Commentary

Is Arbitration A Trap For The Unwary Insurance Agency?

By
Peter H. Bickford

[Editor's Note: Peter H. Bickford is an independent counselor and arbitrator to the insurance and reinsurance markets, with particular focus on dispute resolution, solvency, regulatory, agency and operational issues. In addition to being a practicing attorney for over 30 years, he has been an officer of both a life insurance company and of a broker oriented property/casualty insurance and reinsurance facility with line responsibility for contract and claims operations. He is an ARIAS-U.S. certified arbitrator and umpire. Copyright 2007 by the author. Response articles to this commentary are welcome.]

Arbitration has been a recognized standard for resolving disputes in the insurance industry for centuries, evolving from the need for global commerce to be able to rely on standard business practices and the prompt resolution of disputes.[1] Over the past several decades, arbitration has become the preferred means of resolving disputes between insurers and their reinsurers. In this period the number of full-time reinsurance arbitrators, along with the number of law firms, consultants, and other experts specializing in this field, has skyrocketed.[2] The arbitration boom has also begun to take hold in other areas as well, such as between insurers and commercial insureds and between insurance companies and their agents, with many insurers now including an arbitration clause in their standard producer or agency agreements.

However, this expansion of the arbitration process beyond the reinsurance arena has its critics, and creates special problems for agencies that need to be considered. In his excellent article on the commercial history of arbitration and insurance,[3] Richard E. Stewart, Chairman of Stewart Economics, Inc., observed that:

> ". . . the feeling of many today [is] that insurance arbitrations work best when the dispute is between two members of the same insurance-merchant class (that is, reinsurance arbitrations) rather than between parties of different classes (that is, primary disputes between insurers and lay people)."

In reinsurance disputes, where the parties are considered to be of the same merchant class, the process generally protects both sides equally. It is this level playing field that has provided the basis for the success of arbitration between insurers and reinsurers.[4] However, arbitration as a means of resolving disputes between insurers and agencies is an imperfect solution tilted decidedly toward the insurer. This disparity is highlighted by the result of a recent arbitration in a dispute between a carrier and the program manager of a small but growing and profitable specialty program.[5] A review of this case provides some valuable insights into the arbitration process and exposes some dangers that producers, agencies and program managers should consider carefully when disputes arise with their carriers.

The Facts Of The Case

The insurance agency had created, marketed and managed a small specialty program. After several years of growth and profitability, the agency found itself in need of a new primary carrier to replace an insolvent one. A replacement carrier was found, but it insisted on its form of producer agreement and a

personal guaranty by the agency's principal.[6] The company form of producer agreement included an arbitration clause. To recognize and protect the agency's economic and ownership interest in the program, a "letter of intent" was also entered into between the agency, the new carrier and the reinsurer.

Even though the program was growing and profitable, and fully supported by reinsurance, the new carrier abruptly terminated the agency after two years because the program was not large enough for it. The agency sought an extension to give it time to secure yet another new carrier. The request was flatly denied. In addition, the carrier failed to provide complete loss runs and other reports needed by the agency to secure a new carrier. As a result, the agency was not able to obtain a new carrier except on a producer rather than on a program manager basis, and only after the loss of a significant portion of the agency's business. The agency lost over three-quarters of its business in the first year after the termination, which it claimed was a direct result of the insurance company's improper conduct.

After termination, the agency continued to service the business written through the carrier, but the carrier continually failed to provide timely reports, including reports to the reinsurer necessary for the determination of the agency's profit share. To resolve these issues and to seek compensation for the damage done to the agency and the program, the agency commenced an arbitration proceeding against the carrier pursuant to the arbitration provisions of the agency agreement. The arbitration provisions called for a board of arbitration (or panel) consisting of an arbitrator chosen by each party with the two arbitrators selecting a third arbitrator, or umpire. The agency chose a person experienced in agency issues, and the carrier designated a retired executive of a direct writing reinsurer. The arbitrators then selected as umpire a lawyer with mostly reinsurance experience but who purportedly had brokerage and program business experience.

The agency presented two witnesses at the hearing:[7] the principal and the intermediary that negotiated the original arrangement, including the letter of intent, and who sought to obtain a new carrier for the agency after the termination. The intermediary, an independent third party, corroborated all the basic elements of the testimony of the principal. The carrier presented five witnesses, none of whom having had any day to day dealings with the program or the agency until well after the termination. In other words, the corroborated testimony of the agency's principal was unrebutted. A slam-dunk for the agency! Wrong!

The Arbitration Award And Dissent

An award signed by two of the three arbitrators was issued denying all claims. As is customary in the U.S. reinsurance arbitration world, no reasons were given for this result. The third arbitrator, however, issued a dissent stating that the majority of the panel had ignored the facts, the custom and practice of the insurance/agency industry and the law, and presented a detailed reasoned analysis of the case and the errors of the majority.[8] In the cover letter forwarding the award to counsel, the umpire stated that the dissent was "incomplete and misleading" but gave no explanation for that statement.

Even without an explanation from the majority why it failed to hold the carrier accountable, agencies and program managers can learn some valuable lessons from this case thanks to the rare written analysis by the dissenting arbitrator — an analysis that should be required reading for any agency. Foremost among these lessons are the traps and pitfalls in the arbitration process that should give agencies pause in accepting arbitration as an equitable basis for resolving disputes with carriers.

Is Arbitration Unfair To Insurance Agencies?

The most obvious disparity between the insurance agency community and the insurance companies is economic. For all but a few exceptions, the companies have far greater resources to bring to bear on a dispute. This economic disparity, however, would be present in any forum for resolving disputes, including litigation, so it is understandable that most agencies would consider arbitration the smarter and safer alternative to litigation because of the perceived benefits of time and cost of arbitration over litigation. But there are other more subtle differences and prejudices in the system as it exists today, and these differences should be recognized and considered by the insurance agency community. Among these differences are:

- Arbitration clauses in use today are, for the most part, reinsurance forms that do not

recognize the differences between reinsurance and agency relationships;

- The rules of conduct of arbitration proceedings — including such things as audits, discovery, confidentiality, and the like — have evolved substantially from reinsurance disputes.

- The available community of arbitrators is composed primarily of reinsurance experts with very little experience with or knowledge of agency operations, practices and expectations;

- Many reinsurance oriented arbitrators hold themselves out as qualified to resolve disputes involving agency operations, practices and expectations — including issues of ownership, renewals, transferability and other general standards of practice — when their knowledge of and direct experience with these issues is remarkably lacking; and

- The lawyers and experts supporting the arbitration process are also substantially reinsurance oriented because that is where the work is found.

These very real and consequential differences were evident in the arbitration described above, and a brief review of these issues may help give agencies a better understanding of what they may expect in the arbitration of a dispute with a carrier.

Why Worry About The Arbitration Clause?

Small or mid-sized agencies have limited if any ability to negotiate the terms of their agreements with carriers, but even the larger agencies that may have such negotiating ability generally accept the arbitration clause as presented to them. Resolving disputes at the time of entering into a relationship with a carrier is unlikely to be anywhere near the top of the list of concerns. Besides, the arbitration clause provides a simple means of resolving disputes without litigation and by persons experienced in the insurance business. So what could be bad about that?

The arbitration clauses found in most agency agreements are modeled on clauses that have evolved in the reinsurance business over the past several decades. The most significant provision affecting agencies is the usual requirement that arbitrators must be current or retired executives of insurance or reinsurance companies. To give the appearance of fairness, some companies have added "or agencies" to this requirement. As discussed below, however, this may be of little comfort to agencies when it comes to ensuring a knowledgeable and impartial panel.

Another common problem with the language is that companies usually designate that the location of the arbitration will be where their main offices are located, often forcing a local agency to travel to a foreign jurisdiction to pursue its claims. Similarly, the provision may call for the application of the laws of a jurisdiction other than the jurisdiction in which the agency conducts its business, placing it at a disadvantage in presenting its local customs, practices and expectations.[9]

The main issue for agencies asked to accept an arbitration clause is to make sure that it provides a reasonable method for the selection of a panel with knowledge of and experience with agency business, and that the process called for in the clause will not be unduly burdensome. Of course, the clause itself cannot ensure this result.

Should Reinsurance Arbitrations Define All Insurance Industry Arbitrations?

The answer would seem to be an obvious "of course not." But the booming reinsurance arbitration business has exerted tremendous influence over other insurance industry disputes. Nowhere is this more evident than in the development of "professional" insurance arbitrators and the standard forms and codes of conduct that have emerged.

An example of this growth and development is the development of organizations like ARIAS-U.S., a not-for-profit corporation with a stated objective of "promote[ing] the improvement of the insurance and reinsurance arbitration process for the international and domestic markets."[10] ARIAS-U.S. was founded in 1994 and has grown from a few dozen members to over 600 members today, including insurance and reinsurance companies, law firms, consultants and over 300 certified arbitrators, including the author. In just twelve years of existence, ARIAS-U.S. has developed standards of practice and forms that are used in many if not most insurance and reinsurance

arbitrations in the U.S. today. What could be so bad about such standardization for disputes between carriers and agencies?

The issue is not standardization; the issue is the reinsurance imprimatur that this standardization brings to non-reinsurance arbitrations. Most significantly, the growth of the reinsurance business has brought about a boom in the growth of reinsurance arbitrators that has exposed the dearth of arbitrators with knowledge of and experience with agencies and their business. Historically, arbitration clauses in reinsurance agreements have called for arbitrators to be current or past officers of insurance or reinsurance companies, or some variation of that requirement. Over the years the pool of arbitrators has developed from this requirement, with most active arbitrators having been former company — whether primary or reinsurance — executives. There are exceptions with broker experience, but most of them come from the reinsurance intermediary community. Active, professional insurance arbitrators with direct agency experience are few and far between.

The Agency's Dilemma

The typical reinsurance dispute, even if large sums are at stake, are generally not life or death propositions for the companies. Even without a written explanation of an award, its designated arbitrator can brief the losing party on the reasoning after the fact; and with the award being confidential it can live to fight another day even on the same issue. For agencies, however, the resolution of a dispute can be far more consequential, and often can mean the difference between success and failure of its business.

Consider, therefore, the dilemma facing an agency arbitrating a dispute over a make or break ownership issue with its carrier: The carrier designates as its arbitrator a person who was an underwriter with a direct writing reinsurance company, and who has a long résumé of reinsurance arbitrations. The agency picks an arbitrator with a background in agency business, but who has limited arbitration experience. In reviewing lists of potential umpires, the agency is unable to find experienced arbitrators with any significant agency experience, and it ends up settling on several people that appear to have some experience dealing with agency or program business. The carrier, on the other hand, has no problem presenting names of "qualified" umpires, all of whom spent their careers with insurers or reinsurers. The final choice comes down to a coin flip and crossed fingers.

The seeds of extreme disappointment for the agency in this process are obvious as the agency in the subject case learned.

What Can Agencies Do To Help Level The Playing Field?

Knowledge of the dangers of the arbitration process as it exists today may give agencies some ability to minimize the inequities in the process. The selection of arbitrators qualified to consider the unique issues involved in agency disputes with carriers is one of — if not the most — crucial events in the process. Some possible steps an agency can take to achieve some level of fairness in the arbitrator selection process include:

- If the agency has any negotiation ability with its carrier, it could seek to:
  - Include a contractual requirement that arbitrators must have defined agency experience; or
  - Include some intermediary step in the dispute resolution process such as: requiring mediation before arbitration; or agreeing on a particular individual or position — such as the head of a neutral trade group — to select a qualified umpire if no agreement can be reached between the other arbitrators.
- If the carrier refuses to negotiate changes to its standard form, the agency must try through the vetting process to ensure that the arbitrator candidates have significant actual experience with agency issues.
- Insist on "reasoned" awards. In other words, require that the arbitrators give a written explanation for their award. In the U.S., however, reasoned reinsurance awards are rare, and generally require both parties to agree to require panels to issue reasoned awards.
- Do not agree to confidentiality of the process. Confidentiality is common in reinsur-

> ance arbitrations, but in disputes between agencies and their carriers, confidentiality is often just one more way that carriers can hide their indiscretions in a system already tilted in their direction.

While most qualified arbitrators will decline to serve as an umpire on issues for which they have limited experience or pre-set positions, the agency needs to weed out candidates who — through ignorance or hubris, or both — believe they know everything about everything. Because panel awards generally do not have to be reasoned, and because the grounds for overturning awards in court are very limited,[11] it is remarkably easy for a panel to hide a prejudicial or improper award behind the screen of "unreasoned" awards, limited ability to challenge, and confidentiality. This underscores the importance of the rare issuance of a dissent — unbound by confidentiality — in the subject case.

In the longer term, however, agencies need to recognize the shortcomings of the process and to take joint and concerted actions, separately and through their trade organizations, to expand the pool of qualified and available arbitrators knowledgeable on agency issues, and to make this pool available to the arbitration process as an alternative to the existing pools. If the brokerage and agency community can develop a significant alternative pool to the predominantly reinsurance oriented pools, this development could also spur a change in attitude about the process by carriers, and increase the expertise of the supporting groups — including the law firms and consultants looking to arbitrations as a significant source of their business — on agency issues.

Conclusion

A judge once told me in all sincerity that the best lawyer in the world is no match for a mediocre judge. That truism becomes more glaring in arbitration where the arbitrators do not have to explain their decisions and the standards they can apply are far more subjective. It is therefore essential for insurance agencies faced with resolving a dispute with a carrier through arbitration to be as diligent as possible in finding arbitrators knowledgeable about their business and not predisposed — through background, experience or economics — towards the carriers. Tilting the playing field towards "even," however, is no easy task.

Endnotes

1. For an excellent article on the evolution of arbitration and insurance, see "Arbitration and Insurance Without the Common Law" by Richard E. Stewart, ARIAS-US Quarterly, Third Quarter 2004, Volume 11 Number 3.

2. For example, ARIAS-US, established in the mid-1990s, has over 600 members, insurance and reinsurance companies, law and accounting firms and consultants, and has certified over individual 300 arbitrators. The Reinsurance Association of America also provides a directory of over 200 arbitrators.

3. Footnote 2, *supra*.

4. Even in reinsurance arbitrations, however, there have been increasing criticisms of the process. These criticisms are focused primarily on the increasing cost, length of time and evolution towards litigation proceedings of the arbitration process.

5. See the Arbitration Award and Dissent dated December 7, 2006 in *The Garn Group, Inc. v. Arch Insurance Company*, available in Mealey's Litigation Report: Insurance, Jan. 30, 2007, Doc. #03-070130-021Z.

6. The guaranty allowed the company to sue the principal even if there was an unresolved disagreement with the agency over the amount owed. The company successfully sued the principal under the guaranty before the commencement of the arbitration described in this Commentary. This use of the guaranty to circumvent addressing the agency's claims is another issue of the uneven playing field between insurance companies and agencies. However, that issue is separate from the topic of this article.

7. The author of this article was counsel to the petitioner in this arbitration. The proceeding was not subject to a confidentiality agreement.

8. See footnote 6, *supra*.

9. Because most arbitration clauses state that the arbitrators are to apply custom and practice in the business, the inclusion of applicable law provisions arguably adds an unnecessary and confusing mixture of law and practice to the proceedings.

10. For more information on ARIAS-US, see its web site at www.arias-us.org.

11. For example, the grounds for vacating an arbitration award under the Federal Arbitration Act [9 USCA §10(a)] are limited to:

    (1) where the award was procured by corruption, fraud, or undue means;

    (2) where there was evident partiality or corruption in the arbitrators, or either of them;

    (3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced; or

    (4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made. ■