CARLTON FIELDS

The Perils of Using Baseball Arbitration to Resolve RWI Policy Disputes

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In the world of M&A and private equity deals, buyer-side representation and warranties insurance (RWI) transfers the risk of a seller's representation to an insurer. To adequately safeguard the insurer, it therefore becomes necessary in any post-closing claim to have a thorough claim investigation, followed by a predictable dispute resolution regime set forth in the policy. Depending on the nature of the claim and the information that must be gathered and analyzed, often by expert consultants, processing these claims can take time.

Recently, buyers in M&A deals and their counsel have pushed to use baseball arbitration to resolve RWI policy disputes. While the speedy adjudication of any claim is beneficial, using baseball arbitration to resolve these disputes in particular creates unique problems given the information disparity between the parties in the RWI claims process.

To control the risk to insurers that use baseball arbitration, these insurers should consider incorporating in the arbitration provisions of their RWI policies certain safeguards to help ensure the claims process is fair. A model arbitration clause with these safeguards is included at the end of this article. While there is no guarantee a court will enforce these safeguards, including them may help level the playing field between buyer and insurer.

The Rise of Baseball Arbitration in Commercial Disputes

The term "baseball arbitration" refers to a form of arbitration that can be applied in any industry or context, not just in Major League Baseball. Generally, the key distinguishing feature of the process is that the arbitrator's discretion is limited to the proposals submitted to the arbitrator by the parties before the decision. Most of the time, the arbitrator reads the proposals in advance, but sometimes not. Regardless, this all-or-nothing approach creates a special incentive for the parties to submit reasonable proposals. The arbitrator will likely reject the unreasonably high or low proposal and go with the party with the more reasonable proposal. This, in turn, tends to narrow the differences between the parties' positions.

Typically, the baseball arbitration method is most effective where there is a higher gap between the parties' proposals and the information underlying the claim is external and not hidden from the other side. In other words, in cases where there is no information disparity between the parties. Take for example a dispute involving a baseball player's salary. The baseball player's statistics and the compensation of similarly-situated players are well known to both the player and team. Likewise, in the context of a dispute over the rate of fair market value for the leasing of a premises, a property's rental value can be readily ascertained from publically available market rental rates of comparable properties. In both situations, there is no information deficit for either side before claims are made and proposals are ultimately submitted to the arbitrator. The same cannot be said, however, for claims made under buyer-side RWI policies.

The Information Disparity Problem in RWI Policy Disputes

Contrary to the baseball salary and lease examples, an RWI policy dispute is often a first-party insurance claim. As such, by the time the claim is made, post-closing, only the buyer has access to the relevant information necessary to analyze a very fact-specific claim. The buyer owns the books and records of the purchased companies and controls access to continuing company employees. Thus, in contrast to the seller who sold the companies and made the alleged representations or omissions, the insurer can only access the information through the buyer.

This puts the insurer at a major disadvantage in the claims analysis and dispute resolution process. In a sense, the deck is stacked against the insurer. If it uses baseball arbitration without adequate safeguards in place, it might be influenced to

propose a substantially higher amount than would otherwise be warranted. Likewise, the buyer might be inclined to file an arbitration demand earlier in the claims evaluation process than would otherwise be the case.

Safeguards to Include When Using Baseball Arbitration

To reduce these risks to the insurer, we recommend including certain safeguards in the RWI policy's arbitration clause.

First, the arbitration clause should mandate reasonably extensive discovery not typical in arbitration proceedings. Discovery in arbitration is generally limited and additional discovery is controlled by the arbitrator subject to the rules under which the parties are arbitrating, such as AAA or JAMS rules, which may vary. The clause should also specify the manner and methods of discovery available to the parties, such as depositions, and should explicitly provide for pre-hearing discovery from experts.

Second, the arbitration provision should provide for the two parties to propose their awards only following the close of discovery. This will help ensure that the insurer obtains the requisite information from the buyer before it is required to submit a proposal to the arbitrator, thereby preventing the problem of overbidding in the dark.

Third, the arbitration clause should provide for interlocutory judicial review — i.e., prior to award issuance — of any party's challenges to an arbitrator's qualifications, including the candidate's disinterestedness or bias, and whether the arbitrator meets specified knowledge and experience thresholds. This is significant because, by default, case law construing the Federal Arbitration Act requires parties to wait until after the award to bring such a challenge. *See*, *e.g.*, *Gulf Guar. Life Ins. Co. v. Conn. Gen. Life Ins. Co.* , 304 F.3d 476, 489-92 (5th Cir. 2002) (construing FAA § 10(a)). And waiting until after the award is issued can result in unnecessary costs and delays for parties, which would defeat the purpose of using baseball arbitration in the RWI context in the first place.

While there is no perfect work-around for this barrier to seeking interlocutory judicial review, there are different ways in which the parties can construct the arbitration clause to improve the chances a court will consider such challenges. For starters, the parties can expressly state that the non-bias and qualifications provision of the clause is an essential term of the agreement that goes to the heart of the parties' contract. A challenge to the arbitrator's failure to enforce a core provision of the contract may convince a court to entertain even a pre-award judicial challenge. *See*, *e.g.*, *Gulf Guar.*, 304 F.3d at 490 ("a court may not entertain disputes over the qualifications of an arbitrator . . . unless such claim raises concerns rising to the level that the very validity of the agreement be at issue").

The parties could also write into the clause an express provision that authorizes the court to hear these challenges. Courts sometimes look to the clause to determine whether it authorizes such review. *See*, *e.g.*, *Baylor Health Care Sys. v. Beech St. Corp.*, 3:13-MC-054-D, 2014 WL 66470, at *1 (N.D. Tex. Jan. 8, 2014). Including such language is no guarantee, however, particularly if the court considers its power to entertain such challenges to be jurisdictional, as opposed to being merely discretionary. If viewed as jurisdictional, the court may return to the FAA and conclude it lacks the authority to consider the pre-award challenge.

Finally, the parties could consider changing the choice of law provision to apply the law of a state that allows for this type of judicial review. *See*, *e.g.*, *Arista Mktg. Assocs, v. Peer Grp.* , 522, 720 A.2d 659, 663 (N.J. App. Div. 1998). Or the parties could change the venue to a jurisdiction known for considering such claims even under the FAA. *See*, *e.g.*, *Oakland-Macomb Interceptor Drain Drainage Dist. v. Ric-Man Const., Inc.* , 850 N.W.2d 498, 505 (Mich. Ct. App. 2014). Again, there can be no assurance such a work-around will be effective.

Conclusion

To re-emphasize, insurers should be cautious in using baseball arbitrations to resolve RWI policy disputes. While the benefit of speedy and efficient claims resolutions is attractive to all parties involved, baseball arbitration requires both sides to have equal access to the information underlying the claim at issue. And in the RWI context, there is a natural information disparity that favors the buyer policyholder, thus putting the insurer at a severe disadvantage in this form of dispute resolution process.

There are ways the insurer can ameliorate this risk. As the sample arbitration clause shows, the contract should include provisions allowing for additional discovery and requiring discovery to be fully completed before any claims are submitted to the arbitrator panel. The clause should also provide for judicial review of non-qualified or biased arbitrator selections before issuance of any award. Such safeguards are essential to level the playing field when using baseball arbitration to resolve RWI policy disputes.

Sample Arbitration Clause with Baseball Arbitration Provision

SECTION #	ARBITRATION
(a)	Any dispute between the Insurer and the Insureds hereunder shall be submitted to the [arbitration tribunal, e.g., AAA] in [location, e.g., New York, New York] for confidential, binding arbitration under and in accordance with its Commercial Arbitration Rules for Large, Complex Commercial Disputes then in effect, except to the extent otherwise expressly provided in this Section.
(b)	There shall be three arbitrators. The Insurer and the Named Insured shall each select an arbitrator and the third arbitrator shall be selected unanimously by the two arbitrators. The arbitrators (1) shall be disinterested, and (2) shall have knowledge of (i) the matters which are the subject of the representations and warranties alleged to have been breached and (ii) the valuation of the alleged Loss. In the event that either party-appointed arbitrator shall be challenged for failure to qualify under these requirements, the arbitration tribunal's procedure for adjudicating such challenge shall not be final, and the challenging party may seek judicial review to the extent permissible by law. This is an essential part of the agreement and its non-enforcement is considered a fundamental breach of the contract.
(c)	The parties shall have full and fair access to discovery, from parties and non-parties, including both document and deposition discovery, and including pre-hearing discovery of opposing experts.
(d)	Within two weeks of the completion of discovery, the Insurer and the Insureds shall each submit to the arbitrators and exchange with each other, in advance of the commencement of hearings on the merits, their last, best offers. Following the hearings, the arbitrators, in rendering their award, shall be limited to awarding only one or the other of the two figures submitted. No reasoned award is required.
(e)	The arbitration dispute resolution mechanisms are intended to be the sole and exclusive dispute resolution mechanisms for any dispute arising between the Insurer and the Insureds hereunder and shall survive the cancellation or termination of this Policy and the exhaustion of the Limit of Liability.