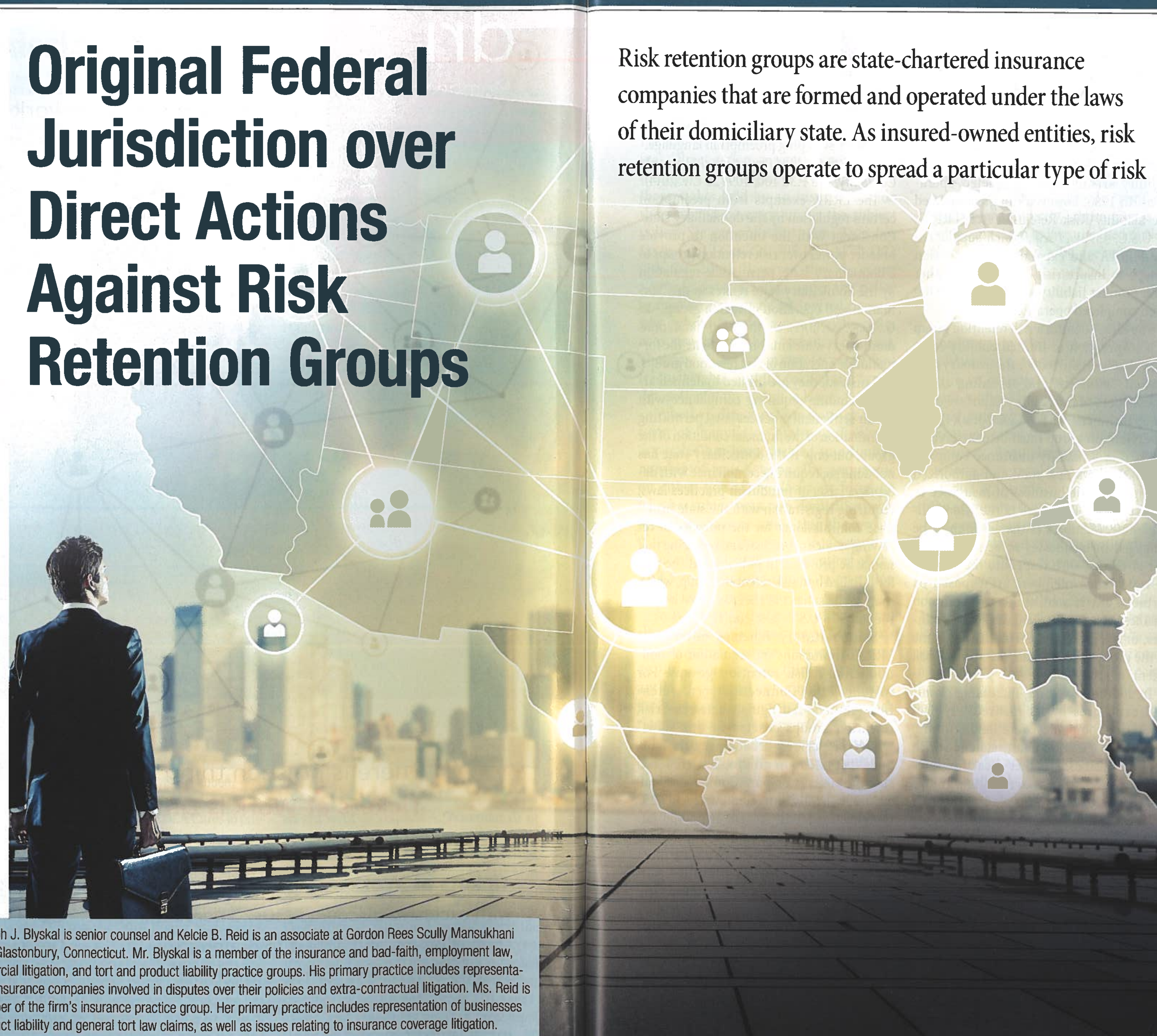
A Needed Shift

Original Federal Jurisdiction over Direct Actions Against Risk Retention Groups

By Joseph J. Blyskal and Kelcie B. Reid

Forcing litigation of direct action claims in state courts is contrary to the goals of protecting risk retention groups from having to comply with varying regulations and ensuring the uniform application of federal law and uniform outcomes.



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Risk retention groups are state-chartered insurance companies that are formed and operated under the laws of their domiciliary state. As insured-owned entities, risk retention groups operate to spread a particular type of risk among their members. The Liability Risk Retention Act (LRRA), 15 U.S.C. §3901 *et seq.*, is a federal statutory scheme that governs risk retention groups and significantly curtails regulation by the states, with the intent of lowering the costs and eliminating some of the regulatory complexities associated with insuring members across multiple states.

To carry out this intent, Congress exempted risk retention groups from "any State law, rule, regulation, or order to the extent that such law, rule, regulation or order would—(1) make unlawful, or regulate, directly or indirectly, the operation of a risk retention group…." 15 U.S.C. §3902(a)(1). There are very narrowly prescribed exceptions to this exemption from federal law, related primarily to the financial condition of risk retention groups and compliance with unfair settlement and deceptive practices laws. 15 U.S.C. §3902(a)(1), §3905. While the state in which the risk retention group is formed enjoys a slightly broader regulatory authority than non-domiciliary states, the scope of permissible regulation is still very limited.

Whether state "direct action" statutes constitute a form of "regulation" that is preempted by the LRRA is an unresolved question in most jurisdictions. Moreover, despite its sweeping preemption of state regulation, the LRRA is not yet one of the three federal statutes that have been held to preempt state law *completely*, which means that diversity jurisdiction is likely required for federal removal jurisdiction. Therefore, contrary to the intent of the LRRA to limit the costs associated with insuring members in multiple states—and contrary to the intent of the complete preemption doctrine to prevent expansion of state law claims that Congress decided should not exist—risk retention groups may be faced with litigating state law direct action claims in state forums that are less likely to dismiss such claims despite broad preemption.

The authors submit that the LRRA provides a right for risk retention groups to operate generally free from foreign state regulation—including being subject to suit under non-domiciliary direct action statutes. State courts are an inappropriate venue for direct actions against a non-domiciliary risk retention group because of the likelihood of inconsistent results across multiple states. As such, the authors further submit that the LRRA provides a basis for original federal question jurisdiction over non-domiciliary state law direct action claims under the doctrine of complete preemption. The authors discuss the bounds and history of the LRRA, recent decisions concerning preemption of direct action

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claims by the LRRA, and the potential for federal jurisdiction over such claims. While the current scope of complete preemption cases giving rise to original federal question jurisdiction is extremely narrow—leaving the courts loath to recognize additional instances for original federal court jurisdiction—a shift is needed to better comply with the LRRA's intent.

Risk Retention Groups Generally

In layman's terms, a risk retention group is a group of individuals and businesses engaged in similar business that offers insurance for similar types of risks. The group is owned by its insureds, which are members of the same industry that face the same or similar liability. This commonality permits the group to insure its members against similar kinds of losses. More technically, a risk-retention group is a legal entity formed under the LRRA and the laws of its domiciliary state, which can insure risks in other states without complying with those other state's insurance laws.

Risk retention groups were created by Congress in response to difficulty faced by manufacturers in obtaining product liability coverage in the 1970s due to the rising number of claims and increasing exposure. Congress enacted the Product Liability Risk Retention Act of 1981 (PLRRA), which permitted businesses with similar liability risk to form risk-retention groups to self-insure product liability and liability arising from completed operations. In 1986, however, Congress enacted the Liability Risk Retention Act (LRRA), 15 U.S.C. §3901 *et seq.*, which supplanted the PLRRA and expanded risk retention groups to insure risks of members other than product liability and liability arising from completed operations.

The LRRA defines a risk retention group as a corporation or limited liability company that is organized for the primary purpose of "assuming and spreading all, or any portion, of the liability exposure of its group members." 15 U.S.C. §3901(a)(4). The risk retention group must be chartered or licensed as a liability insurance company under the laws of a state and authorized to engage in the business of insurance in that state. *Id.* That state is the "domiciliary" state. Members of the group must be "engaged in businesses or activities similar or related with respect to the liability to which such members are exposed by virtue of any related, similar, or common business, trade, product, services, premises, or operations." *Id.* Finally, the name of the group must include the phrase "risk retention group."

In addition to facing increasing claims and exposures by its insureds, typical insurance companies were (and still are) subject to regulation in any state in which they do business, further escalating premiums. Exempting risk retention groups from state regulation makes liability coverage more affordable by permitting such groups to insure members in multiple states without premiums typically charged by state-admitted insurance companies and necessitated by the costs associated with complying with the insurance laws of every state in which they do business.

Broad LRRA Preemption and Limited State Regulation

With limited exceptions, the LRRA provides that "a risk retention group is exempt from *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. Code §3902(a)(1) (emphases added). This language has been characterized by federal courts as "sweeping preemption language." *Wadsworth v. Allied Professional Insurance Company*, 748 F.3d 100, 109 (2d Cir. 2014).

The LRRA exempts from preemption certain regulation by the domiciliary state. Consistent with the intention to provide broader power over risk retention groups to a domiciliary state, permissible regulation by the domiciliary state relates to the "formation and operation of such a group." 15 U.S.C. §3902(a)(1). On the other hand, non-domiciliary states may not regulate the formation or operation of risk retention groups, and instead, they are limited to defined areas, including requiring compliance with unfair settlement practices laws; permitting examination of the financial condition of the group, but only if the domiciliary state has not done so; requiring compliance with deceptive, false, or fraudulent practices laws; requiring registration with the state insurance commissioner for the purpose of receiving service of process; and requiring that notice be provided in policies that the policy is issued by a risk retention group, which may not be subject to the insurance laws of the state. 15 U.S.C. §3902(a)(1).

State statutory schemes mirror the LRRA's limitations on regulation of non-domiciliary risk retention groups. For instance, the Connecticut risk retention statutes distinguish between "risk retention groups charted in this state," which proscribes broader regulations, and "risk retention groups chartered *outside* the state." *Compare* Conn. Gen. Stat. §38a-251, *with* Conn. Gen. Stat. §38a-252 (emphasis added). Absent from the latter section is a requirement that a risk retention group chartered in a state other than Connecticut comply with the insurance laws of Connecticut. *Cf.* Conn. Gen. Stat. §38a-251(a) (requiring *domiciliary* risk retention groups to comply with Conn. insurance laws).

State Direct Action Statutes as a Form of Regulation

State "direct action" statutes typically permit an injured party holding a judgment against an insured to pursue a claim directly against the insurer if the judgment remains unsatisfied for a specified time after judgment. *E.g.*, Wis. Stat. §632.24 (Wis. direct action statute); Conn. Gen. Stat. 38a-321 (Conn. direct action statute); La. R.S. §22:1269 (La. direct action statute). Direct action statutes do not expand the rights of a judgment creditor beyond those rights held by an insured, nor do they expand coverage under the subject policy. *See generally First Am. Title Ins. Co. v. Cont'l Cas. Co.*, 709 F.3d 1170, 1173 (5th Cir. 2013). However, they do create a private right of action under the policy against an insurer by an injured party—who ordinarily would not have such a claim as a stranger to the insurance contract. Therefore, direct action statutes create contractual rights in third parties and are in derogation of the common law.

Whether direct action statutes are a form of "regulation" by non-domiciliary states has been decided in a limited number of jurisdictions. The arguments on either side of the decisions focus on whether subjecting a non-domiciliary risk retention group to suit within the foreign state regulates the group in a way that is inconsistent with the intention of the LRRA to streamline interstate operation of risk retention groups.

In *Wadsworth*, the Second Circuit found that the federal law preempted New York's direct action statute (permitting suit against an insurer by a third-party claimant if a judgment remained unsatisfied for 30 days) from applying to foreign risk retention groups. *Wadsworth*, 748 F.3d at 105. The court noted that New York statutes generally distinguish between regulation of domiciliary and non-domiciliary risk retention groups. *Id.* at 104 (referencing the "more limited regulations [that New York] is permitted to adopt with respect to non-domiciliary risk retention groups" under the LRRA). The Second Circuit found that imposing a statutory cause of action on a foreign risk retention group would "regulate, directly or indirectly," risk retention groups, which was contrary to the LRRA. *Id.* at 108. The court reasoned as follows:

> [The New York direct action statute], which is in derogation of the common law, allows an injured party with an unsatisfied judgment against an insured party to sue the insurer for satisfaction of the judgment in some circumstances.... Although the statute does not increase the amount of the insurer's liabilities, the rights of the injured party are independent of the rights of the insured, and in some circumstances, more favorable. Application of those provisions to... foreign risk retention group[s] would undoubtedly "regulate, directly or indirectly," those groups by subjecting them to lawsuits filed in New York by claimants who are not parties to [the risk retention group's] contracts with insureds.
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> 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.

Id. at 108 (internal citations omitted). *See also Nadkos, Inc. v. Preferred Contrs. Ins. Co. Risk Retention Group, LLC*, 162 A.D.3d 7 (N.Y. App. Div. 2018) ("Section 3420(d)(2) [relating to disclaimers of coverage] alters the rights and obligations of the carrier and insured under the policy by creating additional rights for the injured party, that is not contemplated by the LRRA and not required by other states.").

The Supreme Court of Georgia recently found the LRRA to preempt state direct action statutes and upheld dismissal of an attempted direct claim against a risk retention group in *Reis v. OOIDA Risk Retention Group, Inc.*, 814 S.E.2d 338 (Ga. 2018). Similar to the *Wadsworth* court, the *Reis* court determined that state direct action statutes regulate risk retention groups, contrary to the scope of permissible state regulation under the LRRA. In *Reis* the court was confronted with a direct action against a non-domiciliary risk retention group. *Reis*, 814 S.E.2d at 339. The court found that "direct action statutes are not financial responsibility laws," which would not be preempted by the LRRA, because "they in no manner assure the financial soundness or solvency of a risk retention group." *Id.* at 342. Further, the court stated:

> The direct action statutes would impact operation of the business of insurance of a risk retention group inasmuch as application of the statutes would result in the spreading of risk and associated increases in costs due to the additional financial burden of defending unanticipated lawsuits in which they are directly named as parties, in affecting the relationship between an insurer and insured by creating possible conflicts of interest between the insurer and the policyholder, and in limiting their application to insurers of motor carriers. Therefore, direct action statutes would regulate the operation of risk retention groups.
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> The clear goal of the LRRA is to streamline the operations of risk retention groups... by subjecting them to consistent regulation overseen by their chartering state.

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Id. at 343 (internal citations omitted). The George Supreme Court upheld the lower court's dismissal. *Id.*

In contrast, the Court of Appeal of Louisiana declined to find that the Louisiana direct action statute was a form of regulation. *Zeigler v. Hous. Auth. of New Orleans Hano*, 192 So. 3d 175 (La. Ct. App. 2016). Declining to follow what it characterized as an overly broad reading of the LRRA by the *Wadsworth* court, the *Zeigler* court followed the reasoning of a Missouri appellate court and a Kentucky federal district court. The *Ziegler* court specifically found that the LRRA only prevents regulation of the "operation" of risk retention groups and held that the Louisiana statute merely permits a plaintiff to sue a risk retention group just the same as any other insurer. *Zeigler*, 192 So. 3d 175, 179–81 (citing *Sturgeon v. Allied Professionals Ins. Co.*, 344 S.W.3d 205 (Mo. App. 2011), and *Nat'l Home Ins. Co. v. King*, 291 F. Supp. 2d 518 (E.D. Ky. 2003)).

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tion groups. Unfortunately, this is an issue of first impression in the majority of state jurisdictions, and the issue has not been addressed by the United States Supreme Court. Therefore, risk retention groups will be left to interpret the patchwork of decisions of the relatively few courts that have decided the issue, and they likely will have to litigate the issue in state courts. As explained below, this is contrary to the purpose of the LRRA to limit the costs associated with writing insurance in multiple states.

The Problem Created by State Court LRRA Preemption Determinations

As illustrated by the divergent outcome in *Zeigler*, state court determinations of the scope of LRRA preemption of state direct action statutes creates the potential for risk retention groups to be subject to the direct action statutes of some states but not to those of other states. This is inconsistent with the purpose of the LRRA, which is to protect risk retention groups from having to comply with the widely varying regulatory laws of multiple states. When state courts determine of the scope of LRRA preemption, it also leaves risk retention groups uncertain about whether they must comply with all state direct action statutes, or only some. This issue is further complicated by the lack of established law in most jurisdictions on whether direct action statutes are a form of regulation.

Despite the broad preemptory language of the LRRA, the act is not one of the three recognized areas of "complete preemption" that give rise to original federal jurisdiction. Under the doctrine of complete preemption, "a plaintiff's 'state cause of action [may be recast] as a federal claim for relief, making [its] removal [by the defendant] proper on the basis of federal question jurisdiction.'" *Wurtz v. Rawlings Co., LLC*, 761 F.3d 232, 238 (2d Cir. 2014). Complete preemption occurs and gives rise to original federal jurisdiction

> when a federal statute wholly displaces the state-law cause of action through complete pre-emption. When the federal statute completely pre-empts the state-law cause of action, a claim which comes within the scope of that cause of action, even if pleaded in terms of state law, is in reality based on federal law.

Ben. Nat'l Bank v. Anderson, 539 U.S. 1, 8 (2003). In this way, complete preemption prevents expansion of federal claims through state law. *Rush Prudential HMC, Inc. v. Moran*, 536 U.S. 355, 377 (2002) ("Although we have yet to encounter a forced choice between the congressional policies of exclusively federal remedies and the 'reservation of the business of insurance to the States,' we have anticipated such a conflict, *with the state insurance regulation losing out*....") (emphasis added). *See also Pilot Life Ins. Co. v. Dedeaux*, 481 U.S. 41, 54 (1987) ("In sum, the detailed provisions of [ERISA] set forth a comprehensive civil enforcement scheme that represents a careful balancing of the need for prompt and fair claims settlement procedures against the public interest in encouraging the formation of employee benefit plans. *The policy choices reflected in the inclusion of certain remedies and the exclusion of others under the federal scheme would be completely undermined if ERISA-plan participants and beneficiaries were free to obtain remedies under state law that Congress rejected in ERISA*.") (emphasis added).

Complete preemption arises only in the following areas of law: Section 301 of the Labor Management Relations Act, 29 U.S.C. §185; Section 502(a) of the Employee Retirement Income Security Act, 29 U.S.C. §1132(a); and Sections 85 and 86 of the National Bank Act, 12 U.S.C. §§85–86. *See Sullivan v. American Airlines, Inc.*, 424 F.3d 267 (2d Cir. 2005). Presently, the LRRA is not one of the three acts under which complete preemption occurs, forcing litigants to rely on other grounds for federal jurisdiction.

Moreover, when attempting to remove a direct action on the basis of diversity of citizenship under 28 U.S.C. §1332, an insurer is deemed to be a citizen of its state of incorporation, the state in which it has its principal place of business, and every state in which its insured is a citizen. 28 U.S.C. §1332 (c)(1). As such, diversity removal jurisdiction of a direct action is unlikely. Therefore, a risk retention group sued in state court under a state direct action statute may not be able to remove the proceedings to federal court. *See, e.g., KeyBank Nat'l Ass'n v. Am. Safety Risk Retention Grp., Inc.*, No. 3:18-CV-424, 2018 U.S. Dist. Lexis 85179 (D. Conn. May 22, 2018) (remanding direct action for lack of subject matter jurisdiction). This forces risk retention groups to have the scope of federal preemption determined by a state court, which is contrary to the purpose of complete preemption to create a uniform, predictable body of federal law.

Interestingly, at least one court, the Seventh Circuit, has recognized that when a retention group seeks an injunction preventing application of state law, federal question jurisdiction is created under the LRRA. *Restoration Risk Retention Grp., Inc. v. Gutierrez*, 880 F.3d. 339 (7th Cir. 2018) ("Rather than attempting to assert a federal preemption defense, [the risk retention group] is simply asserting a federal right to operate within Wisconsin free from the restrictions of state regulation, a right that it asserts is grounded in federal law. It seeks an order from the district court requiring state officials to permit it to operate unimpeded from state regulation specifically forbidden by the federal regulatory scheme. Such a claim is premised on a federal right and is fully cognizable in the district court.").

However, a risk retention group that seeks to remove a case brought against it under a direct action statute would likely require either a change in existing complete preemption law or an act of Congress to have the matter heard by a federal court. *E.g., KeyBank Nat'l Ass'n v. American Safety Risk Retention Group*, No. 3:18-cv-424, 2018 U.S. Dist. Lexis 85179 (D. Conn. May 22, 2018) (remanding direct action claim against risk retention group) Alternatively, a risk retention group may be able to resort to seeking declaratory or injunctive relief as was done in *Gutierrez*, to obtain federal jurisdiction.

Though the LRRA does not expressly provide a private right of action, the authors submit that recognizing complete preemption of state direct action claims by the LRRA is consistent with the intent of the LRRA to limit the costs and unpredictability associated with multistate regulation of risk retention groups, and the intent of complete preemption to prevent expansion of state law claims that Congress did not intend. Complete preemption would permit removal of direct actions against risk retention groups and allow federal courts to address the question of whether a judgment creditor may pursue claims against non-domiciliary risk retention groups. The authors submit that there is no basis under either non-domiciliary state law direct action statutes or the LRRA for such claims. Rather, depending on whether it is determined to be permissible "regulation," a risk retention group might be subject to the direct action statute of its domiciliary state in federal court.

Conclusion

The LRRA is intended to protect risk retention groups from having to comply with varying state laws regulating their operation, to limit the costs associated with interstate insurance. Similarly, complete preemption is intended to ensure the uniform application of federal law and predictable outcomes in connection with federally regulated areas of law. Forcing risk retention groups to litigate direct action claims in state courts is contrary to these goals. To be consistent with the purpose of the LRRA and complete preemption, the authors submit that federal courts should have original jurisdiction over direct action claims against risk retention groups. FD