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EXPERT ANALYSIS

Are arbitration clauses in financial contracts going 'bye, bye, bye'?

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The Consumer Financial Protection Bureau is a large, forceful organization that can influence the entire financial services industry simply by passing a rule. One regulation from this agency could crumble the foundation of the industry's certainty and custom. Like the coach who sketches out a play before practicing, critiquing and executing it in a game, the CFPB conducts studies before it promulgates rules.

A recent agency study, which focused on the effects of arbitration clauses in consumer financial services contracts, culminated in a lengthy report issued March 10, 2015. In accordance with this report and its underlying data, the CFPB authored a plan to declare war on arbitration clauses.

Articulating its desire to ban consumer financial companies from using "free pass" arbitration clauses to avoid class action litigation, the agency is proposing regulations that further restrict the use of arbitration clauses in the financial services industry.

These proposed rules, however, are currently in "sketch" form only. They can be undone, altered or amended. But without critique and constructive feedback from those potentially affected, the proposed rules will be finalized — and they could alter the landscape of dispute resolution for the financial services industry.

This analysis illuminates several flaws in the CFPB's arbitration study and encourages the bureau to examine these issues before promulgating a new resolution that could hurt consumers.

While the rules are in sketch form, there is still time for a necessary dialogue on the potential ramifications of eliminating or fundamentally altering arbitration clauses. Before the sketch turns into game-time play, the CFPB should strongly consider the need for additional studies that compare apples to apples instead of apples to oranges.

ARBITRATION CLAUSES

Arbitration clauses serve as a dispute resolution mechanism that is an alternative to traditional litigation, and they affect tens of millions of consumers. These clauses provide for a privately appointed arbitrator to resolve disputes rather than a state or federal court judge.

Arbitration clauses permit either party to the contract to block lawsuits from proceeding in court, and they may also bar consumers from bringing class-action claims.

In the credit card and checking account markets, financial institutions routinely include arbitration clauses in consumer contracts. The inclusion of these clauses reflects the strong public policy in favor of private dispute resolution outside of the court system.

From the viewpoint of the financial services industry, arbitration clauses serve a beneficial purpose: They are a cost-effective means of resolving disagreements. Arbitration precludes attorneys from

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engaging in expensive litigation that can take years to resolve. In fact, arbitration does not even require the parties to hire an attorney.

Because arbitration does not include the burdensome practices of discovery and trial preparation, studies show that consumer arbitration is up to 12 times faster than litigation.

Consumer advocates and plaintiffs' attorneys, however, perceive arbitration clauses as unfairly restricting consumer rights and depriving consumers of their day in court. This backlash against arbitration clauses is propelled, in part, by an unfounded contention that arbitrators are beholden to large corporations and represent a privatization of justice.

Additionally, opponents of arbitration clauses argue that corporations can skirt consumer protection laws and further insulate themselves from responsibility by avoiding class action lawsuits altogether. Consumer advocates maintain that arbitration clauses must be eliminated to ensure that corporations remain accountable.

THE CFPB STUDY

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress authorized the CFPB to study arbitration clauses in consumer financial markets and to issue regulations consistent with the study's findings.

In December 2013, the CFPB published its preliminary results, and it supplemented this data in March 2015. The March 2015 report enhanced the CFPB's initial analysis by collecting data on the kinds of mortgage transaction claims that consumers can bring as class actions and on the settlement amounts in those cases.

Additionally, the CFPB analyzed arbitration clauses in six consumer finance markets: credit cards, checking accounts/debit cards, prepaid cards, private student loans, payday loans and automobile loans.

From this data, the CFPB estimated that consumers and companies file, on average, 600 arbitration cases and 1,200 federal lawsuits each year in the six markets studied. Most arbitration filings involved a debt dispute, and only eight cases per year involved a debt claim of less than $1,000 (25 disputes a year involved consumer claims of $1,000 or less).

In the 1,060 arbitration cases the CFPB examined between 2010 and 2011, arbitrators afforded consumers relief in only 32 cases and these resulted in arbitral awards totaling $172,433. In contrast, between 2008 and 2012, more than 11 million class action members received $1.1 billion in compensation.[1]

After analyzing this data, the CFPB concluded that arbitration clauses deny consumers their day in court and allow corporations to remain unaccountable for harmful low-dollar errors. As a result, the CFPB recommended that all financial services contracts containing arbitration clauses include explicit language permitting class actions.

Additionally, the CFPB's proposal would require companies that use arbitration clauses to submit all arbitration data to the agency, including a list of the claims filed and the awards issued.

CONCERNS WITH THE STUDY

While the CFPB's arbitration data appears at first blush to support the notion that arbitration clauses harm consumers, numerous flaws in the agency's data collection discredit this conclusion.

As a preliminary matter, there is little systemic empirical evidence comparing consumer welfare in arbitration and class actions. In fact, the CFPB's data is premised on just eight primary class action lawsuits.[2]

Similarly, arbitration results are confidential, and there is no federal reporting requirement. It is undeniable that the CFPB's conclusions regarding the effectiveness of arbitration and class actions are extrapolated from a remarkably small and inconclusive data sample.

Given these limitations, it is important that the CFPB and independent organizations conduct additional studies on arbitration and class action success to verify and supplement the data pool before that data is used as a basis for long-term regulations.

Furthermore, the CFPB failed to articulate whether the class-action settlements studied for its report were supported by meritorious claims. A settlement in and of itself is not an adjudication of fault.

When faced with massive discovery costs and prolonged trials, businesses often settle cases — including frivolous lawsuits — rather than spend thousands or millions of dollars in legal defense fees. The class-action data that the CFPB references may have included settlements of meritless claims.

The CFPB also failed to consider the economic and reputational costs businesses incur as a result of frivolous class-action lawsuits. If the bureau bans or alters arbitration clauses and forces businesses to litigate their disputes, the costs that businesses incur may inevitably be passed on to consumers (for example, in the form of higher prices or increased interest rates).

The CFPB, however, contends that no significant cost differential arose when credit card issuers placed a temporary moratorium on the use of arbitration clauses.

Despite the CFPB's assertions to the contrary, this experiment only demonstrates that credit card issuers do not pass on temporary cost increases to consumers. The bureau never undertook a historical cost analysis to compare long-term pricing differentials between companies that use arbitration clauses and those that do not. Such a study is needed before the agency can credibly claim that consumers will not be harmed by an increase in litigation.

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Moreover, the CFPB's claim that almost no American Arbitration Association filings concerning the financial product markets involved $1,000 or less is misleading. The CFPB asserts that the low incidence of small-dollar claims in arbitration can be directly traced to the inclusion of arbitration clauses.

In other words, it says that because few arbitration claims of $1,000 or less are brought in the financial services industry, arbitration is not a feasible dispute resolution mechanism for consumers. The CFPB, however, offers no rationale for this asserted causal connection.[3]

In fact, the agency's conclusion purposefully ignores alternative explanations for the low incidence of small-dollar arbitration disputes. In particular, financial services disputes are often resolved in house without arbitration or litigation. Financial institutions routinely provide refunds and fee adjustments to consumers to maintain amicable relationships.

A study by the Mercatus Center at George Mason University noted that at least one banking institution provided refunds to consumers 68 percent of the time without referring the dispute to arbitration or litigation.[4]

There is a strong likelihood that financial services companies refund or adjust charges incurred by consumers internally rather than involving a judge or arbitrator. The CFPB's findings fail to account for this possibility.

In addition, arbitrations are routinely conducted for low-value claims outside the financial services industry. Approximately 3.5 percent of all general arbitration claims are for $1,000 or less, and 7 percent of all claims are less than or equal to $2,000.

In contrast, low-dollar financial services arbitrations (claims less than $1,000) comprise only 2 percent of all AAA consumer arbitration filings. This means that consumers initiate 75 percent more small-dollar claims for non-financial services products.

The fact that small-dollar claims can account for between 3.5 and 7 percent of all arbitration filings suggests that low-dollar arbitrations are feasible and routinely used. This realization undermines the CFPB's stance that consumers will not pursue arbitration to resolve low-dollar disputes.[5]

The question thus becomes: Why do consumers pursue small-dollar disputes less frequently in the financial services context? It is a question that the CFPB has failed to consider.

The answer, however, cannot be the economic infeasibility of arbitration. It is more likely that the financial services industry has adopted internal dispute resolution mechanisms that benefit consumers without the hassle or exposure of arbitration and litigation.

Until the discrepancy in small-dollar arbitration filings can be explained, the CFPB cannot credibly contend that consumers lack an avenue to seek relief for small-dollar disagreements.

Additionally, the bureau's proposal to ban or alter arbitration clauses in financial services contracts contravenes public policy. The U.S. Supreme Court has repeatedly ruled that the right to use arbitration as an alternative dispute mechanism is protected by the Federal Arbitration Act.

The CFPB has failed to explain why arbitration clauses pose such a formidable threat in financial services contracts while they are favored by strong public policy and Supreme Court precedent.

Similarly, the CFPB has offered no support for its proposition that financial institutions are presently able to avoid accountability. To the contrary, financial institutions are subject to unprecedented regulation, and consumers may even file complaints against finance companies with the CFPB.

Arbitration precludes attorneys from engaging in lengthy and expensive litigation that can take years to resolve.

The agency's own statistics state that financial services institutions have responded to more than 463,840 consumer complaints and have provided prompt responses 98 percent of the time.[6] It is difficult to understand exactly how financial institutions are avoiding accountability — especially given the unparalleled number of regulations controlling financial services activity.

Finally, the claims rate, meaning the rate of actual collections by consumers from the settlement pool, for class-action lawsuits suggests that consumers rarely collect their small-dollar proceeds after a settlement.

Kurtzman Carson Consultants analyzed claims rates in consumer class-action settlements and found the median claims rate to be 0.23 percent (as Forbes magazine notes, the probability of getting a straight flush in a seven-card poker hand is 0.0279 percent). This percentage translates into approximately one claim recovery per 4,350 class members.[7]

The CFPB offers no explanation for the low claims rate success, which seems to support the conclusion that the cost-benefit analysis of filing a claim for a low-dollar dispute is not worth most consumers' time — regardless of whether the dispute is resolved via arbitration or litigation. Rather, the CFPB calculated its own claims rate at 21 percent.[8]

This stark contrast in numbers is likely due to the fact that the CFPB's calculation was an un-weighted aggregate average of class actions.

In other words, the CFPB estimated the total number of class members receiving a payment — no matter how small — and divided it by an estimate of the total number of class members in that same sample.

Furthermore, the CFPB inconsistently applied its own selection criteria in determining which data sets to include in its sample. The wide discrepancy between the Kurtzman Carson claims rate and the CFPB claims rate must be closely examined and reconciled before any conclusions can be drawn about the effectiveness of class actions.

CONCLUSION

The CFPB should resolve the flaws in its data analysis before finalizing its regulations. Once the agency leaves its permanent mark, the landscape of consumer financial contracts will be fundamentally altered. Without considering the drawbacks and limitations of its own study, the CFPB could inadvertently harm consumers instead of advancing their rights.

While the study is a good start at analyzing arbitration and class-action data, it is simply one piece of the play — a sketch of which has barely been started. Requiring pre-dispute arbitration clauses to contain an exception for class actions is premature and could result in negative consequences to the very consumers the CFPB seeks to protect.

NOTES

[1] *See* Consumer Financial Protection Bureau, Arbitration Study: Report to Congress, pursuant to Dodd-Frank Wall Street Reform and Consumer Protection Act § 1028(a) 10-12 (2015).

[2] *See* Jason S. Johnston & Todd Zywicki, The Consumer Financial Protection Bureau's Arbitration Study: A Summary and Critique (2015), http://bit.ly/1M7UaAP; *see also* Alison Frankel, *A Smoking Gun in Debate over Consumer Class Actions?*, Reuters, May 9, 2014, http://reut.rs/29DcXhb.

[3] *See* Johnston & Zywicki, *supra* note 2, at 36.

[4] *Id.* at 38.

[5] *See id.* at 52-53.

[6] Rob Berger, *The CFPB Declares War on Arbitration,* Forbes (Oct. 18, 2015, 10:27 AM), http://bit.ly/29l0Pg1.

[7] Frankel, *supra* note 2; *see also* Daniel Fisher, *Odds of a Payoff in Consumer Class Action? Less than a Straight Flush,* Forbes (May 8, 2014, 4:49 PM), http://bit.ly/29qkA8K.

[8] *See* Johnston & Zywicki, *supra* note 2, at 41.

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