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Time to Prepare for the CFPB's Proposed Rule Imposing a *De Facto* Ban on Arbitration in the Consumer Financial Services Sector

Arbitration provides a fair, easy-to-use and efficient means for resolving disputes. Many financial services companies have established arbitration programs to decide customer disputes.

If the US Consumer Financial Protection Bureau ("CFPB" or "the Bureau") has its way, that all will change.

The CFPB is about to issue a rule that, if it goes into effect, will effectively eliminate these arbitration programs. As outlined by the Bureau, the proposed rule—which the Bureau says it plans to issue sometime in the next several weeks—will prohibit arbitration clauses unless the clauses also permit consumers to bring class action lawsuits.

That will inevitably result in the elimination of arbitration in the financial services context.

Here's why.

Arbitration programs impose significant additional costs on companies, because they must pay all or virtually all of the costs of the arbitration proceeding. Companies will take on those costs if they don't also have to absorb the huge litigation costs of a class action system that virtually everyone agrees is often abused. But companies will not pay for both arbitration and for lawyers to defend the company against class actions. If the CFPB requires class actions, companies will eliminate the costs that are voluntary—and drop arbitration. Indeed, companies have said in the past that the result of a policy change like the CFPB's anticipated rule will be to eliminate arbitration.

It is not at all certain that this rule, if promulgated by the Bureau, would survive the legal challenge that inevitably would follow. For now, affected companies should consider taking the following steps:

- Commenting on any CFPB rule proposal, either directly or through appropriate trade associations;
- Reviewing existing arbitration clauses that apply to disputes over consumer financial products or services and preparing to revisit them once a proposed rule is announced; and
- Anticipating the possible return of the abusive class action litigation that arbitration programs had forestalled for many consumer financial products and services.

The Bureau's proposal will present complex issues at the nexus of the CFPB's regulatory authority and the policy issues relating to both arbitration and class actions. As soon as the proposal is issued, Mayer Brown will host a webinar for clients and friends that will draw on its deep experience in these areas. Until then, here is what covered businesses need to know:

The Bureau's Flawed Arbitration Study

The plaintiffs' bar has long lobbied Congress to prevent businesses and consumers from agreeing to arbitrate future disputes. Indeed, eliminating arbitration is the top goal of the "American Association for Justice"— the plaintiffs' bar lobbying organization.

The Dodd-Frank Act tasked the newly-created CFPB with studying and reporting to Congress on "the use of agreements for arbitration of any future dispute" between financial services companies covered by the Dodd-Frank Act and consumers "in connection with the offering or providing of consumer financial products or services." Congress further authorized the Bureau to issue a rule "prohibit[ing] or impos[ing] 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." But Congress conditioned the use of this authority on a finding by the Bureau that "such a prohibition or imposition of conditions or limitations is in the public interest and for the protection of consumers." Moreover, Congress required the rule to be consistent with the findings of the statutorily required study.

The Bureau's arbitration study, provided to Congress in March 2015, unfortunately fell far short of the impartial review specified by Congress—both in terms of the process employed by the Bureau and the conclusions it reached. Numerous commentators had urged the CFPB to provide meaningful opportunities for public participation in the study, but the Bureau instead utilized a closed process that solicited public comment once at the outset and never again for the three years that the study was underway. The Bureau never informed the public of the topics it had decided to study, never sought public comment on them and never convened public roundtable discussions on key issues, as many other agencies routinely do. As more than 80 Members of Congress explained in a June 17, 2015 letter to Director Richard Cordray, the Bureau "ignored requests to disclose the topics that would be covered by the study, and failed to provide the general public with any meaningful opportunities to provide input on the topics."

Substantively, the CFPB study failed to make any meaningful comparison between the benefits to consumers (as opposed to trial lawyers) of class actions and arbitration and instead provided a skewed, unrepresentative and one-sided account of arbitration's supposed shortcomings. There is strong evidence that arbitration benefits consumers and that class actions provide little consumer benefit. (See, for example, this congressional testimony by one of the authors of this legal update.)

Indeed, the report itself included significant data that demonstrated the lack of benefits from class actions. For example:

- 87 percent of the class actions examined had resulted in no benefit to consumers who were absent class members. The 12 percent that were settled provided benefits on average to only 4 percent of consumers.
- The average settlement value of the studied class actions was only $32.35 per person. The average attorneys' fees, in contrast, were $1 million.

Similar findings were reached by the Mayer Brown study of class actions submitted to the Bureau.

In sum, as an independent academic analysis of the Bureau's study explained, the Bureau's study "sheds no light on what is perhaps the key public policy question: whether class action settlements often represent a deal struck by defendants to avoid massive discovery costs threatened in lawsuits of questionable substantive merit, whereas arbitration may resolve individual claims more accurately in terms of the substantive merits of the dispute." (The flaws in

the CFPB's study are also discussed in detail in this submission to Congress by one of the authors of this legal update.)

The Bureau Announces Its Plan To Ban Mandatory Arbitration

In October 2015, the Bureau announced its intent to promulgate a *de facto* ban on arbitration in the consumer financial services market. As a technical matter, the proposal would not expressly ban all pre-dispute arbitration agreements, but instead would prohibit class action waivers in arbitration clauses. In other words, the Bureau would permit a company to establish an expensive system to support the arbitration of individual disputes, but the company also would have to bear the costs of defending class action litigation. It is highly unlikely that financial services companies will take this deal—the only way to avoid duplicative and excessive costs will be by eliminating arbitration.

The Bureau anticipates that its rule will apply to agreements for:

- extensions of credit by a creditor or credit card issuer, or the brokering, servicing, acquiring, or purchasing of any such credit; extending or brokering automobile leases; or providing debt relief services for such credit or automobile leases;
- accounts with depository institutions;
- products or services subject to the Electronic Fund Transfer Act, transmitting or exchanging funds, or check cashing;
- obtaining information from a credit reporting agency for the purposes of monitoring, on behalf of the consumer, the consumer's credit; and
- collecting debt related to any of these consumer financial products or services.

The Bureau noted that it is also considering whether to cover additional consumer financial products and services, such as payment processing. The Bureau also raised the possibility of various exclusions from its rule, such as for governments or for entities already subject to arbitration rules issued by the Securities and Exchange Commission or the Commodity Futures Trading Commission. In addition, the Bureau announced its intent to impose new reporting requirements on any companies that choose to continue to use arbitration to resolve individual disputes.

The October 2015 announcement stated that the Bureau "expects to commence a rulemaking"—presumably by issuing a notice of proposed rulemaking—after completion of the small business review process required by the Small Business Regulatory Enforcement Fairness Act (SBREFA). Such a proposal would be accompanied by a comment period, after which the Bureau would decide whether to revise the proposal and if and when to make any final rule effective.

Important Limit On The Bureau's Regulatory Authority

The statutory provision giving the Bureau authority to regulate arbitration states that any rule promulgated by the CFPB "shall apply . . . to any agreement 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." In other words, arbitration agreements entered into before the rule goes live (180 days after the rule's effective date) are not subject to the rule's restrictions.

This lack of retroactive effect is an important limit on the rule's practical effect. Plaintiffs' lawyers typically focus on class action cases that involve a large potential class. If a financial services company has an arbitration agreement in effect for all of its existing customers before the rule goes live, then only the company's agreements with new customers will be subject to the CFPB rule's restrictions. Depending on the rates at which the company adds new customers, and loses existing customers, it could be several

years, or more, before the number of customers without an arbitration clause would provide a sufficient incentive for plaintiffs' lawyers to file a class action. In the interim, the company would be able to continue to provide its customers with the benefits of arbitration.

Consumer financial businesses may therefore want to engage in advance planning of their response to a final CFPB rule. (We have been addressing such issues with a number of our clients.)

Continued Judicial Enforcement Of The Longstanding Federal Policy Favoring Arbitration

Even as the Bureau moves to impose its effective ban on arbitration in the consumer financial services market, the federal judiciary has continued to enforce the Federal Arbitration Act (FAA) and its longstanding policy in favor of arbitration.

In *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333 (2011)—which was litigated by two of the authors of this legal update—the Supreme Court held that the FAA preempted a California state-law unconscionability rule that barred the enforcement of arbitration agreements with class waivers. The Court observed that, under Section 2 of the FAA, a court may not "rely on the uniqueness of an agreement to arbitrate as a basis for a state-law holding that enforcement would be unconscionable." The Court also noted that requiring the availability of class procedures in arbitration would "interfere[] with fundamental attributes of arbitration": it would make arbitration more formal and less efficient, and it would greatly increase defendants' legal exposure because class arbitration has the same high stakes of class actions in court, yet is subject to limited judicial review.

In *American Express Co. v. Italian Colors Restaurant*, 133 S. Ct. 2304 (2013), a class of merchants brought a class action against American Express alleging violations of the antitrust laws. The Court held that these antitrust claims were required to be resolved in individual arbitration under American Express's arbitration provision. The merchants argued that the provision ought not to be enforced because the costs of the expert witnesses required to prevail on their antitrust claims would be prohibitive in individual arbitration, but the Court rejected that argument, holding that individual arbitration would be sufficient to vindicate the merchants' rights.

Finally, just last year, in *DIRECTV, Inc. v. Imburgia*, 136 S. Ct. 463 (2015), the Court reversed a California state court decision that had adopted what the Ninth Circuit termed a "nonsensical" interpretation of a DIRECTV service agreement in order to circumvent *Concepcion* and hold the agreement's arbitration provision unenforceable. The Court, in an opinion written by Justice Breyer and joined by Justice Kagan (both of whom dissented in *Concepcion*), reaffirmed that *Concepcion* announced an "authoritative interpretation" of the FAA and that lower courts must follow it.

The continued applicability of these principles in the consumer financial services industry is now threatened—to be replaced with a policy that favors large class action attorneys' fees for plaintiffs' lawyers over fair, efficient and accessible dispute resolution for consumers. Since *Concepcion*, many companies have modeled their arbitration clauses on the provision at issue in that case, which pays consumers' costs of arbitration and awards them incentive payments if they win more in arbitration than they are offered in settlement. As the Court noted in *Concepcion*, such arbitration provisions make consumers likely "*better off* . . . than they would have been as participants in a class action." If the Bureau proceeds as expected, these consumer benefits will disappear, unless a court invalidates the CFPB rule.

Conclusion

Numerous industry stakeholders have been vocal in objecting to the Bureau's study and impending rulemaking on arbitration, which lacks meaningful empirical support and contravenes longstanding federal policy and recent Supreme Court decisions. Nonetheless, the Bureau clearly intends to proceed with its rulemaking. A public comment period on the proposed rule is expected, offering an opportunity for businesses that would be covered by the rule to provide real-world evidence of arbitration's benefits.

Companies should be prepared to assess arbitration programs they may have developed to resolve disputes over consumer financial products or services. They also should anticipate the unfortunate possibility of a swift expansion of abusive class action litigation in the consumer financial services market and develop appropriate strategies to mitigate that risk.

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