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Arbitration clauses often found in fine print of finance documents

LEGAL MATTERS

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Like many businesses every day, you or your company may have recently filled out an application to open a simple checking or brokerage account or to obtain a credit card from a bank. Perhaps you obtained an interim construction loan, an operating line of credit, or letter of credit by signing a lengthy lending, security, or other type of agreement with a financial institution. On a more sophisticated level, you may have entered into an equipment leasing agreement or sought an investment bank's advice in going public in a merger or acquisition. Finally, you may be using the bank's trust department to manage your company's retirement assets or to serve as a custodial/transfer agent for its securities.

Often buried in all the fine print of such an agreement or application is what is referred to as an "arbitration" clause. The following is typical:

"Any controversy or claim arising out of or relating to this agreement, or the breach thereof, shall be settled by arbitration located in San Antonio, Texas, administered by the American Arbitration Association under its Commercial Arbitration Rules, and judgment on the award rendered by the arbitrator(s) may be entered in any court having jurisdiction thereof."

This clause governs any disputes — such as a breach for failure to pay — which arise under the agreement or application. It means that you will go to arbitration if there is a dispute.

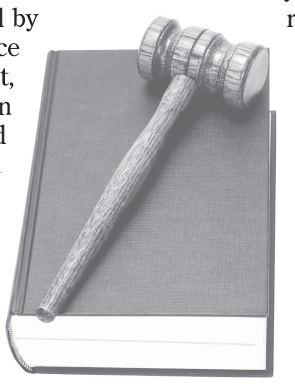
Arbitration is here to stay. Driven by what parties perceive as fundamental deficiencies of the formal judicial system, including protracted length, gamesmanship, belligerency, wastefulness, and problematic results, arbitration has grown exponentially in the last 10 years. Because of its confidentiality, empirical statistics are difficult to come by. Nonetheless, the American Arbitration Association (AAA), probably the largest administrator in the world, notes a 34 percent increase in commercial case filings alone from 1993 to 2002 — from 12,713 to 17,105 cases per year. (AAA's total caseload in 2003 was 174,000 cases, which includes all non-commercial areas.)

Courts and legislatures — both federal and state — continue wholeheartedly to sanction this trend. Arbitration's dramatic increase must be viewed as a seismic shift in the notions of justice in this America with huge economic consequences given the $200 to $300 billion annual cost of civil litigation. Studies seem to confirm general public acceptance of the process.

Arbitration 101

What is arbitration? In a nutshell, arbitration is the process whereby a dispute is submitted to one referee or a panel of three — the arbitrators — for a final and binding determination known as the award. The panel conducts itself similarly to a judge. That is, it conducts an evidentiary hearing, hears opening and closing arguments, rules on evidence, reviews the testimony and evidence presented by the parties, and renders an award enforceable in court.

Typically, to maintain the integrity of the process and to handle the numerous administrative details that inevitably come up, a neutral administrator such as the AAA is used, although not required by law. Arbitration does not replace the formal litigation system but, rather, co-exists with it as an alternative. It is often repeated that arbitration is not viewed as a diminution of the rights of the parties but merely as a change in the venue.



In comparing arbitration to formal litigation, it is helpful to note these major features of arbitration:

- A written clause for resolving disputes by the use of arbitration.
- Normally, non-signatory parties cannot be bound by an arbitration clause.
- Informal procedures. Procedural rules relative to court procedure are simple: strict rules of evidence are not applicable, and there are no requiremtents for transcripts of the proceedings or for written opinions of arbitrators unless the parties agree otherwise. Although there is no formal discovery, rules typically allow the arbitrator to require the "production of documents and other information." While frowned upon, depositions are permissible, particularly if the parties are in agreement.
- Objective and knowledgeable neutrals serve as arbitrators. Arbitrators are selected by the parties for the specific cases because of their knowledge of the subject matter. Based on that experience and expertise, arbitrators can render an award based on thoughtful and thorough analysis. Thus, the selection of an appropriate arbitrator is critical, and studies show that an arbitrator's knowledge of a specific type of case is the most important qualification for his or her effectiveness, not whether the arbitrator has litigation or judicial experience. Typically, most arbitrators are practicing attorneys who, unlike judges, do not maintain "dockets" of hundreds of seemingly anonymous cases; hence, they have a comprehensive grasp of each individual case.
- Arbitration is confidential. Hearings are closed, and proceedings are not a matter of public record. In sensitive business, investment, trust, and family matters, this keeps the "dirty laundry" from being hung out to dry on the front page of the newspaper.

Time and money

The costs of arbitration proceedings are generally less — even while including what can be substantial fees to the administrator and panel — than formal litigation, primarily because of the absence of formal discovery, extensive motion practice, rescheduling or appeals.

In addition, proceedings are much swifter than what frequently takes place in a courtroom. The AAA reports that the vast majority of cases are disposed of within 12 months from the date of filing, with 90 percent of all arbitration hearings concluded in two days or less; the National Arbitration Forum notes the median time of an arbitration from filing to award at two-thirds that of a formal lawsuit.

While the costs are less, final and binding awards are enforceable in court. Arbitrators have broad discretion in rendering awards. AAA Rule 42 provides that an arbitrator "may grant any remedy or relief that the arbitrator deems just and equitable within the scope of the agreement." Court intervention and review are limited by applicable state and federal laws, and award enforcement is facilitated by these same laws. Judicial review is generally limited to egregious defects in the arbitration procedure, not with the merits of the case.

The rising costs of formal litigation, with its perceived deficiencies, bode well for the use of arbitration. If arbitration can indeed deliver "better, faster, cheaper" results it will be here to stay.

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