Unlocking horns

Do trade credit insurance disputes have to end up in court? Arbitration is less expensive, and could be more effective, say Peter Halprin and Vivian Michael

How many times has the refrain, 'see you in court' featured in American movies and television dramas? In reality, the threat often rings hollow. Many real world contracts require the use of an alternative method of dispute resolution such as arbitration, mediation, or even a hybrid of the two.

Arbitration is a creature of contract. This means that parties agree to arbitrate, and to forego the use of national courts, in their transaction documents. Although it can take a number of different forms, arbitration is a process by which parties consensually submit a dispute to a private, non-governmental decision-maker, for a binding decision.

National courts are highly deferential to arbitration awards and generally find arbitration agreements, with a few exceptions, to be enforceable. In trade credit and trade credit insurance disputes, the enforceability of such agreements has been widely recognised. Courts will sometimes go to great lengths to allow a dispute to proceed in arbitration.

In one such dispute involving a trade credit insurance policy, a federal court in the US permitted an arbitration to go forward despite some seemingly contradictory dispute resolution language, because an executive of a grain merchandising company (the policyholder) closely read the insurance policy and made no comments on the arbitration provision. The decision compelled the company to arbitrate the dispute in London, even if that was not the company's intent when it signed the contract.

Given that an arbitration provision is likely to be enforced, the question facing anyone negotiating an agreement containing such a clause is whether the advantages of arbitration outweigh the disadvantages. A related question is whether the arbitration clause can be tailored by negotiation to maximise the advantages while minimising the disadvantages.

The advantages of arbitration

There are a number of perceived advantages to arbitration over litigation, including finality and enforceability, party autonomy and procedural flexibility, neutrality, and confidentiality.

'Finality' refers to the fact that arbitration decisions are final and binding and that there are very limited grounds to challenge an arbitration award in national courts. In addition, the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, which counts more than 150 countries including the US and the UK as signatories, provides for mutual recognition and enforcement of arbitral awards by contracting states, and limits the defences that may be raised in opposition to an award.

From a practical perspective, the enforceability of awards, and the general lack of an appeal mechanism or grounds to challenge an award, means a reduction in litigation costs and delays.

Autonomy and procedural flexibility

Arbitration is very much customisable. The parties have broad freedom to agree on the laws, procedures and rules applicable to their disputes. Used properly, this advantage can save time and money, avoid headaches, and even improve the process.

For example, the parties can agree to a limited exchange of documents and an expedited schedule to reduce costs and get an immediate ruling. This flexibility is particularly useful where companies have an ongoing relationship, in which a number of disputes are anticipated, such as in a long-term material supply contract. It also works well when a firm wants to resolve matters quickly without harming a relationship.

Particularly in international contracts, there is a fear of being hauled into court in someone else's backyard, granting them home-field advantage. Arbitration gets both parties out of such a scenario by bringing disputes to a neutral venue. This is particularly important in trade finance deals, as financial institutions participating in emerging markets may be particularly keen to avoid going to national courts in such markets, where local judges or juries may not look favourably upon the foreign financial institution in such disputes.

Disadvantages of arbitration

The confidentiality of the procedure depends both on the jurisdiction and stage of the proceedings, and may be particularly important for those using sensitive pricing models or algorithms in transactions.

Given these manifold benefits, there would seem to be little reason to avoid arbitration. The reality, however, is that each potential advantage has a flipside, leading many on the buy side of such contracts, such as insurance policyholders, to seek to negotiate arbitration out of agreements where possible.

Finality and enforceability can limit a party's recourse in the event of an unfair decision. For example, an error by an arbitrator in applying the law generally will not provide grounds for vacating an award. By contrast, the misapplication of the law generally provides grounds for reversal in US appellate proceedings.

Party autonomy and flexibility, as well as neutrality and confidentiality, may result in a lack of legal protections, particularly where a party to the arbitration agreement lacks bargaining power. For example, the rules can be set up in such a way so as to favour one side over the other. This often comes up in the insurance context, as arbitration provisions drafted by insurance companies may eliminate the doctrine of legal construction which favours the policyholder's interpretation of a disputed policy provision if it is deemed ambiguous. This doctrine of construction is critical to levelling the playing field in insurance coverage litigation, as policy provisions are often opaque.

> **"While other issues may seem more important in the heat of negotiations, the wrong dispute resolution mechanism can be very costly"**

In the words of one American court:

"Insurance companies could prepare policies in clear, simple and precise language which would inform insureds of the limits of their coverage. Insurance companies could avoid the risk of ambiguity if they use short and precise words and short and simple sentences to express their intent clearly. In spite of continued admonitions of the courts to get rid of such language, insurance companies continue to issue such policies using insurance jargon and verbose and meaningless generalities, all of which result in ambiguities."

In a 2013 trade credit insurance dispute in the US federal court, the relationship between the policy terms 'insured debt' and 'endorsed credit limit' was unclear, and the parties offered little evidence of their intent and understanding. As such, the court declined to grant judgment, without trial, to either party. You can imagine a scenario in which an arbitration panel, freed from burdensome evidentiary standards and from doctrines of construction that favour the policyholder, would construe such ambiguous language in the insurance company's favour.

An arbitration provision which specifies who may serve as an arbitrator, or what law will apply, can stack the deck against one party. For example, while a general provision might allow parties to a trade credit dispute to utilise arbitrators with the proper knowledge of the particular finance instruments, a dispute with an insurance company might call for arbitrators to be current or former insurance company executives. It goes without saying that even a sophisticated financial institution might be concerned about having its insurance dispute resolved by current or former industry executives.

Likewise, confidentiality can hurt a policyholder's settlement leverage, which can reside in the precedential value of an adverse ruling against commonly used policy language. As long as rulings on such language remain confidential, the insurance company can feel free to take inconsistent positions as to its meaning.

See you in arbitration?

The practical takeaway here is simple: ignore the dispute resolution provision at your peril. Trade credit policyholders should work with counsel to develop a dispute resolution mechanism that benefits both parties, or is neutral, so as to permit both sides to have a full and fair airing of any issues. While other issues may seem more important in the heat of negotiations, the wrong dispute resolution mechanism can be very costly.

Alternatively, if one prefers to be in national courts, one can seek to draft a dispute resolution mechanism which calls for the use of national courts or even a draft which contains no dispute resolution mechanism (although that leaves any court with jurisdiction as a possibility). If both parties have confidence in the forum, it may be easy to get agreement to do so. And, if that happens, saying "I'll see you in court," won't sound like an empty threat. TFR

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When arbitration streamlines

An apparel exporter was seeking resolution of three trade credit insurance claims with three different insurance companies and aiming to obtain payment before the end of the fiscal year. Outside counsel was the same on both sides in all proceedings, which hinged on one core coverage issue. Arbitration rules afforded counsel on the two sides the flexibility to agree to eliminate the use of pleadings in more than one case, expediting resolution.

When arbitration stalls

A trade credit insurance policy sold in Bermuda typically calls for ad hoc rather than institutional arbitration. A financial institution pursuing a claim under such a policy ran aground when the arbitrator proved unresponsive, taking the better part of a year to rule on a discovery motion. In institutional arbitration, the policyholder would have had recourse to a case administrator rather than having to risk alienating the arbitrator with repeat requests for a ruling. That said, although institutions are putting more pressure on arbitrators to provide timely rulings, this remains an area of frustration for many users.