

## ARBITRATION IN THE INSURANCE INDUSTRY

A presentation to the Chartered Institute of Arbitrators – London Branch 26<sup>th</sup> October 2011  
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Good evening,

I would like to contribute this evening by offering a personal insight to the context in which ADR is set in today's insurance industry and how the industry could better benefit from using it more.

I am neither a lawyer nor a chartered arbitrator but I am a qualified CEDR accredited mediator and practise as an insurance Claims Advocate from which seat I see the pros and cons of ADR and litigation only too plainly.

I am a firm supporter of ADR and any reasonable method of negotiation that reduces the dependency upon litigation for sorting out the industry's insurance contract disputes both for reasons of time and cost on the one hand and the reputation of the industry on the other.

I feel that the insurance industry, as a general rule, fear that ADR loses the insurer the tight control they have in litigation. I don't agree that it does but that is another matter.

I refer to ADR, as distinct from Arbitration because, as you will all know Arbitration is usually adopted when there is an Arbitration clause in the policy that permits or requires it. Otherwise the tendency, in my experience, is to go to litigation in the normal way. I believe that it will remain difficult to persuade most insurers not already used to Arbitration as a matter of course, to adopt it in their policy wordings for reasons of fear of the unknown.

**Let me start by setting the scene and the context.**

I started work in the insurance industry in 1969 with a firm of Lloyd's brokers placing international property and casualty accounts. Most of my work at that time concerned insurances in North America and Scandinavian countries as well as some in the UK. That just happened to be the portfolio specialisation of the firm I was in.

**I remember a particular occasion** when I was presenting a claim to an underwriter on a factory in Denmark that made feather pillows and duvets. There had been an explosion by spontaneous combustion of the feather dust and a very substantial part of the factory had burnt down and was out of commission. The loss adjusters reported that there were some discrepancies between the description of the factory given by the insured and the description, as they had found it, in fact. These mainly concerned the width of fire breaks, the proximity of the fire brigade and the amount of raw material stored at the factory. The implication of course was that the insurer could repudiate the claim. This was a Lloyds led placement and the leading underwriter was one of the leading Lloyd's syndicates at the time. I was a young broker, presenting him with the claim file and I was fearful that he might want to refuse to pay it. Going back to the office with a declined claim was not good for one's career; a P45 job!

In those days at Lloyd's one had to stand almost to attention next to the underwriter who sitting at his "box" whilst he read the file you'd given him and he didn't expect any interruption. After perhaps one of the longest 10 minutes of my early career he looked up and said, "***Young Flaxman, I think I'd like to speak to your boss about this one, would you like to call him on my phone?***" Needless to say I did, he was in the office, but within about seven minutes he'd hoofed it up to the Lloyd's

underwriter and this is what the underwriter said. ***“Well, John, if I may say so, this is a particularly unfortunate claim and I have been advised by our loss adjusters that there are good reasons why we should not have to pay it. What do you have to say about that?”*** . No broker is ever speechless, by definition, but they can blather with the best of them when they haven't got a good reason for saying something that matters. The boss humbled and bumbled and grovelled and groaned.....

***“Well,”*** said the underwriter, ***“I’ve come to my decision.....(a very long pause... for maximum dramatic effect ) and I really think we ought to pay this one, John, we’ve had them for a long time, the differences pointed out by the loss adjuster are really not that substantial in the scheme of things and I wouldn’t want your client to think that Lloyds doesn’t pay its losses”***.

**Fast forward to May 2010.** By this time I am firmly ensconced in the business of claims dispute resolution and find myself dealing with a professional indemnity claim for a design department of a firm of contractors, a medium sized English firm specialising in architectural cladding. For some 12 or more years they have bought a PI policy, amongst their other insurances, mainly to protect them against errors of specification and advice. A claim was made against them by a client for whom they had fitted cladding some five years before. Some of the cladding had shown signs of cracking and discolouration and under the terms of the contract they're obliged to replace it if it fails within a period of 10 years from the date of installation. The cost of replacement was approximately £1 million, the premium on the policy was a little over £4,000 a year and the underwriters found reasons to deny liability on several grounds.

**It isn't necessary to go into the detail of what they were**, suffice it to say that we were able to show that the cause of the loss was negligence, the exclusions they relied upon did *not* apply and the business description in the proposal form was accurate in all respects. Eventually I met with a senior claims director of the insurance company who in a simple and clearly put sentence said, ***"Mr Flaxman, this company will not be paying this claim; it is a very large claim for a very small premium and we hadn't expected a loss like this. If you want us to pay this claim you will have to take us to court, and we've looked them up don't think your client can afford it."***

Whilst I am fortunate to have experienced both incidents at first hand I am rather ashamed of an industry that has moved so far from the principle of utmost good faith.

**My purpose in citing these two extremes is to illustrate the context in which alternative dispute resolution is now set.** I am a devotee of a concept expressed by Professor Andrew Lickierman of the London Business School in, I think 1983. He was commissioned to report on the liability of auditors and chartered surveyors and he used an expression which I have found most helpful ever since. He described the **"expectation gap"**, the gap between what an insurer wants to sell and what the insured thinks he has been sold. Its width and depth are infinite and it is within perhaps that **chasm of infinity** that the true value of alternative dispute resolution is destined to fit.

**In my experience the best form of dispute resolution is by negotiation.** However, competent negotiation requires a level of knowledge, confidence and skills for which the insurance industry is not designed. Whilst the art of negotiation, intra

market, on premiums and terms and conditions is undoubtedly what the industry does every day the art of negotiation in claims has, in the period of my career, largely been lost. This is because almost all claims are now sent to lawyers or loss adjusters to negotiate on behalf of the insurer and so losing the art of negotiation amongst the insurance professionals themselves. I think that is a pity. Too many insurance personnel are unfamiliar with the legal principals by which contracts of insurance are bound.

In one instance, last year, an underwriter's claims man said to me " ... but this isn't about a contract, it's a policy of insurance". HmMMM.

**An example:** In dealing with a claim a couple of weeks ago I received a letter from a leading insurer reserving their rights in the matter of a property claim and advising the insured to *seek alternative insurance* "to ensure they had cover going forward". I telephoned the author of the letter and recognised, within a very short time, that the person at the other end of the telephone hadn't the faintest idea what "reservation of rights" means in practise. A carefully drafted letter, which I suspect was referred to a more senior member of the organisation, resulted in what I might describe as clarification to my satisfaction; and no other insurance was, of course, necessary. My point is that negotiation of a difficult claim cannot start from a basis of ignorance.

**The insurance industry has, throughout my entire career, at least, treated claims as the poor relation to the business.** The glamour side of the business is selling the policies and making money. Claims departments are often relegated to offices as far away from the company's operational centre as possible; often under-resourced and work is increasingly sub-contracted to loss adjusters, solicitors and

just about anyone else who offers to handle claims more cheaply than the insurer can do it themselves. Consequently, when a claim runs into trouble there is no-one, in the company that has actually accepted the premium, to deal with it. The overwhelming tendency is to fall back on lawyers to get them out of the problem.

Recognising of course that I am standing here in the midst of some of the very best of the legal profession I may or may not be forgiven for saying that the law is just *one* dimension by which disputes can be measured and resolved. The others are commercial prudence, experience and, in the case of insurance contracts, applying the simple doctrine of utmost good faith. Doing the right thing for the right reason.

I am reluctant, even in the face of the commercial adversity the industry faces every day, to forgo the principle/doctrine that utmost good faith should be upheld in contracts of insurance. However, in practice it is nowadays very one-sided and that is partly because the commercial interests of the sub-contractor parties engaged to deal with insurance claims do not have the same commercial interests as the does , or should, the insurer.

From a policyholder's perspective it often appears that the insurers would rather transfer the risk of making a claims decision to a lawyer and to the courts than take that duty and risk themselves as insurance professionals. **It is far easier to tell the insured that the law is not with them than it is to face a commercial dispute as a professional in the art and science of insurance practise.** ADR could redress that balance.

**Exposing oneself to the comparatively sophisticated art of negotiation and mediation** is regarded by most insurers, in my experience, as an unnecessary risk when you can chuck the file at a lawyer BUT It means that the claim will be disputed almost entirely on the words in policy and very often not on the substance of the claim or its commerciality. Before I give you an example let me state clearly that this is not a complaint against lawyers; it is more of a complaint about how they are misused.

**Let me give you an example.** A food processing plant operates for 12 hours of the day and is shut down for the remainder. A warranty in the policy requires all machinery and processing equipment to be switched off when the premises are closed for business. A fire occurred at the premises whilst it was closed. The seat of the fire was suspected, although not proven to be, a small part of the processing equipment that had to be maintained at a consistent temperature at all time for reasons of avoiding contraction and expansion so that unhygienic conditions could not develop in the process. The insurers repudiated liability for the claim on the grounds that the policy contained a warranty that all machinery was switched off when the premises are closed for business. The insured remonstrated and pointed out to the insurer that this piece of equipment is not *machinery* and is well known and accepted in the industry as being the exception to the rule with regard to the switching off warranty. Furthermore, it was demonstrated that the fact had been disclosed to the insurers in the proposal form submission, three years earlier. This claim was still repudiated by the insurers on the advice of the lawyer and they chose to rely solely upon the words actually in the policy where no exception had been made.

In this case there was a happy ending because a trade association was able to prevail upon the insurers, who had a number of its members on their books. It was more the threat of loss of business than goodwill, however, that changed their mind.

**So, to sum up** my first point is that the industry feels itself to be at risk if it not in the hands of its lawyers in almost every situation. Excellent for the lawyers but not so good for us in the ADR world and even less good for the clients who have to rely upon the economic necessity of having insurance but without the opportunity to negotiate for the expected good faith. (The expectation gap, again)

Secondly, I'd like to mention another fear factor which frustrates the advancement of ADR. I experience this first hand, daily, as often the first person that gets to know about a disputed insurance matter after the broker and the insured. Our very business is one of advocacy in matters of insurance claims. It is not one of law, we are not lawyers, we're insurance professionals who know the ways and means of resolving insurance disputes. We very often work alongside lawyers, bringing first hand insurance practise knowledge to the table at an early stage, not just before trial. We always talk to clients , in the presence of the lawyers, about the advantages of avoiding litigation and the benefits of the various methods of ADR, usually starting with simple commercial negotiation with the fallback of mediation and then where possible arbitration, and if all else fails there is still access to the court.

None of us here need any explanation as to the differences in each of those steps **but to the ordinary man or woman it is all gobbledegook.** The overwhelming fear is that if they attempt to negotiate, mediate or arbitrate a dispute they will be

prevented from going to court, if all else fails. ADR has no special meaning to these people, it is simply a word which differs from “litigation”.

**So one of the takeaways, perhaps, from our discussion this evening** is the merits of promoting a consistent and articulate explanation of the different processes in ADR, their costs, their benefits and the flexibility of ADR’s outcome.

Finally, the last step is the ability to hold the hand of the insured in **actually starting and managing the process of ADR** leading to whatever form of ADR is appropriate. We as arbitrators and mediators often tend to assume that once we’ve explained what has to happen the (insured) is able to get on with it and start the process but in fact that is often far from the case. It is very common for them to be enthused about the process only to go home, think about it, forget what they’ve learned and go and ask a solicitor what they should do. Well of course the advice is to litigate and that is why I think perhaps **the ADR fraternity might be missing a trick!**

Ladies and gentlemen,

Thank you.

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