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Mandatory Arbitration Clauses in Consumer Contracts and CFPB's Proposed Rules

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The battle lines over mandatory arbitration clauses with class action bans in consumer finance contracts were drawn about 15 years ago. The war rages on over requiring arbitration to settle disputes between corporations and individuals, and preventing consumers from filing class actions.

In 1925, Congress enacted the Federal Arbitration Act to allow corporations with equal bargaining power to enforce agreements between themselves privately, considering that arbitration may be less expensive and less time-consuming than litigation if sophisticated parties voluntarily agree to arbitrate before a dispute arises. Almost a century later, the Consumer Financial Protection Bureau (CFPB) is considering the appropriateness of foreclosing class actions and mandating arbitration to resolve disputes between financial companies and their customers.

On the one side, consumer finance providers contend arbitration benefits consumers because disputes are decided quickly and, they argue, the statistics show consumers recover more money per claim than they would as members of a class. They further contend class actions benefit only the attorneys, who earn large fees while the class members receive a pittance. On the other side, consumer advocates contend consumers are disadvantaged by the privatization of dispute resolution and, they argue, the statistics show that without the option of being a class member, most consumers elect not to proceed with an action. Consumer advocates argue that regardless of whether the action is individual or class, arbitration necessarily benefits the more powerful litigant because it is a private affair with no discovery or appeals. In about 2000, the use of mandatory arbitration clauses with class action waivers in consumer contracts proliferated and, with that, litigation about their legitimacy.

The disputes focused particularly around the issue of the class action ban. In October 2015, The New York Times published an article about an extensive study it had conducted, investigating the impact of the use of arbitration clauses with class action waivers in consumer contracts. Two quotes from that article demonstrate the strong feelings on both sides of the debate: for the companies, a general counsel for a large, multi-national corporation is quoted saying that class actions are "nuclear weapons aimed at companies" that are only "about plaintiff's lawyers"; and for the consumers, state judges are quoted that class action bans are a "get out of jail free card" for the corporations.[1]

A plethora of actions ensued. The cases regarding the enforceability of the mandatory arbitrations and class action bans were decided both ways until two U.S. Supreme Court cases in 2011 and 2013 appeared to resolve any question whether mandatory arbitration agreements with class action waivers would be enforced. In *AT&T v. Concepcion*,[2] the U.S. Supreme Court held that California's unconscionability doctrine, which invalidated arbitration agreements with class action waivers, was pre-empted by the FAA. The other shoe dropped when the Supreme Court decided *American Express v. Italian Colors Restaurant*[3] holding that class action waiver provisions in arbitration agreements are fully enforceable, and they cannot be struck because the cost of proceeding on an individual basis outweighs any potential recovery.

The issue appeared settled in favor of enforcing the clauses, but the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 made sweeping changes in the American financial regulatory environment in the wake of the financial crisis of 2007-2008. Not only did the Dodd-Frank Act establish the CFPB, but it prohibited arbitration agreements in the residential mortgage market, the largest market overseen by the CFPB.

The Dodd-Frank Act also mandated that the CFPB conduct a study on the use of pre-dispute arbitration clauses in consumer financial markets. The CFPB also received the power to issue regulations on the use of arbitration clauses in consumer financial markets consistent with the result of the study if it found that doing so would be in the public interest and for the protection of consumers. That study was released in March 2015, finding that arbitration agreements limit relief for consumers. Accordingly, on May 5, 2016, the CFPB proposed rules prohibiting defendants from relying on arbitration clauses in defense against class actions.

The CFPB proposed regulations that would apply to a variety of providers that are in the "consumer financial markets of lending money, storing money, and moving or exchanging money."[4] The CFPB considered whether to define consumer credit under either Equal Credit Opportunity Act and its implementing regulation, Regulation B, or the Truth in Lending Act and its implementing regulation, Regulation Z, but determined the Equal Credit Opportunity Act and Regulation B are more inclusive since, for example, they do not have exclusions for credit with four or fewer installments and no finance charge. This may reflect an intention by the CFPB to widen the proposal's application. While the CFPB repeatedly attempted to ground the proposed rules in established regulations with which providers and courts are familiar, the proposal parts with the Electronic Funds Transfer Act by not including prepaid electronic fund transfers and store gift cards. The proposed rules exclude creditors that have fewer than 25 customers in a year or are primarily a nonfinancial goods merchant, broker dealers who are already subject to restrictions on the use of pre-dispute arbitration agreements in class litigation, and governments and their affiliates, but generally speaking, these products and services are either directly offered or provided to consumers for personal use, or they are provided in connection with these products and services.

The proposal prevents any of the covered providers from using a pre-dispute arbitration agreement in a class action litigation in broad strokes:

A provider shall not seek to rely in any way on a pre-dispute arbitration agreement … with respect to any aspect of a class action that is related to any of the consumer financial products or services covered by [the proposed Rules] …[5]

Specifically, this would prevent a provider from moving to stay or dismiss a class action based on the existence of a pre-dispute arbitration agreement, seeking a protective order against the production of discovery, and filing an offensive arbitration claim against a class plaintiff. However, an arbitration proceeding can continue if it begins prior to the consumer's filing a class action. A defendant cannot raise the agreement until the court determines that the case may not proceed as a class (i.e., class certification is denied), including any interlocutory appeals.

The proposed Rules adhere to agreements that are "entered into" after 180 days from the effective date, which is a phrase that appears in Dodd-Frank Act without definition. To assist providers, the CFPB described several examples of when the requirements would and would not apply. The provision obviously would apply when a provider sells a new product to a consumer. It also would apply when the provider purchased a product (such as in the acquisition of a company) that would be covered and the provider becomes a party to the agreement; if the acquiring provider does not become a party to the agreement, then the provision does not apply. If the provider updates or amends the terms of a product or service that is subject to an agreement that was formed prior to the compliance date, this would not be considered a new agreement unless the changes are so great that it amounts to a new product or service.

The Rules propose that any covered pre-disputed arbitration agreement entered into after the compliance date must include the following plain-English statement: "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."[6] The proposal provides for additional language to clarify when multiple products or services are included in the agreement but only some are covered by the rule. Similarly, if the provider becomes a party to a previously existing agreement, the agreement must be amended to include similar language or notice provided to the consumer within 60 days of entering into the agreement. Importantly, the proposal does not currently mandate that covered entities should insert the provision into their pre-dispute arbitration agreements.

While the proposed Rules prevent providers from relying on the arbitration provision in defense of a class action, they do not prevent the provider from requiring arbitration in individual complaints. Arbitration proceedings are therefore likely to proceed. However, the proposed Rules require the provider to submit certain arbitration records to the CFPB about these proceedings in order to further study the impacts on consumers of arbitration and arbitration agreements. Under the proposed Rules, a provider must submit, within 60 days of filing with an arbitrator: (1) the initial claim form and any counterclaim; (2) the pre-dispute arbitration agreement filed with the arbitrator or administrator; (3) the judgment or award, if any, issued by the arbitrator or arbitration administrator; (4) if an arbitrator or arbitration administrator refuses to administer or dismisses a claim due to the provider's failure to pay required filing or administrative fees, any communication the provider receives from the arbitrator or an arbitration administrator related to such a refusal; and (5) any determination that the provider's pre-dispute arbitration agreement does not comply with the arbitrator's fairness principles, rules, or requirements, such as the AAA Consumer Due Process Protocol or JAMS Policy on Consumer Arbitrations Pursuant to Pre-Dispute Clauses Minimum Standards of Procedural Fairness. The proposal also allows the arbitrator to submit the materials to the CFPB, although the provider still has to ensure that they are sent. The requirements also include any communication from the arbitrator regarding the nonpayment of fees because the CFPB understands that providers sometimes force consumers out of court and into arbitration, but then prevent the dispute from proceeding by not paying the necessary fees. The CFPB also understands that an arbitrator often sends a letter when the provider fails to pay its fees, which must be submitted. Any personal information must be redacted before it is submitted. Notably, the list of materials to be submitted does not currently include the responses to a claim or any resolution of the arbitration other than an award, such as settlements or withdrawals by the consumer because the provider remedied the problem.

Public comment on the proposed Rules are due by Aug. 22, 2016.

Bit by bit, the grip of mandatory arbitration with class action waivers may be loosening. Arbitration clauses with class action bans also are being challenged in employment agreements. On May 26, 2016, the U.S. Court of Appeals for the Seventh Circuit issued its decision in *Lewis v. Epic-Systems*,[7] finding that the company's arbitration agreement, which prohibits employees from participating in "any class, collective or representative proceeding," violated the employees' right to engage in concerted activity under the National Labor Relations Act (NLRA). The Seventh Circuit became the first circuit court to agree with the NLRB that engaging in class, collective, or representative proceedings is "concerted activity" and a protected right under §7 of the NLRA; and that it would be an unfair labor practice under §8 of the NLRA for an employer "to interfere with, restrain, or coerce employees in the exercise" of this right. The decision therefore creates a Circuit split, and given the importance of the issue, sets the stage for potential Supreme Court review. Opining that the *Epic-Systems* decision went contrary to the previous trend to find in favor of arbitration in the context of employment, Benjamin Sachs, a professor of labor law at Harvard Law School, was quoted by the New York Times[8] as saying: "This is a major move in the opposite direction."

Private attorneys are trying to chip away at the mandatory pre-dispute arbitration and class action ban in different ways, particularly by arguing that the consumer has not agreed to the terms of the contract. In one case against the activity-tracking monitor company Fitbit, the third amended complaint filed in the Northern District of California alleges that Fitbit devices work properly only when users register them at the company's website. To register, users must agree to terms of service in which they submit to arbitration and waive the right to classwide dispute resolution. The complaint asserts, however, that the named plaintiffs bought Fitbits from independent retailers and did not agree to the company's terms of service before they made their purchases. None of the plaintiffs, according to the complaint, realized from Fitbit advertising or packaging that they would have to sign up at the Fitbit website—and submit to Fitbit's terms of service—to use the devices. Plaintiffs are thus challenging any attempt by Fitbit to force this class that excludes consumers who purchased the product directly from Fitbit into arbitration, contending that no agreement to limit any of their legal rights was requested to complete the purchases, nor was there any timely indication that such an agreement would be necessary to make the devices operational. As of the time of this writing, the motion to dismiss is pending.

Notwithstanding the decision in *American Express v. Italian Colors Restaurant*, plaintiff attorneys continue to challenge American Express' mandatory arbitration. In a case pending in the Northern District of California against American Express among many other defendant banks and credit card companies, plaintiff retailers contend that the defendants illegally conspired to make the retailers responsible for chargebacks for fraudulent transactions if they failed to get new payment card terminals that read cards with micro-chips installed and certified by an allegedly unreasonable deadline of October 2015. The defendants contend that the arbitration agreements they signed with each merchant are valid and enforceable. In response to defendants' motion to compel arbitration, plaintiffs claim that the alleged conspiracy is outside the scope of the arbitration agreements, and that the agreements are procedurally and substantively unconscionable. As of the time of the writing, that motion is pending.

The opposition to mandatory pre-dispute arbitration is particularly strenuous in connection with nursing home agreements. On July 16, 2015, the Centers for Medicare & Medicaid Services (CMS) announced a proposed regulation restricting the use of binding arbitration agreements by nursing homes, and they currently are working on the final rules. The proposed rules require nursing homes to explain the arbitration agreement; the resident must acknowledge understanding the agreement; the agreement must be entered into voluntarily; and the arbitration session must be conducted by a neutral arbitrator in a location that is convenient to both parties. Beyond that, the rules propose that admission to the nursing home cannot be conditioned on signing a binding arbitration agreement. The nursing home industry opposed these proposed regulations, contending that they exceed CMS' statutory authority; they are not necessary to protect resident health and safety; and many of the stated factual and legal grounds for the proposals are wrong. The attorneys general of 15 states and the District of Columbia issued a letter to CMS supporting the proposed restrictions and asking for a ban on arbitration agreements that are presented to nursing home residents on a take-it-or-leave-it basis.

Proponents of mandatory arbitration contend that arbitration benefits consumers. Perhaps the competing interests regarding arbitration are not so irreconcilable, as if arbitration in consumer contracts were required to be voluntary, all parties' interests will be served. Then the only open item will be a big one: whether class actions may be banned contractually by providers in their contracts with consumers.

Endnotes:

1. Jessica Silver-Greenberg & Robert Gebeloff, "Arbitration Everywhere, Stacking the Deck of Justice," N.Y. Times, Oct. 31, 2015, http://www.nytimes.com/2015/11/01/business/dealbook/arbitration-everywhere-stacking-the-deck-of-justice.html.

2. *AT&T Mobility v. Concepcion*, 563 U.S. 333 (2011).

3. [*Am. Express Co. v. Italian Colors Rest.*, 133 S. Ct. 2304 (2013)](#).

4. Arbitration Agreements, 81 Fed. Reg. 32830, 32830 (May 24, 2016).

5. Proposed 12 C.F.R. § 1040.4(a)(1).

6. Arbitration Agreements, 81 Fed. Reg. 32830, 32925-96 (May 24, 2016) (to be codified at 12 C.F.R. § 1040.4(a)(2)(i)).

7. *Lewis v. Epic Sys.*, No. 15-2997, 2016 U.S. App. LEXIS 9638 (7th Cir. May 26, 2016).

8. Jessica Silver-Greenberg & Noam Scheiber, "Court Rules Companies Cannot Impose Illegal Arbitration Clauses," N.Y. Times, May 26, 2016, http://www.nytimes.com/2016/05/27/business/dealbook/court-rules-companies-cannot-impose-illegal-arbitration-clauses.html.

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