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Enough to Hang Your Hat On: Regulating Binding Arbitration of Insurance Disputes in Texas

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ENOUGH TO HANG YOUR HAT ON: REGULATING BINDING ARBITRATION OF INSURANCE DISPUTES IN TEXAS

By: Timothy Azevedo†

ABSTRACT

Texas law is currently silent on the issue of whether insurance companies may sell insurance policies that require policyholders to bring coverage disputes to an arbitrator rather than the courts. As incentives increase for insurance companies to avoid costly litigation and for consumers to cut ever-increasing premiums, this creates a situation where a hasty, ill-considered proposal to allow such policy terms could shake the insurance market and public policy in the state for years to come. Rather than taking a reactive position, the Texas legislature should work with the Department of Insurance and stakeholders to affirmatively decide: (1) whether to allow such policies at all and, if so, (2) to create a robust legal framework that companies and consumers can both benefit from and rely upon. Other countries, such as the United Kingdom, have well-established frameworks in place that can be instructive, as University of Minnesota Law School professor Daniel Schwarcz has argued. Ultimately though, Texas must determine for itself what policy will suit such a vast and diverse state, particularly given its extreme weather.

Texas should consider establishing an independent body to assist in insurance dispute resolution and to promote transparency. This Comment lays out the case for doing so: better outcomes, better insurance, and better access to justice.

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I. INTRODUCTION

[I]nsurance conceives justice according to a conception of sharing for which it undertakes to fix equitable rules. . . . It constitutes a mode of association which allows its participants to agree on the rule of justice they will subscribe to. Insurance makes it possible to dream of a contractual justice.¹

Perhaps due to a harmony between this “contractual justice,” so basic to the concept of insurance as the French philosopher François Ewald explained, and the related idea of contracting in advance to resolve disputes through arbitration, insurance arbitration agreements have become an issue of the day, particularly in Texas. Indeed, in 2016, a major insurer in the state made just such a proposal to add a binding arbitration clause to some of its policies. Because the insurer ultimately withdrew the proposal, the state’s insurance regulator never ruled on the controversial issue. This gap leaves open the possibility for important changes in this area on the horizon. Consequently, government, insurance companies, consumers, and other stakeholders must develop a better understanding of the options available to Texas, one informed not only by Texas’s own unique circumstances, but also by how other states and nations have acted on these kinds of arbitration agreements.

This Comment will discuss the legislative and judicial background of arbitration agreements in Section II at both the federal and state levels in the specific context of insurance. The primary focus of the Comment, however, is on Texas property-casualty insurance policies. Section III uses a comparative analysis discusses how the issue has been treated overseas and in other types of insurance. Section IV evaluates the unique strengths and concerns around arbitration in the insurance business. Given that the current legislative framework (as discussed in Section II) gives states heightened authority to regulate insurance arbitration, the focus of this Comment is not so much an academic inquiry into the relative merits of arbitration compared to litigation, but rather a practical consideration of how a state can best fulfill its regulatory role to maximize its strengths and minimize its weaknesses. Accordingly, in Section V, this Comment will make specific recommendations about how Texas can design an efficient arbitration solution that promotes important public interests that can benefit both policyholders and the insurance industry.

1. FRANÇOIS EWALD, *Insurance and Risk*, in THE FOUCAULT EFFECT 197, 207 (Graham Burchell et al. eds., 1991).

II. BACKGROUND

A. *Legal Framework for Arbitration and Insurance in the U.S.*

Arbitration is defined as “[a] process by which parties consensually submit a dispute to a non-governmental decision-maker, selected by or for the parties, to render a binding decision resolving a dispute in accordance with neutral, adjudicatory procedures affording each party an opportunity to present its case.”² At common law, courts generally disfavored arbitration agreements.³ In 1925, Congress intervened in order to “reverse the longstanding judicial hostility to arbitration agreements,” and passed the Federal Arbitration Act (“FAA”).⁴ This Act was a turning point not only in the acceptance of arbitration as a means to resolve disputes, but arguably the beginning of a “national policy favoring arbitration.”⁵ While initially limited in its application, a series of Supreme Court decisions has expanded its impact. Particularly important was *Southland Corp. v. Keating*, which held that the FAA applied not only in federal court, but also in state courts where the overwhelming majority of civil litigation actually takes place.⁶ In other decisions, the FAA has been held to preempt state laws that purport to ban or even curb arbitration agreements.⁷ Practically speaking, the Act and subsequent Court decisions have resulted in a historic proliferation of arbitration clauses in contracts of all kinds, including insurance policies.⁸

In the insurance industry, however, there is an important legislative caveat. In 1944, the Supreme Court ruled that the insurance industry, previously only subject to state regulation, fell under Congress’s authority to regulate interstate commerce under the U.S. Constitution.⁹ The following year, in 1945, Congress passed the McCarran-Ferguson Act as a legislative response in which Congress essentially determined that it did not actually intend to regulate insurance. The law provides that “[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such Act specifically relates to the business of insurance”¹⁰ Thus the McCarran-Ferguson Act pre-

2. GARY B. BORN, *INTERNATIONAL ARBITRATION: LAW AND PRACTICE* 4 (2d ed. 2016).

3. *Green Tree Fin. Corp.-Alabama v. Randolph*, 531 U.S. 79, 89 (2000).

4. *Id.* (quoting *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 24 (1991)).

5. *Southland Corp. v. Keating*, 465 U.S. 1, 10 (1984).

6. *Id.* at 15-16.

7. *Allied-Bruce Terminix Co. v. Dobson*, 513 U.S. 265, 281 (1995) (preempting state law invalidating predispute arbitration agreements); *Doctor’s Assocs., Inc. v. Casarotto*, 517 U.S. 681, 688 (1996) (preempting state law mandating special notice requirements for arbitration agreements).

8. Susan Randall, *Mandatory Arbitration in Insurance Disputes: Inverse Preemption of the Federal Arbitration Act*, 11 *CONN. INS. L.J.* 253, 256-57 (2005).

9. *United States v. Se. Underwriters Ass’n*, 322 U.S. 533, 560-561 (1944).

10. McCarran-Ferguson Act, 15 U.S.C. § 1012(b) (1947) (2012).

vents federal laws and regulations of general applicability from preempting insurance-specific state laws and regulations that meet the following elements: (1) A federal law must invalidate, impair, or supersede a state law; (2) the state law at issue must have been enacted for the purpose of regulating the business of insurance; and (3) the federal law at issue must not specifically relate to the business of insurance.¹¹ Because Congress has generally declined to exercise its power to make laws that specifically regulate the business of insurance, under McCarran-Ferguson, insurance is decisively regulated at the state level (though of course it goes without saying that Congress could simply pass another law to repeal McCarran-Ferguson). Consequently, the existing diversity of state laws can result in a patchwork of varying policies regarding arbitration in insurance, notwithstanding the FAA. On the other hand, when the parties are not entirely domestic, some courts have upheld international arbitration agreements under the New York Convention.¹² This is beyond the scope of this Comment, however, which is limited to United States insurance policies written in accordance with Texas insurance laws.

B. *Legal and Factual Background of Insurance Arbitration in Texas*

In 2016, a major Texas insurer, Texas Farm Bureau, submitted an endorsement (a modification to the general insurance policy) containing arbitration provisions to the state insurance regulator for approval.¹³ The type of arbitration at issue was (1) *mandatory*, meaning that it was the required method for dispute resolution if the parties could not reach a voluntary agreement; (2) *pre-dispute*, meaning that the parties decided to submit disputes to arbitration at the time the company wrote the policy, rather than after a claim or dispute arose; and (3) *binding*, meaning that the decision resulting from the arbitration process is enforceable by law. Ultimately, Texas Farm Bureau withdrew the proposal from consideration after a hearing.¹⁴ Although the insurance company spokesperson declined to comment further on the matter, other than confirming that the proposal was withdrawn, the proposal came under significant fire from plaintiff attorneys and consumer groups.¹⁵ Under this proposal, policyholders had the option to give up their right to sue in court in favor of binding arbitration; in return, they would receive a discounted rate.¹⁶ The proposal was con-

11. See U.S. Dep't of Treasury v. Fabe, 508 U.S. 491, 501 (1993).

12. See *Murphy Oil USA, Inc. v. SR Int'l Bus. Ins. Co.*, No. 07-CV-1071, 2007 WL 2752366, at *3 (W.D. Ark. Sep. 20, 2007).

13. See Jim Malewitz, *Texas Insurer Drops Push to Let Homeowners Forgo Right to Sue*, TEX. TRIB. (Nov. 3, 2016, 5:00 PM), <https://www.texastribune.org/2016/11/03/texas-insurer-drops-push-let-homeowners-forgo-rig/> [<https://perma.cc/HN9Z-7FXK>].

14. *Id.*

15. *Id.*

16. *Id.*

troversial, with consumer advocates fighting the insurance industry over whether the Texas Department of Insurance (“TDI”) should approve it or not.¹⁷ For now, Texas property-casualty insurance policies do not include any such mandatory arbitration agreements,¹⁸ though there is an important exception discussed in Section III below. It is not unreasonable to assume, however, that similar proposals will recur in the future as Texas law remains silent on the issue—neither prohibiting nor restricting arbitration clauses in insurance policies¹⁹—as discussed further in subsection C.

Costly insurance is nothing new in Texas, creating incentives for both consumers and companies to cut costs. According to the National Association of Insurance Commissioners, the state’s extreme weather has made insurance premiums in Texas the third-most expensive among all states, behind only Florida and Louisiana.²⁰ Although the state suffers from a number of natural disasters including tornadoes, wildfires, and hurricanes, the single most expensive problem for Texas property owners is hail storms.²¹ The state’s weather often produces hail stones of a “Texas-sized” variety: a volley of baseball-sized hail can tear through roofs and windows, damaging property over a wide area.²² According to TDI figures, hail storms caused some \$10.4 billion in damage to homes between 1999 and 2011—a sum greater than the combined total for hurricanes, thunderstorms, and tornadoes.²³

Moreover, rapidly increasing litigation costs continue to create incentives for insurance companies to reduce their exposure to legal expenses specifically. Data collected by TDI indicates that prior to 2012, policyholders sued their insurer in about 0.1% of claims.²⁴ For 2012–2015, the policyholder-insurer lawsuit rate was between 1.5% and 2%, an increase of 1,400% to 1,900%.²⁵ Furthermore, although South Texas only accounts for a small minority of policies written statewide, the region accounted for 56.2% of all claims involving lawsuits between 2010 and 2015.²⁶ Insurance industry representatives claim that much of the uptick in lawsuits stems from two especially

17. *Id.*

18. *Id.*

19. *State Laws Regulating Arbitration in Insurance Contracts*, PUB. CITIZEN, <https://www.citizen.org/article/state-laws-regulating-arbitration-insurance-contracts-0> [<https://perma.cc/LU7E-H4D7>] (last visited Aug. 29, 2018).

20. Lauren Etter, *Attorneys, Insurers Facing Off over Hail Litigation in Texas*, INS. J. (Feb. 4, 2015), <https://www.insurancejournal.com/news/southcentral/2015/02/04/356413.htm/> [<https://perma.cc/A3LU-VMNR>].

21. *Id.*

22. *Id.*

23. *Id.*

24. TEX. DEP’T OF INS., FINAL PRESENTATION TO THE TEXAS LEGISLATURE, INTERIM CHARGES: THE COST OF WEATHER-RELATED PROPERTY CLAIMS AND RELATED LITIGATION 10 (2017), <https://www.tdi.texas.gov/reports/documents/weather-related-propertyclaims.pdf> [<https://perma.cc/K8LM-5F9W>].

25. *Id.*

26. *Id.* at 12.

powerful hail storms that hit South Texas in 2012—along with the attorneys who followed behind the storms, advising policyholders to sue.²⁷ Thus insurers have a strong incentive to lower their litigation costs and pass reductions of 10–25% to policyholders, particularly in South Texas.²⁸

Attempts to cut down on litigation expenses related to insurance is not a new one in Texas either. Under multiple Republican governors, promising to curb so-called “junk lawsuits,” tort reforms have been enacted to make it harder to sue and recover for injuries.²⁹ Tort reform affects litigants who want to sue under someone else’s insurance coverage. However the Texas legislature has also stepped into contract law, making it more difficult for policyholders to sue their own insurance company.³⁰ Under House Bill 1774, policyholders must meet a notice requirement of sixty-one days before filing a lawsuit against their insurer, may not be able to prevent removal of the suit to federal court under diversity jurisdiction by suing an agent or adjuster in addition to the insurance company, and may potentially face limits to recovery for delayed claim payment penalties.³¹ It would appear that the Texas legislature has already taken steps to assist insurance companies seeking to reduce their litigation expense.

Ultimately however, economic pressures (including the need for affordable yet adequately-priced insurance coverage) must be carefully balanced in view of the rights at stake for policyholders, including the right to jury trial guaranteed by the U.S. Constitution.³² In this respect, the Texas Farm Bureau proposal overreached, as discussed further in Section IV. In its proposed arbitration clause, the insurance company not only preselected the company providing arbitration services, but was also the only party providing payment.³³ This structure potentially raises questions of independence and impartiality on the part of the arbitrator.

The clause also limited discovery to a pre-determined set of documents.³⁴ While this cuts down on the time and expense of “fishing expeditions” for information that is not relevant to the present dispute, it also cuts out the possibility of case-by-case determinations that

27. See Etter, *supra* note 20.

28. *Arbitration Clause Made Public. It's As Bad As We Thought*, TEX. WATCH (June 1, 2016), <http://www.texaswatch.org/blog/arbitration-clause-made-public-its-bad-we-thought> [<https://perma.cc/NB6W-AAV5>].

29. *Id.*

30. Deborah Vennos, *New Texas Insurance Code Chapter 542A, Effective September 1, 2017, May Reduce The Number of Harvey Lawsuits*, PROP. INS. COVERAGE INSIGHTS (Aug. 31, 2017), <https://www.propertyinsurancecoverageinsights.com/2017/08/new-texas-insurance-code-chapter-542a-effective-september-1-2017-may-reduce-the-number-of-harvey-lawsuits> [<https://perma.cc/Y8J5-4QCZ>].

31. *Id.*

32. See U.S. CONST. amend. VII.

33. TEX. WATCH, *supra* note 28.

34. *Id.*

might argue in favor of going beyond the typical discovery needs. It also provided for strict secrecy as to the result by both parties and the arbitrator.³⁵ This process makes the fairness of the system overall difficult to monitor, and it becomes impossible to set precedents for novel issues that may arise under arbitration. Under this proposal, in order to take advantage of the discount, consumers, regardless of their sophistication or lack thereof, needed to make substantial legal concessions before knowing precisely how it would impact any claim or dispute that might arise in the future. In sum, these provisions potentially undermine the system's benefits by placing burdens on its utility, fairness, and transparency.

C. *State Laws Governing Insurance Arbitration*

As mentioned previously, Texas has no statute or regulation in force that prohibits mandatory arbitration.³⁶ In this regard, Texas is among a plurality of twenty-four states having no law or regulation regarding arbitration in insurance policies.³⁷ Because there is no law in these states that specifically prohibits or restricts arbitration in insurance policies (refer to Section II above), in theory the insurance policies in those states could legally include mandatory arbitration clauses (though insurance forms and rates must generally also be approved by a state regulator). Indeed, arguably, the FAA (which favors upholding such arbitration agreements) may apply to insurance policies in these states because there is no state law in place for the McCarran-Ferguson Act to protect from federal preemption.

Sixteen other states currently prohibit the use of arbitration agreements in insurance policies by statute.³⁸ In spite of the presence of the state statutes however, there is legal precedent in three of those states holding that the arbitration clauses were enforceable anyway.³⁹ The purpose behind these anti-arbitration statutes was a concern on the part of state legislatures that insurance companies would set the terms of a private arbitration process that was contrary to public policy (echoing the common law position set out in Section II above), placing policyholders at a disadvantage.⁴⁰ Another seven states have statutes that restrict arbitration clauses only under certain circumstances, such as allegations of bad faith or allowing only non-binding arbitration.⁴¹

35. *Id.*

36. PUB. CITIZEN, *supra* note 19.

37. *Id.*

38. *Id.*

39. *Id.*

40. Mark J. Bunim, *When States Prohibit Dispute Resolution: The Use of Mandatory Arbitration Clauses in Insurance Policies*, 71 DISP. RESOL. J. 47, 50 (2016).

41. *Id.* at 56–57.

As can be seen by the assortment of state laws, one advantage of the federal system of government is that it allows for a real-world laboratory of different approaches in the various states. As such, states can experiment with ways to supplement their courts with specialized systems for resolving insurance disputes. Some of these alternative dispute resolution (“ADR”) systems already exist and can produce beneficial results, as discussed in subsection D. This Comment will explore how states like Texas could provide leadership in this space by adopting a mandatory arbitration option that serves the interests of both insurance companies and their customers.

D. *Existing Ability to Resolve Disputes Outside Court*

It is important to note that in the current context, policyholders and insurance companies already have the option to resolve disputes outside of court after they arise. One such option is mediation. No state has a statute prohibiting mandatory mediation clauses.⁴² In mediation, even where both parties agree to submit their disputes to a mediator, the process does not lead to a binding result absent the agreement of both parties.⁴³ In fact, many courts that hear insurance cases encourage or mandate mediation before trial.⁴⁴ Unlike binding arbitration, if the litigants cannot resolve their differences, they still remain free to pursue a remedy in court.⁴⁵

Another option is a special type of arbitration provision known as appraisal, which most property insurance policies have used for more than a century.⁴⁶ This ADR system is designed for resolution of disputes over the amount of a given insured loss.⁴⁷ A typical appraisal clause looks like the following:

If we and you disagree on the value of the property or the amount of the “loss,” either may make written demand for an appraisal of the “loss.” In this event, each party will select a competent and impartial appraiser. You and we must notify the other of the appraiser selected within twenty days of the written demand for appraisal. The two appraisers will select an umpire. If the appraisers do not agree on the selection of an umpire within 15 days, they must request selection of an umpire by a judge of a court having jurisdiction. The appraisers will state separately the value of the property and the amount of the “loss.” If they fail to agree, they will submit their differences to the umpire. A decision agreed to by any two will be the appraised value of the property or amount of “loss.” If you

42. *Id.* at 47–48.

43. *Id.* at 48.

44. *Id.*

45. *Id.*

46. Robert H. Jerry II, *Dispute Resolution, Insurance, and Points of Convergence*, 2015 J. DISP. RESOL. 255, 271.

47. *Id.* at 273.

make a written demand for an appraisal of the “loss,” each party will:

- a. Pay its chosen appraiser; and
- b. Bear the other expenses of the appraisal and umpire equally.⁴⁸

In summary, once invoked by written demand, each party selects an appraiser to make an assessment of the amount of loss (the costs of which are borne by each respective party), and together they agree upon an umpire to decide the matter.⁴⁹ Like arbitration, the umpire’s decision results in a decision that is binding on both parties.⁵⁰ But in contrast to a true arbitration clause where the parties can contest the policy’s *coverage*, the scope of appraisal is generally limited to determining the *amount* of damages.⁵¹ And like any insurance policy provision that gains widespread adoption, the appraisal process is of tremendous consequence to a massive number of disputes. Even after removing all the insurance claims that are resolved quickly and smoothly, the appraisal process cumulatively affects the claim process as the default option when parties are unable to agree on damages in more than *10 million* instances each and every year.⁵² Therefore to prove viable, any pre-dispute arbitration solution must be adaptable to the countless real-world applications of its provisions on a large scale.

Finally, consumers may make a complaint to TDI. The department assists with improper claim denials in addition to a wide variety of other problems such as cancellations, customer service issues, coverage misrepresentations, discriminatory rate increases, fraud, etc.⁵³ TDI contacts the insurance company asking for a detailed response, decides if the issue was handled appropriately, and may take enforcement action if necessary.⁵⁴ This service is a substantial benefit to policyholders who are too busy or unfamiliar with insurance to act on their own, as TDI does much of the work on their behalf, including contacting the company. The process ensures that both parties have the advantage of insurance expertise, as policyholders can benefit from the knowledge of TDI staff. Because a third party goes between the insurer and the insured, the process may also maintain goodwill and business relationships that otherwise might not survive the direct conflict usually involved in a protracted dispute, such as litigation. The insurance company likely has a higher incentive to cooperate with

48. Johnny C. Parker, *Understanding the Insurance Policy Appraisal Clause: A Four-Step Program*, 37 U. TOL. L. REV. 931, 931 (2006).

49. Jerry, *supra* note 46, at 272.

50. *Id.*

51. *Id.* at 272.

52. *Id.*

53. *Insurance Complaint Process*, TEX. DEP’T OF INS., <http://www.tdi.texas.gov/consumer/complfrm.html> [<https://perma.cc/UK9M-5WNG>] (last visited Aug. 28, 2018).

54. *Id.*

TDI in order to maintain a positive relationship with its regulator. Finally, the complaint system also has gravitas and some “teeth” backed by regulatory powers that simply may not be present in a traditional mediation setting. Nevertheless, state-sponsored complaint resolution suffers from its own problems: lack of resources, low claim resolution rates, and the impartiality concerns posed by the potential for regulatory capture.⁵⁵ The next Section explores in greater detail the potential role of public entities.

III. COMPARATIVE ANALYSIS

A. *International*

Regulators help resolve consumer disputes in the United Kingdom through a “private ombudsman” system.⁵⁶ While an ombudsman normally resolves disputes with a government agency, a private ombudsman exists to facilitate resolution of private party disputes.⁵⁷ The Financial Ombudsman Service (“FOS”), an independent public entity which deals exclusively with consumer complaints against financial companies, administers the dispute resolution service.⁵⁸ By blending a variety of private ADR methods with a regulatory conciliation process under a single system, the FOS private ombudsman model offers an ADR mechanism that could be emulated in the United States—as it already has in Australia, Canada, New Zealand, Ireland, India, and Japan.⁵⁹

The FOS is involved in four basic stages of the dispute resolution process: (1) internal complaint procedures, (2) a frontline call office, (3) adjudicator conciliation, and (4) ombudsman review.⁶⁰ In the first stage, the policyholder is required to make a formal complaint with their own insurer.⁶¹ Within eight weeks, the insurance company is required to send a written response which must inform the policyholder of the right to petition the FOS and include an FOS pamphlet describing its services.⁶² The second stage, the frontline call office, essentially plays a gatekeeper role: when a customer calls the FOS, the office confirms that a complaint has been made to the insurer, assessing jurisdiction and timeliness.⁶³ It will then collect the insurance company’s own response to the complaint and assess a £450 fee to the insurer.⁶⁴

55. Daniel Schwarcz, *Redesigning Consumer Dispute Resolution: A Case Study of the British and American Approaches to Insurance Claims Conflict*, 83 TUL. L. REV. 735, 737-38. (2009).

56. *Id.* at 738.

57. *Id.*

58. *Id.*

59. *Id.* at 738-39.

60. *Id.* at 770-71.

61. *Id.* at 771.

62. *Id.*

63. *Id.* at 772.

64. *Id.*

The third stage, adjudicator conciliation, involves an official investigation by an adjudicator (usually someone with a background in industry, the law, government, or ADR).⁶⁵ While they do not have the authority to issue a decision that is binding on the parties, they may encourage settlements based on their view of the circumstances of the complaint.⁶⁶ They also have no regulatory authority, acting independently from (though frequently also working with) the United Kingdom insurance regulator, the Financial Services Authority.⁶⁷

The fourth and final step is the ombudsman review. Here, if the parties have not already reached a settlement voluntarily in the previous stages, the ombudsman may make a final decision, awarding policyholders up to £100,000.⁶⁸ Importantly, the decision is binding—though only on the insurance company (with a limited right of appeal). Policyholders may appeal as a matter of course, though the ombudsman decision is admissible as evidence in court.⁶⁹ Unlike adjudicators, ombudsmen do possess the power to issue binding decisions, but neither possess any regulatory authority.⁷⁰ The ombudsman position itself is a high public office, involving not only resolving cases but also acting as administrators by planning, monitoring, training, and making policy for the FOS.⁷¹

A clever, quasi-judicial framework guides the FOS decision-making process. FOS adjudicators and ombudsmen act in accordance with a statutory “fair and reasonable” legal standard, which requires them to consider factors including the “relevant law, regulations, regulators’ rules and guidance, relevant codes of practice and, where appropriate, what [FOS] considers to have been good industry practice at the relevant time.”⁷² Importantly, ombudsmen are not bound by legal precedent where doing so would not be in the interest of justice (though the FOS must state both the correct law and its reasoning for the divergence).⁷³ Rather, the touchstone for the application of the “fair and reasonable” standard to the facts of the case is the FOS’s own prior decisions.⁷⁴ These decisions operate as a kind of “FOS precedent” that helps ensure that the use of a flexible standard can still result in reasonably consistent decision making.⁷⁵ If any facts are in dispute, the adjudicator tries them according to “the balance of probability” of available evidence for the purposes of his or her written case evalua-

65. *Id.* at 772-73.

66. *Id.* at 773.

67. *Id.* at 774.

68. *Id.* at 776.

69. *Id.* at 777.

70. *Id.* at 777 n.235.

71. *Id.* at 777.

72. FIN. SERVS. AUTH., DISPUTE RESOLUTION: COMPLAINTS § 1.6.2 (2008), <http://fsahandbook.info/FSA/html/handbook/DISP/>.

73. Schwarcz, *supra* note 55, at 778.

74. *Id.* at 775.

75. *Id.* at 778.

tion.⁷⁶ The adjudicator may review these factual findings on appeal only for legal or procedural errors, or when they rise to the level of being "perverse and irrational."⁷⁷

An ombudsman may elect not to decide a dispute because it raises difficult or novel legal issues, leaving it for the courts to decide on their own.⁷⁸ Additionally the accumulation of documents from each of the prior stages constitutes a record that is available in its entirety to the FOS at every consecutive stage.⁷⁹ When there is a final ombudsman decision on a case, the written opinion is abridged and anonymized for publication in a recorder called the "Ombudsman News."⁸⁰ These decisions, in turn, help to guide future decisions, as discussed above. Crucially, this system allows for a measure of both confidentiality (anonymity) and transparency (public disclosure).

While virtually every component on the private ombudsman system is also present in one form or another in the United States, qualitative differences do emerge. The most important difference is the FOS's proven track record of doing its job: resolving disputes.⁸¹ American state regulators, such as TDI, achieve voluntary settlements in only a minority of cases. The FOS, on the other hand, successfully facilitates voluntary settlement (i.e. prior to the binding ombudsman review stage) an impressive 94% of the time.⁸² Not only that, its "clients" are highly satisfied. 88% of British insurance companies are "satisfied with the relationship they have with the FOS," and 70% of consumers believe that the FOS "handles complaints efficiently and professionally."⁸³ While naturally there may be many explanations for the difference in resolution rates, it is worth considering whether Texas can replicate some of FOS's best practices. Section IV explores this topic in greater detail.

The European Union has also acted on insurance dispute resolution. In 2016, EU Online Dispute Resolution regulations took effect, requiring member states to certify ADR entities that are capable of receiving and resolving complaints online (and offline), as well as their compliance with the EU's procedural safeguards.⁸⁴ It further requires the European Commission to operate an online ADR platform that works with the nationally-certified ADR entities.⁸⁵ The headline on its website claims: "Resolve your online consumer problem fairly and ef-

76. *Id.* at 776.

77. *Id.* at 778.

78. *Id.* at 778-79.

79. *Id.* at 777.

80. *Id.* at 779.

81. *Id.* at 783.

82. *Id.*

83. *Id.* at 784.

84. Ramona L. Lampley, *The CFPB Anti-Arbitration Proposal: Let's Just Give Arbitration a Chance*, 48 ST. MARY'S L.J. 313, 337 (2016).

85. *Id.* at 338.

ficiently without going to court.”⁸⁶ It is not mandatory to use these systems, but through these regulations the EU has ensured that modern, low-cost, and accessible dispute resolution options are available to industry and consumers alike.⁸⁷ Perhaps the greatest advantage of these online systems is their scale. As more users take advantage of these online platforms, operating costs and timeframes could significantly improve in comparison to traditional paper and phone systems, providing for better redress of high-volume, low-value disputes.⁸⁸ Similar investment in efficient, tech-savvy solutions can help states like Texas to cut wait times, cut costs, and close the access-to-justice gap that often frustrates attempts to resolve disputes through litigation.

B. *Domestic*

A 2011 Texas statute currently allows consumers purchasing insurance through the Texas Windstorm Insurance Association (“TWIA”), a state-created wind and hailstorm insurer for high-risk property on the Texas coast, to choose a binding arbitration endorsement.⁸⁹ Once selected, the consumer “must arbitrate a dispute involving an act, ruling, or decision of the association relating to the payment of, the amount of, or the denial of the claim.”⁹⁰ It follows that the Texas legislature has already recognized the utility (or at least necessity) of these clauses in connection with the South Texas coastal properties that carry the highest risk of storm damage (and for which it could potentially be forced to foot the bill). On the other hand, the accountability of the state to its customers through the democratic process provides safeguards that are not present for private, commercial enterprises. This observation reaffirms the importance of accountability in any arbitration policy solution.

In July 2018, Williamson County and Travis County justice courts in Texas began using an online dispute resolution platform called “Modria Online Dispute Resolution Solution.”⁹¹ The system originated as an automated dispute resolution system designed for eBay and PayPal, which successfully resolves some 90% of claims received, and was modified by Tyler Technologies, a Texas-based company, for use in the justice system.⁹² Litigants will pay a \$15 fee to

86. *Online Dispute Resolution*, EUR. COMM’N, <https://ec.europa.eu/consumers/odr/main/index.cfm?event=main.home2.show&lng=EN> [https://perma.cc/589M-4A3M] (last visited Aug. 29, 2018).

87. Lampley, *supra* note 84, at 337.

88. *See id.* at 338.

89. *See* TEX. INS. CODE ANN. § 2210.554 (West 2011).

90. *Id.*

91. Claire Osborn and Taylor Goldenstein, *Area Judges Make Plans to Try Out ‘Pajama’ Court*, AUSTIN AM.-STATESMAN: MYSTATESMAN (June 17, 2018, 12:00 AM), <https://www.mystatesman.com/news/local/area-judges-make-plans-try-out-pajama-court/8HHpoy1Ip4qEv6USfjWubO/> [https://perma.cc/S7ZT-6XPA].

92. *Id.*

mediate their claim online, and officials expect that it will save time and money compared to traditional methods.⁹³ Bill Gravell, Justice of the Peace in Williamson County, labeled it “pajama justice” because of the convenience of settling a lawsuit even from one’s home.⁹⁴ Instead of waiting forty-five days for a court hearing, the dispute resolution process can begin immediately.⁹⁵ After opting to use the system, Tyler Technologies will email the plaintiff and defendant with their login information.⁹⁶ The litigants then enter information about the issues in the case, decide what solutions they are seeking, and may select from a range of responses.⁹⁷ This system allows for a sophisticated, automated solution that can be responsive to the many factors, including psychological ones, that underlie dispute resolution. “A lot of people are OK with getting less money than they want out of the case as long as the other person apologizes,” according to a general manager for the program.⁹⁸ If the online dispute resolution is unsuccessful, the litigants can proceed with traditional mediation or in court.⁹⁹ Above all, this system illustrates that local government officials in Texas have attempted to use technology to improve the experience of dispute resolution while also lowering costs. There is no reason that state agencies, a private ombudsman, or the insurance industry in Texas could not follow this example.

IV. ADVANTAGES AND DISADVANTAGES OF ARBITRATION IN INSURANCE

A. *Advantages*

As a threshold issue, states like Texas must first determine whether they should permit pre-dispute arbitration agreements in the first place. Therefore, it is necessary to consider whether the potential disadvantages outweigh the potential advantages, such that Texas should restrict or prohibit the agreements altogether as a matter of policy. Arbitration as a means of dispute resolution generally can provide a number of advantages, including autonomy, flexibility, neutrality, confidentiality, expertise, relative efficiency, and preservation of relationships.

Arbitration can promote autonomy because in theory it allows the parties involved to determine for themselves the choice of law and forum that will govern any disputes.¹⁰⁰ However, the fact that parties

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.*

100. Peter A. Halprin, *Arbitration in Insurance Coverage Disputes: Pluses and Minuses*, POLICYHOLDER ADVISOR, Nov.–Dec. 2014, at 1.

cannot generally negotiate insurance policies on a case-by-case basis, given that regulators must approve the forms in advance, reduces this advantage. To the extent that the insurance market as a whole allows consumers to choose among different options, however, there is still some degree of choice and autonomy. In this vein, an option to select arbitration at the time the insured purchases a policy (with appropriate transparency requirements to ensure consumers understand their choice) promotes greater consumer choice.

Arbitration is also flexible because it need not follow the complex rules of procedure that must be broad enough to encompass the various types of civil litigation, rather the procedure can be tailor to the subject matter and the needs of each individual case. Arbitration can also avoid concern about local bias when one litigant is at home in a given forum and the other is an outsider.¹⁰¹ Confidentiality can also be an advantage in arbitration,¹⁰² where parties may not wish to have their business practices made available via discovery to the general public (and competitors). In the insurance business, maintaining confidentiality is perhaps especially important: success in the insurance industry is premised on building a competitive advantage through proprietary information.¹⁰³ Expertise can also present an advantage in arbitration. An arbitrator selected for having subject matter expertise and experience may know more than a judge who is a generalist, to say nothing of a jury that may not know anything about insurance at all. Consequently, the arbitrator may render a more informed judgment and may not need briefing on industry specifics.

Cost and speed are perceived advantages of arbitration.¹⁰⁴ Less formal procedures and fewer costs present an opportunity to resolve conflicts faster and cheaper than in court. In the context of insurance claims in Texas, only a small percentage of disputes are resolved in court,¹⁰⁵ and others may go unresolved entirely as a result. Litigation in court is frequently slow, expensive, and unpredictable. Plaintiffs in insurance coverage cases have necessarily suffered some kind of loss and as a result usually need quick compensation. Compared to other cases, these plaintiffs may be even shorter on the financial and personal resources that litigation often requires, and they are generally more risk-averse (having already paid for insurance to transfer the risk in the first place).¹⁰⁶ In such situations, slow and costly justice can block access to justice entirely. Even where counsel is available and

101. *Id.* at 2.

102. *Id.*

103. See EWALD, *supra* note 1, at 203 (“Risk only becomes calculable when it is spread over a population. The work of the insurer is, precisely, to constitute that population by selecting and dividing risks.”).

104. Halprin, *supra* note 100, at 2.

105. Only a single-digit percentage of claims result in litigation. See TEX. DEP’T OF INS., *supra* note 24, at 10.

106. Schwarcz, *supra* note 55, at 742.

willing to take cases on a contingency fee basis, reducing the policyholder's immediate concern for cost, speed still remains an important issue. To the extent arbitration offers faster resolution, while still offering a fair hearing of the dispute, it remains possible to improve plaintiffs' access to justice.

Additionally, because the insurance transaction is a sequential exchange (with the policyholder paying premium in advance and later collecting if and when some future condition occurs—unlike the typical sales transaction where the exchange is simultaneous), it is to the insurance company's advantage and the policyholder's detriment to delay payment of the claim as long as possible. Further, when arbitration results in a speedy resolution, it may also allow for parties to maintain business relationships that otherwise might not survive protracted litigation.¹⁰⁷

One alternative to arbitration that can offer similar advantages—namely class-action lawsuits—frequently chosen by consumers in other contexts to litigate high-volume but low-value claims, is rarely a realistic option in insurance disputes. Insurance claims are highly fact-sensitive, concerned with the situation of a particular policyholder at a particular place and time that gave rise to a claim under a particular policy. As such, these cases usually do not share enough common issues to effectively aggregate them in a class-action suit.¹⁰⁸ The insurance-related class-action suits that do arise are usually not related to claims.¹⁰⁹ Consequently, class actions, which provide an efficient, mass-litigation alternative to arbitration generally, do not provide a viable alternative in the context of insurance disputes.

B. *Disadvantages*

While arbitration potentially has many advantages, the same features could also be considered disadvantages. Among these are the potential for waiver of rights, secrecy, lack of fairness, and asymmetrical power. As discussed previously, binding arbitration, while providing additional options to contracting parties, may also involve waiving a constitutional right to a jury trial¹¹⁰ as part of that choice, something that a party should not take lightly. Further, the flexibility and speed of arbitration means that parties may have an informal and abbreviated trial that abrogates rights to procedural fairness they are otherwise entitled to under the more complex and lengthy rules of civil procedure.

Confidentiality might also create a concern for secrecy. If the arbitration is completely confidential, then there is no public record of

107. *Id.*

108. *Id.* at 749.

109. See Eric Helland & Jonathan Klick, *The Tradeoffs Between Regulation and Litigation: Evidence from Insurance Class Actions*, 1 J. TORT L. 2, Oct. 2007, at 17.

110. See U.S. CONST. amend. VII.

opinions, no way to create or recognize precedent from these proceedings, and no way to ensure that the results are just. It may also conflict with the public policy recognized in the Texas Constitution's provision of a right to open courts.¹¹¹ Secrecy may also protect abusive business practices from scrutiny.¹¹² Arbitration can disguise the inequalities that may result from incentives to favor repeat players.¹¹³ In the insurance context, the insurance company is usually the repeat player. While arbitrators may never see a policyholder again, they may need to compete for the business of the insurer.¹¹⁴ Consequently, a desire to obtain more of their business may give arbitrators an incentive to rule in favor of the insurers.

Arbitration agreements may also provide unfair advantages. While flexibility allows an arbitration to proceed quickly and simply, that flexibility may also limit discovery.¹¹⁵ This result most often advantages the party possessing more information—here the insurance company.¹¹⁶ Additionally, it is the plaintiff (usually the policyholder given the sequential nature of the insurance transaction discussed above) who bears the burden of proof for all the necessary elements to make out a claim. Consequently, limited discovery inures to the advantage of the defendant (usually the insurance company).

The finality of arbitration also raises a fairness issue. While arbitrators should apply the law, there are no guarantees that they will do so without error, and there is no possibility of appeal for failure to apply the law correctly.¹¹⁷ Even arbitrators' expertise can result in unfairness to the extent that such expertise usually arises from experience gained through employment in the insurance industry and could result in a bias towards that industry.¹¹⁸

Asymmetry of sophistication between parties also presents an enduring critique of arbitration. Specifically, in the insurance context, insurance policies are contracts of adhesion, meaning that the insurance company drafts them, and they are not usually negotiable (although regulators must normally approve the language first). If insurance companies may draft their own arbitration clauses, it could lead some companies "rigging the system" in their favor as much as possible. Arbitration may already be stacked against unsophisticated consumers. A study by the Consumer Financial Protection Bureau has shown that consumers rarely succeed in arbitration for disputes with

111. See TEX. CONST. art. I, § 13.

112. Randall, *supra* note 8, at 258.

113. *Id.* at 258-59.

114. *Id.*

115. *Id.* at 258.

116. *Id.*

117. *Id.* at 261

118. *Id.* at 259.

(non-insurance) financial companies.¹¹⁹ Out of 1,060 arbitration cases tracked from 2010 to 2011, consumers only prevailed in thirty-two cases.¹²⁰ Finally, by taking courts out of the equation, arbitration may effectively remove an important regulator of the insurance industry.¹²¹ As Robert E. Keeton and Alan Widiss noted, “the influence of the courts on insurance transactions through doctrinal developments has sometimes been considerably more significant than the enforcement of regulatory measures by the commissioner of insurance.”¹²²

V. PROPOSALS TO IMPROVE INSURANCE ARBITRATION IN TEXAS

As previously discussed in the preceding section, while arbitration is promising with respect to the advantages it offers, it is burdened by many potential disadvantages as well. A well-designed dispute resolution scheme, however, may mitigate many of these disadvantages. A new, robust emphasis on transparency by the Texas Department of Insurance; creation of an independent public entity (similar to the British FOS); pre-dispute arbitration agreement language that balances the interests of insurers and policyholders; and greater leverage of technology can allow Texas to borrow from the best practices of other countries and potentially minimize the disadvantages to consumers and society of binding arbitration. Lower cost and the availability of a consumer conciliation process can improve access to justice, which is at the heart of the right to trial. Courts, however, may continue playing an important role by settling the novel legal issues which often arise in insurance cases.

All of these proposals presuppose a great deal of new regulation and oversight. While Texas is not a state known for being overly friendly to regulation, insurance is already a highly-regulated industry. Having a heavily-regulated industry function better is something even wary Texas legislators can appreciate. Furthermore, a private ombudsman, similar to the FOS, would actually allow for *less* government involvement than the present TDI complaint system.

Perhaps the most significant political hurdle is persuading the insurance lobby to buy into (or at least acquiescence to) a new system. Here, the British have shown that it is possible to create a dispute resolution service that is popular with industry.¹²³ A non-partisan, independent body that simply assists in claim resolution may even make

119. CONSUMER FIN. PROT. BUREAU, ARBITRATION STUDY: REPORT TO CONGRESS, PURSUANT TO DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT § 1028(A) (2015), at 12, https://files.consumerfinance.gov/f/201503_cfpb_arbitration-study-report-to-congress-2015.pdf [<https://perma.cc/Q94G-QFCW>].

120. *Id.*

121. *Id.* at 263.

122. ROBERT E. KEETON & ALAN WIDISS, INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES, AND COMMERCIAL PRACTICES § 8.1, at 938 (1988).

123. Schwarcz, *supra* note 55, at 810.

the claim department's job easier. Part of the reason the FOS works well is that its independence helps in its task of managing consumer expectations and explaining adverse coverage decisions because FOS has no direct stake in the issue.¹²⁴ Indeed, in the United Kingdom, the insurance industry actually introduced the FOS, private ombudsman approach.¹²⁵ To the extent that the insurance industry tends to dislike change, Texas can sweeten the deal for insurers by providing additional incentives, such as offering partial relief from bad-faith claims or prompt-payment penalties if they agree to participate in the system.¹²⁶

A private solution also offers insurance companies the prospect of avoiding additional state or even federal involvement. If pre-dispute arbitration agreements are allowed and subsequently abused by bad actors, it raises the specter of regulation that might be a less friendly to business than a voluntary, private arrangement. Therefore, the insurance industry has an interest in a fair and workable regulatory system.

The other reason this system may be preferable for the state of Texas is to maintain state independence and avoid possible federal involvement. Currently, Texas can decide whether and how to regulate the insurance industry. Texans generally tend to pride themselves on managing their own affairs, and they greatly value their independence. Certainly, maintaining the state's prerogative and influence is a priority. Historically, in fact, the threat of federal preemption has probably resulted in more state insurance regulatory reform than any other single factor.¹²⁷ For example, the McCarran-Ferguson Act, by limiting the states' exemption if they did not regulate insurance themselves, resulted in the creation of state insurance regulatory law.¹²⁸ While the FAA presently has a carve out for state regulation of insurance under McCarran-Ferguson (as discussed in Section II), depending on the prevailing politics in Washington, if states are seen as either unfairly obstructing arbitration agreements (contrary to the general policy of the FAA) or as allowing arbitration on terms that are too favorable to the insurance industry (and therefore unfavorable to consumers), Congress could very well intervene and change the law. In the former scenario, the McCarran-Ferguson Act could be repealed, the FAA would be the law of the land in every state, and a public policy favoring arbitration would uphold arbitration agreements in the insurance industry too. Under the latter scenario, the federal government might feel compelled to oversee the state regulators or even di-

124. *Id.* at 810-811.

125. *Id.* at 811.

126. *Id.*

127. Daniel Schwarcz, *Transparently Opaque: Understanding the Lack of Transparency in Insurance Consumer Protection*, 61 *UCLA L. REV.* 394, 457 (2014).

128. *Id.*

rectly regulate itself. If there is one thing the Texas legislature would prefer to avoid, in a state with no great love of Washington bureaucrats, it is to have the federal government involved in the state insurance industry.

On the other hand, it is worth considering some of the differences between the United Kingdom and Texas which may make the implementation of a FOS-like scheme problematic. One meaningful barrier is simply building up the institutional knowledge and capacity for a dispute resolution body comparable to FOS. While TDI has a complaint resolution department, and there are knowledgeable individuals who already work as arbitrators, it will still take an investment of time and money to build an institution from scratch. The insurance industry may also balk at the British approach of rulings that are only binding on insurance companies and not policyholders. One possible reason is that the greater availability of punitive damages in the United States¹²⁹ (which can be much greater than the underlying contract claim) may incentivize policyholders with an unfavorable ruling to calculate that it is worthwhile to re-litigate the claim in court, upsetting the rationale of the system.

Another reason is cultural. Texans simply may not be inclined to give up some familiar and historically-rooted rights to bring claims in court in favor of an unfamiliar and bureaucratic system borrowed from a foreign country. Nevertheless, Texans are also deeply pragmatic, possessing a powerful capacity to borrow and put their own stamp on things. And to the pragmatist, the most important question is whether something works well or not. An arbitration system that can stand on its own merits is its own most persuasive argument.

Texas's size may play a role in its ability to make investments needed to create a workable regulatory system. The sheer size of the state and its insurance market (and the taxes that come from payment of insurance premiums) means that Texas simply has greater resources available to experiment with creating a new regulatory framework than most states. Additionally, Texas could invest in an alternative dispute resolution platform similar to those developed in the European Union. As part of that investment, greater use of technology, either through direct investment by the state (or by the creation of incentives for the state's substantial technology sector) can also lower the cost to resolve disputes, which benefits all parties involved. It may also lower barriers to access the Texas insurance market, as insurers will not have to develop their own proprietary systems, which could promote competition and make insurance less expensive for consumers.

Another important area of opportunity is in promoting transparency. Transparency can alleviate concerns about arbitration by helping customers help themselves in order to better understand their

129. Schwarcz, *supra* note 55, at 782.

insurance coverage and avoid disputes in the first place. Transparency has historically been a neglected area for state insurance regulators.¹³⁰ By comparison, developing more transparent markets is a cornerstone in other areas of modern financial regulation.¹³¹ Transparency, by making available better information, can help Texas deliver on goals of fair and efficient markets at lower cost. It also empowers interested parties, consumer advocates, and journalists to play a watchdog role (at no cost to the state coffers) that supplements state regulatory efforts.¹³²

Courts, however, can still play an important role in insurance law by stepping in when novel or complex legal issues arise in insurance cases that are beyond the private ombudsman system. This avoids one important problem of secrecy in arbitration. Similar to the FOS system, an ombudsman may choose not to decide a dispute, leaving courts to decide difficult or novel legal issues. A limited right to appeal may also preserve the perception of fairness in the system. Where courts do become involved on appeal, the record and documents generated by the private dispute resolution system could be invaluable in quickening the discovery process and resolving cases quickly.

VI. CONCLUSION

This Comment offers a variety of recommendations for how Texas can design and promote a low-cost, efficient arbitration solution that can be mutually advantageous to insurance companies, policyholders, and society. The following methods may provide the means for Texas to play a leadership role in insurance markets while avoiding greater state and federal regulation: (1) a greater emphasis on transparency by TDI; (2) the creation of an independent dispute resolution body; (3) use of the British private ombudsman system as a model; (4) greater leverage of technology; and (5) leaving a role for the judiciary on novel and complex cases. It would enable the advantages of arbitration in insurance, which are autonomy, flexibility, neutrality, confidentiality, expertise, relative cost and speed, and preservation of business relationships. At the same time, it would help in alleviating concerns about the waiver of rights, secrecy, lack of fairness, and asymmetrical power involved in such agreements. In short, it might be “enough to hang your hat on.”

130. Schwarcz, *supra* note 127, at 396.

131. *Id.*

132. *Id.* at 398-99.

