

May 25, 2016

Will Arbitration Clauses in Consumer Contracts Become Extinct?

Arbitration has long been favored by parties fearful of litigation costs and the unpredictability of runaway juries. Congress enacted this pro-arbitration federal policy in the 1925 Federal Arbitration Act (FAA). See generally 9 U.S.C. § 2.

Section 2 of the FAA mandates that arbitration agreements related to contracts “evidencing a transaction involving [interstate] commerce” are binding. See, e.g., *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 277 (1995); *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 401 (1967). Historically, this has embraced everything from loans to leases, including both business-to-business contracts, as well as those between businesses and consumers.

The FAA’s “primary purpose [is to ensure] that private agreements to arbitrate are enforced according to their terms.” *Volt Info. Scis., Inc. v. Board of Trs. of Leland Stanford Junior Univ.*, 489 U.S. 468, 479 (1989). Indeed, the Supreme Court instructs that the FAA “leaves **no place for the exercise of discretion** by a district court, but instead mandates that district courts shall direct the parties to proceed to arbitration on issues as to which an arbitration agreement has been signed.” *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 218 (1985) (emphasis added).

The FAA’s reach is broad. It preempts any state law “to the extent that [the state law] stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress” in passing the FAA. *Volt Info. Scis.*, 489 U.S. at 477 (internal quotation marks and citations omitted); see also *Southland Corp. v. Keating*, 465 U.S. 1, 16 (1984). As recently as 2013, the Supreme Court has upheld the controversial practice of coupling arbitration language with waivers of the right to serve as a class action representative. *American Express Co. v. Italian Colors Restaurant*, 133 S. Ct. 2304 (2013).

The 2010 Dodd Frank legislation empowering the newly created Bureau of Consumer Financial Protection (CFPB) to limit arbitration; the scope of its authority, and the way that authority interacts with existing federal policy under the FAA, remains to be tested. Dodd Frank Section 1028(b) allows, among other things, the CFPB to “prohibit or impose 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, if the Bureau finds that such a prohibition or imposition of conditions or limitations is in the public interest and for the protection of consumers.” In other words, the long-established FAA policy may be scaled back radically under the rubric of consumer protection through the CFPB’s recent proposed rule-making.

The CFPB proposed rule, found in 12 CFR Part 1040, aims to set two limitations in the use of pre-dispute arbitration agreements by covered providers of consumer financial products and services. First, the proposed rule prohibits providers from using a pre-dispute arbitration agreement to block consumer class actions in court and also requires providers to insert language into arbitration agreements reflecting the limitation. According to the CFPB, arbitration agreements are widely used to prevent consumers from seeking relief on a class basis leading consumers to rarely file individual lawsuits or arbitration cases to obtain relief.

Secondly, the proposal would require providers that use arbitration agreements to submit certain records relating to arbitral proceedings to the Bureau. This new rule would apply only to agreements entered into after the end of the 180-day period beginning on the regulation’s effective date. See Dodd Frank Section 1028(d). The new rule will undoubtedly be challenged because the rule threatens nearly 100 years of federal pro-arbitration caselaw and federal policy.

Practice Pointers:

If you represent providers affected by the proposed rule in the core consumer financial markets, consider whether arbitration will remain the preferred method of conflict resolution if confidentiality of the proceedings or limitations on its use became commonplace.

CFPB will be providing proposed language that providers would be required to insert into their pre-dispute arbitration agreements, however, you may want to consider revising your arbitrations agreements now to avoid the entire provision becoming unenforceable based on the new rule.

Providers routinely practicing in arbitral forums may benefit from re-evaluating their legal teams to ensure strong representation in local courts in the various regions in which they operate, as matters formerly addressed by arbitration will increasingly find themselves embattled in local courts, including small claims courts.