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ARBITRATION

CONSUMER LAW

Pre-dispute arbitration clauses should be restricted because they harm consumer welfare, attorney Julie Goldsmith Reiser says. The author says consumers often don't grasp the implications of arbitration clauses until they have a dispute and are seeking relief.

Pre-Dispute Arbitration Clauses: Taking the Alternative Out of Dispute Resolution

BY JULIE GOLDSMITH REISER

Congress in 2010 asked the Consumer Financial Protection Bureau (''CFPB'') to study the effect of mandatory arbitration clauses that have become common in contracts for financial products and services.[1] Five years later, CFPB published its findings in *Arbitration Study: Report to Congress 2015* (''CFPB Study'').[2] Empirical data produced in the *CFPB Study* compelled the conclusion that pre-dispute arbitration clauses harm consumers by forcing them to sign or click away their right to pursue future remedies in a court of law.[3] Predictably, a critique of the CFPB Study followed six months later.[4] The Mercatus Center, a think tank at George Mason University, argued that CFPB's methodology and conclusions were flawed and that banning pre-dispute mandatory arbitration clauses would make consumers worse off.[5]

Julie Goldsmith Reiser is a partner at Cohen Milstein Sellers & Toll PLLC, where her practice focuses on securities fraud litigation and investor protection. She is available at jreiser@cohenmilstein.com.

[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), contained this mandate in § 1028(a), requiring a report on ''the use of agreements providing for arbitration of any future dispute between covered persons and consumers.'' In conjunction with this direction, Congress also granted CFPB discretion to prohibit the use of such agreements if such prohibition ''is in the public interest and for the protection of consumers.'' *Id.* at § 1028(b).

[2] Consumer Fin. Prot. Bureau, *Arbitration Study: Report to Congress Pursuant to Dodd-Frank Wall Street Reform and Consumer Protection Act § 1028(a)* (March 2015). (''CFPB Study'').

[3] *Arbitration Study Report to Congress, pursuant to Dodd-Frank Wall Street Reform and Consumer Protection Act § 1028(a)*, Consumer Financial Protection Bureau (March 2015). (''CFPB Study''). The CFPB Study did not offer a conclusion; although the reported data left little room for doubt that pre-dispute arbitration clauses are harmful to consumers.

[4] Jason Scott Johnston & Todd Zywicki, The Consumer Financial Protection Bureau's Arbitration Study A Summary and Critique (Mercatus Center George Mason University, August 2015). (''Mercatus Center Critique'').

[5] Although nominally affiliated with George Mason University, the Mercatus Center is separately funded, largely by Koch Industries and the Koch Family. The Mercatus Center was founded by Richard Fink, head of Koch Industries' lobbying operation in Washington, D.C., and an executive vice president at Koch Industries. *See* Jane Mayer, *Covert Operations the Billionaire Brothers Waging War Against Obama (August 30, 2010),* http://www.newyorker.com/magazine/2010/08/30/covert-operations. Brian Hooks, the Mercatus Center's COO

However, the Mercatus Center's Critique misses the forest for the trees. Its criticisms focus on a small amount of arbitration data that is available rather than the limitations of drawing conclusions from the minimal amount that exists. In focusing on what is there to the exclusion of why the data is so limited, the Mercatus Center misses three key points: (1) the dearth of data confirms that, in general, consumers fail to opt for arbitration even when arbitration is their *only* option for pursuing a grievance; (2) the disclosure restrictions on arbitrations restrict information flow—thus preventing consumers from learning about problematic practices that may have harmed them; and (3) arbitration clauses' bar on class actions further increases the cost to consumers of recovery, and decreases information access as class actions often generate publicity about a corporate practice.

Adding insult to injury, surveys reveal that consumers do not grasp the implications of arbitration clauses until they have a dispute and are seeking relief. Therefore, consumers undervalue the importance of mandatory arbitration clauses even in the rare instances where consumers might be able to opt out. CFPB correctly concluded that binding individual customers to mandatory arbitration before a dispute arises, rather than encouraging its voluntary use, is harmful to public interest and consumer protection.

CFPB Study and Findings

CFPB scoured information from financial services contracts to understand the frequency with which pre-dispute arbitration clauses are embedded in contracts, the features of such provisions, and the results when disputes arose. The CFPB Study found that pre-dispute arbitration clauses (*e.g.,* mandatory arbitration) are standard in highly concentrated financial industries.[6] For example, seven of the eight largest mobile wireless service providers combined have contracts with 99 percent of all mobile subscribers. Customers of all seven are subject to arbitration clauses.[7] Similarly, approximately 80 million credit card customers' contracts have embedded mandatory arbitration clauses.[8] In the private student loan segment, 85.7 percent of the loan contracts include arbitration clauses.[9] With little notice, over the past 10 years arbitration clauses have become the norm in consumer contracts.[10]

Arbitration clauses not only keep companies out of court, they also include a waiver of class-wide arbitration as a matter of course.[11] Usually, the arbitration provisions also waive a consumer's right to participate in class action litigation.[12] For example, In November 2012, the Pew Charitable Trusts issued a study finding that in checking account contracts, among the 50 largest institutions, 81 percent ban participation in class action litigation.[13] Other differences between arbitration and litigation in court include: 1) no jury trial; 2) limited discovery; 3) limited, if any, appellate rights; and, perhaps most significantly, 4) a much less public forum in which to resolve disputes.[14]

Notwithstanding the prevalence of mandatory arbitration clauses in financial industry contracts and the limitations they impose on consumers' legal rights, consumers are unlikely to consider the form of dispute resolution as a factor in choosing their financial service provider. For example, a majority of those surveyed about their credit card agreement did not know if they had agreed to mandatory arbitration, nor how their legal rights were affected in the event a dispute arose with their credit card issuer.[15]

Another survey found that 87 percent of consumers who claimed not to have entered into a consumer contract with an arbitration clause actually had done so.[16] These surveys reveal that consumers are not aware that they have entered a contract waiving their constitutional right to a jury trial, which are typically buried in lengthy form contracts over which consumers have no say in their terms. Once a dispute arises, however, the consequences of contracts with embedded arbitration clauses are significant.[17]

The difference between the amount recovered and number of consumers eligible to participate in the recovery is directly tied to the format of dispute resolution. CFPB's study revealed that 34 million class members could have or were scheduled to receive cash relief

and executive director since 2006 became the president of the Charles Koch Foundation in 2014. *See* Charles Koch Foundation, *President of the Charles Koch Foundation* (May 7, 2014), http://www.charleskochfoundation.org/president-of-the-charles-koch-foundation/.

[6] The reason for this standardization is well-described in Jessica Silver Greenberg & Robert Gebeloff, ''*Arbitration Everywhere, Stacking the Deck of Justice*,'' The New York Times, (October 31, 2015).

[7] CFPB Study, Section 2 at 7 .

[8] *Id.,* Section 2, n. 19 (referring to 2013 CFPB Study Preliminary Results : Section 1028(a) Study Results to Date (Dec. 12, 2013) at 63-64). Had private settlements of certain antitrust cases not occurred, 94 percent of credit card loans outstanding would be subject to arbitration. CFPB Study at 9.

[9] *Id.* at 7.

[10] Jessica Silver Greenberg & Michael Corkery, ''*In Arbitration, a 'Privatization of the Justice System*,' '' The New York Times (November 1, 2015) (reporting that some of the largest companies contain mandatory arbitration clauses in their contracts: AT&T, Budget, Discover, Ebay, Expedia, Netflix, Starbucks, T-Mobile, and Time Warner).

[11] ''93.9 percent of credit card arbitration clauses, 88.5 percent of the checking account arbitration clauses, 97.9 percent of the prepaid card arbitration clauses, 88.7 percent of the storefront payday loan arbitration clauses, 100 percent of the private student loan arbitration clauses, and 85.7 percent of the mobile wireless arbitration clauses in our sample contained terms that expressly did not allow arbitration to proceed on a class basis.'' CFPB Study at 44.

[12] Theodore Eisenberg, Geoffrey P. Miller & Emily Sherwin, *Arbitration's Summer Soldiers: An Empirical Study of Arbitration Clauses in Consumer and Nonconsumer Contracts, 41 U. Mich. J.L. Reform* 871, 884-5 Tables 3 and 4 (2008).

[13] Pew Charitable Trusts, *Banking on Arbitration: Big Banks, Consumers, and Checking Account Dispute Resolution* (Nov. 2012).

[14] *CFPB Study* at 72; *see also* Greenberg, ''In Arbitration, a 'Privatization of the Justice System,' '' (''Little is known about arbitration because the proceedings are confidential and the federal government does not require cases to be reported'').

[15] CFPB Study Section 3 at 3.

[16] *Id.* Section 3 at 8.

[17] The New York Times published a three-part series that considers ''how clauses buried in tens of millions of contracts have deprived Americans of one of their most fundamental constitutional rights: their day in court.'' Greenberg, ''Arbitration Everywhere, Stacking the Deck of Justice.''

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from class action litigation since 2008.[18] In contrast, instances of initiating arbitration are *de minimis*—averaging 411 cases filed by consumers per year for financial products and services.[19] The New York Times reported that the odds of prevailing in disputes under $2,500 is low; moreover, the odds of obtaining counsel who will represent the consumer in such a dispute is even lower—only 6 percent of arbitrations per year involve disputed amounts below $1,000.[20]

Finally, CFPB's study analyzed the role of public enforcement in identifying and deterring unfair and deceptive practices in the financial industry. The CFPB Study concluded that where the public and private sector brought overlapping claims, the private lawsuits were filed first between 62 percent and 71 percent of the time. In other words, public enforcement typically followed on the heels of private enforcement.[21]

Mercatus Center's Critique of the CFPB Study

Mercatus Center's Critique argues that the CFPB Study should not prompt the restriction of mandatory arbitration clauses in consumer contracts.[22] The Critique's premise is that many class action disputes are settled to avoid the cost of discovery, even when the lawsuit is frivolous. Thus, the argument goes, the settlement harms consumer welfare and the amount distributed benefits lawyers rather than consumers. Meanwhile, the authors claim that arbitrations resolve meritorious individual claims at least as well, if not better, than the court system. Additionally, the Mercatus Center's Critique suggests that consumers' ability to switch service providers serves as a powerful market-based incentive for companies to be responsive to customer complaints.

At the outset, the Critique faults CFPB for failing to provide comparable data on settlement results in arbitration as compared with settlements in class action litigation.[23] While such information could be helpful, it is unavailable because of the private nature of arbitration proceedings—itself a troubling feature of mandatory arbitration clauses. Yet, irrespective of the amount recovered, the sheer number of participants in class action settlements shows that far more consumers participate in and benefit from collective litigation. For example, the CFPB Study data reveal that 11 million individuals filed claim forms to receive a cash distribution in class action settlements. In contrast, only hundreds of consumers, at most, filed arbitration claims during the same time period.

The Critique's suggestion that individual arbitration and individual litigation actions must be compared hinges on ignoring the vast majority of claims that are not pursued because they are too small to bring on an individual basis (these claims might otherwise be pursued through cost-sharing in the context of collective actions).[24] Because arbitration clauses prevent class litigation, it is clear most consumers will receive no relief whatsoever when mandatory arbitration clauses are enforced. Seventh Circuit Judge Richard Posner succinctly made the point: ''The realistic alternative to a class action is not 17 million individual suits, but zero individual suits as only a lunatic or fanatic sues for $30.''[25]

From the inability to pursue negative value claims, also follows a larger point—publicity tied to cases in the court system are more likely to prompt companies to change deceptive practices. As Jenny Yang, chair of the Equal Employment Opportunity Commission, explained: ''arbitration allows 'root causes' to persist because arbitration keeps misconduct hidden from others who may have had the same experience.''[26]

The shortcomings of the arbitration system are sufficiently serious that, as a matter of public policy, mandatory, pre-dispute arbitration clauses should be considered harmful to the public welfare. Consumers are forced to waive legal rights and, potentially, representation in negative value suits, without understanding that they have done so and without being aware that they have been injured by a deceptive practice.

Another argument advanced by Mercatus Center's authors is that consumers would rather switch to a different service provider than litigate.[27] Mercatus Center speculates that by requiring arbitration, a firm reduces the costs of external dispute resolution and can then shift resources to internal dispute resolution. Mercatus Center bases this claim on one mid-sized bank's approach to customer service.[28]

However, logically it does not follow that a single consumer's choice to switch providers is sufficient to change a business practice or provide more sweeping relief to consumers. Moreover, the premise seems to be belied by the fact that 2.5 million consumers lodged complaints with the FTC in 2014, with banking and telephone and mobile service among the top 10 industries

[18] CFPB Study, section 1 at17. The study noted estimated that 11 million class members who submitted claim forms were eligible for cumulative cash payments of $1.1 billion. *Id.*

[19] *Id.*, Section 1 at 11.

[20] *Id.*, Section 1 at 12.

[21] *Id.*, Section 1 at 18.

[22] Mercatus Center Critique at 5-6.

[23] *Id.*, at 6.

[24] Although the Mercatus Center Critique is more candid about its bias in a later portion of the report when it notes: ''[p]erhaps one reason that those denied a refund do not arbitrate is that their complaints lack merit.'' *Id.* Section 1 at 38.

[25] *Carnegie v. Household Int'l, Inc.*, 376 F.3d 656, 661 (7th Cir. 2004).

[26] Greenberg, ''Arbitration Everywhere, Stacking the Deck of Justice.''

[27] Mercatus Center Critique at 28 (citing CFPB Study at note 9, Section 3, at 18.)

[28] Mercatus Center Critique describes a mid-sized regional bank in Texas that analyzed refund requests case-by-case, which resulted in refunding 94 percent of the wire transfer fees that customers complained about in one office and 75 percent of the same fees complained about from another office. *See* Mercatus Center Critique at 31. From this anecdote, the professors suggest that consumers are correct in believing that a business will work to retain their business. A more meaningful approach would be to determine if the bank attempted to refund wire transfers to customers who were subjected to the same practice, yet failed to complain. Instead, the professors conclude that the variation in refund rate across the offices suggests that these were not firmwide practices. Although, even then, the example of one mid-sized bank offering a 68 percent refund rate *to those who complained*, suggests that had consumers worked collectively by pooling resources, the amount refunded would have been well over $2.275 million and would have been distributed to a far greater number of consumers.

receiving complaints.[29] These complaints are indicative of inadequate internal dispute processes, not the fact that mandatory arbitration clauses have created more robust internal resolution practices. Of course, the incentive to offer more robust internal dispute resolution should exist regardless of whether a pre-dispute arbitration clause is embedded into the contract or there is no restriction on external dispute resolution at all.

Finally, despite substantial contrary data in the CFPB Study, Mercatus Center's Critique argues that arbitration is fair to consumers. For example, the Critique's authors claim that legal representation is available to consumers who arbitrate based on lawyers being involved in claims that were actually arbitrated.[30] Yet, once again, the lack of data for those consumers who were deterred from suing because they could not find counsel makes Mercatus Center's conclusion unwarranted. In fact, The New York Times' survey revealed that two-thirds of consumers who went to arbitration over credit card disputes received no monetary award, suggesting that contingent-fee representation is unlikely because counsel will not recoup the cost of their time.[31]

Consideration of consumer welfare ought to include all consumers, not just the litigants. In collective actions, a passive class member may recover, whereas in forced arbitration with collective action bans, that individual has no chance of recovery.[32] Indeed, if Mercatus Center is correct that arbitration seems to ''generate *comparable or even slightly better* results for individual claimants than do individual consumer lawsuits,'' then upon deciding to seek a remedy for their dispute, consumers would choose arbitration if it were economically rational to do so. Again, the Critique offers no reason to require mandatory arbitration as a condition of entering the contract. A consumer ought to be able to weigh the benefits and risks of each alternative and make an informed judgment.

Mercatus Center's criticism specifically focused on CFPB's concern about class action bans in arguing that data on class action awards in negative value suits isn't as favorable as the CFPB Study suggests. For example, Mercatus Center criticizes CFPB's reported claims rates as an aggregated average that improperly combines various types of settlements. This argument might be meaningful if the number of claimants who participated in class action settlements fell below 500 per year like the number of arbitrations. Yet, there were 251 class action settlements that CFPB analyzed, which distributed $1.1 billion to 11 million class members who affirmatively submitted claim forms.

In each year, the number of claims filed exceeded tens of thousands and more typically, hundreds of thousands.[33] These numbers are strikingly higher than the average of only 411 individual arbitrations pursued each year. There may be various ways to evaluate the data, but none that undermine the larger point—relative to arbitration, class actions offer remedies to exponentially more consumers who can share in the costs of litigation, receive a greater aggregate amount of relief, and are more likely to alter corporate practices based on their collective action.

The Mercatus Center's Critique predictably raises the concern that attorneys' fees can be high in some class action cases, but then falls prey to its own lack of data, failing to note that contingency fees are typically as high if not higher in individual actions. There are various checks in the legal system to protect against unnecessarily high fees, from class notice which permits for objections to the requisite court approval. Those checks are entirely absent from individual litigation or arbitration. Mercatus also completely ignores the fees earned by counsel defending class actions and arbitrations.

Restrict Pre-Dispute Arbitration Clauses Because They Harm Consumer Welfare

The Mercatus Center Critique implausibly proposes that consumer claimants do not need counsel for arbitrations against some of the country's largest financial institutions. Indeed, it optimistically claims that a consumer's market power may eliminate small-dollar claims altogether.[34] This ignores the irony of the financial industry having adopted these clauses in a collective effort: This ''free-market'' postulate underpinning Mercatus's theory fails where the market is collusive.[35] In any event, if arbitration really is better and consumers really do not need counsel, nothing prevents consumers making the rational choice to arbitrate their dispute *after* it arises.

The question is why such an option must be mandated from the outset of the relationship before there is a known dispute and where the company is much more familiar with its practices and the arbitration process than is the consumer. Mercatus avoids that larger question because it leads to the obvious answer that companies institute these provisions to immunize themselves from liability in collective actions.

Notably, the Mercatus Center's Critique fails to acknowledge one of the most troubling facts about mandatory arbitration clauses: Businesses themselves do not agree to bind themselves *ex ante*. One empirical study noted that corporations ''overwhelmingly selected arbitration as the method for resolving consumer disputes and permitted litigation as the method for resolving business disputes.''[36]

If arbitration were, in fact, more efficient and effective, then surely commercial entities would insert these clauses into their business contracts. Yet, in fact, they do not pre-commit themselves to waiving their right to access the courts. This fact led one legal scholar to ac-

[29] Colleen Tressler, ''*Consumers told it to the FTC: Top 10 complaints for 2014*,'' (February 27, 2015) https://www.consumer.ftc.gov/blog/consumers-told-it-ftc-top-10-complaints-2014.

[30] Mercatus Center Critique at 23.

[31] Greenberg, ''Arbitration Everywhere, Stacking the Deck of Justice,''

[32] Mercatus Center Critique at 27.

[33] CFPB Study, Section 8 at 27, Table 9.

[34] Mercatus Center Critique at 54-55, noting that if ''consumers do, indeed punish firms that try to attach unreasonable charges and fees by taking their business elsewhere, it may well be that truly small-dollar claims are increasingly being eliminated by the market itself.''

[35] Greenberg, ''Arbitration Everywhere, Stacking the Deck of Justice.''

[36] Theodore Eisenberg, *Arbitration's Summer Soldiers, at* 883.

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knowledge: ''imposed arbitration clauses are nothing but a shield against legal accountability.''[37]

The largest flaw with Mercatus Center's Critique is that it never explains why the data reflect that *mandatory* arbitration is desirable. Instead, at best its arguments suggest that consumers should be more open to *voluntary* arbitration. As F. Paul Bland Jr., Public Justice's Executive Director, noted, ''It is a pretty grim idea that the only way you could have arbitration is to force people into it.''

[37] Samuel Issacharoff & Erin F. Delaney, *Credit Card Accountability*, 73 U. Chi. L. Rev. 157, 173 (2006) (discussing arbitration clauses embedded in credit card contracts).