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Policyholder strategies for countering the insurers' inherent advantage in disputes subject to arbitration.

Arbitration of Insurance Coverage Disputes: A Policyholder's Definitive Survival Guide

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Introduction

Arbitration provisions are becoming increasingly common in insurance policies, particularly where specialty coverage is concerned. Many legal practitioners favor arbitration over litigation, depending on the nature of the case. Unfortunately, when it comes to insurance disputes, arbitration can be disadvantageous for policyholders. Too often, the process is skewed in favor of the insurance company. Increasingly, insurance policy arbitration provisions contain language not only limiting a policyholder's rights, but also eviscerating established legal protections, both statutory and under common law. Most policyholders have no choice when it comes to the inclusion of such provisions, which often consist of standard form language. This has led several states to ban arbitration of coverage disputes. As of July 2010, the following states had anti-arbitration provisions: Arkansas, Georgia, Kansas, Kentucky, Louisiana, Missouri, Montana, Nebraska, Oklahoma, South Dakota, and Vermont.[1] Rhode Island has a statute that allows for arbitration only at the option of the policyholder.[2]

When policyholders feel strongly that an insurance company is employing improper claim-handling tactics, or simply fighting a valid claim, there are sometimes ways that they can avoid arbitration

and have the day in court they deserve. Too many policyholders, however, get stuck dealing with unanticipated claim disputes that must be resolved confidentially under arbitration provisions they may never have read or may not even have realized were included in the policy language. However, when they cannot be avoided, arbitration proceedings can be managed effectively to make the playing field less slanted.

Arbitrators have little incentive to side with policyholders whom they are unlikely to encounter again in the future.

Whether negotiating to avoid having arbitration provisions inserted into your coverage, fighting to avoid an unfair arbitration process, or facing an unavoidable arbitration, policyholders need experienced coverage counsel. At each stage, sophisticated policyholders and risk managers can avoid common mistakes. The idea is to make the negotiation or arbitration process work as well as possible by understanding in advance the ways in which the deck is stacked against the policyholder.

State courts and legislatures understand that coverage disputes do not involve an even playing field. Consequently, case law has developed and statutes have been enacted that contain significant protections for insurance consumers, including presumptions in favor of coverage or against the drafter of unclear policy language, as well as so-called fee-switching laws. Some standard-form arbitration provisions do away with these protections.

The operative arbitration requirement may not even be in the insurance policy itself, but rather included in a side agreement for collateralizing premiums or as "deductible security."[3] Where a policyholder never agreed to arbitrate, but received side agreements containing arbitration provisions or final policy language *after* other essential coverage elements were bound, policyholders should not have to arbitrate.[4]

Here are ten specific ways arbitration can work against policyholders:

1. **Forced Compromise**: Arbitration by its nature is generally more focused on compromise than litigation, wherein a party's rights may be vindicated fully. Insurance companies routinely take advantage of this to avoid paying a claim in full. This is unfair because insurance disputes are different from typical commercial disputes. Policyholder consumers do not purchase insurance to have their loss split down the middle so they receive 50 cents on the dollar. When a policyholder suffers an accidental loss, he or she is not at fault in any way. Even where a policyholder may arguably have been negligent, leading to an accident, the argument can be made that the insurance company accepted that risk, took it into account when underwriting, and calculated and accepted premiums based on full payment. Moreover, most insurance companies evaluate risks — especially risks arising from negligence — before selling insurance and even tout their experience and expertise in doing so as part of what they sell. Accordingly, policyholders may reasonably expect to be made whole for a covered loss and to not be shunted into a confidential process specifically designed to promote compromise.

2. **Loss of Legal Protections**: Arbitrators seeking to find a compromise may ignore or only partially apply routine statutory or common-law protections of policyholder's interests. Certain protections, such as fee shifting, may be less available in arbitration because the arbitrator considers them to have a punitive element at odds with the spirit of compromise. Moreover, as mentioned above, many arbitration provisions expressly take these protections away by, for example, expressly disallowing the collection of fees by the policyholder.

3. **Arbitrator Bias**: Arbitration is a commercial enterprise. Arbitrators have little incentive to side with policyholders whom they are unlikely to encounter again in the future. Individual policyholders are unlikely to be a continuing source of revenue. This is not true of insurance companies that are in a position to offer repeat business. Judges are appointed or elected, but arbitrators generally are chosen by the parties. Arbitrators that are prepared to issue awards or decisions perceived as punitive toward insurance companies

are less likely to be selected more than once by insurance companies, and so they may forfeit a substantial source of repeat business.

4. **Streamlined Justice**: In the more casual atmosphere of an arbitration, arbitrators may feel less compelled than sitting judges to follow the letter of the law. This is a particular problem when it comes to allegations of bad faith or other policyholder protections that an arbitrator may see as tangential and not within the scope of the streamlined arbitration proceedings, which are designed to foster speedy resolution through compromise. For example, even the most well-meaning arbitrator may be less inclined to apply the "any possibility of coverage standard" or construe policy language against the insurance company because the result would yield a complete victory for the policyholder, as opposed to a compromise resolution. Moreover, arbitrators have tremendous latitude with minimal public (and often no judicial) scrutiny.

5. **Erosion of Rights**: Arbitration provisions increasingly contain anti-policyholder consumer provisions, such as purported bars on the collection of "fees" or revisions to the standard rules of construction regarding ambiguity and drafting (*contra proferentum*). The following is a standard form arbitration provision:

   > Any dispute, controversy or "claim" arising out of or relating to this policy shall be finally and fully resolved through arbitration in accordance with the commercial arbitration rules of the American Arbitration Association. The arbitrator(s) and the number of arbitrators shall be chosen in the manner and within the time frames provided by such rules.
   >
   > The arbitration proceeding shall take place in the "named insured's" state of domicile or in the domicile of the "insured," person or entity seeking relief from us or from whom we are seeking relief. The arbitrator(s) shall give due consideration to the general principles of the law of the insured's state of domicile in the construction and interpretation of the provisions of the policy; provided, however, that the terms, conditions, provisions and exclusions of this policy are to be construed in an evenhanded fashion as between the parties. Where the language of this policy is alleged to be ambiguous or otherwise unclear, the issue shall be resolved in the manner most consistent with the relevant terms, conditions, provisions or exclusions of the policy (without regard to the authorship of the language, the doctrine in favor of either party or parties, and in accordance with the intent of the parties).
   >
   > The written decision of the arbitrator(s) shall set forth its reasoning, and it shall be provided simultaneously to both parties and shall be binding on them. The arbitrators' award shall not include attorney fees or other costs. Judgment on the award may be entered in any court of competent jurisdiction. Each party shall bear equally the expenses of arbitration.
   >
   > Many states allow prevailing policyholders to recover their fees as both a counter to the insurance company's enhanced bargaining power (in general, very little policy language actually is negotiated) and to provide economic incentives to force a claim compromise by denying or delaying the provision of coverage.

6. **Denial of Discovery**: In arbitration, policyholders are often denied basic discovery under the guise of economy and efficiency. Basic information on how the claim was analyzed and handled may demonstrate that coverage could exist but was denied improperly. Whether this is true or not, the insurance company can force the policyholder to cooperate and turn over all sorts of loss information under the guise of the need to establish and document the claim. Insurance companies, on the other hand, have been known to hide the ball by requiring a policyholder to make specific requests even when the information is readily available to the insurance company. This defeats the whole purpose of discovery, but arbitrators are often reluctant (and have less authority) to order certain types of documents produced. Arbitrators are often reluctant to compel insurance companies to turn over guidelines or other internal insurance company training documents, reserve or reinsurance information, or information regarding how similarly situated policyholders or claims have

been dealt with in the past or in alternative jurisdictions (insurance companies routinely take different positions on coverage based on favorable state law and do not seem to be troubled by adopting differing interpretations of policy provisions when state case law supports their positions).[5]

Policyholders and other consumers also may not be in a position to "shop around" or successfully negotiate over the inclusion of arbitration provisions in standard-form contracts.

7. **Cloak of Confidentiality**: Similarly, because arbitration proceedings are not public and do not further the development of common law, insurance companies are less constrained in taking outlandish or inconsistent claim positions when they know that arbitration will be the policyholder's sole recourse. In addition, unlike case law, confidential resolutions reached in arbitration proceedings are not available to other similarly situated policyholders merely seeking to require insurance companies to handle claims consistently.

8. **Lack of Economic Consequences**: Because the negative consequences to an insurance company are so limited in terms of application of legal protections, awards of extracontractual damages or prevailing party fees, and development of case law, insurance companies have limited incentive to handle claims responsibly when they know a confidential arbitration will be the policyholder's sole recourse.

9. **Arbitrary Awards**: Most arbitration provisions do not require any level of reasoning to support an award or decision.[6] It is left to the arbitrator's discretion as to whether and how to explain the decision. This often makes it almost impossible to appeal, let alone overturn, an award that is based solely on the arbitrator's unexplained or vague decision.

10. **No Jury**: Jurors are often receptive to arguments seeking to demonstrate that an insurance company is manipulating the system to its economic advantage. Juries are fundamental to the legitimacy of our judicial system and basic notions of fairness, including due process. Policyholders are entitled to have their claims heard by a jury.

Making Arbitration Work for Policyholders

Arbitration has been hailed by some as a dispute-resolution cure-all in our litigious society. It is true that arbitration provides greater flexibility than traditional litigation and can streamline proceedings. As enumerated above, however, arbitration often tilts the field against policyholders specifically and consumers generally. This fact has not gone unrecognized by policymakers and the courts. Numerous states, and some courts, have begun to push back and take action to curb the use and strong legal presumption in favor of arbitration.[7] On a national level, the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law by President Obama on July 21, 2010,[8] requires the newly created Bureau of Consumer Financial Protection to report to Congress the results of a study on the use of agreements "providing for arbitration of any future dispute between covered persons and consumers in connection with the offering or providing of consumer financial products or services."[9]

This apparent trend toward putting some limits on arbitration is not anti-arbitration per se. Rather, it questions whether, where equal bargaining does not exist, it is conscionable to require policyholders or other consumers to forgo their right to the traditional protections of our legal system. This question takes on further urgency because arbitration provisions may be drafted to limit existing consumer protections or to benefit other interests under the guise of streamlined dispute resolution.[10]

The arguments against arbitration of insurance disputes also apply to other consumers in many cases. Neither group typically has input over contract drafting, particularly inclusion of an arbitration clause. Policyholders and other consumers also may not be in a position to "shop around" or successfully negotiate over the inclusion of arbitration provisions in standard-form contracts.

Too often, policyholders buying insurance are

focused almost exclusively on obtaining coverage for the risks that they face. Many policyholders and most consumers fail to consider the consequences of being compelled to arbitrate if and when a dispute arises. As a result, they may accept the presence and onerous construction of an arbitration clause as written without challenge or due consideration of their legal rights. Policyholders, consumers, and insurance brokers should bear in mind, however, that arbitration clauses, like other aspects of an insurance contract, can and should be the subject of negotiation.

Problems with Standard Form Arbitration Clauses

Loss of Legal Protections

The loss or modification of traditional legal protections is a key factor in the movement against arbitration. The loss of legal protections manifests itself in several ways, both legally and procedurally, and is a common theme throughout this part of our discussion. This issue was touched on recently by the United States Supreme Court with regard to a discrimination claim in an employment contract.[11] In *Rent-A-Center*, the court held that a provision of an employment agreement that delegates to an arbitrator the exclusive authority to resolve any dispute over the agreement's enforceability was a valid delegation.[12] The court's decision highlights how an arbitration provision can be used to keep allegations of discriminatory conduct out of the public domain. It also demonstrates the degree of deference that can be accorded arbitration provisions. This heightened deference is at the heart of the problem because it can be abused. When arbitration provisions are laced with language rendering the process unfair, they should be reformed or such language should be held unenforceable.[13] Regrettably, in the *Rent-A-Center* case, the Supreme Court allowed the arbitration to proceed even though it is unlikely that the employee had any meaningful ability to negotiate over the arbitration language under which the employee's rights — or lack thereof — were determined.

Loss of Procedural Protections — Discovery

Traditionally, international commercial arbitration disputes involved parties from different nations with different legal traditions, often in the maritime context, where the issues were relatively clear. As such, extensive discovery, which is uncommon in the majority of jurisdictions throughout the world, generally was unnecessary. In addition, lack of due process was not necessarily a significant issue.

In the United States, however, full disclosure or "discovery" is a cornerstone of the judicial system. The Federal Rules of Civil Procedure are extremely broad with respect to what is discoverable.[14] Parties are entitled to prehearing access to witnesses, including depositions. Indeed, most states have liberal rules with respect to discovery as well.

Many arbitration clauses drafted by insurance companies specifically preclude recovery of punitive damages and attorney's fees.

Arbitration, because of its international origins, as well as its purpose of creating a more efficient and streamlined resolution process, generally is inconsistent with such extensive discovery. While this may not be as true in domestic arbitrations, a Bermuda-Form arbitration, for example, tends to have particularly restrictive discovery from the standpoint of many United States practitioners. For English-seated arbitrations, discovery is a limited term and generally refers only to document production. Access to witnesses is only granted at the hearing, and use of interrogatories, while possible, is rare.

In an insurance dispute regarding the meaning or interpretation of a policy term(s), pretrial access to underwriters and claim handlers often is essential to understand and address the insurance company position. Further, in practice, insurance companies often employ attorneys as claims handlers. This can lead to assertions of the protections of attorney-client privilege with regard to claims handling. This conduct is improper.[15] Arbitrations, because they are more flexible and casual, tend to scrutinize claims of privilege or discovery abuse less closely than courts. Accordingly, streamlined arbitration discovery tends to prejudice policyholders more than insurance companies.

Loss of Substantive Protections — Punitive Damages and Attorney's Fees

Legislative and judicial bodies have recognized the duty of good faith and fair dealing implied in every contract, including insurance policies. Bad faith, or the threat thereof, is an important legal principle protecting policyholders and consumers alike. Many states have, therefore, established statutory schemes under which policyholders may obtain punitive damages and attorney's fees under certain circumstances based on improper insurance company conduct. However, many arbitration clauses drafted by insurance companies specifically preclude recovery of punitive damages and attorney's fees. This creates a significant advantage for insurance companies. It in fact creates a disincentive for insurance companies to behave properly and for policyholders to sue because: (1) policyholders will not be able to obtain their fees, which can be quite high, and (2) the value of the loss may be exceeded by fees or the time and internal company costs expended in prosecuting the claim.

If matters such as bad faith, unfair trade practices, punitive damages, or recovery of legal fees and costs were not fully addressed in the arbitration proceeding, such allegations are much more difficult to pursue on appeal.

As Warren Buffett has noted in his well-known annual letters to Berkshire Hathaway shareholders, insurance companies make money through a concept called "float."[16] That is, insurance companies increase profits by getting a policyholder's money (premium), investing that money, and holding it for as long as possible. The longer a valid claim remains unpaid or a dispute drags out, the longer the insurance company holds the money. Awards of prejudgment interest militate against this phenomenon if a case does not settle and the policyholder is successful, especially in New York.[17]

An arbitration provision that relieves an insurance company of serious economic consequences for not paying a valid claim creates a substantial incentive to deny a complicated or costly claim and initiate arbitration. The threat of punitive damages is a critical arrow in the policyholder's quiver. The possibility of an award of such damages can serve to alter the mathematical advantage of the insurance company. Indeed, merely having the arrow might be enough to persuade an insurance company to settle when coverage has become reasonably clear. Similarly, the availability of attorney's fees changes the equation, even in the absence of a punitive damage award, and promotes settlement of legitimate claims. Arbitration can be time-consuming and expensive. Courts generally have discretion to award fees and many jurisdictions expressly allow for this. Taking recovery of a policyholder's fees off the table at the outset gives the insurance company a tremendous advantage.[18] This is particularly true because insurance companies — unlike policyholders — litigate or arbitrate routinely and are able to procure legal services with volume discounts.

Loss of Substantive Protections — Statutory Remedies and *Contra Proferentum*

As discussed above, insurance companies may limit the causes of action available to a policyholder via language in an arbitration clause. More commonly, however, an arbitrator will refuse to permit statutory or common law causes of action to go forward for reasons of economic efficiency and to facilitate compromise in the arbitration. This can place the policyholder in a very difficult position. On one hand, the policyholder must bring the claim so as to avoid waiving it later.[19] On the other hand, as explained above, arbitrators generally refuse to consider the cause of action as viable in arbitration. Bringing such a claim can also be costly and strategically disadvantageous to a policyholder if it results in a "loss" when rejected by the arbitrator. Thus, a classic Catch-22 can arise where, on appeal, a court may be unwilling to hear issues that could have been heard under the arbitration clause, but were not allowed in the underlying arbitration because of the arbitrator's unwillingness to include issues that are rooted in statutory remedies.

This also relates back to the issues of not being able to collect punitive damages or attorney fees or costs. Certain remedies, in the insurance context, may only be available in conjunction with a demonstra-

tion of violation by an insurance company of unfair trade practices or other statutes designed to protect consumers. If matters such as bad faith, unfair trade practices, punitive damages, or recovery of legal fees and costs were not fully addressed in the arbitration proceeding, such allegations are much more difficult to pursue on appeal. There will be no record of addressing these matters, even assuming the arbitrator renders a thorough, written opinion.

Accordingly, on appeal, a judge may be faced with fashioning a remedy that involves having to send the parties back to arbitration generally or in order to develop more of a record on which to impose sanctions. This is unlikely and inefficient.

Perhaps the single most important disadvantage to policyholders associated with the arbitration of insurance disputes today (and many ancillary insurance documents) is the elimination of the doctrine of *contra proferentum*, the legal concept whereby potentially ambiguous language is construed against the drafter. Provisions attempting such elimination have proliferated recently, particularly in standard-form arbitration clauses.

For example, in Bermuda-Form arbitration clauses, Condition O of the policy purports to negate certain New York (or other applicable state) rules of policy construction with respect to policy language or structure that may be unclear. Anyone who has ever read an insurance policy in its entirety can speak to the general lack of coherence and potential ambiguity inherent therein. Some commentators believe that policy language is purposefully ambiguous so that insurance companies can interpret the language or particular provisions to suit their purposes. Because the insurance company (or an industry group such as Insurance Services Office or the London-based Non-Marine Association) almost always drafts the policy language, the law provides that "a tie goes to the policyholder." In other words, where policy language is potentially ambiguous on its face, under the specific circumstances, based on its structure or because it contains contradictory provisions and multiple reasonable interpretations are possible, the interpretation in favor of coverage prevails.[20] This rule of construction helps level the playing field and furthers an important public policy goal that should, theoretically, compel insurance companies to draft standard-form language that is clearer and more precise.

Documenting and Explaining the Award

In most instances, arbitrators do not have to provide a reasoned award. This further impairs any appeal and subsequent judicial review. Even if a court is willing to hear a challenge to an arbitral award, the lack of a written, reasoned award often provides a limited basis for doing so.

Lack of Precedent and Meaningful Review

Arbitrators are not necessarily bound by the law or decisions in past cases. There is often no meaningful opportunity to appeal arbitrator decisions, no matter how misguided or contrary to law they may be. This works against policyholders in at least two ways. First, rulings against an insurance company in one arbitration are confidential and will not be known outside of the arbitration. As a result, an insurance company is free to take contradictory or inconsistent positions without fear that it will be bound by a single position in the next arbitration.

Second, because courts are extremely reluctant to review the findings of an arbitration proceeding, failure to follow the law will have limited consequences, if any. In general, some judges see arbitration as an administrative necessity that lowers their caseloads by providing legitimate alternative dispute resolution. As stated in nearly every federal court decision on arbitration, federal policy strongly favors arbitration.[21]

In fact, arbitration can be a very effective and efficient means to resolve business disputes between two or more relatively equal parties. However, because "arbitration awards are subject to very limited review," they are ill-suited to coverage disputes, in which the policyholder and insurance company are not equally situated — especially when an arbitrator is relatively unfamiliar with coverage law.[22] Similarly, at the state level, "a court [may] not [be] permitted to vacate an arbitration award when the award is based on errors of law."[23] Given this high threshold, an arbitral award may be considered functionally binding, and it may not be worthwhile to attempt to vacate such an award, even where the award is legally incorrect.

Arbitration Bias

Arbitration is not only a means of alternative dispute resolution but also a commercial enterprise for the arbitrator and for the institution administering the arbitration. As with any well-run business, some attention must be paid to frequent or repeat

customers. In fact, in a 2007 study by Public Citizen regarding mandatory arbitration clauses in consumer finance disputes, consumers lost nearly 94 percent of credit card disputes administered by the National Arbitration Forum. Insurance companies that draft the arbitration clause in a standard-form policy contract will often use the same institutions and even the same arbitrators over and over again. Thus, certain arbitrators may have limited incentive to side with policyholders.

Even if an arbitration contract was entered into as a result of fraudulent misrepresentation, the power to make a determination of fraud often will lie with the arbitrator(s).

Avoiding Arbitration

As a result of the challenges described above, many policyholders may find it prudent to avoid arbitration entirely. The most effective way to do so would be to refuse to purchase coverage requiring arbitration. This can be expensive and may be impossible, especially for novel or hard-to-place surplus lines of coverage.

Once an insurance contract has been entered into and litigation is on the horizon or has commenced, there are essentially two ways to avoid arbitration. First, a policyholder can apply to the court to stay arbitration pending a determination by the court regarding the validity of the arbitration clause or of its enforceability or application under the circumstances, e.g., where not all necessary parties have agreed to arbitrate.[24] This, however, is not likely to provide the policyholder with a means to successfully avoid arbitration because, as a general rule, an arbitration panel is empowered to determine its own jurisdiction.[25] Even if an arbitration contract was entered into as a result of fraudulent misrepresentation, the power to make a determination of fraud often will lie with the arbitrator(s).[26]

The second approach, and one that is far more common, is an attempt to challenge the validity of an arbitration award after the panel has rendered an award. This, however, can be a difficult undertaking given the limited grounds for vacating an award.

Policyholders and brokers would be wise to be more proactive when negotiating over the inclusion of arbitration clauses. The best time to raise the issue is either prior to renewal of a policy or prior to the initial binding of any type of insurance coverage for the first time. In addition, as discussed above, insurance companies have been known to foist arbitration provisions onto unaware policyholders either through the use of so-called side agreements required after coverage is bound or incorporated into the insurance policy at the time the actual policy itself is issued, often some time later after coverage has already incepted. Policyholders and risk managers would be wise to consult their brokers as well as legal counsel to address how to respond when arbitration provisions are introduced with no prior disclosure. In this context it is important to remember that many states bar coverage arbitration. Even when an action is in federal court, district court judges should defer to state laws barring arbitration of coverage disputes.[27]

Making an Arbitration Clause Work for Policyholders

If an arbitration clause cannot be avoided, policyholders may want to consider utilizing experienced legal counsel to assist a qualified broker in developing fairer policy language. The drafter should focus on the following provisions.

Loss of Substantive Protections — Statutory Remedies and *Contra Proferentum*

The absence of *contra proferentum* protections severely prejudices the rights of policyholders. It is therefore necessary to ensure that the arbitration clause does not eviscerate this basic legal doctrine. Second, language such as that found in a Bermuda-Form arbitration clause[28] should not be included under any circumstances if at all possible. Third, perhaps language can be added to the effect that the clause will be interpreted so as to be in conformity with the prevailing canons of construction. This may be helpful since even under the principles of general international merchant law, *lex mercatoria*, contracts are construed against the drafter.[29]

Award, Lack of Precedent, and Meaningful Review

Although judicial review of an arbitral award may be unavailable (either explicitly or as a practical matter), it is important to ensure that some form of review is available and that any arbitration decision includes a detailed written and reasoned award.[30] Under many arbitration rules, a written award is not required. It is incumbent on the policyholder to explicitly include a provision requiring a reasoned arbitration award in writing. This is also an important consideration in selecting arbitral institutions: the other rules of the institution should be carefully considered when purchasing an insurance policy containing an arbitration provision.

Arbitration Bias

Addressing the nature or qualifications of arbitrators may also be useful to policyholders. However, the appearance of being the drafting party should be avoided, and attorneys who provide advice on insurance policy provisions to be included would be well advised to work with a reputable insurance broker who knows the market. Policyholders should retain the right to select at least one arbitrator. Here, size of the panel is also an issue. Three arbitrators are more expensive than one, but having at least one "pick" on the panel can be crucial.

In addition, the qualifications of the arbitrator(s) can be determined in the clause or by agreement prior to the inception of arbitration. Policyholders will typically benefit from the inclusion of a qualified United States lawyer or judge on the panel. As a corollary, a former judge or jurist might be a better panelist than a lawyer and be more likely to follow the letter of the law. Judges and jurists might also have more control over the process and may be more willing to delve into evidentiary issues. In addition, many coverage disputes would best be resolved by those with some sort of specialized professional background, such as architecture or engineering. In all cases, research your arbitrator's background just as carefully as you would that of a witness or expert witness.

Make The Arbitration Work For You

When forced to arbitrate, streamline your case. Go for a quick proceeding with few experts and a limited amount of detail. Use video of the other side's unavailable witnesses effectively and call the least polished and most forthcoming witnesses from the other side. Pick your battles. Arbitrators are human beings. When confronted with a dispute in the midst of a proceeding, they may pick the easy, less confrontational way out. Try to flag and resolve sticky issues before the arbitration actually commences. The importance of picking the right arbitrator(s) cannot be overstated.

Many coverage disputes would best be resolved by those with some sort of specialized professional background, such as architecture or engineering.

Conclusion

When arbitration involves parties with equal bargaining power, it can be an effective tool in resolving disputes efficiently. Standard-form arbitration language in most insurance policies, however, has been manipulated to sway the process in favor of the insurance company, i.e., the party that drafted the policy and offered the coverage more or less on a take-or-leave-it basis.

What is a policyholder to do? There is a strong presumption in favor of arbitration. Nonetheless, judicial challenges have been known to prevail in cases where the policyholder was induced to arbitrate fraudulently or the arbitration provisions shocked the conscience of the court. One of the first things to consider is whether the arbitration provision is, as written, in fact, enforceable.

If you, as a policyholder, must proceed with arbitration, also consider the following:

- Use three arbitrators if the policy language permits that option — and use your pick wisely (you pick one, the opposing party picks one, and the two selected arbitrators then pick a third neutral arbitrator as chair). As with expert witnesses, the more you know about an arbitrator, the better your chances of getting a professional who is interested in fairness and justice.

- Make focused and reasonable "discovery" demands and stick to them. At a minimum, denial of due process in obtaining information may be grounds for appeal.

- Think like an arbitrator. It may be strategically effective to offer compromise positions in briefing or other communications with the arbitrator.

- Use the flexibility of an arbitration to further your interests. Mediation may be a good first step. Exploring confidential settlement proposals with the arbitrator alone at certain points in the proceeding may also be effective. Many arbitrators will allow or even request that the parties submit confidential memoranda only to be read by the arbitrator and not the other side.

- Indispensable parties may not have signed any contract containing an arbitration provision. Such parties cannot be compelled to arbitrate, but their testimony may be essential. This situation can raise legitimate questions for a court about the practicality of proceeding to arbitration.

- Consider whether there was fraud in the inducement to arbitrate. Proving such fraud is generally considered an uphill battle, but it can succeed if it can be demonstrated that misrepresentations were made to reassure a policyholder or consumer with respect to inclusion of an arbitration provision in a contract. Keep in mind, however, that one is very likely to have claims of fraudulent inducement heard by the same arbitrator who will ultimately decide your case.

Endnotes

1 *See* Ark. Code Ann. 16-108-201(b) (arbitration provisions "shall have no application to … any insured or beneficiary under any insurance policy"); Ga. Code Ann. § 9-9-2(c)(3) (arbitration provisions "shall not apply" to "any contract of insurance"); Kan. Stat. Ann. § 5-401(c) (provisions of arbitration act "shall not apply to … [c]ontracts of insurance"); Ky. Rev. Stat. Ann. § 417.050(2) (disputes under "insurance contracts" not arbitrable); La. Rev. Stat. Ann. § 22:629a ("[n]o insurance contract … shall contain any … agreement … depriving the courts … of the jurisdiction of action against the insurer"); Mo. Ann. Stat. § 435.350 (arbitration provisions exclude "contracts of insurance"); Mont. Code Ann. § 27-5-114(2)(c) (insurance contracts not arbitrable); Neb. Rev. Stat. Ann. § 25-2602.01(f)(4) ("does not apply to … any agreement … relating to an insurance policy other than a contract between insurance companies including a reinsurance contract"); Ok. Stat. Ann. Tit. 12, § 1855 ("shall not apply to … contracts with reference to insurance except for those contracts between insurance companies"); S.D. Codified Laws § 21-25A-3 ("does not apply to insurance policies"); Vt. Stat. Ann. Tit. 12, § 5653 ("does not apply … to arbitration agreements contained in a contract of insurance").

2 *See* R.I. Stat. Ann. § 10-3-2 ("allowing arbitration at the option of the insured").

3 Nevius, J.G., "Do You Want a Side Agreement To Go With That Insurance Policy?" *The John Liner Review* 23, no. 1 (2009): 67-71.

4 The law "is well settled that when the existence of the contract from which the obligation to arbitrate arises is itself called into question, it is the obligation of the court, before a dispute is referred for arbitration, to determine, in the first instance, whether the contract itself is valid." *Canada Life Assurance Co. v. Guardian Life Ins. Co.*, 242 F. Supp. 2d 344, 349 (S.D.N.Y. 2003); *Interocean Shipping Co. v. Nat'l Shipping & Trading Corp.*, 462 F.2d 673, 676 (2nd Cir. 1972) ("if the making of the [contract] was in issue … the district court should have proceeded to trial of this question."). This is consistent with 9 U.S.C. § 4 of the Federal Arbitration Act, which provides that a court shall direct the parties to proceed to arbitration only on being satisfied that the making of the agreement for arbitration is not in issue. Thus, a party cannot be required to contest the existence of a contract in a forum that is dictated by the disputed contract. *Maronian v. American Commc'n Network Inc.*, 2008 U.S. Dist. LEXIS 2655, at 23 (W.D.N.Y. Jan. 14, 2008). The Supreme Court's holding in *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967), which requires that claims seeking to avoid or rescind a contract be referred to arbitration, does not apply to situations where the existence of a contract is disputed. Indeed, "[t]he Second Circuit and the Southern District of New York have squarely addressed [the] question and concluded that the *Prima Paint* rule does not apply to challenges to the existence of a contract containing an arbitration provision." *See Town of Amherst v. Custom Lighting Servs. LLC*, 2007 U.S. Dist. LEXIS 88296, 20 (W.D.N.Y. Nov. 30, 2007), citing *Denney v. BDO Seidman LLP,* 412 F.3d 58 (2d Cir. 2005); *Sphere Drake Ins. Ltd. v. Clarendon Nat'l Ins. Co.*, 263 F.3d 26 (2nd Cir. 2001); *Nuclear Elec. Ins. v. Central Power & Light Co.*,

926 F. Supp. 428 (S.D.N.Y. 1996); *PMC Inc. v. Atomergic Chemetals Corp.*, 844 F. Supp. 177 (S.D.N.Y. 1994). Accordingly, policyholders may successfully argue that a court must decide whether a contract exists before a policyholder may be forced into arbitration. *Interocean Shipping*, 462 F.2d at 676. *See also Telenor Mobile Commc'n AS v. Storm LLC*, 524 F. Supp. 2d 332, 350 (S.D.N.Y. 2007), *aff'd*, 584 F.3d 396 (2d Cir. 2009) ("In the Second Circuit, a party challenging the existence or formation of an agreement from which an arbitration proceeding derives is entitled to have those issues decided in court, rather than by the arbitral tribunal, if the party (1) presents 'some evidence' in support of its claim; and (2) has unequivocally denied that an agreement was made.").

5 *See, e.g.*, "Umbrella Coverage Is Available: Don't Get Soaked – Coverage for Environmental Liabilities in the Wake of California's *Powerine* Cases 1 and 2," *Environmental Claims Journal*, Vol. 20, Issue 4 (2008) (discussing California's narrow interpretation the term "damages", and the resulting general liability coverage inconsistency).

6 *See, e.g.*, the above-cited policy arbitration provision merely requiring that "the arbitrator(s)… set forth its reasoning" in writing.

7 *See* Conley, A., "The Montana Supreme Court's Continued, Not-So-Subtle Assault on Arbitration," 35 Montana Lawyer 6 (February 2010); Scott, J.W. and B.G. Grainger, "Limits on Third-Party Discovery Under the Federal Arbitration Act," *Banking and Financial Services Policy Report* 28, no. 11 (2009): 23, n.1; Randall, S., "Judicial Attitudes Toward Arbitration And the Resurgence of Unconscionability," 52 Buff. L. Rev. 185 (Winter 2004).

8 Wall Street Reform and Consumer Protection Act, P. L. 111-203, sec. 1028.

9 *Id.*

10 For example, in addition to modifying traditional contract interpretation principles and selecting favorable forums, arbitration provisions can circumscribe the background and experience of potential arbitrators, may limit appeal rights, and may avoid so-called fee switching statutes or certain types of damage awards designed to deter improper conduct.

11 *See Rent-A-Center, West Inc. v. Jackson*, 130 S.Ct. 2772 (2010).

12 *See id.* There are ways to avoid arbitration. For example, "issues of arbitrability are presumptively for the court to decide." *John Hancock Life Ins. Co. v. Wilson*, 254 F.3d 48, 53 (2d Cir. 2001) (internal quotations omitted); *see also First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 944-45 (1995) (recognizing presumption that arbitrability disputes are to be decided by a court). The Federal Arbitration Act (FAA) "does not confer a right to compel arbitration of any dispute at any time." *Volt Info. Scis. v. Bd. of Trs.*, 489 U.S. 468, 474 (1989). This threshold inquiry is for a court to decide. *See, e.g., Howsam v. Dean Witter Reynolds Inc.*, 537 U.S. 79, 83-84 (2002); *Bensadoun v. Jobe-Riat*, 316 F.3d 171, 175 (2d Cir. 2003). Moreover, it is well settled that the issue of whether a party was fraudulently induced to arbitrate is also an issue for the court, not an arbitration panel. The standard for successfully establishing fraudulent inducement to arbitrate is set forth in *Campaniello Imports Ltd. v. Saporiti Italia S.p.A.*, 117 F.3d 655, 667 (2d Cir. 1997); and *Garten v. Kurth*, 265 F.3d 136, 143 (2d Cir. 2001). Both cases reflect the efforts of the United States Court of Appeals for the Second Circuit to reconcile two circa-1965 United States Supreme Court decisions regarding fraud and arbitrability. *See Moseley v. Electronic & Missile Facilities Inc.*, 374 U.S. 167 (1963) (holding in favor of adjudicating in federal court) and *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967) (holding in favor of compelling arbitration). Under established precedent, a court: "must first decide whether the arbitration clause is itself sufficiently connected with the alleged fraudulent scheme so as to be tainted by it." *See Garten*, 265 F.3d at 143. The *Garten* court also expressly held that: "post hoc evidence can support a finding of a substantial relationship between a general fraudulent scheme and the presence of an arbitration clause in a contract." While allowing for the theoretical possibility under appropriate circumstances, in both *Campaniello* and *Garten*, these courts "simply did not find such a relationship."

The *Campaniello* case involved a dispute over rights to distribute furniture manufactured in Italy and allegations of contractual nonperformance. 117 F.3d at 657-61. The dismissal of the furniture distributor's suit seeking rescission and alleging fraud was upheld on appeal because the plaintiff failed to present "particularized facts specific" to arbitration. *Id.* at 667. The court held "conclusory allegations" that remedies for fraud were "'more extensive' in New York than in Italy" were not "sufficient to establish that the arbitration clause in particular was a tool used to further a scheme to defraud." *Id.* However, arbitration that is used as a means to engage in improper claim handling because it is too one-sided, arguably, could be viewed as part of a scheme to defraud policyholders. In *Garten*, the Second Circuit required arbitration because the only evidence presented by plaintiffs linking arbitration to fraud were threats made by one of many defendants after the contract was entered into regarding costs, and that particular defendant's prior experience with arbitration. 265 F.3d at 143. The circumstances

and, therefore, the legal outcome, could be different where misrepresentations and material nondisclosures are made by an insurance company during initial policy-related negotiations and the policyholder expresses specific concerns over the arbitration provisions.

13 Moreover, to the extent that an insurance company's fraudulent inducement to arbitrate is based on non-disclosures, omissions of material fact may rise to a level constituting fraud if a duty to disclose exists. *Aaron Ferer & Sons Ltd. v. Chase Manhattan Bank, N.A.*, 731 F.2d 112, 123 (2d Cir. 1984). "During the course of negotiations surrounding a business transaction, a duty to disclose may arise … where one party possesses superior knowledge, not readily available to the other, and knows that the other is acting on the basis of mistaken knowledge." *Id.* (citations omitted). A party breaches this implied duty when it does something that "destroy[s] or injure[s] the right of another party to receive the benefits of the contract." *Chase Manhattan Bank, N.A. v. Keystone Distribs. Inc.*, 873 F. Supp. 808, 815 (S.D.N.Y. 1994); *see also Granite Partners LP v. Bear, Stearns & Co.*, 17 F. Supp. 2d 275, 305 (S.D.N.Y. 1998) (implied duty of good faith and fair dealing prohibits either party from acting in a manner "which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract") (internal quotations and citation omitted).

Where an insurance company fails to disclose novel interpretations of insurance policy language that allow it to escape its coverage obligations, arguably its knowledge regarding such interpretations is superior. Moreover, such novel interpretation cannot possibly have been readily available to the policyholder at the time of inception of the policy, and yet it is reasonable to argue that the insurance company knew its coverage position would adversely affect the policyholder's right to the fruits of the policy contract, and particularly could affect the policyholder's ability to defend itself against accusations or losses.

14 *See* Fed. R. Civ. Pro. 26(b)(1).

15 *See, e.g., United States ex rel. Fago v. M&T Mortg. Corp.*, 238 F.R.D. 3 (D.D.C. 2006); *St. Paul Reinsurance Co. Ltd. v. Commercial Fin. Corp.*, 197 F.R.D. 620 (N.D.Iowa 2000) ("it would not be fair to allow the insurer's to conduct a concurrent investigation through an attorney to create a blanket obstruction to discovery of its claims investigation"); *Mission Nat'l Ins. Co. v. Lilly*, 112 F.R.D. 160 (D.Minn. 1986); *Conn. Indem. Co. v. Carrier Haulers Inc.*, 197 F.R.D. 564 (W.D.N.C. 2000) ("adjusting a claim is indisputably the very nature of an insurer's business"); *Amerisure Ins. Co. v. Laserage Tech. Corp.*, No. 96-CV-6313, 1998 WL 310750 (W.D.N.Y Feb. 12, 1998) (applying Illinois law whereby "In the insurance context, to the extent that an attorney acts as a claims adjuster, claims process supervisor, the attorney-client privilege does not apply"); *Arkwright Mut. Ins. Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA*, No. 90 Civ. 7811, 1994 WL 510043 (S.D.N.Y. Sept. 16, 1994); *2,022 Ranch LLC v. Superior Court*, 7 Cal.Rptr.3d 197 (Ct. App. 2003); *Munoz v. State Farm Mut. Auto. Ins. Co.*, 968 P.2d 126 (Colo. Ct. App. 1998) ("If a lawyer is acting in an investigative capacity, and not as a legal counselor, with reference to whether an insurance claim should be paid, then neither statutory attorney client privilege nor the work product privilege protects communications from a lawyer to an insurance carrier"), citing *Nat'l Farmers Union Prop. & Cas. Co. v. District Court*, 718 P.2d 1044 (Colo. 1986); *Bertalo's Rest. Inc. v. Exch. Ins. Co.*, 658 N.Y.S.2d 656 (2d Dep't 1997); *Dakota, Minn. and E. R.R. Corp. v. Acuity*, 771 N.W.2d 623 (S.D. 2009); *In re Texas Farmers Ins. Exch.*, 990 S.W.2d 337 (Tex. Ct. App. 1999).

16 Available at http://www.berkshirehathaway.com/letters/letters.html.

17 In Bermuda-Form arbitration, interest might be applied under UK law, which is discretionary and likely tied to the LIBOR, rather than the 9 percent under NY law. *See* McKinney's CPLR § 5004.

18 *See supra*, the standard-form arbitration provision.

19 *See, e.g., Burmah Oil Tankers Ltd. v. Trisun Tankers Ltd.*, 687 F. Supp. 897 (S.D.N.Y. 1988). According the Southern District in *Burmah Oil Tankers*: "*Res judicata* bars all claims that were or could have been raised by a party to prior litigation on the same cause of action. *Res judicata* thereby prevents splitting a cause of action and the attendant waste of judicial resources, increased burdens on litigants, and undermining of finality of judgments that follow from splitting a cause of action. These concerns particularly apply to arbitration which is intended to promote, speedy, efficient, and inexpensive resolution of disputes." *Id.* at 899.

20 Under New York law, for example: "To negate coverage by virtue of an exclusion, an insurer must establish that the exclusion is stated in clear and unmistakable language, is subject to no other reasonable interpretation, and applies in the particular case." *Westview Assocs. v. Guar. Nat'l Ins. Co.*, 740 N.E.2d 220, 223 (N.Y. 2000) (internal citations omitted)."If the language of the policy is doubtful or uncertain in its meaning, any ambiguity must be resolved in favor of the insured and against the insurer." *Id.* (internal citations omitted).

21 *See Southland Corp. v. Keating*, 465 U.S. 1 (1984); *Moses H. Cohen Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1 (1983).

22 *See, e.g., Folkways Music Publishers Inc. v. Weiss*, 989 F.2d 108, 111 (2d Cir. 1993). The statutory grounds present a high threshold for vacating an arbitration award, they are limited to (1) corruption, fraud, or undue influence in procuring the award; (2) partiality or corruption on the part of the arbitrators; (3) other misconduct by the arbitrators that prejudices the right of any party; or (4) the arbitrators exceeding or imperfectly executing their powers. *Fairchild Corp. v. Alcoa Inc.*, 510 F.Supp. 2d 280, 286 (S.D.N.Y. 2007), citing 9 U.S.C. § 10. The Second Circuit also provides that an award may be overturned for manifest disregard of the law. *Id.* This, however, has been called into question by a recent Supreme Court decision that maintains that the exclusive grounds for vacating an arbitral award are contained in the Federal Arbitration Act. *See Hall Street Assocs. LLC v. Mattel Inc.*, 552 U.S. 576 (2008).

23 *See, e.g., Moncharsh v. Heily & Blase*, 832 P.2d 899 (Cal. 1992).

24 *See also supra* Loss of Legal Protections.

25 *Rent-A-Center*, 130 S.Ct. at 2779.

26 *See id.* at 2778, citing *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404 (1967). *See also* n. 11–13.

27 Federal law leaves regulation of insurance matters such as these to the states. Specifically, the McCarran-Ferguson Act, 15 U.S.C. § 1011 et seq. (the Act), specifically authorizes the states to continue serving their traditional role as the regulators of the insurance industry. As the Second Circuit has held, in the wake of *Burford v. Sun Oil Co.*, 319 U.S. 315 (1943), "[t]he federal courts have abstained in numerous areas where state regulation involved matters of substantial state concern and where state policies were carried out in a statutorily established regulatory program by state officials ... the proper respect for the expertise of state officials and the expeditious and evenhanded administration of state programs counsel restraint on the part of federal courts." *Levy v. Lewis*, 635 F.2d 960, 963-64 (2d Cir. 1980) (*Burford* abstention appropriate where question involved interplay between insurance law and federal law, because federal review threatens to create incoherence and inequities in administration of state scheme); *Corcoran v. Ardra Ins. Co. Ltd.*, 842 F.2d 31, 36 (2d Cir.1988) ("[Abstention pursuant to *Burford* is designed to avoid federal court interference with specialized ongoing state regulatory schemes ..."). As the Second Circuit further held in *Alliance of American Insurers v. Cuomo*, 854 F.2d 591, 599 (2d Cir. 1988), the *Burford* rule applies in situations where it is prudent for a federal court to refrain from interfering in cases presenting state law issues relating to complex state regulations where the federal court decision may disrupt important state policies. Such abstention is appropriate when a federal case presents a difficult issue of state law, the resolution of which will have a significant impact on important state policies and for which the state has provided a comprehensive regulatory system with channels for review by state courts or agencies. In short, federal courts should "abstain from interfering with specialized, ongoing state regulatory schemes." *Id.* (quoting *Levy*, 635 F.2d at 963.)

28 *See supra* n. 20.

29 *See* UNDROIT Principles of International Contracts 2004, Article 4.6 Contra Proferentem Rule, available at http://www.unidroit.org/english/principles/contracts/main.htm. "If contract terms supplied by one party are unclear, an interpretation against that party is preferred."

30 *See* JAMS Optional Arbitration Appeal Procedure, available online at http://www.jamsadr.com/rules-optional-appeal-procedure. Judicial review may be difficult to obtain; however, some arbitral institutions offer a form of appellate review. Although it is difficult to ascertain the usefulness of internal review by an arbitration institution, some meaningful review is better than none at all.

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