Client Alert

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The Time Has Come: The CFPB Issues its Proposed Arbitration Rule

By Nancy R. Thomas and Natalie A. Fleming Nolen

As widely anticipated, the Consumer Financial Protection Bureau (CFPB) issued a Notice of Proposed Rulemaking seeking comments on proposed regulations that would: 1) bar class action waivers; and 2) impose reporting requirements for individual arbitrations pursued pursuant to pre-dispute arbitration agreements ("Proposed Rule"). The Proposed Rule is accompanied by over 350 pages of Supplementary Information in which the CFPB makes it case that class action litigation and CFPB monitoring of individual arbitrations are both "in the public interest" and "for the protection of consumers."[1]

BACKGROUND

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) mandated a CFPB study on the use of pre-dispute arbitration clauses in consumer financial products and services, with a report of its findings sent to Congress. The Dodd-Frank Act further authorized the CFPB to prohibit or impose conditions or limitations on the use of arbitration clauses by regulation if the CFPB determined that it would be in the public interest and for the protection of consumers to do so. However, any such regulation must be consistent with the findings of the CFPB's Study.[2]

The CFPB began the process in 2012, and from the beginning, it has appeared that the CFPB would target class waivers.[3] On March 10, 2015, the Report to Congress, released by the CFPB removed all doubt. On October 7, 2015, the CFPB announced a planned rulemaking seeking to implement this conclusion, as discussed in our previous Client Alert.

Before publishing a proposed rule, the CFPB convened a Small Business Regulatory Enforcement Fairness Act (SBREFA) panel, and communicated with "small entity representatives" (SERs) to obtain feedback on the financial impact of the proposal. Despite the concerns raised by SERs and other market participants regarding the increased cost to providers and to consumers, the CFPB stayed its course and issued the Proposed Rule, which is in line with its earlier proposal.

WHAT DOES THE RULE PROVIDE?

There are two parts to the Proposed Rule. *First*, the Proposed Rule would prohibit covered providers of consumer financial products and services from relying on pre-dispute arbitration agreements to prevent consumers from pursuing class actions in court.[4] As if the ban itself were not sufficient, the Proposed Rule would require all

[1] Dodd-Frank Act § 1028.

[2] *Id.*

[3] *See* Client Alert "CFPB Builds Its Case Against Arbitration Clauses" (Dec. 7, 2013).

[4] Proposed Rule § 1040.4(a)(1).

arbitration agreements in contracts of covered providers to contain 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."[5]

Second, covered providers who include pre-dispute arbitration agreements in their contracts must submit the following information to the CFPB for each filed arbitration: a copy of the claims and any counterclaims; a copy of the pre-dispute arbitration agreement; the details of any awards; any communications the provider receives from the arbitrator or administrator regarding dismissal of arbitration because of failure of the provider to pay fees; and any communications the provider receives from an arbitrator or administrator that its pre-dispute arbitration agreement does not comport with fairness principles, rules or other requirements of the arbitral forum.[6]

The CFPB intends to publish this information in some form but has not yet decided the format or content of these publications.

WHO IS COVERED?

The Proposed Rule covers a broad range of consumer financial contracts governing lending money, moving money, storing money or transferring money.[7] A "provider" is defined as any entity that provides the following consumer financial products or services:

- Consumer credit services;
- Automobile leases;
- Debt management or debt settlement or modification of consumer credit terms or avoidance of foreclosure;
- Credit reporting;
- Deposit accounts, electronic funds transfer accounts or money transfer services;
- Payment processing services, check cashing, check collections or check guaranty services; or
- Debt collection.[8]

There are enumerated exceptions, including broker dealers regulated by the Securities and Exchange Commission, entities that have provided the covered services to fewer than 25 consumers and government entities.[9] The governmental entity exclusion is limited to products and services provided directly by these entities or their affiliates. Non-governmental entities that provide products and services on behalf of governmental entities are not excluded from coverage.[10] Tribal governments or affiliates are excluded only to the extent that they are providing services directly to consumers who reside in the tribe's territorial jurisdiction.[11] Tribal governments

[5] *Id.* § 1040.4(a)(2)(i).

[6] *Id.* § 1040.4(b).

[7] *E.g.*, Supplementary Information at 4-5; Proposed Rule § 1040.3(a).

[8] Proposed Rule § 1040.3(a).

[9] *Id.* § 1040.3(b).

[10] Supplementary Information at 190.

[11] Proposed Rule § 1040.3(b)(2)(ii).

providing services outside of their jurisdiction are covered by the Proposed Rule because the CFPB "believes that the democratic process and its accountability mechanisms are not generally as strong in protecting consumers who do not reside in the territory" of the tribe.[12]

Merchants, retailers, or other sellers of non-financial goods are only subject to the Proposed Rule in certain specific situations, such as when they act as creditors.[13] The CFPB included mobile wireless services contracts in its Study, which had the effect of increasing the percentage of studied contracts with arbitration agreements. But when it came time for the Proposed Rule, the coverage focused on providers of "mobile wireless third-party billing services" that engage in transmitting funds, stating that the CFPB "understands that such services would not typically be integral to the provision of wireless telecommunications services."[14]

POSSIBLE CHALLENGE TO THE RULE?

Based on its actions so far, we expect the CFPB will issue a Final Rule that is similar, if not identical, to the Proposed Rule. If so, it seems likely that the Proposed Rule will be challenged. We can't help but wonder whether 355 pages of Supplementary Information for a 10-page Proposed Rule is the CFPB's attempt to front load its response to any such challenge.

The CFPB may have difficulty meeting its burden to prove that such a final rule is in the "public interest," will "protect consumers" and is "consistent with the study"[15] given the results and limitations of its Study. As the CFPB itself recognizes, it found consumers have a choice as to whether they want to enter into an arbitration agreement, consumer contracts advise consumers of the consequences of this choice, the procedures in arbitration and judicial proceedings are very similar, and arbitration is less expensive.[16]

The CFPB also recognizes the significant limitations in its approach, which left the CFPB unable to draw any conclusions as to whether consumers fare differently in arbitration than in court.[17] And, it is difficult to see what data the CFPB will point to as supporting its proposal to impose significant reporting obligations with respect to individual arbitrations.

The same is true for the CFPB's proposed ban on class action waivers. The CFPB again acknowledges the significant limitations in its analysis of class actions.[18] As was the case in the Report to Congress, the CFPB ignores the hard questions about the value of class actions. Instead of grappling with this challenging issue, on which reasonable people can and do disagree, the CFPB finds class actions are superior based solely on the shift of wealth from financial institutions to plaintiffs' class counsel and class members.

[12] Supplementary Information at 190-191.

[13] Proposed Rule § 1040.3(b)(4).

[14] Supplementary Information at 39, 172.

15 Dodd-Frank Act § 1028.

[16] *Id.* at 41--46, 54 n.216.

[17] *See, e.g.*, *id.* at 57, 62, 92.

[18] *See, e.g.*, *id.* at 62-63.

Although the CFPB prides itself on being a "data driven agency,"[19] it provided little data to justify its conclusions. The CFPB's Study is discussed infrequently in the lengthy section of the Supplementary Information in which the CFPB sets forth the basis for its findings that the Proposed Rule meets the Dodd-Frank requirements.[20] Instead, the CFPB relies on anecdotal evidence and its "beliefs" based on its experience and expertise (despite its relatively short time in existence). This leaves the CFPB stating broad, general principles and conclusions from those principles without any data to support those assertions. A few examples:

- The small number of individual arbitration claims is explained by the fact that legal harms are often difficult for consumers to detect, even though the CFPB's support for this assertion included non-disclosure of fees, which would appear on consumers' monthly statements.[21]
- The class mechanism is a more effective means of providing relief to consumers than other mechanisms despite evidence that 61% of class actions during the studied period were resolved on an individual basis or dismissed due to plaintiff's withdrawal of claims or failure to prosecute, another 10% were dismissed when the defendant won a dispositive motion, and about $425 million out of $2.1 billion in class monetary relief went to plaintiff's attorneys.[22]
- Arbitration agreements "block many class action claims that are filed and discourage the filing of others," even though the CFPB found defendants filed an arbitration-based motion in only 16.7% of the class actions it studied, and only 8% of those motions were granted in whole or in part.[23]
- Class actions are a "more effective means of securing relief for large numbers of consumers affected by common legally questionable practices," even though the CFPB found consumers recover, on average, only about $32 in class settlements and that very few consumers participate by making a claim for a settlement payment.[24]
- "[T]he presence of class action exposure will affect companies' incentives to comply."[25]
- The costs of litigating class actions are justified as a necessary component of an enforcement scheme.[26]

Throughout its discussion, the CFPB simply assumes that class action settlements involved illegal practices, even though defendants did not admit any of the allegations and courts did not rule on the merits of any of those claims. The CFPB does not even attempt to grapple with the "potentially ruinous liability" created by class actions that "places pressure on the defendant to settle even unmeritorious claims."[27]

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[19] *See e.g.,.* Prepared Remarks of CFPB Director Richard Cordray at the Arbitration Field Hearing (March 10, 2015) (explaining CFPB is "committed to data-driven decision-making"); CFPB Strategic Plan, Budget, And Performance Plan And Report (February 2016) at 6.

[20] Supplementary Information at 87-147.

[21] *Id.* at 96-97.

[22] Supplementary Information at 103; Report to Congress, Section 6.2.2 at 8, Section 8 at 33.

[23] Supplementary Information at 92; Report to Congress, Section 6.2.2 at 8-9.

[24] Supplementary Information at 92; Report to Congress, Section 8 at 27-28, 30.

[25] Supplementary Information at 123 n.418.

[26] *Id.* at 131.

[27] *Shady Grove Orthopedic Assocs., P.A. v. Allstate Ins. Co.*, 559 U.S. 393, 445 n.3 (2010) (Ginsburg, J.,dissenting) (internal quotation marks omitted).

The CFPB's Study actually confirmed that plaintiff's lawyers are often the real winners in class action settlements.[28] The CFPB recognizes the very real cost to covered providers of having to defend claims with enormous potential exposure in the context of claims brought under the Telephone Consumer Protection Act.[29] Yet the CFPB downplays this significant cost imposed by class litigation and lacks data to determine whether these costs will be passed on to consumers.[30]

WHEN WOULD A FINAL RULE TAKE EFFECT AND WHICH AGREEMENTS WOULD BE COVERED?

The CFPB confirmed that "the proposed rule would apply only to agreements entered into after the end of the 180-day period beginning on the regulation's effective date."[31] The effective date will be 30 days after the final rule is published in the Federal Register, likely in the second or third quarter of 2017.

The Proposed Rule creates some exceptions to this forward-looking timing. For example, agreements entered into before the effective date would be covered by the Proposed Rule if account ownership changes, for example in a merger or sale of a portfolio.[32] The Proposed Rule clarifies that modifications, amendments, and implementation of terms do not create a new agreement subject to the Proposed Rule. However, a provider would be considered to "enter into" a new contract if a modification, amendment or implementation were to "constitute providing a new product or service."

The CFPB creates a narrow exception for pre-packaged general purpose reloadable prepaid cards that are on store shelves as of the compliance date. Although these providers would be bound by the class action waiver ban, they need not include the required language in the customer agreement for cards that packaged prior to the compliance date if the provider does not have a way to contact the consumer. If the provider has contact information or later obtains it, the provider must contact the consumer and provide an amended agreement containing the mandatory language.[33]

WHAT CAN COVERED ENTITIES DO NOW?

Covered entities will have 90 days to comment once the Proposed Rule is published in the Federal Register. Covered entities that employ arbitration agreements with or without class waivers should consider participating in the rulemaking process so that their views can be heard and made part of the administrative record. They also should begin planning for submission of the data on individual arbitration required by the Proposed Rule.

Companies with arbitration agreements that include class waivers should consider how they will manage what would become two customer populations — those with whom they have an arbitration agreement with a class waiver and those with whom they do not. Companies that do not have arbitration agreements may want to consider adding them before the anticipated effective date of a final rule.

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[28] Report to Congress, Section 8 at 33.

[29] The CFPB explains that it considered exempting these claims from the Proposed Rule in light of the lack of a cap on damages in the statute. The CFPB declined to do so, finding that any action should come from Congress. (Supplementary Information at 214-15.)

[30] *See* Supplementary Information at 80 n.326.

[31] *Id.* at 5.

[32] Proposed Rule § 1040.4(a)(iii).

[33] *Id.* § 1040.5(b).

Client Alert

Contact:

Nancy R. Thomas
(213) 892-5561
nthomas@mofo.com

Natalie A. Fleming Nolen
(202) 887-1551
nflemingnolen@mofo.com

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