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CFPB Proposes Ban on Class-Action Limitations in Arbitration Agreements

May 2016

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On May 5, 2016, the Consumer Financial Protection Bureau (the "CFPB" or the "Bureau") issued a long anticipated Notice of Proposed Rulemaking for arbitration agreements (the "Proposal") that, if finalized as proposed, is expected to result in the curtailment of pre-dispute arbitrations arising from the sale of consumer financial products and services.

The Proposal has two main components:

1. Prohibitions on pre-dispute arbitration agreements ("PDAAs") that bar consumers from filing or participating in class action lawsuits; and

2. Requirements that entities involved in arbitration proceedings pursuant to a PDAA submit certain arbitral records (such as arbitral claims and awards) to the CFPB.

The Proposal would apply broadly to most consumer financial products and services and, in turn, affect the vast majority of consumer financial services companies. As discussed below, it is likely that any final rule would not take effect until the second quarter of 2017, at the earliest.

Given its broad scope and impact, industry will likely continue to participate in the comment process and consider legal challenges to the final rule if it mirrors the Proposal. Further background on the Proposal, a discussion of its key terms, high-level thoughts on potential legal challenges to the rule and what impacted entities should consider are detailed below.

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Background

Under section 1028(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), Congress instructed the CFPB to study "the use of agreements providing for arbitration of any future dispute . . . in connection with the offering or providing of consumer financial products or services" and to summarize its findings in a congressional report.[1] Further, under section 1028(b), Congress granted the CFPB the authority to "prohibit or impose conditions or limitations on the use of an agreement . . . providing for arbitration of any future dispute between the parties, if the Bureau finds that such a prohibition or imposition of conditions or limitations is in the public interest and for the protection of consumers."[2]

March 2015 Arbitration Report

Pursuant to Congress's mandate, in March 2015, the CFPB released a detailed report[3] examining the advantages and disadvantages of PDAAs.[4] Among other things, the report indicated that roughly 600 arbitration cases and 1,200 individual federal lawsuits were filed by consumers annually over the relevant time period.[5] In comparison, roughly 32 million consumers were eligible for relief through class action settlements in federal court each year.[6] While the March report submitted to Congress is "empirical, not evaluative,"[7] the CFPB concluded that arbitration clauses serve as a barrier to class actions. For example, in cases where credit card issuers with an arbitration clause were sued in a class action, the companies invoked the arbitration clause to block the class action 65% of the time.[8] Further, the CFPB found that over 90% of arbitration clauses expressly prohibit class arbitrations.[9] The report also highlighted that over 75% of credit card consumers did not know whether their credit card agreements contained an arbitration clause, and of those who thought they did know, more than half were incorrect.[10] Among those consumers whose contracts included an arbitration clause, fewer than 7% recognized that they could not sue their credit card issuer in court.[11] Notably, the CFPB also found no statistically significant evidence that companies that eliminated their arbitration clauses increased their prices or reduced access to credit relative to those that made no change in their use of arbitration clauses.[12]

October 2015 SBREFA Panel

Under the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA"), unless a covered agency, such as the CFPB, can certify that a proposed rule would not have a significant economic impact on a substantial number of small businesses, the agency must convene a panel of small entity representatives ("SERs") to solicit information on the impact the rule would have on small businesses and to recommend regulatory alternatives. A covered agency must then review the report submitted by the panel and, "where appropriate," modify the proposed rule.

Following the March report, in October 2015, without prejudicing its view on any small business impact an arbitration rule might have, the CFPB convened a SBREFA panel of 18 SERs (the "Panel") to discuss the potential rulemaking on PDAAs. According to CFPB's December 2015 SBREFA report, the majority of the SERs that included PDAAs in their consumer contracts primarily did so in order to defend against class action litigation.[13] Further, most SERs viewed the presence of a PDAA as deterring prospective plaintiffs from filing class actions against them, a fact that statistics on the volume of class suits faced by those SERs before and after implementing PDAAs, including class-action waivers confirmed.[14] The SERs, moreover, felt banning the use of such waivers would increase their exposure to class action lawsuits.[15]

Given such increased exposure, the SERs felt strongly that they would face markedly higher legal and operational costs.[16] Most SERs also rejected the CFPB's argument that the threat of increased class action exposure would cause them to increase compliance efforts materially, suggesting the CFPB's leverage theory would yield diminishing returns given the significant regulatory and litigation risks the SERs already face and the robustness of their current compliance efforts.[17] Finally, although the SERs did not believe that the direct costs of submitting arbitral claims and awards to the CFPB would be significant, they expressed some concern about the indirect costs, such as whether it might cause the cost of arbitration administration to increase.[18] The CFPB's SBREFA report outlined the Panel's 12 recommendations. Chief among them were:

- The CFPB should continue to evaluate the costs to small businesses of defending class actions and how such costs may differ from the costs to large entities;[19]

- The CFPB should determine whether small entities engage in different compliance practices than large entities and analyze the impact class actions have on small entities' conduct;[20]

- The CFPB should seek comment on whether the publication of claims and awards would present a representative picture of arbitration and should continue to assess whether, and by how much, its proposal regarding submission and publication of arbitration materials would increase the costs of arbitration, including administrative fees or covered entities' time;[21]

- The CFPB should consider whether there are alternatives to provide relief to consumers for harms and encourage compliance with relevant consumer financial laws that would not increase small entities' exposure to class action lawsuits that could increase their cost of credit;[22] and

- The CFPB should continue to evaluate whether it can improve consumer access to, and the efficacy of, individual arbitrations and whether these improvements would be sufficient to provide the same benefits the CFPB believes would be provided by the class proposal.[23]

The Proposal is largely silent as to these recommendations. Indeed, the Proposal appears to lay the groundwork for the CFPB to sidestep the SBREFA requirements (and the Panel recommendations) altogether insofar as it indicates the Bureau's preliminary view is that any final arbitration rule is unlikely to have a significant economic impact on small business.[24] Regardless, even if the CFPB concluded it should adhere to the SBREFA requirements, those requirements are flexible enough for the CFPB to elide the Panel's recommendations fully.[25] For these reasons, along with the CFPB's custom to date of finalizing rules largely as proposed, the final rule almost certainly will not account for the Panel's recommendations.

The Proposal

Based on the CFPB's interpretation of its March 2015 study, and despite the input from the SBREFA Panel, the Bureau concluded that the Proposal is in the public interest and for the protection of consumers. Specifically, the CFPB, among other things, emphasized that (1) "individual dispute resolution is insufficient as the sole mechanism available to consumers to enforce contracts and the laws applicable to consumer financial products and services"; (2) "class actions provide a more effective means of securing relief for large numbers of consumers affected by common legally questionable practices and for changing companies' potentially harmful behaviors"; and (3) "arbitration agreements block many class action claims that are filed and discourage the filings of others."[26] Consequently, the CFPB's position is that, by allowing class action exposure, companies and their representatives will "seek to focus more attention and resources on general proactive compliance monitoring and management."[27] The CFPB emphasizes concurrently that creating enhanced incentives and remedial mechanisms to enforce compliance would strengthen the functioning of the consumer financial markets as a whole, creating a more "predictable, efficient, and robust regime" and "reduc[ing] the risk that consumer confidence in these markets would erode over time."[28]

Scope

The Proposal would apply to all "providers," a term broadly defined to include all persons that engage in the offering of consumer financial products and services and one that sweeps in nearly every bank and non-bank, including fintech companies, involved in (among other things) deposit taking, lending, servicing, debt collection, debt sales, credit reporting, debt settlement and money transmission. A few types of entities are exempted, including various merchants.

Key Provisions

As noted previously, the Proposal principally does two things: (1) it prevents covered providers from using mandatory PDAAs to prevent class action lawsuits and (2) it requires covered providers that are involved in arbitrations pursuant to PDAAs to submit certain arbitral records to the CFPB.[29]

The Proposal's provisions banning limitations on class actions generally require all PDAAs to include the following language: "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." The CFPB's requirement of such explicit language in PDAAs is calculated to prevent institutions from circumventing the intent of the rule through creative legal drafting.

Notably, although the Proposal would end restrictions on class action lawsuits in PDAAs, it has no impact on class certification standards or related rules. For example, if class certification is denied, and a PDAA is in place, individual matters may be sent to arbitration.

Timing

The Proposal purports to have prospective effect, applying only to "agreement[s] between a consumer and a covered person entered into after the end of the 180-day period beginning on the effective date of the regulation [i.e., 30 days following publication of the final rule in the Federal Register]."[30] Thus, the Proposal would apply to PDAAs into which covered entities enter on or around seven months after the publication of the final rule; it would not apply to those PDAAs entered into before such time.

However, the Proposal implicates pre-existing PDAAs in two ways. First, it requires covered entities to provide detailed reports on any arbitration based on preexisting provisions, allowing the CFPB to monitor those disputes for systemic practices.[31] Second, it prohibits non-parties to the original, otherwise valid PDAA from enforcing its terms by forcing those who acquire consumer contracts to amend them to conform to the Proposal's requirements.

Industry Response

Strenuous opposition to the CFPB's Proposal has already emerged. Many have asserted that the Proposal, by prohibiting the limiting of class-actions in PDAAs, removes current incentives for institutions to subsidize arbitration costs for consumers and would result in a *de facto* elimination of PDAAs altogether. As the Executive Director of the U.S. Chamber of Commerce's Center for Capital Markets Competitiveness stated, "[n]o economically rational company (or individual) is going to spend additional money voluntarily [on arbitration] when it is forced to pay millions in litigation costs imposed by the broken class action system."[32]

A legal challenge to any final rule that substantially resembles the Proposal is widely expected. Such a challenge could proceed on many grounds, some of which will depend on the final rule text. If, however, a challenge is advanced, it will likely include, at least, the following grounds.

Constitutional Challenge

One possible challenge to the Proposal would be to argue that Congress's grant of authority under section 1028 of the Dodd-Frank Act is inconsistent with the constitutional "non-delegation doctrine," a rule that prohibits Congress from delegating legislative authority to administrative agencies. Specifically, such a challenge would focus on the fact that section 1028's delegation to the CFPB to "prohibit or impose conditions or limitations on the use of an agreement between a covered person and a consumer for a consumer financial product or service providing for arbitration of any future dispute between the parties" is improper because, in effect, it seeks to delegate the power to repeal, in part, the Federal Arbitration Act (the "FAA"), a power belonging exclusively to Congress.[33] Challenges under the non-delegation doctrine may also bootstrap existing challenges to the constitutionality of the CFPB itself now proceeding in the D.C. and Seventh Circuit Courts of Appeal.[34]

Statutory Challenge

Even if the CFPB is properly vested with authority under section 1028, industry may also challenge the Proposal on the ground that the CFPB has not met section 1028(b)'s requirements that the rule be in the public interest, advance the goal of consumer protection, and follow from findings made in the CFPB's own study.

To this end, industry has already developed a body of evidence to suggest the Proposal is not in the public interest. For example, three industry trade associations submitted evidence demonstrating that arbitration is faster and cheaper for consumers than litigation,[35] customers recover substantially more in arbitration,[36] and arbitration does not serve as a barrier to class action litigation.[37] In a letter to the CFPB, they concluded that "there are insufficient data in the [CFPB study] to support a conclusion that mandatory pre-dispute customer arbitration provisions in financial services contracts, or the inclusion of class action waivers therein, should be prohibited. . . . Because such regulation would not be 'consistent with the [CFPB study],' in the public interest, or necessary for the protection of consumers, it would exceed the [CFPB's] authority under Section 1028 of the Dodd-Frank Act."[38]

Next Steps

Institutions subject to the Proposal should:

- Be alert to the deadline for submitting comments on the Proposal. Such comments must be received by the CFPB within 90 days after the Proposal is published in the *Federal Register*.

- Reevaluate existing PDAA approaches. For example, for those using PDAAs, consider how to amend them to reduce litigation risk exposure, including how best to handle class action opt-outs. Although any upside would be short-lived and the cost-benefit analysis carefully considered, those not using PDAAs (or not leveraging class-action limitation provisions in them) may, nevertheless, want to consider doing so as PDAAs in place before the effective date of the final rule will be grandfathered.

- Ensure they leverage other means to reduce class action litigation risk exposure, such as litigation management tactics that draw on legal changes adopted to weed out meritless class actions like the Class Action Fairness Act, the heightened pleading standard and tightening of Rule 23 requirements.

- Carefully monitor allegations in connection with arbitrations subject to the Proposal's reporting requirements to manage potential regulatory and enforcement risk.

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[1] 12 U.S.C. § 5518(a).
[2] 12 U.S.C. § 5518(b).
[3] CFPB, Arbitration Study (Mar. 2015), *available at* http://files.consumerfinance.gov/f/201503_cfpb_arbitration-study-report-to-congress-2015.pdf.
[4] *See* Notice of Proposed Rulemaking, at 37-80, *available at* http://files.consumerfinance.gov/f/documents/CFPB_Arbitration_Agreements_Notice_of_Proposed_Rulemaking.pdf.
[5] CFPB, Fact Sheet on Arbitration Study, at 2, *available at* http://files.consumerfinance.gov/f/201503_cfpb_factsheet_arbitration-study.pdf.
[6] *Id.*
[7] CFPB, Arbitration Study (Mar. 2015), Section 1, at 2.
[8] *Id.*, Section 6, at 61.
[9] *Id.*, Appendix A, at 13.
[10] CFPB, Fact Sheet on Arbitration Study, at 4.
[11] *Id.*
[12] *Id.* at 3-4.
[13] Final Report of the Small Business Review Panel on the CFPB's Potential Rulemaking on Pre-Dispute Arbitration Agreements (Dec. 11, 2015), at 16, *available at* http://files.consumerfinance.gov/f/documents/CFPB_SBREFA_Panel_Report_on_Pre-Dispute_Arbitration_Agreements_FINAL.pdf.
[14] *Id.* at 20.
[15] *Id.* at 33.
[16] *Id.*
[17] *Id.* at 34.
[18] *Id.* at 35.
[19] *Id.* at 34.
[20] *Id.*
[21] *Id.* at 35.
[22] *Id.*
[23] *Id.* at 36.
[24] Notice of Proposed Rulemaking, at 207 (noting that "the proposed rule would not have a significant economic impact on a substantial number of small entities").
[25] Small Business Regulatory Enforcement Fairness Act, Public Law 104-121 § 215 (Mar. 29, 1996) (explaining SBREFA only requires that "where appropriate, the agency shall modify the proposed rule, the initial regulatory flexibility analysis or the decision on whether an initial regulatory flexibility analysis is required").
[26] Notice of Proposed Rulemaking, at 92, *available at* http://files.consumerfinance.gov/f/documents/CFPB_Arbitration_Agreements_Notice_of_Proposed_Rulemaking.pdf.
[27] *Id.* at 119.
[28] *Id.* at 129.
[29] *Id.* at 1.
[30] *Id.* at 83.
[31] Arbitral information gathered by the agency will be used to "monitor[] arbitral proceedings to determine whether there are developments that raise consumer protection concerns that may warrant further [CFPB] action." *Id.* at 6. In this respect, the CFPB may be signaling that it is open to conducting additional rulemakings in this space.
[32] Norton and Webb, *The CFPB's Class-Action Rule: Rich Deal for Trial Lawyers, Raw Deal for Consumers*, U.S. Chamber of Commerce (May 4, 2016), https://www.uschamber.com/above-the-fold/the-cfpb-s-class-action-rule-rich-deal-trial-lawyers-raw-deal-consumers.
[33] This argument likely will depend on an assessment of the final rule's effects and whether they limit the types of arbitrations to which the FAA applies. In this regard, as the CFPB alluded to in its proposal, the FAA dates back to 1925 and has been eroded by Congress since then in ways the Bureau feels limits the practical effect of its Proposal. For example, the Dodd-Frank Act prohibits arbitration agreements in consumer mortgages, and the Military Lending Act prohibits arbitration agreements in consumer credit card contracts with certain covered servicemembers and their dependents.
[34] *PHH Corp. v. CFPB*, Case No. 15-1177 (D.C. Cir. 2015) (challenging the constitutionality of the CFPB's single director structure, which allows the director to be removed only for cause by the President); *CFPB*

v. ITT Educational Services, Inc., Case No. 15-1761 (7th Cir. 2015) (raising a similar challenge). For additional information, see our CFPB Quarterly report, which is available here.

[35] Letter from the American Bankers Association, the Consumer Bankers Association, and the Financial Services Roundtable, at 7-8, *available at* https://www.cfpbmonitor.com/wp-content/uploads/sites/5//2015/07/March-10-2015-Consumer-Arbitration-Study-Comment-Letter.pdf.

[36] *Id.* at 8.

[37] *Id.* at 10.

[38] *Id.* at 2.