Challenging Unfavorable Arbitration Clauses

by Robert Horkovich and Alexander Hardiman

In 1925, the often-cited the Federal Arbitration Act favoring arbitration of disputes was codified by Congress. Notwithstanding this federally legislated presumption in favor of upholding arbitration agreements, however, it is the states, not the federal government, that are vested with the power to regulate the business of insurance under the McCarran-Ferguson Act — and many states have statutes that prohibit or limit the arbitration of insurance disputes under certain circumstances. Currently, approximately 26 states have enacted legislation that expressly limits or wholly restricts submitting claims arising out of insurance disputes to binding arbitration.

Courts in a variety of circumstances have found that a state's insurance code operates to invalidate a policy's arbitration clause where to impose arbitration would otherwiseimpair a state law regulating insurance, most recently in National Union Fire Ins. Co. of Pittsburgh, Pa v. Source One Staffing, LLC.

In the case, AIG sold a California policyholder a workers comp insurance program and had the policyholder enter into a side agreement that set forth certain financial conditions and other provisions in connection with the workers comp program. The side agreement also contained a clause purporting to require arbitration of any disputes over payments due under the program, required that the arbitrators have an insurance industry background, and stipulated that any disputes regarding the arbitration clause be adjudicated in a New York court. When the policyholder disputed amounts that AIG alleged were due under the workers comp program, AIG filed an action to compel arbitration in New York state court.

In its preliminary decision, the Source One court found that the Federal Arbitration Act (FAA) would not trump a requirement under the California Insurance Code that workers comp policies and any side agreements be filed with the state before being issued. Based on AIG's admission that the side-agreements containing the arbitration clause were not filed with the state, the court concluded that "if the court were to find that arbitration is contractually mandated under the FAA, despite the provisions' undisputed non-compliance with the Insurance Code, then the court would be disregarding the Insurance Code on the basis of the FAA." Based on this rationale, the court denied the insurance company's motion to compel arbitration.

The Source One court reaffirmed its ruling on July 25, 2012, by denying the insurance company's motion to reargue the issue of the applicability of the FAA to the dispute and additionally finding the arbitration clause at issue unenforceable because the insurance company had failed to abide by California's statutory insurance policy filing requirements.

In rejecting the insurance company's argument that the FAA made arbitration of the parties' dispute compulsory, the court considered California's interests in regulating insurance and the regulatory framework surrounding that insurance. Recognizing the importance to California of regulating insurance and interpreting and enforcing its own laws, the court held that the insurance company was required to file the policy documents that contained the arbitration clause with the California Department of Insurance and because it had not, the arbitration clause was invalid.

Insurance companies increasingly include arbitration clauses in their policies and tout arbitration as a more economical and efficient way to resolve insurance coverage disputes than litigation. In many cases, however, arbitration can put policyholders at a significant disadvantage. Arbitration clauses may contain conditions mandating application of a particular state's law that is unfavorable to policyholders or requiring that the arbitrators have an insurance industry background. Moreover, in contrast to a court, arbitrators also are not generally required to follow the law strictly, and the circumstances in which an arbitrator's decision can be overturned by a court are severely limited.

Accordingly, while disputes arising out of an insurance policy containing an arbitration clause may appear to be subject to mandatory arbitration, policyholders should be aware that good arguments may exist to support a challenge to that arbitration clause based on the applicable state insurance laws and regulations.

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