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Alert!

News Concerning Recent Insurance Corporate and Regulatory Issues

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NEW YORK'S HIGH COURT DECIDES THAT LIQUIDATION BUREAU IS NOT A STATE AGENCY

The New York State Court of Appeals, New York's highest court, has unanimously held that the New York Liquidation Bureau (the "Bureau") is not a state agency under the State Finance Law, and that the New York State Comptroller (the "Comptroller") does not have the constitutional or statutory authority to conduct a pre-audit of Bureau expenditures, post-audit of the financial management and operating practices of the Bureau, or an audit of the property of insolvent insurers.

In New York, the Superintendent of Insurance (the "Superintendent") acts as a court-appointed receiver of distressed companies. In the event that an order of liquidation is entered against a distressed insurer, the Superintendent, acting through the Bureau, is charged by the court to deal with the property and business of such insurer, is "vested by operation of law with the title to all property, contracts and rights of action of such insurer," and has discretionary authority to dispose of assets and to handle claims of a distressed insurer (subject to court approval).[1]

In this case, the Superintendent as Receiver had refused the Comptroller's request to audit the Bureau, because the Bureau was not a "state agency" subject to oversight by the Comptroller. The Comptroller subsequently issued subpoenas asserting his authority under the New York State Constitution and the New York State Finance Law to "…audit all official accounts, moneys under the control of State officials, and the books, records and documents of entities required to file abandoned property reports with the Comptroller."[2] The Comptroller had also sought production of documents related to the financial records of distressed insurers in liquidation as well as the Bureau's abandoned property account records. The Superintendent, in response, commenced a proceeding against the Comptroller to quash the subpoenas.

The New York State Supreme Court initially quashed the subpoenas, declaring that neither the State Constitution nor the State Finance Law permitted the Comptroller to audit the Bureau or the property of insolvent insurers.[3] The Appellate Division of the

Supreme Court, however, reversed the decision, holding in a majority opinion that the Superintendent is a "state officer" when acting as liquidator, and the Bureau is a "state agency" subject to the Comptroller's constitutional and statutory "power to post-audit the Liquidation Bureau's financial management and operations and to audit property of distressed insurers held by the Superintendent of Insurance."[4,5]

The Court of Appeals' decision in *Dinallo v. DiNapoli*, released on October 11, 2007, reversed the Appellate Division's decision, and held that "…neither article v, § 1 nor the State Finance Law § 111 grant the Comptroller the power to audit the Bureau because assets of a distressed insurer constitute neither "money[s] of the state" nor "money[s] under [state] control."[6] The Court also held that the Comptroller lacks the authority under the Abandoned Property Law to conduct the broad audit functions sought by the Comptroller in this case.

Significant findings in the Court's decision[7] include that "the Superintendent as liquidator is not a state officer but rather one who acts on behalf of a private entity," and that the Bureau "is not a 'state agency' within the ambit of the State Finance Law" because it does not perform a governmental or proprietary function for the state, is not part of the Insurance Department's budget and operates without the benefit of state funds, maintains its own errors and omissions coverage, and is represented by its own private counsel, not the Attorney General, as is normally the case when a state agency is sued.[8]

The Court also determined that the assets held by the Superintendent are not under state control because, *inter alia*, although the Superintendent holds legal title to insolvent insurers' assets, equitable title remains with the distressed insurers for distribution to the creditors and policyholders. Further, the Court found that the State has no interest in the assets of distressed insurers, and these assets do not constitute moneys under state control, because such assets are segregated from the State Treasury, are not commingled with State funds, and remain under the control of the Superintendent in his capacity as liquidator of a private business, not in his public capacity as a regulator.[9]

Following the Court of Appeals' decision, the door is now opened for the Superintendent to impose oversight and reforms at the Bureau without the encumbrance of additional outside oversight. In a statement released pursuant to the *Dinallo* decision,[10] the Superintendent stated that "transparency and accountability are … critical elements in successfully fulfilling the Bureau's legal responsibilities." The statement also discussed various reforms currently underway at the Bureau, including, *inter alia,* a "top to bottom" audit of the Bureau, and "proposed legislative amendments to the existing Insurance Law which require annual audited financial statements for the insolvent insurance companies administered by the Bureau."[11]

NEW YORK PROPOSES MANDATED CATASTROPHE RESERVES REGULATION FOR INSURERS

The New York Insurance Department (the "Department") has exposed a working draft of a new proposed regulation that would require property insurers to establish catastrophe reserve funds for the payment of catastrophic losses in New York. The proposal, intended to address long term exposure to catastrophic risk, would apply to authorized property/casualty insurers that issue insurance policies or reinsurance contracts that cover natural catastrophe losses for property risks located or resident in New York.

As part of the proposal, affected insurers would be required to create a contingent liability account specified as its New York mandatory catastrophe reserve, to be used to fund the payment of claims resulting from qualified catastrophic losses. Each insurer would be required to annually fund its mandatory catastrophe reserve in an amount equal to or greater than the aggregate catastrophe load included in the premium of its policies or reinsurance, as specified in the regulation. Insurers' annual contributions would be net of any reinsurance ceded, and net of any federal, state, or local income tax incurred on such reserves.

This regulation is intended to provide catastrophic coverage across several years by mandating that insurers retain, for twenty years, portions of the yearly premium paid by insureds for catastrophic coverage, rather than recording such funds as income at the end of the policy year. As a result, the Department's proposal would create a twenty-year "rolling term" for the mandated reserves, wherein insurers contribute the required minimum amount into reserves each year for twenty years. At the end of the 20th year, the insurer may take the first year's contribution into income, to the extent that it is not otherwise used to fund losses. The insurer must continue to meet its annual contribution requirements for future years.

Although companies are only required to fund reserves net of taxes, there are significant concerns regarding the tax-recognition of this new category of reserves. In the press release announcing the exposure draft of the proposal, the Superintendent stated, "I'm in favor of tax-deferred reserves for hurricanes, but the industry will only achieve that change if it acts first and gains credibility… Meanwhile, we need to start building protection against the potentially huge costs of hurricanes now."[12]

This working draft has been exposed to industry and consumers prior to going through the formal proposal process. Although the draft has not been formally published in the State Register and opened for public comment, a copy of the October 4, 2007 Exposure Draft can be downloaded by accessing the following link:

http://www.ins.state.ny.us/press/2007/rp071004catreserv.pdf

COURT DISMISSES, WITH PREJUDICE, RACKETEERING CLAIMS AGAINST BROKERS IN BID-RIGGING CLASS ACTION

Following the New York State Attorney General's filing of a civil complaint in 2004 against certain insurance brokers that alleged bid-rigging and improper contingent commission payments, Plaintiffs filed, in various federal districts, class actions against brokers and insurers based on allegations similar to those raised in the Attorney General's complaint. These cases were subsequently transferred to the U.S. District Court for the District of New Jersey, and were consolidated into *In Re Insurance Brokerage Antitrust Litigation; In Re Employee-Benefit Insurance Brokerage Antitrust Litigation,* 2007 U.S. Dist. LEXIS 73220.

The Court recently dismissed Plaintiffs' claims in the consolidated action that allege that Defendants violated the Racketeering Influence and Corrupt Organization Act ("RICO") 18 U.S.C. § 1961, *et seq.* These allegations, which include, *inter alia,* that Defendant insurers and brokers engaged in bid-rigging and conspired to suppress and eliminate competition in violation of RICO, were previously found to insufficiently assert RICO claims, and now, following numerous opportunities to amend the complaints, the Court granted the Defendants' motion to dismiss the RICO claims, and has dismissed the claims with prejudice.

The Court analyzed the standard of review to grant a motion to dismiss a complaint for failure to state a claim under Federal Rules of Civil Procedure Rule ("FRCP") 12(b)(6), the relevant notice pleading requirements of FRCP Rules 8 and 9, and the substantive requirements of a RICO claim. In particular, the Court explored whether Plaintiffs had sufficiently pled the following elements of a RICO claim: (1) conduct (2) of an enterprise (3) through a pattern (4) of racketeering activity, plus (5) an injury to property or business.

The Court examined the Plaintiffs' factual allegations that the defendant brokers and insurers engaged in kickback, steering, and bid-rigging schemes whereby they:

> made material misrepresentations and omissions regarding: (i) the nature of the services provided by the Broker-Defendants and the conflicts of interest that exist between the Broker-Defendants and their clients; (ii) the financial relationships and agreements between the Broker-Defendants and . . . Insurer-Defendants that impact the basis upon which insurance placements and renewals are made; and (iii) the kickbacks paid by the Insurer Defendants to the Broker-Defendants in exchange for having business allocated to them.

In Re Insurance Brokerage Antitrust Litigation, 2007 U.S Dist. LEXIS 73220 at 78.

The Court also examined allegations that the defendants formed alternative forms of "enterprises" to carry out the alleged racketeering. The Court found that the Plaintiffs' factual assertions and deductions were flawed, and that the Plaintiffs' pleadings fail to state allegations cognizable as a RICO claim. The Court concluded that "the totality of Plaintiffs' factual allegations, limited to mere naming of a string of Defendants and a number of unrelated transactions, fails to suggest that actual RICO enterprises were in existence."[13]

The Court further found that the Plaintiffs' legal arguments do not salvage their claims, as the allegations fail to state the requisite "enterprise" element. The Court held that the "Plaintiffs' conclusions unsupported by facts state no RICO enterprise and should be dismissed."[14]

The Plaintiffs also did not meet their pleading requirement with respect to the "conduct" element of the RICO claim. Despite Plaintiffs' contentions that each defendant was a knowing and necessary participant in a fraudulent scheme that furthered the goals of the enterprise, the Court found instead that "Plaintiffs' allegations as to Broker-Centered Enterprises fail to state a claim as required by section 1962."[15]

After concluding that Plaintiffs failed to meet their pleading burden as to the indispensable "enterprise" and "conduct" elements of their RICO claims, by failing to identify a cognizable RICO enterprise or to state facts indicating that Defendants conducted or participated in the conduct of their respective enterprises, the Court considered whether the Plaintiffs should again be permitted to re-plead their claims for the fourth time. The court determined that "three bites at the apple is enough"[16], and that "granting Plaintiff leave to amend would be futile, unduly prejudicial to Defendant and not in the interests of justice."[17] Therefore, Plaintiffs' failure to meet their pleading burden as to the enterprise and conduct elements warranted dismissal of the RICO claims *with prejudice.*

The District Court's decision in *In Re Insurance Brokerage Antitrust Litigation* is the latest in a series of recent judicial developments that appear to erode the effects of the investigation into alleged bid-rigging and contingent commissions initiated by the New York Attorney General and the New York Insurance Department in 2004.[18] Notwithstanding this latest turn of events, the threat of investigation has not been eliminated. For instance, the Connecticut Attorney General has recently filed a complaint against Marsh & McLennan Companies, Inc. subsidiary Guy Carpenter & Company, LLC,[19] alleging that the brokerage conspired with reinsurers to fix prices and engaged in anti-competitive practices, including its failure to disclose to contingent commissions. These allegations of anti-trust and unfair trade violations against the reinsurance broker is evidence that brokers, even those placing business in markets that were previously outside the scope of such investigations, must remain vigilant and attuned to these concerns.

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 Laurance D. Shapiro, Esq. at (212) 908-1363, lshapiro@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.

[1] *See*, New York Insurance Law § 7405.

[2] *Matter of Dinallo v. DiNapoli,* 2007 NY Slip Op 7497, 3 (N.Y. 2007).

[3] *See, Matter of Serio v. Hevesi,* 804 N.Y.S.2d 571, 9 Misc. 3d 835, 841-844 (Sup. Ct., New York County 2005).

[4] *Matter of Serio v. Hevesi,* 831 N.Y.S.2d 160, 40 A.D.3d 72, 83 (N.Y. App. Div. 1st Dep't 2007).

[5] The dissent in the Appellate Division decision emphasized the Court's prior approach of distinguishing between the Superintendent's role as regulator versus its role as a court appointed private trustee when acting as liquidator for insolvent insurers. The dissent raised a number of points demonstrating that the Superintendent as liquidator is not a state official, that the Bureau is not a state agency under the State Finance Law, and that any expansion of the Comptroller's powers to audit the Bureau should instead be taken up by the Legislature.

[6] *Dinallo,* 2007 N.Y. Slip Op 7497 at 6.

[7] The Court of Appeals, in its findings, incorporated a the majority of points raised in dissent by Appellate Division Justices Malone and Catterson in *Serio v. Hevesi*, 831 N.Y.S.2d 160, 40 A.D.3d 72, 83-88.

[8] *Dinallo,* 2007 N.Y. Slip Op 7497 at 13,14.

[9] *Id*. at 6.

[10] The statement is available on the Bureau's website by accessing the following link: http://www.nylb.org/Documents/NYLB_Not_a_State_Agency-final.pdf

[11] *Id.*

[12] The October 4, 2007, press release is available on the Insurance Department website by accessing the following link: http://www.ins.state.ny.us/press/2007/p0710041.htm

[13] *In Re Insurance Brokerage Antitrust Litigation,* 2007 U.S Dist. LEXIS 73220 at 114.

[14] *Id*. at 127.

[15] *Id*. at 142.

[16] (*See, Salinger v. Projectavision, Inc.* 972 F.Supp. 222, 236 (S.D.N.Y. 1997) cited in *In Re Insurance Brokerage Antitrust Litigation*, 2007 U.S Dist. LEXIS 73220 at 151.

[17] *In Re Insurance Brokerage Antitrust Litigation*, 2007 U.S Dist. LEXIS 73220 at 153.

[18] See our last edition of the Alert!, dated September 26, 2007, for discussion of another Contingent Commissions decision. This edition is available at: http://www.cozen.com/cozendocs/outgoing/alerts/2007/icr092507.pdf

[19] In this case, both Guy Carpenter & Company, LLC, and Excess Reinsurance Company are listed as defendants. In addition, the following parties are listed as "co-conspirators": Arch Reinsurance Company (US), Aspen Insurance UK Limited, Employers Mutual Casualty Company, Farmers Mutual Hail Insurance Company of Iowa, Farm Mutual Reinsurance Plan, Swiss Reinsurance America Corporation, The Hartford Steam Boiler Inspection and Insurance Company, The Toa Reinsurance Company of America, and QBE Reinsurance Corporation (USA).