AMERICAN COLLEGE OF REAL ESTATE LAWYERS

2012 MID-YEAR MEETING

THE ARBITRATION OF REAL ESTATE DISPUTES

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ATTACHMENTS

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1. GENERAL

Arbitration is a private adjudicatory process and an alternative to litigation. It is commonly referred to as an alternative mechanism to resolving disputes based on the existence of an agreement to resolve specific issues. Today, almost every state has enacted, in one form or another, a version of the Uniform Arbitration Act. In addition, it is recognized as a viable alternative to litigation under the Federal Arbitration Act (Title 9 U.S. Code, Sections 1-14.)

The necessary ingredients for a successful participation in the arbitration process follow:

A. The practitioner must be knowledgeable about the evidentiary elements that support the client's interest, as well as those elements of the arbitral process which differ from the litigation process.

B. The neutral selected must not only be experienced and knowledgeable in real estate matters, but also the legal pronouncements and equitable theories that will provide the boundaries within which the dispute will be resolved.

C. Most importantly, the arbitration process can be streamlined and customized to fit the particular issues in the real estate dispute. This is accomplished by the practitioner supplying input to the neutral at the commencement of the arbitration process.

D. To provide an understanding to the arbitrator of the fundamental facts and issues which create the relationship between the parties.

E. To provide an understanding to the arbitrator of the factual scenario that resulted in or caused the dispute between the parties.

The most significant advantage of this private adjudicatory process is that the parties select the decision-maker (i.e., the arbitrator or panel of arbitrators), as well as the procedural rules that will be followed in the preparation and presentation of the material. The rules existing regarding the civil court system preclude this option. This flexibility and customization makes the process responsive to the parties' needs and goals. Rules relative to discovery, cross-examination, presentation of exhibits and testimony, and time allocations are agreed on by the participants. Common sense controls the costs and increases the efficiency of case preparation and presentation.

An arbitration can be held before a single neutral or a panel of three. The panel can be comprised of neutrals selected from listings offered by a private provider or each party may name one panelist of their choosing and either the named panelists will select the third neutral or counsel will select the final panelist from the provider's listing. When dealing with party-appointed neutrals, it is important, as soon as the complete panel is formulated, to clarify the role of the party-appointed neutrals. If they are to be an advocate for the party who named them to serve, it becomes an impossible situation. If they are to be truly "neutral" and not have communication with the appointing party, the panel can function. The third panelist should be well versed in the ADR process and should be named panel chairman to control the proceeding.

Party-named panelists who are disciplined in the particular subject matter of the dispute can provide positive input to the panel discussions. As the evidence is being presented in a complex construction panel arbitration dealing with sophisticated equipment or a specific use facility, the fact that one or two of the panel members are well versed in the particular area can be an advantage, particularly when inquiring of a party's expert in the course of the hearing.

If the parties want to adopt mediation as a first step in the contractual dispute settlement procedure, they can insert the following mediation clause into their contract in conjunction with a standard arbitration provision:

> If a dispute arises out of or relates to this contract, or the breach thereof, and if the dispute cannot be settled through negotiation, the parties agree first to try in good faith to settle the dispute by mediation administered by the American Arbitration Association under its Real Estate Industry Rules.

If the agreement does not provide for mediation but the parties want to use a mediator to resolve an existing dispute, they can enter into the following submission:

> The parties hereby submit the following dispute to mediation administered by the American Arbitration Association under its Real Estate Industry Arbitration Rules. (The clause may also provide for the qualifications of the mediator(s), method of payment, locale of meetings, and any other item of concern to the parties.)

When an agreement to arbitrate is included in a real estate contract, lease, mortgage or construction contract, it might expedite peaceful settlement without the necessity of going to arbitration at all. Thus, an arbitration clause is a form of insurance against loss of good will. The parties can provide for arbitration of future disputes by inserting the following clause into their contracts:

> Any controversy or claim arising out of or relating to this contract, or the breach thereof, shall be settled by arbitration administered by the American Arbitration Association under its Real Estate Industry Arbitration Rules and judgment on the award rendered by the arbitrator(s) may be entered in any court having jurisdiction thereof.

If the agreement does not provide for arbitration and the parties wish to do so, they may use the submission process, which is accomplished by use of the following:

> We, the undersigned parties, hereby agree to submit to arbitration administered by the American Arbitration Association under its Real Estate Industry Arbitration Rules (or other appropriate rules) the following controversy: (cite briefly). We further agree that the above controversy be submitted to (one) (three) arbitrator(s). We further agree that we will faithfully observe this agreement and the

rules, that we will abide by and perform any award rendered by the arbitrator(s), and that a judgment of the court having jurisdiction may be entered on the award.

2. REAL ESTATE CONTRACT AND LEASE DISPUTES

The American Arbitration Association ("AAA")[1] has established the Real Estate Industry Arbitration Rules ("AAA Real Estate Rules") to deal with disputes which usually arise under real estate contracts and leases. For example, setting rental increases for renewal periods, enforcing a rent escalation clause, common area maintenance disputes, repair deductions from security deposits, effective exercise of renewal of lease, commencement dates for rental payments are some common problems which can be resolved under these rules.

The AAA Real Estate Rules have been prepared in response to an express need for an efficient voluntary arbitration procedure designed for the unique problems involved in real estate. These rules are sponsored by the AAA and its National Real Estate Industry Dispute Resolution Council. Issues to be arbitrated under the terms of legal agreements regarding real estate or by subsequent mutual agreement of the parties include, but are not limited to, the following:

A. Land value, percentage rate of return, and/or economic land rent for a renewal period of a land lease agreement;

B. Economic rent for a renewal term for office, retail, industrial, or special-purpose space when the renewal period is to be set at the “going rate”;

C. Market value of land, improvements, or both, as provided in a lease agreement that grants the lessee a purchase option at an unspecified price;

D. Market value of a fractional interest in a property in order to arrive at a “buyout” price under the terms of a partnership or other joint-ownership agreement.

E. Appropriate remedy for office, retail, industrial and special-purpose lease disputes involving revenue issues, expense-escalation reimbursements, and operational and occupancy land use issues;

F. Appropriate remedy concerning disputes about the terms and conditions of real estate contracts and partnership agreements;

G. Whether or not a broker has earned a real estate commission and is payable;

H. Appropriate remedy in disputes about the terms and conditions of real estate loans or loan defaults;

I. Review of decisions rendered in a condominium, cooperative or owners’ association dispute; and

[1] www.adr.org

J. Disputes between real estate investors residing in different countries.

When a lease contains an option to purchase, a major concern is the ability to fix the fair market value or future purchase price of the property. A clause designating a neutral appraiser under the AAA Real Estate Rules would relieve the anxiety of both landlord and tenant as to a fair future price. Similarly, this technique can be used to enforce the terms of an escalation clause, resolve tenant build out disputes, establish future rental for extended renewal periods, or interpret clauses by designating an expert neutral to render a decision based upon that expert's experience. Further, disputes relating to a right of first refusal in a lease, as well as whether or not an option to renew or option to purchase was properly exercised by the tenant also lend themselves to resolution under the AAA Real Estate Rules. Tenant build out disputes can be resolved using the AAA's Construction Industry Rules.

Conflict over common area maintenance charges can easily be addressed by an expert neutral who can interpret the customary clause which provides for tenant reimbursement for "all other expenses customarily charged to tenants by landlord or by similar projects in the area for the purpose of maintaining the property." What is a customary repair when dealing with offsets to security deposits? Another advantage to the landlord is that a dispute over the exercise of renewal or purchase options will be dealt with quickly and not tied up in court for an extended period of time, which could have a severe impact on the ability of the landlord to sell the property or lease it at a higher rental.

Other examples may involve disputes arising out of property valuations provided for in option agreements such as fixing the fair market value of property or even establishing the market value of an easement or right of way or contributions to common area maintenance.

3. FINANCIAL INSTITUTIONS

Many financial institutions, especially in California, have surrendered their purported leverage in the court system due to courts finding lenders may have fiduciary duties to their customers and thus have been subjected to large jury verdicts. The other advantage of ADR to the financial institution is that the process is not public, and thus discourages intrusive and abusive discovery usually associated with nuisance suits. An unknown factor, however, is the impact of an arbitration award in a mortgage foreclosure proceeding, especially in Illinois, which does not at this time recognize the Power of Sale without judicial supervision. ADR can also deal effectively with Loan Workout disputes.

As noted, arbitration, if effectively used, can avoid the runaway sympathetic jury, avoid public record of the dispute and avoid the expensive and time-consuming discovery found in the court system. The arbitrator, having the authority to order interim protection during the dispute, can avoid the high cost associated with receiverships.

4. ENVIRONMENTAL DISPUTES

Environmental disputes can arise due to disputes related to land use, natural resource management and public land use, water resources, energy, air quality and solid and hazardous waste/toxic substances. AAA has developed its Environmental Dispute Avoidance and Resolution Program to deal with such disputes that may arise between contiguous land owners,

private businesses, private businesses and governmental agencies and governmental agencies against other governmental agencies.

An excellent example of the use of ADR in the environmental area is the article written by Stephen Crable in the March 1993 issue of the Arbitration Journal published by the American Arbitration Association at pp. 24-36. It cited the following example: In 1984 the State of Maryland filed a $500 million lawsuit against 48 mine operators, manufacturers, distributors and sellers of asbestos-containing materials allegedly installed in over 3,000 state-owned buildings. After more than four years of discovery and motions, the parties agreed to a series of ADR techniques, including use of arbitrators/special masters to resolve thousands of factual disputes. Hearings started in 1989 and concluded one year later. As a result of the recommended findings by the arbitrators/special masters, a majority of the claims were settled. The remaining cases went to trial and the findings of the arbitrators/special masters formed the basis for stipulations of fact.

In addition, the Environmental Protection Agency has issued a comprehensive statement of its policy relating to ADR and environmental disputes. See Final Guidance on Use of Alternative Dispute Resolution Techniques in Enforcement Actions (www.epa.gov/compliance/resources/policies). This publication defines various methods of ADR, lists criteria for choosing cases suitable for ADR, explains how to "nominate" a case for ADR resolution and provides several sample ADR forms.

The EPA has issued final regulations providing for the arbitration of certain Superfund Cost Recovery Claims: Procedures for Small Superfund Cost Recovery Claims, 40 C.F.R. Part 304.

5. TITLE INSURANCE DISPUTES

The arbitration clause is found in the Conditions and Stipulations portion of the title insurance policy, Section 14 of the Owner's Policy and Section 13 of the Lender's Policy. It should also be noted that in all disputes of less than $2,000,000, arbitration is available at the option of either the company or the insured; while disputes in excess of $2,000,000 both the company and the insured must agree. The Residential Policy has a similar arbitration provision in Section 8 of its Conditions.

The clause provides as follows:

> Unless prohibited by applicable law, either the Company or the insured may demand arbitration pursuant to the Title Insurance Arbitration Rules of the American Arbitration Association. Arbitrable matters may include, but are not limited to, any controversy or claim between the Company and the insured arising out of or relating to this policy, any service of the Company in connection with its issuance or the breach of policy provision or other obligation. All arbitrable matters when the Amount of Insurance is in excess of $2,000,000 or less shall be arbitrated at the option of either the Company or the insured. All arbitrable

matters when the amount of Insurance is in excess of $2,000,000 shall be arbitrated only when agreed to by both the Company and insured. Arbitration pursuant to this policy and under the Rules in effect on the date the demand for arbitration is made or, at the option of the insured, the Rules in effect on Date of Policy shall be binding upon the parties. The award may include attorneys' fees only if the laws of the state in which the land is located permit a court to award attorneys' fees to a prevailing party. Judgment upon the award rendered by the Arbitrator(s) may be entered in any court having jurisdiction thereof. The law of the situs of the land shall apply to an arbitration under the Title Insurance Arbitration Rules. A copy of the Rules may be obtained from the Company upon request.

6. LESSONS LEARNED FROM REAL ESTATE ARBITRATION

A. IN GENERAL

1. Even though arbitration is a less formal process than a court hearing, avoid referring to the arbitrator(s) by their first names, even if you know them well. Such informality detracts from the dignity of the arbitration process. Furthermore, it could give rise to a claim of bias as a basis for an appeal of an award, citing the "personal" relationship evidenced by use of first names.

2. Always remember the differences in ADR methods, since each requires a different approach.

   a. Mediation is business based, with the parties in control, and non-binding and NON-ADVERSARIAL.

   b. Arbitration is rights based, with reliance on theories and claims and counterclaims, right versus wrong, binding and non-appealable (except under limited circumstances) and ADVERSARIAL.

3. Beware of the arrogance of assuming an arbitration hearing requires little preparation or familiarity with the rules, having heard that it is only a story being told without rules of evidence. There are various sets of rules promulgated by the American Arbitration Association relating to disputes covering commercial matters, such as construction, securities, real estate valuation and labor. Copies of these rules are available from the AAA offices, and you should always familiarize yourself with the most current set of rules.

4. Do not assume that no matter what is presented in an arbitration hearing, the arbitrators will always award something to everyone, i.e., the Solomon decision. A Special Study prepared by the American Arbitration Association 1990 concluded that arbitrators decide clearly in favor of one party over the other in the majority of cases; found that in 21% of the claims, the claim was denied totally; in 33% of the claims, the arbitrators awarded between 80 and 100% of the claim; in 9% of the claims, the award was less than 20% of the claim; in 12% of

the claims, the award was less than 20% and the "Solomon" decision of 40 to 50% of the claim was reached in only 12% of the claims.

5. One of the major advantages of arbitration is that you will obtain your results a lot faster than by using the court system. The same American Arbitration Association study shows that the median number of days between filing and award was only 166 days. In those cases of more than $1,000,000, the median number of days was 498 days; and $15,000 or less, only 100 days.

6. Do not be insulted, but the transactional attorney whose last experience was in Moot Court should not look to arbitration as good "trial" experience in order to get a taste of the "litigation" process. Do not think for a moment that arbitration does not require good court skills such as cross-examination ability. It is still no place for the transactional lawyer who wants a shot at the court room experience.

B. THE ARBITRATION CLAUSE

1. The arbitration clause must be carefully prepared by the transactional lawyer and the litigation lawyer in cooperation with each other and should be tailored for the particular type of dispute which is the subject of the contract. Even if the AAA has no established rules for your "unique" dispute, do not be constrained to use the process - you can establish your own rules of procedure.

The ability to tailor-make a dispute resolution procedure for your particular transaction, and even select the specific panelists based upon expertise agreement at a time where conflict is absent, cannot be underestimated.

2. A good arbitration clause will:

a. Be self-executing and may be initiated by either party.

b. Take into account joinder of all parties necessary to resolve the dispute and should obtain the commitment of all parties to participate in the arbitration process at the contract stage. Usually it is too late at the dispute stage.

c. Establish standards for the selection of arbitrators with the expertise sought and should provide for a replacement mechanism in the event a panelist resigns or is unable to serve his or her term for reasons beyond their control.

d. Provide for some limited pre-hearing discovery, but should avoid “everything permitted by the Civil Practice Act” of the jurisdiction.

e. Provide for authority to award attorneys’ fees and costs as the arbitrators deem to be just and equitable. This would avoid later disputes over who was a prevailing party, and permits the

arbitrators to use their judgment as to the extent to which fees may be awarded.

f. Request a written opinion explaining the basis upon which the Award was made if the parties desire it.

g. Designate the place of arbitration to avoid forum shopping or local prejudices.

C. SELECTION OF THE ARBITRATOR

1. The absolute key to any successful arbitration is the quality of the panel. Stay away from the prospective panelist whose credentials read as follows: "Real estate closings, estate planning, negligence, worker compensation claims and complex commercial arbitration." Be willing to pay more for a quality panel than the minimum suggested rate - you usually get what you pay for. Quality arbitrators will be more inclined to serve on a panel which will continue over an extended period of time if there is not too great a financial sacrifice.

2. Avoid party-appointed arbitrators: This occurs when I pick one arbitrator and you pick the other arbitrator and our appointees select the third "neutral" arbitrator. In this author's opinion, use of the partisan arbitrator selection process presents an inherent conflict since he/she is clearly partisan but bound by oath and the ethical rules of the American Arbitration Association to act without prejudice to either party.

3. Always investigate the potential arbitrators by contacting other counsel who may have had contact with the arbitrator. Never overlook your own firm's experience. Never assume that nomination as an arbitrator is tantamount to qualification.

4. When drafting the clause relating to the selection of the arbitrator the drafter may provide that the arbitrator may be:

a. A practicing attorney in good standing with no less than "x" years of experience in real estate issues.

b. A certified public accountant or certified appraiser.

c. A balanced panel consisting of a licensed attorney, appraiser and certified public accountant.

d. The arbitrators will be selected from a panel of persons having experience with and knowledge of leasehold disputes, appraisal disputes, and real estate contract disputes.

e. Specify the law which will govern the contract and/or the arbitration proceedings such as the law specified in the agreement and the state in which the project is located.

f. What are the conditions precedent to an arbitration such as mediation or other non-binding dispute resolution process.

g. Consider whether preliminary relief may be required, such as emergency relief similar to a restraining order, by incorporating the American Arbitration Association's Optional Rules for Emergency Measures of Protection.

h. If the dispute involves the sale of real estate, a provision should be included regarding the retention of escrowed funds in a protected escrow account under the protection of the Arbitrator.

i. While discovery is always the "elephant" in the room, it can be controlled at the contract stage to some extent by including reasonable time limits as to when all discovery must be completed and provide the Arbitrator with the authority to resolve discovery disputes of any nature. In addition, depositions should be concluded within a reasonable period of time. No deposition (except for experts) should exceed three hours.

j. It is difficult to establish the length of the hearing at the contract stage, but a provision can be inserted that the proceedings must be completed with 12-18 months. However, this also requires a commitment from the Arbitrator to be available to permit the foregoing.

k. As to damages, while serious consideration should be given to whether or not punitive damages may be awarded to the successful party, provision should be made for the award of attorneys' fees, arbitration costs and expert witness fees to be awarded to the prevailing party. However, also note that some direction should be given to the arbitrator as to who will be determined to be the prevailing party.

l. One of the cornerstones of arbitration is confidentiality. However, while the arbitrators are pledged to confidentiality, an appropriate clause binding the parties to confidentiality must be included to ensure total confidentiality of the arbitration.

m. There is always an assertion that there is no right of appeal in the arbitration process. This can be dealt with by including an appellate procedure in the agreement. But before doing so, counsel and their clients have to come to a decision as to whether they seek finality or vindication since the appeal process can be costly and time consuming. JAMS does have a formal appellate procedure.

n. Designate the location of the arbitration hearings, perhaps to avoid local prejudices.

D. PRE-HEARING CONSIDERATIONS

1. Make sure all exhibits are marked BEFORE the hearing, and that you have sufficient copies for each member of the panel, opposing counsel and the court reporter, if any. Failure to do this in advance telegraphs poor preparation, and if the strategy is to upset the rhythm of witness examination, good arbitrators sense this strategy and you lose points rather than advance your cause.

2. Provide copies of documents to opposing counsel prior to the hearing and during the document exchange period. This will avoid the embarrassment of having opposing counsel exclaim that this is the first time they have seen the document, and, therefore, they will need additional time to review it before they can proceed with their cross-examination. Arbitrators will usually give counsel additional time to prepare and any tactical advantage obtained is only illusory.

3. For the "secretive" opponent who refuses to fully disclose or exchange documents, remind them of the power of the arbitrator to subpoena documents, and indicate that you will advise the panel that the subpoena was necessary due to a lack of cooperation by the opposing side. Further, since documents produced pursuant to subpoena will be seen by you for the first time at the hearing, you will require additional time to review the documents which will delay the process. Chances are that counsel will get the message!

4. Counsel should try to agree on joint exhibits in advance and identify them as such. It is frustrating for the panel to shift from the claimant's set of exhibits to the respondent's set of exhibits, where each bears a different identification for the same document.

E. THE HEARING PROCESS

1. Do not permit the "informality" of arbitration to minimize the need for properly preparing your witnesses. Credibility of counsel and the witness come into question when the witness stares at a document he/she does not recall ever seeing before. What you have done is "sandbagged" your own witness by assuming that less preparation of witnesses is appropriate since there is no judge or jury. Witnesses are under oath and subject to cross-examination. Failure to prepare the witness properly can result in an adverse decision simply because the witness's credibility prevents the arbitrators from giving the testimony much probative value.

2. Do not insult your opponent and the arbitrators by not being able to commit to hearing dates because "your secretary is in charge of setting your appointments." You would not do this before a judge, and you have essentially indicated your disdain for the process and have insulted the arbitrators who will decide your case.

3. Remind your witnesses to look at the arbitrators, not at you, when responding to direct or cross-examination.

4. Even though the rules of evidence do not apply, you should always lay a proper foundation for the question or document and be sure to indicate its materiality and relevance in your case. Even though affidavits are a form of hearsay, the rules do permit arbitrators to admit evidence by way of affidavit. However, the absence of the ability to cross-examine the affiant may cause the arbitrators to give the affidavit less weight in their decision. Have your affiant available for cross-examination; at the least, you have reduced the witness's time by half and reduced the panel's boredom factor by at least that amount.

5. Use objections sparingly, as arbitrators may believe that you are preventing them from hearing evidence on the matter. Use objections to "tell" the arbitrators something such as leading questions may indicate that the witness is not testifying, counsel is testifying, lack of foundation for a document may cause the arbitrator to attach less weight to it; failure of a witness to respond indicates a witness whose credibility should be questioned by the arbitrators,

One of the best objections is "asked and answered." Properly and consistently made, the message to the arbitrators is clear - counsel is engaged in eliciting repetitious testimony which does not shed new light on the issues and causing delay in the proceedings while adding nothing new.

6. Is a transcript necessary? In a complex case, daily copy may assist in preparing for cross-examination. Transcripts are always of assistance when moving to vacate an award since the transcript may provide grounds for vacating the award. Ordering a transcript for the arbitrators may not be useful since the arbitrators have heard the testimony, taken notes and may have caucused between themselves from time to time. An arbitrator faced with voluminous exhibits will look to an equally voluminous transcript with distaste.

7. Do not present the same set of facts in several different ways in the hope that repetition will enforce your position. The arbitrator will not choose the one he/she wants, but will become bored and not pay attention to the critical evidence which is buried in the repetitious presentations.

Furthermore, all this does is present the opportunity to tender additional, unnecessary and repetitive details which presents the other side with the opportunity to engage in overlong and boring cross examination. The result - a panel which loses interest.

8. Start the case with a strong witness, finish with a strong witness, and the middle witnesses will take care of themselves.

Studies have shown that "decision makers" reach a feeling as to who is right and who is wrong at the close of the opening statement, assuming the evidence will support the opening presentations. Therefore, hit them hard or you will spend the rest of the case trying to change their minds.

9. What does the Arbitrator want to see from counsel?

   a. Claims, counterclaims or defenses should be well documented, all documents should be numbered and a summary sheet should be prepared for use by the arbitrators during their deliberations.

   b. Documents should be factual documents and self-authenticating wherever possible, and when introduced, a foundation should be established as to who prepared the document, when it was prepared, by whom it was prepared and finally that it is THE document.

   c. The evidence should be presented in a logical, rational manner consistent with your opening statements. When the arbitrators have a glazed look it is usually because they are unable to determine where you are headed - so remind them every so often.

   d. Focus on the important issues and facts and avoid over trying the case by emphasizing and proving every single fact, regardless of its significance. Who really cares what the witness did in high school if it has nothing to do with the case in chief?

   e. Cooperation between counsel at all times and a professional demeanor between counsel and the panel is the rule. Rambo is out and civility is in! This does not mean you cannot be tough or hard, but do not equate rudeness and incivility with the former.

   f. Avoid hyper-technical, never ending objections. Arbitrators want to find out the facts and will wonder what you are trying to keep out. Remember, the panel was selected for its expertise and sophistication, and unlike a jury, they do not have to be protected from "tainted" evidence.

10. What does counsel want from the panel?

   a. The members of the panel should be experienced in the industry and in the arbitration process.

   b. The panel should establish the ground rules for admission of evidence, witnesses, discovery and enforce those ground rules fairly and even handedly.

   c. A firm but fair panel that "runs" the hearings, keeps counsel from making it the "arbitration from hell" and establishes an interest by asking questions during the proceedings.

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