

Applying Cost-Shifting “Offers of Judgment” in ARIAS Arbitrations

By Daniel M. Perry and Aluyah I. Imoisili

Insurers and reinsurers typically choose arbitration believing it to be a cheaper dispute resolution alternative to conventional litigation. But, in our experience, arbitrations are often now just as expensive as litigation. With the parties’ insistence on expansive discovery, their more frequent use of paid expert witnesses, and the inability to secure speedy resolution of non-meritorious cases, the costs of arbitrating disputes to finality are often far in excess of what the parties anticipated when they inserted mandatory arbitration provisions in their contracts. Arbitrators themselves have no real ability to effectively urge parties to avoid these costs by resolving disputes prior to the arbitration hearing. And unless the parties’ contract entitles the prevailing party to recoup its legal costs, many arbitrators remain reluctant to award them to either party, especially when they do not believe that either side has engaged in bad faith.¹ The result is an arbitration process that does not serve the parties’ interest in creating a more cost-effective substitute to litigation.

One solution to reduce arbitration costs and to encourage settlement is to adopt “offer of judgment” settlement procedures utilized in federal and many state courts. Most courts, unlike arbitration providers, have the ability to, in effect, punish a recalcitrant plaintiff for refusing to accept a good faith settlement offer from a defendant and reward an enterprising defendant for taking the initiative to attempt to settle the matter before trial. This procedural tool is known as an “offer of judgment” or “offer to compromise.” “Offer of judgment” statutes authorize a defendant to propose to a plaintiff a pre-trial settlement offer that, if the plaintiff rejects and the offer turns out to be better (more beneficial to the plaintiff) than the damages the court

eventually awards, entitles the defendant to recover from the plaintiff certain litigation expenses that the defendant incurs after the time that it made the offer. As one court put it, these rules:

encourage settlement by providing a strong financial disincentive to a party—whether it be a plaintiff or a defendant—who fails to achieve a better result than that party could have achieved by accepting his or her opponent’s settlement offer. [] This is the stick. The carrot is that by awarding costs to the putative settler the statute provides a financial incentive to make reasonable settlement offers.²

In federal courts, under Rule 68 of the Federal Rules of Civil Procedure, an “offer of judgment” works as follows. At least fourteen days prior to the commencement of trial, a defendant may serve on the plaintiff, but not file with the court, a written settlement proposal that contemplates a judgment will be entered against it.³ The plaintiff may either accept the offer as-is or reject it. If the plaintiff accepts the offer, the parties then file with the court a notice of the offer and acceptance in the form of an “offer of judgment” that the court enters as the judgment in the case.⁴ If the plaintiff rejects the offer, the outcome depends on the ultimate trial result. If the plaintiff wins the trial, and the amount of the judgment exceeds the amount the defendant offered as a compromise, neither side suffers a penalty. If, on the other hand, the amount of the judgment is less than the amount of the defendant offered the plaintiff (whether or not the plaintiff actually prevails at trial) then the plaintiff incurs a penalty for declining the offer. The plaintiff must pay the costs the defendant incurred after it made the offer of judgment. Costs

article



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are limited to: court filing and other fees, trial and hearing transcripts, certain printing costs (including for copies of documentary exhibits used at trial), witness (subpoena) fees, and compensation of court-appointed experts and certain other professionals (such as interpreters).⁵

State statutes work the same way but often include additional penalties for the party that refuses the offer and sweeteners for the offeror. For instance, in New York, under Rule 3221 of the New York Civil Practice Law Rules, the plaintiff loses its right to recover as a prevailing party any costs it incurs from the time of the “offer to compromise.”⁶ In California, under California Civil Procedure Code Section 998, not only does the plaintiff lose its right to recover its own prevailing party costs, it may be liable for the defendant’s expert witness fees as well as the defendant’s attorneys’ fees if the defendant ultimately prevails at trial.⁷ In addition, a California plaintiff itself may initiate an offer and if it obtains a judgment that is more favorable than the judgment be entitled to recover from defendants its costs, including its expert witness fees that normally are not recoverable by a prevailing party under California law.

Critics of these fee-shifting penalties question their fairness and effectiveness. Indeed, these penalties create an opportunity for gamesmanship. What makes this cost-shifting penalty unique is that the court could theoretically award the defendant its litigation expenses even in situations

where the defendant essentially loses at trial both on issues of liability and the quantum of damages. In rare instances, defendants are able to employ these fee-shifting rules strategically either to coax plaintiffs to accept low-ball offers or to limit their own liability.⁸

The advantages of offer of judgment procedures can present in ARIAS arbitrations, where the participants are typically sophisticated and represented by good counsel, are tangible. In the right cases, where the parties can readily ascertain their likelihood of success on the merits and the potential financial outcome, these penalties can provide a strong incentive to the parties to initiate and consider realistic settlement offers. Indeed, one could make the case that adopting the approach of jurisdictions that allow defendants to recoup as offer of judgment expenses high-dollar attorneys’ fees and expert witness compensation is appropriate in the context of ARIAS arbitrations where both parties tend to have the financial wherewithal to consider and weigh the benefits of an offer of judgment with the potential for substantial cost-shifting. Moreover, if parties implement “offer of judgment” procedures, they can effectively take off the arbiter’s plate the decision of whether to award litigation costs to either side.

A carefully tailored set of rules could make “offers of judgment” appealing to parties in arbitration seeking another means of recovering their costs or encouraging settlement. This article offers some suggestions on parameters for an ARIAS “offer of judgment” procedure for parties to consider adopting in their arbitrations.

(i) Parties Must Agree To Adopt “Offer of Judgment” Procedure

As a practical matter, most parties cannot automatically take advantage of existing “offers of judgment” rules in federal and state court now without first entering into fresh agreements among themselves to do so. For arbitrations governed by federal law, the parties need to have adopted Rule 68 of the Federal Rules of Civil Procedure into their arbitration since

(as courts have long decided) federal court rules do not apply in arbitration.⁹

Similarly, state courts that have considered whether their “offer of judgment” statutes are available in arbitrations have determined that they do not unless expressly authorized in the statute. In *Lane v. Williams*, for instance, the Wisconsin court of appeals vacated an arbitration award that incorporated “offer of judgment” costs.¹⁰ The court reasoned that Wisconsin’s “offer of judgment” statute could not apply in arbitrations even where the parties’ contract had expressly indicated that Wisconsin’s law would govern the arbitration. The court explained that because the Wisconsin statute did not mention “arbitration,” it only applied to “trials.”

Some states, including California, do however allow parties to make “offer of judgment” in arbitration.¹¹ And parties for whom those state statutes govern their proceedings can take advantage of them already—although we are unaware of this practice being used with any regularity in California-based arbitrations.

For parties that cannot employ such state provisions, they must agree in writing, in their reinsurance contracts or in a subsequent agreement, to adopt a specific, spelled-out “offer of judgment” procedure. Alternatively, ARIAS could develop its own “offer of judgment” procedure. The parties can agree to bind themselves either to ARIAS’s “offer of judgment” process alone or all ARIAS arbitration rules or procedures (which would include the “offer of judgment” procedure, if adopted).

(ii) “Offer of Judgment” Should Be Available To Either Party

Like the California system, both sides should be able to make “offers of judgment” with penalties and rewards applying to both sides. This prevents parties from engaging in one-sided stratagem in the arbitration and places incentives on both sides to propose and pursue settlements, which we believe is consistent with one of the primary goals of the arbitration process.

(iii) Final Arbitration Award Should Incorporate “Offer of Judgment” Penalties

The parties must not share the offer with the arbitrators prior to the time that the arbitrators issue their award on the merits of the arbitration. Keeping secret the existence of the offer and its substance eliminates the risk that an arbitrator would be improperly influenced in reaching his or her merits decision.

Concomitantly, the arbitration panel should not make its award “final” until it clarifies with the parties the existence of an “offer of judgment” and how, if at all, it would affect the final amount of the award and to whom it is owed. The panel may have to wait for the parties to compute the final amount of the arbitration award after deducting costs due as a result of the implementation of the relevant “offer of judgment” penalties. The panel should also have an opportunity to evaluate challenges to the applicability of the penalties (discussed below).

(iv) “Offer of Judgment” Should Be Subject To Reasonableness Requirement

To address the gamesmanship concern that parties may submit low-ball bad faith offers just to be entitled to recoup their costs without any downside, the “offer of judgment” should be subject to a reasonableness requirement. Indeed, courts often subject the “offer of judgment” to a requirement that it is not nominal and is made in good faith.² In evaluating the reasonableness of the offer, courts will consider whether the party rejecting the offer had available to it information that rendered the offer reasonable.¹³

In an ARIAS arbitration, if “offer of judgment” penalties are applicable, and a party challenges the good faith of the offer, the arbitration panel should be able to review the reasonableness of the offer in light of their understanding of the merits of the case. The arbitration

panel would be able to strike in truly egregious cases where it is obvious that a party sought to abuse the system (for example, if a defendant made the offer, and the plaintiff rejected it while defendant improperly withheld production of evidence that was unavailable to the plaintiff and that was dispositive of the plaintiff’s claims).

(v) “Offer of Judgment” Should Be Limited To Claims At Issue In Arbitration

Any ARIAS procedure should require the parties to limit the scope of the offer only to those claims at issue in the arbitration before the arbitration panel. If the parties seek a global settlement of all of their existing and future claims against one another, the panel would not have had an opportunity to evaluate the merits of those claims. In fact, some of those claims may not even be subject to arbitration at all and the panel may be overstepping its jurisdiction (and expertise) in assessing the reasonableness of a proposed settlement of claims whose merits are not before it.

(vi) “Offer of Judgment” Penalties Must Be Significant

The “offer of judgment” penalties need to be “meaningful” to be effective in enticing the parties to settle. Given the level of sophistication of most participants in an ARIAS process, the penalties must be in a material amount that will force the parties to consider their options seriously. Thus, we believe that the penalties should include as many litigation expenses as possible, including arbitrator fees, discovery costs, attorneys’ fees, and expert witness compensation, so that the parties are incentivized to settle.

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The ultimate end goal of arbitration should not be to pursue the case to a final hearing at all costs. In our experience, dispute resolution systems operate more efficiently when parties

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(particularly sophisticated commercial institutions) are incentivized to resolve their differences before hearing or trial. If the parties that use the ARIAS process are serious about reducing the costs of resolving their disputes, a tailored “offer of judgment” system—properly designed to eliminate inappropriate gamesmanship but with enough “teeth” to force parties to come to the settlement table—will help achieve this goal.

End Notes

1. See, e.g., *Reliastar Life Ins. Co. v. EMC Nat’l Life Co.*, 564 F.3d 81, 89 (2d Cir. 2009) (holding that although arbitrators would exceed their authority by awarding attorneys’ fees and costs where a contract provides that each party shall bear its own litigation costs, arbitrators may award attorneys’ fees and costs as a sanction for bad faith conduct).
2. *Bank of San Pedro v. Superior Court*, 3 Cal. 4th 797, 804 (1992).
3. See Fed. R. Civ. P. 68.
4. *Id.*
5. See 28 U.S.C. § 1920.
6. See N.Y. C.P.L.R. § 3221.
7. See Cal. Code Civ. Pro. § 998.
8. In *Scott Co. of California v. Blount, Inc.*, for instance, the defendant made an offer of judgment wherein the defendant would pay the plaintiff \$900,000. See 20 Cal. 4th 1103, 1116 (1999). The plaintiff rejected the offer. At trial, the plaintiff prevailed and received an award of \$668,866 (\$442,054 in damages and \$226,812 in attorneys’ fees and costs). Because the plaintiff’s award was less than the defendant’s offer of judgment, the plaintiff owed the defendant its attorneys’ fees and costs, totaling \$881,635.60. The upshot was that although the plaintiff actually prevailed at trial, it owed the defendant more than \$200,000.
9. See Fed. R. Civ. P. 81(a)(6) (“These rules, to the extent applicable, govern proceedings under the following laws, except as these laws provide

other procedures: [...] (B) 9.U.S.C., relating to arbitration [(the Federal Arbitration Act)]"); see also *Foremost Yarn Mills, Inc. v. Rose Mills, Inc.*, 25 F.R.D. 9, 11 (E.D. Pa. 1960) (holding that the Federal Rules of Civil Procedure do not apply in arbitrations); *Great Scott Supermarkets, Inc. v. Local Union No. 337*, 363 F. Supp. 1351, 1354 (E.D. Mich. 1973) (citing *John Wiley & Sons v. Livingston*, 376 U.S. 543 (1964)) ("The parties did not provide in their agreement that the Fed. R. Civ. P. would apply to the arbitration proceedings. Absent such a provision, the Fed. R. Civ. P. do not apply."); *Commercial Solvents Corp. v. Louisiana Liquid Fertilizer Co.*, 20 F.R.D. 359, 361 (S.D.N.Y. 1957) ("By voluntarily becoming a party to a contract in which arbitration was the agreed mode for settling disputes thereunder respondent chose to avail

itself of procedures peculiar to the arbitral process rather than those used in judicial determinations.").

10. 621 N.W. 2d 922, 925-926 (Wisc. App. 2000).
 11. See Cal. Civ. Pro. Code § 998(b); see also *Pili-
 mai v. Farmers Ins. Exchange Co.* 39 Cal.4th 133,
 150-51 (2006) (California Civil Procedure Code
 Section 998 "puts the arbitration plaintiff on
 the same footing as the plaintiff to a civil action
 vis-à-vis costs when the plaintiff has made an of-
 fer that the defendant has refused and obtains
 a judgment more favorable than the offer. Fur-
 thermore, nothing in the . . . legislative history
 [of section 998] indicates that the Legislature
 specifically intended costs to be unavailable to
 arbitration plaintiffs.").

12. See, e.g., *Wear v. Calderon*, 121 Cal. App. 3d

818, 820-21 (1981) (rejecting \$1 offer of judg-
 ment because "the pretrial offer of settlement
 required under [California Code of Civil Proce-
 dure] 998 must be realistically reasonably under
 the circumstances of the particular case. Nor-
 mally, therefore, a token or nominal offer will not
 satisfy this good faith requirement..."); *Pineda v.
 Los Angeles Turf Club, Inc.*, 112 Cal. App. 3d 53, 63
 (1980) (rejecting \$2,500 offer in \$10 million per-
 sonal injury case).

13. See, e.g., *Elrod v. Oregon Cummins Diesel, Inc.*,
 195 Cal. App. 3d 692, 698-70 (1987) (reasonable-
 ness depends on whether the adverse party the
 adverse party knows or reasonably should know
 the information that makes it reasonable).



ARIAS•U.S. Members on the Move

In each issue of the *Quarterly*, this column lists employment changes, re-locations and address changes, both postal and email that have come in during the last quarter, so that members can adjust their address directories. Although we will continue to highlight changes and moves here, remember that the ARIAS•U.S. Membership Directory on the website is updated frequently; you can always find there the most current information that we have on file. If you see any errors in that directory, please notify us at director@arias-us.org.

RECENT MOVES & ANNOUNCEMENTS

Chuck Ehrlich

Chuck has been appointed by the State Bar of California to its statewide 21 member Committee On Alternative Dispute Resolution.

James Engel

James, formerly with Liberty International Underwriters, is now with Endurance Specialty Holdings as their Global Chief Claims Officer. Please note James' new contact information:

Endurance Services Limited
 750 Third Avenue, 10th Floor
 New York, NY 10017
 Direct Tel: +1.212.471.1787
 Email: jengel@enhinsurance.com

Suzanne Fetter

Suzanne wrote to share that she has recently returned to the U.S. from Grand Cayman to start her own Consulting and Arbitration practice. She was formerly employed as a Claims Executive with Greenlight Re in Grand Cayman and will now be working in Chester, CT as she begins her new Arbitration practice. Suzanne is also a U.S. based partner and Reinsurance Consultant for Aurigon Advisors in Switzerland. She can now be reached at the following address.

62 Spring Street
 Chester, CT 06412
 (860) 322-3148 (direct)
 (860) 306-2346 (cell)
 (860) 322-4765 (fax)
 e-mail: suzanne@fettercompany.com

Lydia B. Kam Lyew

Lydia recently made the move from the East coast out West. She can now be reach at the following address:

REnamics LLC
 1048 Alexandria Drive
 San Diego, CA 92107-4115
 Cell 201-918-3195
lkamlyew@gmail.com

Dick White

During December 2015, the Liquidator of Integrity Insurance Company will file a motion with the Liquidation Court closing this estate after some 28 plus years of operation. Dick happily observes that his friends at ARIAS•U.S. will no longer have him to kick around. He plans to relax in Florida during February and March reflecting on what to do next.

Do not forget to notify us when your address changes.

Also, if we missed your change above, please let us know, so that it can be included in the next *Quarterly*.