INSURANCE LAW

THE APPLICABILITY (INAPPLICABILITY) OF INSURANCE LAW §3420 TO NON-DOMICILIARY "RISK RETENTION GROUPS"

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New York Insurance Law §3420, with its several varied provisions, including, inter alia, those pertaining to direct actions against insurers to collect on unsatisfied judgments, notice to the insurer, disclaimers, prejudice, uninsured and underinsured motorist coverage, and interspousal liability coverage, is undoubtedly one of the most important and frequently cited and relied upon statutory provisions in insurance disputes and litigation.

Recent case law has addressed an interesting question regarding whether the direct action and disclaimer/denial of coverage provisions of.Ins. L. §3420 are applicable to "risk retention groups" chartered in another state. Stated otherwise, the question presented in these cases is whether these pertinent provisions of Ins. L. §3420 are preempted by the Federal Liability Risk Retention Act of 1986, 15 U.S.C. §3901, *et seq.* ("LRRA").

Historical Perspective

In *Wadsworth v. Allied Professionals Insurance Company*, 748 F.3d 100 (2d Cir. 2014), the Second Circuit Court of Appeals provided a pertinent outline of the history and structure of the various statutes defining and governing "risk retention groups." As noted therein, a "risk retention group" is "a liability insurance company owned and operated by its members, and those members are its insureds." Further, "[r]isk retention groups offer commercial liability insurance for the mutual benefit of those owner-insureds, who must be

exposed to similar risks and be members of the same industry." 748 F.3d at 109, n. 1; see also, 15 U.S.C. §3901(a)(4); *Hala v. Orange Regional Medical Center*, 60 Misc.3d 274 (Sup. Ct. Orange Co. 2018).

Explaining the birth and rise of risk retention groups, the *Wadsworth* court observed that although under the McCarran-Ferguson Act, 15 U.S.C. §1011, *et seq.*, "the business of insurance is generally regulated by the states rather than the federal government," in the late 1970's "Congress perceived a seemingly unprecedented crisis in the insurance markets, during which many businesses were unable to obtain product liability insurance at any cost. And when businesses could obtain coverage, their options were unpalatable. Premiums often amounted to as much as six percent of gross sales, and insurance rates increased manyfold within a single year." 748 F.3d at 102. See also *Home Warranty Corp. v. Caldwell*, 777 F.2d 1455, 1463 (11th Cir. 1985).

Thus, after several years of study, Congress enacted the Product Liability Risk Retention Act of 1981 ("The 1981 Act"), which was meant to be a national response to the crisis. The 1981 Act, *inter alia*, authorized persons or businesses with similar or related liability exposure to form "risk retention groups" for the purpose of self-insuring. See 15 U.S.C. § 3901(a)(4). While the 1981 Act only applied to product liability and completed operations insurance, "following additional disturbances in the interstate insurance markets, in 1986 Congress enacted the Liability Risk Retention Act of 1986 ("LRRA"), which extended the 1981 Act to *all* commercial liability insurance. See *Preferred Physicians Mut. Risk Retention Grp. v. Pataki*, 85 F.3d 913, 914 (2d Cir. 1996).

As explained further by the *Wadsworth* court, rather than enacting comprehensive federal regulation of risk retention groups, "Congress enacted a reticulated structure under which risk retention groups are subject to a tripartite scheme of concurrent federal and state regulation. First, at the federal level, the Act preempts 'any State law, rule, regulation, or order to the extent that such law, rule, regulation, or order would . . . make unlawful, or regulate, directly or indirectly, the operation of a risk retention group,' 15 U.S.C. §3902(a)(1)....

"The second part of the scheme secures the authority of the domiciliary, or chartering, state to 'regulate the formation and operation' of risk retention groups. 15 U.S.C. §3902(a)(1). Federal preemption, therefore, functions not in aid of a comprehensive federal regulatory scheme, but rather to allow a risk retention group to be regulated by the state in which it is chartered, and to preempt most ordinary forms of regulation by the other states in which it operates. Thus, the Act 'provides for broad preemption of a non-domiciliary state's licensing and regulatory laws.' *Fla. Dep't of Ins. v. Nat'l Amusement Purchasing Grp., Inc.*, 905 F.2d 361, 363-64 (11th Cir. 1990). Similarly, the Act prohibits states from enacting regulations of any kind that discriminate against risk retention groups or their members, but does not exempt risk retention groups from laws that are generally applicable to persons or corporations. 15 U.S.C. §3902(a)(4).'

"While the Act assigns the primary regulatory supervision of risk retention groups to the single state of domicile, the third part of its regulatory structure 'explicitly preserves for [nondomiciliary] states several very important powers.' *Fla. Dep't of Ins.*, 905 F.2d at 364. The Act specifically enumerates those reserved powers in subsequent subsections,

with many powers of the nondomiciliary state being concurrent with those of the chartering state. See 15 U.S.C. §§3902(a)(1)(A)-(I), 3905(d). In particular, subject to the Act's anti-discrimination provisions, nondomiciliary states have the authority to specify acceptable means for risk retention groups to demonstrate "financial responsibility" as a condition for granting a risk retention group a license or permit to undertake specified activities within the state's borders. 15 U.S.C. §3905(d). Additionally, any state may, after an investigation of the group's financial conditions, commence a delinquency proceeding. 15 U.S.C. §3902(a)(1)(F)(I). Any state may also require a risk retention group to comply with any order resulting from such an investigation, or from a voluntary dissolution proceeding. 15 U.S.C. §3902(a)(1)(F)(i)-(ii). In short, as compared to the near plenary authority it reserves to the chartering state, the Act sharply limits the secondary regulatory authority of nondomiciliary states over risk retention groups to specified, if significant, spheres.'"

New York's "Risk Retention Group" Law

As the Second Circuit noted in *Wadsworth*, New York Insurance Law, as it pertains to risk retention groups, "largely mirrors the structure of federal law." Article 59 of the New York Insurance Law ("Risk Retention Group and Purchasing Groups") expressly recognizes the limits imposed by the LRRA, noting that its purpose is "to regulate the formation and/or operation . . . of risk retention groups . . . formed pursuant to the provisions of the federal Liability Risk Retention Act of 1986, to the extent permitted by such law." Ins. L. §5901. As explained further by the Second Circuit in *Wadsworth*, "In keeping with those limits, New York cleanly distinguishes between the broad regulatory authority it exercises over those risk retention groups that seek to be chartered in New York, and the more limited

regulations it is permitted to adopt with respect to nondomiciliary risk retention groups." Section 5903 (a), entitled "Domestic risk retention groups," commands that such groups "shall comply with *all* of the laws, regulations and orders applicable to property/casualty insurers organized and licensed in this state." In contrast, §5904, applicable to "[r]isk retention groups not chartered in [New York]," requires that such groups "comply with the laws of [New York]' set out in ten subsequent subsections, largely tracking the powers reserved to nondomiciliary states by 15 U.S.C. §3902(a)(1)(A)-(I)." Notably, for present purposes, those ten subsections do *not* include any of the provisions of New York Insurance Law §3420.

N.Y. Ins. L. § 3420(a)(2)

In *Wadsworth*, the court was presented with the specific question of whether the section of N.Y. Ins. Law §3420 requiring that any insurance policy issued in New York contain a provision permitting, under certain prescribed circumstances, an injured party with an unsatisfied judgment to maintain a direct action against the tortfeasor's insurer for the satisfaction of that judgment (Ins. L. §3420[a][2]) was applicable to a risk retention group that was domiciled in Arizona but issued policies in New York, or the application of that statute was preempted by the LRRA.

The court held that "any construction of New York law that would impose §3420's direct action requirements on foreign risk retention groups is preempted by §3902(a)(1) of the LRRA," and that "Because the declared intention of New York is to regulate risk retention groups to the extent permitted by federal law, N.Y. Ins. Law §5901, we are

inclined to believe that New York did not intend §3420 to apply to risk retention groups chartered in another state."

The court went on to discuss the doctrine of federal preemption, and to explain that even given the general presumption that insurance regulation is generally left to the states, the language and purpose of the LRRA, which is read broadly, "clearly announce Congress' explicit intention to preempt state laws regulating risk retention groups (LRAA, §3902[a][1]), and that N.Y. Ins. L. §3420(a)(2) "specifically governs the content of insurance policies, requiring insurers to place in their New York contracts a provision that is not contemplated by the LRRA, and that is not required by all other states. Application of the statute would therefore make it difficult for a foreign risk retention group to maintain underwriting, administration, claims handling, and dispute resolution processes. A substantial portion of state insurance regulation consists of such standardized requirements for the content of insurance policies, which vary from state to state. A major benefit extended to risk retention groups by the LRRA is the ability to operate on a nationwide basis according to the requirements of the law of a single state, without being compelled to tailor their policies to the specific requirements of every state in which they do business. Requiring compliance with various state regulations governing the content of insurance policies would, in the aggregate, thwart the efficient interstate operation of risk retention groups."

Wadsworth was followed in *Garcia v. National Contrs. Ins. Co.*, 2015 WL 7016968, *2 (EDNY 2015); see also *Southwest Marine and General Ins. Co. v. Preferred Contractors Ins. Co.*, 54 Misc.3d 1205(A) (Sup. Ct. N.Y. Co. 2016).

N.Y. Ins. L.§ 3420 (d)(2)

On May 3, 2018, the Appellate Division, First Department, in *Nadkos Inc. v. Preferred Contractors Insurance Company Risk Retention Group LLC*, 162 AD3d 7 (1st Dept. 2018), answered, as a matter of first impression, the question of whether a risk retention group's failure to comply with the provision of N.Y. Ins. Law §3420(d)(2), requiring a timely notice of disclaimer, constitutes an unfair claim settlement procedure, prohibition of which is permitted under the LRRA.

Nadkos was a declaratory judgment action that arose out of a construction accident at a property owned by 596 E 19 Partners, LLC, which hired Nadkos, Inc. as a general contractor. Nadkos entered into a subcontract with Chesakl Enterprises, Inc. (the subcontractor) to perform structural steel work. Chesakl hired Vafaev as a sub-contractor, and he allegedly fell and was injured while performing work under his subcontract.

Pursuant to its subcontract with Nadkos, Chesakl obtained general liability insurance from Preferred Contractors Ins. Co. ("PCIC"), a risk retention group, which named the owner and Nadkos as additional insureds. In July 2015, Vafaev commenced an underlying personal injury action against 596, Nadkos, Chesakl and a principal of Nadkos, alleging negligence and violations of Labor Law §§200 and 241(6). On August 25, 2015, Colony Insurance Company, Nadkos' commercial general liability insurer, tendered the underlying lawsuit to Chesakl and PCIC for defense and indemnification. On September 1, 2015,

PCIC denied coverage to Chesakl on the basis of several policy exclusions. On November 16, 2015, PCIC disclaimed coverage to Nadkos based on the same exclusions.

On November 17, 2015, Colony advised PCIC that it had not timely disclaimed as required by Ins. Law §3420(d)(2), and, therefore, that PCIC had waived any defenses to coverage as to Nakdos under its policy. Later that day, PCIC responded that it was a risk retention group organized under the laws of Montana, with a Montana choice of law provision in the policy that rendered N.Y. Ins. L. §3420 inapplicable.

Nadkos thereafter commenced its action against PCIC seeking a declaration that PCIC was obligated to defend and indemnify it, and to reimburse it for incurred defense costs and any indemnity payments made. PCIC moved for summary judgment declaring that it was not obligated to defend or indemnify Nadkos, and Nadkos cross-moved for summary judgment in its favor. The Supreme Court granted PCIC's motion, and denied Nadkos' cross-motion, finding that the LRRA preempted Insurance Law §3420(d)(2).

In analyzing the issue presented to it on Nadkos' appeal, the court noted that under the LRRA, the *chartering state* can regulate the formation and operation of risk retention groups, and preempts most ordinary forms of regulation by *nondomiciliary* states. 15 U.S.C. §3902(a)(1), (4). Therefore, the LRRA "sharply limits the secondary regulatory authority of nondomiciliary states over risk retention groups to specified, if significant, spheres" (*Wadsworth*, 748 F. 3d at 104). One of these "significant spheres" that the LRRA permits nondomiciliary states to regulate is compliance with unfair claim settlement practices of that state (*see* 15 U.S.C. §3902 [a][1][A]). N.Y. Ins. L. §5904(d), which, as noted above, closely mirrors the LRRA, expressly requires foreign risk retention groups to

"comply with the unfair claims settlement practices provisions as set forth in [N.Y. Ins. L. §2001]." Insofar as PCIC is a risk retention group formed and functioning under the LRRA and domiciled in Montana, §5904(d) governed the imposition of regulations on PCIC's operations in New York.

As the *Nadkos* court noted, "Insurance Law §2601(a) provides seven types of acts that if committed without just cause and performed with such frequency as to indicate a general business practice, shall constitute unfair claim settlement practices," and one of these is "failing to promptly disclose coverage pursuant to [Insurance Law §3420(d)]." The court rejected Nadkos' contention that Ins. L. §2601 includes a violation of Ins. L. §3420(d)(2) -- the disclaimer statute -- as an unfair claim settlement practice and was, therefore, a permissible regulation of a risk retention group. In so doing, the court rejected the notion that Ins. L. §2601 referred to Ins. L. §3420(d) *in its entirety*, and did not delineate between subsection (d)(1) [dealing with *disclosure* of coverage] and (d)(2) [dealing with *disclaimers/ denials* of coverage], noting the distinct meanings of the terms "disclose" and "disclaim."

The *Nadkos* court thus concluded that "As Insurance Law §3420(d)(2) is not within the scope of Insurance Law §§2601 and 5904, Supreme Court properly found that section 3420(d)(2) is preempted by the LRRA."

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