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Arbitration Clauses Can Make Dispute Resolution Arbitrary

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The outcome of an arbitration can be determined by choice-of-law provisions and other clauses that dictate who may serve as an arbitrator and how the proceedings must be conducted. This is particularly true in the context of insurance coverage litigation, which often turns upon which state's substantive law applies and on such state's established doctrines of insurance policy interpretation. As a result, policyholders in different states who are sold the same policies do not necessarily have the same coverage.

While this article focuses on arbitration clauses in insurance policies, the principles discussed apply broadly. Parties to any agreement containing an arbitration clause must pay careful consideration to the law applicable to the agreement, as well as any clauses regarding the construction and interpretation of the agreement.

Below, we focus on four provisions generally found in insurance and reinsurance agreements that can fundamentally alter the nature and outcome of a dispute.

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Rules Of Contract Interpretation

The selection of a substantive law governing a contract, including an insurance policy, often dictates the outcome of a dispute. In the insurance context, many insurance policies, including the so-called Bermuda Form policies popularized by Bermuda-based insurance companies, contain a Governing Law and Interpretation provision, which not only dictates the applicable law, but also modifies that law in favor of the insurance companies. One such commonly used clause provides as follows:

> This Policy shall be governed by and construed in accordance with the internal laws of the State of New York, except insofar as such laws may prohibit payment in respect of punitive damages hereunder; provided, however, that the provisions, stipulations, exclusions and conditions of this Policy are to be construed in an even-handed fashion as between the Insured and the Company; without limitation, where the language of this Policy is deemed to be ambiguous or otherwise unclear, the issue shall be resolved in the manner most consistent with the relevant provisions, stipulations, exclusions and conditions (without regard to authorship of the language, without any presumption or arbitrary interpretation or construction in favor of either the Insured or the Company and without reference to parol evidence).

At first blush, the inclusion of New York substantive law would provide comfort to practitioners who are familiar with New York law, particularly where the alternative jurisdictions are foreign and unfamiliar. However, in the insurance context, New York law is favorable to insurance companies in many respects when compared to that of most other states. Indeed, New York law can be quite draconian on many issues, including its general refusal to recognize a claim for bad faith that can be effectively prosecuted by corporate policyholders.

Note that the clause not only requires the application of New York law – it also, modifies New York law by requiring construction of the policy on an "evenhanded" basis. While such a construction can make sense in the context of a carefully negotiated commercial agreement between parties of equal bargaining power, New York law recognizes that insurance companies draft insurance policies with little input from the policyholder -- and, therefore, courts applying such law typically construe ambiguities against the drafter. *See*, *e.g.*, *Westchester Resco Co. v. New England Reinsurance Corp.*, 818 F.2d 2, 3 (2d Cir. 1987) ("[W]here an ambiguity exists in a standard-form contract supplied by one of the parties, the well-established contra proferentem principle requires that the ambiguity be construed against that party. In particular, New York law, which the parties agree governs here, recognizes a general rule that ambiguities in an insurance policy are to be construed strictly against the insurer."). Thus, the requirement of "evenhandedness" ignores the settled rules of contract interpretation, which are based on logic and fair-

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ness. Moreover, the clause prohibits parol evidence on the intended meaning of a policy provision. Accordingly, this clause demonstrates the need for parties seeking to arbitrate disputes to pay close attention to the specific wording of the arbitration clause and any related language pertaining to the laws applicable to the dispute.

Making Application Of Legal Rules Optional

Some insurance policies contain arbitration provisions that arguably permit the arbitrators to render a decision with limited attention to applicable law. One such provision, common to many agreements with this language, provides in pertinent part as follows:

> The Arbitrators and Umpire are relieved from all judicial formality and may abstain from following the strict rules of law. They shall settle any dispute under this Agreement according to an equitable rather than a strictly legal interpretation of its terms.

This clause, which can accompany governing law provisions, arguably nullifies such provisions, as it permits the Tribunal to abstain from following the strict rules of law. In addition, to the extent that there are equities at issue in a dispute, the clause arguably permits the Tribunal to ignore applicable law and to decide the dispute on an equitable basis.

Note that an arbitration award is subject to very limited judicial review. *See Telenor Mobile Communications AS v Storm LLC*, 584 F.3d 396, 405 (2d Cir. 2009). In fact, mistake in application of the law is not a ground for challenging an arbitration award; rather, it must be shown that the arbitrators "exceeded their powers" or (at least in those courts that recognize the doctrine) that the arbitrators demonstrated "manifest disregard of the law."

Turning A Dispute Into An Honourable Engagement

Related to the prior language, some arbitration agreements, particularly in the reinsurance context, contain a so-called Honourable Engagement clause, with language such as the following:

> The Arbiters shall consider this Agreement an honourable engagement rather than merely as a legal obligation and they are relieved of all judicial formalities and may abstain from following the strict rules of law.

While the Honourable Engagement clause is similar to the "equitable basis" clause discussed in the prior section, we note it separately as it has been specifically noted that such clauses "have [been] read generously [by courts], [with courts] consistently finding that arbitrators have wide discretion to order remedies they deem appropriate." *See Banco de Seguros del Estado v. Mut. Marine Office, Inc.*, 344 F.3d 255, 261 (2d Cir. 2003). Indeed, in the reinsurance industry, as in other industries where such clauses may be present, arbitrators often look to industry trade practices in reaching their decision.

Imposing Qualifications On The Arbitrators

Akin to provisions altering the applicable law or the rules with which the arbitrators may employ (or ignore) in rendering a decision, provisions setting forth the required qualifications of arbitrators can also tilt the playing field against a party. In the insurance context, for example, qualifications provisions often begin as follows:

> The arbitrators shall be active or retired executive officers of insurance or reinsurance companies.

Requiring all arbitrators to have served as executive officers of an insurance company would force a policyholder to present its case to arbiters who are likely to be sympathetic to the insurance industry. The provision also significantly limits the pool of qualified arbitrators. Most insurance policies include somewhat broader qualifications language to permit, for example, "active or retired Risk Management Officials in the same or similar industries or active or retired executive officials of Insurance Brokers or Insurance Agents" to serve as arbitrators. A risk management official or broker is more likely to have an understanding of a policyholder's position and to have a lesser risk of bias against a policyholder. Similarly, a qualifications provision that requires a former federal judge to serve as arbitrator can be preferable to a clause requiring the arbitrators to be current or former insurance executives. The best option, however, might be to negotiate away any such qualification so that each party has maximum flexibility in selecting an arbitrator.

Addressing Such Provisions

The foregoing provisions represent subtle ways in which seemingly innocuous arbitration provisions can, in fact, contain wrinkles that radically alter the manner in which the dispute is resolved. The governing law, rules regarding the authority of arbitrators, and the required qualifications of arbitrators are just a few examples of changes that can tilt a dispute resolution provision.

The time to address such provisions, as well as any other wrinkles in an arbitration clause, is not after a dispute has occurred but when the contract is being negotiated. To that end, an attorney negotiating a contract should pay close attention to the dispute resolution provision and, among other things, any related language concerning the interpretation of the contract and the governing law, and the authority and qualifications of the arbitrators. If such provisions are potentially unfavorable, the attorney should try to negotiate their removal or alteration.

Such provisions, however, need not be fatal to a party or policyholder's cause when a dispute arises. Experienced outside counsel can assist in-house counsel and decision-makers in navigating such provisions and prevailing in a dispute, even on a tilted playing field. Although this can be achieved, it is best to negotiate a dispute resolution clause that at the outset provides parties with a fair and neutral mechanism for resolving potential disputes.

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