August 8, 2007

By: Francine L. Semaya, Esq. and William K. Broudy, Esq.

COZEN O'CONNOR
45 Broadway Atrium, Suite 1600 • New York, NY10006-3792
Phone: (212) 509-9400 • Fax: (212) 509-9492
fsemaya@cozen.com • wbroudy@cozen.com

NEW YORK GOVERNOR VETOES MAJOR INSURANCE LEGISLATION

In an August 1, 2007 veto message, New York Governor Eliot Spitzer rejected legislation amending the New York Civil Practice Law and Rules to permit a declaratory judgment action to determine the extent of insurance coverage available to a party to a lawsuit. The vetoed legislation also added a provision to the New York Insurance Law to prevent an insurer from denying coverage on the basis of late notice unless material prejudice could be shown.

While the Governor praised the rationale behind both parts of the legislation, Senate Bill 6306, he opted for a veto because the bill was passed quickly without hearings and without affording an opportunity to insurers and other interested parties to present their views. The Governor stated:

> As a result, I have instructed my staff and the Superintendent of Insurance to work with both houses, the insurance industry, business groups, consumer advocates, the trial bar and the Office of Court Administration to investigate this issue further and to determine the impact of these provisions on injured parties, on insurance rates, and on court caseloads.

The declaratory judgment aspect of the vetoed legislation, although consisting of only one sentence, signals a change in litigation procedure and has broad implications. The current standard in New York is to permit a declaratory judgment action against an insurance company to determine whether there is coverage only after a verdict has been reached against an insured party. The vetoed amendment would have permitted such a declaratory judgment action to be brought simply on the basis of the pendency of an action against an insured. The language states that:

> A party who has interposed a claim against another party may bring a declaratory judgment action for a determination of the existence or extent of coverage owed by an insurer subject to the provisions of article thirty-four of the insurance law to the party against whom the original claim is interposed.

Opponents of the measure see it as an invitation for fishing expeditions to search for insurance company "deep pockets" before issues of liability have been decided. Proponents argue that it offers an opportunity to determine whether coverage is available before going forward with and incurring the expense of a full-blown lawsuit. In his veto message the Governor termed the declaratory judgment provision to be "a commendable goal."

The key language of the late notice portion of the vetoed legislation provided, with emphasis added, that:

> (b) An insurer subject to the provisions of this article shall not deny coverage for a claim based on the failure of an insured to give timely notice of a claim unless the authorized insurer or other insurer subject to the provisions of this article is able to demonstrate *that it has suffered material prejudice as a result of the delayed notice.*
>
> Evidence that such insurer had knowledge of the accident, loss, injury or death that is the subject of the claim, including any communication from the claimant or the claimant's representative or health care provider, or from any other injured person or injured person's representative or health care provider, or from such insurer to the insured regarding the accident, loss, injury or death, shall create a rebuttable presumption that such insurer has not been prejudiced by delayed notice.
>
> Notice given to any licensed agent of such insurer in this state with particulars sufficient to identify the insured shall be deemed notice to such insurer.
>
> The provisions of this section shall be liberally construed in order to effectuate the purpose hereof which is to mitigate against the potential for procedural denial of insurance coverage resulting in unreasonable loss of insurance protection for claimants.

Current New York case law permits an insurer to deny coverage on the basis of late notice without showing prejudice. Therefore, the vetoed legislation, requiring a demonstration of material prejudice, represented a major change to New York's late notice standards. Although he vetoed the entire measure for the lack of an opportunity for interested parties to testify, Governor Spitzer expressed strong support for the late notice provision, and specifically stated that:

> The late notice provisions of the bill are an important reform, because they would prevent insurers from denying coverage to insureds based on a technicality, thereby eliminating the extreme hardship that is brought to bear on those who pay their premiums religiously only to find at a time of need that their policy is not available. Indeed, these changes bring New York's laws into alliance with the laws in a majority of other states.

Although the legislation is dead for now, it is sure to be revived, given the Governor's support and his call for continued review of the potential effects of its provisions.

NEW YORK INSURANCE DEPARTMENT PROPOSES "PRINCIPLES-BASED" REGULATION

The New York Insurance Department (the "Department") has issued a draft proposed regulation (the "Regulation") entitled "Principles Applicable to Insurers and Other Entities Subject to the Insurance Law." Since New York Insurance Superintendent Eric R. Dinallo took office in January, 2007, he has raised the concept of principles-based regulation in his public comments. The proposed Regulation, the first item listed on the Department's 2007 regulatory agenda, is described as an internal draft, but has been issued to some insurance industry representatives for initial comments.

An overall goal of principles-based regulation is to reduce micromanagement by regulators and to give boards of directors and company management more authority and oversight. Such a process imposes greater responsibility and liability on corporate management for their actions.

The Department's principles-based regulation proposal has been launched in conjunction with the formation of the New York State Commission to Modernize the Regulation of Financial Services, chaired by Mr. Dinallo. The goal of the Commission is to maintain New York's position as a major global financial market, in part by streamlining state regulation. The proposed principles-based regulation is not necessarily a panacea for lessening the burden of New York's complex insurance regulatory scheme, particularly in view of the words of the Preamble to the Regulation: "The purpose of this Part is to set forth, in broad terms, the principles that licensees are expected to adhere to in conducting their business in New York. These principles do not pre-empt existing requirements in statute or in regulations."

Even if the proposed principles are put in place, much more work will need to be done to update and streamline New York's insurance laws and regulations. One of Mr. Dinallo's stated goals is to take a hard look at the "49-1" phenomenon, that is, to focus on insurance statutory and regulatory requirements that are unique to New York and to determine whether such rules unduly frustrate companies seeking to do business in the State. Query whether New York will exchange its current "49-1" regulatory scheme with another one- "principles-based" regulation.

The Preamble to the Regulation sets the tone:

Section 5.0 Preamble

> The purpose of this Part is to set forth, in broad terms, the principles that licensees are expected to adhere to in conducting their business in New York. These principles do not pre-empt existing requirements in statute or in regulations. The principles represent, in virtually every instance, the reasoning behind existing statutory and regulatory requirements. The purpose of this Part is to start the transition to principles-based regulation, to get licensees to start to think in broader terms about the

basic principles underlying the existing requirements. The placement of these principles in this Part will assist licensees in adhering to and interpreting statutory and regulatory requirements and will assist the Department in the consistent application of such requirements. Adherence to the principles in this Part should align good, and constantly changing, business practices with the objectives of the regulation of licensees.

The proposed principles set forth in the Regulation are as follows:

(b) (1) A licensee shall conduct its business with integrity, due skill, and diligence.

(2) A licensee shall take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems.

(3) A licensee shall maintain adequate financial resources.

(4) A licensee shall observe proper standards of market conduct.

(5) A licensee shall pay due regard to the interests of its clients and treat them fairly.

(6) A licensee shall pay due regard to the information needs of its clients, and communicate information to them in a way that is clear, fair, and not misleading.

(7) A licensee shall manage conflicts of interest fairly, both between the licensee and its clients and between clients.

(8) A licensee shall take reasonable care to ensure the appropriateness or

suitability of its advice and discretionary decisions for any person or other entity that is entitled to rely upon such.

(9) A licensee shall ensure that the assets of any client for which the licensee is responsible are adequately protected.

(10) A licensee shall interact with the superintendent and other regulators in an open and cooperative way, and shall disclose to the superintendent any information relating to the licensee of which the superintendent would reasonably expect notice.

The Regulation sets forth no enforcement mechanism. Rather, it is in the nature of a set of "Rules to Live By." The Department simultaneously released the following 10 Proposed Principles for Regulators, with a note that the Department does not plan to include the Principles for Regulators in a regulation, but they might eventually be issued in a Department Circular Letter.

10 PROPOSED PRINCIPLES FOR REGULATORS

1. **Risk Assessment** – Regulators, and the regulatory system as a whole, should use comprehensive risk assessment to concentrate resources on the areas that need them most.

2. **Accountability for Efficiency & Effectiveness** – Regulators should be accountable for the efficiency and effectiveness of their activities, while remaining independent and objective in the decisions they make.

3. **Clarity/Implementation/Enforceability** – All guidance from the Department should be easily understood, easily implemented, and easily enforced.

4. **Consultation with Affected Parties** – All interested parties should be consulted when written guidance is being drafted.

5. **Administration of New Regulatory Standards** – When new regulatory standards are being developed, explicit consideration should be given to how they can be enforced using existing systems and data to minimize the administrative burden.

6. **Basis for Investigation/Inquiry** – No investigation or inquiry should take place without a reason.

7. **Basis for Information Request** – An entity should not have to give unnecessary information, nor give the same piece of information twice.

8. **Proportional Punitive Measures** – The few entities that persistently break regulations should be identified quickly, and face proportionate and meaningful sanctions.

9. **Proportionality of Regulatory Actions** – Any regulatory development, action, or other endeavor should be of the right size and scope in proportion to the issue being addressed.

10. **Economic Progress/Innovation –** Regulators should recognize that a key element of their activity will be to allow, or even encourage, economic progress and innovations, and only to intervene when there is a clear case for protection.

The inspiration for principles-based regulation is the United Kingdom's Financial Services Authority (FSA). The FSA regulates banks, securities firms and insurance companies under a regulatory regime that gives the regulated companies an expanded role in determining how they will comply with regulatory requirements, guided by the following 11 Principles:

FSA 11 PRINCIPLES OF BUSINESS

1. **Integrity** - A firm must conduct its business with integrity.
2. **Skill, care and diligence** - A firm must conduct its business with due skill, care and diligence.
3. **Management and control** - A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4. **Financial prudence** - A firm must maintain adequate financial resources.
5. **Market conduct** - A firm must observe proper standards of market conduct.
6. **Customers' interests** - A firm must pay due regard to the interests of its customers and treat them fairly.
7. **Communications with clients** - A firm must pay due regard to the information needs of its clients and communicate information to them in a way which is clear, fair and not misleading.
8. **Conflicts of interest** - A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. **Customers: relationships of trust** - A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement.
10. **Clients' assets** - A firm must arrange adequate protection for clients' assets when it is responsible for them.
11. **Relations with regulators** - A firm must deal with its regulators in an open and co-operative way and must disclose to the FSA anything relating to the firm of which the FSA would reasonably expect notice.

Future ALERTS will provide updates on the status of regulatory change in New York as events develop.

If you would like more information on this or any other insurance, reinsurance or insolvency regulatory actions, please feel free to contact Francine L. Semaya, Esq., Chair, Insurance Corporate and Regulatory Practice Group, at (212) 908-1270, fsemaya@cozen.com or William K. Broudy, Esq. at (212) 908-1289, wbroudy@cozen.com. Comments in this Insurance Corporate and Regulatory Alert! are not intended to provide legal advice. Readers should not act or rely on information in the Alert! without seeking specific legal advice.