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## **Issues Regarding the Reasonableness of Settlement in London Coverage Arbitration**

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It is an all too common scenario. A policyholder is the target of a lawsuit and makes a claim to its insurer. Even though the claim appears to be covered, the insurer ultimately refuses to participate in the defense of the lawsuit and denies the claim, leaving the policyholder to fend for itself. The policyholder decides it is in its best interest to settle the lawsuit. The policyholder informs the insurer and asks it to participate in the settlement. The insurer reiterates its denial of coverage and refuses to participate in, or contribute to, the settlement. The policyholder negotiates a settlement, and the court approves the settlement as reasonable and enters judgment based on the negotiated settlement. In some instances, the court expressly indicates that the settlement is to be binding on all parties, including insurers. The policyholder then pursues the insurer for the insurance coverage it believes it is entitled to.

This is sometimes referred to as “pay and chase,” where the insured pays the settlement or judgment and then chases its insurer for coverage. But what some policyholders may not realize is that the provision in their policy requiring that all disputes relating to the policy, including coverage disputes, be arbitrated in London, will likely change some of the applicable rules and create some additional hurdles to obtain coverage for their settlement.

### **London Arbitration and the ‘Reasonableness’ Issue**

Many of the London arbitration provisions commonly found in some D&O and other types of policies require each party to select an arbitrator, and then the two selected arbitrators appoint the third member of the arbitral tribunal. Most also include a choice of law provision, often selecting New York law to apply, with certain enumerated exceptions such as choice of law principles. Consequently, the reasonableness issue in London arbitration is often decided under New York law, without regard to what jurisdiction and under what law the claim may have arisen.

The reasonableness of a policyholder’s settlement can arise in a variety of ways in London insurance coverage arbitration. There is some authority for the proposition that once an insurer breaches its coverage obligations, a stipulation, such as a settlement, between a policyholder and a third party with respect to the amount of liability is binding upon the insurer, and it is up to the insurer to prove the unreasonableness of the stipulation. *Mitchell v. Lindstrom*, 209 N.Y.S.2d 923, 926-27 (App. Div. 1961). However, insurers may try to convince the tribunal that it is incumbent on the insured to prove the reasonableness of the settlement before it can obtain coverage for that amount from the insurer. Alternatively, some insurers may raise reasonableness as a defense to coverage and provide evidence that the settlement amount was unreasonable under the circumstances and, therefore, not covered. One recent dispute required a three-week hearing where the only substantive disputed coverage issue was the reasonableness of the underlying settlement amount.

In the scenario where the insurer wrongfully refuses to provide a defense and coverage, the policyholder is within its rights to settle its liability. Under New York law, when an insurer improperly denies coverage, the policyholder has the right to make any reasonable and bona fide settlement. *Texaco A/S (Denmark) v. Commercial Ins. Co.*, 160 F.3d 124, 128 (2d Cir. 1998).

“When an insurer unjustifiably disclaims upon the ground that the claim is outside the policy coverage, the insurer is bound, not only by any judgment against the assured, but also by any *reasonable* compromise or settlement made by the insured.” *Mitchell*, 209 N.Y.S.2d at 926-27

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(emphasis added). While the policyholder may be justified in settling its liability in the context of London arbitration, the more difficult issue may be proving the settlement is “reasonable” and mustering the necessary proof to make that showing or counter an insurer’s argument that the settlement was unreasonable.

The seminal New York case addressing the reasonableness of a policyholder’s settlement in relation to recovering the settlement amount from an insurer is *Luria Brothers & Co. v. Alliance Assurance Co.*, 780 F.2d 1082 (2d Cir. 1986). That litigation arose from the sinking of a cargo vessel, the *Agios Giorgis*, on the high seas with the loss of all its crew members and passengers. *Id.* at 1084-86. In 1981, the estates and relatives of the passengers who had perished on the vessel filed a wrongful death action seeking damages of \$9.4 million against Luria Brothers (“Luria”) and others. *Id.* at 1087. Luria provided notice of the lawsuit to its insurers, who declined coverage. *Id.* In February 1983, the parties to the wrongful death action reached a settlement, with Luria contributing \$1,217,656.50 toward the settlement. *Id.* Luria then brought a lawsuit against its insurers seeking indemnity for the amount of the settlement and its legal expenses incurred in connection with the wrongful death lawsuit.

The *Luria* court found that Luria was potentially liable to the claimants in the wrongful death suit and the insurers’ policies did provide coverage for these types of liabilities. The court, in finding the insurers liable for the settlement amount, found:

When an insurer declines coverage, as here, an insured may settle rather than proceed to trial to determine its legal liability. In order to recover the amount of the settlement from the insurer, the insured need not establish actual liability to the party with whom it has settled “so long as ... a potential liability on the facts known to the [insured is] shown to exist, culminating in a settlement in an amount reasonable in view of the size of possible recovery and degree of probability of claimant’s success against the [insured].”

On the facts known to Luria at the time of settlement, Luria had potential liability to the death claimants.

*Id.* at 1091 (alterations in original) (citations omitted); *see also Uniroyal, Inc. v. Home Ins. Co.*, 707 F. Supp. 1368, 1378-79 (E.D.N.Y. 1988) (applying *Luria* to hold that a court’s finding of no liability as to some plaintiffs after settlement with other plaintiffs did not mean the settlement was unreasonable). While *Luria* directs the reasonableness inquiry to focus on the facts known to the insured at the time of the settlement, the possible size of the recovery, and the degree of probability liability will be imposed, it does not discuss what evidence may be relevant to that analysis.

A pre-*Luria* decision gives some insight into factors that New York courts have considered in determining the reasonableness of an insured’s settlement for insurance coverage purposes. In *Sucrest Corp. v. Fisher Governor Co.*, 371 N.Y.S.2d 927 (Sup. Ct. 1975), the court reasoned:

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The settlement of the underlying action for the sum of \$535,000 and [the insured's] proportionate contribution in the sum of \$265,000 occurred during trial, following lengthy and protracted litigation and only after extensive negotiations and conferences presided over by the undersigned both before and during trial of the action. Taking all factors into consideration, and especially the potential liability of the respective defendants to the plaintiff, had *Sucrest* prevailed upon the trial (\$3,635,514.58), it cannot be said that the settlement was either unreasonable or exorbitant. The court finds it was reasonable.

*Id.* at 940. The *Sucrest* court seems to consider the “lengthy and protracted litigation,” the “extensive negotiations and [settlement] conferences” that led to the settlement, and substantial “potential liability” faced by the insured in its reasonableness analysis. *Id.* Some decisions suggest that courts may also consider the involvement of a court or mediator in reaching the settlement as a factor supporting the reasonableness of the amount. See *Uniroyal*, 707 F. Supp. at 1379; *In re Indep. Energy Holdings PLC Sec. Litig.*, No. 00 Civ. 6689(SAS), 2003 WL 22244676, at \*4 (S.D.N.Y. Sept. 29, 2003), see also, *U.S. Gypsum Co. v. Admiral Ins. Co.*, 643 N.E.2d 1226, 1244 (Ill.App.Ct. 1995) (discussing *Luria* and *Uniroyal*).

### **Proving ‘Reasonableness’ in London Arbitration**

Proving the reasonableness of a settlement may present some unique issues and challenges in the context of London arbitration. Specifically, there may be significant issues regarding privilege as well as other challenges to an insured who wants to present evidence supporting the reasonableness of its settlement decision.

Since the *Luria* test focuses on what the insured knew at the time of the settlement, an insurer may demand production of all communications leading up to and related to the settlement. The insurer often argues these materials are the best evidence of what the insured knew at the time of the settlement. In connection with those materials, the insurer may demand production of materials that the insured might normally expect to protect from disclosure by the attorney-client or another applicable privilege or protection. However, just because those materials are privileged or otherwise protected under the applicable law in the insured’s home jurisdiction does not mean the tribunal will recognize that claim of privilege or protection as applying in the arbitration.

Section 34 of the English Arbitration Act of 1996 reserves decision regarding all evidentiary issues to the tribunal:

#### **Procedural and evidential matters.**

(1) It shall be for the tribunal to decide all procedural and evidential matters, subject to the right of the parties to agree any matter.

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(2) Procedural and evidential matters include

...

(d) whether any and if so which documents or classes of documents should be disclosed between and produced by the parties and at what stage ...

Article 9.2(b) of the International Bar Association Rules on the Taking of Evidence in International Commercial Arbitration (“IBA Rules on Evidence”) confirms the tribunal’s authority regarding issues of privilege providing that the tribunal has the authority to exclude from evidence documents based on a “legal impediment or privilege under the legal or ethical rules determined by the Arbitral Tribunal to be applicable.”

Complicating the tribunal’s inquiry is the fact that “[t]here are currently no rules governing the attorney-client privilege in the context of international arbitration,” and consequently, “parties, attorneys, and arbitral tribunals are left to their own devices in determining what will be accorded the protection of privilege in any given arbitration.” Javier H. Rubinstein and Britton B. Guerrina, *The Attorney-Client Privilege and International Arbitration*, 18(6) J. Int’l Arb. 587 (2001). There is even a debate regarding whether a privilege applicable to legal advice is a procedural right, a substantive right, or both. See *Three Rivers District Council v. Governor & Company of the Bank of England*, [2005] 1 AC 610, 646 (H.L. 2004) (appeal taken from C.A.).

The tribunal and parties have a number of options as to what law should govern privilege issues including: a) the choice of law in the policy; b) *lex arbitri*, the law of the location of the arbitration; c) the law of the jurisdiction where the lawyer involved in the communication is admitted to practice; d) the law of the location where the communication originated; e) the law of the jurisdiction where the claim arose; or f) according to general principles without selecting the law of any specific jurisdiction. How the tribunal resolves these issues may result in different rules for different parties and documents.

The insurer’s interest in obtaining the insured’s privileged communications is motivated by a number of factors. Initially, this invasion of privilege or other protections would only apply to the insured’s communications, not the insurer’s. The insurer may argue that disclosure of the privileged communications leading up to the settlement is essential since they are the best reflection of the insured’s knowledge at the time of the settlement, and that is what is relevant for purposes of the *Luria* test. The insurer typically hopes to obtain communications between the insured and counsel to attack the reasonableness of the settlement. These communications might include assessments of the underlying plaintiff’s case that discuss potential defenses to the claims or minimize the insured’s exposure or the amount of damages that may be recovered. In addition, otherwise privileged communications (from once the insured begins to consider settlement through the time the settlement is finalized) may include opinions that the settlement amount being demanded is too high or that contain differences of opinion on whether or not settlement is prudent. In addition to obtaining material to attack the reasonableness of the

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settlement, the insurer may also find additional information that bolsters its other coverage defenses.

An insured has the option of waiving privilege but needs to carefully consider the scope of privilege it has, the totality of information that may be subject to disclosure if privilege is waived, and all the potential ramifications of such a waiver. The insured also needs to consider whether it can successfully present its reasonableness case, as well as the case for coverage, without the otherwise protected materials.

Determining the scope of what materials may be protected is complicated by the uneven and unpredictable application of privileges and other protections in international arbitrations.

Nonetheless, the insured should consider all possible protections, including those beyond attorney-client privilege and work product protection. For example, California provides extremely broad protection for written and oral communications related to or made in the course of mediation. Cal. Evid. Code § 1119; *see also Crow-Crimmins-Wolff & Munier v. County of Westchester*, 511 N.Y.S.2d 117, 119 (App. Div. 1987) (admissions of fact made “without prejudice” in the course of settlement discussions are protected from disclosure); *Randall Elec., Inc. v. State*, 540 N.Y.S.2d 901, 902-03 (App. Div. 1989) (documents created in the course of settlement discussions are not subject to disclosure); *Rush & Tompkins Ltd. v. Greater London Council*, [1989] A.C. 1280, 1305 (H.L. 1988) (appeal taken from C.A.) (broadly applying the “without prejudice” rule to promote settlements). The California provision specifically states that disclosure of the protected written and oral communications “shall not be compelled” in various proceedings, including arbitrations. Cal. Evid. Code § 1119(a), (b). For an insured considering waiving a protection, it is prudent to reach an agreement with the other party or seek guidance from the tribunal regarding the scope and effect of any such waiver before agreeing to do so.

Depending on the underlying litigation and the way in which the settlement was negotiated and consummated, an insured may be able to present a compelling case for the reasonableness of the settlement without resorting to privileged and protected materials. In most instances, some or all of the pleadings, discovery, orders, and judgments from the underlying litigation will be available and not sealed or otherwise protected. In some instances, the plaintiff may have provided expert analysis of the damages being sought in the form of an expert report and/or at deposition. If the settlement involved a fairness hearing, the transcript of the hearing as well as the materials filed in support of the hearing may be helpful. In some instances, in connection with fairness hearings, parties file affidavits from mediators that detail the lengthy and difficult negotiations between the parties and state the mediator’s view that the proposed settlement is a fair and reasonable resolution of the dispute. Obviously, any oral or written findings the court makes supporting the reasonableness of the settlement are strong evidence.

In addition, the extent to which any other insurers on the risk contributed to the settlement, particularly if they are excess to the insurer in the arbitration, may have some impact on the tribunal’s reasonableness analysis. Some insureds include language in their settlement

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documentation that allows the otherwise confidential information to be disclosed to other insurers and in the course of efforts to collect from other insurers.

In most cases, the insured would also have the ability to provide both fact and expert evidence that is prepared just for purposes of the arbitration. The tribunal has ultimate control regarding what fact and expert witnesses will be considered and the manner in which that evidence is presented. In general, “[a]ny person may present evidence as a witness, including a Party or a Party’s officer, employee or other representative.” Article 4.2 of the IBA Rules on Evidence.

While the tribunal has the ultimate authority to determine how such evidence is presented, typically it is submitted in the form of a Witness Statement that serves as that person’s direct testimony. *See Id.* Article 4.4, 4.5. The witness is then usually required to attend the Evidentiary Hearing to undergo cross-examination by the opposing party. *See Id.* Article 4.7. The tribunal can also question the witness. *See Id.* Article 8.2.

Expert testimony may also be used to support the reasonableness of a settlement. In some instances a damages expert can compute the amount of damages the underlying plaintiff or plaintiffs were likely to demand. This will help quantify the insured’s exposure and is particularly helpful where the settlement came before there was a supported demand for damages or where there was no damages expert presented in the underlying litigation. Some insureds have also relied on leading litigators in the jurisdiction where the underlying litigation was located who regularly defend the type of lawsuit that resulted in the claim. They can provide testimony regarding the extent of the insured’s exposure in the underlying litigation and may also be able to testify that had the insured been their client, they would have advised it to settle at the amount for which it ultimately settled. Experts typically provide a report containing their opinions and conclusions, and appear for cross-examination at the Evidentiary Hearing. *See* Article 5 of the IBA Rules on Evidence. The tribunal can question the parties’ experts and, in some instances, may appoint its own expert or experts in addition to or in lieu of the parties’ presenting experts. *See Id.* Article 6.

## **Conclusion**

It is important to recognize early on if an insurance policy with a London arbitration provision, or any international arbitration provision, may be called on to contribute to the settlement of a lawsuit. Coverage counsel should make the insured as well as underlying defense counsel aware of the potential issues that may arise if arbitration is ultimately necessary to obtain coverage for the settlement. By creating that awareness early on, there is an opportunity to build a stronger record to support the reasonableness of any settlement and to maximize the insured’s ability to obtain coverage.

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