Laughing All the Way to the Bank

The Benefits and Detriments of Arbitration to Consumers in Transactions with Financial Service Providers

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I. Introduction

Arbitration is distinctive from traditional litigation and other methods of alternative dispute resolution. In the context of transactions between consumers and financial service providers, such as banks, lenders, mortgage companies, financing companies and brokerage firms, an arbitration provision is usually incorporated into all agreements automatically, so arbitration is generally utilized to resolve conflicts. Arbitration's particular characteristics provide numerous benefits for the financial services industry, and as a consequence, consumers often unwittingly agree to bear the burden of the detriments. Nevertheless, consumers experiencing lack of liquidity often prefer arbitration's speedy process.

Traditionally, members of the financial services industry include banks, finance companies, mortgage businesses, credit card companies, and brokerage firms. This discussion of the financial services industry is applicable to any entity that engages primarily in providing or facilitating funds for consumers.

II. Benefits

Consumers often experience a much more financially urgent demand for recovery than a financial institution would, largely due to individuals' lack of liquidity. Arbitration provides a faster level of decision-making as compared to the traditional judicial system by abolishing the majority of procedural rules, which lengthen the time of litigation, and increase court costs and attorneys' fees.[1]

In addition to being faster than traditional litigation, arbitration may also prove cheaper as a result of it's informal, stream-lined procedure: there is no discovery or filing of extensive motions; the technical rules of evidence are simplified; no empanelling of a jury; and no possibility of lengthy appeal.[2] Again, as a result of a lack of liquidity, the common consumer is probably willing to risk pursuing an award without the aid of procedural devices, which increase the cost of resolution.[3] Consumers may further benefit from the arbitrator's ability to ignore legal repercussions, and an informal atmosphere that permits parole evidence or hearsay if the arbitrator believes it will serve justice.[4] In rendering a decision, arbitrators need not follow the law and are only subject to judicial review under a standard of "manifest disregard" or "arbitrary and capriciousness," depending on the circuit.[5]

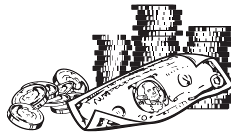
Finality, likewise, is a seductive arbitration quality.[6] A chance for continuous appeal renders any intermediate decision less reliable, and the process extends the length of litigation.[7] While the limited opportunity for appeal may appear disconcerting, consumers, subject to a lack of liquidity of their assets, may prefer to receive an award and have the ensuing debt or payment at their instant disposal.[8]

III. Detriments

Consumers must sacrifice the advantages of traditional litigation to pursue a remedy in arbitration. According to the Eighth Circuit, "the present day penchant for arbitration may obscure for many parties who do not have the benefit of hindsight that the arbitration system is an inferior brand of justice, structured without due process, rules of evidence, accountability of judgment or rules of law."[9]

A. Procedural Detriments

Procedurally, in choosing arbitration, a consumer loses numerous discovery mechanisms. In a dispute between a consumer and a financial institution, the financial institution most likely possesses a substantial portion of the crucial evidence.[10] The arbitrator has very limited power to order presentation of evidence, and no means of enforcement.[11] Financial service providers tend to gather a great deal of information about their clients in the process of creating and administering loans and accounts.[12] The lack of discovery mechanisms could be interpreted as a shield for less than scrupulous litigants.[13] Many courts have deferred to an arbitrator's procedural determinations because (1) procedural questions are often tied to merits of the case; and (2) reservation of procedural issues for courts provides an opportunity for serious delay and duplication of effort.[14]



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Additionally, knowledgeable witnesses may be beyond the reach of a subpoena, especially when the consumer's unscrupulous adversary promptly transports its witnesses to a distant office.[15] A fundamental problem with arbitration is the disputant's inability or unwillingness to provide information needed to reach a quality decision.[16] Relying on voluntary participation by the parties cannot compete with the effectiveness of judicial sanctions and process.[17] While this reduces the cost of discovery, it may defeat a consumer's substantive claims.[18] Therefore, the absence of discovery procedures usually benefits the financial services industry.[19]

Agreeing to arbitration also translates into forgoing a decision by a judge or jury,[20] and preclusion from asserting common law or statutory rights in a court of law.[21] However, losing access to a duly elected judge or a sympathetic jury may be mitigated by relaxed rules of evidence, such as admissions of parole evidence or hearsay.[22]

While juries are notorious for their sympathy, arbitrators gain preference from the financial institutions partially due to their ties to the industry. Since alternative dispute resolution is a private service, arbitrators' conflicts of interest as to persons, issues, or assets are not required to be checked, though a lack of particularly germane disclosure can cause a reviewing court to vacate the arbitrator's award.[23] Furthermore, an arbitrator's neutrality mushrooms into an important aspect of the decision when the financial institution imposing arbitration on the consumer specifies a revenue-driven private firm as the arbitrator.[24] The financial institution's repeated utilization of a particular source of arbitrators may sway the arbitrator's favor. Some scholars typify the repeat player/arbitrator relationship as "symbiotic."[25] Data from arbitration is largely inaccessible to the public, but First USA reported a bank success rate of 99.6% in arbitration between the bank and consumers.[26] Consumers thus rightly remain suspicious of a decision-maker riddled with industry customs and the inherent threat of arbitrator bias.[27]

According to the Federal Arbitration Act and the remarkably similar Uniform Arbitration Act, the standard for invalidating an arbitrator's award due to their bias is a finding of "evident partiality or corruption."[28] The California Supreme Court judged absolute neutrality from an arbitrator unnecessary, though the propensity to prejudice must be heightened when arbitration stems from a contract of adhesion.[29] However, the majority of the time the financial industry will gain an advantage from the courts' distancing as the institutions possess a historical record of past arbitrators' decisions and cater arbitration firms' favor with repeated use.

Consequent to the ability of the arbitrator to conclude disputes without reflecting existing law, financial institutions are enabled to avoid both state and federal legislation intended to protect consumers.[30] Consumer advocates fear that unless arbitrators are trained in and instructed to follow legal rules, the widespread use of arbitration will effectively eradicate a generation of protective legislation and court decisions, except to the extent that such standards have become part of the instinctive response of an experienced member of the industry.[31] According to the United States Supreme Court, "even a serious error on the arbitrator's part does not justify overturning" a decision when the arbitrator is "acting within the scope of his authority."[32]

Consumers will be at a disadvantage due to the lack of records and written opinions, consequently creating an uncertainty in pending and future decisions.[33] Furthermore, the privacy afforded to financial institutions by an arbitration proceeding intrinsically fails to warn consumers of possible danger, or prior unscrupulous action, associated with a particular financial service provider.[34] Consumers would economically spend less if they were confident their claim was viable and likely to be settled, and could choose to accept a settlement without a full hearing on the merits, or could resolve their dispute in small claims court.[35]

Disputants in arbitration are probably less likely to settle their claims early in the process than a similar case in traditional litigation, instead receiving a decision on the full merits.[36] One study found the rate of pursuing a full hearing in arbitration was approximately fifty percent, while the comparable trial rate was about five percent.[37] Another study spanning five federal district courts and at least one state court in each federal district found that less than eight percent of the cases went to trial.[38] In twenty-two and one-half percent of the cases, the judge either dismissed the case or rendered judgments on the merits summarily, and the remaining sixty-nine and one-half percent were resolved by settlement.[39] Arbitration appears to be a more efficient alternative than traditional litigation at first blush in that it costs less to initiate and requires less time to complete. However, arbitration expenses are probably not less than a claim that is not adjudicated due to early settlement or judicial dismissal, and the majority of suits fall in this category, so arbitration is not necessarily cheaper or more efficient in the majority of disputes.

A consumer also sacrifices his or her ability to plead lender liability, a judicially created mutation to protect consumers.[40] Lender liability was an important triumph for consumers as it heightened the duty owed to them by financial service providers and improved their avenues of recourse.[41] Lender liability was justified on the grounds that it provided reasonable compensation for consumers and deterred inappropriate behavior by lenders.[42] Lender liability is considered one of the most urgent causes of arbitration clauses for financial institutions, and may be interpreted as one of numerous attempts at consumer protection aborted in arbitration.[43]

In addition, consumers may forfeit the ability utilize

a procedural device such as a class action suit which defrays expenses.[44] Moreover, class actions give an individual with a claim too insignificant to file on its own the power to pursue the claim in a group.[45] Arbitration was utilized by financial institutions to avoid class action suits and to escape the possibility of huge litigation expenses than might ensue from class actions.[46]

The American Arbitration Association considers itself unable to consolidate related cases or grant class certification in appropriate circumstances because mutual consent is required for all procedural matters, and financial institutions generally will not consent.[47] Although the Uniform Arbitration Act permits a consolidation of arbitration proceedings under some circumstances, the Federal Arbitration Act is silent.[48]

The United States Supreme Court ruled in Green Tree Financial Corp. v. Bazzle that the issue of whether or not a contract was silent on the availability of class arbitration, was related to the contract, and was thus for the arbitrator to decide.[49] While the Court did not entirely occlude the possibility of class arbitration, the decision allows future arbitration contracts to remove any possibility for class arbitration by including a simple provision in drafting the agreement.[50]

Arbitration may be prized by the financial services industry due to its tendency to discourage nuisance suits.[51] The greater cost of undertaking arbitration compared to filing a traditional suit in small claims court, a justice of the peace court, and many district courts directly decreases the number of consumer complaints.[52] In addition, the cogent expertise of panel members screening claims may provide a heightened filter for frivolous claims.[53] Notwithstanding, some scholars argue the incredibly high standard of review for arbitrators' awards, combined with arbitrators' freedom to render decisions in opposition of the law, may encourage frivolous or meritless claims.[54]

B. Results of Lesser Bargaining Power

The financial institution drafts all of the forms used in the relationship with consumers, and couches them in legalese that is incomprehensible to the average client.[55] Many banks' contracts, in addition to being riddled with legalese, do not explain the significance of arbitration and the rights consumers surrender.[56] Furthermore, one-sided terms favoring the drafter of the agreement are common.[57] It appears entirely possible for a consumer to willingly sign a contract of adhesion, a contract unilaterally drafted and presented to the subservient party without a genuine opportunity to negotiate any terms, or an agreement with unconscionable terms, due to the consumer's complete ignorance of the ramifications of the agreement and his or her lesser bargaining power.[58]

The categorization of contracts as adhesive may be accurate as the financial institution often unilaterally drafts the arbitration covenant, presents it to the consumer in boilerplate form, and refuses an opportunity to negotiate any of the terms.[59] Consumers frequently do not have any financial service alternatives as arbitration clauses have become standard in financial agreements.[60] An agreement between a bank and an individual should be subject to a higher degree of scrutiny than agreements between two members of the financial industry, or a business consumer represented by counsel, due to the obvious discrepancy in bargaining power, economic power, and knowledge.[61] Moreover, in Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., the Supreme Court acknowledged in dicta that courts should "remain attuned to well-supported claims that the agreement to arbitrate resulted from the sort of fraud or overwhelming economic power that would provide grounds for the revocation of any contract."[62]

The courts have also rendered contracts with procedural or substantive unconscionable terms unenforceable. Substantive unconscionability focuses on whether the contract allocates the risks of the bargain in an objectively unreasonable or unexpected manner.[63] A contract which contains an arbitration clause that permits the drafter to select a biased administrator or arbitrator is a prime candidate for being ruled substantively unconscionable.[64] Procedural unconscionability decides whether the provision is oppressive and surprising.[65] This encompasses contracts with arbitration terms that are in fine print on the back of a document, use excessive legal language, or that fail to adequately explain the arbitration procedure and the options the consumer is surrendering.[66] The possibility of procedural unconscionability grows more likely if the consumer is non-English speaking, poor, or unsophisticated.[67]

Generally courts hold that a consumer who does not wish to be bound by an unfair arbitration clause may seek financial services elsewhere. However, financial alternatives without arbitration clauses are not available since they are standard provisions in financial institutions' forms.[68] Although there is some indication that the judicial system will attack one-sided terms more aggressively when arising from consumer services, rather than commercial services, arguments that these types of adhesion contracts are inherently unconscionable have been summarily dismissed by the courts.[69]

The Supreme Court has increasingly delegated equitable claims, in addition to legal claims, to arbitration. For example, in Prima Paint Corp. v. Flood & Conklin Manufacturing. Co., the Supreme Court held that a claim of fraud in the inducement of a contract including an arbitration clause must be arbitrated unless the parties expressly record their desire to omit this issue from arbitration.[70] The Supreme Court did, however, allow the judicial system to award relief when a party opposing arbitration presents well-supported claims that the agreement to arbitrate resulted from some sort of fraud or overwhelming economic power in Mitsubishi Motors.[71] It seems that the less bargaining power consumers have when executing agreements with financial services, the more susceptible to serious risk of dominance by the stronger party, resulting in contracts of adhesion.[72]

C. Indirect Effects

Arbitration benefits "repeat players," parties that constantly employ the arbitration process, instead of novice players.[73] Frequent use of the arbitration system grants the institutions skill in choosing arbitrators and permits them to record and refer to arbitrators' prior decisions.[74] Moreover, institutions can accept variances in individual decisions in the interest of obtaining fast, inexpensive, and effective comprehensive resolution.[75] The law of averages dictates that their cumulative expense will be less than the cumulative cost of litigation, and more quickly achieved.[76] Although arbitrators are purported to adhere to a code of professional ethics, there is no working mechanism to enforce professional principles.[77] In addition, an erroneous award, while smoothed by the law of averages for a financial institution, could present a grave injustice to a consumer utilizing the arbitration system a single time.[78]

Arbitration is generally considered to be a cheaper and faster alternative than traditional litigation. However, arbitration and other methods of alternative dispute resolution are not subsidized by taxpayers like the judicial system.[79] The parties must pay fees to the private entity arranging the arbitration depending on the amount of the claim at stake as well as fees to the arbitrator which often increase proportionately to the arbitrator's experience and knowledge.[80] The daily charges

of arbitrators may exceed the amount saved on forfeiture of discovery.[81] Furthermore, many individuals would resolve their disputes in small claims court, justice of the peace court, or possibly a cheaper district court if they were not bound by their contract to seek arbitration, and many cases would settle early in judicial proceedings if such a mechanism existed.[82] Additionally, cases where the amount disputed is large, the issues are complex, and the parties demand litigious procedures, can lose the advantages of arbitration.[83]

By submitting to a resolution process where the decision-maker need not follow the law, consumers lose the benefit of legislation specifically enacted for their protection. Consumer advocates fear that widespread use of arbitration without a requirement that the arbitration system apply the law will erase decades of protective court decisions and legislation.[84] While superseding state and federal consumer protection is hypothetically acceptable if the parties agree to do so prior to their conflict in order to protect the sanctity of contract, most individuals are not aware they are contracting to disregard consumer protection legislation.

Beyond federal favor of arbitration at the expense of consumer protection, the Supreme Court has taken a series of steps to prevent states from enacting legislation to shield consumers. Texas, for example, exempts transactions under $50,000 from its protection statute.[85] Realistically, states' attempts to garner protection for consumers is ineffective because the language of the Federal Arbitration Act has been broadly interpreted to preempt state law whenever the transaction is in the scope of the commerce clause.[86]

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IV. Conclusion

In a transaction consummated by a financial service provider and a consumer, arbitration provides a plethora of benefits for financial service institutions. Consumers benefit from the speed and finality of arbitration, especially due to their lack of liquidity, but must bear the procedural, bargaining power, and indirect detriments.

While both parties stand to gain and lose by submitting to arbitration, the financial services industry is much more likely to reap rewards than a consumer due to their unique position. Financial service providers build greater experience and clearer records due to their repeated use of arbitration. In addition, the lack of procedural mechanisms is more likely to adversely affect the consumer than the financial institution because the institution is likely to possess all of the documents necessary to resolve a dispute. Overall, it seems that while consumers may benefit in some instances of arbitration, it is the financial institutions who will benefit in all instances of arbitration.

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