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ADR in insurance disputes

Resolving insurance disputes: the value of less formal processes

by Michael Mills and Nicholas Furlan

There is nothing new in criticisms of the courts and of the litigation process. In 1853 Charles Dickens made the following remarks about the English Court of Chancery:

This is the Court of Chancery, which has its decaying houses and its blighted lands in every shire, which has its worn-out lunatic in every madhouse and its dead in every churchyard, which has its ruined suitor with his slipshod heels and threadbare dress borrowing and begging through the round of every man's acquaintance, which gives to monied might the means abundantly of wearying out the right, which so exhausts finances, patience, courage, hope, so overthrows the brain and breaks the heart, that there is not an honourable man among its practitioners who would not give — who does not often give — the warning, 'Suffer any wrong that can be done you rather than come here!'¹

Litigation is typically costly, time consuming, uncertain and ultimately unsatisfying, regardless of the outcome.² The potential for conflict between parties to the insurance relationship is evidenced, in part, by the myriad of decided cases on questions of insurance law. This mass of insurance litigation is evidence that participants in such disputes have thus far failed to capitalise on the advantages offered by ADR processes.

This article examines the types of insurance disputes that most frequently arise, and explores the effectiveness of a number of different processes in resolving such disputes. Australian insurers should be cognisant of the experiences of their

American counterparts in employing processes like mediation and arbitration to resolve insurance disputes as part of a growing trend of ADR in the American insurance industry.

Insurance disputes

In the field of insurance, there are two broad categories of dispute which are often the subject of litigation.³

The first category involves disputes over whether a given loss or liability is covered by a particular insurance policy — coverage disputes. A coverage dispute arises when an insured asks his or her insurer to grant indemnity, or pay a claim under a policy, as the case may be, and the insurer refuses to do so. In this case the dispute is between the insured and the insurer.

'Litigation is typically costly, time consuming, uncertain and ultimately unsatisfying, regardless of the outcome.'

The second category involves disputes over whether an insured is liable to a third party — third party disputes (such disputes often arise in relation to liability insurance). In this case a third party makes a claim against an insured. The insured asks their insurer to indemnify them in respect of the third party's claim. A dispute then arises over whether the insured is in fact liable to the third party. In this case the dispute may be between the insured and the third party, or between the insurer and the third party where, for example, the insurer chooses to exercise a right of subrogation under the policy.

There are, of course, a variety of

other categories of dispute which may arise out of the insurance relationship. These include disputes over the meaning of certain words and phrases in an insurance policy (although these are, in effect, coverage disputes); disputes as to the legal rules that should govern the operation of an insurance policy (choice of law disputes); subrogation disputes; and, in some cases, disputes over reinsurance arrangements.

It is not the purpose of this article to consider in detail these other categories of dispute. The focus is rather on the utility of ADR in the context of coverage disputes and third party disputes.

Alternative dispute resolution

There is, of course, a range of options available to disputing parties

who do not wish to proceed to formal litigation. A number of processes, of varying degrees of formality, are available to assist the parties to resolve their dispute themselves, or in some cases, to impose a settlement regime on the parties. These dispute resolution processes can be divided into two broad categories, as follows.

First are consensual processes such as conciliation and mediation. Where consensual dispute resolution processes are used, the parties typically meet with an independent third party to explore settlement options. The role of the third party is not to unilaterally impose a settlement regime, but to assist the parties to



generate and refine their own settlement options.

Second are adjudicative processes such as arbitration, appraisal, early neutral evaluation or minitrial. These processes more closely resemble formal litigation. The parties are given the opportunity to make submissions to an independent umpire. Each party's submissions are weighed by the umpire and a decision is made. This third party must then review that material before formulating an appropriate settlement regime.

The observation often made of ADR processes is that they lie on a continuum of increasing structure and formality. Negotiation, the most informal process, lies at one end of the spectrum, and litigation at the other.⁴ Each process has much to offer parties to insurance disputes. However, the suitability of each will depend on the nature of the insurance dispute in question.

Coverage disputes

Customer and service provider

The relationship between an insured and an insurer is essentially that of customer and service provider. It is inappropriate to litigate a coverage dispute where the parties hope to maintain a relationship in the future. Litigation is costly, time consuming and uncertain. An insurer who subjects a customer to that process will almost certainly lose their business. Coverage disputes are most suited to consensual dispute resolution processes. In fact, consensual processes like mediation are more likely to be successful because the parties are in an existing relationship, particularly where there is a desire on either part that this relationship continue. The parties are already familiar with each other's circumstances, and channels of communication may already be open.

American insurers have realised the benefits of a consensual approach for a number of years. The senior vice president and chief counsel for litigation at one of America's largest insurers has stated that:

ADR provides the opportunity to

preserve business relationships by tempering the emotions and hostilities frequently associated with litigation.⁵

It is also worth noting that an insurer who routinely litigates coverage disputes will quickly acquire a reputation as such in the market place. This can be damaging to an insurer's business — hence the old adage, 'you catch more flies with honey than vinegar'. An insurer who is prepared to be creative in its approach to coverage disputes will appear far more conciliatory and attractive to prospective customers than one who constantly does battle with customers in court.

Preservation of commercial relationships through consensual processes

The natural starting point is negotiation. Negotiation remains the process through which the vast majority of disputes are resolved. It has many advantages. Foremost among them is its adaptability. The negotiation process is constrained only by the imagination of the parties. Negotiations can be between the parties and their solicitors, they can take place in person or over the phone, or they can be between representatives of the parties alone.

Despite its obvious appeal, negotiation is likely to be an ineffective means of resolving coverage disputes in a majority of cases. The outcome of any dispute resolution process is influenced by the relative bargaining strength of each party. Differences in bargaining strength are most pronounced in circumstances where the parties attempt to settle their differences without the involvement of an independent third party.

Consensual dispute resolution processes can be effective in overcoming an actual or perceived power imbalance. A range of techniques is available to a mediator to assist in restoring this balance, including:

- allowing the insured more time in mediation sessions to articulate his or her position;
- keeping the parties physically separate; and



- limiting the number of representatives who may accompany an insurer.

The conciliatory nature of processes like mediation ensures that the parties are given every chance to preserve their existing relationship. Consensual processes encourage the parties to work together to generate settlement options. Where the parties are successful in achieving a settlement, their future dealings are likely to be enhanced by their proven ability to compromise. For this reason, ADR processes can, in some instances, enhance the customer/service provider relationship.

Third party claims

Open justice vs commercial reality

The open administration of justice is a fundamental principle of the common law.

It is the ordinary rule of the Supreme Court, as of the other courts of the nation, that their proceedings shall be conducted publicly and in open view. This rule has the virtue that the proceedings of every court are fully exposed to public scrutiny and criticism, without which abuses may flourish undetected.⁶

A common criticism of ADR is that it takes place in private. Its processes are not subject to the same degree of public scrutiny as court proceedings.

This can be problematic for a number of reasons. As is clear from Justice Gibbs' comments, private dispute resolution is susceptible to abuse, especially by parties in positions of greater bargaining strength. Furthermore, public confidence in systems of dispute resolution will suffer where those systems are kept from public view — justice must be done, and it must be seen to be done. Finally, private dispute resolution does nothing to resolve uncertainty in the application of legal principles. Legal principles are developed by the decisions of courts. Fewer decided cases may mean greater uncertainty in the law, and greater cost to insurers and insureds who find themselves in dispute over legal questions to which there are no clear answers.

On the other hand, the public airing of an insurance dispute may be damaging to either or both parties. There is thus a trade off between, on one hand, the benefits of resolving disputes in open court and, on the other, the commercial attractiveness of keeping certain matters from public view.⁷

A common concern of public liability insurers is that the resolution of a single third party claim in open court may generate several more claims as news of the court proceedings reaches potential claimants. It is clearly preferable to resolve third party disputes in a private forum. Processes such as mediation and arbitration can be held in private, and the parties can agree in advance that details of the settlement be kept confidential. This is typically achieved by the insertion of a confidentiality clause into a mediation or arbitration agreement.

Suitability of consensual and adjudicative processes — class actions

The use of conventional processes to resolve third party disputes is made difficult by the absence of an existing relationship between the parties. For this reason, it may be more efficient to rely on adjudicative processes. Arbitration, for example, does not derive its success from prior dealings between insurer and third party, and it can easily be structured so that the terms of the arbitrator's award are confidential.

Adjudicative processes are valuable in circumstances where there is a possibility that multiple third party claimants will launch representative proceedings. Such proceedings are commonly referred to as class actions.

Avoiding formal litigation of third party disputes is a tactic which insurers should use to head off possible class actions. A single dispute can be resolved confidentially and the publicity which so often draws out additional claimants and leads to instigation of representative proceedings may be avoided.

ADR has a further role to play in the event that representative proceedings are in fact commenced. The American

experience of class action litigation has shown that the process is intensely complicated, time consuming and costly. Some American insurers have designed special claim review panels to resolve such claims individually. A team of suitably qualified professionals employed by the insurer hears each claim. They then advise the insurer, who in turn makes a decision as to what, if anything, the claimant should be offered to settle the claim. This process resembles arbitration, the important difference being that the persons hearing the claim are not independent. For this reason, some insurers build a right of appeal to an independent arbitrator into the claim review process.⁸

ADR in US insurance disputes — recent trends

Prevalence of ADR in insurance disputes

In the United States the resolution of insurance disputes is one of the major areas in which ADR is being effectively utilised. There is a long history of ADR in the US insurance industry, and in recent years its usage has dramatically increased.

A decade ago one major US insurer reported that on any given day it was involved in over 100,000 lawsuits.⁹ US insurers realised that litigation of this magnitude was unsustainable. The pressure on the court system, not to mention the financial drain on insurers, has brought about a resurgence of ADR in this industry. This insurer, and many like it, made a concerted effort to channel insurance related disputes through any one of a number of ADR processes.

There has also been a rise in the different types of insurance related disputes in which ADR has begun to be used.¹⁰ Of particular note is the increased use of ADR to resolve reinsurance disputes. This is significant as reinsurance disputes have, in the past, been rare. Traditionally, reinsurance contracts have included an arbitration clause, and the US has recently seen a dramatic increase in the use of arbitration to resolve disputes of this type.



Industry initiatives

There has been a marked increase in the use of multi-party industry agreements to ensure that the trend towards increased use of ADR in the insurance industry continues. The use of ADR in US insurance disputes has received institutional support from a number of industry bodies. The American Arbitration Association, a leader in the use of arbitration since 1926, has recently established an insurance program aimed specifically at insurance related litigation.

An increasingly large number of Fortune 500 companies have signed the 'ADR pledge'.¹¹ By signing the ADR pledge these companies have made a commitment to use ADR first to resolve disputes with other signatory companies. To date, more than 4000 companies have signed the ADR pledge.

Further, a large number of American insurers have now signed an industry specific agreement called the 'CPR Insurance Industry Dispute Resolution Commitment' which requires them to attempt to resolve certain insurance disputes through non-binding mediation.

ADR initiatives specific to the insurance industry are increasingly being developed in response to major disasters — events from which significant insurance disputes are certain to arise. An example is the 'CPR Inter-Insurer Dispute Resolution Commitment for Disputes Relating to the September 11 2001 Disaster'.

Conclusion

The recent surge in the use of ADR as a means of resolving insurance related disputes is becoming increasingly pronounced in Australia. This trend has been a feature of the US insurance industry for some time, and recent developments have shown that more and more insurers are demonstrating a commitment, both at an individual and at an industry level, to greater use of informal processes like mediation and arbitration. This trend has been supported by industry bodies which encourage the use of such processes.

The benefits to the Australian insurance industry of an increased

use of ADR to resolve insurance disputes, and in particular coverage disputes, has not been lost on Australian insurers. Australia's major insurance companies are beginning to take advantage of processes like mediation, having realised that ADR is more conducive to the continuation of the commercial relationship between the parties, and in some instances the enhancement of that relationship. ●

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Endnotes

1. Dickens C *Bleak House* Penguin Classic London 1996 Chapter 1.
2. See Astor H and Chinkin CM *Dispute Resolution in Australia* Butterworths Sydney 1992 pp 30-40.
3. See generally Mills M 'Mediation of insurance disputes — or, insurers: mediate now, litigate later!' (2000) 11 February *Australasian Dispute Resolution Journal*.
4. Dickens above note 1 pp 72-73.
5. Robinson RL 'ADR in the insurance industry: one company's perspective' (1990) 45(3) *Arbitration Journal* 24 at 25.
6. *Russell v Russell* (1976) 134 CLR 495 at 520 per Gibbs J.
7. For a discussion of the role of confidentiality in dispute resolution processes, and in particular, mediation, see Goldberg SB, Sander FEA and Rogers NH *Dispute Resolution, Negotiation, Mediation and other Processes* Little, Brown and Company Boston 1992 pp 179-195.
8. See generally Grenig JE 'An introduction to the use of alternative dispute resolution to resolve insurance disputes' (2001) Spring *FICC Quarterly* 239 at 256-257.
9. Robinson above note 5 at 24.
10. Robinson above note 5 at 24.
11. The 'ADR pledge' was developed by the Centre for Public Resources (CPR) Institute for Dispute Resolution. The CPR was founded in 1979.