Comparing Policyholder Arbitrations with Reinsurance Arbitrations

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In the last twenty years, arbitration proceedings have been on the rise in disputes not only between direct policyholders and insurers (policy arbitrations) but also between insurers and reinsurers and between reinsurers and retrocessionaires (reinsurance arbitrations). Although there are differences between the two categories of arbitrations, there are more similarities than differences. This article reviews, primarily based on personal experiences of the authors, key areas of similarities and differences between the two categories of arbitrations. This article will consider only policies and reinsurance agreements that cover U.S. based risks.

A. Arbitration Provisions

1. **Policy Arbitrations:** In the United States, many states still do not permit arbitration provisions in policies issued by admitted insurers, particularly for personal lines policies. Some states take a middle ground and permit arbitration only for limited purposes such as valuation of the loss of the covered property in a property insurance policy.

Even though there is strong Supreme Court precedent requiring enforcement of arbitration provisions under the Federal Arbitration Act ("FAA"),[1] practitioners must be sensitive to other laws that could trump the FAA. For example, courts have held that when a State affirmatively prohibits or restricts arbitration provisions, the McCarran Ferguson Act[2] not only grants a State primary regulatory authority to govern the business of insurance but also will "reverse-preempt" the FAA, thus permitting the State prohibition or restriction.[3] On the

[1] *See, e.g., American Express Co. v. Italian Colors Restaurant,* 570 U.S. 228 (2013) (enforcing arbitration provision that prohibited class actions in an antitrust dispute even though the pursuit of an individual claim would not be financially viable or justifiable for an attorney to pursue.)

[2] 15 U.S.C. § 1012(b) (providing that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance …unless such Act specifically relates to the business of insurance…").

[3] *See, e.g.*, *Standard Security Life Insurance Co. v. West*, 267 F.3d 821 (8th Cir. 2001) (declining to enforce an arbitration clause in a sports injury policy that was prohibited by Missouri statute governing the business of insurance); *Continental Ins. Co. v. Equity Residential Properties Trust*, 565 S.E. 2d. 603 (Ga. App. 2002). *See also,* R.I. Gen Laws § 10-3-2 (1998) (providing that insurer has the option to arbitrate as follows:

other hand, courts have enforced arbitration clauses in insurance policies in the absence of any state regulation or statute specifically prohibiting or restricting the arbitration agreement.[4]

By contrast, it is not uncommon for excess and surplus lines policies issued to commercial entities to contain an arbitration clause. The permissiveness in the commercial risk context reflects a lower regulatory and public policy concern than in the personal lines arena. For example, in the standard Bermuda Form for excess insurance policies and in London market policies, an arbitration clause is common. Arbitration clauses are now found in many types of policies like D&O, E&O, employment liability, and cyber liability.

2. **Reinsurance Arbitrations:** Reinsurance arbitration clauses are used generally by most reinsurers. The authors, in their experience, have never seen a reinsurance agreement without an arbitration clause. The range of detail in arbitration provisions vary from the sparse (providing few provisions) to the comprehensive (containing numerous topics).

Older arbitration clauses were quite sparse (and at times consisted of a simple notation like "Arbitration"-without more-in the cover notes between the insurers). Indeed, arbitration clauses often did not select arbitration rules, were not administered by any organization, called for two party appointed arbitrators and one umpire, and mandated experience requirements of all sorts (i.e., present or former executive or lawyer in the insurance industry for a requisite number of years). Arbitration clauses in some older agreements sometimes made reference to an arbitration organization (or its rules) that no longer existed or had a name change.

The more recent arbitration clauses lean toward a more comprehensive provision. They may (or may not) adopt arbitration rules, require particular experience of the arbitrators, specify administration by a particular arbitration organization, mandate choice of law, impose time frames to issue a final award, set forth rules for discovery, and define a broad scope of arbitrable issues. Even today, however, there are reinsurers using arbitration clauses that contain no arbitration rules for the panel to follow or provide for administration by an arbitration organization. In such "no rule" arbitrations, arbitrators must fashion their own procedures "on the fly" (which often trigger resistance from counsel and present challenges to obtaining desired party consent).

> "*…and provided further, that in all contracts of primary insurance, wherein the provision for arbitration is not placed immediately before the testimonium clause or the signature of the parties, the arbitration procedure may be enforced at the option of the insured, and in the event the insured exercises the option to arbitrate, then the provisions of this chapter shall apply and be the exclusive remedy available to the insured.*")

[4] See, e.g., *Monarch Consulting, Inc. v. National Union Fire Ins. Co*, 26 N.Y. 3d 659, 47 N.E. 3d 463, 27 N.Y.S. 3d 97 (upholding enforcement of arbitration clause in workers compensation policy payment agreement, because the State of California did not prohibit the use of this clause).

B. Arbitration Rules / Organization/ Arbitrator Selection

1. **Policy Arbitrations:** Arbitration provisions differ significantly among policies. Bermuda Form policies provide for an "ad hoc" (i.e., non-administered) arbitration, and allow policyholders the choice of the application of New York, Bermuda or English substantive law. (Most policyholders tend to choose the application of New York law). Also, though most Bermuda Form policies provide for the procedural rules of the British Arbitration Act of 1996 (along with situs in London), others provide for the Bermuda Arbitration Act (with situs in Bermuda).[5] Various London market and other excess and surplus lines policies frequently provide for application of New York law under the arbitration rules published by either the American Arbitration Association ("AAA"), Center for Conflict Prevention and Resolution ("CPR"), Federal Arbitration Inc. ("FedArb"), or JAMS.[6] Finally, policy arbitrations can be, at times, non-administered, though usage in the industry leans toward administered proceedings by organizations like the AAA, FedArb and (recently) CPR. [7]

Of more recent vintage, certain policies (and arbitration rules) now provide additional and optional procedures (if mutually acceptable to the parties) for mediation (conducted by a mediator not on the panel of arbitrators) and "one" appeal (conducted by different arbitrator or arbitrators not on the panel that conducted the trial).

Most policy arbitration clauses provide for a panel of three arbitrators, with each side to select an arbitrator and the two selected arbitrators then selecting the panel Chair. In case of a deadlock when selecting a Chair, the Bermuda Form policies provide for selection by lots or by petition to the High Court of Justice of England & Wales.[8] Under the AAA, CPR or FedArb rules, the deadlock can be resolved by the arbitration organization through methods including

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[5] For references on the Bermuda Form policies and arbitrations*, see* Richard Jacobs, Lorelie Masters and Paul Stanley, Liability Insurance in International Arbitration: the Bermuda Form (Second ed. 2011); Davd Scorey, Richard Geddes and Chris Harris, The Bermuda From: Interpretation and Dispute Resolution of Excess Liability Insurance (Oxford University Press 2011); Leon B. Kellner and Vivek Chopra, *Bermuda Form Arbitration: a policyholder perspective* (Perkins Coie LLP ARIAS-US Fall 2017 Conference); Mina Matin, *The Bermuda Form Arbitration Process: A Glimpse Through the Insurer's Spectacles* (Norton Rose Fulbright LLP ARIAS-US Fall 2017 Conference).

[6] AAA rules can be found at adr.org, CPR rules can be found at cpradr.org, Federal Arbitration rules can be found at FedArb.com, and JAMS rules can be found at jamsadr.com.

[7] The standard FedArb arbitration rules provide for the application of the Federal Rules of Civil Procedure except as modified by agreement of the parties.

[8] British Arbitration Act of 1996 § 18.

appointment by the arbitration organization, circulation of a list of additional candidates, a drawing by lots, or other agreed method. Various State arbitration statutes and the Federal Arbitration Act allow deadlocked parties to petition the court for appointment of arbitrators.[9]

2. <u>Reinsurance Arbitrations</u>: Historically, the reinsurance industry resolved disputes "the old fashion way" with a gentleman's handshake. As common as the practice may have been, the older insurance agreements did contain arbitration clauses but were rarely invoked.

Older clauses were sparse in content. Often times, the reinsurers and retrocessionaires, as well as the insurers and reinsurers, signed cover notes with no treaty or facultative agreement. The cover notes contained the general terms of the agreement. The cover note would make reference to mandatory arbitration and the selected forum but would omit inclusion of the arbitration clause (the intent being to formalize the agreement at a later date, which sometimes did not happen).

In the last twenty years, however, two events have contributed to significant changes, ranging from one extreme (on how to avoid arbitration entirely) to another extreme (on how to exploit drafting more comprehensive arbitration clauses). First, there has been increased discontent over perceived disadvantages, monetary expenditures, and procedural limitations encountered in arbitrations. Second, our society has become more litigious, thus, spurring (not surprisingly) more detailed arbitration clauses.

Older agreements tended not to define the scope of arbitrable issues. This omission triggered inevitable litigation in court as to whether specific issues in dispute were even arbitrable. As more recent arbitration clauses specifically provided for broad all-inclusive scope of authority and arbitrable issues, litigation concerning the scope of arbitrable issues has been waning. The trend in more modern arbitration clauses show preference in maximizing not only the scope of arbitrable issues, but also the authority of the arbitrator (now including jurisdiction to resolve not only whether any claim is arbitrable under the arbitration clause but the jurisdiction of the panel too).[10] Some arbitrators obtain at an organization meeting or preliminary hearing mutual consent of the parties to reaffirm or expand the scope of arbitrable issues and authority of the arbitrator to resolve additional issues.

In an effort to improve the effectiveness of arbitration, reinsurers have taken steps to improve arbitration clauses (or to appease the never-ending drafting by corporate attorneys who never litigated). These steps include, among others, language specifying a time frame for issuing an award, specifying the arbitration rules that apply, requiring proceedings to be

[9] Federal Arbitration Act § 5.

[10] *See, e.g.,* Rule 7(a), AAA Commercial Arbitration Rules and Mediation Procedures (including Procedures for Large and Complex Commercial Disputes), effective October 1, 2013, stating that the "Arbitrator shall have the power to rule on his or her own jurisdiction, including…the existence, scope, or validity of the arbitration agreement or to the arbitrability of any claim or counterclaim."

administered by arbitration organizations, relying on arbitration organizations to supply a list of qualified arbitrators, requiring all arbitrators to be neutral, mandating qualified arbitrators from a recognized arbitration organization, and expanding the scope of arbitrable issues (like fraud in the inducement, rescission, void or voidable, enforceability, attorney fee award, other agreements between the parties that either do not have arbitration clauses or provide for a different forum, and third parties related to the dispute).

More recently, some reinsurers started to experiment with requiring mediation prior to an arbitration proceeding. The AAA now has a rule that requires mediation, but either party may opt out.[11] ARIAS-US also has a voluntary mediation program.

Today, reinsurance agreements at times contain comprehensive arbitration clauses that are more than one page long. These lengthy clauses cover a host of issues in an attempt to be all-inclusive. Often times, the effort is not as productive as it was intended. The drafter (under a time or budgetary constraint) may neglect to read the designated organization's rules, may draft rules that are either duplicative or confusing, and may create (unwittingly) expensive procedures. Other times, the rules are too restrictive by requiring arbitrators to issue an award within sixty days of the appointment of a three member panel, mandating no depositions under any circumstances (which can help settle a case), and denying the use of expert witnesses or forensic accountants (thus complicating resolution). In fairness to the drafter, it is simply not possible to predict the nature and complexity of issues that can arise many years after signing a reinsurance agreement.

In an effort to reduce the cost of a panel of three arbitrators, the AAA recently has adopted a new rule granting the parties full flexibility to agree to designate a single arbitrator (typically the chairperson) to be the sole decision maker for (a) part or parts of the proceeding, (b) the entire proceeding (and if agreed by the parties, even the final hearing and issue of the final award), (c) all issues up to the final hearing (and then the entire panel participates and issue the final award), (d) issuance of one or more partial awards, and (e) all issues (including dispositive motions on the merit) up to the final hearing and issue of final award.[12] The rule is sufficiently

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[11] Rule 9, AAA Commercial Arbitration Rules and Mediation Procedures (including Procedures for Large and Complex Commercial Disputes), effective October 1, 2013, stating that, in disputes involving a claim or counterclaim in excess of $75,000, the parties must mediate during the proceeding, unless either party opts out. Any party has the right to opt out.

[12] "Streamlined Three-Arbitrator Panel Option for Large Complex Cases" issued by the AAA (stating that this rule "*allows parties to take advantage of this by utilizing a single arbitrator to manage the early stages of the case, decide issues related to the exchange of information and resolve other procedural matters without incurring the costs associated with the entire panel. The AAA has found that a three-arbitrator panel can actually cost five times as much as a single arbitrator. By maximizing the use of a single arbitrator, the parties will be able to capitalize on the cost savings provided by a single arbitrator while still preserving their right to have the case ultimately decided by a panel of three arbitrators.*"

flexible so as to allow the parties to adopt this procedure mid-stream of the proceeding. Doing so basically eliminates the fees of two arbitrators and maximizes the flexibility and speed with which a single arbitrator (who is truly dedicated and responsive) can take action.

C. Neutrality of the Arbitrators

1. Policy Arbitrations: Neutrality of arbitrators is a key ingredient in policy arbitrations. All of the Bermuda Form, AAA, CPR, JAMS and FedArb rules require that all arbitrators (including the party appointed arbitrators) must be neutral, impartial and independent, unless the parties specifically agree otherwise. Ex parte communications with the arbitrators, excepting initial communications to select a party appointed arbitrator, to discuss the availability or qualifications of a candidate, or to select the panel Chair generally are prohibited.

2. Reinsurance Arbitrations: Traditionally, once a party provides the other with an arbitration notice, each side has a short window of about thirty days to appoint an arbitrator, and then the two arbitrators select an umpire. Unless the parties agreed otherwise, the party appointed arbitrators are not expected to be neutral; the selected umpire will be the sole neutral arbitrator.

The newer arbitration clauses are more comprehensive but still provide for two party appointed arbitrators, who in turn appoint the umpire. The clauses generally provide no guidance on the extent to which *ex parte* communications are permissible or prohibited by party appointed arbitrators. Restrictions and prohibitions can be imposed; (a) if the governing arbitration rules contain restrictions and prohibitions, (b) if the parties agree to require all arbitrators to be neutral from inception, or (c) if the parties agree that the two party appointed arbitrators must refrain from *ex parte* communications either before or even after the initial organization meeting or preliminary hearing.

For example, the AAA rules provide, unless agreed otherwise, that the party appointed arbitrators shall not engage in communications with the appointing party and that the parties must communicate with the entire panel with a copy to all parties. The ARIAS-US rules allow for *ex parte* communications up to certain points in the proceeding or as established in or after the initial organization meeting.

Recently, ARIAS-US adopted Neutral Panel Rules that require three neutral arbitrators and prohibit *ex parte* communications. Also, more members of ARIAS-US are suggesting that the practice of party appointed arbitrators permitting *ex parte* communications is creating friction and controversy in arbitrations that detracts from the desire of a fair and unbiased award. The concern is that allowing a party appointed arbitrator to campaign and watch out for the interests of the appointing party not only injects bias (where unbiased decision makers are desired) but also invites secret conferences between a party appointed arbitrator (who has a vested financial interest to be selected for future panels) and the attorney representing the appointing party (almost suggesting that counsel is unable to represent the client competently without discussing the “inside scoop”).

D. Initial Organizational Conference, Scheduling, Pre-Hearing Disputes

1. <u>Policy Arbitrations</u>: In policy arbitrations, the arbitrators will hold an initial organizational conference with counsel for all parties to address the pre-hearing schedule, scope of discovery, pre-hearing briefing, exchange all exhibits intended to be used at the final hearing, witness statements, expert reports, witness list, rebuttal witness statements, expert reports, and rebuttal expert reports, and often even the final hearing dates. The arbitrators, after typically maximizing agreement on all subjects with counsel, will issue a procedural order that should outline all agreed subjects and matters that remain open for resolution. In Bermuda Form arbitrations under the British Arbitration Act of 1996, the initial order is called the Directional Order No. 1. Under the AAA rules, it is often called Procedural Order No. 1 or Scheduling Order for Final Hearing.

Unless otherwise agreed by the parties, discovery is limited. In Bermuda Form arbitrations, discovery will generally be limited to "standard disclosures" of documents to be relied upon or that adversely affect one's position, which can be supplemented by limited specific requests for categories of relevant documents. Depositions are generally not permitted.

Although no depositions are permitted generally under AAA and ICDR Rules, under certain circumstances they are permitted to preserve evidence. There has been a growing trend over the past fifteen years to permit depositions on a limited basis upon insistence by counsel. FedArb and JAMS rules permit at least a limited number of depositions, unless otherwise agreed by the parties. This trend evidences the difficulties that counsel often have handling litigation without the use of depositions.

Under the International Bar Association (IBA) Rules on the Taking of Evidence in the International Commercial Arbitration, the parties must disclose all documents "relied upon" and allows each party to request specified additional categories documents. Discovery disputes are often resolved using a Redfern Schedule that requires the party to identify the document sought in one column of the Schedule, justify relevance in the next column, the other party to list the objection in another column. The arbitrators will then rule on the requests and objections and note their ruling on the final column of the Redfern Schedule.[13]

In Bermuda Form arbitrations, pre-hearing submissions begin with the filing of original pleadings in the form of a Statement of Claim and a Statement of Response (often containing both defenses and counterclaims). Typically, at the preliminary or organizational hearing, the parties are allowed to amend their initial filings. Similar procedures are required under arbitration rules of the other major organizations, although the names of the pleadings differ.

[13] IBA Rules on the Taking of Evidence In International Arbitrations at Art. 3 (Documents)

Disputes can be raised by motion by either party at or after the initial organizational conference. Experienced arbitration panels will ask the parties to confer and attempt to agree on all pre-hearing disputes prior to seeking panel resolution of the issue.

2. Reinsurance Arbitrations: The procedures governing reinsurance arbitrations are substantially similar to those governing policy arbitrations. The issues litigated in reinsurance disputes, if concerning a pool of risks, will entail complex interaction of coverage, annual caps, and year in which the loss is incurred. The complexity escalates as the number of reinsurers and retrocessionaires participating in the pool, the number of tiered excess loss coverages, the differing annual caps among the policies for different years, the allocation of loss payments among different years and different excess layers, and the years of coverage in question increase.

E. Manner of Proof

1. Policy Arbitrations: It is the general practice in Bermuda Form and many AAA, CPR, and FedArb arbitrations for witness statements and expert reports to be submitted in advance of the hearing. These statements and reports often are provided in lieu of direct testimony of any witness or expert. Typically, the arbitrators will allow the proffering party to elicit some summary live direct testimony to introduce the witness before cross examination. Then cross examination and re-direct will follow. FedArb follows the Federal Rules of Evidence absent the parties agreeing otherwise. Bermuda Form arbitrations are conducted under either the British or Bermuda Arbitration Acts, which often are selected depending on London or Bermuda being the chosen situs. AAA, CPR and JAMS arbitrations have some simple rules to follow, but they do not require application of strict rules of evidence. International commercial arbitrations often are guided by the IBA Rules on the Taking of Evidence.

2. Reinsurance Arbitrations: The procedures for reinsurance arbitrations are substantially similar to those applicable in policy arbitrations, where strict evidentiary rules are disregarded.

F. Rules of Policy Construction

1. Policy Arbitrations: The Bermuda Form generally provides that policies shall be construed in an "even handed fashion" and precludes use of the *contra-proferentum* (construction against the drafter) doctrine or "reasonable expectations" doctrine (what a policyholder should reasonably expect). It also prohibits "parol or other extrinsic" evidence for policy construction. None of the AAA, CPR, FedArb or JAMS provide any specific rules for policy construction. FedArb arbitrations would simply follow the Federal Rules of Evidence unless the parties agree otherwise.

2. Reinsurance Arbitrations: The "traditional" theme in reinsurance arbitrations leans toward informality and away from strict rules of law. Reinsurance arbitration clauses generally contain language that encourage custom and practice over the application of the law. For example, arbitration clauses containing the following text are quite common (but are being

replaced by a new generation of corporate counsel that do not share the same or experience traditional values):

> *This contract [or arbitration provision] is an honorable engagement, and the panel shall not be obligated to follow the strict rules of law or evidence. In deciding the award, the panel shall [or may] apply the custom and practice of the insurance and reinsurance business.*

There is a new crop of reinsurance agreements that specifically disavow application of "follow the fortune" doctrine. This doctrine is being replace by a complicated host of rules that trigger noncoverage in the event of noncompliance by the reinsured entity. This change will impact significantly the traditional "follow the fortune" analysis that has existed for more than a century.

H. Relief and Award

1. **Policy Arbitrations:** The Bermuda Form allows for coverage of punitive damage awards against a policyholder, and its New York choice of law provision specifically excludes any prohibition on such coverage. [14] The arbitral panel is also empowered to award to the prevailing party recovery of all costs, including reasonable attorney fees, under English (or Bermuda) law applicable to Bermuda Form arbitration procedure, as well as under most arbitration organization rules for other policy arbitrations. Unless specifically agreed by the parties, there is no rule regarding punitive damages coverage in AAA, CPR, FedArb or JAMS arbitration rules, but arbitrators acting under those rules are permitted to award attorney fees and costs among or between the parties. Parties in policy arbitrations can choose either a reasoned award, full award, or standard award. Reasoned awards tend to be the preferred choice.

2. Reinsurance Arbitrations: Often the reinsurance treaty or agreement relieves the reinsurer from any bad faith, punitive or exemplary damages (extra-contractual liability) that the insurer may have paid the insured in a judgment or settlement. The arbitration clause generally would not cover this issue. Instead, the reinsurance agreement typically contains a separate clause that preclude indemnity by the reinsurer to the ceding insurer for such damages. The arbitration clause, however, may contain a provision that strips the arbitrator of authority to grant the insurer or the reinsurer any entitlement to bad faith, punitive, or exemplary damages either as between the reinsurer and the insurer or between the insured and the insurer. Such a provision would seem to ensure consistency between (a) the terms of the reinsurance agreement and (b) the scope of authority of the arbitrator and the scope of arbitrable issues. One might ask whether such limitations could be challenged, when the arbitration clause contains language that permits the panel to interpret the agreement as a "gentleman's engagement" and to disregard strict rules of law or evidence (and follow industry custom and practice), where the conduct of a culpable party was egregious.

[14] Bermuda Form Policy, Condition O.

G. Confidentiality

1. **Policy Arbitrations:** Arbitrations under the Bermuda Form will be confidential pursuant to the British Arbitration Act of 1996 and British common law for London chosen situs, and the Bermuda Arbitration Act for Bermuda chosen situs. Although the scope may differ as enforced in the United States, confidentiality is the general practice. By contrast, although confidentiality is not strictly mandatory under AAA, CPR, FedArb and JAMS rules, the arbitrators have authority to order confidentiality for particular materials presented in the proceeding and generally conduct private proceedings that are not open to the public. Typically, the parties agree as to confidentiality in either the arbitration provision or in the initial procedural hearing. Although hearings are private, the parties often engage a court reporter and order transcripts when desired. Confidentiality as to any award often ends as a practical matter, if the final award must be filed in court to seek its enforcement.

2. Reinsurance Arbitrations: The rules on confidentiality will differ among the arbitration clauses adopted, and often the parties submit to the panel an agreed order for entry. The hearings are not open to the public, and in this sense, all hearings are private. Confidentiality provisions in reinsurance agreements are not customary and are rarely seen in arbitration clauses.

H. Conclusion

In summary, there are more similarities than differences between policy and reinsurance arbitrations. Nevertheless, differences do exist. Should ARIAS-US seek to develop a policy arbitration procedure, the procedures should consider State restrictions and limitations where permitted, be fair to the policyholder, promote neutrality of the panel, and grant the panel maximum authority to resolve all issues that can arise.