cut off policy rights of IBNR creditors resulted in the landmark English Court decision in the British Aviation Insurance Company Ltd. Scheme. *See English Court Rejects Solvent Scheme of Arrangement Proposed by British Aviation Insurance Company Limited*, K&LNG Alert, September, 2005.

- appropriate certificates must be obtained, specifically a certificate as to solvency;
- the transferee must have the necessary regulatory authorizations; and
- the Court must consider that it is appropriate to sanction the scheme in all the circumstances.

Thus, if the Equitas-Berkshire Hathaway transaction proceeds to the second phase, there will be a hearing at the English High Court to consider approving the second-phase transfer of coverage responsibility from Lloyd's Names to the new entity designated to receive the transfer. At the Court hearing of the application for approval, the FSA and any person who alleges that he would be materially affected by the transfer is entitled to be heard. The FSA has indicated that, in deciding whether it should appear in connection with the hearing to approve the Equitas-Berkshire Hathaway transaction, it will consider the potential risk to its regulatory objectives of implementing the transaction compared to not implementing the transaction. These regulatory objectives include maintaining market confidence and the protection of consumers. It is not certain how vigorously the FSA will advocate the interests of affected Lloyd's policyholders. Nonetheless, English case law supports the right of policyholders to challenge all or parts of a proposed transfer of coverage obligations contemplated under the Equitas-Berkshire Hathaway transaction.

In conclusion, any Lloyd's policyholders whose coverage rights are implicated by this proposed Equitas-Berkshire Hathaway transaction should consider whether to become actively involved in the approval process. In this regard, K&L Gates insurance coverage lawyers in the U.S. and the U.K. are available to provide counsel to Lloyd's policyholders who believe that they have significant interests at stake in this transaction.