PRE-ANSWER SECURITY AND REINSURANCE ARBITRATIONS

By

Robert M. Hall

[*Mr. Hall is an attorney, a former insurance and reinsurance executive and acts as an insurance consultant as well as an arbitrator and mediator of insurance and reinsurance disputes. The views expressed in this article are those of the author and do not reflect the views of his clients.* *Questions or comments may be addressed to the author at bobhall@qsilver.net.]*

I. Introduction

When a reinsurer which is not licensed in the United States is involved in a reinsurance arbitration, the cedent sometimes moves that the panel order the reinsurer to deposit security for its obligations pursuant to pre-answer security statutes. Unlicenced reinsurers uniformly resist such a motion with considerable vigor. Arbitration panels, typically, do not favor such a motion unless the reinsurer demonstrably is in dire financial straits. Panels tend to react more positively, however, to a motion that the reinsurer should comply with credit for reinsurance collateralization requirements in the reinsurance contract which it executed.

There is considerable wisdom in the reluctance of panels to order collateralization of the cedent's claim against the reinsurer. However, it is not always easy to reconcile this approach with case law and/or a statute which allows or even requires collateralization under these circumstances. Arbitration clauses may absolve arbitrators from following the strict rules of law in resolving the dispute. But such language is not a license to ignore completely applicable precedent or statutes, even those with which one may disagree.

The purpose of this article is to review pre-answer security statutes and case law to determine the application of such statutes to reinsurance arbitrations and to determine any overlap with credit for reinsurance laws and regulations.

II. Pre-Answer Security Statutes

The Reinsurance Association of America publishes a Compendium of Reinsurance Laws & Regulations which includes a listing and summary of all pre-answer security statutes in the United States. According to this Compendium, only five states and the District of Columbia do not have pre-answer security statutes. Most of these statutes are based on the NAIC Model Unauthorized Insurers Process Act[1] (hereinafter "Model") which was adopted in 1949. The Model does not use the term "reinsurer" or "reinsurance" but uses the generic term "unauthorized insurer." Neither does it refer to arbitrations. The purpose and motivation for the Model is described as follows:

The purpose of this Act is to subject certain insurers to the jurisdiction of courts of this state in suits by or on behalf of beneficiaries under insurance contracts. The legislature declares that it is

a subject of concern that many residents of this state hold policies of insurance issued or delivered in this state by insurers while not authorized to do business in this state, thus presenting to these residents the often insuperable obstacle of resorting to distant forums for the purpose of asserting legal rights under these policies.[2]

As to a remedy, the Model states:

Before any unauthorized foreign or alien insurer shall file or cause to be filed any pleading in any action, suit or proceeding instituted against it, the unauthorized insurer shall deposit with the clerk of the court in which the action, suit or proceeding is pending, cash or securities or file with the clerk of the court a bond with good and sufficient sureties, to be approved by the court, in an amount to be fixed by the court sufficient to secure the payment of any final judgment which may be rendered in the action; or procure a certificate of authority to transact the business of insurance in this state.[3]

This language can be read as applying only to unauthorized primary insurers issuing insurance policies to unsophisticated consumers who should not be forced to chase such insurers back to their jurisdiction of domicile for collection of insurance proceeds.[4] It can be argued that it should not be interpreted so as to protect ceding insurers which may have other means of protection, such as security posted pursuant to credit for reinsurance laws and regulations.[5]Given the lack of involvement of any court or clerk of the court in the normal reinsurance arbitration, application of this provision to the arbitration context is cumbersome, at best. Some would argue that it was never intended to apply to such context.

Several states have adopted pre-answer security statutes which are variations on the NAIC model. New York has adopted a statute which requires that security be deposited with the court but provides that "the court may in its discretion, make an order dispensing with such deposit or bond if the superintendent certifies to it that such insurer maintains within this state funds or securities in trust or otherwise sufficient and available to satisfy any final judgment which may be entered in the proceeding . . .."[6] The Connecticut statute on point is very similar.[7]

Two methods of collateralizing reinsurance obligations for credit for reinsurance purposes are single beneficiary trusts (*i.e.* individual to each cedent) or multiple beneficiary trusts (*i.e.* one trust for all cedents). If such trusts are located within the relevant state and are sufficient to cover the dispute in question, it would seem that these trusts could be used as the required security in Connecticut or New York.

The Colorado[8]and Florida[9]variations on the Model have provisions similar to those in New York and Connecticut but which allow the assets to be located in another state. Presumably, this is to recognize that most of these trusts are located in New York banks.

California dispenses with pre-answer security for those reinsurers which comply with the collateralization requirements for that state's credit for reinsurance law.[10] This would appear to recognize, for pre-answer security purposes, not only funds held in trust but also letters of credit which is the collateralization method of choice for most unlicenced reinsurers.

Illinois, however, has rewritten the Model to specifically reference arbitration and to require a specific deposit of securities or a bond by unlicenced insurers:

Before any unauthorized foreign or alien company shall file or cause to be filed any pleading in any action or proceeding, including any arbitration, instituted against it, such unauthorized company shall either (1) deposit with the clerk of the court in which such action or proceeding is pending or with the clerk of the court in the jurisdiction in which the arbitration is pending cash or securities or file with such clerk a bond with good and sufficient sureties, to be approved by the court, in an amount to be fixed by the court sufficient to secure the payment of any final judgment which may be rendered in such action, proceeding or arbitration; or (2) . . . procure a certificate of authority . . . .[11]

This is not intended as a complete explication of the variations in pre-answer security statutes in force in 45 states. However, it does suggest that the obligations of unlicenced reinsurers to file pre-answer security can vary significantly based on the jurisdiction to which the arbitration is subject. A further complication is that arbitration agreements often do not include a specific choice of laws provision, other than the physical locale of the arbitration hearing itself. Thus, reinsurance arbitrators are provided with uncertain guidance from pre-answer security statutes.

III. Pre-Answer Security Case Law

Most of the case law on this topic is issued by New York state courts, the District Court for the Southern District of New York or the Second Circuit Court of Appeals. It is likely that such a concentration of cases results from the facts that New York remains the most prominent reinsurance business center in the United States, most reinsurance trusts are located there and because the District Court for the Southern District is the favored location for litigation of sophisticated financial industry issues.

In any case, the examination of case law will be broken into those cases which emanate from New York and the Second Circuit and those which arise elsewhere. The former group of cases seem to demonstrate a more developed body of law than the relatively few cases spread across all other jurisdictions.

A. New York and Second Circuit Cases

1. Second Circuit Cases

There are a series of four cases in the Second Circuit which speak directly to the issue of whether or not the New York pre-answer security statute applies to reinsurance disputes. The first is the seminal case of Morgan v. American Risk Management, Inc, 1990 WL 106837 (S.D.N.Y.). The receiver of Delta American Re brought suit against various retrocessionaires who sought to rescind their contracts. The retrocessionaires resisted posting security pursuant to the pre-answer security statute arguing: (a) the statute does not apply to reinsurance; (b) Delta American was not then a resident of New York and, therefore, could not utilize it; and (c) that the statute applies to coverage claims, not to actions for recission.

As to their first defense, the retrocessionaires pointed out that the pre-answer security statute is focused on "policies of insurance" delivered in the state, rather than contracts of indemnity. Thus, they argued, this is a consumer statute meant to protect consumers rather a tool for an experienced ceding company to gain leverage over a reinsurer.

The court rejected the argument that the pre-answer security statute did not apply to reinsurance. It referenced McKinney's Insurance Laws §1101(b) which states that the placement of reinsurance with an alien or foreign reinsurer shall not be considered the unauthorized practice of insurance in the state but that such reinsurers still had to comply with the pre-answer security statute. The Morgan court ruled on this point as follows:

The only language in § 1213 which lends support to defendants' theory that the section does not apply to reinsurers is the statement of legislative purpose, contained in subsection (a), that the provision was enacted to protect residents holding "policies of insurance." While a reinsurance treaty is arguably not a "policy of insurance" or even a "contract of insurance," the contention that the legislature did not intend § 1213 to apply to reinsurance must be rejected in light of the express language of § 1101(b)(2)(G).[12]

In addition, the court ruled that the pre-answer security statute could be invoked by a corporation authorized to do business in New York at the time the relevant contracts were executed and that such statute was not limited to coverage actions.[13]

The rationale of the Morgan court on application of the pre-answer security statute to reinsurance was followed in the second case in this series, American Centennial Ins. Co. v Seguros la Republica, S.A., 1992 WL 162770 (S.D.N.Y.). In addition, the court summarily ruled that the statute did not violate the reinsurer's due process rights.

The third in the series of cases on the application of New York's pre-answer security statute to reinsurance is Skandia America Reinsurance Corp. v. Caja Nacional de Ahorro y Seguros,1997 WL 278054 (S.D.N.Y.) In this case, the court merely followed an earlier decision of the New York Court of Appeals[14] that the pre-answer security statute was valid and then applied it to an unlicenced reinsurer which was attempting avoid the result of an adverse order by an arbitration panel.

The fourth case in this series is British International Ins. Co. Ltd. v. Seguros la Republica, S.A., 212 F.3d 138 (2nd Cir.2000). The unlicenced reinsurer appealed from a default judgment arguing that the New York pre-answer security statute did not apply to reinsurance but if it did, it violated due process as a pre-judgment attachment of assets. The court followed Morgan, *supra*, in rejecting the reinsurer's first defense but accepted the reinsurer's argument that pre-answer security is a form of pre-judgment attachment. Nonetheless, the court found no violation of due process: (a) noting the statute allows the reinsurer an opportunity to be heard before its imposition; (b) because the statute is a regulatory requirement: and (c) because the reinsurer has the option to become licenced and avoid the statute's ambit. Moreover, there is a strong public interest in favor of pre-answer security:

In the instant case, by contract, New York State shares with its citizens a significant interest in ensuring that business in the heavily regulated insurance industry have sufficient funds within the state where they conduct business to fulfill each individual insurance claim. In short, the State interest at stake in the enactment of § 1213's security requirement is far more substantial than that involved in the enactment and enforcement of traditional prejudgment attachment statutes, because it reflects the collective importance of the regulation to each of its citizens.[15]

John Hancock Prop. and Cas. Ins. Co. v. Universale Reinsurance Co., 147 F.R.D. 40 (S.D.N.Y.1993) represents an attempt to parse the language of the New York pre-answer security statute to avoid its application. The reinsurer argued that § 1213 required a delivery of a policy of insurance in the state of New York to make it applicable. The court read together this statute and § 1101(b)(2) (see discussion of Morgan, *supra*) to conclude that transactions effected by mail from outside the state qualified for pre-answer security.

One of the few cases vacating a panel award of security is Home Indemnity Co. v. Affiliated Food Distributers, Inc., 1998 WL 318657 (S.D.N.Y.). The arbitration panel conditioned the insured's right to discovery on the insured posting security. This case did not turn on the pre-answer security statute. The insured argued that such a condition violated the proceeding's fundamental fairness because the panel made no review of the merits of the claim prior to ordering security. The court agreed stating: "Requiring a half million dollars in security solely on the basis of a printed billing statement from a party facing counterclaims that equal or exceed the amount billed constitutes fundamental unfairness in any forum, regardless of the risks of arbitration agreed to by both parties."[16]

The prior case should be contrasted with Atlas Assurance Co. of America, 1991 WL 4741 (S.D.N.Y.) which is another non-statutory case where the argument was a lack of fundamental fairness. The panel ordered the reinsurer to place funds in escrow pending the results of an audit. The court found no violation of the fundamental fairness principles:

Under the circumstances, the relief ordered, *i.e.*, the placement of the disputed amount into an interest-bearing escrow account, represents a reasonable interim step until ACIC's requested audit is complete. The order, especially as presently constituted, represents no risk or penalty upon ACIC, and no final adjudication on the merits of the case; if ACIC's audit reveals improprieties in Atlas' books such that ACIC does not actually owe money as alleged, those funds, with interest, will presumably be taken from escrow and returned to it.[17]

The final in the series of Second Circuit cases is British Ins. Co. of Cayman v. Water Street Ins. Co., Ltd., 93 F.Supp. 506 (S.D.N.Y.2000) in which the arbitration panel ordered security based on written submissions. Initially, the reinsurer argued that the New York pre-answer security statute did not apply but if it did, the panel ignored its due process requirement. In addition, the reinsurer argued that the panel was guilty of misconduct and manifested evident partiality. The court rejected the first defense:

However, by focusing on the technical requirements of this one statute, defendant's argument overlooks the essence of arbitration. . . Courts in this Circuit have firmly established the principle that arbitrators operating pursuant to such provisions have the authority to order interim relief in

order to prevent their final award from becoming meaningless. . . As such, the panel's failure to follow the provisions of N.Y. Insurance Law § 1213 cannot be characterized as "manifest disregard." . . The evidence of Water Street's history of financial and geographical maneuvers clearly raises the specter that any final award could be rendered meaningless. [citation omitted] In addition, *despite the fact that N.Y. Insurance Law § 1213 may not, by itself, apply to this case,* it does provide a precedent in law for the arbitrators to find that the amount in controversy is a proper measure of a permissible amount at which to set the security. (emphasis added).[18]

The court's indecision about the application of the New York pre-answer security statute to this case is a bit curious but may be attributable to the fact that the Second Circuit ruling on point in British International Ins. Co. Ltd. v. Seguros la Republica, S.A., *supra,* was handed down approximately a week later.

The other grounds for the vacation sought by the reinsurer were also rejected. Although not given an oral hearing, the reinsurer had the opportunity to put its case to the panel in writing and due process does not require the panel to hear all possible evidence or allow oral argument. The court was somewhat troubled by the panel's failure to consider the merits of the reinsurer's defenses prior to ordering security but ruled that the parties had agreed contractually to relieve the panel of such judicial formalities. Finally, the court ruled that the reinsurer had not met the high standard of proof necessary to show evident partiality.[19]

2. New York State Court Cases

Travelers Ins. Co. v. Underwriting Members of Lloyd's, 659 N.Y.S.2d 11 (Sup.Ct.App.Div.1997) was a motion practice ruling concerning the authority of the court to grant the cedent's motion to require pre-answer security under the applicable New York statute. The court found that the reinsurer did not properly preserve the jurisdictional objection and, therefore, admitted jurisdiction by its answer.

A more substantive exploration of the subject is presented by Curiale v. Ardra Ins. Co. Ltd., 667 N.E.2d 663 (N.Y.1996). The liquidator of a domestic cedent sued an offshore reinsurer for recoverables and moved for a default when the reinsurer's answer was not accompanied by security pursuant to the pre-answer security statute. The reinsurer did not have sufficient assets to post full security and argued that a default on such basis was a violation of due process. The court found that the relevant statute clearly required security under these circumstances and that the public interest on which the statute is based overcomes due process arguments:

Taken to its logical conclusion, [the reinsurer's] position would eviscerate the Legislature's policy, as embodied in the Insurance Law, of ensuring the availability of funds within the State to pay losses on insurance policies issued here. Such a result is not required by notions of procedural due process, especially since the ability to conduct insurance business free from legitimate government regulation is not a constitutionally protected property or liberty interest.[20]

B. Cases from Other Jurisdictions

Only two cases from another jurisdiction involve a pre-answer security statute. One of these cases is International Surplus Lines Ins. Co. v. Certain Underwriters at Lloyd's, 868 F.Supp. 923 (S.D.Ohio 1994) which interpreted an Ohio statute which was almost identical to the NAIC Model and required deposit of assets with the clerk of the court in Ohio. Lloyd's argued that the Lloyd's American Trust Fund should be sufficient security. The court found that the Lloyd's American Trust Fund did not comply with the statute:

The Court agrees with the Plaintiff that the aim of Section 3901.18 is to place in the Court's custody assets sufficient to satisfy and judgment rendered in order to facilitate a plaintiff's ability to enforce a judgment. Accordingly, the Court finds that the existence of the Lloyd's trust does not excuse the Lloyd's Defendants from posting a bond.[21]

The court found, however, that the security posted need not include known but unpaid claims or incurred but not reported claims[22]

The other case in this category involving a pre-answer statute is International Ins. Co. v. Caja Nacional de Ahorro y Seguro, 2001 WL 322005 (N.D.Ill.). In this case the cedent obtained a default arbitration award and sought court confirmation. When the reinsurer opposed confirmation, the cedent asked for security pursuant to the Illinois pre-answer security statute. The reinsurer claimed that it was exempted from compliance with the Illinois statute pursuant to the Foreign Sovereign Immunity Act ("FSIA") since it was an instrumentality of Argentina. The court, however, found that the FSIA is subject to the Convention on the Recognition of Arbitral Awards which authorizes the court to require security upon the application to set aside an arbitration award.[23]

Pacific Reinsurance Management Corp. v. Ohio Reinsurance Corp., 935 F.2d 1019 (9th Cir.1991) did not involve a pre-answer security statute. This was a dispute between a reinsurance pool manager and members of the pool. The arbitration panel ordered the members to escrow balances allegedly due from the members to the manager. The members of the pool challenged the authority of the panel to order the escrow and the amount of assets to be placed in the escrow. The court noted that there was evidence to support the amount of assets ordered to be placed in escrow by the panel and that the court would not second-guess the panel's finding on this issue. In addition, the court ruled: "We hold that the [escrow order] did not exceed the arbitrators' powers, was not tainted by the alleged misbehavior and was not issued in manifest disregard of law or fact. Therefore, we affirm the district court's confirmation of the [escrow]."[24]

One of the few reported cases in which a court found that the panel did not have the authority to require security is Recyclers Ins. Group, Ltd. v. Ins. Co. of North America, 2992 WL 150662 (E.D.Pa.1992). The arbitration clause in the relevant treaty did not list the remedies which might be granted by the panel but there was a clause requiring the reinsurer to provide security to the cedent for unpaid claims for credit for reinsurance purposes. When the reinsurer demanded arbitration, the cedent counterclaimed for security. The panel granted security and the reinsurer sought court intervention on the basis that the panel had exceeded its powers. The court ruled for the reinsurer holding:

I conclude, however, that in this case the panel's award cannot be rationally derived from the terms of the Reinsurance Agreement. . . . [N]owhere in the Agreement, whether in the arbitration clause or elsewhere, is it stated that the arbitration panel has the authority to require a party to post security as a condition to having its claims resolved by the panel or while the claims are being arbitrated.[25]

Four years later, the same court handed down a decision diametrically opposed to the Recyclers decision, notwithstanding the similarity of the facts. Meadows Indem. Co. Ltd. v. Arkwright Mutual Ins. Co., 1996 WL 557513 (E.D.Pa.). The arbitration panel ordered pre-hearing security, the contract required collateralization of unpaid claims for credit for reinsurance purposes and the arbitration clause did not specifically authorize the panel to grant security as a remedy. The court rejected the rationale of the Recyclers court that a specific grant of authority for security was necessary and upheld the panel's order:

The Treaty neither expressly authorizes the arbitrators to impose pre-hearing security measures nor prevents them from doing so. It does not enumerate specific remedies that the arbitrators could impose. The Treaty grants the arbitrators broad powers without limiting those powers in any way, even though they easily could have done so. . . [T]he court finds that Meadows and Arkwright empowered the arbitrators to award relief in any reasonable form or at any stage in the proceeding. . . The court also finds that the arbitrators chose a reasonable method to protect Arkwright's stake in the controversy. . . Because the arbitrators' award was neither in manifest disregard of the Treaty nor completely irrational, the court must confirm the award.[26]

Yasuda Fire & Marine Ins. Co. v Continental Casualty Co., 37 F.3d 345 (7th Cir.1994) involved a security order issued by the arbitration panel at the organizational meeting with a petition to the court that the panel had exceeded its authority. This decision was handed down after the Recyclers but before the Meadows decisions, *supra*, and involved similarly worded reinsurance treaties. The court rejected the Recyclers rationale and found that the panel did not exceed its authority:

While no provision of the agreement explicitly provides that the arbitrator may require Yasuda to post a letter of credit as interim relief pending final arbitration, no article of the agreement precludes that sort of remedy. In fact, as mentioned above, Yasuda and CNA contemplated that letters of credit were appropriate instruments of security in this transaction. . . To this extent, the arbitration panel acted consistently with the agreement in an even broader sense: to protect the bargain giving rise to the dispute.[27]

IV. Credit for Reinsurance Laws

Every state has adopted laws and/or regulations which are designed to determine the circumstances under which a ceding insurer can take credit on its financial statement for the reinsurance it has purchased. The purpose of such laws is to provide a reasonable measure of assurance that reinsurance proceeds will be paid when due. In order to provide such assurance, reinsurers which are not licensed in the United States are required to post collateral in the form of a letter of credit or a trust fund.[28] The cedent can take credit on its financial statement for outstanding losses, including IBNR, to the extent of the collateral posted by its reinsurer.

Few would argue that credit for reinsurance collateralization devices work perfectly in all instances.[29] Some might contend that there are significant flaws in some of the devices. For instance, multiple beneficiary trusts generally are much less liquid that letters of credit and single beneficiary trusts since a creditor has access to funds only after obtaining a judgment and providing thirty days notice. The Lloyd's multiple beneficiary trusts are on a several rather than joint basis and there is no guarantee that the names against which a cedent obtains a judgment will have any funds in the trust when the cedent obtains a judgment. [30] Nonetheless, credit for reinsurance laws and regulations are debated vigorously by the industry, are scrutinized by regulators at the NAIC and at the individual state level and are enacted by state legislatures. As a result, it can be argued that credit for reinsurance laws and regulations: (a) are the framework specifically intended to secure reinsurance recoverables; (b) have been vetted by all interested parties; and (c) render pre-answer security laws redundant to the extent that they apply to reinsurance.

V. Conclusion

While 45 states have pre-answer security laws, it is open to argument whether those laws which are very similar to the NAIC Model were intended to apply to reinsurance arbitrations. Some states (*i.e.* New York) have adopted variations on the Model to make such a connection to more clear. There is very little case law on pre-answer security statutes other than those cases which interpret the New York statute.

In general, case law confirms that an arbitration panel has the authority to order security at an early stage in an arbitration based on its inherent power to find proper remedies to prevent the prevailing party from losing the benefit of its victory. Thus, ordering security only when a party is in financial extremis is well suited to this end.

The substantial duplication created by credit for reinsurance collateralization devices and pre-answer security statutes, however, remains a problem for the courts as well as for arbitration panels considering all applicable law. From a legislative standpoint, perhaps the best means of harmonizing these laws is to adopt the California approach[31] which is to waive pre-answer security to the extent that the reinsurer is in compliance with its collateralization obligations under credit for reinsurance laws. If there are flaws in the credit for reinsurance security devices, these flaws should be addressed directly rather than through a redundant system of pre-answer security.

ENDNOTES

---

[1] . NAIC Model Laws, Regulations and Guidelines at 850-1.

[2] . *Id*. § 1.

[3] . *Id*. at § 3. A.

[4] . The counter argument is that reinsurance is a subset of insurance and that a statutory reference to "insurer" should be read as including "reinsurer" unless the context demonstrates otherwise.

[5] . *See* § IV, *infra*.

[6] . McKinney's Insurance Law § 1213 (c)(1)(A).

[7] . CT ST § 38a-27.

[8] . CO ST § 10-3-1004 (1)(a).

[9] . FL ST § 626.908(1)(b).

[10] . CA ISN § 1620 (3).

[11] . IL ST CH 215 § 5/123(5).

[12] . 1990 WL 106837 *6.

[13] . *Id*. at *7-8.

[14] . Curaile v. Ardra Ins. Co., 644 N.E.2d 663 (N.Y.1966). *See* § III(A)(2), *infra*.

[15] . 212 F.3d at 143.

[16] . 1998 WL 318657 *3.

[17] . 1991 WL 4741 *2.

[18] . 93 F.Supp. at 516.

[19] . *Id*. at 517-20.

[20] . 667 N.E.2d at 669.

[21] . 868 F.Supp. at 927.

[22] . *Id*. at 928.

[23] . 2001 WL 322005 *2.

[24] . 935 F.2d 1019 at 1026.

[25] . 1992 WL 150662 *5.

[26] . 1996 WL 557513 *4.

[27] . 37 F.3d. at 351.

[28] . *See generally* Robert M. Hall, "Unfinished Business: Credit for Reinsurance," 91 Best's Rev. at 75 (1991).

[29] . *See generally* Robert M. Hall "Drawing Down Letters of Credit in an Insurer Receivership Context," XI Mealey's Insol. Rpt. No. 21 at 22 (2000)..

[30] . *See generally* Robert M. Hall, "Changes to Lloyd's U.S. Trust Funds: Considerable Improvement Noted," Int'l J. of Ins. Law P. 3, 204 (1996).

[31] . *See* § II, *supra*.