

THE EXISTING DISPUTE RESOLUTION PROGRAM
DESIGNED BY AND FOR
THE FINANCIAL SERVICES INDUSTRY

AN UPDATE

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Financial issues and disputes dominate today's news and are likely to continue as the long tangle of mistakes, misrepresentations, misjudgments and frauds in the financial sector unwinds. Commercial finance attorneys are facing larger and more complex caseloads than ever as financial institutions and insurers reveal the fragile underpinnings of many types of financial transactions—sub-prime mortgages, securitized debt obligations, commercial loans and mortgages, interest rate swap agreements, and other financial products. This situation is producing disputes not only between borrower and lender, but also between financial institutions that are counter-parties themselves. The recession with its ripple effects is also causing failures by companies to meet contractual obligations, leading to business-to-business commercial disputes.

These realities call for additional participation and alternatives to time-consuming and costly litigation. The American Arbitration Association[®] (AAA) has a history of working with various individuals from the American College of Commercial Finance Lawyers (ACCFL) to meet the needs of parties and their representatives involved in disputes stemming from financial transactions.

For present disputes arising out of the credit collapse of 2008-2009, lawyers can submit cases for arbitration and mediation using the Model Clause developed by the ACCFA and the AAA. A useful guide to use when drafting an alternative dispute resolution (ADR) submission agreement for arbitration or mediation is the AAA booklet, *Resolving Commercial Financial Disputes—A Practical Guide: Including Sample Clauses and Mediation and Arbitration Rules; Amended and Effective September 15, 2005*. (The Booklet is also available at the AAA's Web site at <http://www.adr.org>.) The Booklet contains a full description and explanation of the ongoing AAA Commercial Financial Services arbitration and mediation program.

A set of Supplementary Procedures for use with ADR providers' rules is being considered by the Task Force of the Business Law Section of the ABA in concert with its Dispute Resolution Section in order to streamline and customize drafting future commercial finance contracts. Information about the Task Force's work, as well as the current commercial finance rules and drafting guide, is available on the ADR Task Force page on the [ComFin Web site](#) (through the link [American Arbitration Association 2005 Financial Disputes Guide—Reprinted with Permission](#)—just click on the link). The "Discussion Draft" of Supplementary Rules is available on the ADR Task Force page of the ComFin Web site under the heading "Documents."

What Is the Existing AAA Commercial Finance Dispute Resolution “Program?”

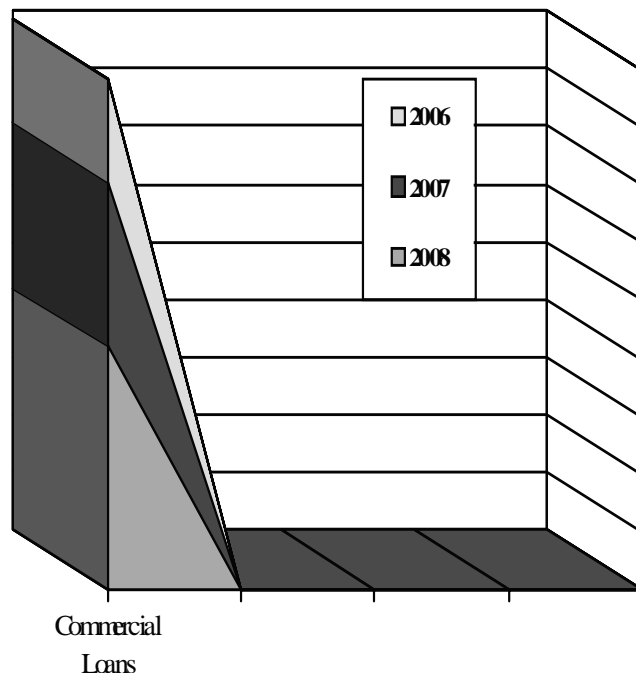
Commercial financial services and ADR experts, in a collaborative effort, designed flexible ADR Model Clauses (Model Clause) for use in the commercial financial services industry. The Model Clause was developed as the result of the joint efforts of the ADR Committee of the American College of Commercial Finance Lawyers (ACCFL) and the American Arbitration Association (AAA). The “Working Draft” of Short and Long Form “Model Mediation and Arbitration Clause for Commercial Financial Services Dispute Resolution” and “Working Draft” for Mediation Rules and Arbitration Rules were unveiled at the 1997 Spring Meeting Program of the Business Law Section. The Program “ADR and the Financial Services Industry: Techniques for Successful Cost-Effective Dispute Resolution” was presented by the Committee on Commercial Financial Services, the Committee on Banking Law and the Committee on Dispute Resolution, together with the American Arbitration Association and the American College of Commercial Finance Lawyers.

The final product provided for a commercial finance-experienced panel of arbitrators, mainly at the time from members of ACCFL, and was launched in 1998 by AAA with the publication and national distribution of its booklet, *Resolving Commercial Financial Disputes—A Practical Guide*. The booklet includes sample clauses, mediation and arbitration rules, and a full explanation of the program.

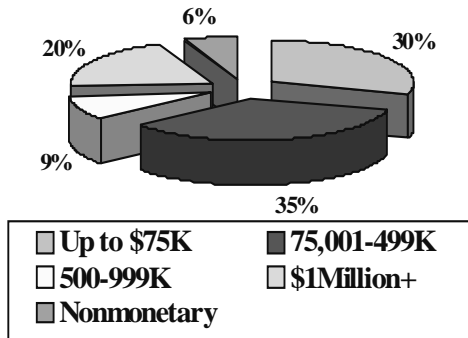
Since the program was developed, many lenders have recognized the value of the undertaking. It continues to be a unique resource for the financial services industry when addressing techniques for dispute resolution designed for the industry. But there are commercial financial services lawyers, in house and in private firms, who simply don’t know that the program is available for consideration and use by their clients.

Dispute-savvy commercial finance lawyers and their litigation partners consider all forms of dispute resolution not only when advising clients on contract construction but also when a dispute arises; a one-size-fits-all litigation approach is no longer adequate. Mediation and arbitration have achieved mainstream status for the efficient, party-controlled resolution of disputes.

The American Arbitration Association has seen an increase in case filings in nearly all of the key segments of the commercial financial sector over the last three years. As the chart to the right reveals, cases arising out of commercial loans are growing, e.g. cases where the mortgage purchaser is claiming breach of the



warranties against the originator about the value of the property or financial health of the borrower. This trend is expected to continue as parties use ADR to achieve speed, cost control, and especially access to arbitrators who have expertise in commercial financial services. This is especially significant, as the nature of financial disputes now involves interest rate swaps and other modern financial transactions between institutions with specialized commercial needs in dispute resolution—thus the increased relevance of the AAA-ACCFL Program.



As the number of claims filed has risen, so has the size of the claims. Arbitrations concerning hundreds and even thousands of mortgages (not consumer transactions) and reaching into the hundreds of millions of dollars are being filed. In 2008, 20% of the AAA’s claims were for \$1 million or more, and 6% sought declaratory awards or other relief. The breakout of claim filing in the commercial financial area at the AAA is shown in the pie chart here.

The Model Clause was created to meet the specialized needs of all parties involved in commercial finance transactions. The Model Clause provides for mediation and arbitration of disputes where the claim is for money damages (and only with the agreement of the parties to other types of disputes). The reason for this is the need to carve out from the arbitration access to judicial and self-help remedies relating to the preservation and realization of the lender’s collateral and to preserve statutorily mandated rights of borrowers under applicable law.

This “carve-out” from the arbitration is a practical and legal necessity. Arbitrators are neither equipped nor authorized to carry out in the arbitration statutory mandates, court rules and other due process procedures required for the administration of foreclosures, replevins, attachments, judicial sales, etc. Debtors, junior lienors, and other third parties may have disputed lien priority rights, claims to sale proceeds, defenses, etc.; but the jurisdiction of the arbitrator is limited to those who are actually parties in the arbitration. Third parties will not normally even have notice of the arbitration. The arbitrator is not the equivalent of the Clerk’s office at the courthouse, and is not authorized to carry out notice and other statutorily and/or judicially mandated procedures or to be a repository for all documents filed and available for those with an interest in the case. Arbitrators and ADR providers have no obligation to retain files beyond a very limited time. Court files are normally public; arbitration files are not.

The Model Clause contains numerous drafting options, allowing it to be specifically tailored to particular financial services needs and uses. The clause is suitable for loan agreements, inter-creditor agreements, subordination agreements, syndication and participation agreements, and workout agreements, among others. With this clause, commercial finance institutions can obtain the benefits of speedy, cost-effective, and predictable dispute resolution while preserving essential statutory and constitutional

rights with respect to the ongoing borrower-lender relationship. With some modifications, the Model Clause could be appropriate for claims and counterclaims for money damages arising out of financial transactions beyond classic commercial lending—derivatives, swaps, etc. They have much in common as to their needs in dispute resolution.

What Is So Different About Commercial Finance Transactions?

Why Must Commercial Finance Arbitration and Mediation Be Limited in Scope?

The commercial lending relationship is a complex one, involving ongoing payment and performance obligations by both the lender and the borrower. These parties frequently must make quick business and credit decisions based upon their legal relationship and the borrower's business activities, knowing that in many situations the decision may lead to the exercise of legal rights by the other party. These decisions may be based on the parties' understanding of the applicable law and the legal remedies available to them.

Disputes between parties in the commercial finance setting often involve not only Uniform Commercial Code (UCC) issues, but also surety law, lending and rate formulas, interpretation of loan agreement covenants, bankruptcy law, asset valuation issues, balance sheet and other financial analysis, lien priority issues other than those governed by the UCC, cross-collateralization problems, corporate law, and matters relating to shareholders and other third parties with financial involvement with the borrower. Rarely while the ongoing lending relationship exists will these disputes ripen into discrete litigation. These disputes may be resolved quickly by agreement because of the exigencies of the situation, or simply by the passage of time because of the inability of one party under applicable law to force the other party to perform its obligation.

For example, if the borrower wants to draw down on a line of credit, and the lender refuses because the lending formula and financial ratios under the loan agreement allow it to decline to lend, the parties may agree on what to do. If they don't agree, the lender simply may not lend at that time. It will all happen quickly because of pressing business issues; neither party will look to a court to resolve the immediate problem.

However, litigation may arise out of the dispute. The lender may decide to call a default and demand repayment of the loan because of the borrower's failure to maintain the collateral and financial ratios, or other breaches of the loan documents. The borrower may respond with a claim for damages due to the lender's failure to lend, and assert defenses to the lender's claims. When this happens, the lending relationship is over and litigation or mediation and/or arbitration becomes the focal point of their relationship.

Lenders rely on specific legal remedies designed to recover the loan and preserve, foreclose, and liquidate collateral. Lenders lend based upon the knowledge that predictable legal remedies and procedures are available in the event of a default or a need to preserve the collateral without a default. The law allows a lender to take speedy action to protect, preserve, or liquidate its collateral position. Similarly, borrowers rely on the specific protections available under applicable debtor/creditor laws to protect their rights. Thus, a borrower can take speedy action, to the extent allowed by law, to try to prevent the lender from exercising remedies that could impair the borrower's continued operation. Neither party, however, can obtain an order of specific performance directing a

lender to lend or a borrower to perform its covenants under a loan agreement (other than those relating specifically to collateral preservation and maintenance).

Depending on the specific situation, the lender will decide whether to call a default and exercise its remedies, and the borrower will decide whether to defend against the exercise of remedies by the lender and/or assert a claim for damages against it.

For these reasons, lenders have found that the standard arbitration clause calling for mediation or arbitration of “any controversy or dispute” does not comport with the business and legal realities of the commercial finance relationship. The industry needs a commercial finance arbitration clause that

- allows the parties to conduct business as they will,
- preserves currently available judicial and self-help remedies for the lender and currently available legal safeguards for the borrower, and
- provides for mediation and arbitration of disputes only over legal defenses and claims for money damages; the arbitration and/or mediation clause should not create specific performance remedies that would not even be available in the courts.

Key Features of the ACCFL Model Clause

The key features of the Model Clause are

- terms defining when a “controversy” becomes an “ADR dispute” ripe for mediation and/or arbitration,
- provision for mediation first (optional) and thereafter arbitration if a resolution does not materialize,
- limitations on arbitral remedies only to those appropriate in a commercial finance setting after preserving well-established available and statutorily mandated rights and remedies,
- inclusion in the ADR process of all parties necessary for resolution of the dispute,
- provision for neutrals from a national roster with commercial finance knowledge and experience, and
- numerous optional provisions to further tailor the agreement.

Definition of “Controversy” and “ADR Dispute” (§1)

The Model Clause limits the type of controversy to be mediated and/or arbitrated by defining two key concepts: a “controversy” and an “ADR dispute.” “Controversy” is an all-encompassing term that embraces any problem that might arise in the lending relationship. “Controversy” means any action, dispute, claim, counterclaim, or controversy of any kind, whether founded in contract, tort, statutory, or common law, now existing or hereafter arising, based upon or arising out of, or pertaining to or related to or in connection with the loan agreements, extensions of credit, and/or the transactions and events arising out of or related thereto.

“ADR dispute” is a narrower term. It sets the criteria for the type of controversy that will be mediated and/or arbitrated. Thus, the parties are contracting that only an “ADR dispute,” not any controversy, will require the parties to use ADR.

What, then, is an “ADR dispute”? This term is defined to mean any controversy if and only if the controversy is such at the time any provision of this Article 00 is invoked that the prevailing Party could under applicable law be adequately compensated by ascertainable money damages, and

one Party to this Agreement has made a claim for money damages against another Party to this Agreement in a writing that has been delivered to the other Party, provided, however, that a demand made by a lender or other financial services provider for repayment of money or for compliance with contracted-for obligations, whether based upon contractual default or otherwise, shall not be an ADR Dispute.

The Model Clause also provides that the parties may mutually agree in writing that a controversy shall be treated as an ADR dispute even though at the time of the agreement the controversy did not meet the above criteria.

Preservation of Rights. The Model Clause provides that an ADR dispute shall be resolved solely and exclusively under the procedures specified in the clause. However, preserved to the parties are the right to pursue equitable judicial relief, injunctive relief, appointment of a receiver, and other self-help and judicial remedies. Unlike the traditional ADR clause exclusions for “provisional remedies,” which are limited to foreclosure-type remedies, the Model Clause includes “protection, continuation and preservation of lien rights and priorities, the processing and payment or return of checks, the right of set-off, recoupment, foreclosure, or repossession, whether such occurs before, during or after the pendency of any negotiation, mediation, or arbitration proceeding.”

Dispute Resolution Methods. In many cases, especially in multi-party transactions, and where a continuing relationship may be desirable, mediation can cut costs and bring about an early resolution of the dispute. This is especially true in commercial financial disputes where workout techniques—which are very similar to mediation techniques—are used.

The mediation clause requires good-faith efforts by the parties. However, the parties are not bound to a resolution in the absence of reaching mutual agreement in the mediation. If the ADR dispute is not resolved by mediation, binding arbitration is required.

Consistent with debtor/creditor law, an arbitrator acting under the Model Clause does not have authority to order specific performance of any obligation or duty of any party, or to issue injunctions.

Optional Provisions. The Model Clause provides a number of drafting options:

Choice of Law (§4). Many in the commercial financial community want to know that the ultimate decision will be governed by applicable law in a particular jurisdiction. The option permits selection of the jurisdiction whose law is to be applied.

Defenses/Punitive Damages (§4). Another option is to exclude defenses based upon the passage of time during negotiation, mediation and arbitration and to choose whether punitive, exemplary, or statutory damages may be awarded in arbitration.

Discovery (§4). There is an option to limit discovery to disputes over a certain size.

Costs and Expenses (§§3,4). While the Model Clause calls for the sharing of mediation and arbitration costs and expenses, an option may be selected to have costs and expenses shared or awarded in accordance with the loan agreement, promissory note, and/or other loan documents.

The Award (§4). The Model Clause provides options as to the specificity of the award. Must the award contain (1) the factual and legal basis for the award, (2) findings of fact and law, or (3) a reasoned opinion? Absent one of these choices, the arbitrator would normally include in the award only the final result. Many lenders will have more confidence in the arbitration process if they have the option of requiring a more detailed award. In addition, an option is provided for either a unanimous decision or a majority decision of the panel.

Time Limitations (§§2,3,10). Another optional provision imposes limitations on the time when the various ADR procedures must be commenced with respect to an ADR dispute.

Other Provisions. Consolidation (§4)/Parties (§§1,5). The Model Clause prohibits consolidation with another arbitration proceeding without the parties' consent. It specifically provides that it is for the benefit only of the signatories and their respective successors and assigns, and therefore is not available to third parties. However, in order to avoid piecemeal resolution of disputes, the clause broadly defines "parties" (in §1) to include "the respective employees, officers, directors, attorneys and other agents of the parties to this Agreement," with the option to include "any partner, limited liability member, shareholder, beneficiary or other equity holder or person who authorized or approved its related parties' execution of this Agreement."

FAA (§4). An arbitration under the Model Clause will be governed by the Federal Arbitration Act, which permits a broad spectrum of enforceable contractual arbitration options.

Survival of Clause (§9). The Model Clause is designed to continue in effect after the last payment to a lender has been made and after contractual termination may have occurred.

Qualifications and Selection of Neutrals. One of the obstacles to both mediation and arbitration in the commercial lending community has been concern over the qualifications of the neutral. The better-informed lenders have recognized that an evaluative approach by a mediator knowledgeable in commercial finance (which can provide a helpful reality check for the borrower) can be especially beneficial. If the case goes to arbitration, it is even more important for the arbitrator to be well versed in commercial finance transactions and issues, since a binding decision will result.

The AAA has a national roster of exceedingly qualified commercial finance mediators and arbitrators available to handle cases under the Model Clause. Members are nominated to the panel by the AAA and the American College of Commercial Finance

Lawyers (ACCFL). However, election to the ACCFL is not a requirement for appointment to the panel.

Selecting the right mediator or arbitrator for a commercial finance case is a critical decision for a lawyer and client. The neutral's experience should include both process and subject matter expertise; this is especially important in selecting an arbitrator because the result is a final and binding award. The AAA provides parties with a list of names (usually 10-15 from panels with experience in that kind of case) and full biographies from which to make their choice. For claims above \$500,000, the Association offers (without charge) an *Enhanced Neutral Selection Process* that, *inter alia*, allows both sides, in the presence of a trained AAA case manager, to submit questions to arbitrators before making their selections, after which conflict checks are conducted. This extensive process provides the parties maximum control and enables them to make informed decisions.

ComFin ADR Task Force. It is especially timely for ComFin members to review the existing AAA commercial finance dispute resolution Program, Rules and Clauses, currently available for commercial finance transactions when evaluating the Task Force project. Failure to do so in analyzing the Task Force project for Supplementary Rules could lead to professional responsibility issues in advising commercial finance clients about arbitration and/or mediation. The Supplementary Rules, if promulgated, should be viewed as standing side by side with the basic rules of the ADR provider selected by the parties if Supplementary Rules are adopted by clients in their arbitration clauses. Careful review of two sets of Rules and the arbitration clause itself will be required for lawyers advising clients, once client preferences and goals have been determined. The main provider rules, the Supplementary Rules, and the arbitration clause itself may be in conflict if they are not modified. Potential conflicts between two sets of rules and the arbitration clause itself in the same arbitration case could be a real problem for the clients.

To avoid conflict problems, we suggest that after review of the AAA Program and the Task Force Discussion Draft of Model Supplementary Arbitration Rules, ComFin members make known their suggestions and comments on the Task Force Project before a final draft is before ComFin for ABA endorsement.

The ABA ComFin ADR Task Force is seeking to promulgate Model Supplementary Arbitration Rules; it is not seeking to propose Model Arbitration Clauses or to substitute the proposed Supplementary Arbitration Rules of ADR providers. Thus, this ADR Task Force project should not be confused with the existing Commercial Financial Services dispute resolution program of AAA. They are independent of each other. One is a work in progress; the other is an ongoing program.

The authors of this article are both working with the Task Force to assist in the process of meeting current needs of financial world clients, while at the same time not creating costly and time-consuming issues if two sets of rules govern for those who select a proposed ABA-sponsored set of Supplementary Rules for various types of finance transactions.

Your input to the ADR Task Force with comments and suggestions for the Discussion Draft is vital. Input from your clients is essential for avoiding problems and meeting their needs. Knowledge of what the Task Force is doing and an awareness of the existing AAA program will provide the basis for the most helpful input.

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