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New York's Appellate Division Refuses to Compel California Employers to Arbitrate in New York State

The Appellate Division, First Department, for the Supreme Court of the State of New York recently held that a group of California-based employers represented by Bond, Schoeneck & King PLLC cannot be compelled to arbitrate disputes under their workers' compensation policies. The September 11, 2014 decision in *Matter of Monarch Consulting, Inc. v. National Union Fire Ins. Co.*, 2014 NY Slip Op. 6158, invalidated the insurer's arbitration clauses contained in side payment agreements associated with the workers' compensation policies, because the agreements were not filed with the California Department of Insurance (CDI), as required by the California Insurance Code.

As part of a comprehensive system regulating insurers that provide workers' compensation coverage, the California Insurance Code requires that insurers file policies, endorsements and forms with the Workers' Compensation Insurance Rating Bureau (WCIRB), which conducts a preliminary inspection and sends the documents on to CDI for approval. In this case, the insurer filed the initial policies, but failed to file payment agreements that were sent to insureds after the policies were issued. The payment agreements governed such terms as the extension of credit, the timing of payment obligations, and dispute resolution procedures. Specifically, they included arbitration clauses requiring that disputes be arbitrated in New York State, and that arbitration be governed by the Federal Arbitration Act (FAA).

When the insureds allegedly defaulted under the payment agreements, the insurer demanded arbitration in New York. The insureds resisted arbitration, arguing that the arbitration clauses violated the California Insurance Code because they were not filed with the WCIRB. The insurer countered that the arbitration clauses are not subject to CDI review because they are not policies themselves, and the FAA would preempt California's law and regulations in any event.

The McCarran-Ferguson Act "reverse-preempts" the FAA

The McCarran-Ferguson Act prevents the FAA from preempting the California Insurance Code.

The First Department held that the McCarran-Ferguson Act prevents the FAA from preempting the California Insurance Code. The McCarran-Ferguson Act provides that the "business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business." The Act further states that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance…unless such Act specifically relates to the business of insurance." The Court reiterated the four-part test to be used when determining whether McCarran-Ferguson "reverse-preempts" a federal statute. Reverse preemption exists where (1) the federal statute does not specifically relate to the business of insurance, (2) the challenged acts constitute the business of insurance, (3) state laws regulate the challenged acts, and (4) the state laws would be "invalidated, impaired, or superseded" by application of the federal statute. The Court held that the FAA does not specifically regulate insurance, and that its applicability would modify California law because it would require insureds to arbitrate even though the payment agreements containing the arbitration clauses were not filed pursuant to the California Insurance Code. The Court noted that the filing requirements are a "fundamental underpinning" to California's regulation of workers' compensation insurance, and gave great weight to a CDI directive prohibiting the use of unfiled collateral agreements that are not attached to the policy itself. In its directive, the CDI emphasized its particular concern with arbitration provisions contained in side agreements, and stated that it "considers such terms unenforceable" unless the arbitration agreement was specifically agreed to when the policy was issued.

Failure to File Payment Agreements Voided Arbitration Clauses

The court refused to compel the insureds to arbitrate the underlying disputes.

By a 3-2 decision, a majority of the Court held that the insurer's failure to file the payment agreements voided the arbitration clauses, and the court refused to compel the insureds to arbitrate the underlying disputes.

The dissent, which underscored the strong national policy in favor of arbitration, disagreed that the McCarran-Ferguson Act prevents the FAA from preempting the California Insurance Code, and would have left the issue of the arbitrability of disputes to an arbitrator in the first instance. The insurer is appealing the decision to the New York Court of Appeals.

The insureds are represented by attorneys Clifford G. Tsan (315.218.8252; ctsan@bsk.com) and Suzanne M. Messer (315.218.8628; smesser@bsk.com) of Bond's Litigation Department.

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