

Locke Lord QuickStudy: Between a Claim and a Hard Place: OFAC Sanctions Preempt State Insurance Laws

Locke Lord LLP

WRITTEN BY

Alan J. Levin | Ryan Last

U.S. sanctions laws present complex conflicts with state insurance laws. While state laws govern the timely payment of claims and other insurance practices, U.S. sanctions administered by the U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC") supersede state laws pursuant to the Commerce Clause of the U.S. Constitution.

If U.S. sanctions laws require an insurance company to withhold payment from a policyholder or claimant due to concerns about violating OFAC sanctions, the insurance company is unlikely to face penalties from a state insurance regulator for non-compliance with state insurance laws and regulations. While state insurance departments, including the New York Department of Financial Services ("NYDFS"), may ordinarily impose fines for non-payment, they, along with state and federal courts, have recognized that adherence to OFAC sanctions preempt state insurance laws and regulations. This QuickStudy explores how OFAC sanctions preempt state insurance laws, the implications for insurers, and the importance of compliance with U.S. sanctions programs.

Summary

Several different federal statutes, first among them, the [International Emergency Economic Powers Act](#) and [Trading with the Enemy Act](#), authorize OFAC to administer and enforce economic sanctions. OFAC operates under executive orders issued by the President of the United States that implement sanctions programs, which are codified in [Title 31 of the Code of Federal Regulations, Part 500](#). OFAC has taken the [position](#) that OFAC sanctions regulations preempt state insurance laws. State insurance statutes regulate an insurer's ability to withhold claim payments, cancel policies or to decline to enter into policies. However, OFAC has recognized that while insurance companies must abide by state insurance laws, they must also sometimes "commit an ostensible violation of state insurance regulations to comply with OFAC regulations."

OFAC Role in Insurance Industry

An insurer is prohibited from engaging in transactions or providing services, including the payment of insurance claims, that violate OFAC sanctions. The federal government does not provide exceptions for state insurance law obligations. If an insurer receives an insurance application from a person on OFAC's [List of Specially Designated Nationals and Blocked Persons](#) ("SDN List"), the insurer is under an obligation not to issue the policy and must report it to OFAC. An insurer violates OFAC sanctions if it issues a policy, receives premiums, pays claims, facilitates a transaction, or otherwise deals with a person or entity on the SDN List. OFAC has provided the following examples of transactions which would be prohibited without an authorized license: (i) an aviation

insurance policy, issued to a non-blocked foreign airline company, which names a Specially Designated National (“SDN”) bank as an additional insured because the bank holds a mortgage on the aircraft; (ii) a liability insurance policy covering the pharmaceutical operations of a company in Columbia, which has been named as a Specially Designated Narcotics Trafficker; (iii) a reinsurance contract for insurance policies underwritten in whole or in part by a SDN insurer; (iv) a property insurance policy written for an international hotel chain which covers hotels in Iran; (v) a liability insurance policy covering a private oil exploration company’s operations in a sanctioned country or territory; (vi) the return of a premium overpayment to a Cuban resident in France; and (vii) the payment to a non-SDN claimant, if the claim is connected to an insurance policy that was issued to a SDN and is now blocked.

An insurer who violates OFAC sanctions may be subject to significant penalties, including civil fines and criminal prosecution. OFAC enforces most sanctions programs based on strict liability, which means that a person can be held civilly liable for violating sanctions regulations even if they were unaware of the violation. Civil and criminal penalties vary by sanctions program and depend on the type of violation. To decide on the type of enforcement action to take, if any, OFAC evaluates a range of “General Factors” outlined in its [Enforcement Guidelines](#) (e.g., willful or reckless violation of law, awareness of conduct at issue, harm to sanctions program objectives, individual characteristics of a person subject to OFAC sanctions programs, compliance programs, and remedial responses). According to these guidelines, OFAC may consider some or all of these factors when determining the appropriate administrative response to an apparent violation of U.S. sanctions. The nature and severity of penalties depend on the specific law or regulation that OFAC alleges has been violated. For example, the maximum civil monetary penalty for a violation of the International Emergency Economic Powers Act is the greater of either \$368,136 or twice the amount of the transaction. Criminal penalties for willful violations of, or willful attempts to violate the International Emergency Economic Powers Act carry up to a million dollars in fines and/or imprisonment of up to twenty years.

Federal Preemption of State Insurance Laws

The Supremacy Clause of the U.S. Constitution ensures that federal law preempts state law when there is a conflict. When OFAC sanctions prevent an insurer from paying a claim, this creates a direct conflict between federal laws and state insurance laws, which typically require insurers to pay valid claims in a timely manner.

While direct cases specifically about insurance companies lawfully withholding payment of insurance claims in order to comply with OFAC sanctions may be limited, broader preemption principles are well-established. Courts have generally found that state laws that conflict with federal law are without effect. In particular, courts have held that federal law will preempt a state law if it is physically impossible to comply with both laws. Based on this, courts are likely to support the view that if state law requires payment or action on insurance claims that conflicts with OFAC sanctions, the federal regulations administered by OFAC would typically prevail. In a 2014 Second Circuit Court of Appeals case, the court held that OFAC’s blocking order preempted New York state law claims. The court ruled that the funds held in a blocked account by a financial institution regulated by the NYDFS could not be released to a claimant, even though New York state law might have required payment in the absence of OFAC sanctions.

State Insurance Laws and Penalties for Non-Payment

State insurance laws, regulated primarily by individual state insurance departments, generally impose penalties on

insurers for the failure to pay legitimate claims in bad faith or in violation of state insurance codes. Under New York's insurance law, insurers are prohibited from engaging in unfair claims settlement practices, including unreasonably delaying or denying payments. Violations of this statute can result in penalties, including fines.

The refusal to pay a claim due to OFAC sanctions could lead to allegations of bad faith under state law. New York courts generally allow policyholders and claimants to pursue bad faith claims under state law. However, if an insurer can demonstrate that making the payment would violate federal law, this has served as a defense against state penalties. In such cases, New York courts have acknowledged that state law may be preempted by federal regulations promulgated pursuant to Congressional delegation of discretionary quasi-legislative authority, such as regulations administered by OFAC. Furthermore, the NYDFS has been granted broad authority to enforce state insurance laws, including investigating claims practices and imposing penalties for violations. However, where OFAC sanctions are involved, the NYDFS has generally acknowledged the supremacy of federal law, limiting its enforcement actions against insurers who refuse to make payments based on OFAC compliance. In 2022, the NYDFS [stated](#), "U.S. persons (including, without limitation, banks, virtual currency businesses, insurers and other financial institutions as well as insurance producers and third-party administrators) are prohibited from engaging in any financial transactions with persons on the SDN List, unless OFAC has authorized otherwise, through licenses listed on the OFAC website, or by obtaining a separate license for a particular transaction."

Challenges and Risks for Insurers

While federal preemption shields insurers from state law liability in cases of OFAC compliance, insurers still face challenges, including:

- **Bad Faith Claims:** Policyholders may still file bad faith lawsuits under state law. While federal preemption generally protects insurers from liability, the litigation itself can be costly and time-consuming.
- **Reputational Risks:** Insurers that refuse to pay claims due to OFAC sanctions may suffer reputational harm, particularly if the refusal is perceived as an attempt to avoid legitimate claims.

Conclusion

Insurers operating in New York and other states must navigate a complex legal environment where OFAC sanctions can conflict with state insurance law. Although federal law preempts state insurance regulations, insurers must remain diligent in their compliance efforts. State courts, like their federal counterparts, have consistently ruled in favor of federal preemption. Nevertheless, insurers must be prepared for potential legal challenges, including bad faith claims, even if such claims are ultimately preempted by OFAC sanctions.

This paper is intended as a guide only and is not a substitute for specific legal or tax advice. Please reach out to the authors for any specific questions. We expect to continue to monitor the topics addressed in this paper and provide further client updates when useful.

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