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Insurers Lose More Ground In Arbitration Clause Debate

By **Bibeka Shrestha**

Law360, New York (January 22, 2013, 8:37 PM ET) -- The Washington Supreme Court ruled Thursday that a state law forbids insurers from requiring arbitration of coverage disputes, adding to a growing consensus that the McCarran-Ferguson Act lets states sidestep a federal law favoring arbitration when it comes to domestic insurance contracts, experts say.

Handing a win to the Washington State Department of Transportation, the state high court struck down arbitration clauses in two policies issued by James River Insurance Co., a carrier that was licensed outside of Washington state. The decision allows the WSDOT to argue in court, rather than in front of arbitrators, that James River owes coverage for a lawsuit brought over a fatal traffic accident near a highway construction project.

The Supreme Court agreed with the trial court that James River's arbitration clause was barred by a Washington state statute. The high court also held that the Federal Arbitration Act — a law that liberally allows the arbitration of legal disputes — did not preempt the Washington statute at issue.

Richard Mancino, an attorney with Willkie Farr & Gallagher LLP, said Thursday's ruling is just the latest in a line of decisions that have enforced state statutes barring the arbitration of domestic insurance disputes.

"It's an example of a court saying no to arbitration even though arbitration is widely accepted as an appropriate means of dispute resolution, and there's a strong federal policy in favor of it," Mancino said. "A different result would occur were this arbitration agreement part of an international insurance contract."

Peter Halprin, an Anderson Kill & Olick PC attorney who represents policyholders, said the James River decision was straightforward and follows rulings in other states.

"This ... case demonstrates what will happen in most situations," Halprin said. "When you have an international angle, that's where you've seen a circuit split."

James River and the WSDOT initially fought over whether two insurance policies for Scarsella Brothers Inc.'s work on a highway project covered a lawsuit brought over a deadly 2009 traffic accident near the construction.

The quarrel later focused on whether the policy clauses requiring arbitration of the dispute were valid, and the WSDOT brought a declaratory judgment suit, asking a court to declare that they were not.

The state statute at the center of the case made it illegal for Washington insurance contracts to deprive "the courts of this state of the jurisdiction of action against the insurer."

WSDOT viewed the Washington statute as an anti-arbitration provision, but James River argued that the law was geared toward blocking forum selection clauses, which would force insurance disputes to be resolved outside of Washington.

James River stressed that modern arbitration would not deprive state courts of jurisdiction because they could still adopt, change or enforce arbitration awards. But the ruling noted that courts' powers are more limited while weighing an arbitration award.

The high court agreed with WSDOT that lawmakers intended for the statute to protect a policyholder's right to bring an original action against the insurer in court.

"Binding arbitration agreements deprive our state's courts of the jurisdiction they would normally possess in an original action by depriving them of the jurisdiction to review the substance of the dispute between the parties," the Washington Supreme Court said. "Unless the Legislature specifically provides otherwise, [the statute] prohibits binding arbitration in insurance contracts."

Citing the U.S. Supreme Court's landmark ruling in AT&T Mobility LLC v. Concepcion, the state high court acknowledged that the Federal Arbitration Act generally preempts state laws that prohibit arbitration clauses. But it said the FAA could not preempt the Washington statute at issue because it was a state insurance law protected by the McCarran-Ferguson Act.

McCarran-Ferguson established that a federal law cannot supersede a state insurance law unless the federal law specifically relates to insurance. According to the ruling, the FAA did not specifically aim to regulate insurance.

Around 26 states place some kind of restriction on enforcing arbitration clauses in insurance contracts, though these measures differ significantly, according to Halprin. Anti-arbitration statutes like Washington's don't always fare well before judges.

Courts that have refused to uphold such state laws have concluded that they don't advance the regulation of insurance and therefore, can be preempted by the FAA, according to Mancino. Moreover, two top-level federal courts have ruled that McCarran-Ferguson doesn't give states the ability to bar arbitration of insurance disputes in the international context.

The Fourth and Fifth circuits concluded that state laws could not preempt the Convention Act, which was passed to help enforce an international treaty calling for the enforcement of written agreements requiring foreign arbitration. The Second Circuit came to the opposite conclusion and upheld a state anti-arbitration provision, however.

"It's certainly an issue to watch," Halprin said. "I do think that there are going to be more and more of these decisions, especially at the federal level where there is a bit of a circuit split."

The arbitration clause debate carries high stakes for both insurers and policyholders

Carriers that employ arbitration clauses are looking for a fair shake, according to Dana Ferestien, a Williams Kastner attorney who focuses on insurance cases.

"The carriers that like to do it believe that they're not going to get necessarily a fair decision maker if they end up with a jury, because of the natural predisposition that people have towards insurance companies," Ferestien said. "On top of that, a lot of the issues are pretty technical ... the quality of the decision maker can be substantially better if you go the arbitration route."

But policyholders see a slew of disadvantages to arbitration, including limited ability to carry out discovery or to appeal unfavorable decisions, as well as the loss of attorneys' fees or favorable insurance contract interpretation principles.

And because the outcomes of arbitrations are private, insurers can maintain inconsistent positions and not get called out on it by policyholders, Halprin said.

According to Ferestien, domestic carriers that try to enforce arbitration clauses in their policies in Washington state after Thursday's ruling could now face bad-faith claims from policyholders.

"Any carrier who continues to include an arbitration provision in their policy is probably taking a fair bit of risk that's going to come back and bite them in the butt, so to speak," Ferestien said. "This case makes it pretty clear that they're not enforceable."

James River declined to comment on the ruling, while attorneys representing the WSDOT were not immediately available on Tuesday.

James River is represented by Joseph Hampton of Betts Patterson & Mines PS.

The case is State of Washington, Department of Transportation v. James River Insurance Co., case number 87644-4, in the Supreme Court of the State of Washington.

--Editing by John Quinn and Katherine Rautenberg.