Morris, Manning & Martin, LLP

Insurance Reinsurance Managed Healthcare Review

www.mmmlaw.com

Summer 2011

LETTER FROM WASHINGTON

FEDERAL SURPLUS LINES REFORM IS ON THE ROCKS

By Robert "Skip" H. Myers, Jr.

The Nonadmitted and Reinsurance Reform Act of 2010 (the "NRRA") was enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The purpose of the Act is to facilitate the reporting, payment and allocation of premium taxes among the states. Section 521 (b)(4) provides that "Congress intends that each State adopt nationwide uniform requirements, forms, and procedures, such as an interstate compact, that provide for the reporting, payment, and allocation of premium taxes for nonadmitted insurance . . . ."

While the Congressional intent was for state laws to be simple and uniform, the implementation of the NRRA by the states has been anything but. Two different models for the implementation of NRRA have been developed. First, the National Association for Insurance Commissioners ("NAIC") developed the Nonadmitted Insurance Multi-State Agreement ("NIMA"). NIMA is an agreement among the states that elect to join and provides for the collection and allocation of premium tax. Second, the National Conference for Insurance Legislators ("NCOIL") developed an interstate compact known as the Surplus Lines Insurance Multi-State Compliance Compact ("SLIMPACT"), which creates uniformity among the states for the laws applicable to the nonadmitted market as well as the collection and allocation of taxes.

The effective date of the NRRA was July 21, 2011. As of that date, the states (some would say predictably) have differed in various ways in the actions they have taken. Nine states have adopted legislation to adopt SLIMPACT while fifteen states have adopted legislation to enter NIMA; however, only three states had actually signed the agreement

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HASSETT'S OBJECTIONS

SUPREME COURT ROUNDUP

By Lewis E. Hassett

As a threshold matter, my teenage son is wrong. *Brown v. Entertainment Merchants Ass'n*, Case No. 88-1448 (U.S. June 27, 2011), is not the most important case of this term to everyone, including insurers. That case recognized that minors have a First Amendment right to video games. While perhaps good news for liability insurers writing video game risks, most insurers are unaffected. As an aside, my son was frustrated to learn that the First Amendment applies only to the government and not to parents.

However, the Supreme Court issued several opinions of interest to the insurance industry. For example, it issued three decisions addressing class actions. While two were pro-business generally, they will have less impact on insurer class actions.

In *Wal-Mart Stores, Inc. v. Dukes*, Case No. 10-277, slip op. (U.S. June 20, 2011), the Court rejected class certification in an employment discrimination claim under Title VII. In that case, the plaintiffs generally alleged female employees suffered discrimination in promotion and pay. The Court held a class could be certified only by "significant proof that an employer operated under a general policy of discrimination." *Wal-Mart Stores v. Dukes citing General Tel. Co. of Southwest v. Falcon*,

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Inside this Issue

BUILDING A SUCCESSFUL FRONTED CAPTIVE PROGRAM

By Joseph T. Holahan

Fronting arrangements arise in a variety of circumstances involving captive insurance programs. For example, a front may be necessary in an association or other group captive program or where a line such as workers' compensation, commercial auto or a contractual liability policy backing service contracts requires a carrier that is authorized or that has a minimum financial strength rating.

This article examines fronting from the perspective of the captive with an eye towards ensuring that important terms and conditions are built into the agreements governing the fronting arrangement from the outset so the captive and its owners are protected.

Much of the discussion will focus on issues of particular concern to associations and other group programs, but many of the topics discussed also pertain to single-parent captives and reinsurance arrangements in general.

Fronting involves retaining a traditional, authorized insurer -- the "front" -- to write coverage, with some or all of the risk reinsured to the captive. Fronting arrangements can vary considerably from program to program. In some programs, the front may retain a significant portion of the insured risk, reinsuring only a fraction to the captive, perhaps with the captive taking more risk over time as it builds surplus. In other programs, 100% of the risk may be reinsured to the captive from the beginning. Similarly, the front may handle marketing, underwriting and claims functions or some or all of these functions may be delegated to persons affiliated with the captive.[1]

The principal agreements governing the fronting arrangement are the reinsurance agreement between the front and the captive, any associated trust agreement to secure the captive's obligations under the reinsurance agreement and, where appropriate, a fronting or program agreement.

If the front's role in the program is limited, a fronting agreement separate and apart from the reinsurance agreement might not be necessary. Often, however, it is useful to address issues that do not fit well in the reinsurance agreement in a separate fronting agreement or a comprehensive program agreement. Separating the reinsurance agreement from the fronting or program

[1] This article does not address state anti-fronting restrictions, which may come into play with some fronting arrangements, depending on the state and how responsibilities for the program are divided between the front and other persons.

Announcements

The firm's June **2011 Insurance Forum** was a success, with presentations on healthcare reform and Dodd-Frank, as well as updates on regulatory issues, alternative risk, bad faith and recent U.S. Supreme Court rulings affecting the insurance industry. Georgia Insurance Commissioner Ralph T. Hudgens was the keynote speaker.

Skip Myers will start his online course on risk retention groups offered by the International Center for Captive Insurance Education ("ICCIE") on October 12th. More information is available at www.iccie.org.

Lew Hassett, **Jessica Pardi**, **Ben Vitale**, **Darren Rowles** and **Brian Levy** have been retained as insurer's counsel in three new putative class actions involving automobile insurance.

Jim Maxson has been elected to serve a two-year term on the Board of Directors of the Life Insurance Settlement Association ("LISA"). Maxson is Co-Chair of the Firm's Insurance-linked Securities Practice and a member of the Firm's Insurance and Reinsurance Practice. LISA is the nation's oldest and largest organization representing participants in the Settlement Industry with a current membership of over 134 companies, doing business in all fifty states and the District of Columbia, Puerto Rico and the U.S. Virgin Islands.

Skip Myers will be speaking at the National Risk Retention Association annual conference in Washington, D.C. on October 5th and 6th.

At the Life Insurance Settlement Association's Compliance Conference to be held in Atlanta, Georgia on October 3rd, **Jim Maxson** will speak on the challenges facing purchasers of life insurance policies in the tertiary market.

Larry Kunin was appointed to the Executive Council of the Business Law Section of the Florida Bar. The Business Law Section serves Florida's lawyers, judges and the faculty of its law schools. Its members share a common interest in laws affecting Florida's businesses, including corporate, contract, bankruptcy, franchise, antitrust, securities and intellectual property law. The Section also addresses the process for resolving business disputes in Florida, including commercial litigation and alternative dispute resolution.

Skip Myers will be speaking at the South Carolina Captive Insurance conference in Charleston, South Carolina on September 13th on regulatory issues affecting risk retention groups.

Lew Hassett's op-ed article on healthcare reform was published in the May 11th issue of the *Atlanta Journal-Constitution*.

On September 22nd, **Jim Maxson** will be speaking in London at the European Life Settlement Association's First Investor Summit on the comparative advantages of structuring investment funds in Luxembourg versus Ireland.

Skip Myers will be speaking at the Captive Live USA conference in Chicago on September 27th on risk retention groups.

On behalf of the National Risk Retention Association ("NRRA"), **Cindy Chang** and **Skip Myers** filed an amicus curiae brief in the U.S. District Court in Las Vegas, Nevada. Skip Myers appeared at the July 21st hearing. The Nevada Insurance Department had issued a cease and desist order which purported to deny ANI-RRG (a member of NRRA) the right to provide automobile liability coverage on the basis that it was not an "authorized insurer". The court held the Nevada law was preempted by federal law (the Liability Risk Retention Act) and granted summary judgment for ANI-RRG, as well as attorneys' fees.

agreement also allows the terms of the reinsurance to be more easily renegotiated without necessarily opening the rest of the program to renegotiation -- and vice versa.

As a threshold matter, clear and unambiguous language in each of the agreements relating to the fronting arrangement -- and the captive program as a whole, for that matter -- is critical to the program's success. Ambiguous terms in the core agreements can, and with alarming frequency do, come back to haunt participants. This is especially true of the reinsurance agreement, as important aspects of the fronting arrangement can get buried in the arcana of the reinsurance agreement without ever being adequately considered and negotiated by the principals.

In association and other group captive programs, a key concern is protection of the program from unfair competition by the front. A front may have an existing presence in the market served by the captive or may expand into the market at some point. Relationships, proprietary information and intellectual property to which the front is privy by virtue of its participation in the program should be carefully protected. Generally, it is not enough merely to protect the renewals for program business. It pays to set out the parties' rights to all proprietary aspects of the program clearly and precisely in writing.

Another important issue in program business is the flow of funds through the program. Often several accounts will be established to administer the program. It is important to document clearly the relationship among these accounts, what sort of account each will be (e.g., fiduciary), who will control and have access to the account, the schedule for making payments to and from the account, who owns accrued interest, any maximum or minimum funding requirements, reporting obligations and what happens if payments from an account are not made on a timely basis. To minimize credit risk with respect to a front or administrator, it is best to have intermediary accounts swept frequently so that premiums quickly make their way to an account controlled by the captive or a trust account established by the captive.

As mentioned above, key aspects of a fronting arrangement can get lost in the highly specialized terms of the reinsurance agreement at the center of the arrangement. For example, generally the front will require the captive to post collateral for its reinsurance obligations, either in the form of a letter of credit or by collateralizing a trust. Collateral is necessary to protect the front from risk of default by the captive and to allow the front to obtain credit for reinsurance under state regulatory requirements.

Reinsurance trusts have become increasingly popular in fronted programs and other reinsurance arrangements as the cost of obtaining letters of credit has risen in recent years. Two aspects of the terms governing the trust are particularly important. First, the front should be obligated to allow periodic distributions of trusteed assets in excess of the captive's reinsurance obligations. Typically, the threshold above which a distribution may be made is 102% of the captive's obligations. Second, the captive should look for maximum flexibility in the investment of assets in the trust and the ability of its own investment manager to invest and reinvest assets in eligible investments without having to obtain consent from the front each time assets are reinvested.

Especially when long-tail risks are reinsured, the captive may want to negotiate a commutation clause in the reinsurance agreement with the front. Ideally, if new business no longer is being insured by the front, such a clause will allow the captive to force a settlement of the parties' net liabilities so that amounts held as collateral in excess of reserves necessary to run off the business can be released to the captive.

Another important aspect of the fronting arrangement involves responsibility for extra-contractual obligations ("ECO") and losses in excess of policy limits ("XPL"). ECO, as the name suggests, involves awards to insureds, such as punitive damages, that go beyond the terms of the insurance contract. ECO typically arises from a successful claim of bad faith in the handling of a claim. XPL is a type of extra-contractual obligation where the loss is covered under the policy, but the insurer is held liable for loss in excess of the policy limits, usually for failure to accept a settlement that was within the limits.

A fronting insurer, of course, will want the captive to accept responsibility for ECO and XPL. But should it? If claims are adjusted by the front at its own discretion, there is no reason the captive should accept liability for ECO or XPL. If, however, an administrator under the control of the captive adjusts claims, it may be reasonable for the captive to accept responsibility for such losses. Other arrangements are also possible. For example, if the front handles claims, the captive may accept responsibility for ECO and XPL if it is given prior notice of the front's intent to contest a claim and consents to decisions about how the claim is handled.

Other provisions of the reinsurance agreement can seem merely routine at first glance but have important consequences if a dispute arises and the provision is not well drafted. Reinsurance agreements typically include an "offset" provision allowing the insurer (front) and reinsurer (captive) to offset amounts due to one another. Especially in programs where the front, as opposed to an administrator retained by the captive, collects premium, it is important that this clause be tightly worded and not subject to expansive interpretation. Many other standard clauses deserve similar scrutiny.

It is a mistake to assume agreements governing the fronting arrangement will be tested only if the program encounters adversity. In fact, it is often a very successful captive program that will put the relationships among the participants and the agreements underpinning them to the test. For example, the principals of a successful program may feel it appropriate to renegotiate terms or look for new partners, putting existing arrangements under stress. Similarly, a front participating in a successful program may come to see the market segment as a new opportunity, which also can lead to conflict.

Ensuring that the agreements at the center of a program are clear, tightly worded and cover all important aspects of the relationship will help avoid problems down the line. Focusing on the language in the agreements when the arrangement is formed helps the parties (and their advisors) think carefully about the key elements of the relationship and mutual expectations so that uncertainties and misunderstandings can be rooted out and resolved before they become an issue. In addition, clear agreements keep things on track as personnel come and go, memories fade or the environment in which the program operates changes.

When a program is stress-free, the parties focus on the business and their perceived mutual expectations. When significant stress arises, the first question is, "What does the contract say?"

Having a successful fronted program, of course, depends on many things. The agreements governing the program are just one such element. Nevertheless, they are in a real sense a foundation on which a good program can be built, brought to success and kept that way. ❑

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to enter NIMA. Five state legislatures have adjourned without taking any action. Legislation is pending in other states. Four states have enacted legislation which purportedly allows the states to tax and keep 100% of surplus lines premium but also allows the states to enter into an agreement or a compact after subsequent determination by the legislature or its designee.

This result is far from simple and uniform. NRRA creates "exclusive authority" in the "Home State" by mandating that "[n]o State other than the Home State of an insured may require any premium tax payment for nonadmitted insurance." The "Home State" under the NRRA is the state in which an insured maintains its principal place of business or if 100% of the insured risk is located outside of its principal place of business, the state with the greatest percentage of an insured's taxable premium for that insurance contract. Section 527(6).

Therefore, Section 521(a) limits rather than enhances state authority by prohibiting non-Home States from requiring any premium tax payments for nonadmitted insurance. NRRA does not preempt existing state law except in regard to non-Home State laws and regulations that apply to nonadmitted insurance sold to a resident of the Home State. Section 522(c). However, NRRA encourages states to act in concert to collect such taxes: "The States *may* enter into a compact or otherwise establish procedures to allocate among the States the premium taxes paid to an insured's Home State. . . ." Section 521(b)(1)(emphasis added).

The NRRA provisions and proposed models from the NAIC and NCOIL set up a series of circumstances where it is unclear what law prevails. This is due, at least in part, to the fact that only a minority of states have adopted any legal changes and even those are not uniform.

- If a non-Home State has not adopted either NIMA or SLIMPACT, is it restricted in its ability to collect premium tax on risks in its state where it is deemed that "transacting insurance" has occurred in that state? Under current state law, generally found in the Nonadmitted Insurer Act of various states, a state has the authority to tax a nonadmitted insurer when that insurer is "doing an insurance business" or "transacting insurance" in the state. If a nonadmitted insurer has satisfied these requirements, is a non-Home State prohibited from taxing its premiums? In other words, does the NRRA preempt Nonadmitted Insurer Acts?

- By what authority does a Home State collect premium tax on an insurance transaction conducted in a non-Home State if the non-Home State has not adopted either SLIMPACT or NIMA?

  A few states have adopted laws that purportedly give the Home State the authority to collect tax on insurance "transacted" in another state. At least one state, Maryland, has included a provision which, in effect, authorizes the Home State to collect tax that "an unauthorized insurer effects. . . on a [Home State resident] . . . through negotiations or an application wholly or partly occurring or made in or from within *or outside* the State . . . ." MD House Bill 959 4-209(4) (emphasis added). In other words, the nonadmitted insurer's non-Home State risks are taxable even if the insurer is not "transacting insurance" for those risks in the Home State. This authority to collect tax at a surplus lines rate is not grounded in authority granted by federal law (although it is encouraged by federal law). Rather, it is authority granted by the law of one state (the Home State) to collect tax on insurance transacted in another state or even offshore. The only legal nexus to the state is the residence of the insured.

The states' multifaceted approach to the NRRA has not only created problems for multi-state insureds and insurance producers (particularly surplus lines brokers), but it also has pitted one state against the other. There are large states with substantial amounts of premium (e.g., Florida, New York, Texas and California) that stand to benefit by collecting all the tax due to the Home State and then keeping it. This certainly was not contemplated by NRRA.

Finally, while Congress intended for the states to adopt a nationwide system of "uniform requirements, forms and procedures," the laws promulgated pursuant to the NRRA and their enforcement are less uniform and more confusing. The U.S. Constitution allows Congress to preempt state law under the Supremacy Clause, but the Tenth Amendment prohibits the federal government from compelling states to adopt and enforce particular statutes. As a result, the NRRA establishes uniformity as a goal, but it was limited to asserting only that the "states *may* enter into a compact or otherwise establish procedures to allocate among the states the premium taxes paid to the insureds Home State. . . ." Section 521(a)(1).

As a result, chaos has ensued. Now the states need to agree to a uniform system and implement it (presumably through an interstate compact) or there will be a movement for Congress to clean up the mess created by the states. ❑

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457 U.S. 147, 157-158 (1982). Because Wal-Mart's general policy forbade sex discrimination, general evidence of stereotypical thinking could not provide the glue to hold together the class. While Title VII does recognize disparate impact claims, and Wal-Mart's policy of according significant local control to employment decisions could support a disparate impact claim, class certification was inappropriate.

While *Wal-Mart's* central holding would apply to employment discrimination cases within the insurance industry, as much as any other, it likely will be of limited application in the typical insurance class action where a plaintiff alleges a centralized business practice that damages a class.

However, a second holding in *Wal-Mart* may prove more valuable. The Court also held that individualized damage claims could not be wrapped into a class action under Federal Rule 23(b)(3)'s authorization of injunctive relief. The Court recognized but did not reach the question of whether monetary relief may be allowed at all under a Rule 23(b)(2) certification but squarely held that individualized claims may not be certified under that provision.

Additionally, the Court squarely rejected individual adjudication of monetary claims via a "Trial By Formula." *Wal-Mart* at 27. The lower court wanted to select a sample of plaintiffs and apply a statistical analysis of their claims to the entire class.

In a different decision, the Supreme Court unequivocally upheld class arbitration waivers in consumer contracts. *AT&T Mobility LLC v. Concepcion*, Case No. 09-893, slip op. (U.S. April 27, 2011). As we have seen in insurance cases, the plaintiff alleged in *Concepcion* that the class action waiver was unconscionable under state law.

While the *Concepcion* decision is of great value to business generally, it will have less applicability to the insurance industry. The basis of *Concepcion* is that the Federal Arbitration Act preempts contrary state law. However, many states have statutes barring or restricting, in whole or in part, the enforcement of arbitration clauses in insurance contracts. *See* Ga. Code Ann. § 9-9-2(c); Miss. Code Ann. § 83-11-109 (uninsured motorist coverage); Neb. Rev. St. § 25-2602.01; S.C. Code Ann. § 15-48-10; Ark. Code Ann. § 16-108-230; Nev. Rev. St. § 689B.067 (group health insurance). In other states, arbitration is formally or informally barred via regulation or regulatory reluctance to approve insurance forms with arbitration clauses. *See United Ins. Co. of Am. v. Fla. Office of Ins. Regulation*, 985 So. 2d 665 (Fla. App. 2008) (upholding insurance department's denial of application to include arbitration clause in life insurance contracts); *Appleton Papers, Inc. v. Home Indemn. Co.,* 612 N.W. 2d 760 (Wis. App. 2000) (arbitration clause unenforceable where form not approved by commissioner of insurance).

The majority of decisions uphold insurance-specific restrictions on arbitrability based upon the McCarran-Ferguson Act which allows state law to control the insurance industry unless Congress expressly provides otherwise. *See Am. Bankers Ins. Co. of Fla. v. Inman*, 436 F.3d. 490 (5th Cir. 2006); *McKnight v. Chicago Title Ins. Co.,* 358 F.3d 854 (11th Cir. 2004). The result is that in those states that restrict arbitrability of insurance contracts, *Concepcion* will be of little help and may be harmful as a practical matter. As industries other than insurance continue to include class action waivers in their contract forms, the class action bar naturally will gravitate to targets in the insurance business.

The business community lost an important class action decision this term which addressed successive putative class actions. *Smith v. Bayer Corp.,* Case No. 09-1205, slip op. (U.S. June 16, 2011). In *Bayer,* the defendant successfully had defeated class certification in a federal case. However, the class action bar then filed a similar action on behalf of a different putative plaintiff in state court. Bayer sought an injunction in federal court, which was granted notwithstanding the Federal Anti-Injunction Act. 28 U.S.C. § 2283. The Anti-Injunction Act bars federal courts from enjoining state actions, absent certain unusual circumstances such as when necessary to "protect or effectuate [the federal court's] judgments." *Id.* The federal district court concluded that an injunction was appropriate to protect the federal court's prior decision rejecting class certification, and the Eighth Circuit Court of Appeals agreed.

The Supreme Court reversed, holding that a federal injunction is inappropriate where the named class plaintiff is different or where the test for certification under state law is different from that under federal law. The Supreme Court recognized the risk of successive litigation but noted that state courts and federal courts apply principles of comity and that the Class Action Fairness Act allows broader federal jurisdiction. *Bayer* at 11. Of course, the reality is that class action plaintiffs intentionally design their lawsuits to avoid removal under CAFA and some state courts' approach to class adjudications manifests the antithesis of comity.

Outside of the class action context, several Supreme Court decisions are of note to business generally, including the insurance industry. For example, in *Federal Communications Comm'n v. AT&T, Inc.,* Case No. 09-1279, slip op. (U.S. March 1, 2011), the Court held that corporations do not have "personal privacy" interests cognizable under the Freedom of Information Act. Because the open records laws of many states are based upon FOIA, and the plaintiff's bar actively seeks information through open records requests, this decision may become important to insurers in the future.

In *Sorrell v. IMS Health, Inc.,* Case No. 10-779, slip op. (U.S. June 23, 2011), the Court accorded some First Amendment protection to data mining as a marketing tool. In *Sorrell*, the Court struck Vermont's Prescription Confidentiality Law which protected pharmacy records revealing the prescribing practices of doctors. The Court held that the restrictions imposed a burden on protected expression.

We do not yet know the breadth of First American protection to be accorded to data mining. In *Sorrell,* the law at issue allowed data mining for other purposes, so the Court viewed the prohibition as content-based. It noted that a broader prohibition may have passed muster. *Id.* at 24-25. ❑

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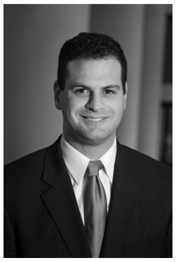

TITLE INSURER'S NEGLIGENT TITLE SEARCH PRECLUDES SUBROGATION

By Brian Levy

The recent decision in *Lawyers Title Ins. Corp. v. MHD Corp.,* 2010 WL 4157301 (Ohio Ct. App. Oct. 22, 2010), addressed whether a title insurer was subrogated to the rights of its insured against a seller where the insurer's negligent title search failed to report a properly recorded encumbrance on the property. The court ruled the title insurer was not entitled to subrogation.

In November 1991, MHD Corporation ("MHD") purchased 12.74 acres of real property from S&S Realty, Inc. ("S&S") pursuant to a warranty deed that contained a right of first refusal on the premises retained by S&S. Lawyers Title Insurance Corporation ("Lawyers Title") acted as the escrow agent and title agent for the sale and, in such capacity, it recorded the warranty deed and issued a title guaranty. The title guaranty did not list the right of first refusal retained by S&S.

In September 2000, MHD conveyed a parcel of the 12.74 acres to Helen Schoen ("Schoen"). Lawyers Title was hired to conduct a title examination, and it subsequently issued a policy of title insurance to Schoen ("Policy"). The Policy did not list the right of first refusal in favor of S&S as a restriction, lien, encumbrance or defect in title to the parcel transferred to Schoen.

On December 8, 2000, S&S filed a lawsuit against MHD and Schoen alleging a violation of S&S's first refusal right pursuant to the 1991 deed. Pursuant to the Policy, Lawyers Title settled the S&S litigation by paying $230,000 to S&S in exchange for a release of all claims against Schoen. Lawyers Title also paid Schoen $78,000 in consideration for Schoen dismissing her cross-claim against MHD without prejudice.

Following the settlement payments, Lawyers Title filed an action against MHD for subrogation pursuant to a provision in the Policy which stated: "Whenever [Lawyers Title] shall have settled and paid a claim under this policy, all right of subrogation shall vest in [Lawyers Title] unaffected by any act of the insured claimant." MHD moved for summary judgment, arguing that Lawyers Title was not entitled to subrogation due to its negligence. The trial court granted MHD's motion for summary judgment.

The Ohio Court of Appeals affirmed summary judgment in favor of MHD. The court ruled that Lawyers Title was not entitled to conventional subrogation under the Policy because "Lawyers Title's loss was precipitated by its own negligent actions in failing to apprise its insured [Schoen] of potential restrictions, encumbrances or defects which were publicly and properly recorded in the . . . records." The court adopted the factual finding of the trial court that Lawyers Title possessed constructive knowledge of the existence of the S&S right of first refusal due to the recordation of the 1991 deed in the public records, and actual knowledge of the S&S right of first refusal, as it was in possession of a copy of the 1991 deed when the property was transferred to Schoen in 2000. The appeals court found that "[t]he trial court properly distinguished between Lawyers Title's general *entitlement to the doctrine of subrogation* and its more specific *right to recovery* under the doctrine in light of its own negligent action in this matter." As such, the court held that "[w]here an imperfect title search has been performed and relied upon by a lender, equity will not reward such negligence by applying the doctrine of subrogation in favor of the negligent party."

The court found unpersuasive Lawyers Title's argument that if equities were to be considered, Lawyers Title is entitled to subrogation because its failure to discover the right of first refusal was a "simple mistake." The court noted that "equitable subrogation" has been applied to provide relief against mistakes but only to benefit a party injured by the mistake of a negligent party, not in favor of the negligent party itself.

This decision by the Sixth District of Ohio's Court of Appeals is inconsistent with an earlier ruling issued by the Eighth District, *Midland Title Security, Inc. v. Carlson*, 872 N.E.2d 968 (Ohio Ct. App. 2007), in which that court held the negligence of a title insurer did not bar the insurer from asserting a contractual right to subrogation. In that case, Midland Title, the escrow agent and title insurer, issued the proceeds of the sale directly to the sellers rather than the mortgagee. The seller cashed the check but ultimately defaulted on the mortgage, and the mortgagee initiated foreclosure proceedings against the property. Midland Title bought the note from the mortgagee to prevent foreclosure.

After buying the note, Midland Title filed suit against the seller, alleging it was the subrogee of the buyer under the terms of the title insurance policy. The trial court agreed with the seller that Midland Title's negligence in issuing the closing check to the sellers precluded it from asserting subrogation and entered judgment in favor of the seller. The appellate court reversed, holding that Midland Title had a contractual right to subrogation and "[e]quitable defenses are not available to challenge conventional subrogation." The opinion in *Lawyers Title* does not cite or refer to *Midland Title.*

This conflict within the intermediate appellate courts in Ohio is mirrored nationwide. In *USLife Title Ins. Co. of Dallas v. Romero*, 652 P.2d 249, 253 (N.M. Ct. App. 1982), the court held the title insurer's negligence barred conventional subrogation. In that case, the court ruled the insurer was not subrogated to an insured's claims for breach of warranty of title after paying a federal tax lien because the insurer failed to exempt the properly recorded tax lien from the coverage provided under the policy. However, the Supreme Court of Arkansas has ruled, consistent with *Midland Title,* that a title insurer's negligence does not bar conventional subrogation. *Welch Foods, Inc. v. Chicago Title Ins. Co.*, 17 S.W.3d 467, 471 (Ark. 2000) ("[W]here the insurer is exercising express contractual rights of subrogation in a claim against one other than its insured and against one to which it owed no legal duty, or who demonstrated no reliance, equitable defenses are unavailing."). The Court of Appeals of Georgia has gone so far as to rule that a title insurer's negligence does not preclude it from asserting a right to equitable or legal subrogation where the policy does not expressly provide a right of subrogation. *Wilkinson Homes, Inc. v. Stewart Title Guar. Co.,* 610 S.E.2d 187, 192 (Ga. App. 2005) (holding that "despite the alleged negligence of [the insurer's] agent" and "[e]ven assuming that the short form of the policy does not provide Stewart Title any contractual right to recover for breach of warranty, the doctrine of equitable subrogation applies here.")

In *Lawyers Title*, the court did not agree that the equities entitled Lawyers Title to subrogation because it made a "simple mistake," but other jurisdictions have found that argument persuasive. In *Castleman Constr. Co. v. Pennington*, 432 S.W.2d 669, 676 (Tenn. 1968), the Supreme Court of Tennessee held that "regardless of the source of the right of subrogation [i.e., conventional or equitable], the right will only be enforced in favor of a meritorious claim and after a balancing of the equities." The court ruled that the equities balanced in favor of the title insurer, although it failed to identify two defects in title, because "ordinary negligence alone will not be held as a complete bar to subrogation where in spite of such negligence the equities are still in favor of the subrogee."

Castleman can be reconciled with *Lawyers Title* and *USLife*. In *Castleman* and *USLife*, the title insurers committed "ordinary negligence" by failing to discover and exempt title defects in the public records. The court in *Lawyers Title* found that the title insurer had actual knowledge of the right of first refusal, which presumably is a more egregious error than "ordinary negligence." ❑

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AFFINITY FINANCIAL CORP. V. AARP FINANCIAL, INC.: "REASONABLE GROUND" TO VACATE DOES NOT MEAN *DE NOVO* REVIEW

By Cindy Chang

In the District of Columbia, under D.C. Code § 16-4423(a), a court *shall* vacate an arbitration award for specified reasons involving corruption, fraud and misconduct. However, D.C. Code § 16-4423(b) provides that the court *may* set aside an arbitration award in the event it sees any "reasonable ground" for doing so.

Dissatisfied parties have seized upon § 16-4423(b) as an opportunity for *de novo* review of the arbitration award. However, several recent D.C. court decisions have declined to interpret the statute as such. *Affinity Fin. Corp. v. AARP Fin., Inc.,* No. 10-CV-2055 (D.D.C. mem. op. July 1, 2011), is the latest decision to reject *de novo* review of an arbitration award.

In *Affinity Financial,* the parties entered into an agreement requiring the resolution of disputes by arbitration. The agreement broadly granted arbitrators authority to "fashion appropriate relief," including monetary damages and equitable relief.

After a four-day arbitration before three arbitrators, the panel issued a written decision unanimously favoring the petitioners, Affinity Financial. The written decision found both parties were in default at various times during the term of the contract, but "considering the law and the equities," the panel awarded Affinity Financial $2.75 million in damages.

Pursuant to the Federal Arbitration Act ("FAA") and the D.C. Revised Uniform Arbitration Act ("UAA"), Affinity Financial petitioned the United States District Court for the District of Columbia to confirm the arbitration award. AARP Financial opposed the petition and filed a motion under FAA and UAA to vacate the arbitration award.

In addition to the grounds for vacatur under the FAA, the D.C. Circuit recognizes "manifest disregard of the law" as a basis for vacating an arbitration award. *Affinity Fin.,* Mem. Op. at 4. To vacate an arbitration award on the basis of manifest disregard of the law, the court must find that (1) the arbitrator knew of a governing legal principle yet refused to apply it or ignored it altogether and (2) the law ignored was well-defined, explicit and clearly applicable to the case. *Id., citing Di Russa v. Dean Witter Reynolds, Inc.,* 121 F.3d 818, 821 (2d Cir. 1997).

The court found the arbitration panel neither exceeded its powers nor manifestly disregarded the law. Importantly, the court also narrowly interpreted D.C. Code § 16-4423(b) to mean "the recognized principle that an arbitration award may be set aside if it manifestly disregards some clear expression of binding law or public policy." *Id.* at 9. A broader interpretation would "undermine the stability and finality of arbitration awards" by circumventing the clear limitation of judicial review under the FAA. *Id.*

This decision follows the D.C. Court of Appeals' decision in *A1 Team USA Holdings, LLC v. Bingham McCutchen LLP,* 998 A.2d 320 (D.C. 2010), which held that the legislative history of the UAA did not support abandoning the standard of "narrow and extremely limited" judicial review of an arbitration award. *A1 Team*, 998 A.2d at 326. Such a standard is necessary to balance the need for expeditious dispute resolution with confidence in the arbitration process. *Id.* at 326-27; *see also Foulger-Pratt Residential Contracting, LLC v. Madrigal Condos., LLC,* 2011 U.S. Dist. LEXIS 45167 at *59-61 (D.D.C. 2011) (following *A1* in finding "other reasonable ground" does not expand the "extremely limited" standard of review to *de novo*). ❑

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Insurance Reinsurance Managed Healthcare Review

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Summer 2011

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