Client Update
A Modest Proposal? CFPB to Gut Arbitration in Consumer Financial Contracts

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On May 5, 2016, the Consumer Financial Protection Bureau (the "CFPB") released its Notice of Proposed Rulemaking (the "Proposed Rule") regarding the use of arbitration clauses in certain consumer financial products and services contracts. The Proposed Rule largely mirrors the CFPB's Small Business Advisory Review Panel Outline for Potential Rulemaking on Arbitration Agreements, released on October 7, 2015 (the "Outline")[1] and would:

- prohibit most providers of consumer financial products and services (with the notable exception of mortgages, for which arbitration is already prohibited) from including in their consumer agreements an arbitration clause that bars the consumer from filing or participating in a class action relating to the financial product or service; and
- require covered providers engaged in arbitration pursuant to a pre-dispute arbitration agreement to submit certain records relating to the arbitration to the CFPB.

The Proposed Rule, if finalized as proposed, would be a seismic change for a broad range of companies providing covered consumer financial products and services, drastically increasing their legal costs and reputational risks.

BACKGROUND

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") directed the CFPB to study pre-dispute arbitration provisions and authorized the CFPB to issue regulations consistent with its findings.[2] In March

[1] Bureau of Consumer Fin. Prot., *Outline of Proposals under Consideration for the SBREFA Process* (Oct. 7, 2015), *available at* http://files.consumerfinance.gov/f/201510_cfpb_small-business-review-panel-packet-explaining-the-proposal-under-consideration.pdf.

[2] Public Law 111-203, 124 Stat. 1376 (2010), §§ 1028(a)-(b).

2015, the CFPB submitted the results of its study to Congress.[3] Despite its findings that the modest cost and relatively expeditious pace of arbitration benefit consumers, the CFPB preliminarily concluded that:

- class actions provide a more effective means of securing relief for large numbers of consumers and for changing companies' potentially harmful behaviors; and
- arbitration provisions block many class-action claims that are filed and discourage the filing of others.

While the CFPB found that the evidence was inconclusive on whether individual arbitration is superior or inferior to individual litigation in terms of remediating consumer harm, it preliminarily concluded that 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.

Following the release of the Outline, in October 2015, the CFPB convened a Small Business Review Panel, the findings and recommendations of which have been released in conjunction with the Proposed Rule.[4] The CFPB also met with other stakeholders to discuss the Outline and the potential impact of its proposals, including holding roundtables with a variety of industry representatives and consumer advocates.

THE PROPOSED RULE

Legal Authority

Dodd-Frank authorizes the CFPB to issue regulations relating to the use of pre-dispute arbitration provisions if the regulations would be "in the public interest and for the protection of consumers."[5] In the Proposed Rule, the CFPB reads the two phrases as separate tests. *First*, the CFPB interprets that "in the public interest" requires it to consider the entire range of impacts that the regulation may have on consumers and on others, including impacts on pricing,

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[3] Bureau of Consumer Fin. Prot., *Arbitration Study: Report to Congress, Pursuant to Dodd-Frank Wall Street Reform and Consumer Protection Act § 1028(a)* (2015), *available at* http://files.consumerfinance.gov/f/201503_cfpb_arbitration-study-report-to-congress-2015.pdf.

[4] Bureau of Consumer Fin. Prot., *Final Report of the Small Business Review Panel on CFPB's Potential Rulemaking on Pre-Dispute Arbitration Agreements* (2015), *available at* http://files.consumerfinance.gov/f/documents/CFPB_SBREFA_Panel_Report_on_Pre-Dispute_Arbitration_Agreements_FINAL.pdf.

[5] Dodd-Frank, § 1028(b).

accessibility, and the availability of innovative products, impacts on providers and markets, and other general systemic considerations.

Second, the CFPB interprets the phrase "for the protection of consumers" to require it to consider the effects of the regulation on promoting compliance with laws relating to consumer financial products and services and avoiding or preventing harm to consumers using those products. *Finally*, the CFPB interprets "for the protection of consumers," as it specifically relates to arbitration provisions, to mean that the regulation must serve to deter and redress violations of the rights of consumers who are using a consumer financial product or service. The Proposed Rule requests commentary on these interpretations.

The Proposed Rule also acknowledges that Dodd-Frank requires that any regulations proposed by the CFPB be consistent with its study. There will almost certainly be litigation concerning the question of whether the regulation is warranted given the CFPB's acknowledgement that under its own study, the evidence is "inconclusive" on whether individual arbitration is superior or inferior to individual litigation in terms of remediating consumer harm.

Scope

The scope of the Proposed Rule is very broad. It would apply to most providers engaged in:

- extending, or regularly participating in decisions regarding, consumer credit as defined under Regulation B, which implements the Equal Credit Opportunity Act; engaging primarily in the business of providing referrals or selecting creditors for consumers to obtain such credit; and the acquiring, purchasing, selling, or servicing of such credit;
- extending or brokering of automobile leases as defined in CFPB regulation;
- providing services to assist with debt management or debt settlement to modify the terms of any extension of consumer credit, or avoid foreclosure;
- providing directly to a consumer a consumer report as defined in the Fair Credit Reporting Act, a credit score, or other information specific to a consumer from a consumer report, except for adverse action notices provided by an employer;
- providing accounts under the Truth in Savings Act and accounts and remittance transfers subject to the Electronic Fund Transfer Act;

- transmitting or exchanging funds (except when integral to another product or service not covered by the proposed rule), certain other payment processing services, and check cashing, check collection, or check guaranty services consistent with Dodd-Frank; and
- collecting debt arising from any of the above products or services by a provider of any of the above products or services, their affiliates, an acquirer or purchaser of consumer credit, or a person acting on behalf of any of these persons, or by a debt collector as defined by the Fair Debt Collection Practices Act.

Other entities appear to be excluded from the Proposed Rule altogether, including:

- broker-dealers, to the extent they are providing any products and services covered by the Proposed Rule that are also subject to specified rules promulgated or authorized by the Securities and Exchange Commission prohibiting the use of pre-dispute arbitration clauses and providing for making arbitral awards public;
- the federal government;
- a state, local or tribal government and any affiliates to the extent they provide the product or service directly to a consumer residing in the government's territorial jurisdiction;
- any person providing a covered product or service to no more than 25 consumers in the current calendar year and to no more than 25 consumers in the preceding calendar year; and
- certain merchants, retailers or other sellers of nonfinancial goods or services, to the extent they provide, purchase or acquire certain extensions of consumer credit.

Despite extensive commentary in the Proposed Rule regarding potential exclusions, it appears that the CFPB has attempted to broadly cover entities operating within its jurisdiction. The CFPB appears to have responded to some industry commentary by, for example, providing a temporary exception for providers of prepaid cards, which would allow them to continue selling packages that contain noncompliant arbitration provisions, so long as these providers issue consumers a compliant agreement as soon as consumers register their cards. For other product areas, however, it seems clear that the CFPB is trying to cover as much activity as is arguably under its statutory authority. For example, the Proposed Rule states that it would apply to extensions of credit by providers of whole life insurance policies "to the extent that these companies are ECOA

creditors and the activity is not the 'business of insurance'" under Dodd-Frank and arbitration agreements are used for such policy loans. Similarly, the CFPB offers examples of those firms engaged in acquiring, purchasing, selling, or servicing of covered credit that seem particularly targeted to reach those entities that may acquire a loan, even if the Proposed Rule does not apply to the seller of the loan (*e.g.*, an auto dealer).

The CFPB broadly invites comment on the Proposed Rule's coverage, including whether furnishing information to a consumer reporting agency should also be separately identified as a covered product or service, and whether credit counseling services should be included in the Proposed Rule's coverage.

Effective Date

The Proposed Rule would have an effective date of 30 days after the final rule is published in the Federal Register, and the Proposed Rule would apply to agreements entered into after the end of a 180-day period beginning on the regulation's effective date. If the rule is finalized around year-end, it would apply to agreements entered into in the third quarter of 2017.

Although agreements entered into before the end of the 180-day period are effectively "grandfathered" as required by the statute, the CFPB stated that companies that acquire such grandfathered agreements that had been entered into prior to this date (*e.g.*, by a merger or acquisition of the relevant company or acquisition of a portfolio of loans), would be deemed to be entering into the agreement anew as of the time of the acquisition. In other words, it appears any acquisition of grandfathered agreements would result in a loss of the grandfathered status. Thus acquirers would either need to amend the agreement to include the required language or the consumer would need to receive written notice of the change. There will almost certainly be criticism of this proposal as it is arguably an end run around the statutory prohibition on retroactivity.

Prohibition of Class-Action Waivers

The Proposed Rule would require all relevant agreements to include provisions that explicitly prohibit the provider from using the agreement to stop the consumer from being a part of a class action and provides specific required language to this effect that must be included in such agreements. As proposed, the rule seems to bar class-action waivers even for resolution of claims under laws the CFPB cannot enforce. Companies can expect to see an uptick in consumer class-action litigation as a result of this change, as well as additional costs to defend and resolve such claims and to implement any policy and

procedure changes that may be negotiated and included in class-action settlements.

Submission of Records to the CFPB

It remains to be seen whether covered providers will maintain arbitration provisions within their consumer contracts, but if they do, they would be required to submit certain records relating to arbitral proceedings to the CFPB. The records would include the initial claim and any counterclaim, the pre-dispute arbitration provision, the judgment or award, if any, and certain communications between the provider and the arbitrator or arbitration administrator. The CFPB would use those records to continue monitoring arbitral proceedings to determine whether further CFPB action may be necessary. In order to increase the transparency of arbitration, the CFPB would publish certain of these records on its website as redacted by the provider.

CONCLUSION

The CFPB's Proposed Rule represents a significant departure from long-standing federal policy in favor of arbitration. If finalized as proposed, a wide swath of consumer financial product and service providers may no longer be able to enjoy the cost savings and efficiency of arbitration. The CFPB's conservative estimate for the next five years anticipates payouts of over $1.7 billion to consumers in class-action litigation resulting from the elimination of class-action waivers, with corresponding increases in attorney fees and other costs. Moreover, the Proposed Rule acknowledges that many providers may cease to include arbitration provisions in their consumer agreements altogether. The rule, if finalized as proposed, will almost certainly be subject to legal challenge, particularly on the question of its consistency with the CFPB's study. Nonetheless, providers will need to consider the costs and benefits of arbitration clauses in light of the Proposed Rule and potentially prepare for an arbitration-free world and the concomitant class-action risks.

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Please do not hesitate to contact us with any questions.