Why the binding arbitration game is rigged against customers

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Credit: AI-generated image (disclaimer)

You may have noticed it in the boilerplate of your customer contract with a bank, a brokerage firm, or just a cellular phone carrier.

It's the "mandatory arbitration" clause, and it's in contracts that cover trillions of dollars of business. In the event you have a dispute with the company, it says, you agree in advance to surrender your right to sue and to submit your grievance to a supposedly neutral private arbitrator.

Almost every financial firm insists on mandatory arbitration, but so do legions of businesses in other realms: AT&T and Verizon, Amazon and Apple, Blue Cross and Blue Shield, even Spotify and Shazam.

Now, a new analysis of almost 9,000 arbitration cases from the securities industry confirms what many have long suspected: The system is biased against consumers—and not just because big companies have more money to spend on lawyers.

When it comes to arbitration, the study finds, companies have a big information advantage in fishing for arbitrators who are likely to rule in their favor.

Making matters worse, the arbitrators themselves know that being pro-company in one case greatly increases their chances of being picked for future cases.

An Incentive to Slant

"This is not like having judges, who get paid the same no matter what happens," says Stanford Graduate School of Business finance professor Amit Seru, who collaborated on the study with Mark Egan at Harvard Business School and Gregor Matvos at the University of Texas at Austin. "Here, you only get paid if you're selected as an arbitrator. They have incentives to slant toward the business side, because they know that those who don't do so won't get picked. Everyone knows what's happening."

In their study, the researchers scrutinized thousands of customer disputes with stockbrokers and investment advisors. The data came from the Financial Industry Regulatory Authority, which oversees the industry's arbitration process.

The researchers began by confirming that some arbitrators are measurably more business-friendly than others. Comparing cases on an apples-to-apples basis, the researchers estimated that business-friendly arbitrators awarded customers about 12% less money than their more pro-consumer counterparts. On an average case, that equates to about $90,000.

That was just the start, however. Even though the list from which arbitrators are picked is random, pro-business arbitrators were about 40% more likely to be chosen, so their bias had a disproportionate impact. If the arbitrators had been picked purely at random, the researchers estimated, the average award to each customer would have been $50,000 higher.

The Advantage of Experience

How do companies know which arbitrators to pick?

At first blush, the rules for picking arbitrators seem even-handed. After FINRA gives both the customer and the company a list of candidates, each side is allowed to veto or "strike" a certain number of those names.

The problem is that companies generally know more than customers about an arbitrator's record and thus are likely to strike out arbitrators who are more inclined to rule in favor of consumers. On average, each securities firm in the study had been involved in 81 other arbitrations. In non-securities disputes, such as those with cellular carriers, the average company had been in 133 hearings. By contrast, most consumers have never been involved in a previous arbitration and tend to strike arbitrators randomly. As a result, the firms' informational advantage leads to systematically biased outcomes.

The broader problem, says Seru, is that the arbitrators become more biased toward the company side because their own earnings—about $300 for a four-hour hearing, plus expenses—depend heavily on being picked by companies.

"This is a systematic problem," Seru says. "If you look at the data across many, many years, you see a pattern that is biased against consumers and in favor of firms. It may or may not be intentional, but given the design of the system and information available to consumers and firms, it's the outcome one ends up with."

Looking at Fixes

Seru and his colleagues also found that seemingly favorable reform proposals could make things worse.

In 2016, for example, FINRA proposed expanding the lists of candidates and giving both sides more opportunities to "strike" the ones they don't like. But because companies have an information edge, the researchers argue that would actually lead to lower awards for consumers. Similarly, the proposal to increase the arbitrators' fees seems, at first glance, like a good idea. However, the researchers show that such a change would make arbitrators even more biased against consumers, since the "prize" for getting selected in a pro-business environment is larger.

The best way for a consumer to level the playing field, Seru says, is to hire an experienced arbitration attorney. Indeed, the study found that consumers who did that ended up with arbitrators who, on average, awarded almost 5% more money.

Another way for consumers to decrease the corporate advantage is to band together with other customers who have the same grievance. Seru says that would incentivize arbitrators to have "more respect" for the consumer side and potentially act as a countervailing force when they decide how pro-business they wanted to be.

As it happens, the Consumer Financial Protection Bureau did propose a rule that would have prevented financial companies from demanding that customers submit to mandatory arbitration. That would have allowed customers to enter class-action suits. But the Republican-led Congress overturned that rule in 2017.

So what's the best way now for consumers to level the playing field?

"Get them all attorneys," Seru says.

More information: Arbitration with Uninformed Consumers: www.gsb.stanford.edu/faculty-r … uninformed-consumers

Provided by Stanford University

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