INSURANCE
Legal News℠
FOLEY
FOLEY & LARDNER LLP
JUNE 2009

Insurance Industry Developments for Summer 2009

The Continuing Push for Federal Regulation of the Insurance Industry

By Andrew A. Oberdeck[1]

The current economic crisis has brought increased attention to the debate over federal regulation of the insurance industry. Amid broad initiatives directed at regulating the financial services industry in general (including insurance companies), several pieces of legislation have been introduced that are aimed specifically at the insurance industry, including the National Insurance Consumer Protection Act (NICPA), the Insurance Information Act of 2009 (IIA), and the National Association of Registered Agents and Brokers Reform Act of 2009 (NARAB). This article gives a brief overview of each of these proposals.

National Insurance Consumer Protection Act

NICPA, introduced by U.S. Reps. Melissa L. Bean (D-Ill.) and Ed Royce (R-Calif.), creates optional federal regulation and supervision for insurers, insurance agencies, and insurance producers that mirrors that of the current dual banking system.

The bill, which applies only to life, property and casualty, and reinsurance companies and insurance producers, would create an Office of National Insurance (ONI) within the U.S. Department of the Treasury (Treasury) to oversee the national regulatory scheme and monitor the health of the industry as a whole. Insurance companies, agencies, and producers could opt to apply for a federal charter from the ONI's National Insurance Commissioner (NIC) or remain under the current state regulatory system. Thus, states would maintain responsibility of regulating state licensed insurers, agencies, and producers. Key provisions under NICPA include:

- The creation of the ONI within the Treasury.
- The appointment of the NIC by the president for a five-year term, subject to the advice and consent of the U.S. Senate.
- Issuing of national insurance charters for life insurance, property and casualty, and reinsurance.
- Licensing of both national insurance agencies and individual national insurance producers.
- Granting a comprehensive set of supervisory and regulatory powers to the NIC, including the authority to examine national insurers, agencies, and individual producers and the creation of national risk-based capital standards, investment standards, and asset and liability valuation requirements. National insurers also will be subject to an independent audit committee requirement, limitations on dividends, and limitations on transactions with affiliates.
- Granting broad enforcement powers to the NIC.
- Preserving the applicability of certain state insurance laws to national insurers, including: (1) tax laws; (2) unclaimed property and escheat laws; (3) laws related to participation in assigned risk plans or other mandatory residual market mechanisms; (4) laws that provide for compulsory coverage of workers' compensation or motor vehicle insurance; and (5) laws related to participation in state guaranty funds.
- Authorizing receivership for rehabilitation or liquidation of a national insurer for a number of reasons, including the insolvency of a national insurer.
- Establishing certain measures for consumer protection, including: (1) the creation of a Division of Consumer Affairs within the ONI tasked with establishing a regional office in each state to accept consumer questions and complaints; and (2) establishing a National Insurance Guaranty Corporation modeled after state guaranty funds to protect policyholders up to certain established limits when a national insurer is placed into receivership.
- Granting authority to a systemic risk regulator to take action, under certain circumstances, to mitigate or avoid conduct by insurers or affiliates (to the extent they are subject to state oversight) that would have serious adverse effects on economic conditions and financial stability, and to force an insurer to be federally chartered if that insurer is deemed to be "systemically important."

NICPA has been referred to the House Committee on Financial Services in addition to the committees on the Judiciary, Energy, and Commerce. Given the administration's and Congress' focus on initiatives to reform the regulation of the financial services industry in general, it is unclear whether NICPA has the traction to stand on its own or whether some of its provisions will become part of the upcoming financial services regulatory reforms.

Insurance Information Act of 2009

IIA was introduced by Rep. Paul E. Kanjorski (D-Pa.) on May 21, 2009. Mr. Kanjorski introduced a similar bill in April 2008 that was not acted upon in last year's Congress. The new bill essentially mirrors the previous one by calling for the creation of a federal Office of Insurance Information (OII) within the Treasury to provide advice and expertise on insurance regulation to the administration and to Congress.

As established by IIA, the OII would:

- Collect and analyze data on insurance.
- Advise the Secretary of the Treasury on major domestic and international policy issues.
- Report to Congress every two years on the financial state of the insurance industry, meaningful trends in the industry, and on certain actions taken by the OII.
- Establish federal policy on international insurance matters, including working with the International Association of Insurance Supervisors.
- Ensure that state insurance laws remain consistent with federal policy in coordinating international trade agreements.
- Establish an advisory group to help inform and advise the head of the OII. The advisory group would consist of representatives from among state insurance commissioners, state legislators, select federal agencies, the insurance industry, and consumer groups.

IIA is substantially more limited in scope than NICPA, as it is not designed to establish any regulatory authority of the OII or the Treasury. In addition, as with NICPA, IIA excludes health insurance from its provisions. Although the future of the IIA itself is uncertain, it seems fairly likely that the relatively noncontroversial goal of the IIA to provide advice and expertise on insurance regulation to the administration and to Congress will be integrated into the upcoming financial services regulatory reforms in one form or another.

National Association of Registered Agents and Brokers Reform Act of 2009

NARAB was introduced by Reps. David Scott (D-Ga.) and Randy Neugebauer (R-Texas) on May 21, 2009. A similar bill was passed by the House in September 2008, but failed to move in the Senate. The bill would create the National Association of Registered Agents and Brokers (Association) as a private, independent, nonprofit corporation existing under District of Columbia law. The Association would not be part of any federal agency, would not report to any federal agency, and would not have any federal regulatory power.

Under the legislation, insurance producers would become eligible to join the Association by holding (or obtaining) a home state license. Once a member, they would obtain authority to "sell, solicit, negotiate, effect, procure, deliver, renew, continue or bind insurance" in any state for the same line or lines of insurance covered in their resident license. Unlike NICPA and IIA, which exclude health insurance from their respective provisions, NARAB would apply to insurance producers selling any product that is defined or regulated as insurance by the insurance producer's resident state, with the single exception of title insurance. No state, except for the producer's home state, would be allowed to deny a license to any Association member in good standing or require an Association member to obtain a business entity license or membership. However, all states (both resident and non-resident) would still have authority to regulate market conduct and enforce consumer protection laws. Thus, if enacted, the bill would create true licensing reciprocity for those insurance producers that conduct business in multiple states.

The bill leaves the development of further criteria for membership to the Association board. In this regard, the Association board would generally have the power to establish standards regarding personal qualifications, continuing education, training, and experience. Association members would be exempt from nonresident states' continuing education requirements, and the bill contains provisions designed to prevent duplicative continuing education requirements between the Association and a producer's home state.

As opposed to the broadly sweeping changes called for by NICPA, NARAB is limited to the narrow area of uniformity in nonresident producer licensing. NARAB's narrow focus may give it a greater likelihood of enactment when compared to broader, and therefore more controversial, nationalization efforts.

Supreme Court Grants Cert to Review Standard for Patent Eligibility
By David G. Luettgen

On June 1, 2009, the United States Supreme Court agreed to hear an appeal concerning the standards used to determine whether a process is eligible for patent protection under 35 USC § 101. *Bilski v. Doll*, U.S., No. 08-964, 2009 WL 221232 (June 1, 2009) (granting certiorari). Last fall, the U.S. Court of Appeals for the Federal Circuit held that a process is patent eligible under § 101 if: (1) it is tied to a particular machine or apparatus, or (2) it transforms a particular article into a different state or thing." *In re Bilski*, 545 F.3d at 943, 954 (2008). The Federal Circuit indicated that transformations of abstract legal obligations (such as insurance contracts implemented without a computer) would not meet the machine-or-transformation test. See *Bilski*, 545 F.3d at 963. However, the Federal Circuit left to future cases the elaboration of whether or when implementation in a computer is sufficient to meet the machine-or-transformation test. *Bilski*, 545 F.3d at 962. The Supreme Court's review of this case will play an important role in determining whether insurance-related innovations may be patented.

The Supreme Court's Recent Interest in Patentable Subject Matter

The grant of certiorari is another example of the increasing interest the Supreme Court has shown in key substantive areas of patent law. The Supreme Court is clearly interested in clarifying such areas, including the boundaries of what subject matter is eligible for patent protection.

Reading the tea leaves of recent Supreme Court patent decisions in *Metabolite* and *eBay*, the Court has already shown a strong interest in this issue. In *Metabolite*, the Supreme Court ultimately dismissed the petition for certiorari and did not discuss the boundaries of what subject matter is eligible for patent protection. However, in a dissent from that dismissal, Justices Breyer, Stevens, and Souter asserted that the case should be considered and decided. Indeed, the dissent identified clarification of the scope of patentable subject matter as an "important consideration of the public interest" and indicated their belief that the law in this area should be clarified "sooner rather than later." *Lab. Corp. of Am. Holdings v. Metabolite Labs., Inc.,* 548 U.S. 124, 134 (2006) (Breyer, J., dissenting).

In the recent *eBay* decision, several Justices raised some questions about the value of some business method patents. Specifically, in referring to the possibility of granting injunctions for some business method patents, Justices Kennedy, Stevens, Souter, and Breyer commented that "injunctive relief may have different consequences for the burgeoning number of patents over business methods, which were not of much economic and legal significance in earlier times. The potential vagueness and suspect validity of some of these patents may affect the calculus under the four-factor test." *eBay Inc. v. MercExchange, L.L.C.,* 547 U.S. 388, 397 (2006) (Kennedy, J., concurring).[2]

The Questions Presented to the Supreme Court for Review in *Bilski*

The petition in *Bilski* presents two questions for consideration by the Supreme Court:

1. Whether the Federal Circuit erred by holding that a "process" must be tied to a particular machine or apparatus, or transform a particular article into a different state or thing (machine-or-transformation test) to be eligible for patenting under 35 U.S.C. §101, despite this Court's precedent declining to limit the broad statutory grant of patent eligibility for "any" new and useful process beyond excluding patents for "laws of nature, physical phenomena, and abstract ideas"
2. Whether the Federal Circuit's machine-or-transformation test for patent eligibility, which effectively forecloses meaningful patent protection to many business methods, contradicts the clear congressional intent that patents protect "method[s] of doing or conducting business." 35 U.S.C. §273

The second question shows that the Court also may consider not only the broad question of the standard for patent eligibility, but also more specifically the patent eligibility of business method patents. In its en banc decision, the Federal Circuit explicitly declined to adopt a broad exclusion against business method patents. *Bilski*, 545 F.3d at 960. The Supreme Court appears poised to directly tackle business method patents and whether "methods of doing or conducting business" somehow guides the breadth to be afforded the term "process" as used in § 101.

Potential Industry and Patent Litigation Impact

The Supreme Court's decision in *Bilski* will likely have a broad impact on the insurance industry. While most insurance companies would not consider themselves to be in the software industry per se, most insurance companies rely heavily on computers in their day-to-day business operations. Thousands of patent applications have been filed relating to computer-implemented insurance innovations in such areas as application processing, claims processing, underwriting, risk modeling, fraud detection and prevention, Web site features, and benefit plan administration. Insurance companies also face patent threats from companies outside the insurance industry, for example, from software companies that believe they have patented innovations used in many industries, including the insurance industry.

If the Supreme Court narrows the scope of patent-eligible subject matter under 35 U.S.C. § 101, the impact on existing and future patent litigation could be significant. This would be especially true if the Court places any particular focus on business method patents. In recent years, there has been a large number of lawsuits covering a wide range of business activities in all fields, most notably general methods of doing business over the Internet. Certainly, patent holders and applicants will keep a close eye on how the Supreme Court decides the *Bilski* case because it has the potential to alter the patent landscape in this area.

Briefing on the merits should be completed by September 2009. A decision in the case is likely to be handed down sometime in the first half of 2010. In the meantime, insurance companies should consider continuing to proceed with filing patent applications, even if those patent applications are directed to subject matters that may not be patent eligible under the machine-or-transformation test. Any such patent applications filed now will likely be pending long after June 2010 and will be analyzed by the United States Patent and Trademark Office under whatever new standard is formulated by the Supreme Court. At the same time, efforts also should be made to prepare patent application claims that comply with the machine-or-transformation test to the extent possible.

Second Circuit Holds That Arbitration Panel Has Inherent Authority to Award Attorney and Arbitrator Fees as a Sanction, Despite Contract Language Stating That Each Party Shall Bear Its Own Attorney and Arbitrator Fees

By Robert C. Leventhal

In *ReliaStar Life Ins. Co. v. EMC National Life Co.,* 07-028-cv, the United States Court of Appeals for the Second Circuit reversed a district court decision that held that an arbitration panel exceeded its authority by ordering the losing party to pay the prevailing party's arbitrator and legal fees as a sanction for its bad faith arbitration conduct. The lower court based its holding on contract language that stated that each party was to bear the expense of its own arbitrator and its attorneys. The Second Circuit reversed and remanded, holding that under a broad arbitration clause, an arbitration panel has inherent authority to sanction a party and that such sanctions can include awarding arbitrator and attorney fees.

Factual Background

EMC Life and ReliaStar entered into coinsurance agreements that contained arbitration clauses. The arbitration clauses defined the issues that were subject to arbitration broadly and did not contain any express limitations on the arbitrators' power. The contracts also provided that:

> Each party shall bear the expense of its own arbitrator (whether selected by the party, or by the other party pursuant to the procedures set out in Section 10.1) and related outside attorneys' fees, and shall jointly and equally bear with the other party the expense of the third arbitrator.

A dispute between the parties arose, and EMC filed an arbitration demand seeking termination of the coinsurance agreements and a post-termination accounting. The arbitration panel conducted a two-week hearing and ruled against EMC on all issues, held that the agreements remained in force, ordered EMC to pay ReliaStar more than $21 million for amounts past due under the agreements, and awarded ReliaStar its attorneys' and arbitrators' fees and costs.

EMC paid the $21 million, but asked the arbitration panel to reconsider its award of ReliaStar's fees and costs. After further briefing, a majority of the panel awarded ReliaStar more than $3 million in fees and more than $600,000 in costs and stated that the fees and costs were being awarded because EMC's conduct in the arbitration was "lacking in good faith."

ReliaStar petitioned the district court to confirm the final arbitration award. The district court vacated the award of fees and costs, holding that the panel exceeded its authority in awarding those items because the agreement specifically stated that each party was to bear their own fees and costs. ReliaStar appealed, arguing that the district court erred in vacating the award of fees and costs.

The Second Circuit Decision

The Second Circuit reversed the district court's order. It held that the arbitration clause was broad and that the panel had the inherent power to sanction a party's bad faith conduct. Since the award of fees and costs were intended as a sanction for bad faith conduct, it fell within the powers of the panel. The court held that the award of fees and costs was not barred by the contract language that said that each party would bear its own fees and costs, because that contract provision was intended to apply only where both parties arbitrated in good faith. The provision was not intended to strip the panel of its authority to award costs as a sanction for bad faith arbitration conduct, only to indicate that the American Rule that each party bears its own fees and costs was to apply in the normal situation where the parties act in good faith. Since there is an established exception to the American Rule that allows courts to award fees and costs as a sanction for bad faith litigation conduct, the contract provision at issue likewise allows an arbitration panel to award fees and costs as a sanction for bad faith conduct.[3]

The Second Circuit also held that the parties could preclude an arbitration panel from awarding fees and costs, but that "a more explicit statement would be necessary to manifest any intent to override the bad faith exception to the American Rule and to preclude the arbitrators from awarding attorney's and arbitrator's fees as a sanction for bad faith conduct."

Lessons Learned From the Second Circuit's Decision

Parties to a contract should carefully and explicitly tailor the language of the arbitration clause to specifically limit the authority of the arbitration panel if they want to prevent the panel from awarding attorney fees and costs or other extra-contractual damages.

- Language intended to limit the powers of the panel should explicitly state so. For example, the following language would probably be adequate to preclude a panel from awarding fees and costs: "The arbitration panel shall have no power or authority, under any circumstances, to award attorneys' or arbitrators' fees or costs for any reason whatsoever, including as a sanction for bad faith arbitration conduct."
- Contract language that does not expressly limit an arbitration panel's authority is much more likely to be subject to interpretation by the panel, and a court is unlikely to be willing to review the panel's interpretation of the contract term. Language that clearly and expressly limits the power of the panel is more likely to be enforced by a court because the Federal Arbitration Act expressly allows a court to vacate an arbitration award "where the arbitrators exceeded their powers." 9 U.S.C. § 10(a)(4).
  Arbitration panels are increasingly willing to award extracontracutal damages, sanctions, and attorney fees. Each time an arbitration clause is included in a contract, consider whether a panel should be precluded from making these types of awards. While giving a panel the power to sanction bad faith conduct can deter bad faith arbitration tactics, such an award can irreparably damage business relationships and cause the arbitration to become much more contentious.

Pre-Hearing Discovery From Non-Parties in Arbitration: Second Circuit Limits Arbitrators' Authority to Order Discovery

By Brian P. Keenan and Maksim Chester

The Second Circuit, arguably the most influential Federal Court of Appeals for reinsurance matters, considering its situs in New York, recently joined the Third Circuit in holding that the Federal Arbitration Act (FAA) does not authorize an arbitration panel to compel pre-hearing document discovery from non-parties to the arbitration. *Life Receivables Tr. v. Syndicate 102 at Lloyd's of London*, No. 07-1197-cv, (2d Cir. Oct. 23, 2008), *following*, *Hay Group, Inc. v. E.B.S. Acquisition Corp.*, 360 F.3d 404 (3d Cir. 2004) (holding that arbitrators do not have the authority to compel pre-hearing document discovery from non-parties). The *Life Receivables Trust* decision is notable not just for its holding, but also because the Second Circuit elected not to follow the reasoning of two other courts of appeal, furthering a circuit split on the issue and increasing the possibility of a petition for review to the Supreme Court. Previously, the Eighth Circuit held that arbitration panels do have such authority under the FAA. *In re Arbitration Between Sec. Ins. Co. of Am.*, 228 F.3d 865 (8th Cir. 2000) (holding that the arbitrators have the power to compel production of documents from third parties prior to a hearing). The Fourth Circuit also stated in dicta that the FAA may give the arbitrators authority to issue pre-hearing document subpoenas to non-parties, but only if there is a special need for the documents. *Comsat Corp. v. Nat'l Sci. Found.*, 190 F.3d 269 (4th Cir. 1999).

Life Receivables Trust involved an arbitration between an insured, Life Receivables Trust (Trust), and its insurer, Syndicate 102. Trust was a special purpose vehicle affiliated with an entity known as Life Settlements Corporation, which did business as Peachtree Life Settlements (Peachtree). Peachtree was buying life insurance policies from the insureds under those life policies and paying the insureds cash amounts at a discount from the future value of the policies. Peachtree bought some of these life policies for the Trust's account and transferred the policies to the Trust. In turn, Trust paid the premiums and received the benefits upon an insured's death, while Peachtree was continuing to receive contractual fees. For the benefit of Trust, Peachtree also purchased contingent cost insurance (CCI) from Syndicate 102 to protect against the possibility that the insureds lived past their life expectancy. The issue in the case was whether Syndicate 102 had to pay Trust under a CCI policy that protected two life insurance policies owned by Trust. Because the CCI policy had a mandatory arbitration provision, the parties submitted their dispute to a panel of the American Arbitration Association.

During the arbitration, Syndicate 102 issued document requests to Peachtree. After Peachtree refused to produce any documents, Syndicate 102 secured a subpoena from the arbitration panel requiring Peachtree to produce the documents. Peachtree moved to quash the subpoena in federal court, and Syndicate 102 cross-moved to enforce the subpoena. The district court granted the motion to enforce the subpoena. After the adverse decision, Peachtree complied with the subpoena but still appealed the decision to the Second Circuit.

The Second Circuit reversed the district court, holding that the FAA does not give arbitration panels the ability to compel the production of documents from non-parties prior to the hearing. In reaching its conclusion, the Second Circuit strictly construed Section 7 of the FAA, which says that arbitrators "may summon in writing any person to attend before them or any of them as a witness and in a proper case to bring with him or them any book, record, document, or paper which may be deemed material as evidence in the case." 9 U.S.C. § 7. The court held that the FAA's language is clear: Arbitrators only have the power to compel discovery of documents from a non-party when such party appears before the arbitrators as a testifying witness.

The Second Circuit recognized, however, that there is a possibility to secure pre-hearing discovery from a non-party. To obtain such discovery, a party needs to have an arbitration panel, or even just one member of the panel, hold a preliminary hearing for the specific purpose of the document discovery. The FAA states that the arbitrators "may summon in writing any person to attend before them or *any* *of them*." This language allows the panel to compel persons to appear before just one member of the panel for a hearing designed solely to function as a discovery hearing.

Two main lessons may be taken away from the *Life Receivables Trust* decision. First, the enforcement or non-enforcement of a pre-hearing subpoena to a non-party depends on the location of the arbitration, which will determine which circuit's law controls it. If the venue of the arbitration is in the Second or Third Circuits (covering New York, Connecticut, Vermont, Pennsylvania, Delaware, and New Jersey), then the pre-hearing subpoena to a non-party will not be enforced. If the venue of the arbitration is in the Eighth Circuit (covering North Dakota, South Dakota, Minnesota, Nebraska, Iowa, Missouri, and Arkansas), then a pre-hearing subpoena to a non-party will be enforced. If the venue of the arbitration is in the Fourth Circuit (covering Virginia, West Virginia, North Carolina, and South Carolina), it is an open question of whether the subpoena will be enforced, depending on whether the party can show a "special need" for the documents. In other circuits, the answer is unclear, but the Second Circuit's decision will give third parties strong support for their arguments that these subpoenas are not authorized, particularly given the Second Circuit's claim of an "emerging consensus" in this direction (relying on Third Circuit's decision in *Hay Group*, which was authored by Justice Alito prior to his elevation to the Supreme Court).

Second, pre-hearing document discovery from non-parties is not completely precluded in arbitrations even in the Second and Third Circuits. Parties in arbitration who want pre-hearing document discovery should request that the arbitration panel convene a hearing for the purpose of securing the discovery. Another alternative for a party seeking discovery from a non-party is to request that the panel issue the subpoena compelling attendance at the final hearing, and then negotiate with the third party to produce the documents before the hearing. The FAA gives arbitrators the power to compel the attendance of any person at the hearing, and as recognized by then-Judge Chertoff in his concurrence in *Hay Group*, the inconvenience of attending the hearing may persuade a third party to produce the requested documents before the hearing in order to avoid the burden of showing up at the hearing with the documents.

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[1] The author would like to thank Kevin G. Fitzgerald, Ethan D. Lenz, and Sarah E. Molenkamp for their contributions to this article.

[2] "According to well-established principles of equity, a plaintiff seeking a permanent injunction must satisfy a four-factor test before a court may grant such relief. A plaintiff must demonstrate: (1) that it has suffered an irreparable injury; (2) that remedies available at law, such as monetary damages, are inadequate to compensate for that injury; (3) that, considering the balance of hardships between the plaintiff and defendant, a remedy in equity is warranted; and (4) that the public interest would not be disserved by a permanent injunction." *eBay*, 547 U.S. at 391.

[3] Unlike a court, an arbitration panel most likely cannot sanction an attorney appearing before it for bad faith conduct because attorneys are not parties to the arbitration agreement. See, *Porzig v. Dresdner, Klienwort, Benson, North America,* LLC, 497 F.3d 133, 140-41 (2nd Cir 2007); *InterChem Asia 2000 Pte. Ltd. V. Oceana Petrochemicals AG*, 373 F. Supp. 2d 340, 355-56 (SDNY 2005).

Announcements

Recent Successes
Foley Partners **Leonard E. Schulte** and **Thomas J. Maida** authored "Florida Insurance Legislation 2009" in the June 2009 issue of *Florida Underwriter*.

Recent Events
Foley's Insurance Industry Team, Raymond James & Associates Inc., SMART Business Advisory and Consulting, LLC, and Advisen Ltd. hosted the 2009 Insurance Economic Summit at the Westin Chicago River North on April 1, 2009. For more information, please visit: Foley.com/economicsummit.

Leonard E. Schulte spoke on legislative strategies for 2010 at the general session of the Florida Insurance Council's Summer Insurance Symposium and Annual Meeting on June 2, 2009, in Destin, Florida.