The Insurance and Reinsurance Law Review

Fourth Edition

Editor
Peter Rogan

Law Business Research

The Insurance and Reinsurance Law Review

The Insurance and Reinsurance Law Review
Reproduced with permission from Law Business Research Ltd.

This article was first published in The Insurance and Reinsurance Law Review, 4th edition
(published in April 2016 – editor Peter Rogan).

For further information please email
nick.barette@lbresearch.com

The Insurance and Reinsurance Law Review

Fourth Edition

Editor
Peter Rogan

Law Business Research Ltd

PUBLISHER
Gideon Roberton

SENIOR BUSINESS DEVELOPMENT MANAGER
Nick Barette

SENIOR ACCOUNT MANAGERS
Thomas Lee, Felicity Bown, Joel Woods

ACCOUNT MANAGER
Jessica Parsons

MARKETING COORDINATOR
Rebecca Mogridge

EDITORIAL ASSISTANT
Sophie Arkell

HEAD OF PRODUCTION
Adam Myers

PRODUCTION EDITOR
Anne Borthwick, Robbie Kelly

SUBEDITOR
Anna Andreoli, Tessa Brummitt

CHIEF EXECUTIVE OFFICER
Paul Howarth

Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK
© 2016 Law Business Research Ltd
www.TheLawReviews.co.uk
No photocopying: copyright licences do not apply.
The information provided in this publication is general and may not apply in a specific situation, nor does it necessarily represent the views of authors' firms or their clients. Legal advice should always be sought before taking any legal action based on the information provided. The publishers accept no responsibility for any acts or omissions contained herein. Although the information provided is accurate as of April 2016, be advised that this is a developing area.
Enquiries concerning reproduction should be sent to Law Business Research, at the address above. Enquiries concerning editorial content should be directed to the Publisher – gideon.roberton@lbresearch.com

ISBN 978-1-909830-91-2

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

EDITOR'S PREFACE

It is hard to overstate the importance of insurance in personal and commercial life. It is the key means by which individuals and businesses are able to reduce the financial impact of a risk occurring. Reinsurance is equally significant; it protects insurers against very large claims and helps to obtain an international spread of risk. Insurance and reinsurance play an important role in the world economy. It is an increasingly global industry, with the emerging markets of Brazil, Russia, India and China developing apace.

Given the expanding reach of the industry, there is a need for a source of reference that analyses recent developments in the key jurisdictions on a comparative basis. This volume, to which leading insurance and reinsurance practitioners around the world have made valuable contributions, seeks to fulfil that need. I would like to thank all of the contributors for their work in compiling this volume.

Looking back on the past year, market estimates suggest that the insured losses flowing from the explosion at the Port of Tianjin in China may well exceed US$3 billion. The losses will arise on a wide variety of policies ranging from cargo, property and ports and terminals insurance through to product liability and business interruption. Those policies will be subject to a range of governing laws. It is likely that there will be complex issues to consider in relation to each of these types of coverage, both at the direct insurance and reinsurance levels. The US winter storm of January 2016 is predicted to be a multi-billion dollar loss event. In the UK, December 2015 was the wettest on record. Denial of access to homes and businesses was significant, and the insurance market is braced for the ensuing losses.

Events such as these test not only insurers and reinsurers but also the rigour of the law. Insurance and reinsurance disputes provide a never-ending array of complex legal issues and new points for the courts and arbitral tribunals to consider. I hope that you find this fourth edition of *The Insurance and Reinsurance Law Review* of use in seeking to understand them and I would like once again to thank all the contributors.

Peter Rogan
Ince & Co
London
April 2016

Chapter 28

UNITED STATES

Michael T Carolan, Paul W Kalish, William C O'Neill and Rachel P Raphael[1]

I INTRODUCTION

i The scope of the united states insurance and reinsurance market

The United States insurance market is one of the largest financial markets in the world. In 2014, US insurers underwrote approximately $1.28 trillion in life and non-life direct premiums, accounting for just under 27 per cent of the global insurance industry.[2] To put that number in perspective, the $1.28 trillion in underwriting amounted to roughly 7.35 per cent of the total US gross domestic product.[3] Yet even these premiums fail to capture the full scale of the US insurance market. In 2014, the total cash and invested assets of US insurers reached $5.1 trillion.[4] As such, the US insurance market plays a significant role in the global economy.

In 2014, the US insurance market included $655.5 billion in life and health insurance premiums, including annuities.[5] This dynamic and highly competitive segment of the marketplace includes more than 1,000 insurance companies competing to underwrite a wide variety of products.[6]

1 Michael T Carolan, Paul W Kalish and William C O'Neill are partners and Rachel P Raphael is an associate at Crowell & Moring LLP.

2 Insurance Information Institute, International Insurance Factbook 2016, at 3 (2015).

3 The World Bank, Data, GDP (current US$), available at http://data.worldbank.org/indicator/NY.GDP.MKTP.CD (last visited 19 December 2015).

4 Insurance Information Institute, Industry Overview, available at www.iii.org/facts_statistics/industry-overview.html (last visited 19 December 2015).

5 Id.

6 Id.

The 2014 US insurance market also wrote $502.6 billion in premiums in the property and casualty, and specialty markets, including, among others, comprehensive general liability, directors and officers insurance, errors and omissions insurance, and workers compensation coverages.[7] Competition within the highly fragmented property and casualty market is significant, with approximately 2,600 different insurance companies competing for business.[8]

The underwriting of US reinsurance is also robust, with net premiums written to unaffiliated reinsurers totalling approximately $50 billion in 2014.[9] Reflecting the heightened complexity of reinsurance offerings, lower demand for reinsurance products, and intense international competition, this market is concentrated in substantially fewer companies than the direct-side market.[10]

Given the scope of the US market, it should come as no surprise that legal advisers specialising in insurance and reinsurance law span a broad range of specialties including insurance litigation and counselling; claims handling; regulatory compliance; professional and management liability; insurer liquidation and insolvency; and reinsurance disputes. The following sections provide a basic introduction to the language and practice of insurance law within the US market.

II REGULATION

Historically, US insurance and reinsurance companies were solely regulated at the state level. In 1944, however, a US Supreme Court decision raised doubts about state-level insurance regulation. In response, in 1945, the US Congress enacted the McCarran-Ferguson Act,[11] which declared 'that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States'.[12]

7 Id.

8 Id.

9 Reinsurance Association of America, Reinsurance Underwriting Review: A Financial Review of US Reinsurers, 2014 Industry Results, at 1, 10 (2015) (based on results of US reinsurance organisations with over $10 million of unaffiliated reinsurance premium and $50 million of policyholder surplus).

10 Id. at 10.

11 15 U.S.C. §§ 1011 et seq.

12 Id. § 1011.

Since passage of the McCarran-Ferguson Act, regulation of insurance and reinsurance companies is primarily performed at the state level.[13] While the federal government has recently taken steps to increase its regulatory role, those steps have largely been at the edges of the insurance and reinsurance markets.

i State-by-state regulation

State insurance departments and commissioners

In the United States, insurance companies obtain their charter from one domiciliary state, which is the primary regulator of the solvency of the insurance company.[14] However, in general, an insurance company must also obtain a licence in each state in which it intends to issue policies. (An exception to that rule is for non-admitted or 'surplus lines' insurers, which are addressed below.) For these carriers, the company's business practices, such as marketing, are regulated separately in each state in which it is licensed. The laws and rules regarding such business practices vary from state to state.

All 50 states have an insurance regulatory department, generally led by a chief insurance regulator. State insurance departments are generally funded by fees and taxes on insurance companies, including fees for licensing and examinations.

National Association of Insurance Commissioners

The National Association of Insurance Commissioners (NAIC) operates to coordinate insurance regulatory efforts across the states. The NAIC is a private, voluntary association of chief insurance regulators from the 50 states, the District of Columbia, and five US territories. The NAIC is funded by assessing fees for its services and publications.

Although the NAIC lacks any actual regulatory authority, it is the leading voice with respect to the state-based insurance regulatory system in the United States.

Issues subject to state regulation

In general, insurance regulation in the United States is conducted to protect the public and consumers of insurance products by regulating the business practices of insurance companies while monitoring their solvency. The goal is twofold; first, to regulate the terms of insurance

13 This chapter does not address the US health insurance market. That market is primarily regulated by the federal government. For example, in 1965, the US Congress passed the comprehensive health insurance plans known as Medicare and Medicaid; in 1974, the US Congress passed the Employee Retirement Income Security Act, which placed employee benefit plans (including health plans) primarily under federal jurisdiction, and the HMO Act, which set standards for federally qualified health maintenance organisations; in 1996, the US Congress passed the Health Insurance Portability and Accountability Act, which established minimum federal standards for the availability and renewability of health insurance; and, in 2009, the US Congress passed the Affordable Care Act, a set of comprehensive health insurance market reforms.

14 Certain large states, such as California and New York, regulate the solvency of any insurance company selling policies in their state, regardless of its domicile.

contracts to maintain fairness between the insurance company and the consumer, and, second, to assure that the insurance company will be available to pay the valid claims of consumers when they are presented.

In practice, these goals are met through regulations on a variety of topics, outlined below.

Company licensing

Insurance companies are generally required to obtain licences from state insurance regulatory authorities before transacting insurance in a given state.[15] Once granted, the insurance licence specifies which lines of insurance the company is permitted to sell within the state. Because licensing is done on a state-by-state basis, approval by one state does not carry over into any other state. Licence applications submitted to states other than an insurance company's domicile generally are called 'expansion applications'.

Typically, states require certain minimum levels of capital and policyholder surplus to obtain a licence. The amount of capital and surplus will depend on the type and volume of business the insurance company intends to write. In addition to capital requirements, state regulators reviewing an insurance company licence applicant evaluate the company's management, business plan and market conduct.

Producer licensing

Individuals or companies that sell, solicit or negotiate insurance in the United States must be licensed as a 'producer' in each state in which the individual or company operates. This includes insurance agents and insurance brokers.

The requirements for licensing of producers vary from state to state and producers typically have to meet separate licensing requirements for each state in which they sell insurance. In most states, the producer licensing process includes an examination and a background check. The process for licensing resident producers can be different from the process for licensing non-resident producers.

Rate and product regulation

In the United States, individual states regulate both the types of products certain insurance companies can offer and the rates those insurance companies can charge for their products. The level and specificity of product and rate regulation varies from state to state.

The general legal standard applicable for rates in all states is that rates may not be inadequate, excessive, or unfairly discriminatory. On the whole, states do not set mandatory rates. Instead, insurance companies choose the rates they intend to use in a given state in which they are licensed and then inform the state of the chosen rates, with justification.

For commercial lines within the property and casualty insurance market, states take a variety of approaches to regulating insurance rates. Some states require that rates be filed with the state and approved by the state prior to use. Other states require only that rates be filed with the state. Finally, certain states have no filing requirements at all.

With respect to insurance product regulation, state regulators often require pre-approval of certain life and property and casualty insurance products offered in their

15 The most important exception is for surplus lines.

individual state in an effort to assure that offered products can be readily understood by consumers. That pre-approval process includes, among other things, a review of policy forms and marketing materials prior to the sale of such policies in their state.

Market conduct regulation

States also regulate the business of insurance by prohibiting insurance companies from engaging in unfair, deceptive or anti-competitive conduct. To enforce these regulations, states perform market conduct examinations of licensed or admitted carriers and producers. States also use enforcement actions to compel insurance companies to adhere to specific standards with respect to the interactions between the companies and consumers or policyholders. In some states, enforcement actions may also be brought by the state attorney general under laws outside insurance-specific regulations.

Solvency and accreditation

All 50 states and the District of Columbia have adopted financial reporting laws that require insurance companies to file quarterly and annual financial statements on the forms authored by the NAIC. Likewise, insurance companies must calculate their risk-based capital in accordance with procedures set by the NAIC.[16]

These coordinated financial requirements are part of the NAIC's accreditation programme. Accreditation is a certification issued to a state insurance department once it has demonstrated that it has met and continues to meet a variety of legal, financial and organisational standards as determined by the NAIC. Accreditation is necessary so that when an insurance company is domiciled in an accredited state, the other states in which the insurance company is licensed, or writes business, or both, can be assured that the domiciliary state is adequately monitoring the financial solvency of that company. As of December 2014, all 50 states, plus the District of Columbia and Puerto Rico are accredited.

Financial examinations

Each of the 50 states and the District of Columbia subject insurance companies operating within their state or territory to a full financial examination at least once every five years. These examinations are designed to verify the financial statements discussed in the preceding section of this chapter.

Uniform standards, including the NAIC Model Law on Examinations and the NAIC's *Financial Condition Examiners Handbook*, apply to financial examinations by almost all 50 states. These standards specify both when a financial examination is to be conducted and the guidelines and procedures to be used by the state in its conduct of the financial examination. Generally, states use a risk-focused approach to financial examinations.

16 State control of the regulation of insurance companies was confirmed by the Insurance Capital and Standards Clarification Act of 2014, which was signed into law on 18 December 2014. The Act makes clear that if an insurer's activities are regulated by state insurance regulators, it is not subject to the minimum capital requirements for depository institution holding companies and nonbank financial companies laid out in the Dodd-Frank Act (discussed below).

Insurance companies that operate in multiple states are subject to financial examination by each state. These multiple financial examinations, however, are coordinated to some extent for group examinations.

Credit for reinsurance and collateral requirements

Historically, most US states required that for ceding insurers to get full financial statement credit for reinsurance placements with unauthorised reinsurers (reinsurers not licensed or accredited in a ceding insurer's domicile), the unauthorised reinsurers must post 100 per cent collateral for the reinsured liabilities. This allowed state-based insurance regulators to indirectly regulate transactions with reinsurers outside its jurisdiction. In recent years, such indirect regulation has come under criticism.

In response to this criticism, a number of states have reduced collateral requirements for certain approved non-admitted reinsurers. As of August 2015, 32 states have passed legislation to implement revised reinsurance collateral provisions focused on the solvency risk of reinsurers as opposed to their admitted status.[17]

Insurance insolvency

In the United States, insurance company insolvencies are exempt from federal bankruptcy law. Instead, the rehabilitation and liquidation of insurance companies has been specifically delegated to the states. Thus, domiciliary state laws establish the process for the receivership or liquidation of an insolvent insurance company.

Notably, the insolvency clause standard in almost all US reinsurance contracts may require the reinsurer to indemnify an insolvent insurer's estate for the full amount of any covered claim allowed in the proceeding, despite the fact that the estate in liquidation may actually pay only a fraction of the allowed amount to its policyholder.

ii Federal regulation of insurance

Although the primary source of insurance regulation is by the states, the US federal government does play a role with respect to certain regulatory issues.

Direct federal programmes

In a number of hard-to-place insurance markets, the US federal government has stepped in to provide direct insurance or reinsurance support. Under these programmes, federal regulation

17 Covered Agreement on Reinsurance Collateral, NAIC Government Relations Issue Brief (August 2015). As of December 2014, the NAIC has approved seven countries as Qualified Jurisdictions: Bermuda, Germany, Switzerland, United Kingdom, France, Ireland and Japan. Reinsurers that are licensed and domiciled in these jurisdictions are eligible for reduced reinsurance collateral requirements. Id.

either pre-empts or directly supports private insurance, supplanting the states' regulatory role for the specific insurance market.[18] Examples of direct federal insurance involvement include terrorism risk insurance,[19] flood insurance[20] and crop insurance.[21]

Liability Risk Retention Act

In 1986, the US Congress enacted the Liability Risk Retention Act of 1986 (LRRA). The LRRA allowed for the formation of risk retention groups (RRGs), which are entities through which similar businesses with similar risk exposures create their own insurance company to self-insure their liability (but not property) risks. RRGs are only required to be licensed as an insurance company in one domiciliary state. Once so licensed, an RRG is exempted from most insurance regulations for any other state in which the RRG operates.

Dodd-Frank Act

In response to the 2008–2009 financial crisis, in 2010 the US Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The Dodd-Frank Act increased the federal government's regulatory role with respect to insurance and reinsurance in a number of ways.

Federal Insurance Office

The Federal Insurance Office (FIO), an organisation within the US Treasury Department, is responsible for monitoring all aspects of the insurance industry to identify issues or gaps in the regulation of insurance companies that could lead to a systemic crisis in the insurance industry or the US financial system. The FIO does not, however, currently have any express regulatory authority over the insurance industry.

18 The examples cited herein of direct US federal government participation in insurance markets are illustrative and not exhaustive.

19 Initially enacted in 2002, the Terrorism Risk Insurance Act of 2002 (TRIA), Pub. L. 107–297, 116 Stat. 2322, was reauthorised in 2007 and expired on 31 December 2014. On 12 January 2015, HR 26, the Terrorism Risk Insurance Program Reauthorization Act of 2015, was signed into law. This legislation will, among other things, extend the federal terrorism reinsurance programme established by the TRIA until 31 December 2020 and incrementally raise the trigger for reinsurance coverage each year from $100 million to $200 million beginning in 2016.

20 Originally enacted in 1968, the National Flood Insurance Program (codified at 42 U.S.C. § 4011) was reauthorised and reformed in 2012 through the Biggert-Waters Flood Insurance Reform Act of 2012, Pub. L. 112–141. On 21 March 2014 the Homeowner Flood Insurance Affordability Act of 2014 was signed into law. Among other things, this 2014 law repeals and modifies certain provisions of the Biggert-Waters Act.

21 The Federal Crop Insurance Corporation was initially created by the US Congress in 1938 (codified at 7 U.S.C. § 1501) in response to the economic difficulties brought to the US farming industry by the Great Depression. In 1980, the programme was expanded through the Federal Crop Insurance Act, Pub. L. 96-365. Of note, the Federal Agriculture Reform and Risk Management Act of 2013, signed into law on 7 February 2014, includes, among other things, expanded crop insurance subsidies paid by the US government over the next 10 years.

The FIO monitors all lines of insurance, except for health insurance, long-term care insurance, and crop insurance. The FIO also has certain responsibilities relevant to the insurance industry and the US financial system, including, among others: acting to pre-empt state regulations that conflict with international insurance agreements, monitoring whether traditionally underserved communities have access to affordable insurance products, and reporting to the US Congress, including annual reports on acts to pre-empt state law because of international insurance agreements, a report on modernisation of insurance regulation, and reports on the US and global reinsurance markets.

Financial Stability Oversight Council

In 2010, the Financial Stability Oversight Counsel (FSOC) was created with the purpose of identifying and responding to risks to the financial stability of the United States. The FSOC has the authority to subject a 'non-bank financial company' (NBFC), including an insurance company, to supervision by the Federal Reserve if it determines that the company is a 'systemically important financial institution' (SIFI) through a multistage determination process. In making its determination, the FSOC considers factors such as size, leverage, interconnectedness and current regulatory scrutiny.[22] By statute, the FSOC may only designate a NBFC as a SIFI if the company's material financial distress, or its size, scope, nature, scale, interconnectedness, concentration or mix of activities, pose a threat to the financial stability of the United States.[23] Once a company is identified as a SIFI, it is subject to direct supervision by the US Federal Reserve Board and enhanced prudential standards, including specific reporting requirements, risk-based capital requirements, liquidity requirements, risk management requirements, leverage limits, and credit exposure limits. Once a company has been designated, the FSOC is required by statute to re-evaluate each year, and considers whether material changes at the company warrant a rescission of the SIFI designation. Aside from the annual re-evaluations, a designated company can request a re-evaluation if it has undergone a change that materially reduces the threat that it might pose to US financial stability.

On 4 February 2015, FSOC voted to adopt changes to its NBFC designation process.[24] In general, these changes aim to improve transparency by (1) informing NBFCs that they are under evaluation earlier in the review process, (2) providing for increased engagement with NFBCs and financial regulators during both the initial review and annual re-evaluation, and (3) making more information available to the public about the FSOC process.[25]

22 Financial Stability Oversight Council, Nonbank Designations – FAQs, available at www.treasury.gov/initiatives/fsoc/designations/Pages/nonbank-faq.aspx (last visited 23 January 2016).

23 Id.

24 US Department of the Treasury, 'Financial Stability Oversight Council Announces Changes to Nonbank Designations Process' (2 February 2015), available at www.treasury.gov/press-center/press-releases/Pages/jl9766.aspx. A copy of the FSOC Supplemental Procedures Relating to Nonbank Financial Company Determinations is available at www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental%20Procedures%20Related%20to%20Nonbank%20Financial%20Company%20Determinations%20-%20February%202015.pdf.

25 Id.

Nonadmitted and Reinsurance Reform Act – surplus lines

In the United States, all 50 states allow issuance of surplus lines business by unlicensed or non-admitted insurance carriers. Generally, consumers must use a specially-licensed insurance broker and demonstrate they are unable to find the specified coverage through the admitted market. Once the exceptional need is demonstrated, the risk can be placed with non-admitted carriers.

In situations where the risk placed with a surplus lines carrier is located in multiple states, the surplus lines broker is sometimes faced with conflicting state requirements for surplus lines placement, including allocation of the tax payments. Effective as of 2011, the Nonadmitted and Reinsurance Reform Act (NRRA) addressed these conflicts by investing exclusive taxing authority with respect to surplus lines and non-admitted insurance policies in a policyholder's 'home state'. The NRRA also encourages (but does not mandate) the formation of interstate compacts to manage the reporting, payment, collection, and allocation of premium taxes remitted on surplus lines policies covering multistate risks. In addition, the NRRA provides that surplus lines insurance is subject only to the regulatory requirements of the policyholder's home state (except for workers' compensation business). Finally, the NRRA permits large commercial insurance purchasers that meet certain conditions to directly access the surplus lines market.

NRRA – reinsurance

The NRRA also addresses certain issues of regulatory redundancy with respect to reinsurance. Under the NRRA, if an insurer's domicile recognises credit for reinsurance for the insurer's ceded risk, then no other state may deny such credit for reinsurance, so long as the domiciliary state is NAIC-accredited, or has solvency requirements substantially similar to those required for NAIC accreditation. The NRRA also pre-empts the laws and regulations of non-domiciliary states, to the extent that such laws or regulations: restrict or eliminate the right to resolve reinsurance disputes pursuant to reinsurance contractual arbitration provisions; require that a certain state's law shall govern the reinsurance contract; or attempt to enforce a reinsurance contract on terms different than those set forth in the reinsurance contract itself. Finally, the NRRA invests exclusive authority to regulate the financial solvency of a reinsurer in the reinsurer's domiciliary state.

III INSURANCE AND REINSURANCE LAW

i Sources of law

As discussed above, pursuant to the McCarran-Ferguson Act, the US Congress has declared that states will be the primary regulators of the insurance and reinsurance markets.

In the United States, each state has both statutory and common law applicable to insurance issues. State common law is a significant source of law for the purpose of resolving disputes. In broad terms, it applies to issues such as: legal duties, the interpretation of contracts, procedure, and damages. Individual state statutes applicable to insurance, though they vary in breadth and focus, generally regulate insurance companies operating within the state. Common state statutes include provisions requiring companies to be licensed or barring insurers from acting or marketing its products in a deceptive manner.

Notwithstanding the McCarran-Ferguson Act, federal law also addresses insurance issues. Under the US Constitution, federal statutes may pre-empt state statutes and laws where they overlap. Thus, a federal statute such as the NRRA (discussed above) may pre-empt

inconsistent state laws. Federal common law, while fairly narrow in scope, impacts insurance and reinsurance companies indirectly. One example is federal common law relating to the application of the Federal Arbitration Act, which guides decisions on whether policyholders or cedents are bound to arbitrate a dispute with insurers or reinsurers.

ii Making the contract

The requirements for the creation of an enforceable insurance or reinsurance contract mirror those of most written contracts – offer, acceptance, consideration, legal capacity and legal purpose. In practical terms, an application or submission and the tender of the initial premium represent the offer to contract. Acceptance is generally demonstrated through execution of the policy or agreement. Without an offer and acceptance, there is no meeting of the minds and no contract.

Insurance and reinsurance contracts are negotiated and placed both directly and through intermediaries. In either case, prospective insureds or cedents provide the information requested by the insurance carrier or reinsurer for the placement. If necessary, the insurance carrier or reinsurer's underwriter can (but is not necessarily required to) seek more information. At all times, the prospective insured or reinsured generally is under an obligation to disclose all material information relating to the risk being covered.

Following the agreement on terms, the insurance or reinsurance contract is documented. In most individual consumer insurance markets, the insurance policy is initially crafted by the insurance company. In other instances, a manuscript policy may be negotiated.

iii Interpreting the contract

Because of variations among state laws, there are no overarching rules of insurance contract interpretation. In general, the rules of interpretation applicable to commercial contracts apply to insurance policies. State or federal courts that interpret contract provisions typically try to determine the objective intent of the parties. Unambiguous insurance policy provisions are generally enforceable. While these principles apply generally to reinsurance agreements as well, it is important to note that reinsurance disputes are typically viewed through the prism of industry custom and practice. Indeed, in reinsurance arbitrations the arbitrators' charge is often to view the parties' agreement as an 'honourable engagement' and they are often directed to interpret the contract without a need to follow strict rules of law and with a view to effecting the purpose of the contract in reaching their decision.

iv Intermediaries and the role of the broker

Insurance intermediaries, including agents and brokers, play a key role in the US insurance and reinsurance markets. Currently, there are more than two million individuals and more than 500,000 businesses licensed to provide insurance services in the United States.[26]

There are a number of types of agents and brokers. Broadly speaking, a general insurance agent contractually represents the insurance company and is authorised to accept risks and issue policies, a soliciting agent has authority to seek insurance applicants, but

26 NAIC, Producer Licensing and NARAB II (12 January 2016), available at www.naic.org/cipr_topics/topic_producer_licensing_narab_II.htm.

has no authority to bind an insurance company, and a broker is a licensed, independent contractor who represents insurance applicants and ceding insurers in the negotiation and purchase of insurance or reinsurance.[27]

The conduct of insurance intermediaries is regulated through state statutes and laws. Typically, an agent or broker has a duty to faithfully carry out the instructions of its client. Depending upon the circumstances, a heightened 'fiduciary duty' may also apply.

v Claims

The laws regarding insurance and reinsurance claims issues vary from state to state. The key issues include: notice, good faith and dispute resolution.

With respect to notice, both insurance and reinsurance claims generally require that a policyholder or insured provide reasonably timely notice of claims or other information. For insurance claims, timely notice is considered a condition precedent to coverage in many states and, in the absence of reasonably timely notice, a claim may not be covered. For reinsurance claims, in some jurisdictions, unless timely notice is stated to be a condition precedent in the reinsurance contract, a reinsurer seeking to avoid a claim on account of late notice must prove that it was economically prejudiced.

Both insurance and reinsurance claims may involve issues of good faith and fair dealing. Insurance companies, for their part, must respond to the claims of their policyholders consistent with contractual good faith and fair dealing requirements. If the insurance company fails to do so, it opens itself up to a potential breach claim by the policyholder. In reinsurance, the duty of utmost good faith applies to both cedents and reinsurers. Thus, while cedents must fully disclose all material information about the ceded risk, for most lines of business reinsurers have a concomitant duty to 'follow the fortunes' of their cedents, which requires indemnifying cedents for all businesslike, good faith, reasonable claim payments.

In the United States, many casualty insurance policies contain arbitration clauses. In some states, however, such clauses are not permitted and disputes are required to be resolved through litigation in state or federal courts. On the other hand, most reinsurance contracts contain dispute resolution clauses mandating confidential arbitration.

IV DISPUTE RESOLUTION

i Jurisdiction, choice of law and arbitration clauses

A few key issues relating to insurance and reinsurance dispute resolution are the forum in which a suit can or must be brought, the law that will govern the dispute and the dispute resolution process. In that regard, some insurance policies and most reinsurance contracts contain provisions relating to jurisdiction, choice of law, or arbitration, either separately or together within a single dispute resolution clause. A typical forum clause, for example, requires any lawsuit related to the policy or contract to be filed in a given state or federal court. Similarly, a typical choice of law clause dictates which jurisdiction's laws shall apply to disputes arising out of the contract. Finally, a typical arbitration clause states that all disputes regarding the contract shall be resolved by arbitration and, in most instances, spell out certain procedures applicable to the arbitration process.

27 Depending upon the facts, a broker may also act for the insurance company or reinsurer.

Where those issues are not spelled out in the applicable contract, state and federal courts use a variety of legal rules for determining whether the chosen forum for a lawsuit is appropriate and choosing which state's law will apply. Arbitration, however, is a matter of contract or agreement; thus, a party that did not or has not agreed in its contract to arbitrate a dispute typically cannot be forced to do so.

ii Litigation

The judicial system in the United States is made up of two different court systems: the federal court system and the state court systems.

In the federal system, there are three levels of courts: the District Courts, which are the federal trial courts; the interim appellate courts, called the Circuit Courts of Appeal; and the US Supreme Court, the final appellate court. Only two types of cases are heard in the federal system. The first is cases dealing with issues of federal law. The second is cases between citizens of two different states or between a US citizen and a foreign entity, provided the amount in dispute meets a minimum threshold. In total, there are 94 US district courts throughout the 50 states. There are 13 US circuit courts of appeal, each with separate jurisdictional coverage. There is one Supreme Court. Notably, the right to appeal to the Supreme Court typically is not automatic; the Supreme Court must agree to hear the case.

No two state court systems are exactly alike. Typically, state court systems are made up of two sets of trial courts: trial courts of limited jurisdiction (probate, family, traffic, etc.) and trial courts of general jurisdiction (main trial-level courts). Most states also have intermediate appellate courts. All states have one final appellate state court.

Each state has its own rules of evidence for cases tried in its courts. Each state likewise has its own rules of procedure for cases progressing through its court system. On the other hand, the federal district courts have a unified set of evidence rules and a unified set of rules of procedure.

Except in certain limited circumstances, the general rule in the United States is that each party pays its own costs of litigation.

iii Arbitration

The most widely used alternative dispute resolution process in the United States is arbitration. There are numerous types of insurance and reinsurance arbitrations. The differences between each type generally relate to the following: the number of arbitrators; arbitrator selection procedures; arbitrator neutrality; and arbitration hearing procedure.

In general, US insurance and reinsurance arbitrations are conducted before either one arbitrator or three arbitrators. The selection process truly varies; in some instances, there is a process managed by an independent third-party for selection of the entire panel, in other instances, the parties choose and organise the selection process. Two prominent and independent groups that certify arbitrators and in varying degrees organise insurance and reinsurance arbitrations in the United States are the American Arbitration Association and the AIDA Reinsurance and Insurance Arbitration Society.

Typically, in the single-arbitrator process, the arbitrator is neutral and often has expertise in the particular type of dispute. Where the arbitration panel consists of three arbitrators, the general process is that arbitrators are either all neutral, or the parties each appoint a single arbitrator and follow a process for selection of a neutral umpire. In the latter process, it is common for both parties to be able to communicate with their appointed arbitrator prior to the hearing, but in the end, party-appointed arbitrators are expected to

rule based on their view of the merits of the dispute. Although there are grounds to vacate or modify an arbitration award under the Federal Arbitration Act (or similar state statutes) and the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (also known as the New York Convention), unless there is prior agreement otherwise, arbitration decisions are considered binding.

In most instances arbitrators are not bound by strict rules of evidence during the hearing. It is also common that witnesses appearing at an arbitration hearing will be questioned by each of: the presenting party's attorney, the opposing party's attorney, and the arbitration panel.

Finally, the general rule in the United States is that each party pays its own costs for insurance and reinsurance arbitrations. However, insurance and reinsurance contracts may specify otherwise. Additionally, unless forbidden by the applicable contract, arbitration panels are generally empowered to order one party to pay the other party's costs.

iv Mediation

Beyond settlement conferences, most state and all federal courts have adopted mediation processes designed to encourage dispute resolution without a trial. In general, the process is voluntary and the mediator is an independent third-party without court affiliation. However, in a number of states, parties in commercial disputes are required to participate in at least one mediation or settlement conference prior to moving forward with trial. In addition, parties to an insurance dispute will often agree to retain a private mediator to help resolve one or more issues.

v Alternative dispute resolution

A range of dispute resolution techniques are used in the United States. Beyond arbitration and mediation, alternative dispute resolution procedures include early neutral evaluations, peer review, and mini-trials. A number of industries – including the construction, maritime, and securities industries – have adopted such procedures to handle intra-industry claims. Of course, the level of interest in these procedures can vary greatly by company or industry.

V YEAR IN REVIEW

2015 was an eventful year for the US insurance industry, with significant industry, judicial, and regulatory developments. While a comprehensive review of developments in the industry far exceeds the scope of this article, the following is a sampling of the key emerging issues and events that will be on the minds of insurers throughout 2016.

i NAIC Cybersecurity Task Force issues cybersecurity guidance for insurers and regulators

On 16 April 2015, the NAIC Cybersecurity Task Force[28] adopted the Principles for Effective Cybersecurity: Insurance Regulatory Guidance, which are intended to encourage insurance companies and state insurance regulators to proactively reduce cybersecurity

28 Formed in November 2014, the Cybersecurity Task Force is responsible for (1) monitoring cybersecurity developments; (2) advising and making recommendations to the NAIC

risks to consumers' confidential and personally identifiable information.[29] The 12 guiding principles are intended to help insurers and regulators safeguard consumer information and improve practices for responding to cybersecurity incidents.[30] Through these principles, the NAIC calls on state insurance regulators to require insurers to adopt security measures and implement data breach response procedures.[31] The NAIC also asks regulators to work with insurers, producers and the federal government on a coordinated approach.[32] Among other things, the NAIC directs insurers to (1) identify cybersecurity risks, (2) adopt cybersecurity practices governing confidential and personally identifiable information, and (3) ensure that third parties entrusted with sensitive information have implemented appropriate security measures. The NAIC's guidance also includes specific cybersecurity practices that insurers should put in place, such as periodic cybersecurity training and assessments for employees, intermediaries and third parties.[33]

ii California Supreme Court allows insurers to recover directly from insured's independent legal counsel

In August 2015, the California Supreme Court, in *Hartford Casualty Insurance Company v. J R Marketing, LLC*,[34] held that insurers are entitled to seek reimbursement directly from independent counsel for excessive legal fees incurred in defending the insured. Hartford initially refused to defend its insured but was eventually compelled by court order to provide its insured with independent Cumis counsel, subject to a reservation of rights.[35] After the underlying action concluded, Hartford sought reimbursement from Cumis counsel for fees incurred in defending individuals that were not entitled to coverage under the insurer's policies. The trial court dismissed the insurer's complaint, concluding that the insured's right to reimbursement was from its insured only,[36] and the Court of Appeals affirmed.[37]

The California Supreme Court reversed and agreed with Hartford that by charging unreasonable and unnecessary fees, Cumis counsel was unjustly enriched.[38] According to the California Supreme Court, assuming Cumis counsel's fees 'were objectively unreasonable and unnecessary to the insured's defense in the underlying litigation and that they were not

Executive Committee regarding cybersecurity; and (3) coordinating activities with other NAIC committees and representing the NAIC in communicating with other organisations on cybersecurity issues.

29 NAIC, 'NAIC cybersecurity task force adopts regulatory principles' (17 April 2015), available at www.naic.org/Releases/2015_docs/naic_cybersecurity_task_force_adopts_regulatory_principles.htm.

30 The full text of the Principles for Effective Cybersecurity: Insurance Regulatory Guidance is available at www.naic.org/documents/committees_ex_cybersecurity_tf_final_principles_for_cybersecurity_guidance.pdf.

31 Id.

32 Id.

33 Id.

34 61 Cal. 4th 988 (Cal. 2015).

35 Id. at 993–94.

36 Id.

37 Id. at 996.

38 Id. at 998–99.

incurred for the benefit of the insured', then 'principles of restitutions and unjust enrichment dictate that [independent counsel] should be directly responsible for reimbursing [the insurer] for counsel's excessive legal bills'.[39]

iii NARAB II marks progress toward a national licensing standard for insurance intermediaries

On 12 January 2015, the National Association of Registered Agents and Brokers Reform Act of 2015 (NARAB II) was signed into law as part of HR 26, the Terrorism Risk Insurance Program Reauthorization Act of 2015.[40] NARAB II established the National Association of Registered Agents and Brokers (Association) with the goal of simplifying insurance producer licensing in the United States.[41] Eventually the Association will serve as a central clearinghouse for non-resident insurance producers.

Under NARAB II, the Association is an independent non-profit corporation run by a 13-member board of directors comprised of eight current or former state insurance commissioners and five insurance industry representatives appointed by the President and confirmed by the Senate.[42] Once an insurance producer is accepted by the board as a member of the Association, that producer will be authorised to sell, solicit and negotiate insurance in other states, provided the producer is licensed for those lines of business in his or her home state, pays the state's licensing fee and complies with the Association's continuing education requirements.[43] Although NARAB II grants the Association certain disciplinary enforcement powers, state regulators will continue to oversee insurance producer conduct, investigate complaints, protect consumers and regulate marketplace conduct.[44]

iv First Circuit considers effect of honourable engagement language in reinsurance and retrocessional agreements

In March 2015, the US Court of Appeals for the First Circuit in *First State Insurance Company v. National Casualty Company*[45] faced an issue of first impression regarding whether the honourable engagement language in arbitration provisions found in reinsurance and retrocessional agreements gives arbitrators authority to grant equitable remedies.[46] The parties to a series of reinsurance and retrocessional agreements had arbitrated disputes over billing and contract interpretation, and the arbitrators had handed down a contract interpretation award that established a payment protocol under the agreements.[47] The award also allowed,

39 Id. at 999 (emphasis in original).

40 Producer Licensing and NARAB II, *supra*, note 26.

41 Id.

42 On 11 January 2016, President Obama nominated four individuals to the Association board: the South Carolina Department of Insurance Director, the Minnesota Department of Commerce Commissioner and two executives at insurance brokerages. Id.

43 Id.

44 Id.

45 781 F.3d 7 (1st Cir. 2015).

46 Id. at 12.

47 Id. at 9.

in certain circumstances, for payments made according to the protocol to be subject to a reservation of rights.[48] The District Court for the District of Massachusetts summarily confirmed the arbitrators' contract interpretation award and the final award.[49]

On appeal, the First Circuit considered whether the arbitrators had exceeded their authority.[50] The First Circuit affirmed the confirmation of the awards, holding that the 'honourable engagement provision empowers arbitrators to grant forms of relief, such as equitable remedies, not explicitly mentioned in the underlying agreement' and that the payment protocol and reservation of rights procedure is such a remedy.[51] In support of its conclusion, the court noted the 'huge advantage' of allowing arbitrators to grant equitable remedies: 'the prospects for successful arbitration are measurably enhanced if the arbitrators have flexibility to custom-tailor remedies to fit particular circumstances. An honourable engagement provision ensures that flexibility.'[52]

v MetLife announces possible break-up to avoid SIFI designation

On 18 December 2014, FSOC formally designated MetLife, Inc as a non-bank SIFI.[53] MetLife was the third insurance company labelled as a non-bank SIFI, following American International Group, Inc (AIG) and Prudential Financial, Inc in 2013.[54] On 13 January 2015, MetLife filed suit in the US District Court for the District of Columbia seeking to overturn the designation.[55] The Dodd-Frank Act allows a designated entity to seek judicial review of FSOC's decision within 30 days,[56] and MetLife was the first NFBC to file such a challenge.[57]

Although the MetLife litigation is ongoing, on 12 January 2016 MetLife announced that it is considering a possible spin-off of its US retail life and annuity business.[58] MetLife pointed to the 'regulatory environment' as the driver for the planned separation.[59] More specifically, MetLife explained that its US retail business is part of a SIFI and the increased capital requirements associated with such a designation could put the business at a 'significant competitive disadvantage'.[60]

48 Id.

49 Id.

50 Id. at 11.

51 Id. at 12.

52 Id. (internal citations omitted).

53 *The Wall Street Journal*, 'MetLife Considers Challenging "Systemically Important" Label', available at www.wsj.com/articles/metlife-designated-as-systemically-important-by-u-s-panel-1418937044/?mod=mktw.

54 The bases for FSOC's designations of AIG, Prudential and MetLife are available at www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx.

55 A press release announcing MetLife's lawsuit is available at www.metlife.com/about/press-room/index.html?compID=155136.

56 MetLife, *supra* note 53.

57 Bloomberg News, 'MetLife to File First Lawsuit Over Systemic-Risk Label', available at www.bloomberg.com/news/2015-01-13/metlife-to-file-first-lawsuit-over-systemic-risk-label.html.

58 'MetLife announces plan to pursue separation of U.S. retail business' (12 January 2016) available at www.metlife.com/about/press-room/us-press-releases/index.html?compID=192215.

59 Id.

60 Id.

vi Litigation over stand-alone cyber policies expected to continue in 2016

The global cyber liability insurance market has continued to expand rapidly. In 2014, annual premiums reached approximately $2.5 billion and premiums are expected to triple to $7.5 billion by 2020.[61] Alongside this continued growth, the market is already seeing litigation concerning stand-alone cyber policies. In May 2015, a California federal court faced such a case. In *Continental Casualty Company v. Cottage Health Systems*,[62] an insurer sought a declaration that it did not need to provide coverage under a cyber policy related to a data breach that resulted in the release of private healthcare patient information stored on the insured's servers.[63] The insurer argued that, contrary to the insured's representations in its application, the data breach was caused by the insured's use of servers without adequate security measures.[64] The insurer also pointed to a policy exclusion for 'failure to follow minimum required practices' as a basis for judgment in its favour.[65]

In July 2015, the suit was dismissed without prejudice so the parties could comply with the cyber policy's mandatory alternative dispute resolution provision.[66] Although *Continental Casualty* was not decided on its merits, it represents one of the first challenges to the scope of a cyber policy. Both insurers and policyholders will be paying close attention as these cases take shape. In light of the notoriety of cybersecurity incidents and the growing popularity of stand-alone cyber policies, disputes concerning the scope of coverage are expected to occur with increasing frequency in 2016.

VI OUTLOOK AND CONCLUSIONS

The growth of the size, scope and complexity of the US insurance and reinsurance markets continued in 2015. Likewise, the numerous and varied laws and regulations applicable to insurance and reinsurance companies are evolving to keep pace with the industry. As this growth and evolution will no doubt continue in 2016 and beyond, industry executives, representatives and practitioners will need to stay abreast of these changes to respond in a timely fashion to new and emerging issues.

---

61 PricewaterhouseCoopers, 'Insurance 2020 & beyond: Reaping the dividends of cyber resilience' (2015).
62 No. 2:15-cv-03432.
63 Id.
64 Id.
65 Id.
66 Id.

Appendix 1

ABOUT THE AUTHORS

MICHAEL T CAROLAN

Crowell & Moring LLP

Michael T Carolan is a partner in Crowell & Moring's insurance and reinsurance group, where he focuses on litigating and arbitrating disputes concerning a variety of issues, including reinsurance, complex insurance coverage, and brokers' liability. Michael has represented both company and intermediary clients in life, health and property and casualty disputes regarding issues such as policy and contract interpretation, notice, underwriting practices and claims management, allocation, follow the fortunes, rescission, fraud, misrepresentation, and sunset and commutation clauses. He has also written on reinsurance issues related to credit default swaps and financial products. Michael received his JD from George Washington University in 2006. Prior to joining Crowell & Moring, Michael represented a variety of domestic and offshore captive insurance companies owned by US corporations, providing counselling on tax and health care issues, reinsurance and fronting arrangements, policy drafting, claims management, and commutation agreements.

PAUL W KALISH

Crowell & Moring LLP

Paul W Kalish is co-chair of Crowell & Moring's insurance and reinsurance group. He received his BA from Duke University in 1983, where he graduated *magna cum laude*, and his JD from Northwestern University School of Law in 1986, where he was an editor of the *Northwestern University Law Review* and member of the Order of the Coif. Paul represents domestic and Bermuda-based clients in a variety of litigation and counselling matters, including: (1) serving as national coverage counsel for insurers with regard to various tort (implants, asbestos, pharmaceuticals) and environmental matters; (2) representing insurers and reinsurers in liquidation matters, such as the Midland Insurance Company and Home Insurance Company liquidation proceedings; (3) representing insurers in international arbitrations including a London-based arbitration arising out of Hurricane Katrina; (4) representing insurers sued for unfair claims-handling practices and negligent undertaking in connection with the handling of thousands of underlying claims; and (5) counselling

insurers with regard to new insurance products and policy wording. In addition, since 2000 Paul has served as counsel for the Coalition of Litigation Justice, a group formed by insurers to address abuses and inequities in the US mass tort litigation environment.

WILLIAM C O'NEILL

Crowell & Moring LLP

William C O'Neill is co-chair of Crowell & Moring's insurance and reinsurance group and heads the firm's reinsurance practice. Bill is recognised as a top insurance and reinsurance attorney in *Chambers USA*, Euromoney's *Expert Guide: Insurance and Reinsurance* and *Who's Who Legal: Insurance & Reinsurance*. He regularly handles arbitrations and litigation involving many lines of business, including property and casualty, life, trade credit and health insurance. In the past several years, he has successfully taken significant life, property and casualty and health disputes through hearing and final award, while resolving numerous additional disputes on favourable terms short of hearing. Bill often counsels clients regarding business, strategy and regulatory matters. Bill received his JD from Cornell Law School in 1997.

RACHEL P RAPHAEL

Crowell & Moring LLP

Rachel P Raphael is an associate at Crowell & Moring in the insurance and reinsurance group. Her practice involves litigation, arbitration, and counselling on a wide variety of insurance and reinsurance issues and includes pre-dispute advice as well as insurer and reinsurer representation in complex disputes. Rachel received her JD from Harvard Law School and her BS, with high honours, from the McIntire School of Commerce at the University of Virginia. Rachel previously worked as a law clerk for the Office of the Assistant General Counsel for International Affairs of the US Department of the Treasury and as an investment banking analyst at Houlihan Lokey.

CROWELL & MORING LLP

1001 Pennsylvania Avenue NW
Washington, DC 20004
United States
Tel: +1 202 624 2500
Fax: +1 202 628 5116
mcarolan@crowell.com
pkalish@crowell.com
woneill@crowell.com
rraphael@crowell.com
www.crowell.com