Private Dispute Resolution in the Banking Industry

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Erik Moller, Elizabeth Rolph, Patricia Ebener
The mission of the Institute for Civil Justice is to help make the civil justice system more efficient and more equitable by supplying policymakers and the public with the results of objective, empirically based, analytic research. The ICJ facilitates change in the civil justice system by analyzing trends and outcomes, identifying and evaluating policy options, and bringing together representatives of different interests to debate alternative solutions to policy problems. The Institute builds on a long tradition of RAND research characterized by an interdisciplinary, empirical approach to public policy issues and rigorous standards of quality, objectivity, and independence.

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Preface

For more than a decade the Institute for Civil Justice has been studying alternative dispute resolution issues. Early research focused on publicly provided ADR services, especially court-administered arbitration. Recently, attention in the policy community has shifted to private ADR providers, and the ICJ has embarked on a series of studies to address issues in this new area.

This document describes the introduction of private, binding arbitration into the banking industry. Later studies in this series will focus on the nature of private dispute resolution providers and the implications of private ADR for disputants, the courts, and the public.

The study should be of interest to corporations, to corporate law firms interested in the options available for dispute resolution in the private sector, and to decisionmakers who wish to learn more about this growing area of ADR activity.

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Summary

In the early to mid-1980s, the banking industry became aware of rapidly rising litigation costs and believed that a liability crisis was developing in certain areas of litigation. Responding to this belief, a few prominent firms in the industry turned to new private alternative dispute resolution mechanisms, including arbitration and mediation, as possible vehicles for forestalling this impending crisis.

Binding arbitration was one mechanism the firms already knew and with which they had some positive experience, so private binding arbitration seemed promising. The firms implementing this alternative targeted a few high-exposure business areas in which to test the innovation, incorporating a requirement for arbitration in suitable contracts. Then, as the value of arbitration was proven, the firms expanded its application to new areas. Such successes proved the value of arbitration to other firms, which have begun incorporating it into their own contracts.

This case study first describes the introduction of private, binding arbitration into the banking industry through information gleaned during interviews with officials from five banks. It then examines some of the effects of this innovation on volume of caseload, liability exposure, and transaction costs for one particular bank that made its records available to us.\(^1\)

First, the five firms did not turn to private alternative dispute resolution (ADR) without substantial prior experience with the innovation through California’s mandatory, public-sector judicial arbitration program. In effect, this public program served as a demonstration program for the potential use of arbitration in the private sector. The firms had also been exposed to private binding arbitration through organizations such as the American Arbitration Association in disputes with other entities.

Second, firms in California’s banking industry chose and implemented private arbitration mechanisms that were appropriate for the industry’s goals: reducing liability exposure and litigation costs. The lead firms found binding arbitration attractive because it limits exposure by limiting the risk of punitive damages and

\(^1\)Because we promised confidentiality, we are unable to name this bank. It is, however, a major state financial institution that accounts for a substantial market share.
eliminating the unpredictability of juries, thereby reducing the incentives for plaintiffs' attorneys to take cases and perhaps producing a more uniform and predictable set of outcomes.

It is difficult to quantify the effects of the introduction of arbitration on the outcomes of interest to the firms in our study, liability exposure and litigation costs. However, data from the bank that made its records available contained information that was relevant to these outcomes. We analyzed the effects of this innovation on: (1) the number of new cases filed and number of cases disposed of as measures of the volume of cases; and (2) expected value of new cases and amount of funds paid for verdicts and settlements as measures of the value of the caseload.

The bank decided to implement a contractual arbitration provision in areas of perceived growing liability exposure in late 1986 and early 1987. The collected data for this bank bear out the general perception expressed by the institutions that we interviewed that their caseload volume and liability exposure decreased after the implementation of binding private arbitration. Interestingly, the data regarding actual funds paid for verdicts and settlements is not so dispositive.

The data show a marked decrease in the number of new cases filed in the areas affected by the bank's arbitration program. In 1986, arbitrable claims accounted for approximately 12 percent of the new claims against the bank. The number of such new claims filed in subsequent years declined steadily until they accounted for only 3 percent of the new cases filed against the institution. This is particularly important, because the overall number of cases was also declining, although at a lesser rate than that for arbitrable claims. Equally marked changes occurred in the number of cases disposed of in arbitrable areas of litigation. Together these measures indicate a decline in caseload volume.

Similarly, the expected liability of new cases declined during this period from 43 percent of the bank's expected exposure in 1986 to 0.1 percent of its expected exposure in 1990. However, the amount of funds paid for verdicts and settlements in arbitrable actions as a percentage of funds paid for total cases increased from 14 percent in 1984 to 62 percent in 1985 before declining somewhat to 39 percent in 1990, the end of the period for which we obtained data. These data present conflicting evidence regarding the change in the value of the bank's caseload. While expected liability in arbitrable areas declined, funds paid in those areas increased. However, it is possible, if not likely, that without arbitration provisions, the amount of funds paid to dispose of arbitrable cases would have been considerably higher.

Although contractual binding arbitration may be successful from the industry's viewpoint, it raises some serious public policy questions. The firms we
interviewed turned to private ADR in the face of rising legal fees and punitive damage claims. Punitive damages act as deterrents because they punish certain kinds of conduct. To the degree that ADR eliminates punitive damages, justice and deterrence may not be well served. In addition, the judicial mechanism resolves the immediate dispute, but also establishes legal precedents through written opinions and exposes the parties’ actions to public scrutiny. Since the results of private arbitration are not usually matters of public record, they cannot be used in these fashions, to establish standards of conduct for the future or to bring attention to unwanted behavior. This brings into serious question the legal system’s ability to effect changes in the common law and in statutory interpretation when private ADR is widespread.

Despite these issues, the future appears quite bright for the use of private ADR in the California banking industry. More firms are adopting these mechanisms as a part of their dispute resolution strategies, and the firms that have already employed them are expanding their use. In addition, a recent California Supreme Court decision has made the finality of an arbitrator’s decision more certain. In sum, all the evidence, including the experiences of the firms examined in this case study, suggests that the banking industry is satisfied with private ADR mechanisms, that these mechanisms are serving the industry well, and that the industry will continue to expand their use.
Acknowledgments

We wish to gratefully acknowledge financial support from the American Corporate Counsel Association, without which this research would not have been possible, and the cooperation of the several banking firms and their employees who generously gave of their time and expertise. We are also indebted to Kevin McCarthy, David Finegold, and Polly Phipps, each of whom read and commented on drafts of this report—none of whom bears responsibility for any errors that may persist. Finally, we would like to acknowledge the careful editorial assistance of Phyllis Gilmore and the patient secretarial support of Pat Williams.
1. Introduction

Background

In recent years, rising litigation costs have received considerable attention, especially in the business community. New legal rules, rising jury verdicts, rising legal fees, overcrowded courts, and increasingly complicated and slow procedures have conspired to make dispute resolution within the traditional court system protracted and expensive.\(^1\) In addition to the numerous attempts at reform and case management the courts themselves have undertaken to alleviate some of these problems,\(^2\) businesses in a broad range of sectors have implemented, or at least considered adopting, a variety of alternative strategies to contain these growing costs. One strategy that businesses seem to find promising is the use of private dispute resolution mechanisms in lieu of the public court system. These mechanisms include binding arbitration, mediation, mini-trials, and summary jury trials.\(^3\)

There is considerable anecdotal evidence indicating why businesses are dissatisfied with the traditional disputing mechanisms and what they hope to find in alternative processes.\(^4\) However, little structured research has been conducted that enables us to systematically characterize the circumstances that prompt businesses to turn to private dispute resolution procedures, the process governing successful innovation of the dispute resolution mechanism, or the consequences of using new private procedures. Yet this information is essential if one is to understand the future role of the private sector in this important area and, in turn, identify what significant public policy issues might be raised by the migration of a portion of the civil caseload to the private sector.

Purpose and Methods

Purpose

To inform our understanding of the circumstances under which businesses turn to private sector dispute resolution and with what consequences, the Institute for

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\(^1\)See Trubek et al. (1983).
\(^2\)See Ebener and Betancourt (1985).
\(^3\)See Meyerson and Cooper (1991); Goldberg, Green, and Sander (1985).
\(^4\)See Butler (1988).
Civil Justice, with the support of the American Corporate Counsel Association, undertook an examination of the introduction of private alternative dispute resolution (ADR) in the California banking industry, currently a leading user of these services. We expect this study to enable us to

- characterize the perceived benefits and limitations of the various private dispute resolution alternatives in the banking sector,
- describe the innovation process as it works in banks, and
- obtain empirical measures of the effects of private dispute resolution on important outcomes for the innovating firms, including caseload, exposure, and transaction costs.

Although we cannot necessarily generalize from the experience of these banks to other California banks, to banks in other states, or to other industries, this case study should nonetheless be useful in furthering our understanding of the growth and effects of private ADR.

**Analytic Framework**

As the academic literature details, innovation can assume many different guises; it might be a product, a process, a technique, or an organizational structure. In deciding to resolve its disputes through a private dispute resolution forum instead of the traditional court forum, a firm introduces a technical innovation. Frameworks developed in the innovation literature provide a cohesive explanatory foundation for our case study of innovation in the California banking industry.

Many models of the diffusion of innovation have been developed. They can be separated into two distinct groups: One group is primarily concerned with diffusion of innovations among individual consumers and households,\(^5\) the other with the diffusion of innovation among firms. The literature explaining innovation among firms tends to focus on the characteristics of the innovation, the adopting firm, and the adoption process, while that explaining consumer adoption has put relatively more emphasis on the process of information flow and the role of a market and infrastructure.\(^6\)

For this study, we have drawn on the models explaining innovation in firms, particularly relying on the model constructed by Zaltman, Duncan, and Holbeck

\(^5\)See Rogers and Shoemaker (1971); Robertson (1971).
\(^6\)See Brown (1981).
(1973), which most closely parallels the experience we hope to understand. They construct a framework for the examination of the diffusion of innovation in the context of organizational decisionmakers and actors, concentrating on the temporal relationship of the stages of the diffusion process. According to this framework, the process of innovation diffusion is divided into stages and substages:

1. Initiation stage:
   a. knowledge and awareness,
   b. attitude and opinion formation, and
   c. decision to adopt.

2. Implementation stage:
   a. initial implementation, and
   b. continued implementation.

The initiation stage of the innovation process is somewhat complex. Innovators in any given firm must be aware that the innovation exists and that it might be applied to their business activities, either in response to a perceived problem or to improve efficiency. After further exploration, they will form an opinion on its applicability to their situation and make a decision to adopt or reject the change. Once the organization decides to innovate, it must implement the innovation. In the initial implementation substage, the organization first introduces the innovation and then attempts to use it effectively. For example, organizations that are considering an innovation may test it on a trial basis in a particular application. If the initial implementation substage has been successful (that is, the innovation has performed to its expectations with few problems), and the members of the organization are comfortable with it and understand its value, the organization may expand its use in the continued implementation stage.

Consistent with the above theoretical framework, our study will explore how California banks navigated the innovation process, including:

- the problems they perceived in the ex ante environment
- sources of information on the innovation
- familiarity with alternative innovations
- the exact form of the innovation.

To be successful, innovations must ultimately satisfy those adopting them. Therefore, we are also interested in the actual effects of private dispute resolution on outcomes of importance to the innovating firms, as well as perceptions of the success of the innovation.
Methods

As noted above, this study is ultimately intended to illuminate the process of diffusion of private ADR through the business sector and the consequences of its adoptions for businesses. Since budget limitations precluded any research design that depended on large-scale data collection, we bounded our efforts both geographically and with regard to the industries captured: We decided to focus on the banking industry in California. Because we are interested in innovation, we are looking for “leading edge” activity. The banking industry has been a leader in the use of private ADR mechanisms. Because the legal context for private ADR differs from one state to another, we chose to look at banking practices in one state rather than in several, and we chose California, a state with a reputation for pioneering new legal practices.

Again, because of severe budget constraints, we chose to rely on case studies of a few institutions rather than attempt large-scale data collection from the state’s numerous banks. We identified large banks that were leaders in the adoption of ADR services. We concentrated on them for several important reasons: (1) They would have the longest experience with the use of ADR and therefore provide the most information about the innovation process; (2) they were likely to be the industry “trend-setters”; and (3) they would account for much of the state’s banking business. We identified two of the banks in this group, and both agreed to participate in the main wave of information collection. In addition, we identified an additional three banks that cooperated in telephone interviews. We visited both main participants, administering a formal, open-ended questionnaire, and attempted to collect relevant data on caseloads, liability exposure, and litigation costs for 1982 through 1992—a time frame that encompasses the introduction of private ADR. Both interviews were successfully completed, but case-level data proved to be impossible to collect from one of the two banks.

In addition to primary data collection, we reviewed the very limited literature on the emergence of private ADR services, and we reviewed the California case law to obtain necessary contextual information.

Inevitably, a study of this scale suffers from important limitations. First, because we rely on a limited number of case studies, our conclusions are descriptive and cannot be generalized to other industries or even to the entire banking sector. They are, however, suggestive in important respects, and they apply to the dominant institutions in the industry. Second, the data that we were able to collect concerning the effects of the use of private ADR on one bank’s litigation costs are limited to that one firm and, even for that bank, do not allow us to
understand the detailed effects. Nonetheless, these data are also suggestive of certain outcomes, and are important as the types of measures banks themselves are using to determine the success of their private ADR programs.

**Organization**

The report is organized into six sections. In Section 2, we discuss the legal and business context in which the decisions to turn to private ADR were made. In Section 3, we describe the decision to adopt ADR, and in Section 4, we describe the implementation process. In Section 5, we outline the effects of the introduction of private ADR on caseload, liability exposure, and litigation costs. Finally, in Section 6, we discuss the conclusions that might be drawn from the case studies.
2. The Context for Innovation

Although innovation may flow simply from the existence of an obviously superior mechanism, it may also result from changes in the external environment that create a new problem calling for resolution. The latter situation—a new problem in search of a solution—best characterizes the environment in which banking firms turned to private dispute resolution. During the mid-1980s, banking firms found themselves subject to dramatically expanding liability exposure as a result of state court decisions expanding the firms’ contractual obligations and awarding plaintiffs increasingly large verdicts. This combination of changing law and large, high-profile jury verdicts focused the firms’ attention on the need for innovation. We will initially consider the legal background of the substantive areas of law that encouraged the industry to examine ADR mechanisms: lender liability laws and class actions.

Lender Liability Laws

In the mid-1980s, the banking industry was struck with a series of pro-borrower court decisions. These decisions broadened the scope of the duties owed to a borrower by a banking institution as part of the customer-institution relationship (generally referred to as “lender liability”). As a result of this expansion in duties, the institutions were exposed to a greater variety of potential tort liability. In addition, juries awarded plaintiffs large sums of money in verdicts against the banking institutions for, among other things, breaching these newly established tort rules. These trends prompted the banking industry to see itself entering a lender liability crisis. By the late 1980s, a more conservative California Supreme Court drastically limited the expanded scope of these liability rules, but the expansion has not been entirely reversed.¹

Prior to the mid-1980s, banking institutions faced the same range of potential liability as any other business.² This included breach of contract; torts, such as personal injury; and other general causes of action. The distinction between

¹This discussion concerns the California legal environment. California was on the leading edge of this lender liability wave, and so banking firms in this state were subject to these concerns earlier than those in other states.
²This excludes such extraordinary situations as asbestos litigation or product liability exposure to which some industries were subject.
breach of contract and tort was very important. Damages for breach of contract were limited to compensatory damages equal to the expectations of the parties at the time of the execution of the contract. However, damages for tort could include punitive damages and were only available if a defendant breached a duty or standard of care owed to another.

With Seaman's Direct Buying Service, Inc. v. Standard Oil Co., 36 Cal. 3d 752, 686 P.2d 458, 206 Cal. Rptr. 354 (1984), the California Supreme Court began expanding the duties owed customers by banking institutions by extending the circumstances under which a party in a commercial relationship owed a duty to the other party in the commercial relationship. Because of these expanded duties, the banks could be liable under a tort theory where before they would only have been liable under a breach of contract theory. For example, where one party was dealing from a position of comparative bargaining power, the Court implied that the more powerful party would owe a duty of care to the weaker party. This change in the law created the possibility for tort liability, and, therefore, punitive damages and large verdicts in situations not previously contemplated.

This trend continued and was applied directly to the banking industry in Commercial Cotton Co. v. United California Bank, 163 Cal. App. 3d 511, 204 Cal. Rptr. 551 (1985), in which the California Court of Appeals held that a tort existed against the bank as a result of the breach of a fiduciary duty between a bank and its depositors created by their commercial relationship. The court, following Seaman's, found that a “fiduciary” relationship between the two existed, which raises the standard by which the conduct of the bank is judged. This decision upheld a large verdict in favor of the plaintiff. In addition to broadening the duties owed in a commercial relationship, it established the precedent for large verdicts against banking institutions. As a result, banking institutions expected to be inundated with complaints. The combination of more lenient rules and large jury awards would, they believed, encourage plaintiffs to bring suit.

By the late 1980s, another series of California court decisions reversed the trend of the previous few years, limiting the customers’ rights vis-à-vis the banking institutions. In a number of pro-lender cases, the courts severely restricted, but did not wholly eliminate, the new theories of liability that had emerged in the

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mid-1980s. In these cases, the courts held that the new theories of liability still existed. However, they also found that the bank-customer relationship was not a "fiduciary" or "quasi-fiduciary" relationship as contemplated by the California Supreme Court in Seamen's. Therefore, the relationship between a banking institution and its customers is not one that would open the door to the additional tort remedies available pursuant to Seaman's. Despite this subsequent retrenchment, the banking industry faced a window of extreme liability in the mid- to late 1980s.5

Class Actions

Consumer and shareholder class actions posed a second area of significant concern to banking firms. A class action is a form of litigation in which a group of plaintiffs with virtually identical claims against a defendant bring suit against that defendant in the name of one of the plaintiffs. Because the number of plaintiffs in these actions can reach into the millions, the possible recovery against the defendant can be quite large, even when individual claims are quite small. Plaintiffs' attorneys working on contingency find such high stakes cases very attractive, and successful actions usually spawn new complaints. Firms in the industry faced class action litigation regarding bank policies and fees during the 1980s that caused them great concern, and firms generally began to sense a growing threat from these very high-stakes cases.

Perceptions

A changing external environment, namely court decisions that expanded bank liability and a few highly visible class-action claims, caused firms in the banking industry to believe they were seriously threatened. They believed that plaintiffs were filing more suits, verdicts were getting larger, and the litigation process was getting slower and more expensive.6 A number of banks could identify clear changes in their liability. However, it is less clear whether or not they were actually documenting a growth in claims or escalating costs and losses as a result of these legal changes. It is this combination of perception, whether accurate or not, and fact that created the sense of crisis, inspired the innovation process, and drove important members of the industry to take remedial action.

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5While this discussion only references California cases, similar changes were taking place in other states.
6See, e.g., Campbell (1990); Golann (1989).
3. The Initiation Stage

Awareness of and Attitudes Toward Innovation Alternatives

In response to their perceptions of a growing liability crisis and despite subsequent retrenchment by the California courts, banking institutions sought various ways to reduce their exposure and litigation costs in the mid-1980s. Rather than experimenting with radical innovation, they turned to mechanisms with which they were already familiar and relatively comfortable. Two received particular attention: binding arbitration and mediation.

Arbitration

Arbitration is an adjudicatory process and is the ADR mechanism most like the traditional judicial process. Arbitration can take the form of either a binding procedure, most commonly where the parties have voluntarily referred their dispute to arbitration, or a nonbinding procedure, as in the case of the court-annexed mandatory arbitration system at work in the California courts. Though we will describe both forms of this mechanism, we are generally referring to the binding arbitration procedure in the context of this discussion.

In a binding arbitration proceeding, the parties choose a neutral third party to act as decisionmaker and fact finder. The arbitrator may be an individual or a panel of individuals. Typically, the arbitrator, or arbitrators, are experts in the particular substantive area at issue in the dispute. Each party presents facts, proofs, and arguments to the arbitrator supporting its position, much as in a traditional trial. However, the arbitration proceedings are typically considerably less formal than court proceedings. The arbitrator will issue an award, sometimes supported by an opinion, disposing of the dispute.

Many states have court-annexed arbitration systems whose rules, procedures, and jurisdiction are established by statute and court rules. Generally, these arbitrations are mandatory within the jurisdiction established by statute. However, where the proceeding is mandatory, the decision of the arbitrator is nonbinding to avoid any Seventh Amendment right-to-jury issues. Typically, the decision can be accepted by the parties or rejected by one of the parties. If one of the parties rejects the decision, the case then proceeds to trial. To encourage the
parties to abide by the arbitration decision, some jurisdictions impose a penalty on a party for rejecting an arbitration decision in cases where the trial decision is substantially similar to the arbitration decision.

The benefits typically cited by the proponents of arbitration are economy, informality, privacy, speed, finality, and expertise. The proponents of arbitration argue that the disputants' costs associated with arbitration are less than those associated with a traditional forum, primarily because of the reduced discovery and motion practice associated with arbitration.\(^1\) The proceedings are informal, without the strict enforcement of the rules of evidence, allowing the disputants to express their underlying concerns. The proceedings and the outcomes are usually private. Because of the first and second points, the disposition time for most arbitrations is quite short. Arbitration decisions are subject to only the most limited of appeals. Last, the decisionmaker is often knowledgeable in the substantive area of the dispute.

What are considered benefits by arbitration's proponents are also often cited by arbitration's opponents as the costs of arbitration. For example, the fact that there is only limited appeal of arbitration, while providing the finality of the decision, also limits the review of such decisions. Likewise, the privacy of the proceedings, while identified as a benefit by some, is also noted as a cost of arbitration by others because there is the danger that disputants will use the privacy of arbitration to silence cases involving potentially damaging precedents or information. As a corollary to the privacy cost, cases that would once have been part of the common law through litigation and thereby guide future behavior are lost to the system through arbitration.

**Awareness.** By the mid-1980s, firms were already quite familiar with various forms of arbitration. California had enacted a mandatory judicial arbitration program in 1979, which required all claims for less than $25,000 to be submitted to a nonbinding, court-annexed arbitration proceeding before going to trial. Almost every banking firm had some exposure to arbitration through this program. Furthermore, many firms had participated in private, binding arbitration proceedings pursuant to contracts in which they were parties. Respondents reported that their experiences with both judicial and contractual

\(^1\)It is not clear that this argument is accurate. Previous ICJ reports regarding the California court-annexed arbitration system note that there is little if any cost savings associated with the use of arbitration. However, the nonbinding court-annexed procedures examined in those studies differ considerably from the binding procedures adopted by the banks here. The nonbinding procedures seem to provide a surrogate for the settlement process, and when cases do not settle, litigants bear the costs of both arbitration and continued litigation. See, e.g., Lind, et al. (1989). The mechanisms here are a surrogate for litigation. The costs and savings associated with private ADR are one of the subjects of this inquiry and have not been previously documented.
arbitration had been generally positive and that their firms also often attempted to move disputes into arbitration through negotiation and agreement after a claim had been asserted. Thus, it can be said that banking firms had reasonably broad experience with a variety of arbitration formats prior to the moment when they began their search for an innovation in the late 1980s.

**Attitudes.** On balance, firms within the industry believed arbitration was serving their needs. Respondents reported that firm managers saw it as an effective method to keep litigation costs down. In particular, they noted that the awards in arbitration decisions were typically less than those in jury verdicts, and that arbitration awards were more consistent and predictable. Because of the reduced process involved with arbitration, i.e., limited or nonexistent discovery and motion practice and shorter times to disposition, they also noted that their attorneys’ fees were reduced. These observations and experiences did much to cement firm attitudes toward arbitration.

**Mediation**

Mediation, on the other hand, is a nonadjudicatory proceeding. It is a process in which a neutral third party assists the disputants in reaching a settlement of their conflict. Mediators are, essentially, facilitators with few or no fact-finding or decisionmaking functions bestowed upon them, and their primary role is to force the exchange of information between the parties, to identify those issues that are not in dispute and those that are in dispute, to determine realistic goals for the parties, and to produce a settlement.

Procedurally, the most important ground rules to mediation are confidentiality and the absence of binding authority in the mediator. Beyond this, there are very few procedural rules. The format is as flexible as the creativity of the disputants and the mediator. Typically, the procedure will include face-to-face meetings between the parties, as well as separate, individual meetings between the parties and the mediator. At the individual meetings, the mediator discusses the strengths and weaknesses of that party’s case. These meetings are confidential, and the mediator does not share information unless authorized to do so by the party. If a settlement is reached, the parties have an agreement that is enforceable as a contract. The result will often be a compromise between the positions held by the two parties.

The benefit of mediation is that it is a nonadjudicatory mechanism that allows for the continuance of business relations. Many of the other benefits associated with arbitration can be repeated as benefits of mediation. Mediation generally costs little, takes little time, ensures privacy, and provides expertise. Again, what to
some are benefits to others are costs. In addition, the fact that mediation is a nonadjudicatory process leading to a binding outcome only at the agreement of the parties limits its usefulness in some situations.

**Awareness.** Firms in California’s banking industry also had experience with dispute resolution through mediation or mediationlike procedures. Most had substantial experience with mandatory pretrial settlement conferences, a procedure that is analogous to mediation.\footnote{2} In addition, some firms had, on occasion, turned to private mediation after a dispute was underway as a vehicle for resolving conflicts. These experiences with mediation offered firms a basis on which to compare innovation alternatives.

It is interesting to note that the two innovations considered by California banking firms were pioneered outside the industry. Firms gained particularly broad exposure to both the arbitration and mediation formats in the context of litigation in the public courts. Without intending to, the California courts mounted a large-scale demonstration program for both forms of ADR.

**Deciding to Innovate**

**Arbitration**

The firms in our case study ultimately made the decision to incorporate binding arbitration provisions into contracts with their customers. These firms were reasonably familiar with this dispute resolution mechanism, their experiences with it had been positive, and they believed it would be responsive in limiting the threats they believed they faced: growing exposure and growing litigation costs. As we noted above, expanding court definitions of duty opened the door to increasing liability. Firms believed that these changes would be accompanied by additional growth in claims triggered by plaintiffs and a plaintiffs’ bar eager to exploit new and potentially lucrative opportunities and hopeful that, rather than risk large losses, firms would settle. Moreover, firms believed that the costs, in terms of both time and money, of defending against these claims were also growing.

Respondents report that their firms concluded that both their exposure and their transaction costs could be reduced by the adoption of arbitration provisions.

\footnotetext{2}{A mandatory settlement conference is required to be held in all civil matters in California. At the conferences, the judge sits down with both parties and their attorneys and seeks to settle the action prior to trial. Many commentators argue that it is impossible for the judge to be an effective mediator in this setting and an impartial fact-finder at the subsequent trial. However, that is the current procedure in most jurisdictions.}
First, they believed that their exposure would be both more predictable and better contained with arbitration. In their view, arbitrators generally had a better grasp of underlying contractual issues than juries and were less likely to consider factors outside those presented in the case at issue; for example, the fact that the bank is a large institution able to spread out any losses relative to the individual, who may be forced into extreme hardship. Firms also believed that arbitrators were less likely to award punitive damages. Furthermore, firms anticipated that the fact that disputes would be heard before an arbitrator would, in turn, affect plaintiffs' and plaintiffs' attorneys' calculus in deciding whether to bring suit in the first place; as possible verdicts declined, plaintiffs would be less likely to bring suit. For all these reasons, arbitration seemed to be an innovation that was particularly responsive to their perceived need to reduce their liability exposure.

Second, arbitration was typically a faster route to disposition. Although attorneys, both in-house and outside counsel, were required to manage arbitration cases, arbitration entailed less discovery, less pretrial case processing, and a shorter, more predictable adjudicatory hearing. Both the staffing and processing costs associated with arbitration were, therefore, less than those associated with a trial of comparable size.\(^3\)

**Mediation**

Mediation was not adopted by the institutions in the banking industry as an innovation to the dispute resolution process. While the institutions contacted did not comment on the reason for this, two factors can be speculatively identified. First, as mentioned above, mediation is not an adjudicatory forum. The institutions did not feel comfortable in entrusting a whole class of disputes to a mechanism entirely different from the traditional mechanism. Second, mediation requires, as does any settlement procedure, that both parties enter into the negotiations in the good faith interest of settling. If both parties do not bring this state of mind with them, any settlement negotiation will be a waste of time. It is very difficult to ensure that parties will be interested in settling a dispute after the dispute arises, let alone at the time of the formation of the commercial

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\(^3\)Another commentator has summed up the decisionmaking factors as follows (Brown, 1981):

1. characteristics of the innovation such as its profitability or cost savings and its required investment,
2. characteristics of the industry such as its competitiveness and previous technological investment,
3. institutional effects such as societal concerns and political actions, and
4. characteristics of the firm such as its size, aggressiveness and innovativeness of management, and the level of information about the innovation.

Much of what has been discussed up to this point can also be analyzed using this structure.
relationship. Therefore, a mediation provision could be prejudiced by the parties’ subsequent contentious relationship, ultimately forcing the dispute into litigation.⁴

**Potential Barriers to Arbitration**

In considering the diffusion of an innovation, it is important to understand the obstacles to innovation, as well as those forces that support innovation. From all accounts, there was some resistance to the adoption of arbitration provisions in the firms represented in our study.

The main internal obstacle was simply lack of momentum. It was necessary to overcome a fair amount of inertia within the institutions among executives and in-house counsel and outside counsel to implement the innovation. However, none felt sufficiently threatened to rise in opposition. In addition, representatives from both business and the in-house counsel or staff of the firm typically joined to support the innovation. Firms also report that they did not encounter any resistance from customers with whom they were negotiating contracts that included new arbitration provisions.⁵ Therefore, the firms were able to implement the arbitration innovation despite a long history of experience with the traditional litigation system.

However, certain aspects of California law did present a rather significant barrier to the broad diffusion of arbitration across the entire range of business of the banking firms. California’s one-action rule and other provisions of the state’s anti-deficiency statutes provide protections to borrowers using real property security to collateralize their loans.⁶ These provisions may jeopardize the ability of real-property-secured lenders to pursue their remedies against the security

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⁴An additional option now being explored by some institutions is a mediation/arbitration provision that provides for arbitration only in the event of the failure of an initial mediation.

⁵The plaintiffs’ bar notes that the customers did not object to the addition of such provisions because of an extreme inequality of bargaining power; borrowers and customers are simply in no position to be dictating terms. An additional fact that there was no resistance to the addition of these clauses was ignorance, not acquiescence. Resistance was felt from some consumers and consumer groups objecting to these clauses on constitutional grounds. See, e.g., Badie, et al. v. Bank of America.

⁶Pursuant to the provisions of the one-action rule, a security holder with a security interest in real property must attempt to satisfy the debt against the real property before trying to get a personal judgment against the debtor in a lawsuit. If the creditor attempts to bring an “action” as defined under California law without first doing so it will lose its real property security interest. See Cal. Civ. Proc. Code § 726. The concern was, and still is, whether an arbitration was an “action.” If so, the institution could lose its real property security interest by going to arbitration before first foreclosing on its real property interests.

At least one bank avoided this issue by requiring that in any case in which a real property security interest was involved, the action would be commenced in the public court system, but the parties would request that the court refer the case to arbitration pursuant to the provisions of California Code of Civil Procedure § 639.
after first seeking redress through ADR forums. A large amount of the banking lending portfolio is secured by real-property. Because of this and the uncertainty concerning the application of these California statutes to arbitration decisions, some lenders were reluctant to pursue the arbitration innovation wholeheartedly. For example, in at least one case, a lender who strongly supported the innovation refrained from applying the provision to contracts that applied to real property.
4. Implementing Arbitration in the Banking Services Industry

As described by Zaltman, Duncan, and Holbek (1973), innovations are implemented in two substages: (1) the initial implementation substage, in which the innovation is introduced into the organization, and (2) the second implementation substage, in which use of the innovation expands through the firm. This model accurately describes the introduction of private binding arbitration in the banking industry. At the outset, only a few firms introduced arbitration and only into some areas of their business. Over time, these firms have expanded the use of arbitration into other areas of their business, while other firms, after seeing the successful introduction of the procedure, are now following their lead.

Initial Implementation

As a first step in the innovation process, firms must take the new concept and craft it to match their needs and institutions. The banking firms that chose to turn to arbitration, then, had to decide just what form of arbitration they would introduce and in what business situations they would introduce it. Despite differing decisionmaking organizations among the banks, there was considerable agreement among the firms regarding early implementation decisions.

The Innovation

In drafting arbitration provisions, the institutions have many choices to make regarding the arbitration procedure to be adopted. Almost uniformly, the institutions chose to adopt the American Arbitration Association (AAA) Rules and procedures as the arbitration procedure in their general arbitration clause or agreement. Interestingly, the general arbitration clauses adopted by the institutions were quite similar.

Briefly, arbitration provisions provide for the administration of the arbitration; the number, qualifications, selection, powers, and fees of the arbitrator or arbitrators; the scope of the arbitration clause; the location of the arbitration; the use of discovery; the filing of briefs; and many other procedurally important factors. All of these choices can have a potentially powerful impact on the
arbitration. Each must be established by the terms of the arbitration agreement or clause.

However, instead of explicitly describing these aspects of a detailed arbitration arrangement, each of the respondent institutions has simply incorporated one or another of certain established sets of rules into their arbitration clauses; for example, AAA's Commercial Arbitration Rules. The AAA Commercial Arbitration Rules establish all of the procedures for the arbitration and provide that AAA may supply arbitrators and facilities. The benefit of adopting the AAA Rules is that they have withstood the tests of both time and scrutiny. They are conceded to be enforceable. Institutions are also typically familiar with the AAA, its rules, and its arbitrators because of previous arbitrations. Similarly, other firms have adopted the rules and procedures of Judicial Arbitration and Mediation Services, Inc. Some institutions have also incorporated a judicial reference provision into their documents, which requires that, should any civil action be filed concerning the document, the dispute must be referred to a private judge or other ADR mechanism under California Code of Civil Procedure § 638.

The institutions may alter the AAA rules in any fashion they desire, and they have taken some advantage of this option. In particular, they have specified that any dispute in which real property security is at issue will not be subject to arbitration directly, but rather to judicial reference under the auspices of the AAA. This mechanism allows the firms to avoid the effects of the California one-action and anti-deficiency judgment rules.

**Its Application**

The firms we interviewed initially implemented arbitration provisions in the litigation areas of the greatest litigation cost concern. In essence, firms with centralized decisionmaking categorized their disputes according to subject matter, asking which category of litigation was most likely to benefit from a contractual dispute resolution provision, and introduced contractual provisions in these areas. Their assessments are likely to have been qualitative or intuitive rather than the product of a systematic cost-benefit analysis. After gaining some experience with the procedure, they assessed the value of extending it to other categories.

Firms with decentralized decisionmaking came to similar implementation decisions, but in a slightly different manner. For example, one firm was organized so that each area of banking stood as an independent division. In this firm, all decisions, including the decision to implement an innovation, were
made at the division level. Therefore, each division independently made the decision whether or not to adopt arbitration clauses based on a determination of the costs and benefits of such a decision for the unit. Interestingly, the divisions that decided to incorporate such clauses were responsible for substantially the same types of business to which arbitration was applied in firms with centralized decisionmaking.

Regardless of the approach taken, each firm first applied the arbitration provisions to those areas of liability where greatest concern for litigation costs existed, the possible advantages of ADR were most obvious, and the least potential downside was anticipated. For example, in one organization, the litigation area of greatest concern was lender liability litigation. The initial implementation of the innovation for this organization was in the documents that were leading to this lender liability caseload. Other areas of litigation that were nonetheless of considerable concern for the institution were not involved in the initial implementation of the innovation. It was only after the institution had some successful experience with the arbitration provision innovation that it expanded the use of such provisions into other areas of concern.\footnote{This process of expansion is continuing. Each institution noted an expectation that the use of arbitration would be broadened into other areas of the firms' businesses.}

**Perceived Consequences**

In the context of the initial implementation phase, it is enough to note that the innovators must be satisfied that the innovation is performing up to a certain level to move beyond the initial implementation substage to sustained implementation. This satisfaction may be based simply on perceptions and not necessarily on empirical analysis.

In the present case, our respondents noted that, after the initial implementation substage, they were impressed that the innovation did have the anticipated effect of controlling liability exposure and transaction costs. This conclusion was based on the perceptions of those within the institution and not on an analysis of the actual exposure and cost data. The institutions then expanded the use of the innovation into other areas of litigation exposure.
Sustained Implementation

Typically, the distinction between initial and sustained implementation is rather subtle. As noted by Zaltman, Duncan, and Holbek (1973), many different sequences have been put forward as representing the “implementation” stage. In the case of the organizations within the banking industry, as noted above, there appears remarkable consistency in the approaches taken in the implementation of the ADR innovation. Each of the firms we have examined has applied to particular types of liability—those that appeared to cause the greatest immediate concern to the firm. After an initial successful experience with ADR, the institutions have expanded its application to other areas of exposure that are a source of considerable litigation cost. This suggests the transition to sustained implementation.

It is not apparent how many institutions have passed into the sustained implementation substage with regard to the arbitration innovation. It is clear, however, that at least some of the major institutions have made this transition. Phone interviews indicate that the arbitration innovation is now diffusing through the industry as more firms undertake initial implementation.
5. The Effects of Introducing Private Arbitration

The banking institutions we surveyed believe that private arbitration has served them well. They also believe that arbitration has led to a decrease in their litigation levels and have noted a corresponding decrease in aggregate litigation costs over that period. Their impressions, however, are based largely on intuition and anecdotal evidence. Unfortunately, only one of the firms has kept data that permit ready tracking of changes in the costs of litigation, in staffing levels, and in the number of complaints filed against them over the past several years. We use this one example to develop some empirical insights into the actual effects of arbitration on outcomes of interest to these firms.¹

The Caseload

The typical caseload of this institution is large and diverse, including virtually every form of possible litigation to which a banking institution may be party. The nature of its caseload allowed the institution considerable latitude in choosing the most beneficial areas in which to innovate. In any given year studied, the institution had litigation in the following areas: real property, personal injury, loans, negotiable instruments, breach of written agreement, personal property, operational disputes, trust, interpleader, escrow, letter of credit, collection action, personnel disputes, credit, credit card litigation, securities violation, class action, breach of privacy, antitrust, breach of warranty by dealer, IRS enforcement of summons, accounting, tax disputes, low-exposure cases, theft, and defamation. Among these many areas of litigation, the institution chose to innovate in the area where arbitration promised the greatest reductions in transaction costs and liability exposure: loans.

Outcomes of Interest

As businesses, banks are most concerned with certain attributes of their caseloads: those aspects related to the cost of these cases to the bank. The costs

¹Because we assured confidentiality to participants in our survey, we cannot identify the institution. It is, however, a major state financial institution that accounts for a substantial market share and that has a caseload in excess of 500 cases per year.
associated with a caseload can be divided into two different outcomes of interest: (1) the value, or potential liability, associated with those cases; and (2) the transaction costs associated with resolving these disputes. The first outcome concerns the actual liability of the bank, aside from the transaction costs of resolving any disputes. The second refers to the processing costs that the bank incurs. A third characteristic of a caseload that is of interest is the volume of cases that are filed against the bank. This characteristic does not directly affect the costs of the caseload to the bank but is suggestive of both liability and transaction costs.

These outcomes are, unfortunately, not necessarily directly measurable, and even where measurable, the information is not always recorded. Instead, we are often forced to use surrogate measures to estimate any changes in these characteristics. Such is the situation in the present case. In the remaining subsections, we identify surrogate measures for the outcomes of interest and describe how these measures have changed during the period following ADR implementation.

**Measuring Effects**

Given the limitations of the available data, it is difficult to know how best to measure the effects of introducing mandatory private arbitration on liability losses and transaction costs over time. Indicators of these outcomes are highly variable and change over time, independent of any firm actions. They will be affected by, among other factors, economic conditions and substantive legal changes. Measures, such as the costs of litigating each claim, will be affected by the complexity of the cases, as well as by these external factors. Therefore, any predictions based on these indicators of what the firm’s exposure and costs would have been in the absence of innovation and what it has saved by innovating are somewhat speculative. Nonetheless, these measures offer the best evidence available regarding the effects of arbitration on outcomes of concern.

The first measures we analyzed are indicators of the volume of the caseload against the bank. While not one of the outcomes of interest, as we noted, caseload volume is nonetheless an important characteristic. First, the number of new cases filed against the firm is a direct measure of the volume of the caseload against the bank. A change in the number of new cases filed against the bank clearly shows a change in the volume of the caseload against the bank. Second, the number of cases disposed of by the bank each year reflects the number of cases that the bank is able to resolve through whatever mechanism.
Other surrogate indicators can be used to measure changes in the first outcome of interest—the value, or potential liability, of the bank’s caseload. These indicators include the value of new cases, the expected liability of new cases against the firm, and the funds paid for verdicts and settlements in the actions disposed by the bank each year. These measures give some idea of the liability, both actual and potential, to which the firm is subject. The value of cases is the amount claimed against the institution by the plaintiffs. The expected liability of new cases is the value placed on the claim by the institution’s counsel. The expected liability of new cases is the better of these two measures of liability, since the values of claims are often grossly inflated by plaintiffs. This measure provides an indication of the potential liability of the caseload against the bank. The funds paid for verdicts and settlements in the actions disposed of by the bank provides a measure of the actual liability of the bank in each year—for banks the bottom line.

The second outcome of interest, the bank’s transaction costs for its caseload, includes the attorneys’ fees and the processing costs required to resolve these disputes. The only surrogate measure that we were able to obtain regarding this outcome is the bank’s in-house counsel staffing levels.

The data we obtained describe the cooperating bank’s caseload and staffing for the years 1984 through 1990, the years spanning the introduction of the arbitration provision to the bank’s documentation in late 1986 and early 1987. For each caseload measure and for each year, we made two comparisons of the given data. First, we compared the arbitrable caseload, all loan-related disputes, with the total caseload for each year. Second, we made a similar comparison of changes from one year to the next, for both the arbitrable caseload and the total caseload, using the initial 1984 levels as a baseline for each measure, and presenting statistics for each year as a percentage of 1984 levels. A comparison between the bank’s total and arbitrable caseloads regarding all of these measures through the implementation period suggests whether or not the introduction of contractual arbitration provisions had the anticipated effect on the value of the bank’s caseload.

**Number of New Cases Filed**

The number of new cases filed provides a measure of the bank’s caseload volume. If arbitration provisions are deterring plaintiffs from filing cases, this measure should decline through the period studied. The data indicate that the amount of new arbitrable litigation decreased markedly after the introduction of the
requirements in 1988\(^2\) (see Table 1 and Figure 1). In 1986, arbitrable claims accounted for approximately 12 percent of the new claims against the institution. The number of such new matters filed in subsequent years declined steadily until they accounted for only 3 percent of the new cases filed against the institution. This is especially significant, because the overall number of cases was also declining, although at a lesser rate than within the arbitrable area litigation. Particularly dramatic declines occurred in 1988 and 1990, which in part should be attributed to the substantive changes in lender liability laws previously discussed. However, the overall decline, especially that seen in 1986 and 1987, is probably largely related to the introduction of the arbitration provision.

The declining caseload is also reflected in the percentage change from the previous year in the number of arbitrable cases and total cases. We examined this by comparing the size of the caseloads each year to the 1984 caseload levels.\(^3\) The number of total cases initially increased to 110 percent of the 1984 level and subsequently decreased or remained constant each following year through 1990. Likewise, the number of arbitrable cases initially increased to 108 percent of the 1984 level and subsequently decreased in each of the following years of the study, always decreasing at a greater rate than the total number of cases. Eventually, the levels reached were 17 percent and 73 percent of the 1984 levels of arbitrable and total cases, respectively. Therefore, the percentage of the total caseload represented by arbitrable claims decreased over the period studied from 12 percent to 3 percent.

**Number of Cases Disposed of**

The number of cases disposed of is a second measure of the volume of the caseload against the bank. If the adoption of contractual arbitration provisions is accomplishing what is expected of it, we should observe a decrease in the number of arbitrable claims disposed of during a year because fewer claims would be initially made against the bank.

Table 1 and Figure 2 document such a trend. The number of arbitrable claims disposed of decreased from about 14 percent of the total claims disposed of in

\(^2\)The timing for this decrease indicates that it was more likely a result of the introduction of the arbitration than the change in the lender liability law. The post-institution swing in lender liability laws did not take place until 1988 and 1989. The marked decrease in litigation in the areas in which the institution innovated occurred in 1986 and 1987. 1988 and 1989 show additional reductions, which could be attributed to both the continued affect of the innovation and the change in the substantive area of the law.

\(^3\)One concern with using 1984 as a benchmark year is that we do not know if 1984 was exceptional, either in terms of its litigiousness or its passiveness. Therefore, any comparison with this year cannot reflect any absolute conclusions.
Table 1
Changes in Caseload

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<tbody>
<tr>
<td>Number of new cases filed</td>
<td></td>
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<tr>
<td>Number of arbitrable cases as a percentage of total cases by year</td>
<td>12</td>
<td>11</td>
<td>10</td>
<td>9</td>
<td>5</td>
<td>5</td>
<td>3</td>
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<tr>
<td>Number of arbitrable cases each year as a percentage of 1984 arbitrable cases</td>
<td>100</td>
<td>108</td>
<td>92</td>
<td>66</td>
<td>36</td>
<td>30</td>
<td>17</td>
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<tr>
<td>Number of total cases each year as a percentage of 1984 total cases</td>
<td>100</td>
<td>110</td>
<td>110</td>
<td>89</td>
<td>82</td>
<td>71</td>
<td>73</td>
</tr>
<tr>
<td>Number of cases disposed of</td>
<td></td>
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<tr>
<td>Number of arbitrable cases disposed of as a percentage of total cases by year</td>
<td>14</td>
<td>13</td>
<td>11</td>
<td>11</td>
<td>12</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Number of arbitrable cases disposed of each year as a percentage of 1984 arbitrable cases</td>
<td>100</td>
<td>129</td>
<td>117</td>
<td>97</td>
<td>114</td>
<td>51</td>
<td>54</td>
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<tr>
<td>Number of total cases disposed of each year as a percentage of 1984 total cases</td>
<td>100</td>
<td>139</td>
<td>147</td>
<td>129</td>
<td>140</td>
<td>118</td>
<td>128</td>
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<tr>
<td>Expected liability of new cases</td>
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<td>Expected liability of arbitrable cases as a percentage of total cases by year</td>
<td>28</td>
<td>43</td>
<td>42</td>
<td>15</td>
<td>3</td>
<td>44</td>
<td>0a</td>
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<td>Expected liability of arbitrable cases each year as a percentage of 1984 arbitrable cases</td>
<td>100</td>
<td>142</td>
<td>144</td>
<td>38</td>
<td>13</td>
<td>37</td>
<td>0a</td>
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<tr>
<td>Expected liability of total cases each year as a percentage of 1984 total cases</td>
<td>100</td>
<td>94</td>
<td>97</td>
<td>70</td>
<td>112</td>
<td>24</td>
<td>127</td>
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<tr>
<td>Funds paid for verdicts and settlements</td>
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<td></td>
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<tr>
<td>Funds used for verdicts and settlements of arbitrable cases as a percentage of total cases by year</td>
<td>14</td>
<td>62</td>
<td>35</td>
<td>12</td>
<td>6</td>
<td>14</td>
<td>39</td>
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<td>Funds used for verdicts and settlements of arbitrable cases each year as a percentage of 1984 arbitrable cases</td>
<td>100</td>
<td>1356</td>
<td>481</td>
<td>108</td>
<td>345</td>
<td>131</td>
<td>407</td>
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<tr>
<td>Funds used for verdicts and settlements of total cases each year as a percentage of 1984 total cases</td>
<td>100</td>
<td>293</td>
<td>185</td>
<td>123</td>
<td>820</td>
<td>126</td>
<td>142</td>
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</tbody>
</table>

*aThis figure reads 0 percent in Table 1 and on Figure 3 because of rounding error.
Figure 1—Number of New Cases Filed—Percentage Arbitrable Each Year and Percentage of 1984 Levels

Figure 2—Number of Cases Disposed of—Percentage Arbitrable Each Year and Percentage of 1984 Levels
1985 to approximately 6 percent of the total claims disposed of in 1990. In addition, the number of arbitrable cases disposed of each year decreased during the period to 54 percent of the 1984 level. The number of total cases disposed of each year increased from the 1984 level, but stayed relatively constant through the period. This reaffirms the conclusion that the number of claims in arbitrable areas of liability declined after arbitration was introduced.

**Expected Liability of New Cases**

*Expected liability of new cases* filed against the bank provides a measure of the value of the caseload facing the bank. Again, if arbitration provisions were having the anticipated effect, the expected liability of arbitrable cases should decline, and between 1987 and 1990, arbitrable cases did account for a substantially diminishing share of the firm's expected liability. As previously noted, the total possible liability to which the institution may be subject can be severely affected by any unusually large claim and can be especially misleading if that claim is completely or largely unfounded. For example, in 1989, three large lender liability claims were filed against the firm in question, and these claims accounted for 91 percent of the total value of new claims made that year.\(^4\) However, the institution correctly expected that the liability resulting from these actions would be considerably less than the amount claimed. Therefore, a more appropriate measure for "liability" is the expected liability that the institution anticipates from the claim.

Table 1 and Figure 3 illustrate changes in the expected liability arising from new claims made between 1985 to 1990. New claim liability exposure declined during this period from 43 percent of the institution's expected exposure in 1985 to 0.1 percent of the institution's expected exposure in 1990. These data show an initial increase in expected liability in 1985 and into 1986, followed by a decline over the next years until 1990, with an aberration in 1989.\(^5\) This decline reflects the change in the substantive law in 1986, followed by the effects of the addition of arbitration provisions, and the subsequent retrenchments by the California Appellate and Supreme Courts.

A similar analysis follows from the somewhat more erratic data reflecting the percentage of 1984 levels of expected liability for each year. The total expected

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\(^4\) These data are not shown in the data presented in the chart or graphs.

\(^5\) This aberrant year resulted from the fact that the expected liability of the firm's caseload outside of arbitrable areas dropped a dramatic 88 percent from the year before. Therefore, though the expected liability of arbitrable new claims did increase somewhat this year, it is not nearly so remarkable as at first appears.
liability and arbitrable expected liability each year as a percentage of 1984 levels varied greatly over the period, and so a detailed description is not meaningful. However, it can be noted that, while total expected liability of new cases filed increased during the period, expected liability from arbitrable cases actually decreased. The expected liability from arbitrable cases declined each year except 1989. Therefore, while we do not want to overstate the conclusion, it appears that expected liability from new arbitrable cases declined markedly during the period.

**Funds Paid for Verdicts and Settlements**

However, in contrast to the expected liability measure of caseload value, the dollar amounts used for the disposition of arbitrable cases as a percentage of total cases have actually risen through the period. This measure increased from 14 percent in 1984 to 62 percent in 1985 before declining somewhat. However, in 1990 the level was 39 percent, still higher than the 1984 level. In fact, the dollar amounts used for the disposition of both arbitrable cases and total cases have
risen (see Table 1 and Figure 4). In every year, this measure was higher than the 1984 levels for both.

This measure must be considered carefully. The data reflect cases disposed each year. These cases consist of a large number of cases started at various times prior to, and including, the year of disposition. It is probable that a number of these cases were actually begun before the introduction of arbitration clauses and were not subject to arbitration. In fact, a case that is pending for a length of time is likely (1) to be more complex and difficult; (2) to subject the bank to a relatively large verdict or settlement; and (3) not to be subject to arbitration. Therefore, even though this amount is the bottom line for the bank, it is not a precise measure of the effect of the introduction of arbitration cases on liability.

**In-House Counsel Staffing Levels**

The documented decrease in claims and liability exposure might well be expected to significantly affect the firm's need for legal staff. Although no

![Graph](image)

Figure 4—Funds Paid for Verdicts and Settlements—Percentage Arbitrable Each Year and Percentage of 1984 Levels
institution provided us with a breakdown of its outside counsel fees, the firm with case-level data did provide its in-house counsel staffing figures for the period 1987 to 1990. These figures show that in-house staffing levels decreased by 65 percent over those 4 years, substantially reducing the firm’s internal litigation costs. However, the importance of these figures should not be overstated. This was a time of overall bank down-sizing, with banks cutting intern staff and shifting their functions to external sources, and these figures are also consistent with such efforts.

Qualitative Assessments of the Arbitration Innovation

Although only one firm was able to supply us with data, all the firms interviewed had concluded that private binding arbitration was more cost-effective for the institutions than the public judicial system. Firms that had adopted private arbitration provisions described themselves as facing fewer cases, losing smaller verdicts, and paying smaller litigation costs as a result of adopting the innovation.

The lender liability plaintiffs’ bar confirms some of the institutions’ conclusions regarding the effects of the use of arbitration. The plaintiffs’ bar argues that arbitration is not an attractive forum for plaintiffs. They believe arbitrators typically favor the banking institutions and perceive less opportunity for a substantial recovery in arbitration. They, therefore, bring cases less often, leading to lower litigation rates and lower recoveries. To buttress their point, they note that it was the appearance of arbitration provisions, not the substantive change in the lender liability laws, that accounted for the rather dramatic decrease in lender liability litigation in the late 1980s. Thus, the plaintiffs’ bar supports many of the banks’ assertions regarding the effects of the use of arbitration provisions.

Overall Assessments of the Measuring Effects

The data generally confirm that the adoption of private arbitration provisions has reduced liability and transaction costs. First, caseload volume facing the institution has declined. Second, by one measure of caseload value, the value of the caseload has declined, although by another measure, the value has not changed. Last, the plaintiffs’ bar confirms the conclusions reached from the data.

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6In addition, the plaintiffs’ bar feels that the forced removal of cases from the public trial court system insulates the institutions from much of the impact of their actions, including punitive damages when appropriate, negative press, and future precedent.
that the introduction of contractual arbitration provisions has led to a decrease in litigation levels and costs. While not conclusive, the existing data do bear out these firms’ perceptions that their liability exposure decreased during the period after the implementation of binding private arbitration.
6. Conclusions Suggested by the Case Study of the Banking Industry

Summary

This case study describes the introduction of private, binding arbitration into the banking industry and examines some of the effects of this innovation on one banking firm. The industry became aware of rising litigation costs and perceived a liability crisis in certain particular areas of litigation. In response to the perceived crisis, a few prominent firms in the industry turned to a new mechanism to address their perceived problem. They turned to a mechanism they knew and with which they had some positive experience, private, binding arbitration. These firms targeted a few high-exposure areas of their business to test the innovation. As it performed successfully, they expanded the application of arbitration to new areas of business. Subsequently, other firms have been persuaded of the innovation's value and have begun incorporating it into their contracts. Thus, the diffusion process is under way.

It is difficult to quantify the effects of the introduction of arbitration on the liability exposure and litigation costs of the firms. However, data from one institution that made its records available to us support the conclusion that the use of contractual arbitration clauses has been responsible for reductions in both of these areas. That firm experienced a decline in the number of cases filed and a decrease in liability exposure in the litigation areas affected. While few institutions have kept such data, all institutions we interviewed perceive similar benefits.

Observations

The public-sector judicial arbitration program appears to have served as a successful demonstration program for the private sector. Despite its reputation for being one of the most conservative industries in business, California's banks have become outspoken innovators and some of the principal users of private ADR. But these firms did not turn to private ADR without substantial prior experience with the innovation. Perhaps their greatest exposure to alternatives came through the California courts, which had, by the mid-1980s, a well-established mandatory judicial arbitration program for all claims of less than $25,000 and mandatory settlement conferences in many jurisdictions. Certainly,
without this exposure, it would have been much more difficult for those in favor of innovation to convince their firms that the introduction of private ADR mechanisms would be beneficial.

**Firms in California's banking industry chose and implemented private arbitration mechanisms appropriately given their goals.** The lead firms chose an ADR mechanism—binding arbitration—that addressed their goals of reducing liability exposure and litigation costs. Binding arbitration limits exposure by limiting the risk of punitive damages and eliminating the unpredictability of juries, thereby reducing the incentives for plaintiffs' attorneys to take cases, and perhaps producing a more uniform and predictable set of outcomes.¹ Because it is generally simpler and shorter and precludes a return to the courtroom, arbitration could also be expected to reduce litigation costs. Firms applied the new procedures in a limited, experimental fashion at the outset, expanding the use of the procedures as they gained experience. Firms appeared to be very judicious in the application of arbitration to their various areas of litigation. Because the lead firms were careful during initial implementation, the innovation has been successful and diffusion is now under way.

**Although successful from the perspective of industry, the use of contractual binding arbitration may raise some serious public policy questions.** This analysis has proceeded from the perspective of the firms in the banking industry. What were their concerns? How did they attempt to solve them? Were they successful? However, the introduction of contractual, binding arbitration may raise some important issues, as we noted, for plaintiffs and for the public. Punitive damages and large verdicts serve both to punish an individual or entity for egregious behavior and to deter others from behaving in a similar fashion. To the degree that ADR eliminates these sanctions, justice and deterrence may not be well served.

Furthermore, cases that are resolved outside the traditional court system cannot be used to test current judicial interpretation. Courts not only resolve disputes but also establish, reinforce, and revise standards of conduct through their written opinions. No private ADR mechanism can serve this function. And if whole categories of cases are removed from public scrutiny, how appropriate changes in the common law and in statutory interpretation might be accomplished becomes a serious question.

¹Although this is the conventional wisdom, there is no conclusive empirical evidence that supports this perception.
The Future of Arbitration and ADR in the Banking Industry

The future appears quite bright for the use of private ADR in the banking industry. Firms describe their experience with private ADR as successful and indicate they intend to expand its use into new areas of business. Recent moves by the Bank of America and Wells Fargo Bank, two of California’s largest banks, regarding the use of private ADR provisions illustrate their enthusiasm. Bank of America extended arbitration to cover disputes arising in its mammoth credit card business. Any dispute regarding the use of Bank of America credit cards, such as false charges, must be submitted to arbitration on the request of either party, and the bank is likely to make such a request. Wells Fargo Bank recently amended its bank account agreement, requiring that any dispute regarding an account be submitted to mediation and, in the event of the failure of mediation to resolve the dispute, to binding arbitration. This provision affects any number of causes of action that previously may have been brought in the courts. According to our respondents, these changes reflect a broader industrial trend.

The trend to expand the use of private arbitration is likely to accelerate in the wake of the recent Supreme Court ruling in *Moncharsh v. Helly & Blase*, 3 Cal. 4th 1, 10 Cal. Rptr. 183, 832 P.2d 899 (1992). Prior to this decision, a “binding” arbitration decision could be reviewed by a trial court for a variety of errors. For example, the decision could be overturned where the arbitrator committed a clear error of fact or law that caused substantial injustice to a party. Although this power was rarely exercised, in *Moncharsh*, the Supreme Court held that a trial court should limit review of an arbitrator’s decision only to a range of errors defined by statute. Thus, an arbitration decision becomes relatively more final. As the arbitration decision becomes more secure, it should become more attractive to banking institutions.3

However, it should be repeated that certain types of litigation are not appropriate targets for the introduction of ADR mechanisms. For example, all institutions indicated a reluctance to include such provisions where real property security is involved, because of California’s anti-deficiency legislation, in particular the one-action rule. In another domain, banks cannot create an ADR provision to cover, for example, slip-and-fall tort cases, because there is no contract between the firm and the plaintiff. Outside of these few areas where contractual private ADR

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2 Center for Public Resources (1992).
3 This article concerns bank behavior prior to 1992. Current litigation pending in San Francisco regarding the adoption of arbitration provisions, *Badie v. Bank of America*, has temporarily halted the diffusion process as banks await the trial’s outcome. At that time, we expect the diffusion process to continue consistent with this outcome.
provisions cannot be negotiated or imposed either for legal or practical reasons, banking institutions appear to be contemplating their use.

In sum, all the evidence suggests that the banking industry is satisfied with private ADR mechanisms, that these mechanisms are serving the industry well, and that the industry will continue to expand their use. Moreover, it is likely that successful implementation of these ADR mechanisms in this industry will facilitate similar innovation in other industries. However, we should remember that this case study deals largely with the perceptions banks have of the effects of ADR. Our ability to determine the effects of private ADR unambiguously will require substantial additional information.
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Mass Torts


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Wrongful Termination


Compensation Systems

Design


**Performance**


