United States

Pre-answer Security in Reinsurance Arbitrations

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It is a well-established principle that pre-answer security laws apply to reinsurance[1] and to reinsurance arbitrations.[2] Courts have consistently determined that arbitration panels have the inherent power to require a party to post security so long as the arbitration agreement between the parties does not preclude such a remedy. Thus, a reinsurer can be required by an arbitration panel to deposit security for its obligations under pre-answer security statutes.[3]

The question of when an arbitration panel should require a reinsurer to post pre-answer security has spurred much controversy and debate, and different views have emerged as to the factors that should guide an arbitration panel's enquiry into this matter. This article will argue that pre-answer security should be mandated in cases where a reinsurer has engaged in a pattern of evading its obligations while at the same time being financially capable of paying. In cases where the reinsurer is financially impaired and an order to post pre-answer security could force it into insolvency, great care should be taken before imposing an order to post pre-answer security.

Purpose behind pre-answer security statutes

The purpose of pre-answer security is to ensure that if the defendant reinsurer defends itself and is unsuccessful, it will be able to satisfy the judgment. Many believe arbitration panels are justified in ordering a reinsurer to deposit pre-answer security only if the reinsurer is found to have financial problems and is thus in danger of not being able to pay a possible judgment in favour of the cedent. While this approach does ensure that the cedent will be able to collect on its policy, it also carries with it the disadvantage of pushing the troubled reinsurer into a deeper financial crisis.

A more compelling reason for arbitration panels to order pre-answer security exists where a reinsurer has a history of refusing to honour judgments against it. Many reinsurers, while solid financially, refuse to participate in arbitration proceedings or honour judgments when they do not have assets in the jurisdiction where the dispute is filed. This approach provides the same benefit as ordering pre-answer security in cases where the reinsurer is in financial trouble since the deposit still secures payment to the pre-existing plaintiff should a judgment be entered in its favour. This method, however, does not cause unneeded injury to the reinsurer or innocent third parties because, unlike the prior approach, it does not necessarily cause companies in a precarious financial condition to become insolvent. This is important because if a reinsurer is forced to enter into insolvency proceedings it may not be able to take the necessary steps to bolster its financial condition.

Cases

Recognising the wisdom of such an approach, courts have often required reinsurers to post pre-answer security when they have wilfully neglected to pay their obligations and have had the capital to post security. For example, in *British International Insurance Company of Cayman v Water Street* 93 F Supp 2d 506 (SDNY 2000), the reinsurer, Water Street, neglected to pay the cedent moneys owed under reinsurance contracts. The arbitration panel ordered Water Street to post pre-answer security. Water Street resisted this order but the District Court confirmed the arbitration panel's award and ordered Water Street to post US$1.7 million in pre-answer security.

The court reasoned in its decision, 'The evidence of Water Street's history of financial and geographical manoeuvres clearly raises the specter that any final award could be rendered meaningless.' Clearly, the pre-answer security was awarded to protect British International's claim, as there was evidence that Water Street had the money to satisfy a judgment and the court was worried that the reinsurer could hide assets to avoid paying any arbitral judgment.

The amount of pre-answer security that a reinsurer is ordered to post can be subject to change as circumstances change. In *Ideal Mutual Insurance Company v Korean Reinsurance Corporation* 657 F Supp. 1174 (SDNY 1987), Ideal and Korean Reinsurance entered into several contracts where Korean Reinsurance was to assume part of Ideal's risk on liabilities already assumed by Ideal. When Ideal then attempted to collect on those liabilities, Korean Reinsurance refused to pay its obligations. After Ideal filed suit, the District Court ordered Korean Reinsurance to post pre-answer security, which they posted. Owing to ensuing events, Ideal incurred more damages because of Korean Reinsurance's failure to pay and amended its complaint, requesting that a larger sum of pre-answer security be deposited. The court granted this request. The court resolved that Korean Reinsurance had a history of non-payments and therefore it was ordered to post security.

Similarly, in *Morgan v American Risk Management, Inc* 1990 WL 106837 (SDNY 1990), the reinsurer was ordered by the court to post a pre-answer security deposit of US$7 million owing to the reinsurer's failure to pay its contractual obligations to Morgan, the liquidator of Delta Reinsurance Company. America Risk 'argu[ed] that it would be unfair to require them to tie up a huge amount of assets – thereby giving the liquidator undue leverage'. The court found that American Risk's 'defenses, no matter how meritorious, have no bearing on the security requirement. In fact, New York law specifically sets out the only pertinent pre-answer defenses' and the court decided that American Risk's defences were not mentioned within the law.

Courts have also wisely refused to award pre-answer security on the basis of a reinsurer's lack of financial stability. The Pennsylvania Insurance Commissioner in its suit against Kansa General Insurance Co, a Finnish company, requested that Kansa post pre-answer security. The District Court held that the Bankruptcy Code excused an insolvent foreign reinsurer from posting pre-answer security. In the case of *In re Petitions of Laitasalo* 193 BR 187 (SDNY 1996), the court noted:

> 'It is philosophically inconsistent with New York Insurance Law that Kansa should be required to post security to defend itself against the Kansa claim. In essence, that security would transform her unsecured claim into a second claim to the detriment of the other US creditors.'

In other words, it was not appropriate to require Kansa to post a security bond because Kansa's other unsecured US creditors would suffer disproportionately.

In other cases, however, courts have ordered reinsurers to pay pre-answer security even though they lacked the financial resources to comply with the order. The District Court in *John Hancock Property/Casualty Insurance Co v Universale Reinsurance Co, Ltd* 1993 WL 267345 (SDNY 1993) ruled that financial weakness is not an exception to the requirement of posting pre-answer security. Universale, a Swiss reinsurer, was ordered to deposit security regardless of its troubled financial status.

Similarly, the New York state court in *Curiale v Ardra Insurance Company, Ltd* 667 NE 2d 313 (NY 1996) ignored Ardra's objection to pre-answer security. Ardra contended that if it paid the full security deposit of over US$10 million, it would not be able to defend itself. The court required that the reinsurer post security and when the reinsurer failed to comply with this order, a default judgment was entered against the reinsurer. The reinsurer argued the large security bond was a violation of due process because it left Ardra unable to defend itself from the suit filed against it. The Court of Appeals made clear that the most important interest is in 'ensuring the availability of funds within the state to pay losses on insurance policies issued here', not in preserving the well-being of Ardra.

It is argued that, notwithstanding these decisions, arbitration panels and courts need to consider a reinsurer's financial situation before requiring pre-security. Sometimes it may be that a reinsurer's financial problems should preclude a requirement that pre-answer security be posted, especially if there are other creditors at risk, as in *Laitasalo*. At other times pre-answer security will be ordered regardless of the financial stress it will put on the reinsurer, as in *John Hancock* and *Curiale* mentioned above.

Questionable tactics

Unfortunately, there are reinsurers, such as Seguros La Republica, SA ('SLR') discussed below, who continuously choose not to pay their contractual obligations or the pre-answer security that is ordered as a result of not paying contract obligations. Such recalcitrant reinsurers may well have the money to pay pre-answer security deposits yet they refuse to do so. Pursuant to the principles developed in this article, these are precisely the reinsurers who should be ordered to pay pre-answer security. SLR has a history of engaging in protracted litigation. This defeats the purpose of arbitration, which is 'to provide a speedy and inexpensive determination, without the extended delays inherent in a court proceeding'.[4]

Furthermore, it is puzzling why a financially viable reinsurer would choose to allow a default judgment to be rendered against it rather than posting pre-answer security. In *British Int'l Ins Co v Seguros La Republica, SA* 212 F3d 138 (2d Cir 2000) the court entered a default judgment against SLR in the amount of US$11,801,024.98 after SLR refused to post pre-answer security pursuant to New York Insurance Law section 1213(c). Instead of posting the court-ordered pre-answer security amount of US$5.7 million, SLR now stands to pay the plaintiff more then twice that amount. Fortunately, the plaintiff did not need to incur the expenses associated with a contentious arbitration. SLR's failure to post pre-answer security, thereby resulting in the entry of a default judgment, has precluded SLR from defending its rights in a case where it might have been able to minimise damages.

Conclusion

In conclusion, an arbitration panel may carefully consider ordering a reinsurer to post pre-answer security in cases where the reinsurer is experiencing financial difficulties. Perhaps, pre-answer security to cover the claimant's anticipated legal fees should suffice. Conversely, pre-answer security should be strongly favoured when a reinsurer has a history of refusing to honour its obligations and has the financial resources to post security.

Notes

1 *Morgan v American Risk Management, Inc* 1990 WL 106837 (SDNY); *American Centennial Ins Co v Seguros la Republica, SA* 1992 WL 162770 (SDNY); *Skandia America Reinsurance Corp v Caja Nacional de Ahorro y Seguros* 1997 WL 278054 (SDNY); *British International Ins Co Ltd v Seguros La Republica, SA* 212 F3d 138 (2d Cir 2000).

2 *Northwestern National Insurance Co v Kansa General Insurance Co* 92 Civ 7433 (LJF), 1992 US Dist LEXIS 17841 (SDNY 24 November 1992); *American Centennial Insurance Co v Seguros La Republica SA* 91 Civ 1235 (MJL), 1992 US Dist LEXIS 8720 (SDNY 18 June 1992).

3 *Yasuda Fire & Marine Insurance Co of Europe v Continental Casualty Co* 37 F3d 345, 350 (7th Cir 1994); *Pacific Reinsurance Management Corp v Ohio Reinsurance Corp* 935 F2d 1019, 1027 (9th Cir 1991).

4 *Prozina Shipping Co Ltd v Elizabeth-Newark, Shipping, Inc* No 98 Civ 5834, 1999 WL 705545, 4 (SDNY Sept 10, 1999).