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# REVIEW

Insurance • Reinsurance • Managed Healthcare

A Publication of Morris, Manning & Martin, LLP Fall 2005

## LETTER FROM WASHINGTON

### CAPTIVES ATTRACT REGULATORY ATTENTION

**By Robert H. Myers Jr.**

Captive insurance companies used to be exotic offshore financial creatures. However, the growth of captives and other forms of alternative risk transfer have placed captives into the mainstream of risk management. Twenty-four states now have some form of captive insurance law authorizing the establishment of captives. The number of risk retention groups has more than doubled in the past five years. The economy of at least one state – Vermont – is significantly, and positively, affected by the alternative risk transfer industry.

*"The head of the nail that sticks up will get hammered." – Japanese Folk Saying*

Continued on page 11

## HASSETT'S OBJECTIONS

### THE UNCONSCIONABILITY REVOLUTION

**By Lewis E. Hassett**

Congress enacted the Federal Arbitration Act ("FAA") in 1947 as a means of preempting traditional judicial hostility towards arbitration. *Volt Info Sys., Inc. v. Bd. of Trustees of Leland Stanford Jr. Univ.*, 489 U.S. 468, 474 (1989) (the FAA was designed "to overrule the judiciary's long standing refusal to enforce agreements to arbitrate and to place such agreements upon the same footing as other contracts"); *Stone v. Doerge*, 328 F.3d 343 (7th Cir. 2003); *Pritzke v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 7 F.3d 1110 (3rd Cir. 1993). The Supreme Court of the United States has made clear that federal policy supports the enforcement of arbitration clauses and that doubts as to arbitrability are to be resolved in favor of arbitration. *Moses H. Cone Mem. Hosp. v. Mercury Constr. Co.*, 460 U.S. 1, 24-25 (1983). Although federal policy favors arbitration, state law determines whether the parties intended to refer a particular

Continued on page 8

## PLAYER'S POINT

### "TRICK OR TRIA"

**WILL CONGRESS CREATE A MODEL ACT OR A MONSTER?[1]**

**By Thomas A. Player**

As Halloween nears, the debate in Congress over the future of the Terrorism Risk Insurance Act ("TRIA") will heat up in earnest with expiration of the current federal terrorism insurance program at year end.

Earlier this year, it seemed possible at times that Congress might allow TRIA to expire without any further action, leaving the market to cope with insuring terrorism without a federal backstop. While Congressional Democrats were supportive of an extension, key Republican legislators repeatedly emphasized that TRIA was conceived purely

Continued on page 7

## Inside this issue

# Announcements

In a recent survey taken by ***US Insurer*** magazine of in-house insurance counsel, **Morris, Manning & Martin** was voted in the top ten overall in insurance matters nationwide, with specific recognition in Litigation and Dispute Management.

**Lew Hassett** has been named to the Editorial Board of the ***Insurance Coverage Law Bulletin***, published by American Law Media.

**Bill Megna** recently was appointed as the Vice-Chairman of the New Jersey State Bar Association's Insurance Law Section.

**Bill Megna** contributed an article for the Second Quarter 2005 issue of The DC Captive Insurance Newsletter titled "Managed Care and Managed Risk." If you would like a copy of this article, please e-mail Bill at wmegna@mmmlaw.com.

On July 13, **Bill Megna** spoke at a seminar in Princeton, New Jersey held by the Captive Insurance Council of the District of Columbia. Bill discussed the regulatory issues that need to be addressed in the formation and management of captives and RRGs.

Acting as General Counsel and Secretary of the organizational meeting of the Enterprise Risk Management Institute International, **Tom Player** met with interested parties and principals from around the world in New York in September. **Bill Winter** contributed significantly in the preparation for the conference.

**Tom Player** participated in a conference held in New York in September, Preparing for the Future of Finite and Structured Risk (Re)Insurance. (He and Tony Roehl represent numerous insurers and reinsurers in connection with regulatory investigations into finite risk transactions.)

**Tom Player** participated in the First Annual Bermuda Captive Conference held in Southhampton, Bermuda in September.

**Skip Myers** will be speaking on the redomestication of an insurance company at the annual meeting of the Captive Insurance Council of the District of Columbia in Washington, DC on September 28.

**Skip Myers** will be speaking on October 17 to the National Risk Retention Association in Washington, DC on the regulatory challenges faced by captives.

## GEORGIA SUPREME COURT HOLDS THAT FEDERAL ARBITRATION ACT IS PREEMPTED BY THE MCCARRAN-FERGUSON ACT

**By Kristin B. Zimmerman**

The Georgia Supreme Court recently held that a Georgia statute barring the enforcement of arbitration clauses in insurance contracts trumped the Federal Arbitration Act ("FAA"). 9 U.S.C. § 1, et seq. The court found that the McCarran-Ferguson Act ("MFA"), 15 U.S.C. § 1012, which bars the implied pre-emption of state insurance laws, overrode the reach of the FAA. *Love v. Money Tree, Inc*., No. S04G1474 (Ga., June 6, 2005). In *Love*, a lender, The Money Tree, brought collection efforts against borrowers who had purchased automobile club memberships in connection with certain loans. The membership agreements included an arbitration clause. The Money Tree moved to compel arbitration, arguing that the dispute was governed by the FAA. The Georgia Court of Appeals ruled that automobile club memberships were not insurance and that the MFA did not preclude application of the FAA.

The Supreme Court of Georgia reversed, holding that the automobile club memberships did constitute insurance. The court then addressed whether the FAA requires the parties to submit their dispute to arbitration even though Georgia law provides that agreements to arbitrate disputes regarding "contracts of insurance" are invalid. Off. Code Ga. Ann. § 9-9-2(c)(3). While noting that the FAA's rule requiring the enforcement of arbitration provisions agreements preempts contrary state law, the Court also recognized that the MFA prohibits the application of any federal statute that would "invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance," unless the federal law expressly so provides. 15 U.S.C. § 1012. The FAA does not expressly apply to insurance contracts.

Thus, the Court had to decide whether Off. Code Ga. Ann. § 9-9-2(c)(3) was enacted for the "purpose of regulating the business of insurance" and, if so, whether the application of the FAA would impair the state statute. In its discussion of the issue, the court noted that other courts had held that such state laws were enacted for the purpose of regulating insurance, that application of the FAA would impair those laws, and that the MFA precluded the FAA from preempting those state laws. Finally, the court stated that the issue of whether Georgia law forbids the arbitration of an insurance dispute is not an issue that goes to the merits of the parties' underlying dispute, but rather is an issue of arbitrability that may be decided by a court.❑

*Kristin Zimmerman is an associate in the firm's insurance and healthcare groups. Kristin received her bachelor's degree from Emory University, her master's degree from Rollins School of Public Health, and her law degree from Emory University School of Law.*

## THE REGULATORY VIOLATION DOMINO EFFECT

**By Joseph L. Cregan and Anthony C. Roehl**

While every producer knows that a regulatory violation in a state can place his or her producer license in jeopardy in that state, what most producers don't know is that a violation of one state's insurance statutes or regulations can be the grounds for a separate finding of a violation of law in another state.

Almost every state has a requirement for insurance producers to report any administrative action taken against the producer in another jurisdiction. Generally, producers have 30 days after the final disposition of a matter to report it to all other states where that producer is licensed. Failure to report the violation is itself a violation of the other state's regulatory laws and can subject the producer to a consent order, fine or license suspension or revocation. This requirement is in Section 17 of the NAIC Producer Licensing Model Act that has been adopted in some form by virtually every state. However, failing to report the violation is not the only risk.

The Producer Licensing Model Act also contains a standard clause adopted by virtually every state that allows a state to suspend, revoke or non-renew a license where the producer violated any law or regulation of another state. For example, State X can take action against a producer based solely on State Y's action, without requiring there to be a proven violation of a law or regulation in State X. Thus, a regulatory violation in even one state can have a domino effect into other jurisdictions that can ultimately jeopardize a producer's very livelihood.

State departments of insurance have been seizing on the reporting requirements to assess small fines or require consent orders against producers who are in violation of another state's law, even if it had no bearing on the producer's operations in that state. Further, because a national database has been developed by state regulators to track and document regulatory fines and consent orders, departments of insurance have recently become more aggressive in tracking down producers who have failed to report a regulatory action from another state. The end result is that very minor regulatory violations are being escalated through non-reporting (and even reporting!) to seriously jeopardize producers' licenses. Both our firm and certain sympathetic state regulators have begun to refer to this as the "agent domino effect."

In the end, the only way to completely protect a license is to make sure that you don't violate any statutes or regulations. Failing perfect compliance, we recommend two things to our producer friends and clients holding multi-state licenses:

1. Avoid haphazardly entering into any final adjudication of an alleged regulatory violation. Seek out competent counsel to make sure that your rights are protected, realizing that a minor regulatory violation in one state can quickly spread to other states, creating a much larger problem than first anticipated. To coin a phrase, once the bell is rung, it is impossible to unring it.
2. If you do have a regulatory violation, make sure you know the reporting obligations in all states where you are licensed. At the very least, properly reporting the violation mitigates the allegation that the producer has somehow tried to hide the prior regulatory action and will likely ultimately lead to a smaller fine or no fine or consent order at all in the other states.

Although we firmly believe that the enactment of the Producer Licensing Model Act has been a major step towards uniformity and reciprocity for multi-state producers, the domino effect described herein creates a pitfall, perhaps unintended by the NAIC, that can lead a producer into a multi-state regulatory quagmire.❑

*Joe Cregan is a partner in the firm's insurance group. He concentrates in the areas of insurance regulation, mergers and acquisitions of insurers, insurance company financial matters and general administrative law. Joe received his bachelor's degree from Youngstown State University, his master's degree from Kent State University and his law degree from Georgia State University.*

## Announcements

In October and December, respectively, **Tom Player** will make a presentation at CSC's Future Focus Conference with former South Carolina Insurance Commissioner John Richards on the changing regulatory environment resulting from the contingent commission investigations, and at the South Carolina Captive Insurance Association meeting in Charleston on the use of captives in light of proposed changes in TRIA (see, Player's Point, page 1).

The Georgia Life Settlement Act is fully effective on November 5, 2005. The Act represents the first regulation in Georgia of the life settlement industry and creates several new licensing categories. The Act also creates a complex regulatory scheme regarding the secondary purchase and sale of life insurance products. The Georgia Department of Insurance is currently drafting regulations to fully implement the Act. For more information on the new Act, please see our Summer newsletter or email **Tony Roehl** at troehl@mmmlaw.com.

**Tony Roehl** has been selected as an Adjunct Professor at the Georgia State University College of Law and will be teaching a class on insurance law during the Spring 2006 semester.

## CALIFORNIA SUPREME COURT ENFORCES ARBITRATION CLAUSE, FINDING NO CONFLICT WITH "SERVICE OF SUIT" PROVISION

**By Matthew A. Barrett**

In *Boghos v. Certain Underwriters at Lloyd's of London*, Case No. S117735 (Cal. App. July 18, 2005), the California Supreme Court held that a disability insurance policy's arbitration and service of suit clauses did not conflict and that the arbitration clause was therefore enforceable. The Court in *Boghos* also concluded that the policy's stipulation that the insured share arbitration costs with the insurer did not render the arbitration clause unenforceable. The Supreme Court reversed the judgment of the Court of Appeal and remanded the case to the trial court.

In September 1998, Antone Boghos, the owner of a plumbing business, applied for disability insurance underwritten by certain Lloyd's of London underwriters ("Lloyd's"). The application contained an arbitration provision. The subsequent policy's arbitration clause provided in part:

> ***BINDING ARBITRATION: Not withstanding [sic] any other item set forth [sic] herein, the parties hereby agree that any dispute which arises shall be settled in Binding Arbitration. By agreeing to Binding Arbitration, all parties acknowledge and agree that they waive their right to a trial by jury. . . .***

The policy also set forth that the venue of arbitration would be in Los Angeles County unless the parties agreed otherwise. According to the policy, arbitration costs would be equally split among the parties.

In addition to the arbitration clause, the policy contained a "service of suit" clause. That provision stated that, "In the event of the failure of underwriters to pay any amount claimed to be due under the insurance described herein, Underwriters have agreed that, at the request of the Assured (or Reinsured) they will submit to the jurisdiction of a court of competent jurisdiction within the United States."

Lloyds's began to pay benefits under the policy after *Boghos* claimed that he suffered a debilitating blow to his head. In December 2000, however, Lloyd's communicated that it would no longer pay benefits. Boghos filed suit, asserting claims for breach of contract, breach of the covenant of good faith and fair dealing, and intentional infliction of emotional distress. Lloyd's moved to compel arbitration of the claims.

The California Supreme Court reversed the Court of Appeal's (and trial court's) finding that the policy's arbitration and service of suit clauses conflicted, creating an ambiguity that had to be resolved in favor of the insured. The Court found no ambiguity and thus no occasion to apply the rule that ambiguities in insurance contracts are resolved against the insurer. It concluded that the arbitration clause itself shows that the parties intended for the arbitration clause to require all disputes to be settled in binding arbitration, "even if other provisions, read in isolation, might seem to require a different result." The Court pointed to the first sentence of the arbitration clause: "*Notwithstanding any other item set forth herein*, the parties hereby agree that any dispute which arises shall be settled in Binding Arbitration" (italics and standardization of spelling provided by the Court).

Mr. Boghos advanced several arguments against enforcing the arbitration clause, all of which the Court promptly rejected. Boghos contended that enforcement of the arbitration clause renders the service of suit clause surplusage. The Court disagreed, reading the service of suit provision to apply in the event that the insured needed to compel arbitration or enforce arbitration awards. The Court also held that the service of suit clause conveyed rights not given by statute, thus rejecting Boghos' claim that the interpretation of the service of suit clause ultimately accepted by the Court would duplicate statutory rights and render the service of suit provision surplusage.

Boghos also argued that the service of suit clause should apply over the supposedly less specific arbitration clause. The Court rejected this contention, holding that the rule of construction that more specific contractual provisions govern over less specific ones applies only in the event of an ambiguity, which did not exist. Finally, the Court rejected Boghos' claim that enforceability of the arbitration clause would permit Lloyd's to contravene its promise to submit to suit in court, permitting Lloyd's to deceive policyholders. The Court found no such promise and no deception.

In addition to the above arguments, Boghos contended that the arbitration clause was unenforceable under California case law due to the requirement that Boghos pay costs (for arbitration) that he would not have to pay in court. The Court distinguished cases cited by Boghos, *Armendariz v. Foundation Health Psychcare Svcs.*, 24 Cal. 4th 83, 99 Cal. Rptr. 2d 745, 6 P.3d 669 (2000) and *Little v. Auto Stiegler*, 29 Cal. 4th 1064, 130 Cal. Rptr. 2d 892, 63 P.3d 979 (2003). *Armendariz* and *Little*, the Court concluded, addressed the legality and effect of employer-mandated arbitration clauses "covering claims by employees based on statutory and constitutional provisions. . . ." In *Armendariz* the Court was concerned that employer-mandated arbitration clauses would become vehicles for waiver of rights supplied by the California Fair Employment and Hosing Act, which were found not to be waivable. The *Little* decision extended *Armendariz* to "employer-mandated arbitration of tort claims for wrongful discharge in violation of public policy."

Continued on page 10

## USE OF FEDERAL COURTS FOR DISCOVERY IN FOREIGN PROCEEDINGS

**By Heather Champion Brady**

Since 1855, Congress has endeavored to assist foreign tribunals and other "interested" persons in obtaining discovery for use in foreign proceedings. Their efforts have culminated in §1782 of Title 28 of the United States Code, which provides, in relevant part, that United States district courts "may … order [discovery] for use in a proceeding in a foreign or international tribunal, including criminal investigations conducted before formal accusation." *28 U.S.C. §1782*. The United States Court of Appeals for the Second Circuit described that the two objectives for the statute "are to provide equitable and efficacious discovery procedures in United States courts for the benefit of tribunals and litigants involved in litigation with international aspects" and "to encourage foreign countries by example to provide similar means of assistance to our courts." *In the Matter of Lancaster Factoring Co., Limited*, 90 F.3d 38, 41(2d Cir. 1996) (internal citations omitted).

To determine whether a district court is authorized to grant a request for discovery pursuant to §1782, the courts consider three factors: (1) whether the person from whom discovery is sought resides or is found in the district, (2) whether the discovery is for use in a proceeding before a foreign tribunal, and (3) whether the application is made by a foreign or international tribunal or "any interested person." *28 U.S.C. §1782*; *Schmitz v. Bernstein Liebhard & Lifshitz, LLP,* 376 F.3d 79, 83 (2d. Cir. 2004).

On June 21, 2004, the Supreme Court of the United States further defined the limits of §1782 in *Intel Corp. v. Advanced Micro Devices, Inc.,* 542 U.S. 241 (2004). The Supreme Court held that complainants as well as litigants are within §1782's "interested person" reach, and that a "proceeding" before a foreign "tribunal" does not need to be "pending" or "imminent" in order for an applicant to invoke a §1782 request. *Id*. at 2476-77. The Supreme Court also held that §1782 does not impose a foreign-discoverability rule that requires an "interested person" to show that they would be able to obtain the discovery if they were located in the foreign jurisdiction. *Id*. at 2480.

The Court cautioned, however, "that §1782(a) authorizes, but does not require, a federal district court to provide judicial assistance to foreign or international tribunals or to "interested person[s]" in proceedings abroad." *Id*. at 2482. In the *Intel* case, the Supreme Court articulated four considerations to guide a district court's discretion under §1782. First, the district courts should consider "when the person from whom discovery is sought is a participant in the foreign proceedings … , the need for §1782(a) aid generally is not as apparent as it ordinarily is when evidence is sought from a nonparticipant in the matter arising abroad." *Id*. at 2483. Second, the courts "may take into account the nature of the proceedings underway abroad, and the receptivity of the foreign government or the court or agency abroad to U.S. federal-court judicial assistance." *Id*. Third, the district courts "could consider whether the §1782(a) request conceals an attempt to circumvent foreign proof-gathering restrictions or other policies of a foreign country or the United States." *Id*. and Fourth, the courts should consider whether the §1782 request is "unduly intrusive or burdensome." *Id*.

A foreign tribunal's opposition to United States Federal court aid for obtaining discovery has been a factor in denying §1782 requests. The United States Court of Appeals for the Second Circuit denied an application for discovery assistance filed by shareholders in a German corporation for use in a German proceeding against the corporation when the German government made it very clear that ordering the discovery would jeopardize the ongoing criminal investigation of the German Corporation. *Schmitz*, 376 F.3d. at 81, 84. The court reasoned that granting the discovery request would discourage foreign tribunals from assisting the U.S. courts in the future, thus running counter to one of the objectives of the statute. *Id*. at 85.

On remand from the Supreme Court, the United States District Court for the Northern District of California denied Advanced Micro Devices, Inc.'s ("AMD's") application for discovery pursuant to §1782(a) in *Advanced Micro Devices, Inc. v. Intel Corp.*, No. C 01-7033 (N.D.Cal. Oct. 4, 2004). The court reasoned that all four of the Supreme Court's factors weighed against AMD's request for discovery from Intel. The court stated that *Intel*, the party from whom discovery was sought, was a participant in the foreign proceedings and that the foreign tribunal could have ordered *Intel* to produce the discovery AMD sought. The court also based their denial of AMD's request on the foreign tribunal's resistance to the court's assistance. The foreign tribunal argued to the court that granting AMD's request would jeopardize the tribunal's interests. Furthermore, the court reasoned that AMD's §1782 request appeared to attempt to evade the foreign tribunal's determination not to pursue the discovery AMD requested. Finally, the court found that AMD's request was overly broad, making the §1782 request unduly intrusive and burdensome.

The Second Circuit Court of Appeals has held that a district court is not in the position to determine the practices of a foreign tribunal based on a party's interpretation of the foreign law when deciding a §1782 request. In *In re Application of Grupo Qumma,* the Southern District of New York reiterated the Second Circuit's holding and applied

Continued on page 10

## SECOND CIRCUIT EXAMINES THE DUTY TO DEFEND AUTOMOBILE LEASEE AGAINST INDEMNITY CLAIM OF LEASOR

**By Katherine R. Lahnstein**

In *Allianz Ins. Co. v. Lerner*, Case No. 04-2280-CV (2nd Cir. Aug. 2, 2005), the Second Circuit addressed an insurer's duty to defend the leasee of an automobile against the leasor's claim for indemnification. The leasee, Regina Lerner ("Lerner"), leased a new Mercedes Benz from Mercedes Benz Credit Corporation ("MBCC"). Lerner obtained insurance from Allstate with limits of $100,000 per person. Because under New York law a leasor of a vehicle is vicariously liable for the driver's negligence, MBCC obtained its own insurance from Allianz.

Lerner subsequently was involved in an accident, resulting in injuries to the minor child of the other driver. The child's claim was settled. Allstate paid its policy limit of $100,000, and MBCC paid $340,000. Allianz, as MBCC's subrogee, demanded reimbursement from Lerner under the indemnification provisions of the lease. Allstate refused to defend Lerner, arguing that the policy did not cover MBCC's contractual claim for indemnification. The trial court agreed with Allstate.

On appeal, Lerner "argued that MBCC's 'liability to the infant plaintiff and, by extension … Allianz's claims against Lerner, 'resulted' from 'a covered auto accident,' and do not depend for viability on whether the Allianz lawsuit itself is a claim for 'bodily injury and damage.'" *Allianz Ins. Co.*, Slip Op. at *6. In other words, since the claim arose from an "accident," the duty to defend arose notwithstanding that Allianz' cause of action was contractual. The Second Circuit agreed with Lerner, finding "but for the accident and the resulting bodily injury claims asserted by Andrew Baron [the infant], MBCC and Allianz would not have any claims against Lerner." *Id.* at 7. Therefore, Allstate's duty to defend did not end with payment to the injured plaintiff, but ended with the resolution of all claims arising from the covered auto accident.

The court noted that this construction of Allstate's insurance policy "imposes a broad duty to defend that theoretically extends beyond the standard range of possibly covered claims to reach any claims against an insured so long as they are the result of a covered auto accident." *Id.* (citations omitted). However, because all of the claims and allegations arose from the same incident, it was not unreasonable for Lerner to expect Allstate to defend her throughout the litigation. The court also noted that this decision "accords well with the dual role of automobile insurance as both liability insurance and … litigation insurance." *Id.* (citations omitted).

Continued on page 9

## ARE LIFE INSURERS UNLAWFULLY DISCRIMINATING AGAINST POTENTIAL INSUREDS THAT FINANCE POLICIES?

**By Anthony C. Roehl**

Using a lender to finance insurance premiums is certainly nothing new. In fact, the state of Georgia has had a law on the books regulating premium finance companies for the last 35 years. However, a new use of premium financing has life insurers up in arms, and many may be taking what could be unlawful action to deal with what they consider to be an abuse of the life insurance market.

The last several years have seen incredible growth in the secondary market for life insurance policies. In fact, the sale of life insurance policies is now accepted as an established estate planning mechanism and a way to reap value from policies that would otherwise lapse. However, the secondary market poses issues for life insurance companies.

Life insurers have typically relied on a percentage of policies lapsing before maturity. The so-called "lapse rate" is built into the pricing structure for policies and used by insurers to properly price their policies. Recently, however, premium finance programs for life insurance tied with a potential sale after several years on the secondary life market have developed, and insurers have found themselves faced with sophisticated financiers looking to arbitrage their pricing by financing policies that should never lapse.

Insurers' reaction to this potential arbitrage has been mixed. Some life insurers recognize that premium finance programs are operating in their market and continue to write policies without any specific concern. A growing number of insurers, on the other hand, have determined that they will not write financed policies.

The preferred mechanism for weeding out these policies has become a questionnaire regarding the client's intent. While no two questionnaires are identical, most seek to determine whether (1) a client intends to execute a collateral assignment of the applied for life insurance policy and (2) if the client intends to sell the applied for policy in the future. The forms must be signed by each applicant and accompany the life insurance policy. The problem is that, by utilizing the client intent questionnaire, regulators could consider the insurers to be unlawfully discriminating against policyholders in violation of state unfair trade practices laws.

The NAIC Model Unfair Trade Practice Act (which has been adopted in almost every state) prohibits "making or permitting any unfair discrimination between individuals of the same class, the same policy amount and equal expectation of life and the rates charged for any contract of life insurance or of life annuity and the dividends or other benefits payable thereon or in any other of the terms and conditions of the contract." See O.C.G.A. § 33-6-4(b)(8)(A)(i) for an example.

Continued on page 9

as a temporary measure designed to help stabilize markets in the wake of 9/11. Republican staffers let it be known that their principals felt "burned" by promises from the industry at the time TRIA was enacted that the program would only be temporary. Opposition to extending TRIA was especially strong from House Majority Leader Tom DeLay.

In June, the Treasury Department released its long awaited report on the federal terrorism reinsurance program. The report, which was heavily influenced by policymakers within the White House, suggested that TRIA had served its purpose and was now crowding out private capacity for terrorism coverage.

While we understood that legislators and the Administration were staking out negotiating positions in the face of mounting pressure to extend TRIA, nevertheless, at times the future of TRIA seemed uncertain.

A consensus now appears to be emerging that the Feds must continue to play some role in the insurance of terrorism risk. Treasury's report on TRIA was soon followed by testimony before Congress by Treasury Secretary Snow acknowledging that the government might still have a role to play as a backstop to the private market, albeit less of a role. Uncharacteristically, Alan Greenspan weighed in on the debate, suggesting that private markets did not have the ability to insure terrorism risk at catastrophic levels and that government intervention at some level was needed.

In Congressional hearings held in July, Secretary Snow suggested that the "trigger" for federal involvement in terrorism coverage should be a minimum loss of $500 million rather than the current $5 million. He also suggested that the TRIA deductibles and co-insurance amounts should be increased so that private insurers would bear more of the risk. In addition, Treasury took the position that commercial auto, liability and other lines that are less exposed to terrorism risk should be excluded from any federal backstop for terrorism insurance.

As Player's Point goes to print, Congressional staffers are working on alternative proposals for a federal terrorism insurance program to succeed TRIA. We understand the plan is to introduce both proposals when Congress returns in September to gauge which gains the most traction.

Although the details of the proposals are still being negotiated, reportedly one proposal is an extension of the current program through the end of 2007 with the federal role scaled back along the lines suggested by Treasury, but with the added feature that group life would be included.

The second alternative is a private pooling mechanism backstopped by federal reinsurance. Details of this proposal are sketchy, but the concept is clear: Facilitate the creation of a private pool to insure terrorism risk and back the pool with federal reinsurance that recedes as capital accumulates in the pool. This alternative has its genesis in a white paper released in June by the Property and Casualty Insurers of America and has as its model Pool Re created in the U.K.

It's always dangerous to make predictions about the course of Congressional deliberations, but here goes.

It is unlikely that enough time remains this year to work out a federal program that differs significantly from what we have now, except with respect to the level of federal involvement. The most likely result is a temporary extension of the existing program with the federal role pared back along the lines previously discussed and the formation of a working group to come up with a "permanent" solution for terrorism insurance, perhaps in the form of a public/private pool.

What is in place with TRIA is a refined mechanism to discharge what will surely be a governmental obligation in the event of a large scale terrorist attack. Much thought and discipline has gone into putting in place the machinery for coverage, claims handling and reimbursement. While a pool might be better at some level, in my view Congress has too many competing pressures to break the new ground needed to develop a pool by year end.

A good compromise on TRIA might look something like this:

- Extend the current program, but change the definition of an "Act of Terrorism" to include any terrorist act motivated by ideology. The current program excludes acts of domestic terrorism. This was never a good idea, as the London bombings surely showed.
- Set the threshold loss for qualification as an Act of Terrorism covered by TRIA at $50 million, not $5 million; admittedly, this is an arbitrary figure but the $500 million level suggested by Treasury seems artificially high.
- Raise the TRIA deductible to 20 percent of direct earned premium and modify the group attribution rules. Although Treasury may be right that the current level is too low, the fact remains that many insurers still cannot obtain reinsurance for their TRIA deductibles.
- Keep the TRIA co-insurance at its current level of 10 percent.
- Carefully study the deletion of non-critical lines from the program, such as commercial auto; add group life to the program.
- Extend the program through 2007 with the mandate that any further extensions include participation by the private sector.

Continued on page 8

**PLAYER'S POINT** Continued from page 7

- Create a study committee, including industry and headed by Treasury, to present a proposal for a permanent program by June 30, 2006.

We are truly hopeful that a workable solution will be crafted by Congress over the next three months. We are mindful that the Biggest, Scariest Monster would be for Congress to do nothing. ❑

Endnotes

[1] My appreciation to Joe Holahan for his significant contribution to this article. Joe is the head of the firm's Terrorism Insurance Group and practices in Washington, D.C.

*Thomas Player is a partner and chairman of the insurance and reinsurance group. His areas of expertise include insurance and reinsurance, mergers and acquisitions, complex regulatory issues and dispute resolution. Tom received his bachelor's degree from Furman University and his law degree from the University of Virginia.*

**As this Newsletter goes to press, the nation and the insurance industry are coping with the devastating effects of Hurricane Katrina, said to be perhaps the worst natural disaster in U.S. history. A side effect of the size of the insured losses may be reconsideration by Congress of the lack of tax deductibility of catastrophe reserves. Catastrophe reserve deductibility would aid in the creation of pools for terrorism coverage and enhance the marketability of CAT Bonds, including those covering terrorism losses.**

**HASSETT'S OBJECTIONS**

Continued from page 1

dispute to arbitration. *First Options of Chicago v. Kaplan*, 514 U.S. 938 (1995).

The gist of these decisions is that whether the parties agreed that a particular dispute would be subject to arbitration would be decided as a matter of state contract law, but that state hostility towards arbitration could not be a factor in the determination and application of state contract law. As stated in *Allied-Bruce Terminix Companies, Inc. v. Dobson*, 513 U.S. 265, 281 (1995):

> **States may regulate contracts, including arbitration clauses, under general contract law principles and they may invalidate an arbitration clause "upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. What States may not do is decide that a contract is fair enough to enforce all its basic terms (price, service, credit), but not fair enough to enforce its arbitration clause. The Act makes any such state policy unlawful, for that kind of policy would place arbitration clauses on an unequal "footing," directly contrary to the Act's language and Congress' intent.**

The following year, the Supreme Court provided examples of state laws that could be applied to invalidate arbitration clauses, i.e. "fraud, duress or unconscionability." *Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681, 687 (1996). The Court's reference to unconscionability was unfortunate, since lower courts have seized upon that language to avoid the arbitration of consumer contracts. *Discover Bank v. Superior Court*, Case No. S113725 (Cal., June 27, 2005) (waiver of class arbitration in credit and agreement held unconscionable); *Maestle v. Best Buy Co.*, Case No. 79827 (Ohio App., Aug. 11, 2005) (arbitration clause in amendment to credit court agreement held unconscionable); *Whitney v. Allied Communications, Inc.*, Case No. WD-64196 (Mo. App. July 5, 2005) (arbitration clause in cell phone contract held unconscionable); *Kinkel v. Cingular Wireless, LLC*, 828 N.E.2d 812 (Ill. App., May 18, 2005) (waiver of class arbitration in cell phone contract held unconscionable; but allowing arbitration otherwise to continue); *Wisconsin Auto Title Loans, Inc. v. Jones*, 696 N.W.2d 214 (Wis., March 24, 2005) (arbitration clause in automobile loan agreement held unconscionable); *Blankfield v. Richmond Health Care, Inc.*, 902 So.2d 196 (Fla. Dist. Ct. App., May 25, 2005) (limitation on remedies in arbitration clause void); *D. R. Horton, Inc. v. Green*, 96 P.3d 1159 (Nev. 2004) (arbitration clause home warranty unconscionable). This has been a banner year for the "unconscionability revolution." Five of the above cases were decided in the last four months.

Courts that have barred enforcement of arbitration clauses on grounds of unconscionability have bifurcated their analysis into "substantive unconscionability" and "procedural unconscionability." In theory at least, an arbitration clause must be both substantively and procedurally unconscionable to be declared unenforceable, although some courts will strike agreements with a high degree of either category of unconscionability.

Procedural unconscionability refers to contractual terms "which, imposed and drafted by the party of superior bargaining strength, relegates to the subscribing party only the opportunity to adhere to the contract or reject it." *Discover Bank*, Slip. Op., p. 12. An important factor is whether the consumer had a reasonable opportunity to negotiate. Under that test, most consumer contracts would be procedurally unconscionable. A national business cannot allow deviation from its forms, since its systems are predicated on uniformity. Moreover, as any life insurer ensnared in vanishing premium litigation can attest, deviation from forms by the sales force is an invitation to litigation.

Substantive unconscionability focuses on "oppression or surprise due to unequal bargaining power," meaning "unfairly one-sided." *Discover Bank*, Slip Op., p. 12. This is the inquiry that most people associate with unconscionability, i.e., whether the contract is unfairly one-sided.

Judicial recognition of the doctrine of unconscionability makes sense. Courts should not be forced to be parties to contracts that are unfairly punitive or one-sided.

The problem with applying unconscionability to arbitration clauses is that the courts are assuming, and may sometimes

Continued on page 9

## HASSETT'S OBJECTIONS

Continued from page 8

be saying, that arbitration is an inherently bad thing. One can argue whether arbitration is fair or socially desirable, but these are decisions for Congress. If the FAA means anything, it means that arbitration is not undesirable; it is at least neutral. This federal policy approving of arbitration should preclude a finding of substantive unconscionability.

While lower courts have cited the language in *Doctors,* 517 U.S. at 687, recognizing unconscionability as a defense to arbitration, they ignore a footnote in which the Supreme Court also barred an arbitration-specific finding of unconscionability:

> **It bears reiteration, however, that a court may not rely on the uniqueness of an agreement to arbitrate as a state-law holding that enforcement would be unconscionable for this would enable the court to effect what the legislature cannot.**

*Doctor's*, 517 U.S. at 687.

In *Green Tree Fin. Corp. – Alabama v. Rudolph*, 531 U.S. 79 (2000), the Court set a high bar for unconscionability in the arbitration context. In that case, the consumer complained that the arbitration process would be too costly to vindicate her federal truth in lending and equal credit claims. The Court found that the consumer must present convincing evidence that arbitration would be so cost-prohibitive compared to litigation so as to preclude the enforcement of federal rights.

The decision in *Discover Bank* is particularly troubling. Suddenly, the right to bring a class action is a fundamental right, the loss of which is unconscionable. That is a remarkable decision, given that class actions are creatures of the rules of civil procedure. Moreover, even if class actions are precious to the California Supreme Court, arbitration is important to Congress.

Scholars can debate whether contractually mandated arbitration of consumer contracts is bad policy. But, ultimately, that is a legislative decision, not a judicial one. The "unconscionability revolution" is nothing more than judicial hostility towards arbitration masquerading as the thoughtful application of a state law doctrine. The very premise of these cases is that arbitration is inherently undesirable and unfair and, at best, should be treated like cigarettes and liquor with warnings and obstacles. Until the Supreme Court, or perhaps Congress, addresses unconscionability in the arbitration context, the federal policy promoting arbitration will be crippled in consumer cases.❑

*Lewis Hassett is a partner in the firm's litigation group and chairs the firm's insurance and reinsurance dispute resolution group. His practice concentrates in the areas of complex civil litigation, including insurance and reinsurance matters, business torts and insurer insolvencies. Lew received his bachelor's degree from the University of Miami and his law degree from the University of Virginia.*

## THE SECOND CIRCUIT EXAMINES

Continued from page 6

The court specifically emphasized the distinction between the duty to defend and the duty to indemnify. It criticized the lower court for failing to make this distinction, focusing instead on the duty to indemnify, and finding that because the contractual claim fell outside the duty to indemnify, it also fell outside the duty to defend. The appellate court stated that the appropriate query is "whether the claims asserted against the insured may rationally be said to fall within policy coverage, whatever may later prove to be the limits of the insurer's responsibility to pay." *Id.* (citations omitted). In other words, the lower court should have looked at what might have been covered at the outset, and not what was actually indemnified, to determine the scope of the duty to defend.❑

*Katherine R. Lahnstein is an associate in the firm's litigation group. She handles litigation matters arising from intellectual property, insurance and contract disputes. Katherine received her bachelor's degree from the University of Virginia and her law degree from the University of Georgia School of Law.*

## ARE LIFE INSURERS UNLAWFULLY DISCRIMINATING

Continued from page 6

Insurers may be violating this antidiscrimination provision by refusing to write individuals that are in the same underwriting class but where one potential policyholder would like to finance his policy and the other would not. In theory, similarly situated individuals with a similar life expectancy should be charged the same amount for insurance. Any discrimination between similarly situated individuals would not be actuarially valid based on their life expectancy, and their ultimate intent towards a policy should not put them in different classes. Insurers may well argue that if one potential policyholder has a lower chance of his or her policy lapsing, that individual should be in a different class from a standard individual. However, life insurance is typically priced based on mortality, and mortality does not factor in lapse rates.

The use of investor intent questionnaires is a recent development and does not appear to yet have been challenged by any potential policyholder or state department of insurance. Ultimately, insurers may find that it is beneficial to write financed policies as a way to open up markets, increase premium revenues and generate a stable cash flow. Of course, to the extent that there is an actual arbitrage occurring, insurers may revise their pricing structure. At any rate, discriminating against similarly situated potential policyholders does not appear to be the answer to address pricing imbalances and regulators may consider such action a violation of unfair trade practices laws.❑

*Tony Roehl is an associate in the firm's insurance and corporate groups. His principle areas of concentration are insurance regulation and insurance company financial matters. Tony received his bachelor's degree from the University of Florida and his law degree from the University of Michigan.*

## USE OF UNITED STATES FEDERAL COURTS

Continued from page 4

it to their case. *In re Application of Grupo Qumma,* No. M 8-85 (S.D.N.Y. April 22, 2005), citing *In re Euromepa S.A.,* 51 F.3d 1095, 1099-100 (2d Cir. 1995). In the *Qumma* case, Qumma, a party to a proceeding in Mexico, sought evidence from a party who was not participating in the foreign proceeding. The party from whom the evidence was sought argued that the evidence was inadmissible in the Mexican proceeding because the period to proffer evidence had expired. Each side submitted different interpretations of the Mexican law in regards to the admissibility of the evidence Qumma sought. The court held that it was not their responsibility to interpret Mexican law when ruling on the §1782 request, and granted Qumma's application for discovery. The court reasoned that this ruling was promoting the twin aims of the statute since the Mexican court ultimately would decide whether to admit the evidence. If the Southern District denied Qumma's request, the Mexican court would never have the opportunity to decide admissibility.

Although the Supreme Court articulated that the need for §1782(a) aid generally is not as apparent as it ordinarily is when evidence is sought from a nonparticipant in the matter arising abroad, this consideration has not always led to a denial of a §1782 request when the person from whom discovery is sought is a party to the foreign proceeding. In *In re Application of Procter & Gamble Co.*, the United States District Court for the Eastern District of Wisconsin granted a §1782 discovery request by Procter & Gamble ("P&G"), the defendant in the foreign action, to obtain discovery from Kimberly-Clark Corporation ("KC"), the plaintiff in the foreign proceeding. *In re Application of Procter & Gamble Co.,* 334 F.Supp.2d 1112 (E.D. Wis. 2004). The district court granted P&G's request on the ground that the information sought would be useful in the foreign proceeding and reasoned that the foreign court is not obliged to consider the evidence obtained pursuant to a §1782 request. *Id*. at 1115, 1116. The court stated that permitting the discovery would not burden the foreign court with irrelevant evidence since it is the foreign court's discretion to consider the evidence. The court also found that P&G's requests did not undermine the policies of the foreign countries in which the suit was pending. *Id*. at 1116.

**The United States District Court for the Southern District of New York reached a similar finding in *In re the Application of Servicio Pan Americano De Proteccion*, 354 F.Supp.2d 269 (S.D.N.Y. 2004). Pan Americano, the defendant in the foreign proceeding, sought assistance from the Southern District of New York in obtaining a limited set of documents from the plaintiff of the foreign proceeding for use in the foreign proceeding. Pan Americano was unable to obtain the discovery in the foreign jurisdiction. The court granted Pan Americano's request reasoning that although the party from whom discovery was sought was a party to the foreign proceeding, the documents would aid the foreign court since the documents requested were unobtainable under the foreign law due to the limitations of the foreign discovery rules. The court determined that granting Pan Americano's request might encourage the foreign tribunal to provide assistance to United States courts in the future.**

It appears that courts are willing to grant §1782 requests when the discovery requested would be useful to the court and/or the parties in the foreign proceeding without being overly burdensome on the party from whom the discovery is sought. Whether the party from whom discovery is sought is a party to the foreign proceeding is not always a determining factor when granting or denying a §1782 request. However, the case law shows that the district courts will defer to a foreign tribunal's wishes if the tribunal opposes the §1782 request.❑

*Heather Champion Brady is an associate in the firm's litigation group. Heather received her bachelor's degree from Clarion University of Pennsylvania and her law degree from the University of Pittsburgh School of Law.*

## CALIFORNIA SUPREME COURT

Continued from page 4

The Court in *Boghos* declined to extend the holdings of *Armendariz* and *Little* –both of which involved employer-mandated arbitration provisions -- to insurance disputes.

The *Boghos* Court did not close the door to challenges to the arbitration clause. To the contrary, it effectively invited unconscionability arguments on remand. The Court noted that no court had yet addressed (1) whether the arbitration clause's cost sharing provision was unconscionable, (2) whether Boghos' ability to pay his share of such costs was relevant to the unconscionability analysis, (3) whether the venue selection clause was unconscionable, and (4) whether any unconscionable clauses should be severed and the matter referred to arbitration.❑

*Matthew Barrett is an associate in the firm's litigation group. He focuses principally on insurance litigation and business litigation. Matt received his bachelor's degree from Berry College and his law degree from the University of Georgia, J.D.*

Continued from page 1

The success of captives has recently resulted in attention from three regulatory sources – the National Association of Insurance Commissioners ("NAIC"), the Government Accountability Office ("GAO"), and the Internal Revenue Service ("IRS"). Each of these regulatory agencies presents challenges to the alternative risk transfer community that will shape the future.

The Government Accountability Office. The GAO has been working on an analysis of risk retention group ("RRG") regulation for almost two years. As of the date of this writing, the report had not yet been released, although its release is imminent. Although it has not yet been made public, it is understood that the GAO has detailed the inconsistencies among the ways in which states monitor and regulate RRGs and has highlighted some of the successes and failures of the Liability Risk Retention Act ("LRRA"). It is believed that the report will call upon the states to adopt uniform standards of regulation and to tighten regulation in certain specified areas. On the basis of what the GAO has studied, it may be reasonable to predict where the GAO's criticisms will come. The GAO studied accounting (GAAP v. Statutory), corporate governance, the role of "entrepreneurs," control of RRGs by members, and financial solvency, among others.

Congress also has a role. As a federal law, the LRRA preempts state law. The federal law allows the "lead state" (the state of domicile) to bear the brunt of the regulatory responsibility and creates a broad preemption of non-domiciliary state law. Congress may want to amend the LRRA to address some of the problems identified by the GAO report.

The National Association of Insurance Commissioners. The NAIC is also focusing on the RRG regulation. Two working groups – the Risk Retention (C) Working Group and the Risk Retention Group (E) Task Force – are simultaneously looking at the issues. While the Working Group has sought to analyze specific regulatory problems, the Task Force has taken a different approach. It is analyzing the requirements of the NAIC accreditation program and comparing them to the laws and regulatory infrastructure in the states where RRGs are domiciled. The objective is to impose uniformity among the states.

While the goal may be laudatory, the implementation may be problematic. Most RRGs are regulated as captives. The purpose of the LRRA was to facilitate with the establishment of member-owned insurers to provide coverage when the market has failed to do so. RRGs have succeeded in doing this, particularly in the area of healthcare liability. The imposition of traditional regulatory standards on RRG captives could be onerous and destructive.

Internal Revenue Service. The growth of captives and, in particular, segregated cell captives, has stimulated the demand for more specific guidance from the IRS regarding the tax treatment to be afforded to captives. The IRS recently released Revenue Ruling 2005-40, which analyzed four hypothetical captive situations to clarify the circumstances under which sufficient transfer and distribution of risk occurs to result in the treatment of a transaction as "insurance" for tax purposes. Revenue Ruling 2005-40 reiterated existing IRS positions, although it did specifically address the issue of the utilization of an LLC and how it is treated as a "disregarded entity" for federal income tax purposes and does not result in risk transfer and distribution.

Interestingly, the IRS has requested comments on four areas affecting captive insurance – cells, loan backs, homogeneity, and finite insurance. The IRS will consider the comments that it receives before providing guidance on these cutting edge issues. The decisions of the IRS on these matters will have a significant impact upon the growth of the captive industry.

***"Each and every action produces an equal and opposite reaction." – Sir Isaac Newton***

The increased regulatory attention to captives and risk retention groups demonstrates that the regulatory system is responding to new developments. On the one hand, the actions of the GAO, NAIC, and IRS could be salutary. Industry change requires regulatory change.

On the other hand, the actions of the GAO, NAIC and IRS bear the possibility of being excessive, restrictive, and even misdirected. Both insurance consumers and insurance providers benefit from good regulation. Much work should be done to ensure that the regulatory reaction to insurance industry change is fair and "equal" to the task and not just "opposite."❑

*Robert "Skip" Myers is a partner in the firm's insurance group and practices in the areas of insurance regulation, antitrust, and trade association law. Skip received his bachelor's degree from Princeton University and his law degree from the University of Virginia.*

# MMM Insurance & Healthcare Attorneys


| | | |
|---|---|---|
| Paul H. Arne | 404.504.7784 | parne@mmmlaw.com |
| Matthew A. Barrett | 404.504.7688 | mbarrett@mmmlaw.com |
| Brooks W. Binder | 404.504.7626 | bbinder@mmmlaw.com |
| Ward S. Bondurant | 404.504.7606 | wbondurant@mmmlaw.com |
| Joseph L. Cregan | 404.504.7782 | jcregan@mmmlaw.com |
| Dick Dorsey | 404.495.3660 | ddorsey@mmmlaw.com |
| Jason Eakes | 404.504.7603 | jeakes@mmmlaw.com |
| Amanda S. McHugh | 404.504.7629 | amchugh@mmmlaw.com |
| Lewis E. Hassett | 404.504.7762 | lhassett@mmmlaw.com |
| Richard L. Haury Jr. | 404.504.7713 | rhaury@mmmlaw.com |
| Joseph T. Holahan | 202.408.0705 | jholahan@mmmlaw.com |
| Simon R. Malko | 404-495-3646 | smalko@mmmlaw.com |
| William F. Megna | 609.430.1414 | wmegna@mmmlaw.com |
| Daniel J. Mohan | 404.504.7610 | dmohan@mmmlaw.com |
| Robert 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 | troehl@mmmlaw.com |
| Leigh Els Wilde | 404.504.7618 | lwilde@mmmlaw.com |
| Bruce H. Wynn | 404.504.7694 | bwynn@mmmlaw.com |
| Kristin B. Zimmerman | 404.504.7611 | kzimmerman@mmmlaw.com |





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**Fall 2005**

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