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Institution Disputes Involving Financial Institutions: Developing U.S. Experiences – A Prototype for NAFTA Cross-Border Situations?

John D. Berchild, Jr.*

I. Introduction.

One of the fundamental “glues” of the NAFTA process is the linkage of dispute resolution mechanisms to both specific and general aspects of the NAFTA Treaty (Treaty) and related side agreements.1 With respect to the area of financial services, the Treaty contains specific dispute resolution provisions in Chapter 14, which intersect with the special investment-related dispute resolution provisions in Chapter 11 and the general provisions in Chapter 20.2

Notwithstanding the critical importance of the formal NAFTA dispute resolution provisions, one of the significant and oft-forgotten “spin-off” effects of the NAFTA is its promotion of private (contractual) alternative dispute resolution (ADR) solutions to cross-border commercial, business, investment, and financial disputes arising among NAFTA contracting parties.3 Given that this latter statement is unfolding as a practical truth, the primary point of this article is to demonstrate that the United States has already built up significant internal experience with ADR in the financial services area. This experience may be able to serve as a prototype model or reference point for the private resolution of NAFTA-related financial and commercial disputes.

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1 See, inter alia, LEON TRAKMAN, DISPUTE SETTLEMENT UNDER THE NAFTA (1996).
3 See Leon Trackman, Address at SMU Law School on NAFTA and Dispute Resolution (Mar. 1, 1999).
In its most general sense, commercial ADR is the resolution of disputes in a forum other than the traditional judicial system. It is an alternative to adverse publicity, costly and time-consuming litigation, and, in the United States, runaway juries. For these and numerous other practical reasons, many banks and other financial institutions in the United States (particularly in California and elsewhere) have found ADR a more attractive means of dispute resolution.

In the United States, especially in the context of lender liability claims made against banks and other financial institutions, ADR, most notably binding arbitration, has been viewed by many institutions as the appropriate avenue by which to avoid excessive damage awards made by relatively unsophisticated juries. Recent experience and empirical evidence has substantiated the benefits of arbitration by both decreasing the number of cases being filed and lowering the size of the awards.

However, lender liability is not the only precipitating factor for why the U.S. and other financial institutions should consider ADR. For example, intercreditor arrangements in syndicated loans lend themselves to ADR, because public disputes between institutional lenders often generate negative public and commercial relation value. In addition, structured financings, such as project financing and construction financing, often contain complex performance requirements, disputes over which may be better left to non-judicial experts for resolution. Moreover, disputes related to financial arrangements that present complex regulatory compliance issues (e.g., environmental compliance) may benefit from ADR rather than court proceedings. In the case of NAFTA, where all contracting parties adhere to the New York Convention on the Enforcement of Arbitral Awards, parties to financial disputes may find a contractually-constructed ADR forum more satisfactory than submitting to the uncertainties of a foreign court whose laws are based on a different legal tradition.

This article provides an overview of ADR and its statutory and contractual underpinnings, as viewed from recent U.S. experiences. It also discusses the perceived benefits and detriments of ADR, particularly as they relate to financial institutions. While mediation is a major part of the ADR process, this article will deal primarily with binding arbitration. Except in limited or specifically negotiated situations, mediation clauses are not normally found in loan documents and are not conducive to most commercial disputes involving financial institutions. Furthermore, although consumer issues are often closely related to protective legislation not normally accorded to commercial transactions, this article will deal with disputes relating to commercial business transactions rather than consumer financial transactions. This is not to say that arbitration is not increasingly being used and enforced in

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9 See, e.g., Michael Gordon, Address at the Cologne Conference (Mar. 1999).
consumer transactions; on the contrary, it is anticipated that within the next five years, most major U.S. banks and lending institutions will implement arbitration procedures for consumer transactions. However, as indicated above, the more general objective of this article is to demonstrate that the United States has developed a significant experience base with respect to private financial dispute resolutions. This experience may serve as a beneficial reference point as the use of private ADR NAFTA-related financial disputes increases.

II. The Recent Lender Liability Experiences: One Precipitating Factor.

For the U.S. financial industry, expanding theories of lender liability, rising jury verdicts, and increasing legal fees have all resulted in the court system being prohibitively expensive and, in a jury context, often incapable of a predictable result. Even if a financial institution can ultimately prevail in a seriously contested lender liability case, it is usually only after a protracted and expensive appeals process. This has resulted, initially in the California banking industry, in a number of financial institutions introducing private ADR processes as a standard requirement in most, if not all, of their loan documents. Some of these financial institutions, such as Bank of America, Union Bank of California, and Wells Fargo Bank, extensively use binding arbitration clauses, while other financial institutions use only arbitration clauses in selected types of transactions or with selected borrowers.

The experience of the California banking industry's introduction of private, binding arbitration appears successful. A study by the Rand Institute for Civil Justice provided the first empirical study concerning the success of arbitration in controlling excessive litigation expenses and jury verdicts in lender liability cases. Although the Rand study was based on early and preliminary information, its conclusion (with some qualifications) suggests that through the use of binding arbitration, the number of cases filed has declined as well as liability exposure and litigation costs and expenses. Rand's conclusion was based primarily on empirical data from one major banking institution (Bank of America) and anecdotal evidence of similar benefits from the other banks involved in the study. Furthermore, the perception by the banks was that arbitration also limits their exposure by lessening the risk of punitive damages and eliminating the unpredictability of juries. The reduction in the award factor lowered the incentives for plaintiffs' attorneys to take cases. The Rand study further concluded that the future appears quite bright for the use of ADR in the banking industry and that financial institutions would continue to expand its use into new areas of their banking business.

During the five years since the Rand study was released, California financial institutions have continued to have significant success in the use of arbitration. In my interviews

12 Rand Institute for Criminal Justice, Private Dispute Resolution in the Banking Industry, 1993, information or copies of the study can be obtained through Rand Distribution Services, 1700 Main Street, P.O. Box 2138, Santa Monica, California 90407, Phone No. (310) 451-7002 [hereinafter Rand Institute Study].
with the legal departments of some of California's major financial institutions, they stated
that they generally experienced a significant decrease in litigation and related expenses.
Most significantly was the surprising fact that arbitrations were not found to have greatly
increased significantly. Experience has shown that disputes tended to be worked out inform-
ally between the bank and its customer. If litigation was not available to the plaintiff bar,
the alternative of arbitration did not seem to offer the leverage or possibility of significant
recoveries often required to entice plaintiff's counsel to take on the more dubious claims of
borrowers. Tempering this positive assessment, however, is the fact that with the continu-
ing "boom" economy, litigation has generally decreased across the board for banks. The
real test concerning the success of arbitration for financial institutions will be when times
are tough and options for cooperative negotiations are few.

III. Precipitating Factors for Move Toward ADR Techniques.

A. TYPES OF ADR.

ADR is generally defined as a consensual, contractual procedure for resolving disputes
outside of the judicial adversary process. ADR procedures fall into two broad categories,
arbitration and mediation. Arbitration resembles litigation, and while it can be non-bind-
ing, the binding form is the preferred method, especially when the parties agree prior to a
dispute. Mediation involves a negotiation process, usually under the guidance of a trained
mediator, and is non-binding in nature.

1. Mediation.

Mediation is by definition non-adjudicatory. It is a process by which parties submit
their dispute to a neutral third party who assists them in reaching a settlement of their
conflict. It is essentially an extension of the negotiation process. Mediators are facilitators
whose primary role is to identify the issues and interests of each party in an effort to find a
basis for resolving the dispute. While many lawyers erroneously view mediation as a settle-
ment conference in which a judge pushes two parties toward the middle in an attempt to
settle a matter, the mediation process should be viewed as performing much more of a
psychological role. Mediation enables the mediator to transcend the posturing of parties so
that their true concerns may be addressed. In mediation, the focus is far more on the psy-
chology of settlement rather than using a nonjudicial/litigation forum to impose a third
party's will or decision on a specific issue.

The primary benefits of mediation are confidentiality and a process in which parties
are directly engaged in negotiating a settlement through a neutral third party who can view
the dispute objectively and assist the parties in exploring alternatives that they might not
have considered on their own. It is an especially useful process when the business relation-
ship is more important than the dispute. Mediation offers an ideal format for the resolution
of a matter that needs to be handled without the risk of destroying the bigger business rela-
tionship. To have a successful mediation, both parties are usually genuinely interested in
resolving and settling a particular matter rather than trying to "win" the contest. Normally
too, the result of a mediation is a compromise between the two parties' positions.
The absence of the ability of a mediator to provide a binding determination and the fact that mediation requires that both parties have a genuine interest in settling makes mediation an unattractive procedure to use in loan documents on a uniform basis. Banks usually want to be paid upon default and a forced mediation process does not fit the dynamics of such transactions. If the parties are not interested in compromise at the time of the dispute, mediation usually fails, which forces the dispute into litigation.

Some financial institutions, however, have combined mediation with arbitration. For example, mediation is first attempted, and, if the matter is not resolved within a certain period, it is then resolved by binding arbitration. Because of problems with discoverability and the specter of a pending adversarial proceeding, this type of clause often dooms the mediation process to failure in a lender liability context between a debtor and a creditor. Such a clause may, however, have major benefits in loan documents by and between the financial institutions, such as intercreditor participation or syndication agreements. Parties to these arrangements are often much more interested in having a process available for a negotiated settlement prior to the initiation of an adversarial proceeding.

IV. A Closer Look at Arbitration.

Arbitration is an adjudicatory process. It is a method of dispute resolution in which a neutral third party hears the matter and then resolves it by rendering a decision enforceable under state or federal law. Arbitration commences with the referral of the dispute to one or more impartial persons preferably with an expertise in that type of transaction or business. Arbitration can be either binding or non-binding in nature; however, the use of non-binding arbitration is not often used in agreements that are expected to deal with prospective problems and disputes. Non-binding arbitration is traditionally used as a means to handle a dispute that has already arisen where both parties would prefer to avoid the litigation process, but also want to preserve access to the judicial system (e.g., rules of evidence and appeal rights) if the non-binding determination of the arbitrator is not acceptable. When used in this context, it is recommended that the arbitration clause require the party who rejects the arbitrator’s decision and proceeds with litigation to bear both parties’ costs and expenses in the event the judicial decision is the same or more onerous than the decision of the arbitrator. Such a clause can be useful in lending weight and credibility to the arbitrator’s non-binding decision.

Normally, the arbitrator would be chosen from a panel of experts in the substantive area involved in the arbitration. The arbitrator, in conformance with the contractual provisions dealing with the arbitration, hears the facts, proofs, and arguments, and then renders a decision. Arbitration is designed to be confidential and informal with an emphasis on efficiency and economy. Unless specially contracted for, juries are not available. Parties can exercise additional control over the arbitration process by incorporating or deleting specific rules, or by establishing discovery procedures, location, rules of evidence, etc. The basis of arbitration, while contractual in nature, is supported by state and federal arbitration statutes and the rules of various arbitration associations.

Binding arbitration decisions are final unless otherwise provided for by contract. Judicial intervention and review is limited by statute and existing case law. State and federal arbitration statutes also facilitate enforcement of arbitration awards. Once your private contractual dispute is settled, the power of the state is available for enforcement.
A. The Statutory Basis for Arbitration.

Arbitration is a private contractual procedure of resolving disputes outside of the judicial arena. While court process can and is used to enforce rights, decisions, and awards, it is the contract, supported by underlying federal and state statutes, that controls the procedure.

Under the Federal Arbitration Act (FAA), a written agreement to arbitrate existing or future disputes between the parties to an agreement is "valid, irrevocable and enforceable, [and] grounds exist in law or equity for the revocation of any contract."13

Section 3 of the FAA provides that a court must stay judicial proceedings pending arbitration if it determines that an issue before it is properly referable to arbitration under an arbitration agreement. The United States Supreme Court has held that, if the parties clearly have agreed to arbitration, the determination as to whether a valid agreement to arbitrate exists or whether an agreement to arbitrate that particular claim exists will be made by the arbitrator.14 The arbitrator also decides whether the contract as a whole was induced by fraud, is unconscionable, or is a contract of adhesion.15

The FAA applies to transactions involving interstate or foreign commerce and preempts incompatible state arbitration laws.16 Through the use of the Commerce Clause in the United States Constitution, federal courts have expansively construed this provision to encompass matters that appear to have only minimal contacts with interstate commerce.17 Even if the FAA does not apply, virtually all states now recognize arbitration and have enforced agreements to arbitrate. A significant majority of states have also enacted statutory schemes based on the Uniform Arbitration Act declaring arbitration agreements enforceable. When drafting an arbitration clause, serious consideration should be given to what statute (federal or state) should be incorporated. However, because of the multi-state or national nature of many lending transactions, incorporation of the FAA would normally be the preferred route.

B. Administrative Organizations and Forum.

Parties may agree to the forum for arbitration. The matter can be handled privately between the parties and an arbitrator of their selection, without the services of an arbitration administrative organization, or they may elect to be governed by rules or administrative organizations that handle the adjustment issues. In loan documents, the parties' use of a professional arbitration administrative organization should be designated. On a national basis, the most commonly used administrative organizations by financial institutions are the American Arbitration Association (AAA) and J.A.M.S./Endispute (JAMS).

The use of established administrative organizations helps ensure standards of consistency and predictability. Both AAA and JAMS issue standard procedural rules specifying the mechanics, fees, and selection of arbitrators. The incorporation of that organization's

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rules can be used as a “filler” for issues not specifically covered by the arbitration section in the loan documents. In addition to providing various sets of rules for the conduct of a particular arbitration, they also perform a number of administrative functions. These administrative functions include providing an administrative staff for case handling, including scheduling hearings, sending notices, providing hearing rooms, and distributing documents. They will also determine arbitrator fees and bill the parties for these fees. AAA and JAMS differ significantly from a third major arbitration group entitled the Center for Public Resources (CPR). CPR is an alliance of several hundred corporate general counsels, law firms, legal academics, and judges. It is not an administrating organization. Its major role is educational in nature with a goal to integrating ADR techniques into the mainstream of legal practice. In 1989 CPR issued its Rules for Non-Administered Arbitration of Business Disputes. However, while CPR is not usually used in arbitration clauses due to its “non-administration” format, counsel who are involved in drafting arbitration clauses or handling arbitration matters should be aware of its policies and procedures.

This significant growth in the arbitration business makes it incumbent upon attorneys to make sure that they have a working knowledge of available organizations for arbitration and the particular rules and procedures that control each of those organizations. Simply incorporating boilerplate or standard arbitration language can give an attorney and his or her client an unpleasant surprise when it comes to such matters as filing costs and expenses, discovery restrictions, rules of evidence, requirements to follow the law, available remedies, and rights of appeal to the courts.

The applicable forum and rules dictate the fee structure and procedure for filing claims. Administrative fee structures are varied and the rules should be carefully read prior to accepting an arbitration provision. The amount and extent of such fees can come as a rude surprise to a claimant and his counsel. You will usually find an initial filing fee (often based on the amount of the claim) and, if there is a counterclaim, that party will also be paying a filing fee. Additional fees include daily hearing fees, cancellation or postponement fees, and hearing room rentals. These costs and fees will be in addition to each party’s own personal attorneys’ fees (if an attorney is used) and expenses. For example, AAA’s filing fee is based on the amount of each claim and counterclaim as disclosed when filed and is due and payable at the time of filing. AAA’s present filing fee structure is:

<table>
<thead>
<tr>
<th>Amount of Claim</th>
<th>Filing Fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $10,000</td>
<td>$500</td>
</tr>
<tr>
<td>Above $10,000 to $50,000</td>
<td>$750</td>
</tr>
<tr>
<td>Above $50,000 to $100,000</td>
<td>$1,250</td>
</tr>
<tr>
<td>Above $100,000 to $250,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Above $250,000 to $500,000</td>
<td>$3,500</td>
</tr>
<tr>
<td>Above $500,000 to $1,000,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Above $1,000,000 to $5,000,000</td>
<td>$7,000</td>
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</tbody>
</table>

When no amount can be stated at the time of filing, the minimum fee is $2,000, subject to increase when the claim or counterclaim is disclosed. When a claim or counterclaim is not for a monetary amount, the AAA will determine an appropriate filing fee. The minimum filing fee for any case having three or more arbitrators is $2,000. The administrative fee for claims in excess of $5,000,000 will be negotiated.18

18 Source: AAA Commercial Arbitration Rules, as amended and effective July 1, 1996.
This is much different from normal court filing fees where such fees are usually the same for a $50,000 lawsuit as they are for a $50 million lawsuit. In addition, ongoing costs, such as the per diem payable to the arbitrator, are normally payable in advance or as the arbitration proceeds. While this up front expense differs from the standard court process, arbitration usually results in far lower litigation costs and fees than would be incurred in a judicial proceeding because of its speed and efficiency.

C. ARBITRATORS AND THEIR SELECTION.

Proponents of arbitration assert that arbitrators are often better able to resolve complex commercial disputes than many judges and most juries. Arbitration clauses can name experts or panels of experts to serve, specify procedures for selecting arbitrators, and specify qualifications for such arbitrators. Special attention should be paid in drafting an arbitration clause to ensure the selection of a panel consisting of experts familiar with the practices and technical issues of the banking industry. A carefully selected panel of experts is likely to comprehend the facts presented more quickly and intelligently, and it is more likely to decide the case on the facts presented than on emotional factors that typically appeal to lay jurors. The arbitrator or arbitrators do not need to be lawyers. However, in a loan context, only designating a banker or other person familiar with the financial practices as the single arbitrator would be unwise. For an arbitration panel, however, consideration might be given to having one of the arbitrators be a non-lawyer with extensive financial experience. In drafting an arbitration clause, carefully spell out the qualifications and expertises required for particular arbitrators, or ensure that qualified panels of neutrals will be available by the particular arbitration administrative organization. For most commercial transactions, the use of more than a single arbitrator is not recommended. While a three-person panel may be advisable for large dollar matters, the use of such a panel for the standard commercial transaction is often prohibitively expensive and time-consuming. Attempting to schedule three neutrals for the same time for an extended period is virtually impossible. In the long run, use of such panels can be more expensive and time-consuming than the use of a courtroom.

A major complaint from the bar has been a concern that many arbitrators do not have the experience or expertise to handle particular matters. Arbitration services such as AAA and JAMS are attempting to respond to this concern by selecting panels of experts available for particular types of matters. Because of the accelerated pace of arbitration, the availability of expert neutrals is a critical issue which needs to be more seriously addressed by arbitration administrative organizations if arbitration for financial disputes is to succeed in the long run. Having an attorney as an arbitrator whose background is patent law or personal injury law or even a retired judge whose background is criminal law poses real and serious concerns to the attorney and banking client wanting to use arbitration. Without an assurance of expertise and knowledge of the particular field, most of the benefits of arbitration quickly disappear.

D. DISCOVERY AND MOTION PRACTICE.

Unless specifically agreed by the parties to the contrary, discovery and motion practice is limited or nonexistent in arbitration. While discovery may be permitted under federal law on the issue of whether a valid agreement to arbitrate exists, the arbitrator will ordinarily deny discovery on the merits in the absence of exceptional circumstances. This can
be a double-edged sword to a lender arbitrating a dispute with its borrower. On the one hand, by eliminating discovery and motion practice a substantial factor contributing to high litigation costs and delay is eliminated from the proceeding. On the other hand, limited discovery may be necessary to properly prepare for the arbitration hearing. Further, by eliminating motion practice, many essential pre-trial remedies otherwise available would also be eliminated (e.g., claim and delivery, attachment, summary judgment).

E. THE ARBITRATION HEARING.

The parties in conjunction set the arbitration hearing with the arbitrator or panel of arbitrators. A preliminary hearing is often first scheduled, in person or by telephone, to handle such matters as discovery, witness lists, briefs, and other procedural issues which, if handled first, will enhance the value and conduct of the hearing itself. Oftentimes, the arbitrator will require written briefs to be filed prior to the actual hearing. Since timing is often short, forcing counsel to focus in writing on the merits of their case is an invaluable tool for arbitration. The actual hearing typically takes place at a neutral locale, such as a conference room at the offices of the arbitration service. Most commercial arbitration statutes grant parties the right to counsel but do not require that a party be represented by an attorney. The arbitrator conducts the hearing itself. Parties present their respective cases to the arbitrator, including the presentation of evidence and the examination of witnesses. One simplifying factor is that the arbitrators normally are not bound by the rules of evidence. While this may simplify matters, it can be dangerous, especially when one considers the non-appealability of arbitration.

Thereafter, the arbitrator reaches a decision and makes the award expeditiously. The typical award merely states which party prevails and the amount to which such party is entitled. Arbitrators rarely explain the rationale of their awards or give opinions. In support of this practice, courts will not inquire into the rationale during any review or approval of the award. If a party believes a mistake was made in determining the award, he or she may ask the arbitrator to reconsider. Typically, however, when asked to reconsider an award, arbitrators will reaffirm the award without explanation.

F. ENFORCEMENT OF THE AWARD.

Most parties comply with the arbitration award voluntarily in accordance with its terms. This compliance is expected in light of the parties' desire to avoid costly and time-consuming litigation as evidenced by the initial decision to arbitrate. However, sometimes when the hard reality of having to pay hits, it may take the authority of the state to facilitate collection. If payment is not made voluntarily, proceedings are then brought to the appropriate court to confirm the award and perhaps also to enter a judgment on the award. Such a proceeding would usually be brought in the form of an application to the court to confirm the award. Reference should be made to the applicable arbitration statute or court rules.
G. Judicial Review.

The scope of judicial review of arbitration proceedings or awards is generally limited to (1) the selection of the arbitrators, (2) the conduct of an orderly hearing and the opportunity of all parties to present their proof, and (3) whether the award was within the scope of the arbitrators' authority (as established by the arbitration agreement). It has long been established that:

If the award is within the submission, and contains the honest decision of the arbitrators, after a full and fair hearing of the parties, a court of equity will not set it aside for error, either in law or fact.\(^9\)

Consequently, in practice, unless a statutory ground for vacating or modifying the award exists, the award will be confirmed. Uniformly, under the FAA and the state arbitration statutes, there are essentially four statutory grounds for vacating an arbitration award:

1. Where the award was procured by corruption, fraud, or undue means;
2. Where there was evident partiality or corruption by the arbitrator;
3. Where the arbitrator was guilty of misconduct, including any misbehavior by which the rights of any party have been prejudiced; or
4. Where the arbitrator exceeded his or her powers granted under the arbitration contract.

Most state courts have held that the above-statutory grounds for judicial review are exclusive, whether as part of the Federal Arbitration Act or the Uniform Arbitration Act (which more than half of the states have adopted).\(^20\) Limited judicial review became even more limited in a recent decision of the California Supreme Court. The Court held that an award reached by an arbitrator pursuant to a contractual agreement to arbitrate is not subject to judicial review except for those specific statutory grounds as provided in the applicable arbitration act. Further, the existence of an error of law by an arbitrator, even though apparent on the face of the award and even though it causes a substantial injustice, does not provide grounds for judicial review.\(^21\)

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\(^{19}\) Burchell v. Marsh, 58 U.S. 344, 349 (1854).


V. Arguments and Issues Concerning Arbitration.

A. Excessive Jury Awards.

Arbitration is one method often suggested as an antidote to the damage awards (both compensatory and punitive) given to debtors for various claims, including lender liability claims. Jurors with no knowledge or expertise in the commercial area, or more specifically the financial industry, are much more likely to be influenced by plaintiffs' emotional appeals of bad faith or other alleged wrongdoing. Juries typically want to "correct the harm" by punitive measures against the wrongdoer. By resolving disputes in arbitration rather than before a jury, it is possible that any punitive damage award would be significantly lower than the judicial alternative. To date, there have been relatively few known large punitive damage awards by arbitrators.22

B. Threatened Liability Claims.

As most lenders have experienced in the workout context, borrowers, with increasing frequency, have threatened to bring suit for damages based on various lender liability claims. Whether or not the threat is real or there is likelihood that the claimant would be awarded damages at trial, these threats are utilized by even unsophisticated debtors as a means of avoiding liability for legitimate loan obligations. Often this results in workout agreements much more favorable to the borrower than is otherwise warranted, because the lender would rather suffer smaller losses at the workout phase than incur significant legal costs and risk punitive damages if sued.

Arbitration proponents suggest that binding arbitration clauses deter this negotiation strategy because borrowers will see their threats as less meaningful when played before an unsympathetic and professional arbitration panel. Plaintiff lawyers may also be less inclined to take a case involving lender liability claims if it is to be heard before an arbitration panel. Consequently, the use of arbitration clauses may serve to decrease the occurrence of unmeritorious claims. Although no new empirical studies have been published since the Rand Study, financial institutions have continued to experience less litigation since using arbitration clauses.

C. Time and Expense.

The process of arbitration is usually less time-consuming and expensive than traditional litigation. Disputing parties can privately schedule arbitration proceedings to commence soon after disputes arise. Conversely, complex pretrial discovery procedures and congested court dockets make prompt judicial dispute resolution virtually impossible. Costs of litigation are usually much higher than that of arbitration as discovery and motion practice are so integral to the litigation process.

D. Arbitrators' Special Knowledge and Expertise.

If selected on the basis of special knowledge of and experience pertaining to the relevant law and commercial practices, arbitrators are better suited than most judges and virtually all juries to handle complex commercial disputes. An experienced arbitrator should

22 See discussion concerning the Rand Study supra p. 363.
be able to analyze complex cases and issues without as much explanation or guidance as required by judges unfamiliar with the area or inexperienced jurors. Carefully selected arbitrators would be able to develop a more accurate understanding of the commercial dispute and its complex issues and their special knowledge and expertise would further serve to speed the process along and reduce the risk of unpredictable results so often faced in litigation.

The key to having capable and desirable arbitrators is the specification of the expert, necessary qualifications, and/or the selection process in the arbitration clause. Ideally, the arbitration panel should consist of experts knowledgeable in the practices and technical issues of the banking industry.

E. ADVERSARIAL NATURE, PRIVACY.

Because litigation tends to be more adversarial in nature than arbitration, parties with valued, long-standing relationships might prefer arbitration (or mediation) to litigation so as not to destroy those relationships. As discussed earlier, mediation and non-binding arbitration are also useful tools in situations in which parties are interested in maintaining their relationship. Further, the fact that arbitration proceedings are not of public record decreases the possibility of a lender receiving unwanted publicity in connection with the dispute.

F. LIMITATION ON CLASS ACTIONS.

The great weight of case law authority holds that arbitrations cannot be conducted on a class action basis unless the parties have agreed that a class action is an available remedy. These case decisions are primarily based upon Section 4 of the FAA which requires that the courts give effect to the parties’ arbitration agreement and, unless provided for in the arbitration agreement, the courts lack the power to consolidate arbitration proceedings unless the arbitration agreement authorizes consolidation. The court is only allowed to enforce the arbitration agreement as the parties write it and, absent a provision providing for the class treatment of disputes, courts have no authority to certify class arbitration.23 In contrast to Dickler and Keating, at least one other state court, consistent with federal practice, held that arbitrations could not proceed on a class action basis without the arbitration provision allowing for such class treatment. To order class arbitration without such a provision would rewrite the contract between the parties.24

G. THE ARBITRATION AWARD.

Arbitrators typically do not provide written opinions or even orally discuss their rationale in arriving at the stated award. Arbitrators may not always engage in thoughtful analysis of a dispute because they do not have to reveal their reasoning for the decisions.


Arbitrators are also notorious for making compromise awards in the interest of fairness, even when one party should clearly win on the merits based on established legal precedent. Further, there is always the risk that arbitrators may treat emerging theories of law as established law when in fact such theories may be anything but settled.

H. JUDICIAL REVIEW AND NONAPPEALABILITY.

There is no appeal from an arbitrator’s decision if rendered pursuant to the FAA or the Uniform Arbitration Act as adopted by most states. As discussed above, there are only certain circumstances in which a court can even review the arbitration process or a monetary award. This further increases both the risk of compromise awards when one position clearly should prevail at law and the risk that arbitrators will not base their decision on established theories of law. As a result, arbitrator errors that could have been reversed through an appeal to the appellate courts (if the case had been originally tried in the courts) will not get beyond the arbitration stage. This risk is especially serious in connection with the continuing “emerging theories” in connection with lender liability.

I. AVOIDING ARBITRATION THROUGH NONJOINDER OF NECESSARY PARTIES.

Unless all the necessary parties to a dispute are bound by the arbitration clause, a party may be able to avoid enforcement of the arbitration clause under state law. For example, California’s Arbitration Act contains a number of grounds that would allow a court to refuse to enforce an arbitration agreement or to delay its commencement. Those grounds include:

1. a party to the arbitration agreement is also a party to litigation with a third party arising out of the same or related transactions and there is the possibility of conflicting rulings on a common issue of law or fact, or
2. the court determines there are other issues between the parties which are not subject to arbitration and which are subject to a pending action, a determination of which may make arbitration unnecessary.25

J. PROVISIONAL REMEDIES; SCOPE OF CLAUSE.

If an all-inclusive arbitration clause is used (e.g., all claims or disputes arising under or in connection with the loan shall be subject to arbitration), the lender may be precluding the availability of pretrial remedies traditionally available to lenders, such as claim and delivery and attachment. Consequently, when drafting an arbitration clause for loan documents, the lender must carefully and specifically state what disputes are subject to arbitration.

Parties may identify certain types of claims arising out of a particular transaction as being arbitrable and others as not. In order to preserve quick access to the court to obtain desirable pretrial remedies, it may be advisable to split the proceedings by excluding from a general arbitration clause the determination of whether the loan is in default and the subsequent related proceedings, including entry of judgment on the debt.

Historically, several jurisdictions prevented the bifurcation of proceedings arising out of a single transaction. This was known as the “intertwining” doctrine, which granted district courts the discretion to try all claims together in federal court when presented with both arbitrable and non-arbitrable claims arising out of the same transaction.

The U.S. Supreme Court held that under the FAA, a federal district court may not deny a motion to compel arbitration of state law claims under an arbitration agreement on the ground that the claims are intertwined with non-arbitrable federal claims. The Court concluded that the primary purpose of the FAA is to ensure the enforcement of arbitration agreements, not to promote judicial efficiency.

Responding to the concern that a state arbitrator’s fact finding might have a collateral estoppel effect on non-arbitrable federal claims, the Court stated that “it is far from certain that arbitration proceedings will have any preclusive effect on the litigation of non-arbitrable federal claims.”

K. Formalities.

In all jurisdictions, the agreement to arbitrate must be written. Under some circumstances, the parties need not sign the agreement, but in the lender-borrower situation it is advisable for a lender to obtain a borrower’s signature to the agreement. To compel arbitration, a party needs to establish: (1) the existence of an agreement to arbitrate; (2) that the claim is arbitrable; and (3) that the right to compel arbitration has not been waived.

L. Contracts of Adhesion.

Contracts of adhesion will be upheld unless it can be shown that the agreement to arbitrate was unconscionable under the circumstances. In a Supreme Court case, the McMahons were customers of the brokerage firm Shearson/American Express, Inc. Within the scope of that relationship, the McMahons signed certain “fine print” customer account cards providing for arbitration of certain disputes relating to their accounts. In response to the argument that the arbitration clauses in the account cards were void as contracts of adhesion, the Court upheld the agreement to arbitrate stating that “absent a well-founded claim that an arbitration agreement resulted from the kind of fraud or excessive economic power that would provide grounds for the revocation of any contract,” the clause should prevail. Nevertheless, if the terms of an arbitration clause appear onerous and one-sided, a court may conclude that enforcement of such an agreement is unfair. For example, the California Court of Appeals denied confirmation and enforcement of an arbitration award on the grounds of unconscionability based on the fact that, among other things, the lender required the California borrower to pay substantial filing and hearing fees ($850 on a $2,000 claim) and arbitrate in a distant locale, i.e., Minnesota.

M. Rescission; Fraud in the Inducement.

An arbitration clause may be rescinded upon any grounds justifying the rescission of a contract. Quite frequently litigated is the claim that the arbitration clause was fraudulently induced and therefore should be rescinded. An arbitration clause within a broader contract is generally considered to be a severable part of the contract. If a court in an action to enforce the arbitration clause determines that the arbitration clause was fraudulently induced, it will not compel arbitration. If it is determined that the otherwise enforceable

28 Id.
clause was not so induced, the court must compel arbitration, leaving all arbitrable issues to the arbitrator, including questions regarding the validity of the underlying contract.

N. WAIVER.

A party who fails to act in accordance with the arbitration agreement runs the risk of losing its right to compel arbitration thereunder. Such inconsistent actions may be construed as a waiver of the right to compel arbitration. Bringing an action at law or asserting a counterclaim in an action is usually held to be such a waiver.\(^3\) Some courts, however, have not found a waiver when the other party is not prejudiced by the participation in litigation.\(^3\)

Waiver may also be found by the failure to object to the initiation of court proceedings by the other party, by otherwise participating in litigation, or by delay or failure to perform the necessary steps leading to arbitration.

O. THIRD PARTY CLAIMS.

Neither arbitration agreements nor arbitration decisions are binding on third parties. In most financial transactions, there are a number of related third parties such as junior secured creditors, guarantors or sureties, and affiliates of the debtor who may have been "harmed" by the lender's alleged wrongdoing or may be liable to the lender for the borrower's indebtedness. By proceeding to arbitration only with the borrower, the lender could conceivably be facing a myriad of claims by or against others in separate litigation. In cases not governed by the FAA, the lender may be able to stay the arbitration pending the joinder and resolution of the claims of all parties in litigation, if the law of the applicable state so allows, but this would defeat the original purpose of the arbitration agreement. It may also destroy the ability of the lender to enforce arbitration against the debtor. At the very minimum, a lender should obtain an agreement to arbitrate from all guarantors and sureties involved in the transaction.

P. PUNITIVE DAMAGES.

The majority rule is that an arbitrator does not have the authority to award punitive damages even if the arbitration clause specifically authorizes such awards.

The distinctions between arbitration as a private forum, the public nature of traditional litigation, and the virtual lack of judicial review of arbitrators' awards were significant factors in establishing the majority rule. Furthermore, some courts seem to look at the right to impose punitive remedies as being beyond the scope of traditional contract law. The attitude seems to be that the right to punish is best reposed in the state rather than in a third party through contract.

There are several decisions, however, that have upheld punitive damages awards by arbitrators under the FAA and certain state arbitration statutes.\(^3\) The court in Willoughby

\(^3\) Demsey v. Assocs., Inc. v. S.S. Sea Star, 461 F.2d 1009 (2d Cir. 1972).
\(^3\) Carolina Throwing Co. v. S&E Novelty Corp., 442 F.2d 329 (4th Cir. 1971).
upheld a broad arbitration clause which conferred authority to: (1) consider the disputes between the parties; and (2) fashion appropriate remedies by which those disputes might be resolved. The court concluded that limiting the remedies under a broadly framed arbitration clause, especially when punitive damages were "neither explicitly nor implicitly prohibited by the agreement," would thwart the goals of arbitration.\(^{34}\)

Q. **Multiple Damages and Attorneys' Fees.**

Even in those situations where punitive damages would not be allowed, it does appear that an arbitrator may award multiple damages. The United States Supreme Court held that an arbitrator under a general arbitration clause could arbitrate both the Securities Act and civil RICO claims that the plaintiff brought against his broker.\(^{35}\) Civil RICO mandates that a prevailing party recovers treble damages plus its attorneys' fees.

An arbitrator, however, is not normally authorized to award attorneys' fees to a prevailing party unless those attorneys' fees are expressly provided for in the arbitration contract. This is supported by Section 10 of the Uniform Arbitration Act, which essentially provides that unless there is an agreement to award attorneys' fees, they will normally not be included in an award by an arbitrator. In addition, the AAA Commercial Arbitration Rules themselves do not provide for the awarding of attorneys' fees. Generally, arbitration expenses are to be borne equally by the parties, unless they agree otherwise.\(^{36}\)

VI. **Conclusion.**

U.S. financial institutions, particularly in California and other western states, have been increasingly using ADR as a preferred remedy in their commercial loan transactions. As more East Coast banks accept ADR, its use will also accelerate in the West. Unless a major change occurs in the case law or at the legislative level (and changes are not currently anticipated), ADR will be found in many, if not most, U.S. loan documents in the future.

While the underpinnings of arbitration are statutory (both federal and state), it must be kept in mind that this is a "contractual" procedure. Careful draftsmanship and clarity of language is paramount. Ambiguities will be resolved against the drafter. With the courts and international treaty generally supportive of arbitration, a loosely or carelessly drafted arbitration provision can result in a matter being arbitrated without any guidelines, procedures, or limitations provided to the arbitrator. Without carefully planned procedures and terms, the parties can be left with a procedure lacking support from case law precedent, rules of evidence, or rights of appeal to protect against mistakes or excesses of an arbitrator. It will be the responsibility of counsel to understand the ADR process and to properly protect their client with well-drafted, comprehensive ADR provisions.

More broadly speaking, this increasing U.S. experience with commercial ADR for financial disputes should prove "translatable" to the NAFTA context.

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\(^{34}\) *Id.*


\(^{36}\) *AAA Rule 49.*
APPENDIX A

A. CHECKLIST FOR ARBITRATION

Arbitration clauses are based in contract. They must be in writing and, subject to a small number of statutory and judicial limitations, can be as general or specific as the party's desire. When preparing an arbitration clause, counsel should not rely on boilerplate forms but should carefully consider all aspects of the transaction and how best to fit the arbitration clause to the particular matter. The following is a checklist of issues to consider when preparing an arbitration clause.

B. TYPES OF ARBITRATION

- Mediation
- Mediation/Arbitration (Attempt mediation and if not successful proceed to arbitration)
- Nonbinding Arbitration
- Binding Arbitration

Identity of Administering Agency
What set of Administrative Rules
Governing law
(e.g., Federal Arbitration Act, particular state arbitration act, what state law applies, is there a governing law in the loan documents)
Statute of limitations
(e.g., "Any applicable statute of limitation shall be applied."

Arbitrator to follow the law
(e.g., Some Administrative Rules do not require the arbitrator to follow the law of a particular jurisdiction. By requiring the arbitrator to follow the law of a particular jurisdiction, parties should be better able to control predictability but such a clause often can increase to the courts for appeal.

Arbitrator all or only certain disputes
(If a broad form of arbitration clause is desired, the clause should specifically state that the arbitrator can review all matters and disputes directly or indirectly related to the transaction, including actions sounding in both tort and contract.)
Punitive damages
Rules of evidence
Provisional remedies (e.g., attachment, replevin)
Fees (if different from the Rules)
Location of hearing
Judicial reference
Selection of arbitrator
  (one or a panel of three, how selected, panel
  or individual depending on size of matter)
Qualifications of arbitrator
Preliminary Hearing
Discovery
Depositions
Interrogatories
Witness Lists
Briefs
Time limits
Stenographic record
Times to respond
Representation by counsel
Written decision of arbitrator
Time limits on arbitrator
Power to issue sanctions
Power to issue subpoenas
Payment of attorneys' fees, costs, and expenses in the award
Limitations on damages
Failsafe for large verdict
  (Some financial institutions have drafted
  arbitration clauses that allow the losing party
  access to a trial *de novo* if the award exceeds
  a certain amount (e.g., $5,000,000))
Statement that arbitration decision is binding and final
Statement that courts may issue orders enforcing arbitrator's
decision
Appeal rights
APPENDIX B

SAMPLE COMMERCIAL MEDIATION CLAUSE

A. Agreement to Use Procedure. The parties have entered into this Agreement in good faith and in the belief that it is mutually advantageous to them. It is with that same spirit of cooperation that they pledge to attempt to resolve any dispute amicably without the necessity of litigation. Accordingly, they agree if any dispute arises between them relating to this Agreement (the "Dispute"), they will first utilize the procedures specified in this Section (the "Procedure") prior the commencement of any legal action.

B. Initiation of Procedure. The party seeking to initiate the Procedure (the "Initiating Party") shall give written notice to the other party, describing in general terms the nature of the Dispute, the Initiating Party’s claim for relief and identifying one or more individuals with authority to settle the Dispute on such party’s behalf. The party receiving such notice (the "Responding Party") shall have five (5) business days within which to designate by written notice to the initiating Party, one or more individuals with authority to settle the Dispute on such party’s behalf. (The individuals so designated shall be known as the "Authorized Individuals").

C. Direct Negotiations. The Authorized Individuals shall be entitled to make such investigations of the Dispute as they deem appropriate, but agree to promptly, and in no event later than thirty (30) days from the date of the Initiating Party’s written notice, meet to discuss resolution of the Dispute. The Authorized Individuals shall meet at such times and places and with such frequency as they may agree. If the Dispute has not been resolved within thirty (30) days from the date of their initial meeting, the parties shall cease direct negotiations and shall submit the Dispute to mediation in accordance with the following procedure.

D. Selection of Mediator. The Authorized Individuals shall have five (5) business days from the date they cease direct negotiations to submit to each other a written list of acceptable qualified attorney-mediators not affiliated with any of the parties. Within five (5) days from the date of receipt of such list, the Authorized Individuals shall rank the mediators in numerical order of preference and exchange such rankings. If one or more names are on both lists, the highest-ranking person shall be designated as the mediator. If no mediator has been selected under this procedure, the parties agree jointly to request a State or Federal District Judge of their choosing to supply within ten (10) business days a list of potential qualified attorney-mediators. Within five (5) business days of receipt of the list, the parties shall again rank the proposed mediators in numerical order of preference and shall simultaneously exchange such list and shall select as the mediator the individual receiving the highest combined ranking. If such mediator is not available to serve, they shall proceed to contact the mediator who was next highest in ranking until they are able to select a mediator.

E. Time and Place for Mediation. In consultation with the mediator selected, the parties shall promptly designate a mutually convenient time and place for the mediation, and unless circumstances require otherwise, such time to be not later than (45) days after selection of the mediator.

F. Exchange of Information. In the event any party to this Agreement has substantial need for information in the possession of another party to this Agreement in order to
prepare for the mediation, all parties shall attempt in good faith to agree to procedures for
the expeditious exchange of such information, with the help of the mediator if required.

G. **Summary of Views.** At least seven (7) days prior to the first scheduled session of
the mediation, each party shall deliver to the mediator and to the other party a concise
written summary of its views on the matter in Dispute, and such other matters required by
the mediator. The mediator may also request that a confidential issue paper be submitted
by each party to him.

H. **Parties to be Represented.** In the mediation, each party shall be represented by
an Authorized Individual and may be represented by counsel. In addition, each party may,
with permission of the mediator, bring such additional persons as needed to respond to
questions, contribute information and participate in the negotiations.

I. **Conduct of Mediation.** The mediator shall determine the format for the meet-
ings, designed to assure that both the mediator and the Authorized Individuals have an
opportunity to hear an oral presentation of each party's view on the matter in dispute and
that the authorized parties attempt to negotiate a resolution of the matter in dispute, with
or without the assistance of counsel or others, but with the assistance of the mediator. To
this end, the mediator is authorized to conduct both joint meetings and separate private
caucuses with the parties. The mediation session shall be private. The mediator will keep
confidential all information learned in private caucus with any party unless specifically
authorized by such party to make disclosure of the information to the other party. The
parties commit to participate in the proceedings in good faith with the intention of resolv-
ing the Dispute if at all possible.

J. **Termination of Procedure.** The parties agree to participate in the mediation pro-
cedure to its conclusion. The mediation shall be terminated (1) by the execution of a set-
tlement agreement by the parties, (2) by a declaration of the mediator that the mediation
is terminated, or (3) by a written declaration of a party to the effect that the mediation
process is terminated at the conclusion of one full day's mediation session. Even if the
mediation is terminated without a resolution of the Dispute, the parties agree not to termi-
nate negotiations and not to commence any legal action or seek other remedies prior to
the expiration of the five-day period if litigation could be barred by an applicable statute of
limitations or in order to request an injunction to prevent irreparable harm.

K. **Fee of Mediator; Disqualification.** The fees and expenses of the mediator shall be
shared equally by the parties. The mediator shall be disqualified as a witness, consultan,t,
expert, or counsel for any party with respect to the Dispute and any related matters.

L. **Confidentiality. Mediation** is a compromise negotiation for purposes of the Federal
and State Rules of Evidence and constitutes privileged communication under
________________________ law. The entire mediation process is confidential, and no stenograph-
ic, visual or audio record shall be made. All conduct, statements, promises, offers, views and
opinions, whether oral or written, made in the course of the mediation by any party, their
agents, employees, representatives or other invitees and by the mediator are confidential and
shall, in addition and where appropriate, be deemed to be privileged. Such conduct, state-
ments, promises, offers, views and opinions shall not be discoverable or admissible for any
purposes, including impeachment, in any litigation or other proceeding involving the par-
ties, and shall not be disclosed to anyone not an agent, employee, expert, witness, or repre-
sentative of any of the parties; provided, however, that evidence otherwise discoverable or
admissible is not excluded from discovery or admission as a result of its use in the mediation.
APPENDIX C

WELLS FARGO BANK, N.A. ARBITRATION LANGUAGE:

The following is the standard arbitration language used by Wells Fargo Bank, N.A. in its commercial loan documentation in California. If the loan documents are not governed by California law, revisions will need to be considered in subsections (4), (5) and (6).

Section ___ ARBITRATION.

A. Arbitration. Upon the demand of any party, any Dispute shall be resolved by binding arbitration (except as set forth in (E) below) in accordance with the terms of this Agreement. A “Dispute” shall mean any action, dispute, claim, or controversy of any kind, whether in contract or tort, statutory or common law, legal or equitable, now existing or hereafter arising under or in connection with, or in any way pertaining to, any of the Loan Documents, or any past, present or future extensions of credit and other activities, transactions or obligations of any kind related directly or indirectly to any of the Loan Documents, including without limitation, any of the foregoing arising in connection with the exercise of any self-help, ancillary or other remedies pursuant to any of the Loan Documents. Any party may by summary proceedings bring an action in court to compel arbitration of a Dispute. Any party who fails or refuses to submit to arbitration following a lawful demand by any other party shall bear all costs and expenses incurred by such other party in compelling arbitration of any Dispute.

B. Governing Rules. Arbitration proceedings shall be administered by the American Arbitration Association (AAA) or such other administrator as the parties shall mutually agree upon in accordance with the AAA Commercial Arbitration Rules. All Disputes submitted to arbitration shall be resolved in accordance with the Federal Arbitration Act (Title 9 of the United States Code), notwithstanding any conflicting choice of law provision in any of the Loan Documents. The arbitration shall be conducted at a location in California selected by the AAA or other administrator. If there is any inconsistency between the terms hereof and any such rules, the terms and procedures set forth herein shall control. All statutes of limitation applicable to any Dispute shall apply to any arbitration proceeding. All discovery activities shall be expressly limited to matters directly relevant to the Dispute being arbitrated. Judgment upon any award rendered in an arbitration may be entered in any court having jurisdiction; provided however, that nothing contained herein shall be deemed to be a waiver by any party that is a bank of the protections afforded to it under 12 U.S.C. § 91 or any similar applicable state law.
C. No Waiver: Provisional Remedies, Self-Help and Foreclosure. No provision hereof shall limit the right of any party to exercise self-help remedies such as setoff, foreclosure against or sale of any real or personal property collateral or security, or to obtain provisional or ancillary remedies, including without limitation, injunctive relief, sequestration, attachment, garnishment or the appointment of a receiver, from a court of competent jurisdiction before, after or during the pendency of any arbitration or other proceeding. The exercise of any such remedy shall not waive the right of any party to compel arbitration or reference hereunder.

D. Arbitrator Qualifications and Powers: Awards. Arbitrators must be active members of the California State Bar or retired judges of the state or federal judiciary of California, with expertise in the substantive laws applicable to the subject matter of the Dispute. Arbitrators are empowered to resolve Disputes by summary rulings in response to motions filed prior to the final arbitration hearing. Arbitrators (i) shall resolve all Disputes in accordance with the substantive law of the state of California, (ii) may grant any remedy or relief that a court of the state of California could order or grant within the scope hereof and such ancillary relief as is necessary to make effective any award, and (iii) shall have the power to award recovery of all costs and fees, to impose sanctions and to take such other actions as they deem necessary to the same extent a judge could pursuant to the Federal Rules of Civil Procedure, the California Rules of Civil Procedure or other applicable law. Any Dispute in which the amount in controversy is $5,000,000 or less shall be decided by a single arbitrator who shall not render an award of greater than $5,000,000 (including damages, costs, fees and expenses). By submission to a single arbitrator, each party expressly waives any right or claim to recover more than $5,000,000. Any Dispute in which the amount in controversy exceeds $5,000,000 shall be decided by majority vote of a panel of three arbitrators, provided, however, that all three arbitrators must actively participate in all hearings and deliberations.

E. Judicial Review. Notwithstanding anything herein to the contrary, in any arbitration in which the amount in controversy exceeds $25,000,000, the arbitrators shall be required to make specific, written findings of fact and conclusions of law. In such arbitrations (i) the arbitrators shall not have the power to make any award which is not supported by substantial evidence or which is based on legal error, (ii) an award shall not be binding upon the parties unless the findings of fact are supported by substantial evidence and the conclusions of law are not erroneous under the substantive law of the state of California, and (iii) the parties shall have in addition to the grounds referred to in the Federal Arbitration Act for vacating, modifying or correcting an award the right to judicial review of (A) whether the findings of fact rendered by the arbitrators are supported by substantial evidence, and (B) whether the conclusions of law are erroneous under the substantive law of the state of California. Judgment confirming an award in such a proceeding may be entered only if a court determines the award is supported by substantial evidence and not based on legal error under the substantive law of the state of California.
F. **Real Property Collateral: Judicial Reference.** Notwithstanding anything herein to the contrary, no Dispute shall be submitted to arbitration if the Dispute concerns indebtedness secured directly or indirectly, in whole or in part, by any real property unless (i) the holder of the mortgage, lien or security interest specifically elects in writing to proceed with the arbitration, or (ii) all parties to the arbitration waive any rights or benefits that might accrue to them by virtue of the single action rule statute of California, thereby agreeing that all indebtedness and obligations of the parties, and all mortgages, liens and security interests securing such indebtedness and obligations, shall remain fully valid and enforceable. If any such Dispute is not submitted to arbitration, the Dispute shall be referred to a referee in accordance with California Code of Civil Procedure Section 638 et seq., and this general reference agreement is intended to be specifically enforceable in accordance with said Section 638. A referee with the qualifications required herein for arbitrators shall be selected pursuant to the AAA's selection procedures. Judgment upon the decision rendered by a referee shall be entered in the court in which such proceeding was commenced in accordance with California Code of Civil Procedure Sections 644 and 645.
APPENDIX D

BANK OF AMERICA N.T. & S.A. ARBITRATION LANGUAGE

The following is standard ADR language used by Bank of America in commercial loan agreements. Note that if California law does not govern the transaction, this language will have to be modified.

Section 1. ARBITRATION.
(a) This paragraph concerns the resolution of any controversies or claims between any one or more of Borrowers and the Bank, including but not limited to those that arise from:
(i) This Agreement (including any renewals, extensions or modifications of this Agreement);
(ii) Any document, agreement or procedure related to or delivered in connection with this Agreement;
(iii) Any violation of this Agreement; or
(iv) Any claims for damages resulting from any business conducted between any one or more of Borrowers and the Bank, including claims for injury to persons, property or business interests, including without limitation any claim that any action by the Bank or its representatives is tortious.

(b) At the request of any Borrower or the Bank, any such controversies or claims will be settled by arbitration in accordance with the United States Arbitration Act. The United States Arbitration Act will apply even though this Agreement provides that it is governed by California law.

(c) Arbitration proceedings will be administered by the American Arbitration Association and will be subject to its commercial rules of arbitration. The arbitration will be conducted within Los Angeles County, California.

(d) For purposes of the application of the statute of limitations, the filing of an arbitration pursuant to this paragraph is the equivalent of the filing of a lawsuit, and any claim or controversy which may be arbitrated under this paragraph is subject to any applicable statute of limitations. The arbitrators will have the authority to decide whether any such claim or controversy is barred by the statute of limitations and, if so, to dismiss the arbitration on that basis.

(e) If there is a dispute as to whether an issue is arbitrable, the arbitrators will have the authority to resolve any such dispute.

(f) The decision that results from an arbitration proceeding may be submitted to any authorized court of law to be confirmed and enforced.

(g) The procedure described above will not apply if the controversy or claim, at the time of the proposed submission to arbitration, arises from or relates to an obligation to the Bank secured by real property located in California. In this case, both the Borrowers and the Bank must consent to submission of the claim or controversy to arbitration. If all parties do not consent to arbitration, the controversy or claim will be settled as follows:
(i) The Borrowers and the Bank will designate a referee (or a panel of referees) selected under the auspices of the American Arbitration Association in the same manner as arbitrators are selected in Association-sponsored proceedings;
(ii) The designated referee (or the panel of referees) will be appointed by a court as provided in California Code of Civil Procedure Section 638 and the following related sections;

(iii) The referee (or the presiding referee of the panel) will be an active attorney or a retired judge; and

(iv) The award that results from the decision of the referee (or the panel) will be entered as a judgment in the court that appointed the referee, in accordance with the provisions of California Code of Civil Procedure Sections 644 and 645.

(h) This provision does not limit the right of the Borrowers or the Bank to (i) exercise self-help remedies such as setoff, (ii) foreclose against or sell any real or personal property collateral, or (iii) act in a court of law, before, during or after the arbitration proceeding to obtain (A) an interim remedy, and/or (B) additional or supplementary remedies.

(i) The pursuit of or a successful action for interim, additional or supplementary remedies, or the filing of a court action, does not constitute a waiver of the right of the Borrowers or the Bank, including the suing party, to submit the controversy or claim to arbitration if the other party contests the lawsuit. However, if the controversy or claim arises from or relates to an obligation to the Bank which is secured by real property located in California at the time of the proposed submission to arbitration, this right is limited according to the provision above requiring the consent of both the Borrowers and the Bank to seek resolution through arbitration.

(j) If the Bank forecloses against any real property securing this Agreement, the Bank has the option to exercise the power of sale under the deed of trust or mortgage, or to proceed by judicial foreclosure.
APPENDIX E

UNION BANK OF CALIFORNIA, N.A. ARBITRATION LANGUAGE

The following is the standard ADR language used by Union Bank of California, N.A. for commercial loan transactions. The Bank often handles this by a separate agreement rather than incorporating the language into the specific loan documents.

ALTERNATIVE DISPUTE RESOLUTION AGREEMENT

THIS ALTERNATIVE DISPUTE RESOLUTION AGREEMENT ("Agreement") is made and entered into as of the __________ day of __________, 19__, by and between the undersigned ("Obligor") and Union Bank of California, N.A. ("Bank") (Obligor and Bank herein collectively, the "Parties" and individually, a "Party"). Initially capitalized terms used in this Agreement which are not otherwise defined herein shall have the respective meanings set forth in Paragraph 7 of this Agreement.

1. CLAIMS SUBJECT TO ARBITRATION OR JUDICIAL REFERENCE.

   (a) Any Claim other than a Claim that arises out of or relates to any obligation under any Subject Document that is secured, in whole or in part, by an interest in real property shall, at the written request of any Party, be determined by Arbitration.

   (b) Any Claim that arises out of or relates to any obligation under any Subject Document that is secured, in whole or in part, by an interest in real property shall be determined by Arbitration only with the consent of both Parties. If both Parties do not consent to the determination of any such Claim by Arbitration, then such Claim shall, at the written request of any Party, be determined by Reference.

   (c) The determination as to whether or not a Claim arises out of or relates to any obligation under any Subject Document that is secured, in whole or in part, by an interest in real property shall be made at the time the arbitrator or referee is selected pursuant to Paragraph 2 of this Agreement.

2. SELECTION OF ARBITRATOR OR REFEREE. Within 30 days after written demand, or within 30 days after commencement by any Party, of any lawsuit subject to this Agreement, the Parties shall select a single neutral arbitrator pursuant to the Commercial Arbitration Rules of the AAA or a single neutral referee pursuant to the Judicial Reference Procedures of the AAA. However, the arbitrator or referee selected must be a retired state or federal court judge with at least five years of judicial experience in civil matters. In the event that the selection pursuant to such Commercial Arbitration Rules or Judicial Reference Procedures does not result in the appointment of a single neutral arbitrator or a single neutral referee within 30 days, any such Party may petition the court to appoint a single neutral arbitrator or single neutral referee with the judicial experience described above. The Parties shall equally bear the fees and expenses of the arbitrator or referee unless the arbitrator or referee otherwise provides in the award or statement of decision.

3. CONDUCT OF ARBITRATION OR REFERENCE.

   (a) Except as provided in this Agreement, the arbitrator shall have the powers provided under Applicable State Law and the Commercial Arbitration Rules of the AAA, and the referee shall have the powers provided under Applicable State Law and the Judicial Reference Procedures of the AAA.
(b) The arbitrator or referee shall determine all challenges to the legality or enforceability of this Agreement.

(c) The arbitrator or referee shall apply the rules of evidence to the same extent as they would be applied in a court of law.

(d) A Party may not conduct discovery unless the arbitrator or referee grants such Party leave to do so upon a showing of good cause. All discovery shall be completed within 90 days after the appointment of the arbitrator or referee, except upon a showing of good cause by any Party. The arbitrator or referee shall limit discovery to non-privileged material that is relevant to the issues to be determined by the arbitrator or referee.

(e) The arbitrator or referee shall determine the time of the hearing and shall designate its location based upon the convenience of the arbitrator or referee, the Parties and any witnesses. However, such hearing shall be commenced within 30 days after completion of discovery, unless the arbitrator or referee grants a continuance upon a showing of good cause by any Party. At least 7 days before the date set for such hearing, the Parties shall exchange copies of exhibits to be offered as evidence, and lists of the witnesses who will testify, at such hearing. Once commenced, the hearing shall proceed day to day until completed, unless the arbitrator or referee grants a continuance upon a showing of good cause by any Party. Any Party may cause to be prepared, at its expense, a written transcription or electronic recordation of such hearing.

(f) Subject to the provisions of this Agreement, the arbitrator may award, or the referee may report, a statement of decision providing for any remedy or relief, including without limitation judicial foreclosure, deficiency judgment and equitable relief, and give effect to all legal and equitable defenses, including without limitation statutes of limitation, the statute of frauds, waiver, and estoppel.

(g) The award of the arbitrator or the statement of decision of the referee shall be supported by written findings of fact and conclusions of law delivered by the arbitrator or referee to the Parties concurrently with such award or statement of decision.

(h) In the event that punitive damages are permitted under Applicable State Law, the award of the arbitrator or the statement of decision of the referee may provide for recovery of punitive damages provided that the arbitrator or referee first makes written findings of fact that would satisfy the requirements for recovery of punitive damages under Applicable State Law. Any such punitive damages shall not exceed a sum equal to three times the amount of actual damages as determined by the arbitrator or referee.

(i) The arbitrator shall have the power to award or the referee shall have the power to report a statement of decision providing for reasonable attorneys' fees (including a reasonable allocation for the costs of in-house counsel) and costs to the prevailing party.

(j) In the event that Applicable State Law provides that publications or communications made in a judicial proceeding are subject to a litigation privilege, such litigation privilege shall apply to the same extent to publications or communications made in the Arbitration or Reference.
4. PROVISIONAL REMEDIES, SELF-HELP, AND FORECLOSURE. No provision of this Agreement shall limit the right of any Party (a) to exercise self-help remedies including, without limitation, set-off, (b) to foreclose against or sell any collateral, by power of sale or otherwise or (c) to obtain or oppose provisional or ancillary remedies from a court of competent jurisdiction before, after or during the pendency of the Arbitration or Reference. The exercise of, or opposition to, any such remedy does not waive the right of any Party to Arbitration or Reference pursuant to this Agreement.

5. FINAL, BINDING, AND NONAPPELLABLE JUDGMENT. Any court of competent jurisdiction shall, upon the petition of any Party, confirm the award of the arbitrator and enter judgment in conformity therewith. Any court of competent jurisdiction shall, upon the filing of the statement of decision of the referee, enter judgment thereon. Any such judgment shall be final, binding and nonappealable.

6. MISCELLANEOUS. In the event that multiple claims are asserted, some of which are found not subject to this Agreement, the Parties agree to stay the proceedings of the claims not subject to this Agreement until all other claims are resolved in accordance with this Agreement. In the event that claims are asserted against multiple parties, some of whom are not subject to this Agreement, the Parties agree to sever the claims subject to this Agreement and resolve them in accordance with this Agreement. In the event that any provision of this Agreement is found to be illegal or unenforceable, the remainder of this Agreement shall remain in full force and effect. In the event of any challenge to the legality or enforceability of this Agreement, the prevailing Party shall be entitled to recover the costs and expenses, including reasonable attorneys' fees, incurred by it in connection therewith. Applicable State Law shall govern the interpretation of this Agreement. This Agreement fully states all of the terms and conditions of the Parties' agreement regarding the matters mentioned in, or incidental to, this Agreement. This Agreement supersedes all oral negotiations and prior writings concerning the subject matter hereof.

7. DEFINED TERMS. As used in this Agreement, the following terms shall have the respective meanings set forth below:

(a) “AAA” shall mean the American Arbitration Association.

(b) “Applicable State Law” shall mean the law of the state in which this Agreement is executed by Obligor; provided, however, that if any Party seeks (i) to exercise self-help remedies, including without limitation set-off, (ii) to foreclose against or sell any collateral, by power of sale or otherwise or (iii) to obtain or oppose provisional or ancillary remedies from a court of competent jurisdiction before, after or during the pendency of the Arbitration or Reference, the law of the state where such collateral is located shall govern the exercise of or opposition to such rights and remedies.

(c) “Arbitration” shall mean an arbitration conducted pursuant to this Agreement in accordance with Applicable State Law, and under the Commercial Arbitration Rules of the AAA, as in effect at the time the arbitrator is selected pursuant to Paragraph 2 of this Agreement.

(d) “Claim” shall mean any claim, cause of action, action, dispute or controversy between or among the Parties, including any claim, cause of action, action, dispute or controversy alleged in or subject to a lawsuit between or among the Parties, which arises out of or relates to:
(i) any of the Subject Documents,
(ii) any negotiations, correspondence or communications relating to any of the Subject Documents, whether or not incorporated into the Subject Documents or any indebtedness evidenced thereby,
(iii) the administration or management of the Subject Documents or any indebtedness evidenced thereby, or
(iv) any alleged agreements, promises, representations or transactions in connection therewith, including but not limited to any claim, cause of action, action, dispute or controversy which arises out of or is based upon an alleged tort or other breach of legal duty.

(e) "Reference" shall mean a judicial reference conducted pursuant to this Agreement in accordance with Applicable State Law and under the Judicial Reference Procedures of the AAA, as in effect at the time the referee is selected pursuant to paragraph 2 of this Agreement.

(f) "Subject Documents" shall mean any and all documents, instruments and agreements previously, concurrently or hereafter executed by Obligor in favor of Bank, or between Obligor and Bank, which incorporate by reference an alternative dispute resolution agreement or another agreement providing for the resolution of Claims between or among the Parties by arbitration or judicial reference, any and all related documents, instruments and agreements, and any and all extensions, renewals, amendments, substitutions and replacements of any of the foregoing; and "Subject Document" shall mean any one of such Subject Documents.

8. WAIVER OF RIGHT TO TRIAL BY JURY. In connection with an Arbitration or Reference, or any other action or proceeding, the Parties hereby expressly, intentionally and deliberately waive any right they may otherwise have to trial by jury of any Claim.

This Agreement is duly executed by the Parties as of the date first written above.

("Bank")
Union Bank of California, N.A.
By: ________________________________
Title: ______________________________
Printed Name: ______________________

("Obligor")
By: ________________________________
Title: ______________________________
Printed Name: ______________________