Arbitration World

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From the Editors

Welcome to the 15th edition of *Arbitration World*, a publication from K&L Gates' Arbitration Group. This special edition focuses on issues and recent developments in the insurance coverage field. We also include our usual round-up of news items in international commercial arbitration and investment treaty arbitration.

We hope you find this edition of *Arbitration World* of interest, and we welcome any feedback (email ian.meredith@klgates.com or peter.morton@klgates.com).

News from around the World

Marcus M. Birch, London

Africa

Egypt

The Cairo Regional Centre for International Commercial Arbitration (CRCICA) has adopted the *UNCITRAL Arbitration Rules 2010*. CRCICA is the second arbitration centre to adopt the 2010 version of the Rules, after the Kuala Lumpur Regional Centre for Arbitration. Other institutions are reported to be considering adoption of the updated rules, which are intended to replace the previous UNCITRAL Arbitration Rules from 1976.

Americas

Argentina

An Argentinean appeal court has held that a mining dispute raises "public order" issues and is not arbitrable. In *CRI Holding Inc. Sucursal Argentina v. Compañía Argentina de Comodoro Rivadavia Explotación de Petróleo S.A.*, an American subsidiary and an Argentine corporation had executed a Joint Operation Agreement (JOA) to develop mining activities. The JOA was governed by Argentine law, including the Argentine Code of Mining, and contained an agreement to arbitrate any disputes arising out of it.

The first instance circuit court rejected CRI's claim for the constitution of an arbitral tribunal, reasoning that the provisions of the Argentine Code of Mining concern "public order" issues. The appeal court upheld that decision, declaring that any dispute between two mining companies which required the interpretation and application of the Argentine Code of Mining was not arbitrable. On that basis, the court held the agreement to arbitrate to be invalid.

The decision has attracted commentary and is perceived in some quarters as contrary to a trend to widening the scope of the notion of arbitrability in commercial disputes.

U.S.A.

The US Supreme Court has granted certiorari in *Stok & Associates P.A. v. Citibank, N.A.,* which raises the issue of when a waiver of a contractual right to arbitrate will be held as binding and irrevocable. Specifically, the Court will assess whether, under the Federal Arbitration Act, for a waiver to be binding and irrevocable it is necessary for the non-waiving party to establish prejudice as a result of the opposing party waiving its contractual right to arbitrate by participating in litigation. The case is expected to be heard this year.

The Supreme Court of New York has held that parties arbitrating anywhere in the world may apply to attach assets held in New York State, even if the case has no connection to the US. *Sojitz Corp v Prithvia Info. Solutions Ltd* involved a contract between a Japanese company and an Indian company governed by English law, which provided for LCIA arbitration in Singapore. Sojitz sought to attach US$40 million of Prithvi's assets located in New York, as security pending an arbitration award. Sojitz successfully obtained an attachment order, and Prithvi's argument that the court did not have jurisdiction over the parties or the dispute was dismissed. The case is the first time a New York court has granted an attachment order in support of an international arbitration between non-US parties. It arises out of a 2005 amendment to the Civil Practice Law and Rules which explicitly empowered the courts to make interim orders in support of international arbitrations, even where the proceedings have not yet been commenced, provided there is a risk that an eventual award "may be rendered ineffectual without such proper relief."

The US Supreme Court has upheld a contractual clause prohibiting class action arbitrations. In *AT&T Mobility v Concepcion*, the arbitration clause in AT&T's consumer contracts for mobile phone services prohibited class actions. The Court found that whilst California state law regards contractual clauses prohibiting class actions (whether in arbitration or litigation) as unconscionable and therefore unenforceable, that state rule was pre-empted by the Federal Arbitration Act In a narrow majority decision, http://www.supremecourt.gov/opinions/10pdf/09-893.pdf, the Court held that the clause was effective.

Asia

Hong Kong

It has been announced that the new Hong Kong Arbitration Ordinance will come into effect on 1 June 2011. The new Ordinance (reported on in the last edition of *Arbitration World*) is expected to improve the framework for arbitration in Hong Kong and to make it a more attractive venue for parties.

India

The Indian Budget for the financial year 2011–2012 includes a new levied service tax of 10.3% for services provided "*to any business entity, by an arbitral tribunal, in respect of arbitration*". The tax is likely to come into force in May or June 2011.

The tax will apply to the provision of arbitration services to Indian business entities, whether or not the seat of arbitration is in India. Where the seat is in India, then the obligation to file returns and pay tax will lie on the arbitral tribunal. Where the seat is outside India, and none of the arbitrators are based in India, the obligation to file returns and pay the tax will lie on the Indian business entity receiving the services.

India is not the first country to charge VAT on arbitration services, but certain commentators are concerned that the new tax will make Indian arbitration and arbitrating with Indian parties more expensive and less desirable.

Thailand

It is reported that the Thai government has recently introduced a requirement for arbitrators and counsel to obtain a work permit to conduct hearings in Thailand. Penalties are in place for failure to obtain the work permits.

Europe

France

The Paris Court of Appeal has added a chapter to the long-running *Dallah v. Pakistan* case.

The case, which has been reported previously in *Arbitration World* (February 2011 and October 2009 issues), involved an arbitral award of US$18 million obtained by a Saudi construction company against the Government of Pakistan. Dallah's attempts to enforce the award in England were

denied by the English courts, on the basis that the alleged parties did not have a common intention to be bound by the arbitration agreement, as required under French law, the law of the seat of the arbitration.

Meanwhile, in 2009, Dallah had obtained an enforcement order from a Paris court. Pakistan appealed. In its judgment of 17 February 2011, the Paris Court of Appeal confirmed the enforcement order. The Court did not apply the "common intention" test relied on in the English courts, but an objective test of whether Pakistan had behaved as a party to the arbitration agreement.

The judgment has been widely commented on, particularly in light of the different approach taken from that in the English courts. An appeal to the Court of Cassation is expected.

Institutions

IBA

The IBA Guidelines for Drafting International Arbitration Clauses have been made available in a range of languages and will be officially launched at the 2011 IBA Conference in Dubai later this year. The guidelines, which were approved in late 2010, cover the basic elements of arbitration clauses, the optional elements and complex clauses, including multi-tier, multi-party or multi-contract provisions. The guidelines were originally drafted in English, but the IBA has now made available French, Greek, Italian and Russian versions. Arabic, Chinese, Spanish and Turkish translations are also currently under review, and more language versions will be made available before the formal launch of the guidelines later this year.

World Investment Treaty Arbitration Update

Lisa M. Richman, Washington, D.C., Hugh A. Carlson, London, and Sabine Konrad, Frankfurt

In each edition of *Arbitration World*, members of K&L Gates' Investment Treaty practice provide updates concerning recent, significant investment treaty arbitration news items. This edition features a discussion of damage awards against the Russian Federation and Tajikistan; two awards rejecting claims under the UK-Egypt bilateral investment treaty ("BIT") and NAFTA; a report on Australia's decision to avoid providing for investor-state arbitration in future treaties; and an update on the request for clarification of a jurisdictional award by the Government of Jordan.

Award in Dispute over Expropriation of Investment in Yukos Made Public—Russian Federation Responsible for a Fraction of Damages Requested

Last September a tribunal constituted under the Arbitration Institute of the Stockholm Chamber of Commerce issued its award in the case of *RosInvestCo UK Ltd. v. The Russian Federation,* SCC Case No. 079/2005. The decision, published in January, arose out of a claim brought by RosInvestCo UK ("RosInvest"), a subsidiary of the distressed asset investor Elliot Group, against Russia under the UK-Russia Investment and Protection Agreement ("IPPA").

At issue was RosInvest's US $10 million speculative investment in shares of Yukos in late 2004, protected by an asset protection agreement that allocated the risk to Elliot Group's parent. RosInvest purchased the shares at a time when their value had diminished significantly because of Russia's actions against Yukos, including auctioning off of Yukos' common shares in its principal production facilities to a State-owned company. (For a further discussion of actions relating to the auctioning of the shares, see our report in the October 2010 edition of *Arbitration World*.)

The tribunal concluded that Russia's measures constituted an unlawful expropriation under Article 5 of IPPA because their effect was intended to "destroy Yukos and gain control over its assets." Despite this, the tribunal awarded damages of only US $3.5 million, plus simple interest at LIBOR, a fraction of the US $232.7 million requested. In reaching its decision, the tribunal agreed with the Respondent's damages report that, at the time of RosInvest's investment in late 2004, the market (and therefore RosInvest) was fully aware of Yukos' precarious situation and the government's likely actions. The tribunal also determined that the proper valuation date was January 2007, when the economic risk for the shares was shifted to

RosInvest (for which RosInvest paid US $3.5 million—which therefore represented market value for the shares in the tribunal's estimation).

The award has attracted criticism for its interest calculation because it relies on the interest rate applicable under the IPPA for **lawful expropriations** notwithstanding the tribunal's conclusion that Russia's conduct constituted an unlawful expropriation. The tribunal rejected claimant's request for compounding of accrued interest, basing its decision on the "speculative" nature of RosInvest's investment instead of Russia's unlawful actions.

Despite Finding Tajikistan Breached its Obligations under the ECT, Tribunal Declines to Award Compensation

An arbitral tribunal sitting under the auspices of the Stockholm Chamber of Commerce recently ruled that the Republic of Tajikistan breached its obligations under Articles 10(1), 10(7) and 13 of the Energy Charter Treaty ("ECT") in relation to its treatment of an Austrian investor. *See Al-Bahloul v. Tajikistan*, SCC Case No. V (064/2008), Final Award of 8 June 2010. Despite this conclusion, the tribunal declined to award any damages to the investor on the theory that he failed to properly substantiate the quantum.

The claim by Mr. Mohammad Al-Bahloul arose out of Tajikistan's alleged failure to grant oil and gas exploration licenses to his company for four different Tajik sites in 2001 in spite of contractual undertakings to do so. Tajikistan opted not to defend itself in the case, although it sent a letter at the outset denying the tribunal's jurisdiction to consider the claims seeking specific performance and compensatory damages of over US $200 million (plus interest).

In its award, the tribunal first declined to order Tajikistan to issue the contested licenses. It held that specific performance is a permissible remedy under both international law and the ECT, but should not be granted where its implementation is "materially impossible", which it was because the Claimant was seeking issuance of exclusive exploration rights to the sites retroactively to 2001. While declining to award specific performance, the tribunal was prepared to award financial compensation, but ultimately awarded no damages.

The tribunal acknowledged that the discounted cash flow ("DCF") method proposed by Mr. Al-Bahloul's expert may be appropriate. However, it determined that the DCF calculation cannot be based on mere "speculation". The tribunal determined that there were too many "unsubstantiated assumptions" to support use of the DCF method. For example, the tribunal determined that Mr. Al-Bahloul failed to prove that he could have financed the exploration (had the licenses been granted), that the exploration would have been successful, and that he could have sold the hydrocarbons produced. These facts "*destroyed the causality between the breach committed by the State and the loss of the alleged future cash flows* [i.e., lost profits]." Because he did not offer an alternate method to assess the damages, the tribunal denied his claims for compensation, while requiring Tajikistan to pay part of his legal costs.

Tribunal Finds that a Contract Procured by Fraud May Serve as the Basis for Jurisdiction, but not for an Award of Damages on the Merits

In a dispute relating to Egypt's alleged illegal termination of an airport concession contract, the arbitral tribunal in *Malicorp Ltd. v. Egypt*, ICSID Case No. ARB/08/18, rejected the claimant's arguments that Egypt breached the UK-Egypt BIT.

The tribunal first found it had jurisdiction to consider the dispute despite Egypt's argument that the contract was procured by fraud, rendering it unavailable to be protected under the BIT. The tribunal's conclusion was premised on the fact that the contract, whether procured by fraud or not, constituted an "investment" under the BIT and Article 25 ICSID Convention. The tribunal acknowledged that a consideration of whether there is an "investment" protected by the BIT generally is an issue for the merits, but that to determine the "scope of the jurisdiction *ratione materiae*," the tribunal must also consider this issue at the jurisdictional stage. The commitment to contribute meaningfully at a later date convinced the tribunal that the contract constituted an investment, despite Malicorp's minimal performance under the contract.

Although disputing that the test was controlling, the Tribunal acknowledged that the contract met the *Salini* test for "investments" (a contribution, of a certain duration, presenting risk and promoting the economic development of the host country) along with an additional factor that the investment must be "of a nature to generate returns." It bears noting that several decisions have argued that the *Salini* test does not apply to the analysis of whether something constitutes an "investment". *See, e.g.*, *Alpha Projektholding GmbH v. Ukraine,* ICSID Case No. ARB/07/16, Award of 8 November 2010; *Saba Fakes v. Turkey*, ICSID Case No. ARB/07/20, Award of 14 July 2010; *Malaysian Historical Salvors SDN BHD v. The Government of Malaysia*, ICSID Case No. ARB/05/10, Decision on the Application for Annulment of 16 April 2009; *Biwater Gauff v. Tanzania*, ICSID Case No. ARB/05/22, Award of 24 July 2008.

On the merits, the *Malicorp* tribunal agreed with Egypt's contention that the concession contract had been validly terminated under Egyptian law. Egypt made two primary arguments in support of termination: first, Malicorp's alleged fraud in procuring the contract and second, the non-performance of its contractual obligations. The tribunal accepted the second reason as sufficient to justify termination, noting that Malicorp did not take the "significant legal, financial and most of all technical steps required to launch such a project." Given that conclusion, the basis for Malicorp's claim of expropriation was negated. In assigning costs, the tribunal observed that Egypt "was not itself completely beyond reproach in the phase leading to the conclusion of the contract", however, and therefore ordered each side to bear their own costs.

United States' Flawless Record in NAFTA Arbitrations Remains Unmarred—Arbitrators Reject all Claims in Tobacco Industry Dispute

In a recently released decision, a tribunal dismissed claims brought pursuant to Chapter 11 of the North American Free Trade Agreement ("NAFTA") alleging discrimination and violation of the standard of fair and equitable treatment. *See Grand River Enterprises Six Nations, Ltd. et al v. United States,* UNCITRAL, Award of 12 January 2011. The dispute concerned tobacco control legislation implemented by U.S. states beginning in the late 1990s.

Grand River Enterprises, an Ontario, Canada-based corporation, and three individual claimants, all of whom are members of First Nations (an indigenous group), alleged that they operated an "enterprise" for the production of cigarettes in Canada and their distribution and sale in the United States that was discriminated against by the legislation. The tribunal determined that, because of the location of the production plant in Canada, three of the claimants did not have investments that qualified for NAFTA protection. It was unconvinced by the claimants' arguments that the production plant and distribution facility, in the aggregate, constituted an "enterprise" for the purposes of NAFTA Article 1139.

The tribunal rejected on the merits claims from the fourth claimant, Arthur Montour, who owned distribution companies based in the U.S. that he alleged were adversely impacted by the tobacco control laws. Although he had a qualifying investment eligible under NAFTA, the tribunal reasoned that Mr. Montour could not have had a reasonable expectation that his investment would be treated differently than other, similar investments because of alleged immunity from regulation under the terms of U.S. federal Indian law. The tribunal declined to analyze the potential conflicts between the regulations at issue and U.S. federal Indian law, and instead determined that Mr. Montour should have been aware of the extensive regulation of the tobacco business by the U.S. Because of the conflict, he should not have expected to receive immunity.

In response to the contention that the U.S. also violated the obligation to assure national and most favored nation ("MFN") treatment, the tribunal determined that there was insufficient evidence that Mr. Montour's distribution business was subjected to enforcement measures that were not applied to other similarly situated businesses. The tribunal declined to weigh in on the debate between the parties as to whether a difference in treatment must have been motivated by or related to the investor's "nationality" before a finding of discrimination could be upheld or whether a differential treatment

(relative to a competitor) would suffice to violate NAFTA.

Australia Rejects Investor-State Arbitration for Future International Trade Agreements

The Government of Australia has announced that it will no longer include investor-state arbitration in its trade agreements. In a trade policy statement issued on 12 April 2011, the government acknowledged that it had included such provisions in past agreements at the request of domestic businesses, but would discontinue the practice. *See Gillard Government Trade Policy Statement: Trading our way to more jobs and prosperity* (*available at* http://www.dfat.gov.au/publications/trade/trading-our-way-to-more-jobs-and-prosperity.pdf). The government noted that: "[i]f Australian businesses are concerned about sovereign risk in [foreign] countries, they will need to make their own assessments about whether they want to commit to investing in those countries". *Id.* at page 14.

The trade policy statement follows a November 2010 research report on trade and investment barriers by the Australian Government Productivity Commission. The report concluded that it was "doubtful" that including investor-state dispute settlement provisions in international agreements "affords material benefits to Australia or partner countries" and recommended that the government exclude such provisions in future agreements. *See Bilateral and Regional Trade Agreements Productivity Commission Research Report* (*available at* http://www.pc.gov.au/__data/assets/pdf_file/0010/104203/trade-agreements-report.pdf), pages 276, 285.

The government prefaced the decision primarily on two policies. First, it wants to avoid granting foreign businesses greater rights than those available to domestic companies. Second, it aims to prevent constraints on the government's ability to legislate on social, environmental and economic matters. For example, it seeks to avoid any "limit [on the government's] capacity to put health warnings or plain packaging requirements on tobacco products", an effort that has been unpopular with foreign tobacco companies, or its ability to continue a prescription drug policy that has drawn criticism from global pharmaceutical companies.

The impact of the policy shift on the negotiations surrounding the Trans-Pacific Partnership Trade Agreement between Australia, the United States, New Zealand, Brunei, Chile, Malaysia, Peru, Singapore, and Vietnam remains to be seen. As Australia's position plays out in practice, proper investment structuring (to take advantage of bilateral investment treaties allowing for investor-state arbitration) will become all the more important for Australian businesses wishing to invest abroad.

UPDATE: Jordan Requests Clarification of Award—Arbitration Claim Reinstated

Following the May 2010 award in *ATA v. Jordan*, ICSID Case No. ARB/08/2, concluding the claimant was entitled to proceed with its arbitration under the terms of an agreement struck down by the Jordanian court, Jordan requested an interpretation of the award pursuant to Article 50 of ICSID. (For a more detailed discussion of the May 2010 award, see our report in the October 2010 edition of *Arbitration World*.) Jordan sought clarification as to whether the tribunal intended to fully restore the arbitration agreement in question, thereby giving both parties to the original agreement the right to arbitration, or intended to provide that right only to ATA and not to APC (the Jordan-controlled counterparty). Considering the *Chorzow Factory* principle that "reparation must, as far as possible, wipe out the consequences of the illegal act," the tribunal observed that it was necessary to restore the *status quo ante*, that is, the entire contract. To fashion a different arbitration clause would have been beyond the tribunal's competence. Despite ATA's arguments to the contrary, the tribunal therefore concluded that APC was not barred from exercising rights flowing from the restored arbitration agreement.

Business Interruption Claims and Natural Disasters

Ian Fisher, Singapore

The recent devastating earthquake and tsunami that hit Japan has reminded us all of just how destructive the natural world can be. In addition to being a humanitarian crisis it will continue to cause

financial loss to businesses operating both in the immediate vicinity of the devastation and throughout Japan, with far-reaching effects beyond its borders.

Many of the losses will be insured. Those losses will not only concern the physical damage or destruction of insured property (PD) but also business interruption (BI) losses.

In recent years there have been a number of other natural disasters which have caused similar widespread damage and devastation over huge areas. These include the Asian Tsunami of December 2004 and Hurricanes Katrina and Rita in the US in the autumn of 2005. Those disasters generated a number of disputes between insureds and their insurers on the extent to which PD and BI insurance covers such losses.

This was a particular issue in the leisure industry where the impact on the region's economy could be particularly severe if the region affected by the disaster is also a tourist location. For example, hotels often continued to suffer BI losses for a long period after the damage to the hotel had been repaired given the damage to the wider area and people's reluctance to visit an area associated with such a catastrophe. One area of dispute between insurers and insureds that has arisen is whether the BI loss is caused by the PD or by the more general downturn in tourism, and whether loss caused by the general downturn should be indemnified under the terms of the policy.

A decision of the English High Court last year addressed this issue and the decision is of significant importance to combined PD and BI insurance which follows the standard UK wording.

Orient-Express Hotels Ltd v Assicurazioni Generali SpA (2010)

The claimant in this case, Orient-Express Hotels Ltd (OEH), was the owner of a luxury hotel situated close to the historic French Quarter of New Orleans. As a result of Hurricanes Katrina and Rita in autumn 2005 the hotel suffered significant physical damage. As a consequence the hotel was closed throughout September and October 2005. The surrounding area of New Orleans was also devastated by Hurricanes Katrina and Rita resulting in a state of emergency being declared and a city-wide curfew being imposed. The BI section of the subject policy provided cover for *"loss due to interruption or interference with the Business directly arising from Damage"*. "Damage" was defined as *"direct physical loss destruction or damage to the Property"*.

The policy also included a 'Trends Clause' (also known as a 'Special Circumstances', 'Other Circumstances' or 'Adjustments' clause) which provided for revenue figures to be adjusted as necessary so as to *"represent as nearly as may be reasonably practicable the results which but for the Damage would have been obtained ..."*.

The policy also included clauses providing extended cover for Loss of Attraction (LOA) and Prevention of Access (POA). OEH recovered an indemnity under these extensions; however, that cover was subject to significantly lower limits than the limits available under the main BI cover in the policy.

A claim was made by OEH under the combined PD and BI policy. Generali disputed part of the BI claim on the basis that there was no insured interruption as, even if there had been no physical damage to the hotel, the curfew and wider area damage would have prevented it from receiving visitors.

The matter was referred to arbitration and an award was made in favour of Generali. OEH appealed against the decision of the Tribunal under Section 69 of the Arbitration Act 1996 on two questions of law:

1) whether the policy provided cover in respect of loss which was concurrently caused by both physical damage to the property and damage to or consequent loss of attraction of the surrounding area; and

2) whether the same event(s) which give rise to the BI loss were also capable of being or giving rise to 'special circumstances', allowing an adjustment of the BI losses within the scope of the 'Trends Clause'.

In relation to the first question OEH accepted that the normal rule for determining causation in fact is the "but for" test. However, OEH argued that a "but

for" causation test was not appropriate in the actual circumstances. OEH argued that this was a situation where it was "fair and reasonable" to relax the "but for" test. Further, OEH argued that it was an accepted principle that where there are two proximate causes of a loss an insured can recover on the basis that it is sufficient that one is a peril insured, provided that the other is not expressly excluded. Whilst that principle had been applied to concurrent interdependent causes, it was argued that it should be applied to concurrent independent causes.

The Court rejected OEH's arguments. While there may be cases where fairness and reasonableness required the relaxation of the "but for" test, this was not one of them. The Court considered there to be clear express terms in the policy, particularly in the 'Trends Clause', which required the "but for" test to be applied. The Judge said, *"This is made clear in the Trends Clause which is predicated on calculating the recoverable losses on the basis of what would have happened 'had the Damage not occurred' or 'but for the Damage'. As such it is difficult to see how it could ever be appropriate to disregard that causal test, or how the Policy would work if one did."*

In relation to the second question, OEH argued that the 'Trends clause' should not be construed so as to permit an adjustment for the consequences of the very same insured peril which caused the insured damage and relevant BI loss. The Court rejected that argument. The Court ruled that there was nothing in the wording of the clause which restricted it to circumstances which were entirely independent of the events leading to the insured loss. The clause was concerned only with Damage and not the cause of the Damage. OEH's interpretation required words to be read into the clause which were not there.

Comment

A number of the arguments that were put to the court were similar to those made by insureds in other disputes following natural catastrophes, such as the Asian Tsunami. The decision therefore provides clarification of the position, particularly in relation to the interpretation of the 'Trends Clause' which had not previously been considered in any reported English case.

While the decision provides guidance when considering BI claims under UK wordings the situation may be different when dealing with other, non-UK, wordings which may for example cover interruption flowing from 'loss' rather than 'Damage'. As ever it is important to pay particular care to the specific wording used in the relevant policy. Nevertheless, the decision highlights a potential difficulty that insureds might face in looking to claim for BI losses which arise from a devastating natural disaster.

Drafting Arbitration Clauses for Insurance Policies

Laura Atherton, London

Dispute resolution provisions in insurance contracts are often given little attention and may contain clauses that have been lifted wholesale from other documents without proper consideration of whether they are suitable. This can create obvious difficulties since a clause designed for one type of policy may be totally inappropriate for another.

Insurers in certain classes of business favour arbitration, rather than litigation, as a means of dispute resolution since the confidentiality of arbitration allows them to resolve conflicts with policyholders behind closed doors. It also avoids the creation of multiple binding precedents regarding the construction and interpretation of their policy wordings. Before approaching any drafting points, policyholders should consider whether arbitration is appropriate for their purposes or whether litigation would be preferable.

Assuming the parties have agreed on the use of arbitration, those involved in negotiating and drafting the clause need to be aware of some of the common pitfalls and consider how to avoid them.

Consistency within the policy and between policies

Consistency of dispute resolution terms is particularly important in insurance contracts. It is not unheard of for the same policy to provide for arbitration in one clause, but refer to particular courts having exclusive jurisdiction in another. Policyholders should check that there are no such

inconsistencies in their insurance policies as this can delay the resolution of any coverage dispute while the parties argue over which dispute resolution provision should apply.

Another problem frequently encountered is that of inconsistency between the dispute resolution provisions of the primary policy and excess layer policies. Some excess layer insurers agree to follow the form of the primary layer policy, but seek to impose their own chosen method of dispute resolution, which may not be consistent with that of the primary layer.

This can lead to considerable legal and practical difficulties. Imagine an insured in a coverage dispute with its insurers who discovers that all of its insurance policies provide for dispute resolution in the courts of West Virginia, save for the primary layer, which provides for London-seated arbitration. The insured would probably be forced to enter into two separate sets of proceedings in two separate jurisdictions on the same coverage issues. This would increase the expense of the proceedings, but also create a real risk of inconsistent decisions in the two proceedings. The moral is that a dispute resolution clause (and indeed all the wording in a policy) should be assessed not only on its own merits but also in the context of the whole insurance programme.

Making the clause work

The most serious risk to an arbitration clause in a policy is that the clause fails altogether. It is surprising how often arbitration clauses in insurance policies are missing certain key components. A clause that lacks key elements, or contains uncertain or contradictory wording, may fail to constitute an effective or meaningful submission to arbitration. Such clauses are known as "pathological" clauses, and tribunals and courts often refuse to enforce them, requiring the parties to fall back on court litigation. Policyholders should ensure that their clause contains a clear and unambiguous submission by both parties to a specifically-identified form of arbitration.

A related, but less serious risk is presented by gaps and inconsistencies in the text which, while not serious enough to constitute "pathological" defects, can nonetheless lead to debate over the precise meaning of the clause, and consequent delay and additional legal costs involved in resolving such debate and 'filling in the blanks' in the arbitration clause once a dispute has arisen. This delays resolution of the coverage dispute and gives insurers yet more scope to delay payment.

Basic ingredients in any arbitration clause, in addition to the agreement to arbitrate, include provision for the seat (the legal place of the arbitration) and the procedural law of the arbitration. The policyholder needs to consider carefully whether the insurers chosen place of arbitration is acceptable, particularly if the insurer is based in another jurisdiction.

The procedural law may be different from the substantive law governing the dispute. This is the practice in the well-used "Bermuda Form" which is a form of excess layer insurance written by Bermuda insurers which typically provides for arbitration with English seat and English procedural law but the law of the contract of insurance is New York law.

Other matters worth defining in a clause include the language of the arbitration, whether the arbitration is to be administered by a particular institution (e.g. ICC, LCIA or ICDR) and any procedural or evidential rules the parties wish to apply to the arbitration. If the parties intend to use institutional arbitration rules, they should consider whether to provide for the rules in force at the time of entering into the policy or those in force at the time of the referral of the dispute to arbitration and check what the rules may say on that issue. A check on those rules is essential: it is not unknown for parties to discover, once a dispute has arisen, that the arbitration clause refers to the rules of an arbitral institution which no longer exists.

The arbitrators

The identity and experience of the arbitrators will be important in the handling and determination of any dispute. It is preferable to address questions of how many arbitrators, from what background, and how the arbitrators are to be chosen at the stage of clause drafting rather than once a dispute has arisen.

One big issue is the number of arbitrators. It is common for arbitration clauses in insurance

contracts to provide for three arbitrators. Depending on the circumstances, this may not be necessary and one arbitrator may suffice. Remember that three arbitrators will mean three sets of arbitrators' fees and can mean it takes longer to convene hearings at the tribunal's convenience, and longer for the final award to be issued given the involvement of three arbitrators.

A common source of delay in progressing a dispute is the time taken by the parties to agree upon suitable arbitrators. Consider whether this delay could be avoided by wording in the arbitration clause limiting the selection to a defined category of individuals, for example those with particular insurance expertise, or by providing in the clause that appointments are to be made by an independent institution or individual such as the ICC or the President or the Deputy President, for the time being, of the Chartered Institute of Arbitrators.

A particular issue in the insurance context arises from the fact that insurers often include in arbitration clauses a requirement that arbitrators have a certain number of years of insurance industry experience. This may mean that those eligible for appointment come from an insurance company background and will often have a 'pro-insurer' outlook. Where there are to be three arbitrators, policyholders may wish to consider inserting a requirement that at least one of the arbitrators has experience in their own industry and/or that at least one is an insurance lawyer with experience of acting for policyholders.

Costs provision

Finally, a word of warning on provisions for costs. Some insurance policies adopt dispute resolution clauses which provide that the costs of an arbitration will be borne equally between the parties. Such a clause can be highly problematic for a policyholder seeking to challenge an insurer's refusal of coverage, because even if successful, the policyholder would still have to cover its own costs of the proceedings. However, where the seat of the arbitration is in England, such an agreement as to costs (unless made after the dispute arises) would be invalid by Section 60 of the English Arbitration Act.

As the above shows, a small amount of time spent reviewing and checking the wording of the dispute resolution clause in your insurance contracts can pay dividends in the event of a coverage dispute.

Repeat Arbitrator Appointments and Issue Conflicts in Bermuda Form Arbitrations

Joseph C. Safar, Pittsburgh

A large number of insurance policyholders are now buying various forms of liability coverage on the basis of what has become known as the "Bermuda Form". Historically, the name comes from the fact that a number of Bermuda-based insurers (including ACE and XL) began writing excess liability coverage in the 1980s using a then new and unique form of insurance.

The typical Bermuda Form policy provides that New York Law is the substantive law of the contract of insurance but includes an arbitration clause providing for London-seated arbitration under the Arbitration Act 1996 (the "Act") before a tribunal of three arbitrators, consisting of two arbitrators nominated by the respective parties, and a chair, who is nominated by the two party-appointed arbitrators. While all three arbitrators are legally bound under section 33(1)(a) of the Act to act impartially, there is a tendency by insurers to repeatedly appoint arbitrators from a relatively small group of candidates.

A number of factors inherent in Bermuda Form arbitration place policyholders at a disadvantage in dealing with "repeat appointments" and the often related potential problem of so called "issue conflicts" (*i.e.*, where an arbitrator has given an award in a previous arbitration which raised similar (or the same) issues). Bermuda Form arbitrations are typically confidential, with confidentiality being strictly enforced by the English courts, and awards are not reported. By virtue of their involvement in multiple arbitrations, insurers have a significant "private" base of knowledge concerning potential arbitrator candidates and are far more likely to have some indication, based on past cases, of how a given arbitrator might view a particular issue. By comparison, few policyholders have been involved

in multiple Bermuda Form arbitrations, let alone a sufficient number to have a comparable knowledge base. As a result, insurers enjoy a significant informational advantage in selecting a sympathetic party-nominated candidate and, potentially, a sympathetic chair.

There is no legal requirement that arbitrators disclose repeat appointments or potential issue conflicts, and the ability to remove arbitrators, or to successfully challenge an award for bias, based on an arbitrator's prior experience with the parties or issues is limited under English arbitration law. Accordingly, policyholders may wish to seek out alternative ways to neutralize the advantage that insurers enjoy in the arbitrator selection process.

Absent an agreement on the scope of what is to be disclosed, arbitrators in Bermuda Form arbitration will make disclosure of potential conflicts based on their own interpretation of best practices, with an eye toward the universally-recognized, ultimate goal of delivering a legally enforceable award. There is, however, an inherent tension between an arbitrator's autonomy in making disclosure and his economic self-interest in the nomination. This tension is exacerbated when the arbitrator has a track record of nominations from the same party, or from parties that are consistently on the same side of a given set of issues.

In an effort to provide guidance on best practices in dealing with conflicts, the International Bar Association published a set of Guidelines on Conflicts of Interest in International Arbitration (the "IBA Guidelines"). The IBA Guidelines, however, are not legally binding; they are guidelines only and do not overwrite any applicable national laws. *See* IBA Guidelines, Introduction, ¶ 6. Further, while many arbitrators feel that the IBA Guidelines embody best practices (or at least a safe harbor) and voluntarily follow them, some disagree with at least some aspects of the IBA Guidelines. Thus, the IBA Guidelines can be a useful tool in dealing with potential conflicts, but it is important to have an understanding as to their applicability, and, if they are confirmed or agreed as applying, to understand their substantive limitations.

If the IBA Guidelines apply, they employ a hybrid subjective/objective approach to disclosure and disqualification. Under Part I, which sets forth the general standards regarding disclosure and impartiality, an arbitrator is supposed to disclose "facts or circumstances that may, in the eyes of the parties, give rise to justifiable doubts as to the arbitrator's impartiality." IBA Guidelines, Part I, General Standard 3(a). Any doubts are to be resolved in favor of disclosure. *Id.*, General Standard 3(c). Part II provides a series of practical rules applying the general standards. Under Part II, an arbitrator is specifically required to disclose if he has been appointed within the past three years on two or more occasions by one of the parties or an affiliate. *Id.*, Part II, Rule 3.1.3. The arbitrator is also required to disclose if he has publicly advocated a specific position regarding the case that is being arbitrated. *Id.*, Rule 3.5.2.

Part II does not address, one way or the other, the arguably most problematic issue-based conflict: one arising from an arbitrator having decided the same issue in prior arbitrations. This issue conflict is pernicious where the arbitrator is a repeat appointee. And it is insidious because it likely will not become apparent to the arbitrator until after the tribunal has been constituted and the arbitration has commenced, as discussion of the merits is generally considered off limits when interviewing prospective arbitrators. *See, e.g.*, Chartered Institute of Arbitrators, Practice Guideline 16: The Interviewing of Prospective Arbitrators, paragraph 9. Thus, when it comes to light, the arbitrator will be faced with having accepted an appointment by a repeat-nominating insurer under circumstances where the insurer had unilateral knowledge that the arbitrator had previously decided a key issue in the case in the insurer's favor. Such a scenario certainly gives rise to legitimate questions in the eyes of a policyholder and accordingly should be viewed as falling within the general disclosure mandate in Part I.

It should also be noted that the IBA Guidelines recognize an exception to disclosure in specialized areas of practice, such as maritime or commodities trading, where it is common practice for the parties to draw from a small pool of arbitrators familiar with the industry. *Id.*, Part II, n. 6. This carve-out for maritime and commodities trading is rooted in English traditions dating to the 17th century. Arguably Bermuda Form arbitration (between a

policyholder and insurer) should not be viewed as qualifying for this specialized exception to disclosure.

As a practical matter, application of the IBA Guidelines is unlikely to produce a disqualification of a repeat appointee or an issue-conflicted arbitrator. Repeat nominations and prior advocacy of a particular position are considered "Orange List" conflicts, which do not result in automatic disqualification of an arbitrator. *Id.*, Part II, ¶ 4. Instead, the purpose of "Orange List" disclosure is to inform the parties so that they can further explore the situation. If an objection is lodged, the arbitrator is supposed to recuse himself if there is a justifiable, objective doubt as to the arbitrator's impartiality. *Id.*, Part I, General Standard 2(b). The arbitrator is unlikely to conclude that this standard has been met. Accordingly, it will almost always fall on the aggrieved party to decide whether to apply to the English courts to attempt to disqualify the arbitrator. The prospect of mounting a successful challenge based on prior experience with the parties or issues, however, is not good under the current state of English law.

Under Section 24(1)(a) of the Act, a party may apply to the court to remove an arbitrator on the grounds "that circumstances exist that give rise to justifiable doubts as to his impartiality." Historically, English courts have applied either a "real danger" of bias test, *see R v Gough* [1993] AC 64, or, more recently, a "real possibility" of bias test, *see Porter v. Magill* [2002] AC 357. Although there is debate as to whether material differences exist, the "real possibility" test (sometimes also referred to as the "reasonable suspicion or apprehension" test) might be easier to satisfy insofar as apparent bias is judged from the perspective of an objective, informed non-judicial observer rather than the court. Even under the "real possibility" test, however, courts have refused to disqualify an arbitrator based merely on previously expressed views, including that he had previously decided a particular issue in favor of one party. *See Amec Capital Projects Ltd v. Whitefriars City Estates Ltd* [2004] EWCA Civ 1418 para [20-21]. This rather high standard for impeachment was said to guard the purposes of the Act—the speedy resolution of disputes and the summary enforcement of awards—against facile challenges. *Id.*, para [22].

While limiting spurious challenges to arbitrators is a legitimate goal, an equally legitimate goal, and one with which the arbitration community, as opposed to the courts, ought to be at least equally concerned, is the desire to preserve the integrity of arbitration in the eyes of those who use the process. The repeat appointment of the same arbitrators by insurers, combined with the inherent informational imbalance among the parties, gives rise to a legitimate sense of unease on behalf of policyholders that deserves attention.

At least one preeminent arbitrator has noted the need for increased clarity in the guidelines addressing "repeat players" in insurance matters. *See* William W. Park, *The Borders of Bias: Rectitude in International Arbitration,* in *Making Transnational Law Work in the Global Economy: Essays in Honour of Detlev Vagts* 582 (P. Bekker, R. Dolzer & M. Waibel, eds., Cambridge University Press (2010)). Unfortunately, there is presently no initiative in the arbitration community to address this specific need.

As a consequence, a policyholder's interests are presently best protected through the effective management of the appointment of the tribunal chair. Effective management of chair appointment begins with the selection of coverage counsel experienced in Bermuda Form arbitrations. Experienced coverage counsel will possess valuable information regarding repeat insurer nominees. Experienced counsel will also help select a policyholder-nominated candidate who is sensitive to issues raised by repeat insurer appointments and will take appropriate steps to ensure that the chair is free from these issues. These steps will include insisting upon disclosure standards and a chair profile that disqualifies repeat appointees from serving as the chair. If chair selection is managed properly, a policyholder need not fear an insurer's party appointment of a repeat nominee. Indeed, with the right chair and tribunal dynamic, it might even work to a policyholder's advantage.

Continued Conflict over Whether McCarran-Ferguson Act "Reverse Pre-emption" Bars International Insurance Arbitrations

Paul K. Stockman, Pittsburgh

As we reported in the May 2010 issue of *Arbitration World*, there is a notable gap in American courts' otherwise consistent support of arbitration agreements when insurance is involved. Many American states have laws invalidating arbitration clauses in insurance contracts. Arkansas, Georgia, Hawaii, Kansas, Kentucky, Louisiana, Missouri, Nebraska, Rhode Island, South Carolina, South Dakota, Virginia, and Washington bar enforcement of these arbitration requirements altogether, and California, Maryland, Mississippi and Wyoming limit arbitration clauses in certain types of policies.

While the Federal Arbitration Act (FAA) in other contexts preempts state laws that purport to limit arbitration, the FAA is itself "reverse preempted"—somewhat unusually—when insurance is involved, by the terms of the McCarran-Ferguson Act, which provides that state laws "regulating the business of insurance" control over any inconsistent "Act of Congress," unless the federal enactment "specifically relates to the business of insurance." 15 U.S.C. § 1012(b). Courts have typically held—at least in the context of domestic arbitrations—that state laws prohibiting insurance arbitration "regulate the business of insurance" and override the FAA's otherwise binding provision that all arbitration provisions are enforceable. As a result, the enforceability of an arbitration clause in domestic insurance policies, in American courts, will turn on considerations of state law.

Whether the same result obtains when the insurance policy has an international dimension is an even more complicated question. As we previously reported, there is a divergence of views among the federal Courts of Appeals over whether the McCarran-Ferguson Act also "reverse preempts" the New York Convention. The Court of Appeals for the Second Circuit, seated in New York and hearing disputes from federal courts in New York, Connecticut and Vermont, has held (in a 1995 decision) that state laws can invalidate arbitration clauses in both domestic and international insurance contracts. This is because, the court held, the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention) is implemented in the United States by an "act of Congress."

On the other hand, the Court of Appeals for the Fifth Circuit, seated in New Orleans and hearing disputes from federal courts in Texas, Louisiana and Mississippi, recently held (in a divided *en banc* decision) that state anti-arbitration laws apply only to domestic arbitrations. In the court's view, the New York Convention is a "treaty," not an "act of Congress" (despite the existence of an implementing federal statute).

When there are such direct conflicts among the Courts of Appeals, the Supreme Court in many instances will step in and resolve the conflict, and indeed the losing party in the Fifth Circuit case asked the Court to do so. There was some hope that the Supreme Court might take up the case; for example, it sought the views of the executive branch, asking the Solicitor General to file a brief advocating the government's position on whether the Court should take the case. Such a request often indicates that the matter has garnered some interest on the part of the Justices. Nonetheless, the Court declined to resolve the dispute, denying *certiorari* in the Fifth Circuit case on October 4, 2010.

As a result, the split in authority continues, and has intensified in recent months. Most recently, on February 23, 2011, a federal trial judge in South Carolina adopted the Fifth Circuit's position. In that case, *ESAB Group v. Arrowood Indemnity Company,* the court compelled arbitration, in Sweden, of a dispute over insurance coverage for bodily injury claims allegedly arising out of exposure to welding rod fumes. An appeal is underway to the Court of Appeals for the Fourth Circuit (as well as a motion for reconsideration in the district court), but the divergence in case law will remain regardless of how the case is ultimately resolved. (The Fourth Circuit sits in Richmond, Virginia, and its decisions bind federal judges in Maryland, Virginia, West Virginia, North Carolina and South Carolina.)

In consequence, different standards may apply to control the enforceability of arbitration clauses in international insurance contracts, depending on which court in the U.S. comes to consider the issue.

Accordingly, parties to an insurance dispute should not assume that an arbitration clause in the relevant policy document is or is not binding. Whether that is the case will depend **both** upon the venue of any litigation in which the issue falls to be considered **and** the specific state law that is held to govern. Further, parties involved in such a dispute should promptly seek the advice of counsel who are experienced in both arbitration law and insurance law, in order to arrive at and implement an optimal strategy either to ensure or defeat arbitration.

Political Risk Insurance—Making Recoveries and the Use of Arbitration

Jane Harte-Lovelace and Frank Thompson, London

Many policyholders with assets or other financial interests in emerging territories are likely to have purchased Political Risks Insurance ("PRI") to protect their investments. The evolving political situation in the Middle East and North Africa may well give rise to situations which are claimable events under such policies. Investors in affected territories should be reviewing their PRI policies if they believe investments are at risk, particularly as it is a common pre-condition of coverage for this type of insurance that insurers are given immediate notice of loss. Another common feature of PRI policies is that disputes with insurers are to be determined by arbitration seated in London, which is widely recognised as the leading insurance market for commercial PRI cover.

What risks do PRI policies cover?

To identify if a claimable event under a PRI policy has occurred (and needs to be notified to insurers), it is important to understand the scope of coverage available under the policy. The wording of each insurance contract will differ from policy to policy and needs to be carefully examined in every case. Broadly, there are general differences between a PRI policy covering an interest in a physical asset and coverage in respect of a financial instrument. However, a PRI policy should cover at least one, if not more, of the following risks:

- **Currency inconvertibility and transfer restriction**: This aspect of the policy protects insureds against financial losses arising from the inability to convert dividends, profits and other investment earnings (or in the case of lenders, debt and interest payments) from the local currency into hard or tradable currency (say US dollars or euros). The principal purpose of this coverage is to insure against excessive delays in acquiring foreign exchange caused by host country action (or inaction), adverse changes in exchange control laws and by deterioration in conditions governing the conversion and remittance of local currency.
- **Confiscation and expropriation:** Historically, the principal expropriation risk was from overt nationalization of infrastructure projects and other investments. In recent years, the nature of expropriation claims has become more sophisticated and PRI policy wordings may also now provide coverage for more complex (or indirect) situations such as selective discrimination, where the national authority introduces new taxes or other regulations/restrictions which only apply to foreign investors. Such measures may have been introduced in response to an economic crisis at a national level, rather than representing an overt attempt by foreign governments to seize assets.
- **Political violence:** This aspect of the policy covers loss of investments or income, or loss or damage to physical assets, which is caused by politically motivated acts of war or civil disturbance, including revolution, insurrection, sabotage or terrorism. Policyholders may also have the benefit of Property Terrorism insurance as part of their main property programme (or a separate stand-alone policy) which may also respond to such occurrences.
- **Business Interruption:** Many PRI policies blend in coverage for business interruption losses. Where included, this provides coverage for consequential losses, such as loss of trading profits and increased costs and expenses, which flow from the occurrence of political risk perils

covered elsewhere in the policy. The quantification of consequential losses is an area ripe for dispute with insurers and the recoverability will be significantly affected by the wording of the policy and the information provided to insurers prior to inception.

Accessing the coverage under PRI policies—key considerations

The wording of insurance policies will often be complex and contain a number of terms and conditions which need to be complied with to preserve the ability to maintain the insurance claim. There are a number of procedural steps which policyholders need to be prepared to take, in some cases swiftly, to advance their claim even before any dispute arises. Key considerations during the claims process are:

- **Notification:** A feature of many PRI policies is that they require prompt notice of loss. This notification obligation may arise not only after an actual loss has been suffered, but also upon discovery of an event which is "likely" to give rise to a claim on the policy. Once again, the actual wording of the notification provisions of the policy will be crucial, and policyholders should expect that insurers will insist on strict compliance with the notification conditions, particularly when the policy is governed by English law.
- **Proof of loss:** PRI policies typically require the policyholder to submit a formal presentation of the claim and relevant underlying documentation (known as a Proof of Loss) within a certain time period following notification. Experience demonstrates that insurers insist on strict compliance with such provisions and may seek to reject an otherwise valid claim on the basis of alleged non-compliance.
- **Preservation of documents:** Care needs to be taken to preserve documents, as well as in the preparation and presentation of the insurance claim. Insurers have certain expectations of what documentation is required to support an insurance claim and, if the compilation of supporting documents is poorly managed, this can create problems at the Proof of Loss stage and beyond.
- **Waiting periods:** Many policies incorporate language which provides that certain aspects of coverage only become available after a defined period of time (or waiting period) has elapsed and this can be as long as 180 days. Policyholders must take care to ensure that they observe other terms of the policy during the waiting period, such as "due diligence" clauses which require the insured to take all reasonable precautions to minimize a potential loss and to keep insurers informed.

Dispute resolution in PRI policies

Unfortunately disputes continue to arise on claims under PRI policies. Insurers do raise policy defences on a number of grounds and often several grounds are relied upon by insurers at the one time to deny a claim. These grounds include allegations that the policyholder has failed to comply with the procedural steps outlined above or has breached other terms and conditions of the policy or that the policyholder has failed to give adequate disclosure of information to insurers before the policy came into force and that a particular loss does not fall within coverage under the wording of the policy at issue.

The typical form of dispute resolution clause in PRI policies applies English law as the substantive law of the contract and calls for resolution of disputes through binding arbitration, usually applying the rules of the London Court of International Arbitration (LCIA) or the International Chamber of Commerce (ICC). Therefore, although the policyholder and subject matter of the policy may have no connection with England, any dispute which cannot be resolved through negotiation is likely to be heard in London, which is where many of the insurers and their legal representatives will be based. Insurers and their counsel are becoming more experienced with this process as they are involved in more arbitrations and there is a developing practice as to how these arbitrations are conducted. Particular issues can arise at different stages including the selection of the panel, where insurers may look to appoint "repeat players" to the tribunal such as an underwriter or barrister who is regularly named by the same insurer (see the article by Joseph Safar on this topic in this issue of *Arbitration World*), and the production of documents, where the applicable rules are

somewhat different from the normal litigation approach to disclosure in England, the United States and other jurisdictions. K&L Gates have represented a number of policyholders in LCIA and ICC arbitrations concerning PRI policies and related insurance products.

U.S. Courts Expand the Extent of Insurance Coverage for Construction Defects under Commercial General Liability Policies

Daniel G. Rosenberg, Chicago

In many instances when a construction project is defective, the resulting dispute about who should pay to correct that defect is resolved through arbitration. There are many reasons for this choice of dispute resolution forum, ranging from the ability to select arbitrators with sufficient industry knowledge to expense reduction.

But wherever the construction defect dispute is to be resolved, a general contractor's insurance coverage for the defective building is often critical. In many instances without the solvency of an insurer behind it, a general contractor might not be able to pay to resolve or even defend itself from the dispute. In many other instances even if the contractor can afford to correct the defect, it will take a significant business loss if forced to do so without the backing of its insurer.

Fortunately, a growing trend throughout the U.S. is expanding the availability of insurance coverage for construction defects under the commercial general liability (CGL) policies that are a core portion of any contractor's risk management program. Specifically, the highest courts in various states in the U.S. are increasingly ruling that a construction defect is an occurrence under a CGL policy. This ruling protects the very risk transfer a CGL policy is designed, in part, to provide.

The Occurrence Issue

A CGL policy is a broad insurance policy used by companies doing business throughout the U.S., but the CGL policy is particularly important in the construction industry given the risks it covers. Most CGL policies provide that the insurer "will pay those sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage.'" Obviously bodily injury and property damage are massive risks on a construction site.

The CGL policy language typically provides that it will apply to "bodily injury" and "property damage" caused by an "occurrence." "Property damage" is typically defined in significant part as "physical injury to tangible property, including all resulting loss of use of that property" or "loss of use of tangible property that is not physically injured." An occurrence is defined as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions."

As noted, a significant property damage risk is that the construction will be completed improperly and the resulting project will be defective in some way. This is particularly a risk for general contractors. Such parties often oversee construction and are responsible for the entire project, but do not perform important aspects of the construction itself. Such work is often performed by subcontractors or sub-subcontractors. From a general contractor's view, if a subcontractor wrongly performs its work leaving the building defective, the general contractor should be insured for that risk.

Indeed, for more than twenty years the insurance industry has drafted its form CGL policy to generally cover construction defects when such a defect is the result of a subcontractor's actions or causes damage to the work completed by a subcontractor. Specifically, while the CGL policy form excludes from coverage necessary restoration, repairs or replacements to the general contractor's work, the same exclusionary language includes an exception for subcontractor's errors. Specifically, the policy form provides that the "your work" exclusion "does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor."

Unfortunately, when the time comes to pay or defend construction defect claims resulting from subcontractor error, insurers have often refused to

honor their contractual obligations. Instead the insurers argue that a construction defect alone is not an "occurrence" because the defect was not an accident and/or that a CGL policy is not designed to provide coverage for breach of warranty claims, breach of contract claims or "pure economic loss." This position is contradicted by: (a) the complete language of the policy itself as quoted in significant part above; (b) the history of the policy forms; and (c) the intent of the insureds purchasing these policies. Nonetheless, in many instances, such insurer arguments often carried the day in many U.S. courts. That trend has, fortunately, changed and now only a minority of courts accept such insurer-centric arguments.

The Trend in the Right Direction

As recently as March of 2011, a state supreme court rejected an insurer's attempt to evade its coverage obligation on the basis that certain construction defects were not "occurrences." Specifically, in *American Empire Surplus Lines Ins. Co. v. Hathaway Development Co., Inc.*, the Supreme Court of Georgia rejected an insurer's argument that defectively installed plumbing was not "accidental." Instead, the court ruled: "A deliberate act, performed negligently, is an accident if the effect is not the intended or expected result; that is, the result would have been different had the deliberate act been performed correctly." In so ruling, the Georgia court adopted the reasoning of the Supreme Court of Texas as expressed in *Lamar Homes v. Mid-Continent Cas. Co*. The Georgia Court specifically noted that its decision was in "accord with the trend in a growing number of jurisdictions which have considered construction defect claims under CGL policies and interpreted the word 'accident' in this manner."

Other recent cases have reached similar results. In the last five years alone, the highest courts in Florida, Georgia, Indiana, Kansas, Mississippi, New Hampshire, North Dakota, Tennessee and Texas have each addressed this "occurrence issue" and ruled that a construction defect can be an occurrence. Prior to 2006, other states' highest courts, including California's Supreme Court, had ruled likewise.

Perhaps beginning a new trend, the state of Colorado has taken the unusual step of making sure its law is on the correct side of the occurrence issue through legislation. Specifically, in 2010, the Colorado legislature passed a statute labeled "An Act Concerning Commercial Liability Insurance Policies Issued to Construction Professionals," which directed all Colorado courts to interpret the term "accident" in insurance policies to include "the work of a construction professional that results in property damage, including damage to the work itself or other work . . . unless the property damage is intended and expected by the insured." The act was in response to the Colorado Court of Appeals decision in *General Security Indemnity Co. of Arizona v. Mountain States Mut. Cas. Co.*, which had accepted the insurer's "occurrence" argument.

Certain States Are Yet to Join the Trend

Several states in which significant amounts of construction occur have not yet joined the increasing majority of states that have resolved the occurrence question in favor of policyholders. For example, the highest court in Pennsylvania has addressed this issue and accepted the insurer argument. Similarly, courts in the states of Illinois and New York continue to accept the insurers' arguments that a construction defect is not an occurrence. The decision in *West Bend Mutual Ins. Co. v. The People of the State of Illinois* provides a recent example. In *West Bend*, the Illinois Appellate Court ruled that CGL policies were "not intended to pay the costs associated with repairing or replacing the insured's defective work products, which are purely economic losses." Relying in part upon its impression that a CGL policy was never designed to apply to construction defects, the court ruled that certain improper construction was not an "occurrence."

What Does the Trend Mean?

In most states, contractors will be afforded the coverage they paid for when they purchased their CGL policies. This benefits not only contractors, but also owners who are more likely to have a solvent entity to pay to correct their buildings when they are constructed incorrectly. However, this trend has not yet reached a significant number of states or has been explicitly rejected by certain states' highest courts. Consequently, in such states as Illinois, Pennsylvania and New York, construction industry participants need to be aware of this hole in contractor's CGL coverage and take

the appropriate steps to manage this risk. Knowledgeable insurance brokers or legal counsel may often be able to help mitigate this risk. Moreover, construction industry groups in states that are, so far, yet to join the trend may wish to consider studying and possibly implementing Colorado's legislative solution.

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