EXECUTIVE SUMMARY

OVERVIEW OF 11 U.S.C. ' 304

The philosophy of ' 304 of the U.S. Bankruptcy Code, enacted in 1978, is to aid foreign courts and accommodate the increasing number of foreign insolvency proceedings having extraterritorial effects within the U.S.

U.S. courts have held that a foreign representative may obtain nationwide injunctive relief in the U.S. by filing a ' 304 petition in the district where the alien=s principal U.S. place of business is conducted or where its principal assets are located. Injunctive relief encompasses the stay of actions against the debtor, including arbitration and the exercise of setoffs against its property, and the turnover of the debtor=s property to its foreign jurisdiction of domicile.

REGULATORY CONCERNS

Regulators have recently expressed concern that ' 304 may serve to undermine U.S. credit for reinsurance and surplus lines laws. The several reported cases demonstrate that the effect given recent ' 304 petitions is inconsistent with the philosophy of insurance regulatory laws.

Although regulators have expressed concern about the application of ' 304 with respect to letters of credit, it appears that most cases affecting U.S. located assets have been in the context of multiple creditor trust agreements.

EFFECT OF ' 304 ON COLLATERAL PROVIDED PURSUANT TO U.S. REGULATORY LAWS

Reversionary Interest

In a case involving an insolvent Panamanian reinsurer, the U.S. district

court held that the reinsurer had only a reversionary interest in the trust fund. A stay with respect to the funds claimed by U.S. creditors was improper and was upheld only with respect to the reinsurer=s reversionary interest. (Note that despite the explicit wording of the trust agreement, the reinsurer argued that only direct policyholders had a right to claim against the trust, not ceding insurers. The court did not reach this issue.)

APolicyholder@ and Other Trust Terms

In a case involving an insolvent Israeli reinsurer to repatriate the corpus of a trust funded by a LOC, the reinsurer claimed that the ceding insurer was not a beneficiary of the trust despite the fact that the reinsurer established the trust and wrote no U.S. direct business.

Many credit for reinsurance trusts refer only to Apolicyholders@ and not to ceding insurers. This is true in the Lloyd=s Ameircan Trust Deed and the Gibralter Casualty Trust Agreement which are reviewed in the materials.

Customary Trust Restrictions

Additionally, many credit for reinsurance trusts contain four conditions that must be met before a U.S. creditor can enforce a claim against the trust: a judgement from a U.S. court, expiration of the appeal period, a certified copy of the judgment, and the expiration of a 30-day period during which the judgment is not paid.

In a decision concerning an insolvent Bermudian reinsurer, the court held that the filing of the Bermuda receivership petition appeared to halt the running of

the 30-day waiting period to obtain assets from the trust and permitted the entire trust to be returned to Bermuda. The court noted that Bermudian law would apply to the 30-day issue, possibly resulting in no legitimate U.S. beneficiaries of the trust and the return of the trust assets to the estate for distribution to all creditors.

ADDITIONAL RESTRICTIONS NOT CONTEMPLATED BY TRUST AGREEMENTS

In the case previously noted involving the Israeli reinsurer, the court acknowledged that U.S. claims exceeded the assets of the U.S. trust but nonetheless required that U.S. creditors had to prove their claims in Israel before resorting to the trust.

Despite the fact that trust agreements securing U.S. liabilities explicitly provide for payment from the trusts on a first-come-first-paid basis, U.S. federal courts have approved the turnover of assets or distribution of these trusts based on a pro rata basis.

Additional restrictions have been placed upon creditors= rights to access these trusts including the imposition of a requirement that U.S. creditors litigate and arbitrate against other parties before exercising litigation or arbitration rights against the alien debtor or otherwise accessing their rights to the U.S. trusts.

FEDERAL LEGISLATION

The obvious and straightforward resolution of the problem is amendment of ' 304. Proposed language is included in the materials.

It is noted that other industries (e.g., swap and derivatives dealers and banks) have expressed significant problems with the application of ' 304 and may prefer an amendment that resolves their concerns, not just those of the insurance and reinsurance industry.

Disadvantages to a federal solution involve possible opposition from bankruptcy practitioners, a lack of interest by Congress and expediency.

STATE LEGISLATION

Various issues are raised when considering a state legislation option including whether a state can require the waiver of a federal privilege.

Although most state-mandated waivers of federal rights are invalid, the application of the McCarran-Ferguson Act to insurance and reinsurance effects a different result. McCarran-Fergusen results in a reverse preemption, upholding a state=s right to require an alien insurer or reinsurer to waive ' 304 protections.

State legislation could require, in the reinsurance context, that an alien reinsurer include a waiver of ' 304 in its contract and/or trust agreement in order for the ceding insurer to take credit for ceded reinsurance. Alternatively, it appears that state law could require that in all situations where credit is taken, waiver of ' 304 by the alien reinsurer is an implied term of the reinsurance contract or the trust agreement securing liabilities under the contract.

Likewise, state legislation, in the surplus lines context could require waiver of ' 304 or imply it as a condition of doing business in the U.S.

THE EFFECT OF BANKRUPTCY CODE SECTION 304 ON FUNDS REQUIRED PURSUANT TO U.S. INSURANCE REGULATORY LAW

A. INTRODUCTION

The following is intended to be a summary of some of the decisions which have affected intended beneficiaries of funds provided by alien insurers and reinsurers for the protection of U.S. policyholders and ceding insurers, pursuant to U.S. regulatory laws. This summary is intended for illustrative purposes and is not an exhaustive list or analysis of all U.S. caselaw in existence regarding this subject matter.

This material is provided as a resource to U.S. regulators and interested parties in current discussions regarding the effect of ' 304 and whether it may undermine the goals of U.S. regulators in establishing standards by which alien insurers and reinsurers may conduct business in the U.S.

B. BACKGROUND OF ' 304

1. *Philosophy of Bankruptcy Code Amendment*

Section 304 of the U.S. Bankruptcy Code was specifically enacted as part of the Bankruptcy Reform Act of 1978 Ato address complex and increasingly important problems involving the legal effect the United States courts give to foreign bankruptcy proceedings@ and to foster international cooperation in the administration of bankruptcy estates.[1] In enacting ' 304, Congress provided a mechanism for the courts in this country to aid foreign courts and accommodate the increasing number of foreign insolvency proceedings having extraterritorial effects within the U.S.[2]

2. *A Foreign Representative of a Foreign Proceeding May File Petition*

The Aforeign representative@ who must file a petition under ' 304 is defined as a Aduly selected trustee, administrator, or other representative of an estate in a foreign proceeding.[3]

Having determined that the petition has been filed by a proper representative, the court must determine if the foreign insolvency proceeding constitutes a proper Aforeign proceeding.@ AForeign proceeding@ is defined in the Bankruptcy Code as a

> proceeding, whether judicial or administrative and whether or not under bankruptcy law, in a foreign country in which the debtor=s domicile, residence, principal place of business, or principal assets were located at the commencement of such proceeding, for the purpose of liquidating an estate, adjusting debts by composition, extension, or discharge, or effecting a reorganization.[4]

3. *Relief Available*

Section 304(b), which enumerates the relief available under this section provides:

> (b) Subject to the provisions of subsection (c) of this section, if a party in interest does not timely controvert the petition, or after trial, the court may --
>
> (1) enjoin the commencement or continuation of --
>
> (A) any action against --
>
> (i) a debtor with respect to property involved in such foreign proceeding; or
>
> (ii) such property; or
>
> (B) the enforcement of any judgment against the debtor with respect to such property, or any act or

> the commencement or continuation of any judicial proceeding to create or enforce a lien against the property of such estate;
> (2) order turnover of the property of such estate, or the proceeds of such property, to such foreign representative; or
> (3) order other appropriate relief.[5]

Thus, ' 304 not only provides relief to the debtor from ongoing U.S. litigation, it allows the bankruptcy court to enjoin attachment of assets or creation of liens and authorizes the court to order the turnover of assets to the alien jurisdiction.

Typical ' 304 injunctive language reads as follows:

> Ordered that all persons and entities are enjoined and restrained from . .
>
> > (b) commencing or continuing any action or other legal proceeding (*including, without limitation, arbitration*, or any judicial, quasi-judicial, *administrative or regulatory action, proceeding or process whatsoever*) against the [debtor] or any of [its] property in the United States, or proceeds thereof;
> >
> > (c) enforcing any judicial, quasi-judicial, administrative or *regulatory judgment, assessment or order or any arbitration award,* and commencing or continuing any act or any action or other legal proceeding (including, without limitation, arbitration, or any judicial, quasi-judicial, administrative or regulatory action, proceeding or process whatsoever) to create, perfect or enforce any lien, *set-off* or other claim against the [debtor] or any of [its] property in the United States or any proceeds thereof, *including, without limitation, rights under reinsurance contracts;* and
> >
> > (d) *drawing down any letter of credit* established by [the debtor], or withdrawing from, setting off against, or

> otherwise applying property that is the subject of any escrow agreement or similar arrangement, *in excess of what is expressly authorized by the terms of the contract* and any related trust or other agreement pursuant to which such letter of credit, escrow, or similar arrangement has been established. . .[6] (emphasis added)

4. *Venue of Case*

Venue for a ' 304 proceeding is governed by 28 U.S.C. 1410 which provides that a ' 304 petition

(a) to enjoin commencement, continuation or enforcement of an action or judgment may be commenced only in the district court where the action is pending.

(b) to enjoin enforcement of a lien or require turnover of property may be commenced only in the district court where the property is located.

(c) to obtain relief other than that specified in (a) or (b), may be commenced only in the district of the debtor=s U.S. principal place of business or the principal location of U.S. assets.

While some bankruptcy commentators have claimed that a foreign representative must bring a separate action in every jurisdiction where relief is sought,[7] two recent insurance cases have held that nationwide injunctions can be obtained, similar to the bankruptcy automatic stay, by commencing a proceeding where the debtor=s principal assets or business can be found.[8]

Once a ' 304 petition is filed, the bankruptcy court is directed to determine whether to grant relief under ' 304(b) by considering Awhat will best assure an economical and expeditious administration of such estate@ consistent with six factors:

(1) just treatment of all holders of claims against or interest in such estate;

(2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding;

(3) prevention of preferential or fraudulent dispositions of property of such estate;

(4) distribution of proceeds of such estate substantially in accordance with the order prescribed by this title;

(5) comity; and

(6) if appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns.[9]

C. FOCUS OF REGULATORY CONCERNS

Provisional liquidators of a number of alien insurers and reinsurers have now successfully invoked ' 304 to obtain broad, preliminary and permanent injunctive orders enjoining the

initiation or continuance of actions against the alien debtors and, in some cases, the return of trust assets to the alien=s domiciliary jurisdiction.

Recently, U.S. regulators have voiced concern over ' 304 actions and the perception that the Bankruptcy Code may undermine state credit for reinsurance laws.[10]

Some have focused their concerns on letters of credit. The following material will illustrate that ' 304 has affected trust funds to a greater extent than letters of credit.

Certain representatives in the industry have noted that the regulators= concerns are misplaced, claiming that ' 304 does not interfere with state credit

laws. The following material indicates that the manner in which trusts are analyzed by bankruptcy courts does appear to alter the intent of U.S. regulatory laws and presents significant obstacles to the concept that U.S. creditors should have an efficient means of accessing collateral provided for their benefit, particularly in the event of the insolvency of the alien company.

D. EFFECT OF ' 304 ON U.S. COLLATERAL PROVIDED TO SECURE RECOVERIES FROM ALIEN INSURERS AND REINSURERS

The following is a summary of some decisions which have affected the ability of U.S. policyholders or reinsureds to access collateral that has been provided by alien insurers and reinsurers for their benefit. As stated in the introduction, this is intended to be illustrative and is not an exhaustive list of relevant cases.

In this section, there are references to two trust fund documents -- the Lloyd=s American Trust Deed and the Gibralter Casualty Company Trust Agreement. These documents are referenced for illustrative purposes only and use of the documents is not intended to focus attention on either entity or to imply that either entity is financially insecure or has issued uniquely deficient documents. In fact, these trust documents are referenced because they contain typical clauses that are widely in use in the marketplace.

The following materials focus on some of the relevant problems introduced in ' 304 cases involving insolvent alien insurance or reinsurance debtors, including:

- X The interest that an alien debtor=s estate has in letters of credit or trust funds provided to secure U.S. liabilities.
- X The effect that the term Apolicyholders@ has on the ability of a reinsured to access collateral securing reinsurance recoverables.

- X The effect that typical trust fund restrictions, i.e., the requirement that 30 days expire before recovering a judgment, have upon bankruptcy courts= analyses.

- X The imposition of additional restrictions upon a U.S. creditor=s right to recover funds including: filing and proving a claim in a foreign jurisdiction, subjecting U.S. creditors to foreign law, imposing pro rata distribution restrictions inconsistent with the terms of a trust agreement, and requiring arbitration with other parties before perfecting a claim against the trust.

1. *Letters of Credit and Reversionary Interest in a Trust*

On December 10, 1991, Latino Americano de Reaseguros, S.A. (LARSA), an insolvent Panamanian reinsurance company being reorganized under the laws of Panama, filed a ' 304 petition to enjoin two lawsuits brought by Insurance Company of Hannover (Hannover). Both lawsuits arose from LARSA=s failure to meet its reinsurance contract obligations to Hannover.[11]

Hannover had entered into reinsurance agreements with LARSA and in the customary manner, secured LARSA=s reinsurance obligations with a clean and irrevocable letter of credit (LOC). The LOC was issued by Banco Cafetero (Panama) S.A., a Panamanian bank. When

Hannover drew on the LOC, Banco Cafetero refused payment thereby forcing Hannover to file suit against the bank seeking the proceeds of the LOC.

Hannover also believed that LARSA=s reinsurance obligations were secured by assets held in a trust at Citibank, New York, for the benefit of Hannover and other U.S. reinsureds. When LARSA refused to pay Hannover amounts due under the reinsurance agreements, Hannover brought suit seeking to collect from the

trust.

On June 10, 1992, the bankruptcy court entered a preliminary injunction, pursuant to ' 304, enjoining Hannover from prosecuting both actions. The matter was appealed to the U.S. District Court which issued its opinion on February 17, 1993, the significant findings of fact and holdings include:

X With respect to the LOC, Hannover=s action is against the bank, not LARSA. The LOC is an irrevocable and unconditional promise on the part of the bank to pay the beneficiary upon the presentation of specified documents. The fact that the issuing bank holds collateral of the debtor to secure the extension of credit has no bearing on the beneficiary=s right to receive payment from the bank on the bank=s contract. Section 304 relief is improper because the action is not against the debtor or the debtor=s property.

X LARSA established a trust fund at Citibank in the amount of $1.5 million pursuant to New York Regulation 41. LARSA has a reversionary interest in the fund after distribution to its policyholders. According to an independent audit, LARSA has outstanding/potential liabilities of approximately $523,000.

X Outstanding liabilities from reinsurance business were not included in the audit report. On February 22, 1991, a supervising insurance examiner for the New York Department sent an approval letter to Citibank, authorizing it to release the excess funds. (In addition to Hannover=s claim, Transworld Assurance Company also claimed an interest in the trust in the amount of approximately $77,000 as a reinsured of LARSA.)

X The trust agreement states that it covers Aany contract or policy of insurance or reinsurance . . . made by [LARSA] wherein the premiums and losses are expressed to be payable in U.S.A. currency.@

X LARSA claims that the trust fund was created for the benefit of direct policyholders and that Hannover is neither a direct policyholder nor a New York insured.

X Without addressing whether Hannover was a proper beneficiary of the trust, the court vacated the ' 304 stay of litigation with respect to any portion of the trust that was due beneficiaries, finding that the purpose of the trust was to take the property outside of the debtor=s control and

was not within the reach of the bankruptcy court.

X LARSA=s interest in the trust property was reversionary and the stay with respect to that reversionary interest was proper.

2. *The Interpretation of APolicyholders@ and Related Terms*

The Liquidators of Israel Reinsurance Company, Ltd. (Israel Re) filed a ' 304 petition to repatriate the corpus of a trust funded by a LOC to Israel.[12] The petition was filed initially to

obtain a TRO against the liquidator of Integrity Insurance Company (Integrity) who was seeking funds from the trust as a result of Israel Re=s failure to pay reinsurance obligations to Integrity.

Israel Re maintained a trust fund at Bankers Trust Company consisting of a $2 million LOC. The trust agreement provided that the purpose of the trust was to secure Israel Re=s AAmerican Insureds and Reinsureds.@

Israel Re reinsured Integrity from 1982 through 1985 under three reinsurance agreements. Integrity maintained that each of these agreements was an AAmerican Policy@ and Integrity was an AAmerican policyholder@ and therefore a beneficiary of the trust under the terms of the trust agreement.

According to Integrity, prior to the filing of the ' 304 petition, Israel Re attempted to deplete the assets in the trust through two improper tactics:

First: Israel Re instructed the trustee to pay funds to reinsureds that Israel Re claimed to be trust beneficiaries. The trustee refused because Israel Re had presented no proof that losses had been sustained by entities covered under the trust. In fact, the documentation submitted indicated that the period

applicable to those reinsureds was prior to the funding of the trust. After abandoning this attempt, Israel Re sent an entirely new list of reinsureds with a demand for payment which, again, the trustee denied.

Second: In order to obtain the proceeds under the terminated trust, Israel Re misrepresented to the trustee the outstanding liabilities of the trust. Israel Re claimed that no policies were issued during the term of the trust and no American Policyholders existed. These representations were made and/or certified by Israel Re=s U.S. counsel as well. Israel Re did not inform the trustee of the reinsurance contracts it had issued. Integrity was an American Policyholder within the terms of the trust during the entire term of the trust.

Israel Re later claimed in a declaration submitted to the U.S. District Court that the certifications to the trustee had only been intended to refer to Adirect@ insurance policies issued to Aconsumer insureds@ in the U.S. Yet, this explanation conflicts with Israel Re=s former interpretation of AAmerican Policyholders@ in which it stated

> [Israel Re is a] reinsurer who deals with reinsurance transactions only. Our U.S. clients or policy-holders are, therefore, U.S. insurance or reinsurance companies only (never the insured himself) . . . We maintain that a reinsurance treaty is an %American Policy= and a U.S. insurance or reinsurance company is a %Policy-holder= under the terms of the Trust Agreement. . .

It appears that in light of Israel Re=s admission that the only policyholders that could be trust beneficiaries were insurance companies or reinsurance companies, Israel Re attempted to persuade the trustee to release funds without an

independent audit through misrepresentation.

Faced with an independent audit, Israel Re abandoned its efforts to obtain the trust proceeds until it filed the ' 304 petition, discussed below.

Like the LARSA case, debtors in ' 304 petitions have argued that the term Apolicyholder@ does not include reinsureds. Despite this fact, many credit for reinsurance trusts, including those established by Lloyd=s, refer to Apolicyholders@ only and do not reference Acedents@ or Areinsureds.@[13]

3. *The Effect of Customary Trust Fund Restrictions*

Although the LARSA court determined that the alien debtor=s estate had an interest in only the remainder of the trust fund, after U.S. creditors had been paid, other courts have found that failure to comply with all conditions customarily contained in trust agreements (pursuant to which credit for reinsurance is granted) may result in the turnover of the entire trust as a reversionary interest, and may result in distribution not necessarily limited to U.S. creditors for whom the trust was established.

River Plate was a reinsurance company organized under the laws of Bermuda.[14] In order to sell reinsurance in the U.S., River Plate established a trust with Bankers Trust in the amount of $1.5 million. The fund was established Aas security for its American insureds and reinsureds whose claims may be payable in currency of the United States of America . . .@

Like most trusts established for credit purposes,[15] the River Plate trust

restricted the enforceability of a creditor=s claim against the trust to compliance with all of the following four conditions:

- X issuance of an American judgment in favor of the policyholder and against the debtor;
- X expiration of the time to appeal within the time permitted or through the final disposition of any appeal or appeals that may be taken with respect to the judgment;
- X filing with the trustee of a certified copy of the judgment; and
- X expiration of a 30-day period from the time of the filing with the trustee of the certified copy of the judgment without such judgment having been satisfied.

Reinsurance Company of America (RCA) was a reinsured that reduced to judgment in Illinois a prior arbitration award of $600,000. The judgment was then registered in New York and RCA attempted to levy on the trust fund. RCA filed a certified copy of the judgment with

Bankers Trust, commencing the 30-day period. Other cedents also obtained judgments and commenced the same process.

Prior to the expiration of the 30-day period, River Plate filed a receivership petition in Bermuda. A ' 304 petition was filed long after the expiration of the 30-day period. The provisional liquidators claimed that the trust was property of the estate. RCA disputed that claim.

The bankruptcy court held that River Plate had a reversionary interest in the trust fund and further held that because the 30-day period had not expired at the time the receivership petition was filed, the reversionary interest constituted the entire trust fund. The court found that though $8 million of U.S. claims had been

asserted, and in some cases attachments made against the trust fund, no U.S. creditor indicated that they had completed the four required steps prior to the filing of the receivership petition.

The court ordered the turnover of the trust to the estate and noted that whether the filing of the receivership petition stopped RCA=s 30-day period form running would be a matter for the Bermuda Courts to decide pursuant to Bermuda law.

Presumably, as a consequence of the court=s decision on the preliminary injunction, one can discern that if the Bermuda courts determined that the filing of the petition stopped the 30-day period from running, no U.S. creditor would have a valid claim against the trust and the remainder would become estate property for distribution to all creditors.

In Israel Re, the bankruptcy court discussed the River Plate injunction and noted that unlike that situation, none of the U.S. creditors of Israel Re had yet obtained a judgment -- the first of three conditions required by the trust agreement.[16] Yet, the court acknowledged that A[t]he claims filed by American Policyholders far exceed the $2 million trust. . .@

The court in Israel Re noted that while the debtor was seeking withdrawal of the entire trust for return to Israel, it intended to distribute the trust to U.S. creditors pro rata -- it did not seek to share the trust assets with general creditors until U.S. creditor claims had been satisfied.

Integrity maintained that Israel Re=s reversionary interest was Avalueless@

because the claims against the trust far exceeded the trust assets. (Israel Re admitted that there was $5 million in claims against the $2 million trust.)

The court refused to turnover the trust to the debtor at that time because it could not determine the amount of the debtor=s reversionary interest. It did, however, enjoin the continuation of Integrity=s and others= claims against the trust to permit adjudication of those claims in Israel and it vacated Integrity=s attachment on the trust.

4. *Imposition of Additional Restrictions on a U.S. Creditor=s Right to Recover Collateral Securing Liabilities*

Although U.S. credit for reinsurance laws require the establishment of trust funds for the protection of U.S. creditors, courts have denied attempts by U.S. creditors to access those funds by imposing additional restrictions beyond those contemplated in either the credit for reinsurance laws or the terms of the trust agreements.

The following arguments have been advanced by U.S. creditors, to no avail:

X In Israel Re, counsel for Integrity noted that the *trust agreement explicitly provided that in the event of Israel Re=s insolvency*, U.S. creditors were to be paid from the trust in accordance with creditor=s compliance with four conditions, as discussed above. Notwithstanding that fact, the bankruptcy court vacated Integrity=s attachment and required that the claims be adjudicated in Israel.

X The bankruptcy court required that U.S. creditors prove their claims in the Israeli liquidation proceeding and accept pro rata distribution of the trust assets *notwithstanding the fact that the trust agreement explicitly provided that in the event of the insolvency of Israel Re a creditors= judgment,* after having complied with the four conditions, Ashall be forthwith satisfied by the Trustee . . . *without regard to the rights of any other policyholder or policyholders* . . .

- X Provisional liquidators have argued that U.S. creditors who attempt to proceed against U.S. trusts are attempting to obtain preferential treatment. Yet such action is explicitly countenanced by the terms of the trust agreements which provide for payment on a first-come-first-paid priority scheme. This is a typical provision in many U.S. insurance regulatory trusts.[17]

- X U.S. credit for reinsurance and surplus lines laws were designed to require that sufficient collateral be held in the U.S. to satisfy U.S. insureds and reinsureds. Presumably, the purpose of these laws, at least in part, was to ensure that sufficient assets are available to meet obligations *and that those assets are located in the U.S. so that U.S. creditors would not have to pursue their claims in foreign jurisdictions*. Yet ' 304 operates as a mechanism for alien companies to avoid that result and repatriate the funds originally required to be located in the U.S. and/or require pursuit of those claims in a foreign jurisdiction.

Additionally, the manner in which such proofs of a claim must be pursued has likewise been altered through the use of ' 304 proceedings.

In connection with the KWELM scheme of arrangement, Allstate appealed the entry of a permanent injunction in a ' 304 proceeding which Allstate claimed altered its contractual right to arbitration.[18]

The bankruptcy court in that matter issued a permanent injunction staying arbitrations against the debtor until a creditor compiled with certain steps required by the U.K. scheme of arrangement.

Pursuant to the scheme of arrangement, a creditor must

- X submit complete details of a claim to KWELM;

- X if the claim is not recognized by KWELM, creditors must first proceed in litigation or arbitration against the KWELM co-insurers; and

- X present to KWELM the substantive judgement or final settlement obtained against the co-insurers.

If within 6 months the KWELM companies do not recognize the claim on the basis of the judgment or settlement secured against the co-insurers, the creditor may institute proceedings, including arbitrations, against the KWELM companies in any forum where the action might have been brought originally.

The imposition of such additional requirements to prove a claim beyond any requirements of the trust agreement terms, coupled with the necessity of proving claims in a foreign jurisdiction, subject to pro rata distribution inconsistent with the explicit terms of trust agreements -- substantially alters the protections afforded by the credit for reinsurance and surplus lines laws and the terms of trust agreements established pursuant to such laws.

Additionally, the right of a reinsured to collect as a Apolicyholder@ under a trust intended to benefit reinsureds is called into question, as well as the possibility that, like the River Plate decision, turnover of estate property may result in distribution to non-U.S. creditors even though such result is entirely inconsistent with the intent and the terms of the trust agreement.

While liquidators of alien insurers and reinsurers understandably are interested in avoiding the expense of multiple litigation in the U.S. (the states provide some relief through ancillary receivership provisions) one must be increasingly reminded that the alien insurers came to the U.S. to sell insurance and reinsurance -- based upon U.S. trust funds to assure their U.S. credit.

E. THE AVAILABILITY OF STATE AND FEDERAL LEGISLATIVE REMEDIES

Assuming that it is determined that ' 304 undermines the availability of recoveries to U.S. policyholders and ceding insurers contemplated by U.S. reinsurance credit and surplus lines laws, there are several legislative remedies available to regulatory authorities and U.S. creditors.

1. *Federal Legislation*

The most obvious and straightforward resolution is amendment of the U.S. Bankruptcy Code. In consultation with several bankruptcy and reinsurance attorneys, we developed the following proposed amendment over a year ago.

> 304(d). Notwithstanding subsections (b) and (c) of this section, the court shall not grant relief under (b) of this section to a foreign insurance company not engaged in the insurance or reinsurance business in the United States with respect to claims by United States creditors against:
>
> > (1) A deposit required by state insurance laws;
> >
> > (2) A trust required by state insurance laws to protect United States policyholders or claimants against such policyholders;
> >
> > (3) A trust, letter of credit or other security device authorized under state insurance laws to allow a domestic insurance company which cedes reinsurance to the debtor to reflect the reinsurance as an asset or deduction from liability in the ceding insurer=s financial statements; or
> >
> > (4) A surplus lines broker, reinsurance intermediary or other party subject to the jurisdiction of the United States in connection with the insurance or

> reinsurance provided by such foreign insurance company.

While this amendment would appear to resolve the problem with respect to insurance and reinsurance companies, there may be other industries concerned about the effect of ' 304 that would prefer to broaden the terms of the amendment. For example, some have suggested that both swaps and derivative dealers and banking institutions have a significant concern about ' 304 when one of the affected parties is domiciled in a foreign jurisdiction. Broadening the amendment may have beneficial affects both from a lobbying and substantive perspective.

The disadvantages to a federal solution are mostly political and practical: Can a bankruptcy amendment succeed in the current Congress? How long will it take? Does it have to be processed through the newly formed National Bankruptcy Review Commission? Will it attract opposition from bankruptcy practitioners who have no understanding of insurance regulatory laws?

2. *State Legislation*

It was recently suggested to the credit for reinsurance resource group that a provision be included in the model law and state statutes which requires that an alien reinsurer waive ' 304 protection as a condition of the ceding insurer=s ability to take credit for ceded reinsurance. This suggestion raises several questions.

1. Can a state compel an alien reinsurer to waive a privilege granted under a federal law, specifically ' 304?

2. Does the existence of the McCarran-Ferguson Act change the answer to question 1?

3. If the answer to question 2 is Yes, then which forum=s law applies to

matters arising under the state law -- the state=s law or the law of the alien=s domicile?

4. Is the waiver enforceable against the alien=s receivership representative?

The short answer to these questions is outlined below. The detailed analysis and support for the following conclusions are contained in the memorandum attached as Addendum 1 to these materials.

3. *State Mandated Waiver of a Federal Privilege and the Effect of McCarran-Ferguson*

Generally, parties can be subjected to many state legislative controls -- which in effect become parts of a contract -- so long as the regulation is reasonable. Likewise, parties can waive rights granted by law, constitutional or otherwise, via formal documents or conduct. However, the law limits contractual waivers in some instances, e.g., as void against public policy.

Notwithstanding waiver limits, it appears that states can pass general laws which affect the writing of contracts, including a mandatory or permissive waiver, as long as such laws are Areasonable.@ Where such a state-mandated will affect federally granted right or privilege, Areasonableness@ is determined by the standards of the Supremacy Clause of the U.S. Constitution and the Preemption Doctrine.

When Congress exercises a granted power, concurrent conflicting state legislation may be challenge via the Preemption Doctrine -- the Supremacy Clause, U.S. Const. Art. VI, C1.2, mandates that federal law overrides, i.e., preempts and invalidates, any state regulation where there is an Aactual conflict@ between the

two sets of legislation such that both cannot stand. The definition of Aactual conflict@ is key to this matter.

U.S. Supreme Court cases addressing the issue of Aactual conflict@ between a state and federal law can be generalized into six categories, only the sixth is relevant here

> (6) Express congressional grant of power to states to regulate the matter at issue -- a state law is valid where Congress has granted states the power to interfere in matters in which they otherwise had no power (e.g., insurance is interstate commerce regulated under the Commerce Clause, thus controlled by the federal government, officially relinquished to state control by the McCarran-Ferguson Act.).

Under this type of law, *a court would uphold a state law which requires a party to waive a federal right* because Congress explicitly delegates responsibility for regulating a specific field to the states.

By its terms, the McCarran-Ferguson Act gives the states the power to regulate the Abusiness of insurance.@ 15 U.S.C. ' 1012(a). Furthermore, Ano act of Congress shall be construed to invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance[.]@ *Id.* at 1012(b).

A state law amending a credit for reinsurance and surplus lines law to compel alien reinsurers to waive their rights under 11 U.S.C. ' 304 fits the three-part test and retains McCarran-Ferguson protection. Such laws directly affect insurance companies= solvency and a state law designed to prevent the flight of assets from the jurisdiction under Section 304 affects the amount of money policyholders will

be paid on their insurance claims. Moreover, the state law waiver of Section 304 rights, whether considered to be voluntary or involuntary, is protected by McCarran -- Section 304 does not expressly address insurance, therefore it could not preempt

a state law that expressly and directly denies Section 304's operation. For that matter, there would be a direct conflict between these laws which would result in the state law, per McCarran, preempting the federal law (reverse preemption).

4. *Proposed State Legislation*

The reverse preemption discussed above applies with such force that it appears a state could condition reinsurance credit on a waiver of ' 304 within the alien trust document or simply amend its law to *imply* a waiver of ' 304 in all contracts entered into in that state or trust agreements securing liabilities pursuant to those contracts. Of course, the non-U.S. insurer or reinsurer would be able to employ state ancillary receivership laws to the extent they may be applicable, consistent with the terms of the contracts and trusts.

Likewise, state law could require the inclusion of the ' 304 waiver in surplus lines trust agreements as a condition of doing business in the U.S., or imply the waiver through state law.

The disadvantage of a state insurance law solution is the obvious issue of 50 state legislatures and the fact that other industries may prefer a broader solution,

e.g., swaps and derivatives, banks.

F. CONCLUSION

In light of the above, an amendment to ' 304 may be the best long term solution, but it may be preferable to affect the insurance solution through state legislation while simultaneously advocating a bankruptcy code amendment.

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ENDNOTES

1. *See* House Rep. No. 95-595, 95th Cong., 1st Sess., 324-325 (1977); S. Rep. No. 95-989, 95th Cong., 2d Sess., 35 (1978); In re Culmer, 25 Bankr. 621 (Bankr. S.D.N.Y. 1983); In re Banco De Descuento, 78 Bankr. 337 (Bankr. S.D. Fla. 1987).

2. In re Gee, 53 Bankr. 891, 896 (Bankr. S.D.N.Y. 1985).

3. 11 U.S.C.A. ' 101 note 24 (West 1991).

4. 11 U.S.C.A. ' 101 note 23 (West 1991).

5. 11 U.S.C.A. ' 304 (1991).

6. *See* In re Evans (Orion Ins. Co. PLC), Nos. 94-B-44968 (SMB) and 94-B-44969 (SMB) (Bankr. S.D.N.Y. July 13, 1995) (order granting preliminary injunction).

7. *See* COLLIER ON BANKRUPTCY &3.02[3][b] at 3-153 (15th ed. 1994).

8. *See* In re Kingscroft Ins. Co., 150 Bankr. 77, 80-81 (Bankr. S.D. Fla 1992); Evans v. Hancock (In re Evans [Orion Ins. Co. PLC]), 177 Bankr. 193 (Bankr. S.D.N.Y. 1995).

9. 11 U.S.C.A. '304(c) (West 1991).

10. In addition to concerns expressed by New York at recent meetings of the Credit for Reinsurance Working Group, the Illinois Commissioner expressed concern about this issue to the NAIC in July, 1992. In a letter dated July 29, 1992, James W. Schacht requested that the NAIC file an amicus curiae brief on behalf of the Insurance Corporation of Hannover in its dispute with liquidators of an insolvent Panamanian reinsurance company, Latino Americano de Reaseguros, S.A.

11. In re Ocana (Latino Americano), 151 Bankr. 670 (Bankr. S.D.N.Y. 1993); *See supra* note 9, involving the same case.

12. In re Rubin (Israel Reins.), 106 Bankr. 269 (Bankr. S.D.N.Y. 1993).

13. *See* Lloyd=s American Trust Deed dated April 7, 1989, Sixth paragraph that states

> A(A) The American Trust Fund shall enure for the

benefit of all policy holders to whom the Name is liable in respect of the American business.@

Also note that the Gibralter Casualty Trust Company Agreement with The Chase Manhattan Bank, N.A., notes that Gibralter is a surplus lines insurer but states that the trust is established Afor the purpose of securing in the manner and to the extent set forth in this Agreement its American insureds and reinsureds whose claims may be payable in currency of the United States of America.@ It also defines an AAmerican Policy@ to include reinsurance contracts and a Apolicyholder@ to be a holder of an AAmerican Policy.@

14. In re Lines (River Plate Reins.), 81 Bankr. 267 (Bankr. S.D.N.Y. 1988).

15. *See* Lloyd=s American Trust Deed dated April 7, 1989, Sixth paragraph and Gibralter Casualty Company Trust Agreement dated May 13, 1986. Both trust agreements contain substantively identical language to that in the River Plate trust agreement.

16. The trust agreement required that a claimant obtain a final judgment in a U.S. court as well as a certified copy of the judgment, provide proof of the finality of the judgment, and wait 30 days from the filing with the trustee without the judgment having been paid. Although described as three conditions, it was substantively identical to the four conditions in the River Plate trust agreement.

17. *See* Lloyd=s American Trust Deed dated April 7, 1989, Sixth paragraph that states

> A(C) Where the claim of any policyholder becomes enforceable [after the four conditions have been met], the judgment therein referred to shall be forthwith satisfied . . . out of the American Trust Fund *without regard to the rights of the other policyholders to whom the Name is liable in respect of the American business* . . .

Similarly, the Gibralter Casualty Company Trust Agreement dated May 13, 1986 provides in Article II, paragraph 2.2 that after the four conditions have been met

> Athe said judgment shall be forthwith satisfied by the Trustee out of the Trust Fund then in its hands, without regard to the rights of any other policyholder or policyholders. . .@

18 . Allstate Ins. Co. v. Hughes, 174 Bankr. 884 (Bankr. S.D.N.Y. 1994).