FOURTH CIRCUIT ISSUES IMPORTANT DECISION ON ENFORCEABILITY OF ARBITRATION AGREEMENTS IN INTERNATIONAL INSURANCE CONTRACTS

In a case with significant implications for non-U.S. insurers that directly or indirectly insure risks in the United States, the Fourth Circuit Court of Appeals recently decided that arbitration clauses in international insurance agreements involving at least one non-U.S. citizen (or non-U.S. property) are enforceable pursuant to Chapter 2 of the Federal Arbitration Act (the "FAA") and the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "New York Convention" or the "Convention"), notwithstanding laws in certain states abrogating arbitration clauses in insurance policies. In *The ESAB Group, Inc. v. Zurich Insurance plc*, __ F.3d __, 2012 WL 2697020, No. 11-1243 (4th Cir. July 9, 2012) ("*ESAB")*,[1] the Fourth Circuit was asked to decide whether a South Carolina law prohibiting arbitration of disputes under insurance contracts should "reverse preempt" Chapter Two of the FAA and the Convention, pursuant to the McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015, a federal statute that allows state statutes that "regulate the business of insurance" to preempt federal laws that do not specifically relate to the business of insurance. At least fifteen states have statutes that prohibit enforcement of arbitration clauses in insurance policies.[2]

The Second Circuit and the Fifth Circuit had each previously addressed the reverse preemption issue and decided it differently, creating a circuit split.[3] In *ESAB*, relying in part on Supreme Court precedent examining the scope of the McCarran-Ferguson Act, the Fourth Circuit determined that McCarran-Ferguson was "directed to implied preemption by domestic commerce litigation" and that "Congress did not intend for the McCarran-Ferguson Act to permit state law to vitiate international agreements entered by the United States." *ESAB*, 2012 WL 2697020 at *10-11. The *ESAB* court therefore held that Chapter Two of the FAA, as implementing legislation of a treaty, is not subject to reverse preemption, and affirmed the district court's order referring to arbitration in Sweden those claims arising under insurance policies with arbitration clauses.

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1 Willkie Farr & Gallagher LLP represents Appellee Zurich Insurance plc in this matter.

2 The states that prohibit enforcement of arbitration clauses in insurance policies include Alabama, Arkansas, Hawaii, Kansas, Kentucky, Louisiana, Massachusetts, Missouri, Nebraska, Oklahoma, South Carolina, South Dakota, Vermont, Virginia and Washington.

3 *Stephens v. American International Insurance Co.*, 66 F.3d 41 (2d Cir. 1995); *Safety National Casualty Corp. v. Certain Underwriters at Lloyd's, London*, 587 F.3d 714 (5th Cir. 2009) (en banc), *cert. denied* 131 S.Ct. 65 (2010).

Background on Relevant Legislation

Until 1944, regulation of the insurance industry was generally considered a matter reserved for the individual states. In that year, however, the Supreme Court held that insurance was subject to federal regulation under the commerce clause. *See United States v. S.E. Underwriters, Ass'n*, 322 U.S. 533, 552-53 (1944). In response, Congress acted to restore the states' preeminence in matters of insurance by passing the McCarran-Ferguson Act, which provides: "No Act of Congress shall be construed to invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such Act specifically relates to the business of insurance." 15 U.S.C. § 1012(b). Since its passage, courts have routinely held that the McCarran-Ferguson Act permits reverse preemption of federal statutes of general applicability that conflict with state laws enacted for the purpose of regulating the business of insurance. Notably, a number of courts have held that McCarran-Ferguson reverse preempts Chapter One of the FAA.[4]

In addition to preserving the states' preeminence in regulating insurance, Congress has also taken steps to strengthen the enforceability of arbitration clauses in commercial agreements. In 1925, Congress enacted the FAA, 9 U.S.C. §§ 1-16, which, the Supreme Court has repeatedly confirmed, established a liberal federal policy in favor of the enforceability of arbitration agreements. *See, e.g.*, *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740, 1745 (2011); *CompuCredit Corp. v. Greenwood*, 132 S.Ct. 665, 668-69 (2012).

On September 30, 1970, the United States acceded to the New York Convention. 21 U.S.T. 2517. The New York Convention obligates its signatories to recognize and enforce arbitration agreements and awards based on arbitration agreements that are covered by the Convention. An arbitration agreement falls under the Convention when it is "commercial" and does not "aris[e] out of . . . a [legal] relationship which is entirely between citizens of the United States . . . unless that relationship involves property located abroad, envisages performance or enforcement abroad, or has some other reasonable relation with one or more foreign states." 9 U.S.C. § 202. Article II of the New York Convention directs the courts of contracting states, "when seized of an action" involving an arbitration agreement covered by the convention to refer the parties to arbitration. New York Convention, art. II(3).

Prior to U.S. accession, Congress passed Chapter Two of the FAA to aid in the enforcement of the Convention and to conform certain federal laws governing issues such as jurisdiction, venue and removal. Chapter Two of the FAA provides that the Convention "shall be enforced in United States courts in accordance with this Chapter." 9 U.S.C. § 201. Chapter Two also provides, among other things, that federal district courts shall have original jurisdiction over

[4] *See, e.g.*, *Am. Bankers Ins. Co. v. Inman*, 436 F.3d 490, 494 (5th Cir 2006); *McNight v. Chicago Title Ins. Co.*, 358 F.3d 854, 859 (11th Cir. 2004) (per curiam); *Standard Sec. Life Ins. Co. of N.Y. v. West*, 267 F.3d 821, 823-24 (8th Cir. 2001) (per curiam); *Mut. Reinsurance Bureau v. Great Plains Mut. Ins. Co.*, 969 F.2d 931, 934-35 (10th Cir. 1992). These courts have held that it is within a state's authority, under McCarran-Ferguson, to abrogate arbitration clauses in U.S. domestic insurance agreements that do not fall under the New York Convention.

actions falling under the Convention, and that the presence of an arbitration agreement falling under the Convention provides a basis for removal to federal court of any action pending in a state court. 9 U.S.C. §§ 203, 205.

The Circuit Split

The Second Circuit was the first federal appellate court to address whether state laws precluding arbitration of insurance disputes could reverse preempt the New York Convention by operation of McCarran-Ferguson. *See Stephens v. American International Insurance Co.*, 66 F.3d 41 (2d Cir. 1995). The court was presented with a Kentucky law nullifying arbitration clauses in actions involving an insurance liquidator. Analyzing the interplay of that statute and the New York Convention, the Second Circuit first concluded in summary fashion that the New York Convention was not self-executing, and therefore had no force of law except through Chapter Two of the FAA. *Id*. at 45. Relying on the McCarran-Ferguson Act's directive that "no Act of Congress" shall be construed to supersede any state law regulating insurance, the court found that Chapter Two of the FAA was an "Act of Congress" that should be reverse preempted by the Kentucky law. *Id*. The Second Circuit did not consider whether McCarran-Ferguson could be interpreted to reach U.S. treaty obligations.

More recently, the Fifth Circuit, sitting *en banc*, ruled that the McCarran-Ferguson Act did not permit a Louisiana statute nullifying arbitration clauses in insurance agreements to reverse preempt Chapter Two of the FAA and the New York Convention. *Safety National Casualty Corp. v. Certain Underwriters at Lloyd's, London*, 587 F.3d 714 (5th Cir. 2009). The Fifth Circuit assumed for purposes of its decision that the New York Convention was not a self-executing treaty. Nevertheless, the court concluded that the term "no Act of Congress" in the McCarran-Ferguson Act did not extend reverse preemption to treaty obligations, whether self-executing or implemented by statute. *Id*. at 722-26.

The Fourth Circuit's Decision in *ESAB*

The appeal before the Fourth Circuit arose from an attempt to use a South Carolina statute prohibiting the enforcement of arbitration clauses in insurance policies − similar to the Kentucky and Louisiana statutes examined by its sister circuits – to overcome the requirements of the Convention.[5] Plaintiff-Appellant The ESAB Group, Inc. ("ESAB") was a South Carolina-based manufacturer of welding materials and equipment that had been sued in various products liability actions alleging injurious exposure to manganese fumes. *ESAB*, 2012 WL 2697020 at *5. In the late 1980s and early 1990s, ESAB's parent, a Swedish company, purchased seven insurance polices from a Swedish insurance company, five of which contained clauses mandating that

[5] The South Carolina Uniform Arbitration Act states: "A written agreement to submit any existing controversy to arbitration . . . is valid, enforceable and irrevocable. . . .This chapter however shall not apply to: . . . (4) Any claim arising out of personal injury, based on contract or tort, *or to any insured or beneficiary under any insurance policy* or annuity contract." S.C. Code Ann. § 15-48-10(a) (emphasis added).

disputes be arbitrated in Sweden. Defendant-Appellee Zurich Insurance plc ("ZIP") was an Irish insurance company that assumed the rights and obligations of the issuing insurance company under the ESAB AB policies.

In 2009, ESAB initiated an action in the Court of Common Pleas in Florence, South Carolina against ZIP. ESAB claimed that the policies required ZIP to indemnify and defend ESAB in connection with the manganese fume products liability actions. ZIP removed the action to the District of South Carolina, citing the removal provision in Chapter Two of the FAA. *See* 9 U.S.C. § 205. ZIP also initiated arbitration proceedings in Sweden under the policies, arguing that arbitration in Sweden was the proper forum for disputes arising out of the policies.

ZIP also moved to dismiss the action in favor of arbitration, and ESAB cross-moved to remand, arguing that the federal court lacked subject matter jurisdiction because the South Carolina Uniform Arbitration Act operated to reverse preempt the FAA and the Convention. Acknowledging the circuit split on the issue, the district court held, like the Fifth Circuit, that policies with arbitration clauses falling under the Convention were governed by the FAA and the Convention, which could not be reverse preempted under McCarran-Ferguson.

On appeal, the Fourth Circuit unanimously affirmed the district court's order. Relying on *Am. Ins. Ass'n v. Garamendi*, 539 U.S. 396, 428 (2003), the court held that "Supreme Court precedent dictates that McCarran-Ferguson is limited to legislation within the domestic realm." *ESAB*, 2012 WL 2697020 at *9. The Fourth Circuit also stressed the Supreme Court's prior direction that the New York Convention and Chapter Two of the FAA "demand that courts 'subordinate domestic notions of arbitrability to the international policy favoring commercial arbitration.'" *Id.* at *11, quoting *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 639 (1985). The Fourth Circuit concluded that Chapter Two of the FAA "as legislation implementing a treaty, is not subject to reverse preemption." *Id.* In so holding, the Fourth Circuit affirmed the principle that "the federal government must be permitted 'to speak with one voice when regulating commercial relations with foreign governments.'" *Id*. at *12 quoting *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 285 (1976). The court thus rejected the notion that the McCarran-Ferguson Act delegated to the states the authority to abrogate international agreements entered into by the United States. *Id*. at *11.

The Fourth Circuit's decision in *ESAB* provides important precedent for foreign insurers that underwrite insurance for entities based in the United States, or that issue global policies to foreign entities with subsidiaries located in the U.S. The policies governing those international commercial arrangements often specify that disputes arising out of those agreements will be adjudicated in an arbitration forum chosen by the parties. In light of the Fourth Circuit's holding in *ESAB*, the weight of authority now strongly supports the enforceability of such arbitration clauses under the New York Convention.

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