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Reinsurance

# How To Lose The Right To Arbitrate In One Easy (Mis)Step

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# Commentary

## How To Lose The Right To Arbitrate In One Easy (Mis)Step

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The recent decision of *Nielsen Contracting, Inc. v. Applied Underwriters, Inc.*, 232 Cal.Rptr.3d 282 (Cal. App. 4 Dist. 2018), provides a cautionary tale of the failure to comply with insurance regulatory filing requirements of collateral agreements to insurance policies.

Nielsen Contracting, Inc. and T&M Framing, Inc. (collectively, "Nielsen") signed a "Request to Bind" with Applied Underwriters, Inc. and Nielsen was issued a worker's compensation policy by an Applied subsidiary. Nielson also signed a separate three-year Reinsurance Participation Agreement (RPA) with another Applied subsidiary. The RPA "modified and supplanted" many of the terms of the worker's compensation policy, including an arbitration provision that provided for arbitration in the British Virgin Islands and a delegation clause that granted the arbitrator the authority to rule on disputes concerning the **enforceability** of the arbitration provision. This language is customarily construed by the courts as permitting the arbitrator to determine enforceability of arbitration agreements - **but not in this case**.

In 2016, the California Insurance Commissioner issued an administrative decision in an unrelated case involving a different insured that had challenged the same insurance program offered by Applied. The Insurance Commissioner found that the RPA was void as a matter of law for various reasons, including that it had neither been filed nor approved by the Insurance Department. The Commissioner observed that regulations require insurers to seek approval from the Commissioner for arbitration provisions that differ from the provisions in a previously approved insurance worker's compensation policy.

In 2017, Nielsen filed an action against Applied and its subsidiaries, seeking a declaration that the RPA was void and that it was a contract of adhesion with unfair and unconscionable terms. Nielson alleged that the collateral agreements to the policy contained a requirement to arbitrate that was neither filed with nor approved by the California Insurance Department.

The defendants moved to compel arbitration. The trial court held that Nielson's challenge was not derivative to its challenge to the legality of the main contract.

Instead, Nielson was asserting that *"both the delegation provision and the arbitration provision are illegal and unenforceable separate and apart from the evident unenforceability of the entire RPA, albeit for the same reason, i.e., failure to file with, and obtain approval from, the Insurance Commissioner."*

232 Cal.Rptr.3d at 287. The court agreed with Nielson that the court must first resolve Nielson's challenge to the enforceability of the delegation clause, adding:

*The delegation and arbitration provisions qualify as collateral agreements which modify the obligation of the underlying CIC [insurance] policy that should have been attached to the original CIC policy as endorsements and filed with the Insurance Commissioner for approval. Because they were not filed and approved, they are unenforceable as a matter of law pursuant to [section] 11658 and [Regulations section] 2268.*

*Id.*

The Court of Appeals held that the court, and not the arbitrator, should rule on the enforceability of the delegation clause, noting that, *although the general rule is that courts will decide challenges to the validity of an arbitration clause unless the parties have "clearly and unmistakably" agreed to delegate the issue to the arbitrator* (which Applied did in a separate agreement but failed to file with the Department), the "court is the appropriate entity to resolve challenges to a delegation clause nested in an arbitration clause when a specific contract challenge is made to the delegation clause." *Id.* at 289-90. In reaching this decision, the Court of Appeals relied on the U.S. Supreme Court's decision in *Rent-A-Center, West, Inc. v. Jackson*, 561 U.S. 63 (2010), that judicial consideration of contractual defenses to the enforceability of a delegation clause is triggered only if the challenge is "directed specifically to the agreement to arbitrate."

In doing so, the Court of Appeals rejected the defendants' contention that the lower court could only rule on the delegation clause if the challenge to the delegation clause was different than the challenge to the RPA or the arbitration clause. The court reasoned that precluding courts from ruling on defenses to a delegation clause because the same defense is brought to invalidate other provisions would treat delegation clauses differently from other clauses. Moreover, Nielsen had made a "specific, substantive challenge" to the delegation clause that was separate from its challenge to the arbitration clause, and therefore it was proper for the court to rule on the challenge of the enforceability of the delegation clause.

Having reached this conclusion, the Court of Appeals agreed with the lower court's finding that the provisions of the collateral agreements were unenforceable because they had not, as required, been filed with the Insurance Department.

Although arbitration agreements are more frequently found in reinsurance agreements, rather than in direct insurance policies, the insured and the insurer did agree to arbitrate. Keeping policyholder disputes out of court provides a distinct advantage for insurers, for, setting aside the expense factor (which is likely less in arbitration), court proceedings are less predictable, increasing the risk factor for insurers. In this instance, arbitration would have been a distinct advantage, and ultimately one the insurer could not avail itself of.

This case presents a cautionary tale to insurers that where insurance policy forms are required to be filed and approved by the applicable insurance department, the insurers should make sure that any collateral agreements be appended to the policy and subjected to the filing and approval requirements. If not, the insurer may well lose the right to arbitrate the dispute - in one easy (mis)step. ■

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