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HASSETT'S OBJECTIONS

MANIFEST DISREGARD OF LAW — NOT DEAD YET

By Lewis E. Hassett

Section 10 of the Federal Arbitration Act lists specific grounds upon which a court is authorized to vacate an arbitration award. 9 U.S.C. § 10. Over the years, courts added an additional ground, i.e. "manifest disregard of law." *See First Options of Chicago v. Kaplan*, 514 U.S. 938, 942 (1995) ("parties [are] bound by [an] arbitrator's decision not in manifest disregard of law."); *Wilko v. Swann*, 346 U.S. 427, 436-37 (1953) ("[I]nterpretations of the law by the arbitrators in contrast to manifest disregard [of the law] are not subject, in the federal courts, to judicial review for error in interpretation . . . ."). The courts were not completely consistent as to what constituted a manifest disregard of law. All agreed that it required something other than an erroneous conclusion of law. One of the more restrictive tests was adopted by the Second and Third Circuits and required the complaining party to "bear the burden of proving that the arbitrators were fully aware of the existence of a clearly defined governing legal principle, but refused to apply it, in effect, ignoring it." *Bellantuono v. ICAP Securities USA, LLC*, No. 12-4253 (3rd Cir. Jan. 30, 2014); *Dufercov Int'l Steel Trading v. T. Klaveness Shipping A/S*, 333 F.3d 383, 389 (2nd Cir. 2003). While the burden was high, the complainant did have some legal basis to challenge the award. The Ninth Circuit adopted a more lenient standard under which *vacatur* is authorized where "the arbitration panel commits clear and obvious error in the face of contrary law." *La Tour v. Citigroup Global Mkts, Inc.*, No. 12-55643 (9th Cir. Nov. 12, 2013).

In *Hall Street Assocs., LLC v. Mattell, Inc.*, 552 U.S. 576, 586-87 (2008), the U.S. Supreme Court stated that the text of Sections 10 and 11 of the Federal Arbitration Act "compels a reading of [those sections]

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WHAT IS INSURANCE ANYWAY?

By Joseph T. Holahan

For traditional insurance products, there is little question that the product is "insurance" as defined by state law and therefore subject to state regulation governing the business of insurance. Outside that well-charted domain, however, lie all manner of contracts providing indemnity or risk transfer that may or may not be regulated as insurance. How does one know if a particular contract constitutes insurance? What is insurance anyway?

Insurance, of course, is regulated primarily at the state level. State statutes establishing the authority of state regulators to regulate the business of insurance typically define the term "insurance" very broadly. Under California law, for example, insurance is "a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from a contingent or unknown event."[1] On its face, this definition could apply to any contract that includes an indemnification clause. Clearly, the California legislature did not mean the statute to extend so far.

In general, there are three types of contracts that involve indemnification or other risk transfer but have been recognized as not constituting insurance: (i) first-party warranties, (ii) extended warranties or service contracts and (iii) contracts where risk shifting or indemnification is not the principal object and purpose of the contract or which otherwise are not insurance under one or more tests employed by the courts. Each of

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[1] Cal. Ins. Code § 22. Other states have similarly broad definitions of insurance. *See, e.g.*, Fla. Stat. § 624:02; N.Y. Ins. Law § 1101.

Inside this Issue

Announcements

Jessica Pardi represented a large fast-food franchisee and franchisor and won a summary judgment motion entitling the franchisee and franchisor to $6 million in coverage under primary and excess business owners' policies. The Tennessee Court heard oral argument on December 6, 2013, and the judge ruled from the bench in favor of the insureds.

Chris Petersen was appointed and served on Governor Terry McAuliffe's transition team. Mr. McAuliffe was elected Governor of Virginia in November 2013.

Lew Hassett and **Kelly Christian** obtained a declaratory judgment in favor of an insurance pool for Georgia counties and county officers. A deputy county sheriff was sued in federal court for an allegedly unjustifiable fatal shooting. The plaintiff's attorney claimed that because the deputy was serving on an inter-governmental drug task force and was cross-deputized by other sheriffs, the law enforcement liability provisions of all the counties' policies could be stacked. If accepted, the pool would have been liable up to the limits of multiple policies. The court entered a declaratory judgment limiting the plaintiff's potential recovery to the limit of the single policy of the county where the deputy was employed.

Jim Maxson was re-elected for a third term to the Executive [Committee] of the European Life Settlement Association (ELSA).

Skip Myers attended the Captive Insurance Company Association (CICA) annual meeting on March 9-11 in Phoenix and spoke regarding current problems affecting risk retention groups.

Lew Hassett was selected as a 2014 Georgia Super Lawyer in the area of business litigation. Super Lawyers includes top lawyers from more than 70 practice areas who have attained a high degree of peer recognition and professional achievement. The final selections represent no more than 5 percent of the lawyers in Georgia.

Jessica Pardi will attend the Surplus Lines Conference in Florida on April 3-4 where she will address Georgia regulatory developments.

Tony Roehl will attend the annual meeting of the American Association of Managing General Agents (AAMGA) on the Big Island of Hawaii on May 18-21.

Ross Albert and **Brian Levy** obtained a favorable judgment in a potentially precedent-setting insider trading case against the U.S. Securities and Exchange Commission (SEC). The victory received substantial national and international media attention, including articles in the *New York Times Dealbook*, the *Atlanta Journal-Constitution*, *Law360*, *Legal Times*, *Courthouse News Service*, *Securities Docket*, *Compliance Building* and on the blog and Twitter account of noted entrepreneur, Mark Cuban.

TAX COURT ALLOWS DEDUCTION FOR PAYMENTS MADE ON BEHALF OF SUBSIDIARIES TO WHOLLY-OWNED CAPTIVE INSURER

By Brian J. Levy

They may not be as delicious as apple pie or enjoyable as baseball, but tax loopholes are just as American. The U.S. Tax Court recently provided a new mechanism for corporations to reduce tax liabilities when, in *Rent-A-Center, Inc., et al. v. Commissioner*, 142 T.C. 1 (Jan. 14, 2014), it ruled a parent corporation could deduct as a trade or business expense, payments made on behalf of its subsidiaries to a wholly-owned captive insurer that provided coverage for the subsidiaries. Of particular note is the Court's departure from *Humana Inc. v. Commissioner*, 88 T.C. 197 (1987), and adoption of the reasoning of the federal appellate court that reversed a portion of *Humana* in *Humana Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989).

From 2003 through 2007 (the "Tax Years"), Rent-A-Center, Inc. ("RAC") was the largest domestic rent-to-own company and filed consolidated federal income tax returns for itself and 15 subsidiaries. For the Tax Years, the Internal Revenue Service ("IRS") determined total deficiencies against RAC in excess of $40 million attributable to deductions taken by RAC for payments made to its wholly-owned, Bermuda-based captive insurer, Legacy Insurance Co., Ltd. ("Legacy").

RAC formed Legacy in December 2002 as a way to save costs on insurance premiums. Legacy provided RAC's primary level coverage for workers' compensation, automobile and general liability. RAC purchased excess coverage from Discover Re for the same risks. The annual premium Legacy charged RAC was actuarially determined using loss forecasts developed by its broker and was allocated to each RAC subsidiary that owned covered stores. Notably, all of RAC's stores were owned and operated by its subsidiaries. RAC paid the premiums for each policy and at the end of each year adjusted the allocations attributable to each subsidiary to reflect actual insurance costs. Legacy employed a third-party administrator to evaluate and pay claims.

The Tax Court found that payments to Legacy were deductible because: (1) Legacy was a bona fide insurance company, and not, as the IRS claimed, "a sham entity created primarily to generate Federal income tax savings," *Rent-A-Center*, 142 T.C. at 7. and (2) the payments were deductible insurance expenses.

On the question of whether Legacy was a bona fide insurance company, the Tax Court quickly found that RAC considered tax consequences in forming Legacy, but it was not a "tax-driven transaction," because Legacy "made a business decision premised on a myriad of significant and legitimate considerations." *Id.* The Tax Court determined Legacy was a bona fide insurance company

because: (i) RAC faced actual and insurable risk, (ii) comparable coverage with other insurance companies would have been more expensive (if available at all), (iii) the contracts between Legacy and RAC's other subsidiaries were bona fide arm's-length contracts, (iv) premiums were determined actuarially and (v) because Legacy was subject to Bermuda's regulatory control and met its minimum statutory requirements, paid claims from its separately maintained account and was capitalized adequately.

The question of whether RAC's payments to Legacy were deductible as insurance expenses involved more extensive analysis and ultimately led to the Tax Court reversing a portion of its earlier decision in *Humana*. The Internal Revenue Code does not define insurance, but the U.S. Supreme Court has established two necessary criteria —risk shifting and risk distribution. The Tax Court also considers whether the arrangement involves insurance risk and meets commonly accepted notions of insurance. The IRS conceded the criteria of insurable risk was present because RAC faced insurable risk related to workers' compensation, automobile and general liability. The Tax Court easily found that Legacy distributed risk by insuring the risks to subsidiaries that collectively owned upwards of 2,600 stores, had 14,300 employees and operated 7,100 vehicles. The Tax Court also ruled that Legacy constituted an insurer in the commonly accepted sense, in that it was adequately capitalized, regulated by Bermuda, issued valid and binding policies, received actuarially determined premiums and paid claims.

Accordingly, the deductibility of RAC's payments to Legacy turned on the existence of risk shifting from RAC's subsidiaries to Legacy and the Tax Court's interpretation of *Humana*. In *Humana*, the Tax Court faced two distinct issues: the deductibility of premiums paid by a parent to a captive (parent-subsidiary arrangement) and the deductibility of premiums paid by affiliated subsidiaries to a captive (brother-sister arrangement). In that case, the Tax Court held that neither parent-subsidiary premiums nor brother-sister premiums were deductible because the risk did not shift to the captive insurer.

The Sixth Circuit affirmed the Tax Court's ruling relating to the parent-subsidiary arrangement, but reversed with respect to the brother-sister arrangement. It ruled that brother-sister premium payments were deductible because risk shifts when a subsidiary that has no ownership interest in the captive insurer pays premium under an insurance contract to the insurer. The court went on to lay out a roadmap for RAC's later arrangement, refuting the Tax Court's reasoning that denying deductions in the brother-sister context was necessary to prevent a parent to a captive insurance company from avoiding the non-deductibility of payments in the parent-subsidiary context by paying premiums on behalf of its subsidiaries.

Adopting the portion of the Sixth Circuit's decision in *Humana* that approved deductions in the brother-sister context, the Tax Court in *Rent-a-Center* overruled its prior precedent and ruled that brother-sister arrangements shifted risk because the claims paid by the captive did not affect the net worth of the insured subsidiaries. The Tax Court rightly reversed itself in the case of the arrangement set up by RAC, but, as a concurring opinion aptly noted, the deductibility of captive insurance transactions is based on the facts and circumstances of each case and insurance brokers helping a corporation create a captive insurer would be wise to closely follow those in *Rent-a-Center*. ❑

Brian J. Levy is an associate in the firm's Insurance and Reinsurance and Litigation Practices. Mr. Levy received his bachelor's degree from the University of Virginia and his law degree from William and Mary School of Law.

EFFECTIVE RESERVATION OF RIGHTS: DON'T SKIMP ON THE CORRESPONDENCE!

By Jessica F. Pardi

A carrier that fails to reserve its rights to deny coverage likely properly waives all defenses to coverage. Moreover, if the carrier has been defending its insured without an effective reservation of rights and then revokes the defense based upon a coverage denial, a presumption of prejudice arises in favor of the insured. The necessary steps to reserve rights and the timing of such reservation were at issue in *The Cincinnati Insurance Co. v. All Plumbing, Inc. Service, Parts, Installation, et al.*, U.S.D.C for the District of Columbia, Civil Action No. 12-851 (Memorandum Opinion dated October 18, 2013). In this recent case, The Cincinnati Insurance Co. ("Cincinnati") filed a declaratory judgment action (the "Dec Action") seeking a ruling that Cincinnati need not defend its insureds, All Plumbing, Inc. ("All Plumbing") and Mr. Kabir Shafik ("Shafik"), and need not indemnify FDS Restaurant, Inc. ("FDS") for damages alleged in a lawsuit filed by FDS (the "FDS Action").

Prior to institution of the FDS Action, in September of 2010, Love the Beer, Inc. ("Love") filed a putative class action against All Plumbing and Shafik (the "Love Action") alleging that All Plumbing and Shafik sent unsolicited faxes in violation of the Telephone Consumer Protection Act ("TCPA") 47 U.S.C. § 227. FDS was a member of the putative class in the Love Action which was served on All Plumbing and Shafik in November of 2010. Cincinnati claimed All Plumbing and Shafik never notified Cincinnati of the Love Action, but, rather, counsel for Love contacted Cincinnati in November of 2011 (a year after service) and asked Cincinnati to defend its insureds. One month later, Cincinnati informed All Plumbing and Shafik it would defend them in the Love Action but that such defense would be pursuant to a full and complete reservation of rights.

Thereafter, FDS filed a separate putative class action against All Plumbing and Shafik alleging similar violations of the TCPA. Cincinnati received a copy of the complaint from FDS's counsel, the same counsel that represented FDS in the Love Action. Cincinnati retained counsel for All Plumbing and Shafik to defend against the FDS Action.

Subsequently, Love moved for leave to file an amended complaint in the Love Action eliminating the class allegations and limiting all allegations to only those of the named plaintiff, Love. The motion was granted, and the Love Action never was certified as a class action.

In February of 2012, Cincinnati informed FDS in writing that coverage for the FDS Action may be barred for various reasons including All Plumbing and Shafik's failure to provide prompt notice of the claim. Cincinnati did not, however, communicate to All Plumbing or Shafik that the defense of the FDS Action was being provided pursuant to a reservation of rights.

In the Dec Action, FDS argued Cincinnati was estopped from denying coverage because it assumed the defense of the FDS Action without properly reserving its rights. Cincinnati argued it reserved its rights in the FDS Action when it provided All Plumbing and Shafik a full and complete reservation of rights in the Love Action; i.e. because FDS was a member of the putative class identified in the Love Action, and the FDS Action involved the same causes of action under the TCPA as those alleged in the Love Action, the December 2011 reservation of rights in the Love Action reserved Cincinnati's rights as to claims asserted on behalf of every member of the class, including those in the separate FDS Action. Cincinnati also argued that the filing of the Dec Action adequately informed All Plumbing and Shafik of the coverage issues. Finally, Cincinnati argued that because the FDS Action was "still in its infancy" at the time Cincinnati filed the Dec Action, All Plumbing and Shafik sustained no prejudice and, accordingly, Cincinnati could not be estopped from asserting coverage defenses and/or a denial of coverage.

The Court disagreed. Despite the many similarities between the Love and FDS Actions, the Court held they were two distinct lawsuits, and because the Love Action never was certified as a class action, FDS never was a party to the Love Action. Therefore, Cincinnati could not have communicated a reservation of rights in the FDS Action by means of the December 2011 letter pertaining to the Love Action. The Court also noted that the letter sent to FDS's counsel in the FDS Action stating there likely were notice issues cannot count as a reservation of rights effective against its insureds because the letter was not sent to the insureds.

While the presumption of prejudice which attaches when an insurer assumes the defense of an action without reserving rights can be rebutted, Cincinnati was unable to rebut such presumption because the Court found that Cincinnati took important actions in defense of All Plumbing and Shafik in the five-month period between assuming the defense in the FDS Action and disclaiming liability. These actions included selecting defense counsel, filing an answer, successfully removing the FDS Action to federal court and opposing FDS's motion for class certification. All Plumbing and Shafik's inability to engage their own defense counsel for such strategic decisions constituted prejudice, thereby preventing Cincinnati from now denying coverage. Some jurisdictions specifically have found that the filing of a declaratory judgment action preserves an insurer's defenses to coverage even if the insurer did not send a proper reservation of rights. The Court noted, however, that in each of those cases the underlying lawsuit against the insured was truly in its initial stages.

The lesson of *Cincinnati Insurance Co. v. All Plumbing* is that carriers should reserve rights early and often; i.e. issue separate reservations for separate lawsuits even if the actions are related or similar; send the reservations before taking any significant defensive actions; and never assume an insured will receive communications sent to others, even if they are affiliated. ❑

Jessica F. Pardi is a partner in Morris, Manning & Martin's Insurance and Reinsurance Practice. Ms. Pardi's practice includes reinsurance arbitrations, complex coverage disputes, bad faith matters, managing general agency disputes and life settlement controversies. Ms. Pardi received her undergraduate degree from Boston University and her law degree from the University of Virginia.

APPLYING AUTOMATIC STAYS IN INSURANCE LIQUIDATIONS

By Patrick Curtin

For policyholders, creditors and others connected with an insurer, news that the company is being liquidated can come as a surprise, to say the least. Therefore, it is important for all parties involved to understand how the insurance liquidation process works.

In many ways, an insurance liquidation is similar to a Chapter 7 bankruptcy under federal law. The similarities include the "automatic stay" that goes into effect when a person or company files bankruptcy. When an entity files for bankruptcy protection, 11 U.S.C. § 362 "freezes" the assets and liabilities of the bankrupt entity; accordingly, creditors cannot move forward with collection, and the debtor cannot dispose of any property potentially subject to collection. As part of the process, any "judicial, administrative, or other action or proceeding against the debtor" is stayed until the assets and liabilities of the debtor can be determined. 11 U.S.C. § 362(a)(1). Without the stay, creditors might "race to the courthouse" to press their claims before an entity's assets are exhausted. This could lead to inconsistent adjudications, res judicata issues and the denial of worthy claims. The automatic stay gives the bankruptcy court time to determine the merits of the claims against the bankrupt estate and make an orderly, efficient and equitable distribution of its assets.

Things work similarly in insurance liquidations, with one major difference: the law of the state in which the insurer is domiciled governs the liquidation. Accordingly, when an insurer is insolvent, it is the domiciliary state's regulatory authority which will petition for an order of liquidation, and a court in that state which will issue the automatic stay. Ensuring this stay order is given proper effect is one of the key responsibilities of the liquidator.

In the state-based insurance regulatory world, logic suggests reciprocity ought to make the stay effective in non-domiciliary states. If states do not respect out-of-state court orders concerning insurers, the regulation

of insurance is hampered greatly. In the liquidation context, a stay that applied only to one state allows creditors to race to the courthouses of other states, undercutting the purpose of the stay order.

By its own terms, a stay order issued by a state court applies everywhere. Washington D.C. law, for example, stipulates that "no action at law or equity or in arbitration shall be brought against the insurer or liquidator, *whether in the District or elsewhere*." D.C. Code § 31-1322(a)(emphasis added). This language is from the Insurance Rehabilitation Model Act (IRMA) drafted by the National Association of Insurance Commissioners (NAIC), and is typical of state statutes on insurance liquidations. While it may sound simple, getting an automatic stay order recognized in "foreign" states can be difficult. State courts often are unfamiliar with the insurance liquidation process or hesitant to enforce the stay, to say nothing of aggrieved plaintiffs. How then, can a liquidator ensure the stay order is respected? The liquidator has several sources of authority to prevent this from happening.

First, many states have codified the reciprocity principle and provided a mechanism by which it can be enforced. Some courts may apply the stay automatically, and other courts may force the liquidator or the liquidator's representative to seek a local stay order. Familiarity with the laws of the states in question is essential. For example, in New Jersey, the liquidation may rely upon N.J. Stat. 17B:32-53, which specifies that "[t]he courts of this State shall give full faith and credit to injunctions against the [foreign] liquidator or the insurer." Absent a compelling argument that the provision somehow does not apply to the case at hand, a foreign court will respect the statute and give effect to an out-of-state court's automatic stay.

If there is no such statute, the liquidation may turn to the U.S. Constitution. The issue of reciprocity is not unique to the insurance context but instead is inherent in a federal system. The drafters of the Constitution anticipated such difficulties and provided a solution in the Full Faith and Credit Clause of Article IV, Section 1 of the U.S. Constitution. The Full Faith and Credit Clause mandates that the judgment of a court in one state "qualifies for recognition throughout the land." *Baker v. General Motors Corp.*, 522 U.S. 222 (1998) (affirming the general principle that a judgment of a competent state court on an issue over which it has adjudicatory power must be given effect in other states). In the insurance liquidation context, courts have applied this principle in *Beecher v. Lewis Press Co.*, 238 A.D.2d 927 (App. Div. N.Y. 1997)(holding that non-enforcement of a Rhode Island court ordered stay "would violate the purpose of the injunction, which is to preserve and protect the assets of [the insurer in liquidation] for an equitable distribution amongst its claimants and assured.") and in *Bryant v. Shields, Britton & Fraser*, 930 S.W.2d 836 (Ct. App. TX 1996) (holding that "because the liquidation order is a final, enforceable order in Tennessee, Texas courts must afford it full faith and credit."). Simply alerting an out-of-state court or counsel of these holdings may be enough.

In states without such precedent, claimants may try to proceed despite the stay. In these cases, the liquidator must seek an appropriate—and perhaps creative—solution. For instance, in some cases an appeal to a claimant's practical side may convince the claimant that the liquidation's claims process is more likely to yield fruit. The correct approach for each situation is as unique as its individual circumstances. ❑

Patrick Curtin is an associate in the firm's Insurance and Reinsurance Practice and focuses in the areas of insurance regulation, alternative risk transfer and corporate matters. Mr. Curtin received his bachelor's degree from Miami University and his law degree from Georgetown University Law Center.

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as [the] exclusive" grounds upon which an arbitration award may be vacated. While the Court did not expressly reject the continued viability of manifest disregard of law as grounds for *vacatur*, some commentators and district courts were quick to sound the death knell of manifest disregard of law as grounds to vacate an arbitration award.

Not so fast. Like Carrie's hand from the grave, the doctrine still lives. Of the seven Circuits that have addressed the continued viability of manifest disregard of law as grounds for *vacatur* since the *Hall Street* decision, four have ruled one way and three the other. Specifically, the Second, Fourth, Sixth and Ninth Circuits have held that manifest disregard of law remains a grounds for *vacatur* because an arbitrator essentially would have exceeded his or her powers under Section 10(a)(4) of the Act by manifestly disregarding the law. *See Abu Dhabi Investment Auth. v. Citigroup, Inc.*, No. 13-1068-CV (2d Cir. Feb. 19, 2014); *Wachovia Sec. LLC v. Brand*, 671 F.3d 472, 480 (4th Cir. 2012); *Coffee Beanery, Ltd. v. WW, LLC*, 300 F.App'x. 415, 418 (6th Cir. 2009); *Cobble Club, Inc. v. Improv W. Assocs.*, 553 F.3d 1277, 1281 (9th Cir. 2009).

Conversely, the Fifth, Eighth and Eleventh Circuits have held that manifest disregard of the law no longer serves as a ground to overturn an arbitration award. *See Frazier v. CitiFinancial Corp.*, 604 F.3d 1313, 1314 (11th Cir. 2010); *Medicine Shoppe Int'l, Inc. v. Turner Invs., Inc.*, 614 F.3d 485, 489 (8th Cir. 2010); *Citigroup Global Mkts., v. Bacon*, 563 F3d 349, 350 (5th Cir. 2009). In *DIRECTV, LLC v. Arndt*, No. 13-10033, 213 WL 5718384 (11th Cir. Oct. 22, 2013), the Eleventh Circuit reversed the vacation of an arbitration award, stating, "The arbitrator's award may have been ugly, and could have been mistaken, incorrect, or in manifest disregard of the law, but those are not grounds for vacating the award under [Section 10(a)(4) of the FAA]."

However, the Fifth Circuit recently wobbled a bit in *ConocoPhilips, Inc. v. Local 13-0555 United Steel Workers Intern. Union*, No. 12-31225 (5th Cir. Jan. 30, 2014), where the court stated, "If an issue has been

submitted to an arbitrator, a court will set that decision aside only in very unusual circumstances, such as fraud, manifest disregard of the law, corruption, undue means, and the arbitrator overstepping its powers." While that language was *dicta*, it may reflect some disagreement on the court.

Not only has manifest disregard of law survived in some circuits, sometimes it succeeds. In *Dewan v. Walia*, No. 12-2175 (4th Cir. Oct. 28, 2013), the court held that an arbitrator had manifestly disregarded the law by refusing to enforce a release provision. The Eighth Circuit recently overturned an arbitrator's award on the grounds that he had manifestly disregarded the law. *Reyco Granning LLC v. International Broth. Of Teamsters, Local Union No. 245*, 735 F.3d 1018 (8th Cir. Nov. 15, 2013). However, on January 14, 2014, the full Eighth Circuit granted rehearing *en banc* and may rule the other way.

Until the U.S. Supreme Court resolves the differences among the Circuits, the viability of manifest disregard of law as grounds to vacate an arbitration award will remain unsettled. For now, and to the extent a business has a choice, it should designate the federal venue carefully. ❑

Lew Hassett is Co-Chair of the firm's Insurance and Reinsurance Practice and Chair of the firm's Litigation Practice. His focus is complex civil litigation, including insurance and reinsurance matters, business torts and insurer insolvencies. Mr. Hassett received his bachelor's degree from the University of Miami and his law degree from the University of Virginia.

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these arrangements is discussed below.

First-Party Warranties

Generally speaking, a first-party warranty is a warranty of the quality of goods or services by the manufacturer or seller with a promise to repair or replace defective goods, repeat services or provide a refund. Such warranties generally are not regulated as insurance so long as the following conditions are met: (i) the warranty is incidental to the sale of a product or service, (ii) the warranty is not negotiated separately from that sale, (iii) no separate consideration is charged for the warranty and (iv) the benefit provided is limited to repair or replacement of the product, repetition of services or a refund.[2]

It also may be permissible for a first-party warranty to cover incidental damage resulting from a defective product or service.[3] If, however, a contract covers damage resulting from outside causes unrelated to an inherent defect, it generally is considered insurance. For example, a warranty from the seller of tires offering to repair or replace the tires if they are damaged due to poor construction or defective materials and expressly excluding damage resulting from road hazards is not insurance.[4] In contrast, a contract covering tires for damage resulting from hazards such as punctures, underinflation or poor alignment likely is insurance.[5]

Extended Warranties and Service Contracts

Like a first-party warranty, an extended warranty involves a promise to repair or replace defective goods, but unlike a first-party warranty, an extended warranty is offered for a separate consideration. The cost of the extended warranty is not included in the purchase price of the product and is negotiated separately. In addition, an extended warranty often covers not only inherent defects, but also failure of the product due to normal wear and tear. An extended warranty may be offered by a seller, but it also may be offered by an unrelated third party.

Extended warranties have been a growth industry in recent years, and consumers are now very familiar with the extended warranties commonly offered for goods such as electronics, appliances, cars and trucks, watercraft and other vehicles. Another common form of extended warranty is the home warranty covering major home systems and appliances offered by a party other than the builder.

Most states now regulate these and other types of extended warranties as "service contracts." Typically, a separate regulatory scheme is found in state law for vehicle service contracts and service contracts covering electronics, appliances and other consumer goods. Home service contracts also may be subject to their own regulatory scheme.

Other Contracts

Beyond first-party and extended warranties, there is a third, less defined category of contracts that share characteristics with insurance but are not necessarily subject to regulation as such. As mentioned above, many state statutory definitions of insurance are broad enough to capture just about any contract that includes an indemnification or other element of risk shifting. Clearly, not all such contracts constitute insurance.

Courts employ a variety of practical tests to distinguish non-insurance arrangements involving indemnification or other risk shifting from insurance subject to regulation by state insurance regulators.

The most widely used test considers whether risk shifting is the "principal object and purpose" of the relationship between the parties to the arrangement. Where it is not, courts conclude that the relationship does not constitute insurance. The leading case applying the "principal object and purpose test" is *Jordan v. Group Health Association*.[6] In that case, the Court of Appeals for the District of Columbia Circuit concluded that the following analysis should be employed in evaluating

[2] *See, e.g.,* Ark. Code Ann. § 4-114-102(c)(1) and 4-114-103(14); N.C. Gen. Stat. § 58-1-20(a)(1); W.Va. Code § 33-4-2(a)(4) and (b)(5).

[3] *See, e.g.,* Cal. Ins. Code § 12805(a)(4) (warranty of vehicle or watercraft part that includes indemnification for consequential and incidental damage resulting from failure of the part does not constitute insurance).

[4] *State ex rel. Herbert v. Standard Oil Co.*, 35 N.E.2d 437 (Ohio 1941).

[5] *State ex rel. Duffy v. Western Auto Supply Co.*, 16 N.E.2d 256 (Ohio 1938). *But see Petro, Inc. v. Serio*, 804 N.Y.S.2d 598 (Sup. Ct. NY 2006) (service contract from home heating oil contractor that included clean-up service for oil spills was not insurance because although risk of spill was not entirely a matter of whether contractor's services were satisfactory, risk was sufficiently within contractor's control for clean-up service to qualify as a first-party warranty of services).

[6] 107 F.2d 239 (D.C. Cir. 1939).

whether an agreement constitutes a contract of insurance:

> [O]bviously it was not the purpose of the insurance statutes to regulate all arrangements for assumption or distribution of risk. That view would cause them to engulf practically all contracts…. The question turns not on whether risk is involved or assumed, but on whether that or something else to which it is related in the particular plan is its principal object and purpose.[7]

Under the principal object and purpose test announced in *Jordan*, the fact that an agreement contains an element of risk shifting will not cause the agreement to be deemed a contract of insurance so long as the principal object and purpose of the agreement is something other than shifting risk.

Courts in many states have employed the principal object and purpose test in evaluating whether an agreement that includes an indemnification or other risk shifting constitutes insurance.[8] State attorneys general also have employed the principal object and purpose test when asked to opine on this issue.[9]

The principal object and purpose test is a fairly subjective analysis. There is no bright line for determining whether risk shifting is sufficiently incidental to a larger relationship or transaction so as not to be characterized as insurance. Of course, the more limited in scope the indemnification or other risk shifting is in relation to a larger relationship between the parties, the greater the likelihood that it will be deemed not to be insurance.

In applying the principal object and purpose test, some courts have added a second criterion for evaluating whether an arrangement constitutes insurance—namely, "to what extent the specific transactions or the general line of business at issue involve one or more of the evils at which the regulatory insurance statutes were aimed."[10]

For example, in *Truta v. Avis Rent A Car System, Inc.*,[11] the California Court of Appeals held that a collision damage waiver offered by a rental car agency was not insurance. The court based its holding on two grounds. First, the waiver was incidental to the main purpose of the transaction, which was the rental of a car. Second, the waiver was not the sort of arrangement the insurance regulatory statutes were designed to address. In this regard, the court noted there was no risk the rental agency could default on the waiver because the waiver did no more than release the customer from liability for damage to the rental agency's property. Thus, a central concern of the insurance regulatory statutes—to regulate the maintenance of reserves and the investments of insurers to protect insureds in the event of loss—was absent from the transaction.[12]

Not all courts have adopted the principal object and purpose test. Some courts have combined the test with various other considerations. Other courts have focused on whether certain standard indicia of insurance are present in a relationship, such as the transfer and spreading of risk and payment of fees as consideration for the assumption of risk.[13] Still other courts have looked to the same elements in determining whether a relationship constitutes insurance but have considered an additional factor—namely, whether the relationship involves the transfer and distribution of risk among a large group of persons bearing similar risks.[14]

The Minnesota Supreme Court's decision in *Allen v. Burnet Realty, LLC*,[15] provides an excellent example of the variety of factors a court may consider in evaluating whether an arrangement constitutes insurance. In *Allen*, the court considered an indemnification and legal defense program offered by a realty agency to its brokers. The court concluded that the arrangement was not insurance because the agency was not assuming any risk for the conduct of its sales associates that it did not already have under principles of *respondeat superior.*[16] In addition, the court noted that the agency exercised a certain amount of control over the actions of the sales associates from whom liability might arise, which was inconsistent with the concept of insurance.[17] Finally, the court found that although the agency charged sales representatives an annual fee to participate in the program, it charged all representatives the same fee and therefore did not engage in any underwriting of risk unique to individual representatives.[18] From these facts, the court seemed to conclude that the agency was not acting in the manner one would expect for the creation of an insurance contract.

In the end, whether a contract involving indemnification or other risk shifting constitutes insurance often is a difficult question to answer given the variety of tests the courts have relied upon to answer this question and the frankly impressionistic analysis that often is used. Nevertheless, several common themes emerge from a reading of the cases in this area. Factors that may cause a court to conclude that a contract does not constitute insurance include the following: the element of risk shifting is incidental to a larger relationship or transaction; the covered risk is wholly or at least partially within the control of the party offering indemnification, causing the arrangement to look more like a first-party warranty; the arrangement is no more than a waiver of liability so that the consumer is not at risk of default

[7] *Id.* at 247 - 248.

[8] *See, e.g., Sasiadek's, Inc. v. Tucson*, 765 P.2d 566 (Ariz. App. 1988); *Title Ins. Co. of Minnesota v. State Bd. of Equalization*, 842 P.2d 121(Cal. 1992); *Transp. Guarantee Co. v. Jellins,* 174 P.2d 625 (Cal. 1946); *Automotive Funding Group v. Garamendi,* 114 Cal. App. 4th 846 (2003); *Lemy v. Direct Gen. Fin. Co.,* 885 F.Supp. 2d 1265 (M.D. Fla. 2012); *Boyle v. Orkin Exterminating Co.,* 578 So.2d 786 (Fla. App. 1991); *Barberton Rescue Mission, Inc. v. Dep't of Commerce,* 586 N.W.2d 352 (Iowa 1998); *State ex rel. Londerholm v. Anderson*, 408 P.2d 864 (Kan. 1965); *Allen v. Burnet Realty LLC,* 801 N.W.2d 153 (Minn. 2011); *New Mexico Life Ins. Guar. Association v. Moore,* 596 P.2d 260 (N.M. 1979); *Hertz Corp. v. Corcoran,* 520 N.Y.S.2d 700 (Sup. Ct. NY 1987); *H&R Block Eastern Tax Services v. Dep't of Commerce*, 267 S.W.3d 848 (Tenn. App. 2008); *Rayos v. Chrysler Credit Corp.*, 683 S.W.2d 546 (Tex. App. 1985).

[9] *See, e.g.*, 1973 Ariz. AG Lexis 57; 61 Ops. Cal. Atty. Gen 214 (1978); 55 Op. Atty. Gen. Md. 196 (1970); 1960 Tex. AG Lexis 90.

[10] *Truta v. Avis Rent A Car System, Inc.*, 193 Cal. App. 3d 802, 812 (1987).

[11] *Id.*

[12] *Truta* at 813. *See also Automotive Funding Group, Inc. v. Garamendi*, 114 Cal. App. 4th 846 (2003) (debt cancellation program offered by an auto lender did not constitute insurance because it was incidental to the loan contract between the lender and borrower and was not the sort of transaction the California insurance regulatory statutes were designed to regulate).

[13] *See, e.g., Griffin Systems, Inc. v. Washburn*, 505 N.E.2d 1121, 1123-24 (Ill. App. 1987).

[14] *See, e.g., Jim Click Ford, Inc. v. Tucson*, 739 P.2d 1365, 1367 (Ariz. App. 1987).

[15] 801 N.W.2d 153 (Minn. 2011).

[16] *Id.* at 158.

[17] *Id.* at 159.

[18] *Id.*

by the other party; and the arrangement does not bear the common indicia of insurance, such as the payment of premiums, case-by-case underwriting of risk or adjustment of claims. ❑

Joseph T. Holahan is Of Counsel in the firm's Insurance and Reinsurance Practice and a member of the firm's Privacy Practice. Mr. Holahan advises insurers and reinsurers on a variety of legal matters, including all aspects of regulatory compliance. He often advises clients on the development of captive programs and reinsurance arrangements. Mr. Holahan received his bachelor's degree from the University of Virginia and his law degree from the Catholic University of America.

MMM INSURANCE & HEALTHCARE ATTORNEYS

Robert P. Alpert	404.504.7692	ralpert@mmmlaw.com
Paul H. Arne	404.504.7784	parne@mmmlaw.com
Anthony Boggs	404.504.5484	aboggs@mmmlaw.com
Ward S. Bondurant	404.504.7606	wbondurant@mmmlaw.com
Kelly Christian	404.504.7612	kchristian@mmmlaw.com
Jason T. Cummings	404.495.3650	jcummings@mmmlaw.com
Patrick Curtin*	202.216.4117	pcurtin@mmmlaw.com
Jason D'Cruz	404.504.7601	jdcruz@mmmlaw.com
Dick Dorsey	404.495.3660	ddorsey@mmmlaw.com
Jeffrey K. Douglass	404.504.7793	jdouglass@mmmlaw.com
Lewis E. Hassett	404.504.7762	lhassett@mmmlaw.com
Joseph T. Holahan	202.408.0705	jholahan@mmmlaw.com
Larry H. Kunin	404.504.7798	lkunin@mmmlaw.com
Brian J. Levy	404.504.7657	blevy@mmmlaw.com
Simon R. Malko	404.495.3646	smalko@mmmlaw.com
James W. Maxson	404.504.7671	jmaxson@mmmlaw.com
Shannon McNulty	404.504.7735	smcnulty@mmmlaw.com
Robert "Skip" H. Myers, Jr.	202.898.0011	rmyers@mmmlaw.com
Jessica F. Pardi	404.504.7662	jpardi@mmmlaw.com
L. Chris Petersen	202.408.5147	cpetersen@mmmlaw.com
Thomas A. Player	404.504.7623	tplayer@mmmlaw.com
Anthony C. Roehl	404.495.8477	aroehl@mmmlaw.com
Lisa Wolgast	404.504.7748	lwolgast@mmmlaw.com
Bruce H. Wynn	404.504.7694	bwynn@mmmlaw.com

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* pending admittance to Washington D.C. Bar Association