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State Laws May Preclude the Arbitration of Insurance Disputes

By Alexander D. Hardiman and Rene F. Hertzog

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 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. A recent decision from the New York State Supreme Court, however, provides a good example of how policyholders can successfully challenge unfavorable arbitration clauses.

The often-cited policy favoring arbitration of disputes was codified in 1925 by Congress in the Federal Arbitration Act, 9 U.S.C. § 1. Because states are vested with the power to regulate the business of insurance, many states have statutes that directly or indirectly prohibit or limit the arbitration of insurance disputes under certain circumstances, despite the federally legislated presumption in favor of upholding arbitration agreements. Currently, approximately 26 states have enacted legislation that expressly limits or wholly restricts submitting claims arising out of insurance disputes to binding arbitration.

Courts have found that a state's insurance code operates to invalidate a policy's arbitration clause where to impose arbitration would otherwise directly or indirectly impair a state law regulating insurance. A recent decision from the Supreme Court of the State of New York, New York County highlights how a state's Insurance Code may trump and invalidate an arbitration provision. Last summer, that court held that the Federal Arbitration Act did not preempt the California Insurance Code so as to compel arbitration of a dispute

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Alexander D. Hardiman is a shareholder in Anderson Kill's New York office. Mr. Hardiman is an experienced litigator, focusing on insurance coverage litigation and dispute resolution, with an emphasis on commercial general liability insurance, directors' and officers' (D&O) insurance, fiduciary liability insurance, errors and omissions (E&O) insurance, as well as property insurance issues.
(212) 278-1588 | ahardiman@andersonkill.com

Rene F. Hertzog is an attorney in Anderson Kill's New York office. Ms. Hertzog's practice concentrates on insurance recovery exclusively on behalf of policyholders, corporate and commercial litigation and environmental law.
(212) 278-1166 | rhertzog@andersonkill.com

involving alleged funds owed under a workers' compensation insurance program, where the insurance company failed to file the policy documents containing the arbitration provision with the relevant state agency. *See National Union Fire Ins. Co. of Pittsburgh, Pa v. Source One Staffing, LLC*, Index No.: 652366/2010, July 27, 2011. In that decision, the court concluded: "if the court were to find that arbitration is contractually mandated under the FAA, despite the provisions' undisputed noncompliance 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 court reaffirmed its ruling on July 25, 2012, by denying the insurance company's motion to reargue the issue of the applicability of the Federal Arbitration Act 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. *See National Union Fire Ins. Co. of Pittsburgh, Pa v. Source One Staffing, LLC*, 36 Misc.3d 1224(A), 2012 WL 3156438 (N.Y. Sup. Ct. July 25, 2012).

In rejecting the insurance company's argument that the Federal Arbitration Act 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.

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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