By Patrick M. Birney

State Insurance Law Trumps Code: "Reverse Preemption"

In re MF Global Holdings Ltd.,[1] a case decided by Hon. **Martin Glenn**, may spark a renewed focus on the role that state-enacted insurance regulations can play in trumping provisions of the Bankruptcy Code. In *MF Global*, the court made it clear that a New York insurance law prohibited a proposed modification of the scope and terms of a debtor's insurance policy insofar as the state law satisfied the "reverse preemption" standards adopted by the McCarran-Ferguson Act.[2] The vast and ever-expanding body of state-enacted insurance law could provide a basis to circumvent provisions of the Bankruptcy Code, so long as the standards currently employed by the McCarran-Ferguson Act are satisfied. This article will first provide a brief overview of the ability of Code provisions to preempt state law, then provide a primer of the McCarran-Ferguson Act and an analysis of the *MF Global* decision. Lastly, the article will conclude with the creative application of state insurance regulations to "reverse preempt" components of the Bankruptcy Code.

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The Bankruptcy Code and Preemption of State Law

When the Supremacy Clause[3] and Bankruptcy Clause[4] are read in tandem, it is clear that Congress had authority to enact the Bankruptcy Code[5] and that once enacted, the Code ascended to the "supreme law of the land and states have no jurisdiction to enact laws governing the same."[6] A fundamental element of the federalist system as preserved by the Tenth Amendment, however, is that states *do* retain certain traditional sovereign powers that permit the regulation of matters relating to the Bankruptcy Code. Because of that, courts should assess claims of preemption with the "starting presumption that Congress does not intend to supplant state law."[7] Lacking a patently well-defined statement from Congress, courts should not presume that the Bankruptcy Code intended to trample on states' rights.[8]

Indeed, the presumption *against* preemption is particularly strong in the bankruptcy context.[9] The U.S. Supreme Court has noted that absent a "clear and manifest" purpose to the contrary, "the Bankruptcy Code will be construed to adopt, rather than to displace, preexisting state law."[10] In the same vein, it has also noted that "[i]f Congress wishes to grant ... an extraordinary exemption from nonbankruptcy law, 'the intention would be clearly expressed.'"[11]

Nevertheless, the *Bankruptcy Reporter* evidences a long history of instances where courts have concluded that the Bankruptcy Code preempts state statutory and common law.[12] The decision in *MF Global Holdings* may reinvigorate a focus on state law or, alternatively, prompt state legislatures to unequivocally "reverse preempt"[13] provisions of the Bankruptcy Code where issues of insurance are in controversy.

The McCarran-Ferguson Act and Reverse Preemption

In adopting the McCarran-Ferguson Act,[14] Congress created "an exemption to normal preemption rules for federal statutes not directly related to insurance."[15] The "McCarran-Ferguson Act is unusual in the extraordinary deference it displays towards state [insurance] regulation."[16] To understand the genesis of this particular congressional "reverse preemption" policy, a brief primer on the McCarran-Ferguson Act is necessary.

In 1944, the Supreme Court in *U.S. v. South-Eastern Underwriters Ass'n*[17] concluded that the U.S. insurance industry was subject to federal oversight—and in particular federal antitrust enforcement—pursuant to the powers conferred on Congress to regulate "[c]ommerce among the

1 469 B.R. 177 (Bankr. S.D.N.Y. 2012).
2 McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015 (2000).
3 U.S. Const. art. VI, § 2.
4 U.S. Const. art. I, § 8, cl. 2.
5 11 U.S.C. § 101, et seq.
6 Kathryn R. Heidt, "Undermining Bankruptcy Law and Policy: *Torwico Electronics Inc. v. New Jersey Dep't of Envtl. Prot.*," 55 *U. Pitt. L. Rev.* 627, n.1 (1995).
7 *New York State Conf. of Blue Cross & Blue Shield Plans v. Travelers Ins. Co.*, 514 U.S. 645, 654 (1995).
8 *See, e.g., BFP v. Resolution Trust Corp.*, 511 U.S. 531, 544-45 (1994).
9 *Integrated Solutions Inc. v. Service Support Specialties Inc.*, 124 F.3d 487, 493 (3d Cir. 1997).
10 *BFP*, 511 U.S. at 544-45.
11 *Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Prot.*, 474 U.S. 494, 501 (1986) (citation omitted).
12 *See, e.g., In re Pariseau*, 395 B.R. 492, 495 (Bankr. M.D. Fla. 2008) ("[T]he vast majority of courts have held that the Bankruptcy Code preempts state law claims allegedly arising from an abusive bankruptcy filing or other wrongful conduct committed during the course of a bankruptcy case."); *In re Dan Hixson Chevrolet Co.*, 12 B.R. 917, 920 (Bankr. N.D. Tex. 1981) (concluding that § 365 preempted Texas Motor Vehicle Code).
13 "Reverse preemption" is defined as "a form of inverse preemption that prevents a generally applicable federal law from inadvertently invalidating, impairing or superseding state laws enacted to regulate" any area of law. *Riverview Health Inst. LLC v. Medical Mutual of Ohio*, 601 F.3d 505, 511, n.1 (6th Cir. 2010).
14 15 U.S.C. §§ 1011-1015.
15 *MF Global*, 469 B.R. at n.17.
16 Jonathon R. Macey and Geoffrey P. Miller, "The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation," 68 *N.Y.U. L. Rev.* 13, 20 (1993).
17 322 U.S. 533 (1944).

several states,"[18] (Prior to *South-Eastern Underwriters*, insurance was outside the scope of congressional oversight because it had been assumed that the issuance of an insurance policy was not considered a transaction affecting interstate commerce.[19]) Congress's reaction to *South-Eastern Underwriters* was swift, culminating with the passage of the McCarran-Ferguson Act,[20] which "removes Dormant Commerce Clause challenges to insurance regulation by nullifying the preemption effect of all Congressional legislation (and therefore federal regulation) not specifically targeted toward insurance."[21]

The McCarran-Ferguson Act provides that "[n]o 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, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance."[22] In turn, courts interpreting the McCarran-Ferguson Act have employed a three-part test[23] to determine whether the state insurance regulation will reverse preempt federal law, and in particular the Bankruptcy Code:[24] (1) does the federal statute specifically relate to the business of insurance?;[25] (2) was the state law at issue enacted to regulate the business of insurance?;[26] and (3) does the federal statute at issue invalidate, impair or supersede the state law?[27] All three parts of the test must be satisfied in order to trigger reverse preemption.[28]

Thus, the first factor and threshold question is whether the Bankruptcy Code "specifically relates to the business of insurance."[29] The McCarran-Ferguson Act will not permit reverse preemption if it does. Courts and commentators alike who have weighed in on this issue have inevitably concluded that the Bankruptcy Code does not "specifically relate" to the business of insurance.[30] Two primary rationales support this conclusion. The first is that the Supreme Court in *Barnett Bank of Marion County NA v. Nelson*[31] alluded to the fact that because the Bankruptcy Code used general language not "specifically related" to insurance, its provisions could be reverse preempted by the McCarran-Ferguson Act.[32] The second rationale is that § 109(b)(2) of the Bankruptcy Code expressly excludes domestic insurance companies from relief under the Bankruptcy Code.[33]

The second factor in the test to determine whether the state insurance regulations will reverse preempt federal law looks at whether the state insurance regulation was "enacted for the purpose of regulating the business of insurance ... [t]he broad category of laws enacted 'for the purpose of regulating the business of insurance' consists of laws that possess the 'end, intention or aim' of adjusting, managing or controlling the business of insurance."[34] In short, if the state regulation is intended to adjust, manage or control the business of insurance, the regulation would reverse preempt the Bankruptcy Code.

> **[A] movement may be contemplated to obtain express legislative directives on important insurance-related issues in order to secure reverse preemption of the Bankruptcy Code.**

The third factor analyzes whether the Bankruptcy Code would act to "invalidate, impair or supersede" the state insurance regulation.[35] As noted by the Supreme Court in *Humana Inc. v. Forsyth*,[36] so long as the federal statute does not directly conflict with the state insurance regulation, disturb an express state policy or restrict the state's regulatory scheme, the McCarran-Ferguson Act would not act to prohibit the application of a specific Code provision.[37]

MF Global: New York Insurance Law Preempts the Bankruptcy Code

On Oct. 31, 2011, MF Global, a financial derivatives broker and commodities brokerage firm, and certain of its affiliates (the "debtors") sought chapter 11 protection following a spectacular meltdown of their business. Since the bankruptcy filing, various directors, officers and employees (the "individual insureds") of the debtors have been named as defendants in lawsuits throughout the country, alleging violations of state and federal securities laws, as well claims based on state consumer protection and common laws.[38] The debtors' insurance carriers were called upon to provide insurance coverage for these claims under the debtors' directors and officers (D&O) policy and errors and omissions (E&O) policy.

The D&O policy provided the individual insureds with priority to any interest that may be asserted by the debtors (the "priority of payment provision").[39] "The Priority of Payment Provision ... clarif[ied] that the coverage potentially afforded to the Individual Insureds for nonindemnifiable losses must be paid prior to any payments made for matters implicating coverage potentially provided to the Debtors."[40] Although the E&O policy provided coverage for both the individual insureds and the debtors, it "was obtained for the protection of the Individual Insureds and [was] not a vehicle for corporation protection."[41]

The insurance carriers requested judicial relief, including relief from stay, so that they could advance or reimburse

18 William Goddard, "In Between the Trenches: The Jurisdictional Conflict Between a Bankruptcy Court and a State Receivership Court," 9 *Conn. Ins. L. J.* 567, 573 (2002-03).
19 *In re First Assured Warranty Corp.*, 383 B.R. 502, 531 (Bankr. D. Colo. 2008).
20 Goddard, *supra* n.18, at 574.
21 Goddard, *supra* n.18, at 574.
22 15 U.S.C. § 1012(b).
23 *U.S. Dept. of Treasury v. Fabe*, 508 U.S. 491 (1993).
24 *Davister Corp. v. United Republic Life Ins. Co.*, 152 F.3d 1277, 1279 n.1 (10th Cir. 1998).
25 *MF Global*, 469 B.R. at n.17.
26 *Id.*
27 *Id.*
28 *First Assured*, 383 B.R. at 531.
29 15 U.S.C. § 1012(b).
30 *See, e.g.*, Goddard, *supra* n.18, at 576; *First Assured*, 383 B.R. at 533.
31 517 U.S. 25, 42 (1996).
32 *Nelson*, 517 U.S. at 42 ("Many federal statutes with potentially preemptive effect, such as the bankruptcy statutes, use general language that does not appear to 'specifically relate' to insurance.").
33 *First Assured*, 383 B.R. at 533. The author assumed for purposes of this article that the first test is met in relation to the Bankruptcy Code.
34 *First Assured*, 383 B.R. at 534 (citing *Fabe*, 508 U.S. at 505).
35 *First Assured*, 383 B.R. at 537.
36 525 U.S. 299, 311 (1999).
37 *First Assured*, 383 B.R. at 537 (citing *Humana*, 525 U.S. at 310).
38 *MF Global*, 469 B.R. at 181.
39 *Id.* at 193.
40 *Id.*
41 *Id.*

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defense costs for the individual insureds.[42] Several of the debtors' customers objected to the carriers' claims for relief (the "objectors").[43] The objectors argued, among other things, that cause did not exist to lift the automatic stay because the priority-of-payment provision in the D&O policy ran afoul of the Bankruptcy Code.[44]

The *MF Global* court concluded that the insurance carriers were authorized to advance defense costs under the policies. The court relied, in part, on New York state insurance law and the McCarran-Ferguson Act, finding that "New York State Insurance Law requires that [the carriers] abide by the terms of the [p]olicies, notwithstanding any other provision of the Bankruptcy Code."[45] Specifically, the court analyzed § 3420(a)(1) of the New York insurance law, which provides:

> The insolvency or bankruptcy of the person insured, or the insolvency of the insured's estate, shall not release the insurer from the payment of damages for injury sustained or loss occasioned during the life of and within the coverage of such policy or contract.[46]

The court noted that § 3420(a)(1) of the New York insurance law was automatically written into every insurance contract[47] and made it clear that the "filing of a bankruptcy petition does not alter the scope or terms of a debtors' insurance policy and preserves such proceeds for those covered by the insurance policy ... [u]pon review of the New York Insurance Law and the Bankruptcy Code, the Court finds that all three requirements of the McCarran-Ferguson Act are met and thus, section 3420(a)(1) of the New York Insurance Law [reverse] preempts the Bankruptcy Code to the extent of any inconsistency between the two laws."[48] The court found cause to lift the automatic stay and thus granted the motions to lift the automatic stay.

42 *MF Global*, 469 B.R. at 181.
43 *Id.* at 186.
44 *Id.* The objectors also argued that the proceeds of certain of the policies were not property of the debtors' estates, but the court did not reach this issue. *Id.*
45 *MF Global*, 469 B.R. at 186.
46 N.Y. Ins. Law § 3420(a)(1) (McKinney, 2009).
47 N.Y. Ins. Law § 3420(a) (McKinney, 2009).
48 *MF Global*, 469 B.R. at 194-95, n.17.

Implications of *MF Global Holdings Ltd.*

The intersection of the Bankruptcy Code, the McCarran-Ferguson Act and state insurance regulations has, for the most part, been analyzed by bankruptcy courts in the context of disputes arising between insurance company liquidators or receivers and insurance holding companies or noninsurance company affiliates who were the subject of bankruptcy proceedings. *MF Global* instructs us that counterparties to or beneficiaries of insurance agreements may look to existing state insurance law (or more likely to state legislatures where no legislation exists) to orchestrate the reverse preemption of specific provisions of the Bankruptcy Code.

An issue that remains hotly contested is the ability of a corporate entity to assign insurance policies as part of an asset sale without the consent of the insurer.[49] In the non-bankruptcy context, and without statutory guidance, courts have relied on the common law to enforce consent-to-assignment clauses.[50] As a result, a company that acquired a policyholder's assets and liabilities could not generally receive the benefits of the policyholder's "occurrence-based" liability coverage without the consent of the insurer. The Bankruptcy Code instructs otherwise,[51] and the Third Circuit recently affirmed that § 1123(a) of the Bankruptcy Code preempts state law and permits the assignment of insurance policies to a post-confirmation trust, notwithstanding anti-assignment clauses contained in said polices.[52]

There are strong public policies supporting the inclusion and enforceability of anti-assignment clauses in insurance contracts. Nevertheless, a survey of state insurance laws reflects an apparent absence of legislative action on the issue. Informed by the McCarran-Ferguson Act and reinvigorated by *MF Global*, a movement may be contemplated to obtain express legislative directives on important insurance-related issues in order to secure reverse preemption of the Bankruptcy Code. abi

49 *Travelers Casualty & Surety Co. v. U.S. Filter Corp.*, 895 N.E.2d 1172 (Ind. 2008); *Henkel Corp. v. Hartford Accident & Indemnity Co.*, 62 P.3d 69 (2003).
50 *Henkel Corp.*, 62 P.3d at 69.
51 *See* 11 U.S.C. §§ 365 and 1123(a)(5)(B).
52 *Hartford Accident and Indemnity Co. v. Federal-Mogul Global Inc.*, 684 F.3d 355 (3d Cir. 2012).