



Separate and Unequal Justice

The Case Against Binding Mandatory Arbitration for Homebuyers

CRL Issue Paper No. 8

February 24, 2005

“Access to the courts has been essential to securing civil rights in this country, and mortgage contracts that force homeowners into a second-class justice system are unacceptable.”

- Wade Henderson, Leadership Conference on Civil Rights, in “Citigroup Must End Mandatory Arbitration,” a Statement of Consumer and Civil Rights Groups

In recent years, predatory mortgage lending has become a pressing policy concern, yet current policies allow lenders to deny justice to victims and potential victims through binding mandatory arbitration (BMA). BMA means that any dispute that arises in connection with the loan must be resolved through a private legal system. Often the requirement to use arbitration is non-consensual or poorly understood by borrowers, who may not realize that BMA eliminates the option of pursuing justice through a court of law. Moreover, borrowers forced into arbitration may be burdened with excessive costs and receive unfair and biased results.

Through BMA, borrowers lose their “day in court” and are forced to use a system of private arbitration that, even under the best of circumstances, is not equivalent to court adjudication. The court system is subject to public scrutiny and provides more procedural options and protections, including the right to a qualified judge and the assistance of an attorney. Arbitration, on the other hand, is conducted in secrecy, allow no appeals, and severely restrict rights of procedure and evidence that claimants automatically receive in courts of law.

These issues become even more problematic when considered in light of the potential disparate impact of BMA on vulnerable populations. Borrowers who receive subprime loans typically have fewer resources and product options. When these borrowers encounter legal problems with their mortgages, the stakes are high, often involving the potential loss of their physical shelter and future financial security.

Several subprime lenders have recognized the negative impact of BMA clauses and have abandoned their use of mandatory arbitration. However, several lenders continue to insert BMA

clauses in subprime mortgage contracts, sometimes even when they do not include similar clauses in their prime products.

The Center for Responsible Lending believes that binding arbitration clauses are incompatible with our nation's public policy in favor of an open and fair path to homeownership.

We estimate that predatory lending activities cost American homeowners \$9.1 billion annually. BMA clauses can serve to protect unscrupulous lenders from the scrutiny of courts while they engage in activities that directly undermine homeownership and drain hard-earned assets from working families. We support policies that would prohibit lenders from placing BMA clauses in subprime mortgage contracts and encourage lenders in the mortgage market to eliminate BMA clauses from all home loans.

BMA is Incompatible with Homeowner Protection and Disclosure Laws

The United States has longstanding policies aimed at creating an open and fair path to homeownership, including the Truth in Lending Act and the Real Estate Settlement Procedures Act. The use of forced arbitration flies in the face of key national goals and harms borrowers in several ways:

- Abuses public reliance on fundamental legal protections. Homeowners shop for loans by rate and term, expecting other standard loan provisions to be consistent with public policies advocating an open and fair path to homeownership. They do not expect to agree to waive their access to the legal system as a part of the homebuying process. Only when claims arise do homeowners realize the breadth and extent to which they have put their homes, and in some cases their life savings, at risk through a forced arbitration clause.
- Covers-up unscrupulous lenders' misdeeds. Arbitration is almost always a confidential process, without a public record, a trait that private arbitration firms specifically market to potential clients.¹ This cloaked process means that patterns of misdeeds by lenders remain hidden. As a result, other homeowners are denied knowledge that might facilitate their claims, while unscrupulous lenders can continue unjust or illegal actions in relative safety.²
- Forces a take-it or leave-it choice on homeowners. Homeowners never bargain for BMA clauses. Rather, they receive the clause unknowingly, or in some cases are told at closing that they must accept an agreement that includes an arbitration requirement to receive the loan. Since borrowers at the closing table do not anticipate filing claims and have not shopped for a loan based on the arbitration clause, they may accept the provision, in spite of misgivings, and hope for the best.

Major Investors Ban Loans with Binding Arbitration

As government-chartered investors, Fannie Mae and Freddie Mac purchase billions of dollars worth of mortgage loans each month and have significant influence on the type of loans originated. The two investors have their own guidelines and protocol, but they both agree that forced arbitration is not good for borrowers.

"Freddie Mac believes that all homeowners should be able to voluntarily choose the mortgage dispute resolution option they believe to be in their best interests," said Paul Peterson, Freddie Mac's chief operating officer when the decision was made.

Freddie Mac officially stopped purchasing loans that included mandatory arbitration provisions in August 2004, and Fannie Mae followed with a similar ban effective October 31, 2004.

- Imposes a disparate and unfair burden on borrowers in the subprime market. For many borrowers in the subprime market, homeownership is more difficult to achieve and represents a proportionately larger stake in their overall financial well-being. Yet borrowers in the subprime market -- disproportionately consisting of the elderly and members of minority groups -- are most likely to be subjected to abusive or predatory lending terms. The possibility of adequate remedies and deterrence are seriously diminished when these borrowers are not permitted access to courts of law. They also receive the brunt of arbitration's negative effects, commonly including excessive costs and biased results.

Forced Arbitration Costs Homeowners More

While proponents of arbitration often tout it as a low-cost alternative to courts, many homeowners find that arbitration fees increases the cost of resolving their dispute.

Substantial and uncertain fees. The combined cost of filing and other administrative fees in arbitration routinely costs homeowners thousands of dollars. While some forums now claim to waive the filing fees for “indigent” plaintiffs, there is no specific standard for granting such a waiver. In addition, the magnitude and uncertainty of other costs, including hearing fees, still serve to deter many meritorious claims.

The table below details just some of the costs homeowners may face in arbitration. It shows that one sample \$150,000 claim would cost a homeowner 100 times more (\$16,000 versus \$150) to arbitrate than to bring in court. Even if the lender offers to pay part of the fees involved, the uncertainty of the total amount is often enough to discourage homeowners from pursuing important claims. For example, the National Arbitration Forum reserves the right to alter the standard charges listed in the following table.³

Arbitration versus Court: Sample Costs for \$150,000 Claim

Item	Arbitration	Court
Filing Fee	\$1,375.00	\$150.00
Request amendment, subpoena, discovery order, time extension from NAF director, continuance from arbiter	\$675.00	\$0.00
Request expedited hearing	\$1,000.00	\$0.00
2 full days of hearings (12 hours)	\$5,500.00	\$0.00
Post-hearing memorandum	\$2,000.00	\$0.00
Written opinion on conclusions of law	\$1,500.00	\$0.00
Dispositive order	\$4,000.00	\$0.00
Total	\$16,050.00	\$150.00

Sources: National Arbitration Forum Code of Procedure (available at <http://www.arbforum.com/programs/code/appx-c.asp>) and Fees from the Administrative Office of the U.S. Courts (available at <http://www.uscourts.gov/faq.html#filing>)

Imposes multiple forum fees on homeowners. Frequently, parties to arbitration find it is still necessary to go to court. They may be required to do so to enforce subpoenas or litigate the issues in arbitration against a third party that was not bound by the forced arbitration clause. The result is that homeowners with legitimate claims are forced into a longer, more costly, and often duplicative process to vindicate their rights.

Inherent Industry Advantages

Predatory lending has been able to thrive, in part, because of the sheer complexity of the typical mortgage transaction. Given the technical nature of lending transactions and the financial sophistication required to evaluate tradeoffs among various loan terms, it is all too easy for unscrupulous lenders to include loan terms that are unfavorable to borrowers. When binding mandatory arbitration is added to this mix, borrowers are at an even greater disadvantage.

Arbitration was originally conceived as an alternative way to resolve disputes between sophisticated commercial entities. It has also had some success in the highly-regulated forms employed to resolve securities disputes,⁴ although some question its effectiveness there as well.⁵ However, unlike securities disputes, where the parties involved are both likely to have substantial assets, home loan arbitration hearings pit lenders against homeowners who typically have little money to finance their dispute.⁶

In fact, homeowners who are pursuing claims that equity has been stripped from their home often find it difficult to use any scarce remaining resources to pay the high costs of arbitration. Together, the costs of losses from predatory lending and the costs of arbitration necessary to remedy these losses can make borrowers unwilling to take the chance that the forum is balanced in favor of the lender. Of particular concern is the ability of African Americans and Hispanics to seek meaningful recourse in arbitration, given that the median net worth (2002 data) of African-American households is \$5,998, and for Hispanic households, \$7,932.⁷

Favorable odds for repeat-players. Repeat-players in arbitration, such as lenders, have an edge over newcomers, such as individual homeowners.⁸ Unlike publicly accountable courts where officials assign hearing officers, lenders may gain an advantage by selecting an arbiter or arbitration forum known to favor industry. Likewise, in order to ensure future business, arbiters have an incentive to act in a manner that garners a lender's approval. A major investigation of arbitration in California exposed potential conflicts of interest between arbitration firms and their corporate clients, citing studies showing that employees win a very low percentage of arbitrated cases compared to their employers who frequently use arbiters.⁹

Two sets of rules. Since lenders draft forced arbitration clauses, they regularly reserve advantages for themselves. For example, some lenders require that all homeowners' claims be arbitrated while reserving their own right to take some or all claims to court.¹⁰ Lenders also may reserve the right to collect costs or attorneys' fees while denying that right to homeowners.¹¹

When lenders pay substantial sums to an arbitration forum and regularly win disputes before the forum, it creates at least the impression of bias. For example, First USA, a consumer creditor, has paid the National Arbitration Forum millions of dollars in fees and has won 99.6% of its claims that were arbitrated before the Forum.¹² Perhaps equally troubling is the connection

between arbitration forums and their corporate clients, who serve as directors and members of the very forums that resolve their disputes with homeowners and consumers.¹³

The Waiver of Homeowners' Claims

Forced arbitration not only changes the procedural aspects of a homeowner's case, as the following points illustrate, it can effectively waive substantive claims in these ways:

- Lack of competence standards and limited judicial review. No binding public standards require the private individuals sitting in judgment in arbitration hearings to meet minimal measures of competence or even to be licensed as an attorney. As a result, homeowners may lose meritorious claims when incompetent arbiters misunderstand or misapply the law. Unfortunately, the limited judicial review available to homeowners harmed by such incompetence is usually too narrow to correct such mistakes. In fact, even when a federal court believes that an arbiter applied the law incorrectly, it generally lacks the authority to overturn the decision.¹⁴ In one reported account, a judge acknowledged that a woman's valid sexual harassment claim had been improperly rejected by an arbiter who misapplied the law, but the judge concluded that he lacked the authority to overturn the decision.¹⁵ To further complicate matters, many arbitration hearings fail even to produce written opinions for review.¹⁶
- Restrictions on penalties, awards, attorneys' fees and limited incentives for legal counsel. Under current law, lenders can insert wholesale restrictions on certain damages in their binding arbitration clauses; for example, they may prohibit any punitive damages. The result is that lenders can conduct illegal but profitable business practices without fear of facing the stiff penalties courts assess for flagrant violations. As a further disadvantage, homeowners may find it difficult to obtain adequate legal assistance, since lenders can place restrictions on the awarding of attorneys' fees. Moreover, because arbitration cases typically result in smaller awards, attorneys have less incentive to accept arbitrated cases on a contingency basis.
- Restrictions on useful class action enforcement of homeowner protections. Many homeowner protection laws have only been enforced because of the ability of complainants to share costs in litigation through class action lawsuits. However, arbitration clauses can, and routinely do, waive the right to pursue class action suits -- even class arbitration is routinely prohibited.¹⁷ Accordingly, a homeowner with a dispute of several thousand dollars can be priced out of justice.
- Frustrates legitimate claims by short-cutting procedural protections. No law ensures that arbitration provide homeowners with a full opportunity to develop and present their case. This is an especially devastating blow to homeowners seeking to vindicate their rights since cases can turn on documents and other evidence that may only be in the possession of the lender.¹⁸ In fact, to sustain certain claims,¹⁹ homeowners must demonstrate that the lender's violations are part of a "pattern or practice," a standard that can almost never be met without substantial discovery. In voluntary post-dispute arbitration this is a lesser concern since both parties are much more likely to understand the dispute at hand and the limitations of the process. However, when a homeowner waives his or her rights through a "standard"

provision before a claim arises, a lack of adequate process protections can prevent a full and fair hearing.

Conclusions

BMA essentially reduces the financial and legal risks of engaging in abusive lending practices by denying borrowers access to the courts and, in effect, rewriting the legal rules that apply to financial transactions. While exceptions may exist, the bulk of evidence reveals arbitration to be a biased and relatively expensive option for homeowners seeking to resolve a claim. Even under the best of circumstances, BMA deprives citizens of their day in court -- citizens who often are fighting for the right to keep their homes and preserve their life's savings. In a nation with a long history of encouraging homeownership, this forced separation from courts of law is patently unacceptable and calls for meaningful policy changes.

A number of states have passed strong anti-predatory lending laws that have been effective in curbing abuses in the subprime mortgage market. However, the ability of the states to address BMA is complicated by the Federal Arbitration Act (FAA), a law enacted in 1925 that has been interpreted to preempt state regulation of arbitration agreements.²⁰ As this use of the FAA has become a serious impediment to justice for homeowners and others affected by BMA, the FAA should be amended to eliminate BMA or to allow the states to do so.

The Center for Responsible Lending has joined a coalition of consumer organizations concerned about the widespread negative effects of BMA, not only in mortgage lending but in many areas of commerce where mandatory arbitration is frequently employed. The coalition's website (<http://www.GiveMeBackMyRights.com>) includes more information about BMA as a broad consumer rights issue.

BMA imposes serious restrictions on homeowners' rights to pursue appropriate judicial remedies, and it is usually not a conscious or desired choice. The potential costs of arbitration, combined with lender advantages and the curtailment of standard legal protections, make mandatory arbitration a poor choice for virtually all borrowers in the subprime market. No one accepts a loan while anticipating a legal dispute but, unfortunately, disputes arise. We should ensure that borrowers have access to a fair and open process for pursuing justice when necessary.

About the Center for Responsible Lending

The Center for Responsible Lending (CRL) is a national nonprofit, nonpartisan research and policy organization dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, the nation's largest community development financial institution.

For additional information, please visit our website at www.responsiblelending.org.

¹ Reynolds Holding, *Private Justice: Can Public Count on Fair Arbitration?*, A15 SAN FRANCISCO CHRONICLE (Oct. 8, 2001) (citing comments from a former arbitration salesman discussing how the firm's arbiter attended sales meetings where he stressed "arbitration was a less expensive, faster, and confidential process").

² Mark E. Budnitz, *Arbitration of Disputes Between Consumers and Financial Institutions: A Serious Threat to Consumer Protection*, 327-28, 10 OHIO STATE JOURNAL OF DISPUTE RESOLUTION 267 (1995) (discussing how confidentiality of arbitration frustrates consumer interests through secrecy).

³ *National Arbitration Forum Code of Procedure*, at <http://www.arbforum.com/programs/code/appx-c.asp>.

⁴ Debbie Goldstein, *Regulated Securities Arbitration Provides Protections Not Available in Home Lending Arbitration*, Coalition for Responsible Lending (2001).

⁵ Paul Joseph Foley, *The National Association of Securities Dealers' Arbitration of Investor Claims Against Its Brokers: Taming the Fox that Guards the Henhouse*, 7 N.C. BANKING INST. 239 (2003) (describing how securities arbitration is exhibiting a growing litigious nature making it less efficient and defeating the primary reason why litigation was replaced by arbitration).

⁶ Arthur B. Kennickell, *An Examination of Changes in the Distribution of Wealth From 1989 to 1998: Evidence from the Survey of Consumer Finances*, Federal Reserve Board (Mar. 29, 2001), at <http://www.federalreserve.gov/pubs/oss/oss2/method.html>; and Arthur B. Kennickell, Martha Starr-McCluer, and Brian J. Surette, *Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances*, Federal Reserve Board (Jan. 2000), at <http://www.federalreserve.gov/pubs/oss/oss2/98/scf98home.html>.

⁷ Rakesh Kochar, *The Wealth of Hispanic Households: 1996 to 2002*, Pew Hispanic Center (2004).

⁸ David S. Schwartz, *Enforcing Small Print to Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration*, 60-61 WISC. L. REV. 33 (1997) (detailing reasons repeat players have advantages and citing a relevant study).

⁹ See Holding, note 1.

¹⁰ See, e.g., *Harris v. Green Tree Financial Corp.*, 183 F.3d 173, 181 (C.A.3 1999) (permitting BMA clauses that give the lender the option to litigate issues in court, while requiring borrowers to use arbitration).

¹¹ See e.g., Paul D. Carrington, *The Dark Side of Contract Law*, 74 TRIAL (May 2000) (discussing loan agreement that reserved rights for lender and required consumer to waive right to join a class action, pay bank's legal fees upon losing, and "arbitrate any claim in an expensive private forum").

¹² See Carrington, note 11 (noting that appellate court held that First USA was not required to show that the arbitration form was neutral and citing a study that showed that employees won 16 percent of cases against repeat players and 71 percent against non-repeat players).

¹³ See, e.g., Carrington, note 11 (noting that "[s]everal corporate officers of General Electric, Sprint and other companies that use the [American Arbitration Association's] arbitrators have been directors of American Arbitration. And last year the association received more than \$2.1 million in membership fees from Aetna, GE Industrial Systems, and other corporations, institutions and individuals.").

¹⁴ See Richard E. Speidel, *Arbitration of Statutory Rights Under the Federal Arbitration Act: The Case for Reform*, 191-198, 4 OHIO STATE JOURNAL OF DISPUTE RESOLUTION 157, (discussing limitations on appeals of arbitration decisions).

¹⁵ Reynolds Holding, *Private Justice: Millions are Losing their Legal Rights*, A1 SAN FRANCISCO CHRONICLE (Oct. 7, 2001) (reporting that an arbiter had misapplied the law and consequently rejected a claim brought by a woman who was subject to verbal and physical harassment—including being "gyrated against"—by a supervisor and that a federal judge agreed that her claim "met all the requirements for proving sexual harassment" but then ruled that he lacked the authority to overturn the arbiter's decision).

¹⁶ See Holding, note 15. See also, Budnitz, note 2 at 312-14 (discussing negative effect arising from lack of arbiter expertise in substantive law).

¹⁷ See *American Arbitration Association Policy on Class Arbitrations* (Oct. 8, 2003), at <http://www.adr.org/ArbitrationPolicy> (declining to administer class arbitration proceedings if prohibited in contract unless required by court).

¹⁸ See Budnitz, note 2 at 312 (discussing limitations in arbitration procedures for discovery of facts in issue).

¹⁹ See e.g., 12 U.S.C. § 1639(h) (setting forth the rule that "[a] creditor shall not engage in a pattern or practice of extending [high-cost] credit to consumers ... based on the consumers' collateral without regard to the consumers' repayment ability, including the consumers' current and expected income, current obligations, and employment").

²⁰ See, e.g., *Doctor's Associates v. Casarotto*, 517 U.S. 681 (1996) (FAA preempted a Montana law that made arbitration clauses void unless special notice requirements applied).