July 19, 2017

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

Today, the Consumer Financial Protection Bureau (CFPB) published a 225-page final rule in the *Federal Register* that will prohibit a variety of providers of consumer financial products and services from entering into or enforcing contracts that include pre-dispute arbitration clauses that would preclude class action litigation. The rule will apply to contracts entered into on or after the rule's compliance date, **March 19, 2018**. The rule will continue to allow the enforcement of arbitration clauses in *individual* litigation, but will require providers to submit certain arbitration and court filings to CFPB. CFPB will then make such documents publicly available on its website with only minimal redactions.

Invoking Section 1028 of the Dodd-Frank Act, CFPB justified the final rule based on its findings that arbitration clauses prohibiting class actions are prevalent in contracts for consumer financial products and services and that they have deterred the litigation of small claims that are uneconomic to arbitrate individually yet potentially meritorious and common to many consumers. By CFPB's estimate, the new rule will lead to more than 100 additional consumer finance class action settlements per year in federal court, which will cost defendants approximately $450 million to $650 million to resolve.

Republicans in Congress have already launched efforts to repeal the rule by legislation under the Congressional Review Act. The rule could also be set aside by a two-thirds vote of the Financial Stability Oversight Council (FSOC), and industry associations have also threatened to challenge the regulation in court. But unless and until the rule is repealed, set aside, or overturned, approximately 53,000 companies (by CFPB's estimate) will have to redraft their standard consumer contracts and prepare for additional class action litigation.

Companies Subject to the New Rule

The new rule 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);

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- 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.[1]

The rule also applies to affiliates of providers, to the extent that they are involved with these activities.[2] Persons exempt from the rule include:

- Companies regulated by the Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission (CFTC) or broker dealers or investment advisors regulated by a state securities commission;[3]
- Companies that provided services to no more than 25 consumers in the current year and prior year;
- Certain merchants of nonfinancial goods or services that extend credit for purchases of their own goods or services;
- Employers that offer financial products or services to their employees; and
- Other persons exempted by the Dodd-Frank Act from CFPB's authority (such as real estate brokers, manufactured home retailers, accountants and tax preparers, lawyers, insurers, and auto dealers).[4]

The Ban on Arbitration Clauses that Prevent Class Action Litigation

CFPB has barred a large variety of providers of 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. If, however, a court denies class action status and this denial is not reversed on appeal, a provider can insist on arbitration.[5] In addition, the rule requires providers, after the compliance date, to insert language into their arbitration agreements stating as follows: "We agree that neither we nor anyone else will rely on 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 filed by someone else."[6]

Submission of Arbitration Records to CFPB

The rule also requires providers to submit certain arbitration filings and court filings to CFPB within 60 days of filing or receipt.[7] CFPB intends to create a publicly available "repository" of these submissions on

its website by no later than July 1, 2019.[8] Prior to submission, the provider is required to redact certain sensitive information concerning natural persons, such as names, addresses, and social security numbers.[9] But there is no provision for the redaction of any other commercially sensitive or confidential information. CFPB disagreed with various objections that arbitration records should remain confidential, finding that it was in the "public interest" to publish the records covered by the rule, even if such publication is in "conflict with State law."[10]

Compliance Date

As required by the Dodd-Frank Act, the regulation applies prospectively to contracts entered into more than 180 days after the effective date of the regulation. The effective date will be 60 days from publication of a final regulation in the *Federal Register*, which occurred today. CFPB calls the day after the 180-day period (March 19, 2018) the "compliance date."[11] 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 rule would appear to require the purchaser to comply with the rule's requirements.

Observations and Implications

Sweeping scope. The new rule has a sweeping scope, covering a broad range of products and services. Companies that have previously been unsure as to whether certain of their products or services fall under CFPB's authority may now have to resolve those questions (or to comply with the regulation out of an abundance of caution). Even if companies determine that they are not subject to the rule, future class action plaintiffs may disagree and invoke the rule in opposing motions to compel arbitration. Such litigation could test the limits of CFPB's jurisdiction, particularly in areas where CFPB has previously refrained from enforcement actions (potentially to avoid such a determination).

Enforcement actions. Companies that fail to comply with the new rule may face enforcement actions, which may result in civil monetary penalties. 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.[12]

Potential legislative repeal. Senator Tom Cotton (R-AR) has already started the process to introduce legislation to repeal the new rule pursuant to the expedited procedures of the Congressional Review Act. Those procedures—which, though rarely invoked historically, have been successfully used to repeal 14 agency regulations since this January[13]—require a simple majority vote in both houses of Congress and the signature of the president. Such a repeal would have to occur within 60 legislative days and would generally prohibit CFPB from reissuing a substantially similar rule. Director Richard Cordray's prepared remarks acknowledged the possibility of such a repeal, but stated: "My obligation as the Director of the Consumer Bureau is to act for the protection of consumers and in the public interest."

OCC objections and potential FSOC repeal. In a letter to Cordray, Acting Comptroller of the Currency Keith Noreika expressed concerns that the rule could implicate the "safety and soundness" of national banks and thrifts, which the Office of the Comptroller of the Currency (OCC) supervises. Noreika asked Cordray to delay the publication of the rule in the *Federal Register* while the OCC conducts an independent review of CFPB's data. Under Section 1023 of the Dodd-Frank Act, the FSOC—which has 10 voting members, including Noreika and Cordray—has the authority to set aside CFPB's rules by a two-thirds vote if it determines that they threaten the safety and soundness of the U.S. banking system. For the FSOC to use this authority, a member must call for a vote no later than 10 days after publication of the rule in the *Federal Register*. Cordray has stated publicly that Noreika has no standing to call for a FSOC vote because the OCC did not object to the proposed rule during the notice and comment period.

Potential court challenges. Industry groups may also challenge the rule in court under the Administrative Procedure Act or based on constitutional objections to CFPB's structure. The *en banc* D.C. Circuit is slated to decide the constitutional issue in *PHH Corp.* v. *CFPB*,[14] following a panel decision that held CFPB's structure to be unconstitutional.[15]

Old contracts remain in effect. The rule does not prohibit companies from enforcing pre-dispute arbitration clauses entered into prior to the rule's compliance date. This could lead to a situation where—for contracts that do not expire after a fixed term—companies have an incentive not to update old agreements after the compliance date. For similar reasons, companies also have an incentive to update such agreements just prior to the compliance date. For a time, the class actions able to proceed as a result of the rule may be limited to those subsets of customers who entered into contracts on or after the compliance date.

Practical considerations for potentially affected companies. Companies should determine whether any of their activities are covered by the new rule and review the arbitration provisions in their existing contracts. Companies should also consider how their business models, including the sales or securitizations of consumer debt or other contracts, are affected by the regulation. If the rule increases a company's class action exposure, it may wish to review its compliance policies and procedures and any affected products and services to assess and mitigate legal risks. Such a review might include a fresh look at the company's disclosures, point of sale processes, and product design. Finally, companies might want to reconsider whether, given the inability of an arbitration clause to defeat a class action and in light of the rule's new reporting obligation, they still prefer to use arbitration clauses at all. For some, it may be better to use a forum selection clause that provides for venue in a convenient court. In addition, the rule does not preclude a company from including a jury waiver in its contracts; nor does it preclude a company from including a class action waiver if those contracts do not require arbitration.[16] The enforceability of such provisions may vary from state to state.

The final rule can be found here. Our memorandum regarding the proposed rule can be found here, and a video regarding the proposed rule 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] 12 C.F.R. § 1040.3(a).

[2] *Id.* § 1040.2(d)(2).

[3] The exemptions for persons regulated by the SEC, CFTC, and state securities commissions did not appear in the draft rule proposed in May 2016. The draft rule would have excluded only "broker dealers," and only to the extent they were already subject to Rule 2268 of the Financial Industry Regulatory Authority (FINRA) or a similar rule approved by the SEC. In explaining the new exemptions, CFPB noted that these other regulators have the authority to regulate the use of arbitration clauses by these persons. Final Rule at 478–81. These new exemptions appear to reflect CFPB's doubt regarding its authority over at least some of these persons.

[4] 12 C.F.R. § 1040.3(b).

[5] *Id.* § 1040.4(a)(1).

[6] *Id.* § 1040.4(a)(2)(i). The rule contains a variation on this language to address situations where a contract covers various products or services, only some of which are covered by the proposed regulation. *Id.* § 1040.4(a)(2)(ii). 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. *Id.* § 1040.4(a)(2)(iii).

[7] *Id.* § 1040.4(b).

[8] *Id.* § 1040.4(b)(4), (6).

[9] *Id.* § 1040.4(b)(3).

[10] Final Rule at 609.

[11] 12 C.F.R. § 1040.5(a).

[12] 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.)

[13] *See, e.g.*, Paul Weiss Client Memorandum, President and Congress Eliminate SEC Resource Extraction Rule (Feb. 15, 2017).

[14] No. 15-1177 (D.C. Cir.).

[15] 839 F.3d 1 (D.C. Cir. 2016).

[16] CFPB believes that the contractual language required by the new rule will render class action waivers "ineffective." Final Rule at 570. But if the agreement does not contain an arbitration clause, then that language is not required.