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CFPB Proposes a Ban on Arbitration Clauses that Prevent Class Action Litigation

Regulation Would Expose 50,000+ Companies to Class Actions

On May 5, 2016, the Consumer Financial Protection Bureau (CFPB) released a 377-page notice of proposed rulemaking that would prohibit, going forward, banks and a variety of other companies from including in contracts arbitration clauses that would prevent consumers from filing or participating in class-action litigation. According to the press release: "With this contract gotcha, companies can sidestep the legal system, avoid accountability, and continue to pursue profitable practices that may violate the law and harm countless consumers."[1] The proposed regulation would continue to allow companies to insist on arbitration instead of *individual* litigation, but would require companies to submit records related to arbitrations to CFPB for monitoring and for potential posting in some form on its website. The public will have 90 days to comment on the proposal once it is published in the *Federal Register*.

The impact of this controversial proposal would be significant: CFPB itself estimates that it would expose approximately 53,000 providers, which currently employ arbitration clauses, to class action litigation.[2] The proposal covers a large swath of what the agency calls the "core" consumer financial markets within its rulemaking authority—lending money, storing money, and moving or exchanging money. Subject to various exceptions and nuances, the reach of the proposed regulation includes:

- Banking products, including deposit accounts and credit cards;
- Most types of consumer lending, such as private student loans, auto loans, auto title loans, and small-dollar or payday loans (also included are the "acquiring, purchasing, selling, or servicing" of such consumer credit);
- Debt collection, debt buying, and debt-relief services;
- Consumer reports, including providers of credit scores and credit monitoring;
- Remittance transfers, domestic money transfers, currency exchanges, mobile payment apps, payment processors and check-cashing; and
- Mobile wireless carrier third-party billing services.[3]

Below, we summarize the proposed regulation's key features and rationale, and discuss some observations and implications, including the possibility that a final regulation will be challenged in court.

CFPB's March 2015 Arbitration Study

Under section 1028(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), CFPB is required to publish a study on mandatory pre-dispute arbitration agreements (for convenience, "arbitration agreements" or "arbitration clauses") in consumer financial markets.[4] That section also authorizes CFPB to issue regulations that "prohibit" or "impose conditions or limitations" on such agreements if doing so is in the "public interest and for the protection of consumers" and the regulations are consistent with the study.

In March 2015, CFPB released a 728-page study that analyzed a number of topics, including the prevalence of arbitration agreements in various consumer financial contracts, consumer understanding of arbitration, and the volume and nature of individual consumer arbitrations and individual and class litigations. Among other things, the study found that hundreds of millions of consumers use financial products or services that are subject to arbitration agreements,[5] including credit cards (53% of outstanding credit card loans are subject to arbitration[6]); checking accounts (58.8% of insured deposits[7]); general purpose reloadable (GPR) prepaid-card contracts (92.3%[8]); and storefront payday loan contracts (83.7%[9]). In addition, between 85% to 100% of arbitration agreements studied provided that arbitration may not proceed on a class basis. Most agreements had a carve-out permitting small claims court litigation. Most agreements also explicitly disclosed that consumers would not have a right to a jury trial and could not be a party to a class action in court.[10]

While CFPB believes that its study was "the most comprehensive analysis to date of the arbitration content of contracts for consumer financial products and services,"[11] it has been subject to extensive criticism, both by industry groups[12] and members of Congress.[13]

CFPB's Proposed Regulation[14]

The proposed regulation has two main sets of provisions—class action provisions and provisions relating to the submission of arbitration documents to CFPB—that would apply to the broad scope of companies selling the products and services noted above. The proposal also provides for a compliance date of 180 days after the effective date of the final regulation.

Class Action Provisions. CFPB proposes to bar a large variety of companies (termed "providers") that offer certain consumer financial products and services from relying in any way on arbitration agreements (entered into following the compliance date) to prevent a consumer from filing a class action or participating in a class action as an absent class member.[15] If, however, a court denies class action status and this denial is not reversed on appeal, a provider can insist on arbitration.[16]

In addition:

- The proposed regulation would require providers, after the compliance date, to insert language into their arbitration agreements stating as follows: "We agree that neither we nor anyone else will use this agreement to stop you from being part of a class action case in court. You may file a class action in court or you may be a member of a class action even if you do not file it."[17]

- The proposal contains a variation on the above language to address situations where a contract covers various products or services, only some of which are covered by the proposed regulation.[18]

- In situations when a contract was originally entered into by other parties, a provider has the option of sending to a consumer a notice in lieu of inserting language into their contract.[19]

In justifying its proposal, CFPB explained that the primary purpose of mandatory arbitration provisions is to allow companies to invoke arbitration as a way of avoiding class-action litigation. Yet, in CFPB's view, individual disputes are "insufficient as the sole mechanism available to consumers to enforce contracts and the laws applicable to consumer financial products and services."[20] CFPB found instead that class actions are an essential tool for enforcing consumer rights, particularly in low-dollar-value cases. In discussing the efficacy of class actions, CFPB cited its conservative estimate that, in a recent five-year period, at least 160 million consumers were eligible for relief in consumer financial class action settlements, which totaled $2.7 billion in cash, in-kind relief, and attorney's fees and expenses.[21]

CFPB acknowledged that for companies that can currently invoke arbitration clauses to avoid class actions, the regulation would likely increase their costs, some of which may be passed on to consumers. This is because exposure to class actions would prompt companies to invest more in compliance and scale back practices that are profitable but legally risky; companies would also bear greater costs defending against and resolving class actions themselves. For example, CFPB estimated that the regulation would increase class action exposure for about 53,000 companies and result in about 103 additional class action settlements in federal court per year, costing around $450 million in payments to consumers and attorney's fees.[22] CFPB nevertheless opined that all of these costs were worth enhanced private enforcement of contracts and consumer protection law. The agency also believes that increased costs would not result in a "noticeable impact on access to consumer financial products or services."[23]

CFPB also noted that Congress, in the Dodd-Frank Act, banned arbitration clauses in residential mortgage contracts. Moreover, since 1992, the Financial Industry Regulatory Authority (FINRA) has had a rule, approved by the Securities and Exchange Commission (SEC), requiring arbitration agreements adopted by broker/dealers to include language disclaiming the application of the arbitration agreement to class actions filed in court.[24]

Submission of Arbitration Documents to CFPB. Relying on its general rulemaking authority and its authority to obtain information to monitor consumer finance markets, CFPB also proposed requiring providers that use arbitration agreements to submit, within 60 days of filing or receipt, records regarding arbitrations concerning covered products or services. This includes information on claims or counterclaims, the arbitration agreement filed with the arbitrator, judgments or awards (if any) issued by the arbitrator, and certain correspondence regarding a provider's non-payment of arbitral fees and the arbitration agreement's non-compliance with arbitral principles or rules.[25] The records would have to be redacted pursuant to CFPB's requirements.

CFPB is considering publishing this information on its website in some form, with appropriate redactions or aggregation as warranted, to increase transparency.[26] CFPB intends to use the information to determine whether there are developments in arbitral proceedings that raise consumer protection concerns and to monitor for products or practices that harm consumers. CFPB also stated that this information would allow it to take enforcement action or make a referral if particular companies were harming consumers with respect to arbitration agreements, such as by "routinely not paying arbitration fees."[27] The agency will consider whether specific practices in relation to arbitration constitute unfair, deceptive, or abusive practices.[28]

Comment Sought on Exemption for Small Entities. CFPB noted that while small entities tend to have arbitration clauses less often than larger entities, in situations where small entities do have such clauses, it believed it was important to have class actions available. Nevertheless, while the agency is not proposing an exemption for small entities, it seeks comment on such an exemption and how it would be defined.[29]

Compliance Date. As required by the Dodd-Frank Act, the regulation, if finalized, would apply prospectively to contracts entered into 180 days after the effective date of the regulation. CFPB proposed that the effective date be set at 30 days from publication of a final regulation in the *Federal Register*. CFPB calls the end of the 180-day period the "compliance date."[30]

If, after the compliance date, a provider purchases and becomes a party to a covered contract that had been entered into prior to the compliance date, the proposed regulation would appear to require the purchaser to comply with its requirements.[31]

Observations and Implications

1. **Sweeping scope of companies and products/services covered**: CFPB has proposed to apply the regulation to what appears to be the full extent of its rulemaking authority in many (but not all) areas. This is the first CFPB proposed regulation to do so. Title X of Dodd-Frank describes CFPB's authority over what it terms "consumer financial products and services" in intricate fashion, listing a variety of activities, various exceptions (such as for certain auto dealers and merchants of non-financial products) and then exceptions to those exceptions.[32] For

companies that have been unsure as to whether certain products or services fall under CFPB's authority, this regulation may prompt companies to resolve those questions (or to comply with the regulation out of an abundance of caution). And while CFPB usually has retained control of when the limits of its jurisdiction are tested in court—insofar as it can decide which enforcement actions to bring—a final arbitration regulation would provide occasion for companies and consumers to litigate these jurisdictional issues. Determining the scope of the regulation's coverage is likely to be an important and vexing issue in the public comment process and in the ultimate implementation of any final regulation.

2. **Enforcement of a final arbitration regulation:** Although not discussed in the proposal, as a regulation issued under Title X of the Dodd-Frank Act, CFPB would have authority to investigate and bring enforcement actions (including the imposition of civil monetary penalties) for violations of the regulation by entities within its enforcement authority, which is a subset of those covered by its rulemaking authority. Generally, CFPB has enforcement authority over banks with more than $10 billion in assets (and their affiliates) and a large variety of non-bank consumer financial services companies. The federal banking agencies would have authority to enforce the regulation with respect to the remaining smaller banks, and the Federal Trade Commission would have concurrent authority to enforce the rule with respect to non-banks. In addition, state attorneys general (and state regulators in some instances) will likely invoke section 1042 of the Dodd-Frank Act as authority for enforcing the arbitration regulation, even including state attorneys general actions against national banks and federal thrifts. (Section 1042 generally requires consultation with CFPB in advance of such enforcement actions.) Further, consumers would likely rely on the final regulation to resist a company's invocation of arbitration rights in alleged violation of the regulation.

3. **Potential challenges to a final arbitration regulation:** News reports have indicated the possibility of one or more industry challenges to any final regulation, and it is likely that the groundwork for such challenges will be laid in the comments on the proposal. Such challenges could be brought in a variety of courts and could be based on a number of grounds, including that CFPB's empirical analysis and reasoning (including CFPB's arbitration study and the statutorily required analysis of costs and benefits) is arbitrary or capricious under the Administrative Procedure Act. Challengers could also argue that CFPB lacks sufficiently clear authority to target the application of arbitration clauses to class actions, particularly in light of the Supreme Court's interpretation of the Federal Arbitration Act in *AT&T Mobility LLC* v. *Concepcion*.[33] Any lawsuits would likely also include constitutional objections to CFPB's structure, which appear to have interested the D.C. Circuit panel in the pending case, *PHH Corp.* v. *CFPB*.[34]

4. **Practical considerations for potentially affected companies or investors in such companies:** Companies should determine whether any of their activities are covered by the proposed regulation and review the arbitration provisions in their existing contracts. Companies should also consider whether their business models, including the sales or securitizations of consumer debt or other contracts, would be impacted by the regulation. Companies may wish to consider whether to participate in the public comment process, either individually or through a trade association, to address the proposal generally or to make more specific suggestions regarding exceptions or clarifications with respect to the regulation's coverage of particular activities. In situations in which companies believe that a final regulation would meaningfully increase their class action exposure, companies may wish to review their compliance policies and procedures and any affected products and services to assess and mitigate this legal risk.

> According to CFPB, in 68% of putative consumer class actions, there was no overlapping private enforcement action, and in those cases where there was overlap, class actions preceded public enforcement actions two thirds of the time.[35]

CFPB's proposed regulation can be found here and its March 2015 arbitration study can be found here.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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[1] CFPB, *CFPB Proposes Prohibiting Mandatory Arbitration Clauses that Deny Groups of Consumers their Day in Court* (May 5, 2016), http://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-proposes-prohibiting-mandatory-arbitration-clauses-deny-groups-consumers-their-day-court/.

[2] CFPB, Notice of Proposed Rulemaking on Arbitration Agreements (NPRM), May 3, 2016, at 285.

[3] "In mobile wireless third-party billing, a mobile wireless provider authorizes third parties to charge consumers, on their wireless bill, for services provided by the third parties. Because mobile wireless third-party billing involves the extension of credit to, and processing of payments for, consumers in connection with goods and services that the provider does not directly sell and that

consumers do not purchase from the provider, the provision of mobile wireless third-party billing is a 'consumer financial product or service' under the Dodd-Frank Act." NPRM at 41 n.157.

[4] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010).

[5] NPRM at 107.

[6] *Id.* at 41.

[7] *Id.* at 42.

[8] *Id.*

[9] *Id.*

[10] *Id.* at 44–46. In addition, CFPB analyzed all arbitrations conducted by the American Arbitration Association from 2010 to 2012 in six consumer financial markets, and found that consumers filed approximately 616 arbitration disputes each year. The six markets are credit cards, checking accounts, general purpose reloadable (GPR) prepaid cards, storefront payday loans, private student loans, and mobile wireless third-party billing services. CFPB also analyzed individual litigations filed in federal court in five of the six markets during 2010–2012, and found approximately 1,154 lawsuits filed per year. *Id.* at 55. CFPB analyzed putative class actions filed in the six markets in federal court and select state courts (Utah, Oklahoma, and New York, plus seven counties) and found 187 filings per year during this timeframe. *Id.* at 61, 64.

[11] *Id.* at 38.

[12] For example, on July 13, 2015, the American Bankers Association, the Consumer Bankers Association, and the Financial Services Roundtable submitted a comment letter to CFPB in response to the CFPB Study, *available at* https://www.aba.com/Advocacy/commentletters/Documents/cl-jointArbitration2015.pdf.

[13] In June 2015, a group of more than 80 House and Senate Republicans sent a letter to Director Cordray asking CFPB to "reopen the study process, seek public comment, and provide the necessary cost-benefit analysis for understanding how a similarly situated consumer would fare in arbitration versus a lawsuit." The lawmakers observed that "[r]ather than focusing on the critical question – whether regulating or prohibiting arbitration will benefit consumers – and devising a plan to address the issues relevant to resolving the question, the Bureau failed to provide even the most basic of comparisons needed to evaluate the use of arbitration agreements." *See* Letter from Members, U.S. Congress, to Richard Cordray, Dir. of the Consumer Fin. Prot. Bureau (Jun. 17, 2015), *available at* http://mchenry.house.gov/uploadedfiles/mchenry-scott-to-cordray-letter-re-arbitration.pdf.

[14] In October 2015, CFPB released an outline of its regulatory proposals in connection with a Small Business Review Panel charged with gathering feedback from smaller industry stakeholders. *See* CFPB, *Small Business Advisory Review Panel for Potential Rulemaking on Arbitration Agreements* (Oct. 2015), at 4, *available at* http://files.consumerfinance.gov/f/201510_cfpb_small-business-review-panel-packet-explaining-the-proposal-under-consideration.pdf. With the release of its proposed regulation last week, CFPB also released findings from that Panel. CFPB, *Final Report of the Small Business Review Panel on the CFPB's Potential Rulemaking on Pre-Dispute Arbitration Agreements* (Dec. 11, 2015), *available at* http://files.consumerfinance.gov/f/documents/CFPB_SBREFA_Panel_Report_on_Pre-Dispute_Arbitration_Agreements_FINAL.pdf.

[15] NPRM at 361 (proposed 1040.4(a)(1)).

[16] *See id.* at 373.

[17] *Id.* at 361 (proposed 1040.4(a)(2)(i)).

[18] *Id.* at 361 (proposed 1040.4(a)(2)(ii)).

[19] *Id.* at 362 (proposed 1040.4(a)(2)(iii)).

[20] *Id.* at 92. In comparing arbitration and *individual* litigation, CFPB concluded that it was unable to say which was superior.

[21] *Id.* at 103.

[22] *Id.* at 285. CFPB also provided figures using more conservative assumptions. See *id.* at 285 n.601.

[23] *Id.* at 132.

[24] *Id.* at 185.

[25] *Id.* at 362-63 (proposed 1040.4(b)).

[26] *Id.* at 142. CFPB stated, for example, that while AAA and JAMS are specified as administrators in the vast majority of arbitration agreements and they have procedural and substantive safeguards, companies may designate other administrators that may be biased or employ unfair procedures. *Id.* at 139-40.

[27] *Id.* at 143.

[28] *Id.* at 229.

[29] *Id.* at 211.

[30] *Id.* at 5, 150. CFPB included a grace period for certain prepaid cards that were packaged before the compliance date. *Id.* at 364 (proposed § 1040.5(b)).

[31] *Id.* at 371 (proposed Official Interpretation 1040.4(1)(i)(B)).

[32] *See, e.g.*, Dodd-Frank Act §§ 1002(5); 1027; 1029.

[33] 563 U.S. 333 (2011). Note that in February 2016 Senator Patrick Leahy introduced a bill, entitled the Restoring Statutory Rights and Interests of the States Act of 2016, which would amend the Federal Arbitration Act to make it inapplicable to claims brought by individual or small businesses "arising from the alleged violation of a Federal or State statute, or the Constitution of the United States, or a constitution of a State, unless the written agreement to arbitrate is entered into by both parties after the claim has arisen and pertains solely to an existing claim."

[34] *See* Per Curiam Order of April 4, 2016, *PHH Corp.* v. *CFPB*, No. 15-1177 (D.C. Cir. Apr. 4, 2016).

[35] NPRM at 114.