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ARBITRATION IN INSURANCE COMPANY LIQUIDATIONS,

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There is almost universal familiarity with insurance regulatory history including *Paul v. Virginia*,¹ *Southeastern Underwriters*² and *McCarran Ferguson*.³ However, after *Paul v. Virginia*, there was varied and intense controversy about who would regulate insurance. On five occasions in 1866-68, 1892-97, and 1904 legislation was introduced in Congress calling for federal regulation.⁴ In 1904 and 1905, President Theodore Roosevelt recommended federal regulation of insurance.⁵ The Insurance Section of the American Bar Association recommended and endorsed federal regulation of insurance in 1905.⁶ Resolutions for constitutional amendments to place the insurance industry under federal regulation were introduced in Congress in 1914-1915 and 1933.⁷ The Temporary National Economic Committee conducted an investigation of the concentration of economic power in the United States. It was commenced at the recommendation of President Franklin Roosevelt, began in 1938 and was highly critical of state regulation of insurance. That Committee recommended national charters for all corporations national in scope, including insurance.⁸ All of the above proposals and recommendations failed.

By 1940, all was calm again after both political party platforms affirmatively supported state regulation of insurance.

The controversy was resurrected by the Supreme Court in *Southeastern Underwriters* in June of 1944 when it held that insurance was interstate commerce, subject to federal, not state regulation and overruled *Paul v. Virginia*. Nine months later, with the signature of President Franklin Roosevelt,⁹ *McCarran Ferguson* became law, one of the last bills signed by President Franklin Roosevelt.

Many directed exclusive attention to the first section of *McCarran* which seemed to give everything to the states:

(a) **State Regulation.** The business of insurance, and every person engaged therein, shall be subject to the laws of the several states which relate to the regulation or taxation of such business.

For some time most seemed to forget there was a second section to *McCarran*, which took something back, and potentially exposed all of the first section to preemption and established that federal law could supersede state insurance regulatory law anytime on any subject if Congress added a reference in a federal statute that it was applicable to insurance.

(b) **Federal Regulation.** No 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, or which imposes a fee or tax upon such business, unless such act specifically relates to the business of insurance . . .

The question which then arose was, under the Federal Arbitration Act ("FAA")¹⁰ which was enacted in 1925 and contains no reference to insurance, considering *McCarran* and state regulation of insurance, can a state liquidator of an insolvent insurance company be compelled to arbitrate a dispute arising from an insurance or reinsurance contract which contains a binding arbitration provision?

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Initially, the rule of law appears clear and simple. The FAA compels arbitration except where a state law, enacted for the purpose of regulating insurance, prevents a liquidator from being compelled to arbitrate under a binding arbitration agreement. That clarity and simplicity has become cloudy and somewhat complex due to judicial decisions, state legislative action, and NAIC drafts of model rehabilitation and liquidation statutes.

In early decisions, state liquidation statutes were ruled by federal courts as having been enacted not for the purpose of the regulation of insurance but for the purpose of winding up the affairs of insolvent insurance companies pursuant to an exemption from federal bankruptcy statutes. The latest holding by the Supreme Court in *United States v. Fabe*,¹¹ held such statutes were enacted for the purpose of regulating insurance. However, in that case, the Supreme Court picked out a provision in the state liquidation priority of claims statute giving preference to general creditors over those of the United States as having no relationship to regulation of insurance, and the court rearranged the priority for payment of claims on that basis. That case is clear authority that state rehabilitation and liquidation statutes are enacted for the purpose of regulating the business of insurance as provided in section (b) of *McCarran*.

Fourteen states and the District of Columbia, by specific liquidation laws, prevent the liquidator from being compelled to arbitrate.¹² In the balance of the states, the current law is not all that simple.

There is a New York rule. In an early New York case, *In Re Knickerboker Agency*,¹³ the New York Court of Appeals held that the general provisions of the rehabilitation and liquidation laws of that state, without a specific provision in regard to arbitration, vested exclusive claim jurisdiction in the Supreme Court of New York and thus that law was a bar to the enforcement of the FAA in actions commenced in the State of New York. That interpretation of state law has been respected by federal courts. However, in instances where proceedings have been commenced outside the State of New York, the Federal Arbitration Act has been held to be binding upon liquidators of New York domestic insurance companies.

Wisconsin is a unique exception to general rules since, as a part of its reinsurance statutes, it provides that binding arbitration provisions in a reinsurance treaty with a Wisconsin domestic insurer are not enforceable in delinquency proceedings.¹⁴ All other statutory and judicial rulings deal only with a party being able to compel a liquidator to arbitrate pursuant to a binding arbitration clause. The Wisconsin statute, in addition to preventing the liquidator or rehabilitator from being compelled to arbitrate, prevents the liquidator or rehabilitator from initiating arbitration.

To clarify, none of the rulings or laws (except Wisconsin) prevent the liquidator from initiating arbitration -- they only prevent the liquidator from being compelled to arbitrate.

There are current outstanding rulings in two federal cases holding that where a state liquidation court enters an order barring the liquidator from being compelled to arbitrate, it will be respected by the federal courts as being effective even though there was no specific statute preventing arbitration. Those orders which specifically included a bar to arbitration are entered pursuant to the general provisions of liquidation statutes giving exclusive claim jurisdiction to state liquidation courts with no mention of arbitration. Liquidation court orders vesting exclusive claim jurisdiction in state courts where the orders do not include mention of arbitration have been held not to prevent the liquidator from being compelled to arbitrate.

The NAIC model rehabilitation and liquidation statutes have taken three different approaches to this issue. The earliest version in 1977 made no mention of any arbitration prohibition.¹⁵ The 1990 version was specific and provided a clear statement that the liquidator cannot be compelled to arbitrate.¹⁶ The latest version in 1994 provided that a liquidation court may enter an order that the liquidator cannot be compelled to arbitrate.¹⁷ In that case, if no order is entered, arbitration proceedings could be commenced by another party and the liquidator would be bound to proceed with the arbitration. To date, several states have enacted the 1990 version; none have adopted the 1994 version.

In determining whether the statutes apply to arbitration in rehabilitation proceedings as well as liquidation proceedings, each state law requires close examination. In several states the statutes apply only to liquidation proceedings and not rehabilitation.

It would appear that the best location for a liquidator is to be in a state which prohibits the liquidator from being compelled to arbitrate. When a dispute arises under a contract containing binding arbitration provisions, the liquidator could examine the

arbitrate. When a dispute arises under a contract containing binding arbitration provisions, the liquidator could examine the specific dispute and make a determination whether, in the interests of the liquidation proceedings, it would be better to proceed with arbitration or litigation. In some instances arbitration will be desirable. In others, for example, where it is necessary or desirable that the intermediary or other third persons be made parties to the proceedings, litigation may be preferable. Binding arbitration provisions in reinsurance contracts traditionally do not bind or include intermediaries or third parties, and they cannot, without having joined in the initial binding arbitration contract, be later made a party to an arbitration proceeding. In arbitration, only the rights of the reinsurer and the reinsured can be determined where they are the only parties who have agreed by contract to binding arbitration.

Without specific state law preventing the liquidator from being compelled to arbitrate, the liquidator can include a provision in the order of the liquidation court enjoining any person participating in the liquidation from commencing arbitration proceedings against the liquidator. There is precedent to support that procedure; however, those cases are found in federal District Courts and not in decisions of the Circuit Courts or the Supreme Court.

Federal abstention under the Burford Doctrine was an issue which arose when federal courts were asked to stay litigation in a state court where the parties had previously agreed to arbitrate. That issue was resolved by the Supreme Court in *Quackenbush v. Allstate*¹⁸ which recognized that a motion by Allstate to compel arbitration implicated a substantial federal concern for the enforcement of arbitration agreements, and under those circumstances, it was inappropriate for the District Court to abstain from ruling on the question under the Burford Doctrine. Federal courts will not abstain from ruling on such requests to compel arbitration under those circumstances.

I co-authored an article on this subject in *32 Tort and Insurance Law Journal* 937 (Summer 1997). That article contains citations of other relevant cases along with citations of relevant statutes of all states and the District of Columbia.

Endnotes

1. 8 Wall 168, 19 L. Ed. 357 (1868).

2. 322 U.S. 533, *reh'g denied*, 65 S. Ct. 28 (1944).

3. 15 U.S.C.A. 1012 (1994).

4. H.R. 738, 39th Cong. 1st Sess. (1866); S. 299, 40th Cong., 2d Sess. (1868); H.R. 9629, 52d Cong., 1st Sess. (1892); S. 2736, 55th Cong., 2d Sess. (1897); S. 7277, 58th Cong., 3d Sess. (1904).

5. Message of Dec. 6, 1904, 39 Cong. Rec. 12; Message of Dec. 5, 1905, 40 Cong. Rec. 95.

6. *Reports of the American Bar Association*, Vol. XXVII, 516 (1905).

7. S.J. Res. 103, 63d Cong., 2d Sess. (1914); S.J. Res. 103, 63d Cong., 2d Sess. (1915); S.J. Res. 58, 64th Cong., 1st Sess. (1933).

8. S. Doc. No. 35 at 40-43 (1941); S. Doc. No. 39 at 16 (1941).

9. 1992 Cong. Rec. Vol. 91 Part 2 (1945).

10. 9 U.S.C. 2 (1994).

11. *Id.* at p. 948.

12. Colorado; Georgia; Kansas; Kentucky (only to disputes arising before July 15, 1996); Mississippi; Missouri; Nebraska, New York; North Dakota; Rhode Island; Tennessee; Utah; Washington; Wisconsin.

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13. *Id.* at p. 940.

14. *Id.* at p. 954.

15. *Id.* at p. 954.

16. *Id.* at p. 953.

17. *Id.* at p. 953.

18. *Id.* at p. 953.