

## CFPB's Arbitration Study—A Warning to Consumer Financial Service Companies

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*This alert was originally published in Law360 on January 17, 2014.*

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*On December 12, 2013, the Consumer Financial Protection Bureau published its “Arbitration Study Preliminary Results,” mandated by Section 1028(a) of the Dodd-Frank Act (the “Study”). Unfortunately (and despite its statements to the contrary), the Study could be read as evidence that the CFPB intends to either ban or to severely limit arbitration provisions in consumer financial service contracts. Lenders and other financial service providers should consider the Study’s approach, possible actions by the CFPB, and steps that can be taken in anticipation of those actions.*

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Although so far industry commentators have been critical of the preliminary Study<sup>1</sup>, elements of it may be useful to consumer financial service companies when reviewing current arbitration provisions in anticipation of possible action by the Consumer Financial Protection Bureau (“CFPB”), which could include prohibiting or imposing conditions or limitations on the use of an arbitration agreement between consumer financial service providers and consumers.

### **Background of the CFPB Study Required by the Dodd-Frank Act**

Section 1028(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) directs the CFPB to study the use of pre-dispute arbitration contract provisions in connection with offering or providing consumer financial products or services, and to provide a report of its conclusions to Congress. Once the findings are submitted to Congress, the CFPB may then by regulation prohibit or impose conditions or limitations on the use of an arbitration agreement by a consumer financial service provider (a “covered person”) if it finds the prohibition, condition, or limitation “is in the public interest and for the protection of consumers.” The CFPB confirmed that it expects to finalize the report and submit it to Congress in 2014.

<sup>1</sup> A copy of the Study can be found at: [http://files.consumerfinance.gov/f/201312\\_cfpb\\_arbitration-study-preliminary-results.pdf](http://files.consumerfinance.gov/f/201312_cfpb_arbitration-study-preliminary-results.pdf).

The “preliminary” 168-page Study has been subject to much criticism by industry participants because, while incomplete in its research, it nevertheless signals the antipathy the CFPB has for the use of arbitration agreements in contracts between consumer financial service providers and consumers. For example, although couched as a factual presentation, the Study’s initial “conclusions” raise serious issues about the lack of balance by the CFPB in analyzing this complex issue. The preliminary findings include:

- Nearly all the arbitration clauses studied include provisions stating that arbitration may not proceed on a class basis—which is probably the single most important concern to the industry.
- In the credit card market, larger bank issuers are more likely to include arbitration clauses than smaller bank issuers and credit unions.
- In the checking account market, larger banks tend to include arbitration clauses in their consumer checking contracts, while mid-sized and smaller banks and credit unions do not.
- In its prepaid card sample, arbitration clauses are included across the market.
- The American Arbitration Association (“AAA”) is the predominant administrator for consumer arbitration about credit cards, checking accounts and prepaid cards.
- Most arbitration clauses contain small claims court carve-outs.
- Credit card issuers are significantly more likely to sue consumers in small claims court than the other way around.

In most instances, the tone of the Study in the preliminary findings can be read as justifying the CFPB’s eventual conclusion that these and other factors are detrimental to consumers and should be regulated.

In point of fact, however, while the tone of the Study appears to be somewhat hostile to the use of arbitration clauses, an objective reading of the research indicates that the conflict resolution system that has developed is working well with regard to the prompt resolution of small dollar amount claims—an area which is important to both consumers and offerors of consumer financial products. For example, for very small claims, the carve-out from arbitration of small dollar amount claims (requiring that litigation utilize specialized small claims courts) appears to work fairly and efficiently. For larger claims, the amounts rarely exceed \$20,000-to-\$30,000 and they are handled expeditiously by the use of arbitral forums.

Of particular note is that the Study, based upon reports gathered by the CFPB from a number of sources, indicates that the aggregate number of both small claims actions and consumer financial service-related arbitrations was very small compared with the total consumer financial service market as a whole. Stated another way, unlike the somewhat hostile tone of the Study towards arbitration, the preliminary data shows that the current consumer system using arbitration is operating efficiently and fairly.

### Analysis of the Study

The criticisms in the Study may be the result of the awareness by many members of the consumer financial services industry of the long-held opinion of consumer advocates that the use of arbitration provisions in consumer financial contracts is unfair and tilts the playing field against the individual consumer in favor of corporate interests. However, that perspective by consumer advocates as applied to the conclusions by the CFPB (e.g., whether to regulate arbitration provisions in consumer financial contracts) should be counterbalanced by several considerations. First and foremost, the use of arbitration provisions is based on a national public policy that **strongly favors** alternative dispute resolution. As indicated in numerous Supreme Court decisions over the past several years, the Federal Arbitration Act (“FAA”) endorses enforcement of arbitration agreements, finding contrary laws and rules preempted, including the use of arbitration agreements in contracts between consumer financial service providers and consumers.

Second, although the Study focuses a great deal of attention on the fact that many arbitration provisions prohibit the arbitration of class claims, the courts have decided that there is no substantive right to litigate claims on a class basis.<sup>2</sup> While it would not be possible at this point to predict the regulatory actions that may be taken by the CFPB with regard to arbitration agreements, opponents of consumer arbitration may push the CFPB to require that arbitration agreements in contracts between consumer financial service providers and consumers permit the arbitration of class claims.

It is established national public policy to encourage the use of arbitration, as evidenced by the FAA and *Concepcion* and its progeny. Therefore, the CFPB should be required to justify any action it takes to limit the use of arbitration in consumer financial contracts by an exceptionally high evidentiary standard—which currently appears to be somewhat absent based upon an objective reading of the preliminary results published in the Study. Accordingly, unless the CFPB can conclusively demonstrate actual consumer harm (i.e., the prohibition, condition, or limitation on the use of arbitration agreements “is in the public interest and for the protection of consumers”), it would appear likely that any regulatory action by the CFPB to prohibit or limit arbitration could be successfully challenged under the Administrative Procedures Act (“APA”).<sup>3</sup>

### Recommendations

In anticipation of possible adverse regulatory action by the CFPB, it would be in the industry’s best interests at the moment to continue developing research and issuing studies that support the continued and unabated use of arbitration provisions in consumer financial contracts should the final report prepared by the CFPB contain arguments supporting a contrary conclusion.<sup>4</sup>

In addition, although industry commentators have been critical of the Study, elements of it may be useful to industry participants when reviewing their current arbitration provisions. This is particularly important because it is not at all clear whether a regulation adopted by the CFPB limiting consumer arbitration provisions would be retroactive in application or would otherwise nullify an existing provision in a consumer financial contract on a go-forward basis.<sup>5</sup>

The Study identifies several features in consumer arbitration provisions reviewed, and in each case provides statistics about their inclusion in various categories of contracts for consumer financial products. These features include whether the arbitration provision:

- Allows the consumer to reject the arbitration clause for a limited period;
- Carves out disputes eligible for small claims court from the obligation to arbitrate;



<sup>2</sup> In *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740 (2011), California’s *Discover Bank* Rule—a rule that largely invalidated class action waivers in arbitration provisions in consumer contracts in California and other states following similar rules—was found preempted by the FAA because it “stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.” The ruling paved the way for enforcement of arbitration agreements within the FAA’s scope across the nation, including arbitration agreements with class action waivers.

<sup>3</sup> The statutory standard in Section 1028(a) of the Dodd-Frank Act (i.e., that the imposition of limitations on arbitration must be in the public interest and for the protection of consumers) appears to be significantly higher than the general standard required to support and justify agency actions under the APA.

<sup>4</sup> Section 1414(e) of the Dodd-Frank Act completely prohibits pre-dispute arbitration provisions for most residential mortgage loans, whereas the terms of Section 1028(a) impliedly confirm that the use of arbitration for other categories of consumer financial contracts is valid (but subject to an adverse determination by the CFPB).

<sup>5</sup> Any regulation prescribed by the CFPB will 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, as established by the CFPB. Accordingly, lenders can anticipate adverse CFPB action by updating or adopting arbitration provisions for their current universe of contracts.

- Identifies an entity (or entities) that may administer the arbitration (including procedures governing how the arbitrator (or arbitrators) are to be selected);
- Delegates enforceability decisions to the arbitrator;
- Precludes class proceedings;
- Limits the recovery of punitive or other damages;<sup>6</sup>
- Delimits the time period in which a claim must be brought;
- Imposes confidentiality and nondisclosure obligation on the parties;
- Mandates a location for a hearing;
- Allocates the costs of arbitration to the consumer and the company;
- Requires a contingent minimum recovery; and
- Addresses various core characteristics of the arbitration process.

It should be noted that many of the approaches taken in the arbitration provisions reviewed by the CFPB reflect a process that has evolved over several years with lenders who have attempted to draft arbitration clauses that would withstand attack based upon unconscionability grounds. Although the courts have sharply cut back the use of state law-based theories of unfairness to challenge consumer arbitration provisions, prudence dictates a balanced, even-handed approach when drafting consumer arbitration provisions lest the CFPB use its authority to prohibit unfair, deceptive and abusive practices in regard to specified arbitration features.

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<sup>6</sup> Complicating the CFPB analysis is the “cross-over” applicability of contract laws that impact arbitration provisions, such as the Uniform Commercial Code governing many portions of checking and other deposit contracts, as well as local state banking laws. (In many instances, these local laws permit parties to modify rules governing contractual relationships, including damages and statutes of limitation.)

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