VOLUME 16 NUMBER 4

ARIAS U.S. QUARTERLY

FOURTH QUARTER 2009

Pre-Hearing Security - *A Primer for Arbitrators*

Pre-Hearing Security

Privilege 101 – A Primer on the Attorney-Client Privilege, the Work Product Doctrine and Waiver

Are "Unreasoned" Arbitration Awards "Irrational"?

REPORT: Board of Directors Elections

REPORT: 2009 Fall Conference

OFF THE CUFF: Is a Good Client Also Hard to Find?

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editor's comments

T. Richard Kennedy

Congratulations to Susan Stone on being elected Chair of our Board of Directors. Susan is a highly respected and experienced lawyer in the field of insurance and reinsurance dispute resolution. She has been active for several years in the affairs of ARIAS•U.S., and is clearly dedicated to the work and goals of our Society.

Congratulations also to Dan FitzMaurice on being elected President of the Society, to Elaine Caprio Brady as President Elect, and to Damon Vocke as a new member of the Board.

It is interesting to note that Damon Vocke is the General Counsel of General Reinsurance. The last person who held that position when coming on the Board, 15 years ago, was our own Ed Rondepierre. Ed was a member of the Founding Board of ARIAS•U.S. and served as the Society's first President.

We are greatly indebted to Tom Forsyth, who is leaving the Board after many years of service, including serving as Chair and President, and to Frank Lattal, who has just completed his term as Chair, but – fortunately for us – will continue on the Board for another year. Both Tom and Frank have made major contributions to the continuing success of the Society, and we hope each will continue to be active for many years to come.

This issue's cover article, *Pre-Hearing Security – A Primer for Arbitrators*, by Peter Chaffetz and Karen Baswell, is an excellent discussion of issues presented on a pre-hearing request for security, including the powers of the panel, the several types of security devices, arguments likely to be made for and against the panel granting security, and the extent of protection afforded to a party that is granted security. Given the number of requests for pre-hearing security in reinsurance arbitrations, the article deserves a close read by all involved in the process.

Kim Marrkand and Fritz Huszagh, in *Privilege 101 – A Primer on the Attorney-Client Privilege, the Work Product Doctrine and Waiver*, present a careful review of attorney-client privilege and the attorney work product doctrine, including ways either privilege may be lost, even inadvertently. Readers will find the discussion of recent case law dealing with these concepts within the reinsurance context to be particularly helpful.

Parties and panels in reinsurance arbitrations often wish to avoid "reasoned" awards based on an unfounded fear that an articulation of reasons for the award will increase the likelihood of vacatur by a court. Robert Hall, in *Are "Unreasoned" Arbitration Awards "Irrational"*? reviews case law to make the interesting argument that failure to provide reasoning actually may increase rather than decrease the chance of an award being vacated.

Fellow Editor Eugene Wollan in our *Off the Cuff* column completes his thoughts of what qualities make good participants in adversary proceedings. See *Is a Good Client Also Hard to Find*? for his discussion, which I think you will find both thoughtful and amusing.

This being our last issue of the year, I would like to pay special tribute to our Managing Editor, Bill Yankus. Bill is our unsung hero, who keeps us all on schedule – which is far from an easy task – writes reports on such matters as Board of Directors' actions, conferences, and newly certified arbitrators, umpires and mediators. He then, with the help of CINN Creative Director Gina Balog, pulls the whole issue together, complete with an appropriate cover. On behalf of all the Editors, thank you, Bill.

With best wishes to each of our members for a Happy and Healthy New Year,

T. Richard Kennedy

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Editorial Policy

ARIAS•U.S. welcomes manuscripts of original articles, book reviews, comments, and case notes from our members dealing with current and emerging issues in the field of insurance and reinsurance arbitration and dispute resolution.

All contributions must be double-spaced electronic files in Microsoft Word or rich text format, with all references and footnotes numbered consecutively. The text supplied must contain all editorial revisions. Please include also a brief biographical statement and a portrait-style photograph in electronic form.

Manuscripts should be submitted as email attachments to trk@trichardkennedy.com .

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feature

Pre-Hearing Security – A Primer for Arbitrators

This article is based on a paper presented at the ARIAS•U.S. 2009 Fall Conference.

Peter R. Chaffetz

Karen C. Baswell

As a start toward identifying best practices in this area, this paper will canvass some of the issues presented by requests for security...

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Peter R. Chaffetz
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I. Introduction

One difference between reinsurance disputes and other commercial litigation and arbitration is the frequency with which the tribunal in an insurance or reinsurance matter – whether in arbitration or in court – will order the posting of pre-hearing security. While most courts have the power to fashion provisional remedies, including pre-trial security, the statutory grounds for such relief in other types of commercial contract disputes are narrow and courts enforce the statutory requirements strictly.

Another difference that may surprise many in the arbitration community is that the debtor's financial condition is not even a relevant consideration under most state attachment laws. For example, the New York CPLR authorizes pre-hearing attachment, that is, the seizure of a debtor's assets as security for a future judgment, only where the plaintiff: (1) has stated a claim for a money judgment in an amount greater than all counterclaims against it; (2) can show a probability of success on the merits; and (3) can show that the debtor has disposed or is about to dispose of or remove its assets from the jurisdiction with the intent to defraud its creditors or frustrate enforcement of such future judgment.[1]

In contrast, pre-hearing security is common in insurance and reinsurance disputes, where pre-answer security statutes mandate the posting of security by non-admitted carriers in court proceedings and some arbitrations, and many contracts have security provisions that mirror those statutes. And even where the reinsurer is admitted and there is no statutory or contractual security provision, arbitration panels nonetheless consider and sometimes grant prehearing security as a matter of their general authority and discretion.

Indeed, the form of organizational meeting agenda posted on the ARIAS•U.S. web site includes security as a standard issue, and the ARIAS•U.S. practice guide contemplates that panels will receive briefing on the issue of whether and in what amount to award security. However, the practice guide does not indicate what standards should apply to the request, and there is a feeling among some practitioners that the treatment of the issue is not always consistent across panels dealing with similar factual circumstances.

As a start toward identifying best practices in this area, this paper will canvass some of the issues presented by requests for security, including a recap of the scope and sources of the panel's authority, the mechanics of the several security devices, and arguments parties will make for and against requiring security. We conclude by considering whether there is risk for the secured party, even where suitable security is posted.

II. Sources of Authority

A. Statutory and Contractual Sources of Authority for Security.

Although statutory law normally does not control in arbitration, state security statutes often provide the starting point for panel assessment of requests for security. State insurance codes mandate security in two contexts. First, most states allow cedents to take credit for reinsurance placed with non-admitted reinsurers only if the reinsurer maintains security equal to ceded reserves.[2] Contractual security provisions track this statutory requirement, usually requiring the reinsurer to post security and to adjust the amount based on quarterly reporting of reserves by the cedent. In these cases the contract wording will guide panel consideration of security requests.

The second statutory basis for security is state pre-answer security provisions. While these laws do not directly control in most

arbitration contexts, they still provide clear guidance to panels. These statutes provide that where a policyholder sues an unauthorized insurer, the insurer must post security in an amount sufficient to ensure satisfaction of judgment as a condition to filing a responsive pleading. While these statutes differ slightly from state to state, most are based on the NAIC Model Law,[3] and are designed to protect the residents of that particular state from having to enforce judgments in distant forums. Going back at least to 1990 courts have consistently applied these statutes against unauthorized reinsurers as well as insurers.[4]

In most cases, failure to post pre-answer security results in a default judgment entered against the unauthorized insurer or reinsurer.[5] Entry of a default judgment where the reinsurer fails to meet the security requirement is not a denial of due process.[6]

However, there are circumstances when a court may not require an unauthorized insurer (or reinsurer) to post pre-answer security. Some statutes, such as those in New York and Connecticut, allow the court (or supervising authority) to waive the security requirement if it is shown that the insurer maintains "funds or securities, in trust or otherwise," within the state sufficient to satisfy any potential final judgment in the proceeding.[7] Other statutes, such as those in Colorado, Florida, and California, allow this waiver if the insurer can show that it maintains funds or securities available to satisfy the potential judgment in any state in the U.S.[8]

Courts have also declined to require pre-answer security when the party requesting such relief is not the type of party the statute was intended to protect. For example, the Southern District of New York recently rejected a motion for security because the moving party was a Delaware corporation with its principal place of business in Massachusetts.[9] The court reasoned that the purpose of N.Y. Insurance Law § 1213 was to protect New York state residents from having to resort to distant forums. Therefore, only New York residents or corporations authorized to do business in New York could invoke that protection.[10]

Finally, in a technical exception that has arisen with surprising frequency because of the number of state-owned enterprises engaged in insurance and reinsurance, an unauthorized insurer may be exempt from posting pre-award security if it qualifies for immunity under the Foreign Sovereign Immunities Act (FSIA).[11] Section 1609 of the FSIA provides:

> Subject to existing international agreements to which the United States is a party at the time of enactment of this Act[12] the property in the United States of a foreign state shall be immune from attachment arrest and execution...

In 1995, the Second Circuit affirmed a district court ruling that the pre-answer security requirement of N.Y. Insurance Law § 1213 is a form of attachment, and was thus forbidden by FSIA § 1609 if the unauthorized insurer qualified as a foreign sovereign.[13]

This does not mean that sovereign immunity protects a state-owned reinsurer from legal action to enforce its contractual obligations. As noted in *Skandia America Reinsurance Corp. v. Caja Nacional de Ahorro y Seguro*,[14] "[u]nder the FSIA, foreign states are not immune from the jurisdiction of foreign courts with respect to their commercial activities, and their commercial property may be levied upon for the satisfaction of judgments rendered against them in connection with their commercial activities."[15] However, FSIA § 1609 does provide a foreign sovereign immunity from attachment and therefore from the operation of pre-answer security requirements.

In arbitration, one further technicality often negates the sovereign immunity exemption from the pre-answer security statutes. FSIA § 1609 makes clear that sovereign immunity from attachment is "[s]ubject to existing international agreements to which the United States is a party at the time of enactment of this Act." Several courts have held that foreign sovereigns that are signatories to either the N.Y. Convention or the Panama Convention (both enacted prior to the FSIA) have waived their sovereign immunity to pre-judgment attachment in the context of arbitration.[16]

Similarly, some courts have also held that the agreement to arbitrate, in and of itself, may waive foreign sovereign immunity to attachment. The Second Circuit has ruled that a clause providing that arbitrators are "relieved of all judicial formalities and may abstain from following the strict rules of law" constitutes an explicit waiver of immunity from pre-judgment attachment.[17]

B. The Panel's Intrinsic Authority to Require Security

Over the last 20 years, courts have come to recognize broad, intrinsic authority by arbitrators "to order interim relief in order to prevent their final award from becoming meaningless."[18] This was not always the rule. Some earlier cases, dating back to a 1972 non-insurance-related Third Circuit case, *Swift Industries, Inc. v. Botany Industries, Inc.*,[19] had held that an arbitration panel could only order security if the contract explicitly provided for such relief.[20] In *Swift*, the panel had ordered a party to post a $6 million surety bond as security for a potential tax-related liability of $1.5 million. The Third Circuit set aside the award because it found: (1) the agreement between the parties did not mention a bond as a remedy in the event of breach; (2) the parties did not provide for any form of security in the agreement; and (3) the amount of the award was "completely irrational" given the maximum potential liability.[21] A 1992 case from the same circuit, *Recyclers Insurance Group, Ltd. v. Insurance Company of North America*,[22] applied this same restrictive approach to a reinsurance case, rejecting the panel's authority to award security even where the reinsurance contract itself contained a security provision.

We have found no subsequent decision in which a court followed this restrictive approach. Today, courts will generally uphold an award of security (or other provisional remedy), regardless of whether the arbitration agreement specifically provides such authority, so long as there is a colorable justification

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State credit for reinsurance statutes generally provide for security to be posted by way of funds withheld, letter of credit, or assets deposited in a single beneficiary reinsurance trust. In the arbitration context, security may also take the form of a surety bond or an escrow account.

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for the relief ordered,[23] the award "draws its essence" from the contract between the parties,[24] and the agreement does not specifically prohibit such relief.[25]

Nonetheless, the panel's authority is not unlimited. First, there must be due process and fundamental fairness. This means there must be some form of hearing, or opportunity for the parties to submit evidence and argument regarding a request for security.[26] This due process requirement applies regardless of whether the language of the underlying agreement requires awards to be based on a hearing.[27] Refusal to hear evidence from one party or otherwise denying the losing side a fair opportunity to present its case has been held to violate this requirement.[28] In *Home Indemnity Company v. Affiliated Food Distributors, Inc.*, the court vacated an interim security award because the panel refused to permit discovery on a threshold issue unless the respondent first posted security, and the panel had made its order "on the bare assertions of the parties, without even a glance at the underlying dispute or its possible merits."[29]

C. Do The Courts Still Have a Role in Ordering Pre-Arbitration Security in Cases Subject to Arbitration?

In modern practice, the principal role of the courts in security disputes has been to enforce interim awards. Cases dating back to the 1980s have held that an interim award is sufficiently final to qualify for judicial review on either a motion for confirmation or a motion to vacate under Sections 9 and 10 of the FAA.[30]

Sometimes, however, circumstances require that the initial application for security be to the court. The chief drawback to relying on the arbitration panel for security is speed. Because it can take weeks or months to form a panel, cedents sometimes seek provisional relief in court pending panel formation. Federal courts have routinely held that they retain the inherent and equitable power to order preliminary remedies in aid of arbitration, provided the general criteria for those remedies are met.[31] Some states, including New York, provide by statute that courts can entertain an application for preliminary relief in connection with an arbitration.[32] In most instances, however, the party requesting security from the court will have to meet the high burden for pre-judgment attachment. In contrast, while pre-answer security statutes do not require such a showing, that security obligation is triggered only when the reinsurer seeks to file a responsive pleading. Therefore those laws are not directly applicable pre-arbitration.

There are few reported cases that address disputes over security prior to panel formation. In one, *Founders Insurance Company, Ltd. v. Everest National Insurance Company*,[33] the court took a restrained approach to cross-demands for security. It overturned a preliminary injunction against Everest, the ceding company, enjoining it from drawing down on a trust, and it affirmed the denial of an attachment sought by Everest against the assets of Founders, the reinsurer. The court reasoned that Founders faced no irreparable injury from a draw-down on the trust, because Everest had sufficient assets to repay any amount to which it was not entitled. Likewise, Everest was not entitled to an attachment against Founders because the existing trust provided sufficient protection in the event it prevailed in the arbitration.

In *Continental Casualty Company v. Certain Underwriters at Lloyd's*,[34] the district court for the Northern District of California declined to order pre-arbitration security pursuant to the Illinois pre-answer security statute.[35] There, each party had selected its arbitrator, but no umpire had been chosen. The court ruled that while it had authority, and broad discretion, to fashion preliminary remedies in aid of arbitration, part of that discretion included the ability to "commit to the arbitrators the question of whether and how the Illinois security posting statute should be applied."[36]

III. How Does Security Work?

State credit for reinsurance statutes generally provide for security to be posted by way of funds withheld, letter of credit, or assets deposited in a single beneficiary reinsurance trust. In the arbitration context, security may also take the form of a surety bond or an escrow account. Each form of security provides different benefits and costs to the cedent and the reinsurer.

A. Letters of Credit

The unconditional letter of credit ("LOC") is the most common form of credit for reinsurance security as well as the most common security device in reinsurance arbitrations. In the credit for reinsurance context, the ceding company has an unrestricted right to draw on the letter of credit. Because the LOC is unconditional, the issuing bank will not look past the cedent's demand and the cedent need not establish a failure to pay or other default by the reinsurer to draw on the LOC. However, a draw down not based on a contractual default is itself a breach of contract and the reinsurer may bring an action or arbitration to require the cedent to repay the improper draw.

In contrast, when the Panel directs or approves the posting of security by LOC in the arbitration context, the LOC is usually not unconditional. Rather, the panel commonly requires that draw down on the LOC be authorized by order of the panel. Assuming the letter of credit is posted prior to any applicable preference period, it provides a high degree of security for the ceding company. It is now firmly established that the proceeds of a letter of credit drawdown are the property of the issuing bank, not of the purchasing debtor's estate.[37]

However, LOC's are an expensive security option for the reinsurer. To obtain an LOC, the reinsurer must either have a line of credit at the bank, or must provide the bank with acceptable collateral for up to 100% of the value of the LOC. While the LOC is outstanding, the reinsurer loses control of the assets pledged, and the bank will foreclose on the collateral if it pays on the LOC. In addition, the bank will charge a fee, usually calculated as a percentage of the value of the LOC, with additional costs and fees payable for drawing down and for amending the LOC to adjust the amount of security required. Since the recent economic downturn, credit constraints have caused banks to increase LOC fees and to be more conservative in their collateral requirements. As a result the LOC is now a more expensive and burdensome form of security.

B. Regulation 114 Trusts

Another common form of security is the single beneficiary reinsurance trust. Often called a "Regulation 114 Trust," after the applicable New York regulation,[38] these trusts provide a cheaper alternative to letters of credit. A Regulation 114 Trust is entered into between the ceding insurance company, the reinsurance company, and a bank (the Trustee). Regulation 114 requires that the bank be a member of the Federal Reserve System, or a New York State-chartered bank or trust company, and that the bank not be a parent, subsidiary or affiliate of either the ceding company or the reinsurer.[39] The reinsurer must fund the trust using certain assets with a market value at least equal to the reinsurer's obligations under the reinsurance agreement.[40] Equitable title to those assets is transferred to the trustee.

While the ceding company has the right under the trust agreement to demand possession of the trust funds or assets if the reinsurer does not meet its obligations, the reinsurer maintains certain control over the assets in the trust. The reinsurer maintains the right to vote any shares of stock in the trust account, to receive payments of dividends or interest from shares or investments in the trust account, and to withdraw and substitute trust assets (with prior approval of the ceding company), so long as the withdrawals or substitutions do not have the effect of decreasing the total amount of trust assets to a point below the amount of the reinsurer's obligations.[41]

Regulation 114 Trusts can also be less expensive for the reinsurer to create. A trust involves no extension of credit by the trustee bank. Thus, rather than charging a percentage or basis point fee, many trustees will charge only a small fixed fee to create and administer a trust account. Finally, as the reinsurer's obligations change, it is fairly easy to add or withdraw funds or assets, so long as the liabilities from the underlying reinsurance agreement are covered. Such adjustments do not usually require an amendment of the trust agreement itself.

C. Escrow Accounts

Escrow accounts differ from trusts in that title to the assets is not transferred. The funds or assets are placed into a separate account, and are earmarked for transfer if certain conditions are met. Panels ordering security in the form of an escrow account will often retain control over the account and any draw-downs on the assets. Alternatively, they may request that counsel for the secured party hold the escrow account.

IV. When Should a Panel Award or Deny a Request for Security?

Since the panel's authority to award security is broad, and essentially subject to review only on rational basis and procedural fairness grounds, it necessarily falls to the reinsurance arbitration community to develop consistent standards that will best serve the interest of our market. The authority to award security means only that courts will not substitute their discretion for that of the arbitrators; it does not mean that panels should award security in every case.

Broadly speaking panels face two questions: (1) where there is a statutory or contractual basis for the moving party's security request, are there nonetheless circumstances in which it is better to deny security; and (2) absent an explicit statutory or contractual basis for the request, what circumstances make such an award appropriate as a matter of the panel's discretion.

A. How Should the Panel Evaluate Statutory or Contract-Based Security Requests?

For many cases in this category, the award of security is not controversial. While pre-answer security statutes and even the strict construction of the contract do not bind the panel, panels are usually receptive to requests for security in these cases and courts have upheld these awards so long as there has been procedural fairness in

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measuring the amount of security required. The statute and or contract provide clear-cut authority for security to be awarded. Normally, a panel will enforce a contractual security requirement pending arbitration, even where the reinsurer seeks to rescind the contract or denies coverage for all or a portion of the claimed reserves.

But what if the reinsurer claims that the cedent has inflated its reserve estimates as a bad faith pressure tactic, or that the cedent's entire coverage position is frivolous? Arguably, the best approach in this situation is for the panel to consider the reinsurer's argument, but to hold it to a very high burden of proof. Several factors will usually favor this restrictive approach. With respect to a claim of inflated reserves, the contract itself has conferred on the cedent broad discretion to set reserves. It will be the rare case where the panel is in a position to second guess the ceding company's judgment on the record of a preliminary hearing.

The same applies to the merits of most coverage disputes. The posting of security merely preserves the ceding company's ability to collect if it prevails. In a case where the reinsurer would be subject to a pre-answer security requirement or where the contract provides for security, a panel will normally require security unless the correctness of the reinsurer's denial of coverage is stark and obvious from the terms of the contract and the parties' position statements.

In the reported case law, where the counter-party disputes a request for security, courts have sometimes required that a preliminary hearing be conducted before an award of security is made.[42] However, the scope of this hearing can be quite limited and still meet due process requirements. This party requesting security need only establish proof of the existence of a reinsurance contract between the parties, evidence of billings submitted pursuant to that contract, and that those billings remain unpaid.[43] A court may also require that the panel at least "glance" at the merits of the underlying dispute.[44] But, if the panel has honored these procedural requirements, the court will enforce its award.

In a second, more common, scenario, the reinsurer claims that it has no liability for the claim. It further claims that it is solvent if the disputed claim is not payable, but that it cannot afford to secure the allegedly invalid claim pending arbitration. In these circumstances, reinsurers have argued that requiring security as a prerequisite to presenting a defense is unfair and denies due process. As noted, courts have repeatedly rejected that position.[45] In fact, courts are more likely to deny security where the reinsurer has already been judged insolvent, as in that case the transfer of security creates a preference over the claims of other creditors.[46]

While panels have the authority to deny a request for statutory or contractual security because of financial hardship, it will probably be the rare circumstance where it makes sense to do so. As courts have reasoned, the reinsurer was aware of and in most cases agreed to the security procedures at inception of the contract. To deny security where the counter-party most needs it is a material change in the deal and defeats the other party's reasonable contractual expectations.

Finally, some reinsurers may argue that state pre-answer security statutes should not be applied in arbitration. Outside of Illinois, most state pre-answer security statutes, as written, only require unauthorized *insurers* to post security before filing a responsive pleading. Reinsurers may argue that these statutes are really consumer protection laws – designed to prevent state residents from having to "resort[] to distant forums for the purpose of asserting legal rights under [insurance] policies,"[47] – and thus should not apply in the reinsurance context. While these statutes have been consistently applied against unauthorized reinsurers in court,[48] these decisions do not bind a panel. There may be cases in which the nature of the dispute and/or identity of the parties make the rationale of those statutes inapplicable.

B. When Should a Panel Order Security That is Not Authorized by Statute or Contract?

This is the issue on which there may be the least amount of consistency among panels. Cedents routinely invoke the panel's intrinsic authority to award security and seek to justify it in particular cases relying on such factors as the reinsurer's alleged slowness or recalcitrance in paying claims, the cedent's assessment of the strength of its case, and questions about the reinsurer's financial strength.

However, the fact that security awards are so common where there is a statutory or contractual basis says nothing about when security should be awarded in the absence of such authority. In evaluating such requests, panels do not always consider that security is a term that can be and is bargained for at contract formation. Arguably, the absence of a security provision is as much a reflection of the parties' contractual intent as the inclusion of such a provision.

Panels should also at least be aware of the standards that apply in court, where judges view all forms of provisional relief as extraordinary, equitable remedies to be granted with caution. As noted, courts do not generally consider the defendant's solvency or ability to meet a judgment as a relevant factor. They focus instead on the requirements that the party seeking security establish both a high likelihood of success on the merits and that there is an imminent danger that the debtor will put its assets beyond the reach of creditors, usually by removing them from the jurisdiction.[49]

This is not to dispute the panel's unquestionable authority to order security in order to preserve its ability to award effective relief at the conclusion of the proceedings. But panels should recognize that imposing security may be a change in the contract and that it does require the reinsurer to tie up resources that may be needed to meet other, less controversial, claims. Therefore, absent a statutory or contractual basis for requiring security, panels should consider such requests with caution.

V. Is Security Really Secure?

Panels properly focus on doing justice between the parties before them, and should not normally concern themselves with how their award may affect the rights of other creditors who are not parties. However, ceding companies and panels should both be aware of how competing principles of insurance insolvency law may negate a security award as a preferential transfer of assets that are properly a part of an insolvent reinsurer's estate.

Today most states have adopted a version of either the Uniform Insurers Liquidation Act or the NAIC Insurer Receivership Model Act.[50] Borrowing from long-established bankruptcy principles, these statutes all authorize the liquidator of an insolvent insurer or reinsurer to recover for the benefit of the estate payments or other transfers in respect of an existing debt that are made within a certain period before the company entered liquidation. To illustrate, in New York a liquidator may avoid any transfer of an insolvent insurer's or reinsurer's property that was made within a twelve month preference period, if the transfer was made with the intent to give the receiving creditor a greater percentage of recovery than other creditors in the same class.[51]

The preferential transfer laws will have no effect where the debtor transfers the security awarded before the preference period. Conversely, however, if the transfer occurs within the preference period the liquidator can set it aside, regardless of the imprimatur of a panel order.

There is no potential ambiguity as to the date of transfer in the case of a trust or escrow. In contrast, there have been occasional disputes as to when a liquidator may recover LOC proceeds. Fortunately, courts have consistently recognized that payment on the LOC is a transfer of assets by the issuing bank, not assets of the debtor. Therefore, an LOC posted before the preference period creates an enforceable security protection for the beneficiary.

Some creditors have tried to extend that principle to support the position that the *posting* of the LOC does not constitute a preferential transfer of the debtor's property, and that therefore an LOC may be given and enforced even during the preference period. For example, *In re Compton Corp*. involved an LOC issued to a creditor the day before an involuntary bankruptcy petition was filed against the debtor. The debtor gave the bank a promissory note for the amount of the LOC, secured by a pledge of collateral, and a cash payment for the relevant fees. In exchange, the bank issued an LOC in favor of the creditor, which stated on its face that it was "for an antecedent debt" owed to the creditor by the debtor.

The court found no preference involved in the giving of a promissory note, the pledge of security, and payment of fees by the debtor to the bank. This was because issuance of the LOC gave full value in exchange for what the bank received. Nonetheless, the court required the creditor to refund the LOC proceeds. It reasoned that the LOC was specifically issued to satisfy an antecedent debt, and that it was issued within the preference period. Of critical importance, had the LOC not been issued, the beneficiary would have only had an unsecured claim against the debtor's estate, and its recovery would have been limited to the level of other unsecured creditors in its class. Instead, the beneficiary was able to recover in full by drawing down the LOC, and in its place, the bank had a claim against the debtor that was fully secured by the collateral pledged by the debtor.

Subsequent case law gives little guidance as to the current strength of the *In re Compton ruling*.[52] But cedents and panels should be aware of the likelihood that a liquidator will challenge payments under an LOC where the letter is based on collateral pledged during the preference period.

The main lesson from this case applies generally to the goal of making security awards truly secure: The party seeking security should bring the issue before a panel as early as possible. Once formed, panels should act quickly on such requests. The sooner the award is in place, the less likely it is to face subsequent challenge.▼

1 N.Y. C.P.L.R. §§ 6212(a), 6201(3) (McKinney 2008).
2 Robert M. Hall, *Pre-Answer Security and Reinsurance Arbitrations*, 12-18 Mealey's Litig. Rep.Reinsurance 10 (2002). Mr. Hall's article provides an excellent detailed review of pre-answer security statutes and case law on this topic through 2002.
3 Nat'l Ass'n of Ins. Comm'rs, Unauthorized Insurers Process Act, in 6 Model Laws, Regulations and Guidelines 850-1, §3 (2008).
4 *Morgan v. Am. Risk Mgmt.*, 1990 WL 106837 (S.D.N.Y. Jul 20, 1990). *See also British Int'l Ins. Co. Ltd. v. Seguros la*

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Fortunately, courts have consistently recognized that payment on the LOC is a transfer of assets by the issuing bank, not assets of the debtor. Therefore, an LOC posted before the preference period creates an enforceable security protection for the beneficiary.

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Republica, S.A., 212 F.3d 138 (2d Cir. 2000) (upholding the applicability of N.Y. Insurance Law § 1213 to reinsurers); *Int'l Ins. Co. v. Caja Nacional de Ahorro y Seguro*, 293 F.3d 392 (7th Cir. 2002) (affirming default judgment entered against reinsurer by district court for reinsurer's failure to post pre-answer security pursuant to Illinois Insurance Code); *Curiale v. Ardra Ins. Co. Ltd.*, 667 N.E.2d 663 (N.Y. 1996).

5 *See Am. Centennial Ins. Co. v. Seguros La Republica, S. A.*, 1992 WL 147626 (S.D.N.Y. Jun. 16, 1992), *aff'd sub nom. British Int'l Ins. Co. Ltd. v. Seguros la Republica*, S.A., 212 F.3d 138 (2d Cir. 2000); *Int'l Ins. Co. v. Caja Nacional de Ahorra y Seguro*, 2001 WL 322005 (N.D. Ill. Apr. 2, 2001), *aff'd*, 293 F.3d 392 (7th Cir. 2002); *Skandia Am. Reins. Corp. v. Caja Nacional de Ahorro y Seguros*, 1997 WL 278054, at *2 (S.D.N.Y. May 23, 1997); *Curiale v. Ardra Ins. Co. Ltd.*, 667 N.E.2d 313 (N.Y. 1996).

6 *British Int'l Ins. Co. v. Seguros la Republica*, S.A., 212 F.3d 138, 139, 144 (2d Cir. 2000); *Curiale v. Ardra Ins. Co. Ltd.*, 667 N.E.2d 313, 314, 319-20 (N.Y. 1996).

7 N.Y. Insurance Law § 1213 (McKinney's 2009); Conn. Gen. Stat. § 38a-27 (2008); *Curiale*, 667 N.E.2d at 317; Hall, *supra* note 2.

8 Colo. Rev. Stat. § 10-3-1004 (2009); Fla. Stat. § 626.908 (2009); Cal. Insurance Code § 1620(b)(1) (2009); Hall, *supra* note 2.

9 *Quanta Specialty Lines Ins. Co. v. Investors Capital Corp.*, 2008 WL 1910503, at *7-8 (S.D.N.Y. Apr. 30, 2008).

10 *Id. See also Morgan v. Am. Risk Mgmt.*, 1990 WL 106837, at *6 (S.D.N.Y. Jul 20, 1990); *Allstate Ins. Co. v. Administratia Asigurarilor de Stat.*, 875 F. Supp. 1022 (S.D.N.Y. 1995).

11 28 U.S.C. §§ 1602-1611.

12 This clause will be important to the protection of the FSIA in the context of arbitration, discussed *infra*.

13 *Stephens v. Nat'l Distillers & Chem. Corp.*, 69 F.3d 1226, 1229 (2d Cir. 1995).

14 1997 U.S. Dist. LEXIS 7221, at *11-12 (S.D.N.Y. May 23, 1997).

15 *See* 28 U.S.C. §1602.

16 *See Banco de Seguros del Estado v. Mut. Marine Offices, Inc.*, 230 F. Supp. 2d 362 (S.D.N.Y. 2002), *aff'd* 344 F.3d 255 (2d Cir. 2003); *Int'l Ins. Co. v. Caja Nacional de Ahorro y Seguro*, 293 F.3d 392 (7th Cir. 2002).

17 *Banco de Seguros del Estado v. Mut. Marine Offices, Inc.*, 344 F.3d 255, 262 (2d Cir. 2003).

18 *British Ins. Co. v. Water Street Ins. Co., Ltd.*, 93 F. Supp. 2d 506, 516 (S.D.N.Y. 2000). *See also Yasuda Fire & Marine Ins. Co. v. Cont'l Cas. Co.*, 37 F.3d 345 (7th Cir. 1994); *Home Ins. Co. v. Banco de Seguros del Estado*, 1999 U.S. Dist. LEXIS 22478 (S.D.N.Y. Feb. 26, 1999); *Certain Underwriters at Lloyd's v. Argonaut Ins. Co.,* 264 F. Supp. 2d 926 (N.D. Cal. 2003); *Meadows Indem. Co., Ltd. v. Arkwright Mut. Ins. Co.*, 1996 U.S. Dist. LEXIS 14318 (E.D. Pa. Oct. 1, 1996).

19 466 F.2d 1125 (3d Cir. 1972)

20 *Id*.

21 *Id*. at 1132-34.

22 1992 U.S. Dist. LEXIS 8731 (E.D. Pa June 16, 1992).

23 *Landy Michaels Realty Corp. v. Local 32 B-32J, Serv. Employees Int'l Union*, 954 F.2d 794, 797 (2d Cir. 1992); *British Ins. Co v. Water Street Ins. Co., Ltd.*, 93 F. Supp. 2d 506, 515 (S.D.N.Y. 2000).

24 *See Pacific Reins. Mgmt. Corp. v. Ohio Reins. Corp.*, 935 F2d 1019, 1024 (9th Cir. 1991); *Recyclers*, 1992 U.S. Dist. LEXIS 8731, at *9.

25 *See Yasuda Fire & Marine Ins. Co. v. Cont'l Cas. Co.*, 37 F.3d 345, 350-51 (7th Cir. 1994); *Home Ins. Co. v. Banco de Seguros del Estado (Uruguay)*, 1999 U.S. Dist. LEXIS 22478, at *15 (S.D.N.Y. Feb. 26, 1999); *Meadows Indem. Co., Ltd. v. Arkwright Mut. Ins. Co.,* 1996 U.S. Dist. LEXIS 14318, at *22 (E.D. Pa. Sep. 30, 1996).

26 *Yasuda Fire & Marine*, 37 F.3d at 352-53; *Meadows*, 1996 U.S. Dist. LEXIS 14318, at *23.

27 *Yasuda Fire & Marine*, 37 F.3d at 353; *Bell Aerospace Co. Div. of Textron v. Local 516, Int'l Union Etc.*, 500 F.2d 921, 923 (2d Cir. 1984).

28 *Global Reins. Corp. v. Sompo Japan Ins., Inc.*, 2005 U.S. Dist. LEXIS 37969, at *7-8 (S.D.N.Y. Dec. 29, 2005); *Home Indem. Co. v. Affiliated Food Distribs., Inc.*, 1997 U.S. Dist. LEXIS 19741, at *12-14 (S.D.N.Y. Dec. 12, 1997).

29 *Home Indem.*, 1997 U.S. Dist. LEXIS 19741, at *13-14.

30 *See Banco de Seguros del Estado v. Mut. Marine Offices, Inc.*, 230 F. Supp. 2d 362, 369-70 (S.D.N.Y. 2002); *British Ins. Co. v. Water Street Ins. Co.*, 93 F. Supp. 2d 506, 514 (S.D.N.Y. 2000) ("[A]n award of temporary equitable relief such as a security award, separable from the merits of the arbitration, is subject to federal review."); *Yasuda Fire & Marine Ins. Co. v. Cont'l Cas. Co.*, 37 F.3d 345, 348 (7th Cir. 1994); *Pacific Reins. Mgmt. Corp. v. Ohio Reins. Corp.*, 935 F.2d 1019, 1023 (9th Cir. 1991) ([T]emporary equitable orders calculated to preserve assets or performance needed to make a potential final award more meaningful . . . are final orders that can be reviewed for confirmation and enforcement by district courts under the FAA."); *Sperry Int'l Trade, Inc. v. Gov't of Israel*, 532 F. Supp. 901, 906 (S.D.N.Y. 1982) (rejecting the argument that a panel's interim award of injunctive relief was not ripe for confirmation when the award itself provided that either party could seek confirmation, and the contract which provided for arbitration stated that any arbitration award "shall be deemed final and may be enforced.").

31 *See Borden, Inc. v. Meiji Milk Prods. Co.*, 919 F.2d 822, 826 (2d Cir. 1991); *Cont'l Cas. Co. v. Certain Underwriters at Lloyd's*, 1998 U.S. Dist. LEXIS 23547, at *10-13 (N.D. Cal. Nov. 30, 1998) (collecting cases and discussing the power of the Court to order preliminary remedies under the Federal Arbitration Act and the New York Convention).

32 N.Y. C.P.L.R. § 7502(c).

33 2007 N.Y. Slip Op. 5651 (N.Y. App. Div. Jun. 28, 2007).

34 1998 U.S. Dist. LEXIS 23547 (N.D. Cal. Nov. 30, 1998).

35 215 Ill. Comp. Stat. 5/123(5).

36 *Cont'l Cas. Co. v. Certain Underwriters at Lloyd's*, 1998 U.S. Dist. LEXIS 23547, at *13.

37 *Compton Corp. v. Blue Quail Energy, Inc.* (*In re Compton*), 831 F.2d 586, 589 (5th Cir. 1987) (collecting cases).

38 See N.Y. Comp. Codes, R. and Regs., tit. 11, § 126 et seq. (2009).

39 § 126.3.

40 The form of such assets is limited to cash or cash equivalents, certificates of deposit issued by a United States Bank and payable in United States legal tender, and certain specified securities and investments. § 126.5.

41 § 126.4.

42 *Yasuda Fire & Marine Ins. Co. v. Cont'l Cas. Co.*, 37 F.3d 345, 352-53 (7th Cir. 1994); *Meadows Indem. Co., Ltd. v. Arkwright Mut. Ins. Co.*, 1996 U.S. Dist. LEXIS 14318, at *23 (E.D. Pa. Sep. 30, 1996).

43 *Hartford Accident & Indem. Co. v. Ace Amer. Reins. Co.*, 2008 Conn. Super. LEXIS 2470, at *9 (Conn. Super. Ct. 2008); *British Int'l Ins. Co. v. Seguros La Republica*, S.A., 212 F.3d 138, 144 n.3 (2d Cir. 2000).

44 *Home Indem. Co. v. Affiliated Food Distribs., Inc.*, 1997 U.S. Dist. LEXIS 19741, at *12-14 (S.D.N.Y. Dec. 12, 1997).

45 *See John Hancock Prop. & Cas. Ins. Co. v. Universale Reins. Co., Ltd.*, 1993 U.S. Dist. LEXIS 9411, at *4 (S.D.N.Y. Jul. 12, 1993) (holding that financial weakness did not exempt the reinsurer from having to file pre-answer security under New York Insurance Law § 1213); *Curiale v. Ardra Ins. Co., Ltd.*, 667 N.E.2d 313, 319 (N.Y. 1996) ("[T]he State's interest in ensuring the availability of funds from which a judgment against a foreign or alien unlicensed insurer may be promptly paid . . . justifies striking the answer of a foreign or alien insurer if that insurer fails to provide adequate preanswer security . . . [T]he importance of the State interest here outweighs appellant's interest in litigating the merits of the [ ] claims.")

46 *In re Petitions of Laitasalo*, 193 B.R. 187 (Bankr. S.D.N.Y. 1996).

47 N.Y. Insurance Law § 1213 (McKinney's 2009).

48 *See supra* note 4.

49 N.Y. C.P.L.R. §§ 6212(a), 6201(3) (McKinney 2008).

50 Nat'l Ass'n of Ins. Comm'rs, Insurer Receivership Model Act, in 3 Model Laws, Regulations and Guidelines 555-1 (2008). The language adopted in each statute varies by state.

51 New York Insurance Law § 7425 (2009). New York has adopted a version of the Uniform Insurer's Liquidation Act. New York Insurance Law §§ 7408-15. In contrast, the NAIC Insurer Receivership Model Act provides for a two year time period to avoid preferential transfers. NAIC Insurer Receivership Model Act § 604.

52 The U.S. Supreme Court cited the decision in *dicta* for the proposition that "in certain circumstances, transfers from the debtor to another for the benefit of a third party may be recovered from that third party." *Celotex Corp. v. Edwards*, 514 U.S. 300, 312 (1995). The Eleventh Circuit followed the ruling of *In re Compton in American Bank of Martin County v. Leasing Service Corp.* (*In re Air Conditioning, Inc. of Stuart*) 845 F.2d 293 (11th Cir. 1988), but other subsequent cases applying the direct/indirect benefit analysis utilized by the In re Compton court have not allowed the trustee to recover from the LOC beneficiary, due to distinguishing facts. *See ITXS, Inc. v. F&S Hayward, LLC* (*In re ITXS, Inc.*), 318 B.R. 85, 88 (Bankr. W.D. Pa. 2004) (finding that because the letter of credit had been issued to the beneficiary well before the 90-day preference period, the funds drawn by the beneficiary during the preference period could not be recovered as a preferential transfer, as the transfer of the debtor's property which indirectly benefited the creditor (the collateral pledged for the LOC) occurred outside the preference period.); *Litzler v. Chamblee & Ryan, P.C.* (*In re TIC United Corp.*), 2008 Bankr. LEXIS 2040, at *36-37 (Bankr. N.D. TX 2008) (rejecting the Trustee's reliance on *In re Compton* for several reasons, including the fact that the letter of credit was not used to enhance the creditor's recovery on an antecedent debt).