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INSURANCE

Insurance Policy Arbitration Clauses: Perils And Considerations For Policyholders

More and more insurance policies contain arbitration clauses, calling for the policyholder to arbitrate (rather than litigate in a court) any dispute over insurance coverage. Arbitration usually provides advantages for insurance companies that few policyholders fully comprehend at the time of insurance purchase.

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To compound the problem, insurance companies routinely couple arbitration provisions with New York choice of law provisions in certain forms of commercial liability and property insurance. These choice of law clauses purport to apply New York law to disputed insurance policy terms. Again, from the perspective of the policyholder, this can spell trouble. Compared to the law of almost any other U.S. jurisdiction, New York law is less favorable on a number of important insurance coverage issues. Thus, policyholders should be wary of purchasing insurance policies purporting to require arbitration or application of New York law.

Arbitration Perils

Arbitration clauses found in some liability and property insurance policies call for arbitration of any coverage dispute to be brought in London, Bermuda or some other foreign jurisdiction. Such clauses provide immediate benefits for the insurance company and clear disadvantages for the policyholder. Invariably, insurance companies have far greater familiarity with foreign-based arbitrators, including critical information concerning their track records and useful intelligence on how likely they are to rule on or react to certain contested insurance coverage issues. Put simply, this is forum shopping in its greatest sense.

While there are some marvelous arbitrators operating in places like London who are smart, fair and truly impartial, most policyholders lack the experience and sources of intelligence to divine who they are. Furthermore, there are arbitrators who rule for insurance companies time and time again irrespective of the merits of the arbitration. Again, knowledge is the key here. The consequences for failing to avoid such individuals can be irreparable given the difficulties in appealing or voiding an arbitration ruling.

Another issue with arbitrations that arises is the secrecy that is normally attendant to such proceedings. Occasionally, this private forum may appeal to a policyholder that is not eager to make certain evidence or matters public when underlying liability issues are pending or unresolved. In arbitration, however, insurance companies, sensing that no one is alert to their arguments, may take outrageous or frivolous legal positions concerning the interpretation of their insurance policies, thinking that such arguments cannot come back to haunt them in the marketing and selling of their insurance products to existing and prospective insurance buyers. As such, the private nature or arbitration can present a double edged sword for policyholders.

Cost is also a critical issue — especially when talking about foreign arbitrations. For example, legal costs are already substantial in the U.K. Couple those relatively high legal costs with a horrendous foreign exchange rate, and the costs of arbitration can comprise a small (or not so small) fortune. Moreover, in some jurisdictions, the body of law governing arbitrations can require that the losing party not only

incur the cost of its own fees, but also the fees of the prevailing party. This is yet another reason underscoring the absolute need to empanel a fair, professional and impartial set of arbitrators.

The cost issue can be further exacerbated when a few insurance policies sneak in arbitration clauses in large layered or subscription insurance programs. If there is a coverage dispute over two or more policies, the policyholder may be forced into a situation where it is conducting numerous arbitrations *and* a court proceeding simultaneously, even when the issues disputed are identical. In such a scenario, the cost factor goes up exponentially.

It is also worth remembering that special attention should be given to determining whether the policyholder even agreed to forfeit the right to a jury trial in favor of arbitration. Most authorities agree that arbitration, to be enforceable, must result from a knowing agreement to arbitrate disputes in the first place. We have seen occasions where the policyholder had no idea that it was purportedly required to arbitrate and where none of the underwriting documentation, including the insurance binder, made reference that the policyholder was saddled with arbitration. Moreover, state statutes may restrict the effect of foreign-arbitration clauses contained in contracts, including in insurance policies.

Modified New York Law

Many of the insurance policies calling for arbitration also include choice of law provisions. Such provisions can call for the application of a modified form of New York law. But New York law favors insurance companies on a number of significant coverage issues, such as "late notice" and bad faith claims handling.

Another problem with New York choice of law provisions is that they are sometimes modified to remove certain established protections afforded policyholders. For instance, some choice of law clauses state that: "the issues shall be resolved … *without regard to authorship of the language and without any presumption or arbitrary interpretation or construction in favor of either the Insureds or the Insurer.*" Unless policyholders are extremely familiar with insurance coverage doctrines, many would not fully appreciate the implications of such a clause, which essentially seeks to eradicate the long-established rule followed in practically every jurisdiction, including New York, that ambiguous insurance policy terms — including exclusions and terms of limitation — are to be strictly construed against the insurance company and in favor of coverage.

The only real silver lining to some forms of modified New York law provisions is that they may carve out of the application of New York law the prohibition against insuring punitive damages. While punitive damages that are awarded under a theory of vicarious liability may still be insurable under New York law, other forms of punitive damages are usually not. Accordingly, some insurance policies promise coverage for punitive damages and except from the New York choice of law provision the "uninsurability" of punitives.

In sum, however, policyholders should strongly consider whether the purchase of insurance policies containing arbitration and New York choice of law provisions actually serves their interests. In many cases it does not. We have experienced first hand occasions where insurance company attorneys at claim meetings have expressly admonished that the policyholder can expect less coverage because the policies require arbitration of the coverage dispute. This is something that a policyholder will never hear during a meeting with the underwriter and insurance broker at the point of purchase.

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