# PRE-PLEADING SECURITY STATUTES: TYING THE HANDS OF THE UNWARY

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Most states have pre-pleading security statutes that require a foreign insurer to post security before it will be allowed to submit a responsive pleading in court after suit has been filed against it. These statutes should be considered in deciding whether to register to transact insurance business in a state, because the security required to be posted in order to defend litigation may be prohibitive. The statutes should also be considered by parties in dispute with non-admitted insurers, as they can be used to create leverage to force early settlement, and can also protect against problems in executing judgments. This article will address the history and purpose of the statutes, and issues that should be considered in light of the effects these statutes have on non-admitted insurers and reinsurers in litigation.

## I. A Brief of History of Pre-Pleading Security Statutes

State power to regulate the business of insurance underwent a tumultuous phase in the 1940's and early 1950's. While insurance had traditionally been regulated by the states, at a time when commerce clause jurisprudence began ushering in an era of enhanced federal power, the Supreme Court held, in *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944), that the federal government had the power to regulate the business of insurance. In response, Congress passed the McCarran-Ferguson Act, which reserved to the states the continued power to regulate insurance. Thereafter, the Supreme Court gave state insurance regulators a boost in *Travelers Health Ass'n v. Virginia*, 339 U.S. 643 (1950), when it upheld the constitutionality of an aspect of a Virginia Blue Sky Law, allowing for service of process on foreign corporations like the appellant, Travelers Health Association – a Nebraska-domiciled health insurer – to be effective on Virginia's Secretary of the Commonwealth as agent for service. The Court found that Virginia had a legitimate interest in protecting its citizens' ability to sue a foreign insurer by allowing suit against foreign insurers doing business in the state to be served and filed locally.

Thereafter, many states enacted pre-pleading security statutes as a means to further enhance the ability of citizens to recover losses in suits against foreign insurers. A typical statute, patterned after NAIC's model Unauthorized Insurers Process Act, which it promulgated in 1948, is Kansas's, which adopted NAIC's model in 1949:

> Before any unauthorized foreign or alien insurer shall file or cause to be filed any pleading in any action, suit or proceeding instituted against it, such unauthorized insurer shall (1) deposit with the clerk of the court in which such action, suit or proceeding is pending cash or securities or file with such clerk a bond with good and sufficient sureties, to be approved by the court, in an amount to be fixed by the court sufficient to secure the payment of any final judgment which may be rendered in such action; or (2) procure a

> certificate of authority to transact the business of insurance in this state. . .

*See* Kan. Stat. Ann. §40-2003 (2010).

These statutes give the courts discretion in determining the amount of security necessary. They also allow foreign insurers to opt to register with the state insurance authority in order to avoid the security requirements. The statutes have raised a number of issues, some of which are discussed below. Few challenges to application of the statutes have met with success. They should be kept in mind both by foreign insurers seeking to avoid the security requirements or registration, as well as parties in dispute with a foreign insurer, who may wish to take advantage of the leverage these statutes create.

## II. Issues in Pre-Pleading Security Litigation

### A. *Constitutional Concerns*

Various challenges have been made to the constitutionality of the statutes, but have come up short. An oft-cited case from California's intermediate appellate court dealt with challenges on both due process and equal protection grounds. The court in *Trihedron Int'l Assurance, Ltd. v. Superior Court*, 218 Cal. App. 3d 934 (1990) held that California's pre-pleading security statute did not violate the due process rights of the appellant – a West Indies-based insurer – because the statute was narrowly crafted to fulfill a compelling state interest of ensuring that California residents seeking recourse against insurers have a source of recovery. The court distinguished lines of cases which have held that certain prejudgment remedies violate due process where summary procedures result in deprivation of property without an opportunity to be heard on the merits, because in those cases no compelling state interests were at stake. The pre-pleading security statute, the court held, does further a compelling state interest in protecting its citizenry. Other courts have cited the option of registration afforded by the statutes as fulfilling the requirements of due process, as it allows foreign insurers to avoid posting security and thereby being deprived of property without due process.

Likewise, equal protection challenges have failed as well. While the statutes target foreign insurers only, as the *Trihedron* decision notes, they do not *arbitrarily* treat foreign insurers differently than domestic insurers. Rather, the different requirements for foreign insurers are rationally related to the legitimate state interest in ensuring the protection of its citizens, whose ability to recover from a foreign insurer would be hampered if citizens were required to bring suit against the foreign insurer in distant forums, which problem does not arise in relation to domiciliary insurers. As one court noted, "approximately forty states have enacted a similar law, one that has withstood repeated constitutional challenges on both due process and equal protection grounds." *Curiale v. Ardra Ins. Co., Ltd.*, 189 A.D.2d 217 (N.Y. App. Ct. 1993).

Moreover, constitutional challenges have been no more effective in the posture of a non-admitted insurer challenging entry of a default judgment, where a failure to post security resulted in the default. In *British Intern. Ins. Co. Ltd. v. Seguros La Republica, S.A*., 212 F.3d 138 (2d Cir. 2000), the Second Circuit reviewed entry of an $11.8 million default judgment against a non-admitted reinsurer, after the reinsurer had informed the trial court that it would not post the required security, its answer was stricken on plaintiff's motion, and a hearing in damages was held. The reinsurer appealed. The Second Circuit Court affirmed, however, citing *Curiale*, *supra*, in noting that the foreign reinsurer had the option of registering with the state insurance authority, and that requiring it to so submit was not a deprivation of a sufficient property interest to outweigh the state's interest in ensuring its citizenry a meaningful ability to recover a judgment or award. "The ability to conduct insurance business free from legitimate government regulation is not a constitutionally protected property or liberty interest." *Id*. at 143 (quoting *Curiale*, *supra*). The Court held that the notice required to invoke the statute and the opportunity of the non-admitted reinsurer to be heard in response to the demand for pre-pleading security adequately satisfied constitutional due process requirements.

B. *Applicability to Reinsurers and in Arbitrations*

Some reinsurers have argued that pre-pleading security statutes do not apply to them because they are not engaged in the traditional business of insurance. That argument has not met with success, and was specifically rejected by the Second Circuit Court of Appeals in *Seguros La Republica, supra*. There, the Court held that, for the same reason that reinsurers are subject to the same long-arm jurisdictional requirements as insurers, so too they are subject to the pre-pleading security requirements, as both measures are intended to protect citizens from being forced to litigate cases in distant forums. *Id at* 141 (2d Cir. 2000). Nevertheless, some states specifically exempt reinsurers from application of the security statute. *See e.g.* Florida Statutes Annotated, § 626.912 (exempting reinsurers from applicability of pre-pleading security statute).

Courts have also held that such statutes may apply in an arbitration proceeding. *See e.g*. *British Ins. Co. of Cayman v. Water Street Ins. Co., Ltd*. 93 F. Supp. 2d 506, 516 (S.D.N.Y. 2000) (finding justification for an arbitration panel's decision requiring respondent to post $1.7 million in pre-arbitration security pursuant to New York's pre-pleading security statute). Thus, a reinsurer must consider that, even where its disputes are subject to arbitration, the specter of a cedent invoking the protection of pre-pleading security looms.

C. *Litigation Over Amount of Security Required and Proof*

Another issue that arises in the context of pre-pleading security is the amount of security required. In one relatively harsh decision, *Curiale, supra*, the court compelled a foreign reinsurer to post in excess of $10 million -- the estimated amount in controversy -- despite its representation that it could only afford to post $1 million. While the court heard the reinsurer's argument, it declined to hold a formal hearing on the computation of the amount, and turned a deaf ear to the reinsurer's claims as to its ability to pay, finding it "knowingly accepted the

mandates of [New York's pre-pleading security statute] when it opted to do business in New York without procuring a license. The statute unambiguously gives the trial court the discretion to approve the amount of the undertaking." *Curiale v. Ardra Ins. Co., Ltd*., *supra*, 189 A.D. 2d at 221.

As noted in a recent federal court decision in Connecticut, in response to an argument that the pre-pleading security required should be limited based in part on the unlikelihood of success of certain claims, "for purposes of this hearing, the limits of defendant's liability are not the [lesser amount argued by the reinsurer], but, rather, the contract amount under the reinsurance agreement between plaintiffs and defendant. Defendant is not precluded from making its argument on the limits of its liability once the pre-pleading security is posted." *Arrowood Surplus Lines Ins. Co. v. Gettysburg Nat'l Indemnity (SAC) Ltd*., No. 3:09-cv-972 (JCH) (D. Conn. April 6, 2010).

It may not be enough, either, for a foreign insurer to point to U.S. assets, as a means to avoid posting security. In federal court in Ohio, Lloyd's made the argument that its well-known U.S. trusts containing billions of dollars in funds in reserves for policyholder claims, rendered the posting of security unnecessary. The court flatly rejected it, noting "the existence of the Lloyd's trust does not excuse the Lloyd's Defendants from posting a bond." *International Surplus Lines Ins. Co. v. Certain Underwriters and Underwriting Syndicates at Lloyd's of London*, 868 F.Supp. 923, 927 (S.D. Ohio 1994).

D. *Other Defense to Pre-Pleading Security*

Constitutional challenges, assertions of waiver, cries of poverty -- few defenses have met with any success in preventing application of the security statutes. One court held that the Kentucky Insurance Commissioner could not enforce the Kentucky security statute against certain retrocessionaires involved in retrocession agreements with an insolvent Kentucky reinsurer, on the basis of their status as foreign state actors, as the Foreign Sovereign Immunities Act trumped the security statute. *Moore v. National Distillers and Chemical Corp.*, 143 F.R.D. 526 (S.D.N.Y. 1992).

## III. Conclusion

Pre-pleading security statutes are interpreted liberally in favor of requiring security. Thus, a limited hearing will suffice for purposes of due process, and depending on the amount in controversy, the price just to show up and defend claims could be prohibitive, particularly if it involves large-scale underlying exposures, such as long-tail environmental claims that may be weak from a liability perspective, but could create massive exposure in pre-pleading security with serious and immediate effects on capital.

Foreign insurers, reinsurers and retrocessionaires must consider the effect of these statutes, and either register to do business in states that present problematic exposures, establish

choice-of-law provisions that invoke the laws of those states that exempt reinsuers and surplus lines insurers from the effects of the security statutes, take default judgment and seek to shift the battle over execution to home courts, or carefully calibrate reserves to cover all potential exposures to ensure security is available for posting. Domestic policyholders, on the other hand, might look to these statutes as a means to pressure early settlement, force default judgments, or secure available funds for judgments or arbitral awards to preclude problematic enforcement litigation.

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