THE LAWLESSNESS OF ARBITRATION

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INTRODUCTION

Over the past few decades, Alternative Dispute Resolution (ADR) has become a favorite of critics of the American legal system, who decry the system's inefficiency, inaccuracy, and unfairness.[1] ADR is increasingly

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1. *See, e.g.*, Curtis H. Barnette, *The Importance of Alternative Dispute Resolution: Reducing Litigation Costs as a Corporate Objective*, 53 ANTITRUST L.J. 277 (1984); Jeffrey S. Brenner, *Alternatives to Litigation: Toxic Torts and Alternate Dispute Resolution: A Proposed Solution to the Mass Tort Case*, 20 RUTGERS L.J. 779 (1989); Caroline Harris Crowne, *The Alternative Dispute Resolution Act of 1998: Implementing a New Paradigm of Justice*, 76 N.Y.U. L. REV. 1768 (2001); Harry T. Edwards, *Alternative Dispute Resolution: Panacea or Anathema?*, 99 HARV. L. REV. 668 (1986); Eileen Barkas Hoffman, *The Impact of the ADR Act of 1998*, TRIAL, June 1991, at 30; Irving R. Kaufman, *Reform for a System in Crisis: Alternative Dispute Resolution in the Federal Courts*, 59 FORDHAM L. REV. 1 (1990); Robert J. McLucas, *An Insurer's Use of Alternative Dispute Resolution: The Travelers' Experience*, ARB. J., June 1984, Vol. 39, No. 2 at 55; Robert F. Peckham, *A Judicial Response to the Cost of Litigation Case Management, Two-Stage Discovery Planning and Alternative Dispute Resolution*, 37 RUTGERS L. REV. 253 (1985); Lucille M. Ponte, *Putting Mandatory Summary*

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available; certain forms of ADR are mandated by some courts as a precondition to the trial of disputes;[2] and a body of law that is highly favorable to and supportive of agreements to engage in ADR has emerged.[3]

One of the principal weapons in the ADR arsenal, mandatory, binding arbitration, is often cited as a desirable alternative to litigation of disputes in courts of law.[4] Whatever the merits of mandatory, binding arbitration in general, however, in certain kinds of disputes this form of ADR involves

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Jury Trial Back on the Docket: Recommendations on the Exercise of Judicial Authority, 63 FORDHAM L. REV. 1069 (1995); Jerome M. Staller, *The Advantages of Alternative Dispute Resolution in Tort Cases*, PRAC. LAW., Mar. 1985, Vol. 31, No. 2 at 57.

2. *See* W.D. OKLA. LCvR. 16.3 SUPP. § 5.2(b) (compulsory non-binding arbitration for most civil cases in which damages would not exceed $100,000); E.D. PA. R. 53.2, R. 53.2.1 (compulsory, non-binding arbitration for cases with potential awards less than $150,000 and compulsory mediation for odd-numbered civil cases); E.D.N.Y. R. 83.10(d) (compulsory arbitration for most civil cases where the amount in dispute does not exceed $150,000). The Judicial Improvements and Access to Justice Act of 1988 authorized compulsory, non-binding arbitration as a precondition to trial for ten federal district courts: Northern District of California, Middle District of Florida, Western District of Michigan, Western District of Missouri, District of New Jersey, Eastern District of New York, Middle District of North Carolina, Western District of Oklahoma, Eastern District of Pennsylvania, and Western District of Texas. 28 U.S.C.A. §§ 651–58 (West 1994).

3. *See, e.g.*, Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 26 (1991) (questions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration). *See also* Rodriguez de Quijas v. Shearson Amer. Express, Inc., 490 U.S. 477 (1989); Shearson Amer. Express Inc. v. McMahon, 482 U.S. 220 (1987); Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985); Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983) ("[A]ny doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration . . . ."). *See generally* Phillip C. Essig, *U.S. Supreme Court Tackles Arbitration Issues*, 213 N.Y.L.J. 1 (1995); Preston Douglas Wigner, *The United States Supreme Court's Expansive Approach to the Federal Arbitration Act: A Look at the Past, Present, and Future of Section 2*, 29 U. RICH. L. REV. 1499 (1995).

4. *See, e.g.*, Michael J. Brady & Terry Anastassiou, *Binding Arbitration of Coverage and Bad Faith Disputes: A Way out of the Thicket for the American Insurance Industry*, 51 FED'N INS. & CORP. COUNS. 355 (2001); Charles B. Craver, *The use of Non-Judicial Procedures to Resolve Employment Discrimination Claims*, 11 KAN. J.L. & PUB. POL'Y 141 (2001); James R. Holbrook & Laura M. Gray, *Court-Annexed Alternative Dispute Resolution*, 21 J. CONTEMP. L. 1 (1995); John J. McDonald Jr., *Reinsurance Arbitration 2001: Will the New Ways Cripple "Arbitration Clause"?*, 68 DEF. COUNS. J. 328 (2001); Matthew C. McDonald & Kirkland E. Reid, *Arbitration Opponents Barking up Wrong Branch*, 62 ALA. LAW. 56 (Jan. 2001); Lewis D. Solomon & Janet Stern Solomon, *Using Alternative Dispute Resolution Techniques to Settle Conflicts Among Shareholders of Closely Held Corporations*, 22 WAKE FOREST L. REV. 105 (1987); John M. Flynt, Comment, *A Solution to Force-Placed Insurance Litigation for Lenders: Disclosure and Arbitration*, 26 CUMB. L. REV. 537 (1996).

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serious disadvantages. Although this Article uses insurance disputes as an example, these disadvantages are risked in any dispute in which one of the parties is a repeat player and the dispute involves cutting-edge legal issues.

This Article identifies and analyzes the way such problems may arise when insurance coverage disputes are subject to mandatory, binding arbitration. It argues that arbitration often involves a form of contractual "lawlessness" that is especially undesirable in claims that involve new legal issues. This lawlessness not only adversely affects the parties to each dispute, but the legal system as a whole. As a consequence, in our view insurance policyholders should be reluctant to purchase policies that require binding arbitration of coverage disputes. In addition, since the problems that we identify are likely to arise not only in insurance, where new, cutting-edge issues have regularly emerged for decades,[5] but also in other kinds of disputes posing new legal issues, the legal system should reconsider the highly favorable stance that it takes toward mandatory, binding arbitration in general, so as to take account of the negative effects of arbitration lawlessness. A neutral legal and judicial stance toward binding arbitration would be more appropriate.

I. THE CONTEXT OF INSURANCE ARBITRATION

There can no longer be any doubt that arbitration of commercial and corporate disputes has an important role to play in the resolution of American legal disputes. ADR approaches of various sorts, including binding arbitration, are increasingly relied upon as a complement or alternative to conventional lawsuits.[6] In appropriate cases, such devices as mediation and arbitration have the potential to promote speedier, less expensive, and more amicable resolution of legal controversies than ordinary litigation.

Insurance disputes are no exception. Whether the policyholder is an individual, a partnership, or a corporation, bringing a lawsuit against an

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5. *See generally*, Kenneth S. Abraham, *The Maze of Mega-Coverage Litigation*, 97 COLUM. L. REV. 2102 (1997).

6. Between 1998 and 2000, for example, the number of cases filed with the American Arbitration Association doubled. In 2000, 198,491 cases were filed, compared with 140,188 cases in 1999 and 95,143 cases in 1998. *See* AM. ARBITRATION ASS'N, 2000 ANNUAL REPORT 5 (2001); AM. ARBITRATION ASS'N, 1999 ANNUAL REPORT 3 (2000) (on file with the author). *See also*, THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, *Dispute Resolution Statistics*, *at* http://www.nasdadr.com/statistics.asp#arbitration (last visited Mar. 1, 2003) (reporting a twenty-four percent increase in the number of filings with its dispute resolution center from 2000 to 2001).

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insurance company often results in a prolonged, expensive, and uncertain legal conflict.[7] When the suit must be brought against dozens of insurance companies—as is often the case when the claim involves toxic tort, products liability, or environmental cleanup—the prospect of entering into litigation is daunting. Sometimes, of course, there is no alternative: the underlying liabilities involve tens or hundreds of millions of dollars, the policyholder's insurers have denied the claim or are offering to settle for only a tiny percentage of the claim, and the decision not to sue would be tantamount to making a multi-million dollar gift from the policyholder's shareholders to its insurers.

Litigation, however, is not always the only alternative available. Arbitration is almost always a possibility. Few standard-form primary commercial liability and property insurance policies issued by American insurers contain arbitration clauses. Certain non-standard insurance policies, in contrast, do contain mandatory arbitration clauses. For example, excess general liability and umbrella policies issued by the Bermuda-based insurers ACE and XL—both of which were formed in order to provide coverage to American policyholders during the extremely tight market of the mid-1980s—incorporate mandatory arbitration clauses.[8] In addition, in our experience liability insurance policies issued by certain segments of the London market contain such clauses; maritime insurance policies frequently contain arbitration requirements; and a variety of other special-purpose policies often require arbitration as well. Finally, insurers whose policies do not contain arbitration clauses are nevertheless likely to be willing to submit disputed claims to binding arbitration rather than litigating them. That is, pre-claim arbitration requirements are common but not the norm, yet post-claim agreement to binding arbitration is always at least a distinct possibility.

Thus, policyholders sometimes have a choice—either at the point of sale or at the point of claim—regarding the method they will employ to resolve disputes with their insurers. At the point of sale, policyholders purchasing coverage in the non-standard market may be presented with a choice between insurers whose policies do and do not contain mandatory arbitration clauses; and after a dispute arises, even standard-form insurers may be willing or even eager to arbitrate. At each of these decision points, policyholders are faced

7. *See generally* Abraham, *supra* note 5.

8. *See* Mitchell Dolin & Ethan M. Posner, *Understanding the Bermuda Excess Liability Form*, 1 J. INS. COVERAGE 68, 79 (1998); Lorelie S. Masters, *ACE and X.L.: A New "Batch" of Coverage Issues*, 9 COVERAGE 24, 29 (1999).

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with a clear and significant choice between binding arbitration and conventional litigation.

Although the form and nature of insurance arbitrations vary, the general outlines are fairly uniform. Typically there are three arbitrators, one appointed by each of the parties, and a third chosen by the two party-appointed arbitrators. If the party-appointed arbitrators do not agree on the third arbitrator (sometimes called a "referee" or "umpire"), then a designated neutral appoints the third arbitrator. For example, under the English Arbitration Act of 1996, the parties may petition the High Court to appoint a third arbitrator if there is an impasse over his appointment.[9] The rules of the American Arbitration Association also provide a method for appointing the third arbitrator when the parties cannot do so on their own.[10]

Many arbitration clauses contain choice-of-law provisions, designating the law of a specific state to govern disputes under the policy, though sometimes subject to qualifications. For example, the Bermuda-based ACE and X.L. policies designate the law of New York to govern disputes under them, but provide that the policy is to be interpreted in evenhanded fashion, without "arbitrary" rules or construction, without construing ambiguous provisions against either party, and without reference to extrinsic evidence.[11]

Ordinarily, arbitrations are not subject to the strict rules of evidence, but neither is discovery as extensive as in typical civil litigation. Sometimes there is a version of motion practice to narrow issues; and often direct testimony is provided in writing in advance, with in-person cross-examination before the arbitrators. Except under unusual circumstances, actual arbitration hearings tend to last a number of days or a few weeks at most, but not months.

Compared to the rigors of American civil litigation, arbitration as just described may seem to present an attractive alternative. Most importantly, the parties avoid the defining feature of American civil litigation—the lay jury. However, they also lose access to another highly significant feature of litigation—the trial judge and the appellate courts. A choice in favor of binding arbitration instead of litigation therefore risks hidden adverse

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9. Arbitration Act, 1996, c. 1, § 18 (Eng.) (if there is a failure in the appointment procedure, either party may request that the court make any necessary appointments).

10. American Arbitration Association (AAA), Commercial Dispute Resolution Procedures, Rules 13–14 (if the parties are unable to agree upon an arbitrator or cannot do so in a timely manner, the AAA shall have the sole power to make the appointment from among acceptable members of a national panel of arbitrators), *available at* www.adr.org (last visited Mar. 1, 2003).

11. *See* Dolin & Posner, *supra* note 8, at 76–77.

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consequences. Because arbitrations are essentially confidential and set no precedents, they lack an important feature of the rule of law: each arbitration is an island unto itself, not governed by any prior arbitration outcomes and incapable of having an effect on any future arbitration.

This "lawless" feature of arbitration has not only private consequences for the policyholder making the choice to arbitrate, but also public consequences for all future policyholders considering whether to arbitrate or litigate. There are no arbitration precedents because proceedings and results are confidential; no common understanding of the meaning of repeatedly-used provisions emerges unless they are standard-form provisions whose meaning has been publicly litigated; and parties who consider purchasing insurance policies that require arbitration of coverage disputes have no way to anticipate the interpretations that insurers selling these policies may place on such policy provisions when a loss occurs and a claim is filed. Moreover, because any present policyholder will automatically suffer the consequences of earlier policyholders' decision to arbitrate rather than litigate, over time the adverse consequences of successive arbitrations are cumulative. Thus, a seemingly innocent and apparently desirable alternative to litigation turns out to be an enemy of the process of lawfully resolving insurance coverage disputes.

II. THE PRIVATE CONSEQUENCES OF BINDING ARBITRATION

The lawless features of insurance arbitration are troubling in general, but pose especially severe risks in cases that raise issues that have not yet been definitively resolved by established law, or involve the interpretation of non-standard policy provisions whose meaning has not been determined by prior judicial decision. To see how and why, it is useful to consider and then analyze a hypothetical situation involving an insurance claim posing a novel issue. The hypothetical claim can either be litigated or arbitrated, with important consequences flowing from the choice between the two approaches.

A. Litigating Versus Arbitrating a Hypothetical Claim

Suppose that a policyholder makes a claim under its Commercial General Liability (CGL) insurance policy for coverage of certain suits alleging that a product manufactured by the policyholder is defectively designed.[12] The

12. This policy provides the dominant form of general business-liability insurance to virtually all commercial enterprises in the United States. For analysis of the policy, see KENNETH S. ABRAHAM, INSURANCE LAW & REGULATION 393–494 (3d ed. 2000).

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policy excludes coverage of liability for bodily injury or property damage that is "expected or intended" from the standpoint of the insured.

1. Litigating the Claim

The insurer denies the claim and the policyholder brings suit against the insurer for breach of contract. At the close of discovery, the insurer moves for summary judgment on the ground that, because the policyholder had experienced claims alleging liability for this defect in the past, the policyholder "expected or intended" all future damage arising out of this defect, as a matter of law. The issue is whether awareness of a risk that similar claims will be made in the future means that the policyholder "expected or intended" the injuries in question. There is no applicable precedent governing this issue. The trial court grants the insurer's motion and the policyholder appeals.

On appeal the state Supreme Court rules in the policyholder's favor, reversing and remanding the case for trial, on the ground that the standard for determining whether a policyholder "expected or intended" bodily injury or property damage is subjective and particular. Therefore, the court holds, although evidence that there had been past claims and or injuries associated with the alleged product defect is admissible in evidence as tending to prove actual subjective expectation, the mere fact that there have been past claims or injuries does not, by itself, require an inference as a matter of law that the policyholder subjectively expected or intended future injury.

2. Arbitrating the Claim

Suppose now that the same facts exist, except that the policyholder's CGL insurance policy contains a requirement that disputes arising under the policy be arbitrated and that the decision of the arbitrators is binding. The insurer denies the claim. In a motion submitted to the arbitrators (before or at the close of the hearing, depending on the procedure being followed), the insurer argues that as a matter of law the policyholder expected or intended injury, because the policyholder had in the past experienced claims alleging liability for the same product defect at issue in the current claim. As before, there is no precedent governing the issue. The arbitrators accept the insurer's argument and dismiss the policyholder's claim.

B. Analysis

The formal and procedural differences between litigating and arbitrating the hypothetical case are obvious. First, if the parties arbitrated, they kept their dispute out of the public eye. Their dirty linen was not aired in public. Second, they were subject to a set of streamlined rules of procedure and

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evidence. The dispute was therefore less encumbered by legal technicality than it probably would have been had it been litigated. Third, the dispute was probably less costly to process. Counsel fees and other related expenses were lower than in litigation. Finally, arbitrators with at least some familiarity and probably expertise in the subject of the dispute were substituted for the judge and jury who would have decided the case if it were litigated.

The implications of this last feature of arbitration are worth examining, for these implications lead to the potential disadvantages of arbitration. It is not just the jury that is absent from arbitration, but also both the trial judge and recourse to appeal. As a result, neither party has redress when a mistake of law is made in an arbitration. Arbitration decisions are not appealable and may not otherwise be challenged on this (or virtually any other) ground.[13] As a result, there is no way for the parties to obtain an authoritative ruling on issues of first impression raised in the dispute—or in fact on any issue that has not yet been authoritatively resolved by the relevant court or courts. Moreover, even when there is established law on an issue, because of the non-appealability of arbitration results, for practical purposes the dispute is not authoritatively governed by established law. Many arbitration clauses in commercial insurance policies that we have reviewed provide arbitrated disputes are to be resolved under the law of a designated jurisdiction, but not all arbitration clauses contain such choice-of-law provisions. The arbitrators must then determine which state's or nation's law applies. And in any event, when the arbitrators commit error in selecting or applying established law, for practical purposes their error is almost always irreversible.

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13. The Federal Arbitration Act specifies four grounds on which a commercial arbitration award may be vacated:

> (1) where the award was procured by corruption, fraud, or undue means; (2) where there was evident partiality or corruption in the arbitrators; (3) 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 . . . [and] (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.

9 U.S.C. § 10(a) (2002). In addition to the statutory grounds listed in section 10(a), various federal courts have recognized non-statutory grounds for vacating awards. *See, e.g.*, Tanoma Mining Co. v. Local Union No. 1269, 896 F.2d 745, 749 (3d Cir. 1990) (recognizing that an award may be set aside if it displays "manifest disregard" for the law); United Paperworkers Int'l Union v. Misco, Inc., 484 U.S. 29, 43 (1987) (arbitration award may be vacated if it violates public policy); Montes v. Shearson Lehman Bros., Inc., 128 F.3d 1456, 1458 (11th Cir. 1997) ("arbitration award may be vacated if it is arbitrary and capricious.").

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The absence of any redress for mistakes of law committed in an arbitration is especially troublesome for policyholders in coverage disputes that raise cutting-edge issues—issues of first impression, or those on which conflicts between lower courts have not yet been authoritatively resolved. Arbitrators should ordinarily be able to apply any existing law accurately to frequently-litigated issues.[14] It is virtually certain, however, that arbitrators will sometimes incorrectly resolve issues for which there is no directly-governing precedent or the applicable case law is in conflict. A policyholder litigating such issues has a remedy when a trial court commits a legal error: appeal. But a policyholder whose claim is improperly rejected in arbitration has no redress. The policyholder who arbitrated in our hypothetical was left without a claim.

Further, since many of the insurance policies that contain arbitration clauses today are sold by foreign insurers, it is common for these insurers to appoint foreign lawyers or insurance professionals as arbitrators, and such individuals are sometimes selected as the "neutral" arbitrator as well. The risk that these individuals will commit mistakes of law where American law governs the dispute is high, especially if they are not legally trained. Because even foreign arbitrators who are lawyers are not necessarily experts on the way that American law works, however, it is common practice for the arbitrators to hear competing expert testimony on the state of the law applicable to the claim. But this is hardly a substitute for what Karl Llewellyn once called "situation sense"—the ability of a trained judge or lawyer long-acquainted with a field to discern the presence or absence of the subtle factors that affect both the direction and trajectory of legal development and the application of an established rule of law to a particular set of facts.[15] Wooden reasoning that fails to account for these subtleties may be the result.

Just as importantly, when certain insurers always include arbitration clauses in their policies, then the meaning of policy provisions that are unique or distinctive to these insurers' policies never come to be interpreted in accordance with established law governing their meaning, because there are no judicial decisions interpreting these provisions. Nor can any policyholder considering purchasing such a policy predict how its insurer will interpret

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14. *See* William M. Landes & Richard A. Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235, 249 (1979) (suggesting that arbitration is usually limited to disputes where the rules are perfectly clear).

15. *See* KARL N. LLEWELLYN, THE COMMON LAW TRADITION: DECIDING APPEALS 121, 203 (1960).

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terms that are unique to its particular policy form. Instead, each arbitration panel faced with a dispute as to the meaning of a particular provision must proceed as if it is writing on a blank slate. Yet the insurer may actually have already been involved in a series of arbitrations in which the meaning of the provision has been determined. Because of the confidential, non-precedent-setting character of those prior arbitrations, however, the policyholder will have no knowledge of the position the insurer took regarding the meaning of the provision, nor any knowledge of the prior arbitration panel's interpretation of the provision.

In any of these settings, the policyholder is subjected to potentially "lawless" treatment in several different ways. First, the insurer may take different positions regarding the meaning of a particular policy provision without concern for the requirements of judicial estoppel that would ordinarily obtain in a judicial proceeding. Therefore, the insurer may with impunity attempt to treat similarly situated policyholders differently, or differently-situated policyholders the same, each time interpreting the relevant policy provision in an inconsistent, but self-serving manner.

Second, an insurer that takes a position about the meaning of a policy provision is entitled to continue to do so even though one arbitration panel after another rejects the insurer's position. In effect, the insurer gets as many bites of the apple as it wishes. In contrast, in ordinary litigation the doctrines of collateral estoppel and stare decisis would give the insurer only one bite of the apple. It is true that, like the insurer, a policyholder who makes a claim which prior arbitration panels have rejected also has the right to assert that claim without being bound by prior precedent. But unlike the insurer, such a policyholder would never have been precluded in litigation by the doctrine of collateral estoppel from asserting the issue itself, because (unlike the insurer) it had not been a party to any of the prior proceedings.[16]

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16. *See, e.g.*, Parklane Hosiery Co. v. Shore, 439 U.S. 322, 327 n.7 (1979): "It is a violation of due process for a judgment to be binding on a litigant who was not a party or a privy and therefore has never had an opportunity to be heard." Defensive collateral estoppel can only be used by a defendant to prevent a plaintiff from asserting a claim that the plaintiff has previously litigated and lost against another defendant; in contrast, offensive use of collateral estoppel is permitted when the plaintiff seeks to foreclose the defendant from litigating an issue the defendant has previously litigated unsuccessfully in an action with another party. *Id.* at 326 n.4. *See also* Blonder-Tongue Laboratories, Inc. v. Univ. of Illinois Foundation, 402 U.S. 313, 328–29 (1971) (defensive use of nonmutual collateral estoppel requires that the plaintiff was a party to the prior action). Many states now follow the same rules. *See generally* Sup. Ct. Bd. of Ethics v. D.J.I., 545 N.W.2d 866 (Iowa 1996); In Re

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These "lawless" features of binding arbitration mean that every policyholder whose claim must be resolved in arbitration risks proceeding as if it is the first policyholder ever to make the kind of claim in question. The insurer is not bound by the results in past arbitrations, yet may employ the experience and knowledge it has gained in those past arbitrations in attempting to succeed in the current arbitration. Because of its involvement in prior arbitrations, the insurer may know how particular potential arbitrators have ruled on recurring issues; yet the policyholder probably will have no access to such information. And if an insurer were to continually take positions in court that prior courts had consistently rejected, it would face the downside possibility of being held liable for extra-contractual damages for the insurer's bad faith.[17] In contrast, in arbitration the insurer can continue to take such positions with impunity. In arbitration there is in this respect no downside for the insurer; there is only upside.

In certain situations this state of affairs is unlikely to be troublesome for policyholders. For example, when the issue or issues at stake in an arbitration have often been litigated and resolved by courts of law, the risk of being subjected to "lawless" treatment is reduced. The law governing the issue will be clear and arbitrators acting in good faith will find it easy to apply. Similarly, when the issue or issues are subject to established custom or trade usage with which the arbitrators and the parties are familiar, then a resolution consistent with these practice is to be expected. Finally, when a dispute turns mainly on issues of fact rather than legal issues of first impression, resolution of these issues in an arbitration may be highly desirable.

The difficulty many policyholders face, however, is that they cannot know in advance the particular character of the dispute or disputes that may arise under a policy containing a mandatory, binding arbitration clause. Those issues may be well-suited to resolution in an arbitration, or they may be issues that are especially susceptible to "lawless" treatment by the insurer and "lawless" resolution in the arbitration itself. Because it is likely to be impossible to know in advance which class of issues will arise in a policyholder's claim or claims, agreeing to mandatory, binding arbitration of

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Cohen, 753 N.E.2d 799 (Mass. 2001); Falgren v. State Bd. of Teaching, 545 N.W.2d 901 (Minn. 1996); Cities Serv. Co. v. Gulf Oil Corp., 980 P.2d 116 (Okla. 1999); Avila v. St. Luke's Lutheran Hosp., 948 S.W.2d 841 (Tex. App. 1997); Nielson v. Spanaway Gen. Med. Clinic, Inc., 956 P.2d 312 (Wash. 1998).

17. On liability for bad faith, see ABRAHAM, *supra* note 12, at 414–31; ROBERT L. JERRY II, UNDERSTANDING INSURANCE LAW § 25G at 151–61 (2d ed. 1996).

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insurance disputes at the point of sale is a risky undertaking for any policyholder. But even after a claim is made the issues that will arise may not be completely predictable. Though agreement on arbitration shortly after the point of claim is less risky, it is not without the same dangers.

III. THE PUBLIC CONSEQUENCES OF THE DECISION TO ARBITRATE

Just as the consequences of arbitrating a dispute risks lawless resolution for the individual parties, for the reasons described below the repeated practice of arbitrating a class of disputes generally risks lawlessness for the legal system as a whole. The fact that arbitration may have adverse consequence for the development of the law is insufficient reason, in itself, for the law to invalidate or even to look unfavorably on this practice. Freedom of contract should not be lightly set aside, especially when arbitration is the result of an agreement between sizable, well-informed commercial enterprises. But the threat of these adverse consequences should be enough to prompt a rethinking of the strong presumption favoring arbitration that prevails in American law.[18] A neutral stance would be far more appropriate.

To see the way in which binding arbitration may adversely affect legal development, consider once again our earlier hypothetical case that can either be arbitrated or litigated. In this case, once the state supreme court's decision on the expected or intended issue was rendered, under the doctrine of collateral estoppel the insurer was precluded from taking the same position in future cases because the issue had been fully litigated and definitively decided against it. Similarly, under the doctrine of *stare decisis*, the decision was binding precedent that would preclude other insurers from relitigating the issue. Because of both doctrines, and regardless of the identity of the insurer, a trial court would be without authority to hold that, on the same essential facts, a policyholder expected or intended bodily injury or property damage as a matter of law.

In contrast, an arbitration decision is not public, is not publicized, and is not published. In fact, in many arbitrations the parties are obligated to keep all proceedings and the outcome of the arbitration confidential. Certainly the decision of one arbitration panel has no binding or precedential effect on any other panel or insurer. And it is probable that in the view of most insurers, the particular insurer against which the first arbitration panel resolved an issue can continue to take the same position when either the same policyholder or any

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18. *See supra* note 4.

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other policyholder makes a claim involving essentially the same relevant facts. For all practical purposes, a decision by an arbitration panel is a public nullity. Consequently, neither the policyholder nor the arbitrators embarking on the arbitration of a dispute that raises issues which have been the subject of past arbitrations has a body of arbitration-generated precedent to guide them.

Thus, both the confidential and the non-precedent-setting features of binding arbitration have significant disadvantages. Established, publicly-known law is a public good. Such law provides guidance that aids and promotes commercial conduct and business planning. Even if a rule is wrong or unwise, if it is publicly known then those who are subject to the rule can govern their conduct accordingly. Established, publicly-available law also binds legal decision-makers, and by so doing makes the outcome of disputes more nearly predictable. Predictability of outcome promotes settlement. And promoting settlement of disputes is a feature of the public policy of virtually every legal jurisdiction, foreign or domestic. Thus, arbitration of disputes prevents the development of a body of established law and governing interpretations of relevant policy provisions, depriving the parties to future arbitrations of this public good.

Of course, the same charge might be made against settlement, which the law strongly favors. Some commentators have in fact argued that private settlement, as distinguished from trial and judgment, is in some ways against the public interest.[19] Settlement, however, is much less likely to have the same precedent-suppressing effect as arbitration. Settlement takes place in the shadow of litigation; the clearer the law governing a dispute, the smaller the divergence of the parties' estimates of the range of probable outcomes is likely to be, and the more likely settlement is to take place.[20] Settlement is therefore

19. *See, e.g.*, Owen M. Fiss, *Against Settlement*, 93 YALE L. J. 1073 (1984).

20. *See* George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1, 10–11 (1984). Although there has been much subsequent discussion in the literature regarding the Priest-Klein findings, the general point that other things being equal uncertainty of outcome discourages settlement has maintained high credibility. For discussion from various points of view, see Daniel Kessler et al., *Explaining Deviations From the Fifty-Percent Rule: A Multimodal Approach to the Selection of Cases for Litigation*, 25 J. LEGAL STUD. 233 (1996); Steven Shavell, *Any Frequency of Plaintiff Victory at Trial is Possible*, 25 J. LEGAL STUD. 493 (1996); Peter Siegelman & John Donohue, *The Selection of Employment Disputes for Litigation: Using Business Cycle Effects to Test the Priest-Klein Hypothesis*, 24 J. LEGAL STUD. 427 (1995); Peter Siegelman & Joel Waldfogel, *Toward a Taxonomy of Disputes: New Evidence Through the Prism of the Priest/Klein Model*, 28 J. LEGAL STUD. 101 (1999); Robert E. Thomas, *The Trial Selection Hypothesis Without the 50 Percent Rule: Some*

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more likely when there is firm, governing precedent. And when such precedent is absent, litigation leading to the establishment of precedent is more likely. Thus, settlement is unlikely to pose the same problems for the development of the law as arbitration. In fact, the practice of arbitration is likely to impede settlement by impeding the development of precedent.

The result is that, even for parties who are not forced to arbitrate insurance coverage disputes, the more prevalent the arbitration of similar disputes has been in the past, the less established law there will be to guide the adjudication and settlement of disputes that are litigated rather than arbitrated. Of equal importance is the fact that the continued, parallel litigation and arbitration of disputes raising the same issues will risk violating perhaps the single most important principle of our jurisprudence: the idea that like cases should be decided alike. This kind of lawlessness—differential treatment of similarly situated parties—reflects the denial of regularity that a system of established legal rules is designed to avoid. At bottom it is analogous to violation of the principle underlying due process requirements.

Ironically, then, the incorporation of arbitration clauses in a series of separate insurance contracts that are ostensibly the product of individual freedom of contract can combine to create a system in which there is little or no law to guide the resolution of disputes arising under the contracts. Designed to benefit the parties to each individual contract, the aggregate consequence of incorporating arbitration clauses in separate insurance contracts for all the parties can be to create disadvantages for these parties that are far greater than the individual benefits they had hoped to achieve through arbitration. Like the "tragedy of the commons," in which each individual has an incentive to consume more of a valuable common resource than is collectively desirable,[21] the practice of arbitrating of insurance disputes—even when it is in fact advantageous to particular parties—can prevent the development of the common resource of established, publicly-available law governing the meaning and application of insurance policies.

CONCLUSION

Without doubt, arbitration of certain commercial disputes, and even of certain commercial insurance disputes, is desirable. When the law governing

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Experimental Evidence, 24 J. LEGAL STUD. 209 (1995); Donald Wittman, *Is the Selection of Cases for Trial Biased?*, 14 J. LEGAL STUD. 185 (1985).

21. *See* Garrett Hardin, *The Tragedy of the Commons*, 162 SCI. 1243, 1244 (1968).

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an issue is well-settled, or where predominantly factual questions are at issue, arbitration offers a confidential, potentially expeditious method of resolving disputes. When legally unresolved issues may arise, however, arbitration of insurance disputes is a trap for the unwary. Because many major disputes under commercial insurance policies tend to raise such issues, commercial policyholders would be well advised to think twice before purchasing insurance policies that provide for mandatory, binding arbitration. They must weigh the advantages of confidentiality, cost-saving, and decision-maker expertise in certain respects, on the one hand, against the disadvantages of potentially lawless resolution of the dispute without recourse to correction by higher authority. And because binding arbitration impedes the production of publicly-known legal rules, the courts themselves should be more neutral toward arbitration than they have tended recently to be. The strong presumption in favor or arbitrating disputes that at least arguably belong in courts of law should be abolished.

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