Consumer Financial Protection Board considering important rule on arbitration agreements

Agency plans to propose a rule to prevent arbitration clauses in consumer financial contracts from blocking class-action litigation

By Paul Bland
and Gabriel Hopkins

When Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act five years ago, it created a brand new federal agency: the Consumer Financial Protection Bureau (CFPB). Though the agency spent much of its extremely busy first few years focused on the mortgage market, Congress intended it to regulate all consumer financial products and services. Indeed, the statute specifically directed the Bureau to study "the use of agreements providing for arbitration" in contracts for "consumer financial products or services." (18 U.S.C. § 5518(a).) And it empowered the agency, after reporting the results of its study to Congress, to prohibit or limit the use of arbitration agreements in consumer financial products or services contracts if it found that doing so would be "in the public interest and for the protection of consumers." (18 U.S.C § 5518(b).)

On October 7, 2015, the CFPB's Director, Richard Cordray, announced that the agency has "preliminarily determined" that it will propose a rule that could fundamentally change the practice of consumer protection law nationwide.[1] Under the current proposal, contracts for consumer financial products must "provide explicitly" that any arbitration agreement "is inapplicable to cases filed in court on behalf of a class."

This rule, if adopted, would apply to all or nearly all consumer financial products and services under the CFPB's mandate including: credit cards, checking and deposit accounts, certain auto loans, small-dollar or payday loans, private student loans, and others.

The agency is also considering a rule requiring companies to report how often they go to arbitration with their customers, and the results of those proceedings. Such reporting, which the agency could make public, would provide much-needed data for advocates and regulators on the relative merits of arbitration and traditional court litigation for individual consumers.

Some had hoped that the CFPB would go even further in limiting arbitration clauses. But this proposed rule should be extremely welcome news to the plaintiffs' bar and represents the vindication of many years of hard work by consumer protection advocates. Indeed, if the predictions of the agency – and defense lawyers – are borne out, it could initiate a sea change in consumer financial protection litigation.

What does this mean for consumers?

By prohibiting arbitration agreements from covering class action claims, the CFPB's rule would block a major avenue that large financial product and service providers have used to avoid private litigation over unlawful or unfair practices. This is because, under prevailing U.S. Supreme Court precedent dating from 2011, courts must not only enforce contract clauses that require all disputes to be arbitrated – rather than litigated in court – but must also enforce arbitration clauses that prohibit claimants from bringing class actions or joining others in any kind of class claims. Exceptions to this rule are extremely limited, and most consumer financial products and services are subject to arbitration clauses that include class action bans. The rule that the CFPB is considering would eliminate the class action bans, and therefore make arbitration clauses only enforceable in cases brought by individuals.

Although corporate advocates like to attack the class action device in general, and regularly argue that America would be better off if all consumer class actions were banned, the truth is that consumers have won billions of dollars of compensatory and injunctive relief through consumer class actions. The consumer financial industry's ability to impose class action bans on their customers has been devastating to the enforcement of consumer laws. By eliminating one of the industry's weapons against class actions, consumer advocates will regain an essential tool in the fight to protect both their clients' interests, and the interests of the public.

How did we get here?

The rule now under consideration arose out of the Dodd-Frank Act's mandated study of arbitration agreements in consumer financial contracts. After roughly a year of collecting data and comments, the Bureau released a preliminary report in late 2013.[2] It then spent another year and a half gathering more

data, analyzing primary documents from hundreds of court cases and arbitration records, soliciting further comments, and conducting extensive interviews with consumers before publishing its final report in March 2015.[3] The final report provides an extensive and exhaustive analysis of the prevalence of arbitration clauses in consumer financial contracts, their effects on consumer protection, and the relative merits of arbitration and court litigation as means of protecting consumers' interests.

The final report ran nearly 800 pages long, and has been rightly called the most comprehensive study of this issue to date. Two headline conclusions came out of this study and largely underlie the CFPB's decision to consider the current proposals: (1) the report concluded that class actions are more effective for vindicating consumer rights and punishing unfair behavior than individual actions, and (2) the main purpose, for companies, of mandatory arbitration agreements is to block class litigation.

It is worth going through some of the study's central findings to see how the Bureau reached these two conclusions, and, by extension, the proposals announced in October. First, arbitration agreements are extremely widespread in the consumer financial industry. The agency found that tens of millions of Americans are subject to arbitration agreements. For example, arbitration clauses are found in contracts for nearly 50 percent of credit cards and checking accounts, more than 90 percent of prepaid cards, and nearly 100 percent of payday loans and mobile phone contracts. Moreover, large financial products and services providers were much more likely to include arbitration clauses in their contracts, than small or medium-sized companies.

Second, the number of consumers who engage in disputes on an individual basis with their financial service or product provider is very, very small. This, in fact, was true of both traditional court actions and arbitrations. Between these two forums, only about 3,000 consumers sought relief on an individual basis per year in the period studied. Actions in small claims courts (often specifically excepted from an arbitration clause's coverage) were even less frequent. Outside of the small claims forum, individual actions rarely sought less than $1,000, and typically were much more valuable.

Third, in direct contrast to finding number two, the CFPB found that class actions alleging unlawful practices in the relevant markets covered many more consumers. Though the size of claims covered was typically much smaller than those in individual suits, class actions gave roughly 32 million consumers a chance for relief every year in the period studied. The average yearly value to consumers of cash settlements in class actions during the study period was $540 million. The future value of ending a company's unlawful or unfair practice was, of course, unquantifiable – as was the value of deterring other companies from engaging in similar practices – but the Bureau reasonably concluded that it is potentially very substantial. And many consumers have benefited from ancillary relief such as having illegal debts removed from their credit records.

Fourth, corporations accused of predatory and illegal lending had experienced enormous success in getting consumer lawsuits dismissed – without respect to their merits – merely by invoking arbitration clauses that banned class actions. The study noted that more than 100 class actions had been stayed or dismissed in federal court in the period studied. Given the size of many of these classes, that represents potentially millions of consumers who were denied use of this litigation tool.

Fifth, and finally, state and federal regulatory bodies with authority over consumer financial markets did not make adequate substitutes for private class litigation. Though government enforcement can be equally broad in scope, the Bureau found that public actors rarely brought the kinds of claims that private litigants did. Thus, even if government enforcers had the time and resources to identify and address all unlawful or unfair practices in consumer financial markets, they would still not be a full substitute for private enforcement efforts.

The study made quite a few other valuable findings – for example, it set forth extensive evidence that consumers rarely knew that they had agreed to arbitration, and that eliminating arbitration clauses for some companies has not led to increased product costs for their customers.

Why all the fuss?

That the most prominent federal consumer protection law to be passed in recent memory included a mandate to study (and potentially to ban) arbitration agreements in consumer financial contracts, is a pretty big clue about why the plaintiffs' bar should be interested in this development. But for any readers who may not be familiar with the issue, a brief primer follows.

Arbitration is an alternative dispute resolution mechanism. Though procedurally it mirrors traditional courts, there are several important differences, including: comparative informality; confidentiality of proceedings, decisions, and awards; extremely limited judicial review; and selection of the arbitrator(s) by the parties themselves, enabling them to select experts on the relevant industry or issue. It has long been favored over traditional court litigation by businesses when resolving contract disputes with other businesses. For parties with similar bargaining power, such an arrangement can make more business sense than a trial before a generalist judge and a jury of laypeople.

In 1925, Congress passed the Federal Arbitration Act (FAA), 9 U.S.C. § 1 *et seq*., to ensure that courts would honor and enforce valid arbitration agreements and arbitral awards. However, beginning in the 1980's, the US Supreme Court began enforcing contractual arbitration clauses in an ever-wider range of cases. The Court's conservative justices have since aggressively interpreted the boundaries of the FAA, holding up

contractual arbitration clauses in the face of countervailing common law, statutory and even constitutional considerations.

As the case law piled up in favor of industry, many companies – from retailers to telecoms – began inserting mandatory arbitration clauses in the purchase and service contracts that they signed with customers. The low point for consumers came with the twin decisions of *AT&T Mobility v. Concepcion* (2011) 563 U.S. 333, and *American Express v. Italian Colors Restaurant* (2013) 133 S.Ct. 2304. Together, the two cases stand for the propositions that arbitration agreements can legally deny the right to pursue *any* form of collective action, whether in court or arbitration, no matter what the nature of the claims or underlying alleged conduct.

The findings of the CFPB's study illustrate clearly why this has been hugely problematic for consumers. Most seriously, the combination of mandatory arbitration and class-treatment bans has kept meritorious claims from being litigated and unlawful behavior from being corrected. Consumers' individual losses from unfair practices are often too small to make arbitration worthwhile to pursue on an individual basis. As the CFPB found, almost no one, unless they already have a high-value claim, bothers to seek redress for unfair practices on an individual basis. With no or very few individual cases to defend, a company in turn has little incentive to correct an unfair practice, which, aggregated over hundreds of thousands of customers, could be extremely lucrative.

And, of course, pooling of small-value claims is exactly one of the situations that the Federal Rules Committee had in mind when it *designed* the class action mechanism back in 1966. As the Rules Committee anticipated, and the CFPB's study bears out, without private attorneys-general to bring lawsuits, large-scale enforcement of consumer protection laws falls almost entirely to overtaxed and under-resourced state and federal agencies.

Another troubling problem is the risk of intrinsic bias. Arbitrators are professional private judges working for for-profit companies. When their employer has a contract with a major corporation, they can expect to see that "client" many times. Since the parties choose the arbitrators who will hear their dispute, this can incentivize the arbitrators to prefer the repeat players who are most likely to supply future business. This is not merely a theoretical concern. As the CFPB's report and outline of proposals take care to note, in 2008, an arbitration provider called the National Arbitration Forum (NAF) agreed to stop taking consumer protection cases after repeated exposés of pro-corporate bias led the Minnesota Attorney General to bring suit against the company.

All of this is accomplished simply by inserting an arbitration clause and class-action ban into the boilerplate adhesion contracts that have come to define the relationship between companies and their customers. And as commerce increasingly moves online, the clauses are often placed somewhere on a company's Webpage, or buried behind a tiny hyperlink at some step in a purchase process.

What happens next?

As encouraging as the Bureau's October announcement is, consumers will have to wait some time yet before seeing any benefits. In addition to the standard process for proposing and adopting rules under the Administrative Procedure Act (APA), the Bureau will engage in another layer of statutorily mandated review. This review, which has already begun, will seek input on the potential effects of the current proposal on small businesses. At the time of writing, the end date for this process is not known. Once the small business consultation is over, the Bureau will publish a proposed rule per the APA, initiating the usual notice and comment period.

Finally, the Bureau has made clear that, per a provision of the Dodd-Frank Act, the ultimate regulation will not go into effect until 180 days after it is adopted as a final rule. (18 U.S.C. § 5518(d).) Based on this timeline, and assuming that the review and comment periods result in no changes to the current proposals, consumer financial contracts will likely not change until late 2016 or early 2017.

Does the CFPB go far enough?

Though the Bureau's announcement has been praised by many consumer advocates, many also have criticized it for not going far enough. As noted above, the CFPB elected not to prohibit all arbitration clauses, most importantly for individual cases in consumer financial contracts. Many consumer advocates have strongly argued that the Bureau is missing a valuable opportunity to ban the use of arbitration clauses in such cases. Such criticisms are understandable, particularly from advocates whose practice focuses on individual claims, or whose clients are harmed by the conduct of smaller lenders instead of huge national banks. However, to the minds of these authors and their colleagues, the rules discussed in this article are a significant step forward; not a complete victory, but still a very welcome one.

First, in the vast majority of cases, mandatory arbitration is used to kill class actions, not individual court cases. Both the research published in the CFPB's report, and the statements of industry advocates in response to the Bureau's announcement, have made it clear that most large companies are essentially ambivalent about whether an individual consumer's claim goes to court or to an arbitrator. Such claims are rare enough and involve so little exposure for large companies that any difference in cost between the two adjudicatory options amounts to a rounding error from their perspective.

Their focus is on the large liability, headline-splashing risks of tens or hundreds of thousands of consumers challenging a practice collectively. Alan Kaplinsky, an industry advocate who claims to have done more to propagate arbitration clauses in consumer contracts than any other person, stated bluntly

after the CFPB's October announcement that this development will effectively end the use of arbitration clauses by his clients since they will not be able to use them to avoid class cases.[4] Permitting class actions to proceed against the nation's largest financial products and services providers is therefore a huge improvement over the current legal regime if for no other reason than that it will affect the great majority of consumers harmed by unfair practices in these markets.

This reflects the experience of many of the advocates that have been fighting consumer arbitrations in courts for decades. Nearly all practicing consumer lawyers could testify that there are many types of litigation that could not be brought on an individual basis because they are too expensive to handle compared to the amount at issue, or too hard to prove with the limited discovery available in individual cases. Also, many consumers are not aware when they are cheated by predatory lenders, and many illegal actions are not detected by the vast majority of people harmed by them. Unfortunately, though, there is not good broad scale empirical evidence about the effect of arbitration clauses in individual cases. This is probably because many consumer advocates walk away from individual arbitrations. Whatever the reasons, there is a serious dearth of data about the fairness and effectiveness of individual arbitrations.

Of course, it must be noted that industry advocates upset about the CFPB's actions are seeking to have the Bureau abolished, and legislators who have received substantial banking industry contributions have sometimes been very receptive to their complaints. Since the release of the Bureau's final report in March, members aligned with big financial institutions have loudly criticized and challenged any potential action. Senator and presidential hopeful Ted Cruz has sponsored a bill titled "Repeal CFPB Act." S. 1804, 114th Congress (2015). At least one parallel bill has been introduced in the House. H.R. 3118, 114th Congress (2015). A rider in a House appropriations bill seeks to require the CFPB to conduct its arbitration study all over again. H.R. 2995, 114th Congress (2015). As with many other substantial steps forward for consumer protection, this battle will only go well if consumer advocates are able to respond effectively to industry attacks.

Finally, even though most consumer advocates strongly wish that the Bureau had banned the use of mandatory arbitration for all cases against lenders, class and individual, it is important to note that in this area of law, all gains for consumer protection have occurred gradually. The infamous National Arbitration Forum was forced out of the business of handling consumer arbitrations after a law enforcement agency discovered a substantial undisclosed conflict of interest. The Dodd-Frank Act banned arbitration clauses in mortgage contracts. Congress banned creditors from mandating arbitration in high interest loan agreements with members of the military. The General Services Administration and Department of Labor have required federal contractors to eliminate arbitration for Equal Employment Opportunity claims brought by their employees. No one of these victories was total, but each of them gave more and more American consumers and workers a fair shot at redress when a financial services provider treated them unfairly.

Consumer advocates have fought the incremental expansion of arbitration via the court system for decades. Sadly, we have largely lost that fight in the courts, mostly because of the interventions of the U.S. Supreme Court in sharply divided 5-4 decisions. The CFPB's proposed action represents important progress in the effort to claw back lost ground, ensure that consumers get their day in court and that unlawful practices are punished and deterred. These authors are cheered by this step forward. It is hoped that this will not be the last such advance, but will become part of the model for progress that will provide support and precedent for future consumer protection actions from regulators and legislators.

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Endnotes

[1] Outline of Proposal Under Consideration available at: http://files.consumerfinance.gov/f/201510_cfpb_small-business-review-panel-packet-explaining-the-proposal-under-consideration.pdf.
[2] Arbitration Study Preliminary Report available at: http://files.consumerfinance.gov/f/201312_cfpb_arbitration-study-preliminary-results.pdf.
[3] Arbitration Study available at: http://files.consumerfinance.gov/f/201503_cfpb_arbitration-study-report-to-congress-2015.pdf.
[4] Barbara S. Mishkin, *Alan Kaplinsky and Professor Sovern: the arbitration debate continues* (Nov. 23, 2015), https://www.cfpbmonitor.com/2015/11/23/alan-kaplinsky-and-professor-sovern-the-arbitration-debate-continues/.