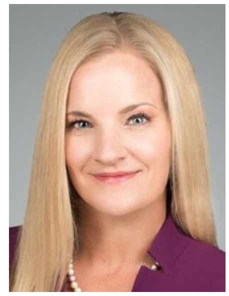
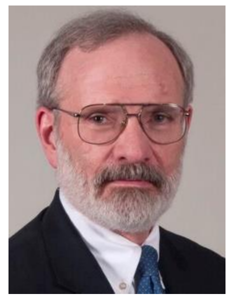
Expect CFPB To Enforce Warning Against 'Coercive' Fine Print

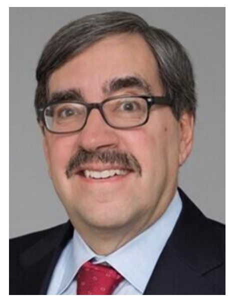
By **Kristen Larson, John Culhane and Alan Kaplinsky** (July 17, 2024)



Kristen Larson



John Culhane



Alan Kaplinsky

On June 4, the Consumer Financial Protection Bureau **used a circular** to warn of consequences for companies that "deceptively slip" unlawful or unenforceable terms and conditions into the fine print of contracts for consumer financial products or services.

The agency asserts in Consumer Financial Protection Circular 2024-03 and its accompanying announcement that such "coercive contract clauses" violate the prohibition on unfair, deceptive, or abusive acts or practices in the Consumer Financial Protection Act.

The CFPB issues circulars to ensure consistent enforcement of federal consumer financial laws and to increase transparency for the benefit of the public and regulated entities, according to Circular 2022-01 from May 2022. The CFPB has authority under Title 12 of the U.S. Code, Section 5511(c)(5), to issue guidance on federal consumer financial laws.

Consumer financial protection circulars are general statements of policy under the Administrative Procedure Act. Circulars are used to provide background information about applicable law, articulate considerations relevant to the CFPB's exercise of its authorities, and advise state attorneys general and state regulators how the CFPB intends to approach enforcement of federal consumer financial laws.

The CFPB has issued 13 consumer financial protection circulars. Except for one, the last six circulars have all addressed certain practices of regulated entities that the CFPB finds may violate the Consumer Financial Protection Act, which prohibits covered persons or service providers from engaging in any unfair, deceptive, or abusive act or practice.

Consumer Financial Protection Circular 2024-03 warns that the use of unlawful or unenforceable terms and conditions in contracts for consumer financial products or services may violate the prohibition on deceptive acts or practices in the Consumer Financial Protection Act.

In a related press release, CFPB Director Rohit Chopra said, "Federal and state laws ban a host of coercive contract clauses that censor and restrict individual freedoms and rights. The CFPB will take action against companies and individuals that deceptively slip these terms into their fine print."

Under the Consumer Financial Protection Act, per the CFPB examination procedures at Page 5, covering unfair, deceptive, or abusive acts or practices, a representation, omission, act or practice is deceptive when:

- "The representation, omission, act, or practice misleads or is likely to mislead the consumer";

- "The consumer's interpretation of the representation, omission, act, or practice is reasonable under the circumstances"; and
- "The misleading representation, omission, act, or practice is material."

In referencing their Bulletin 2022-05 on consumer reviews, the CFPB highlights that many federal laws invalidate contract terms and conditions that require consumers to waive consumer protections provided under federal law, such as the Truth in Lending Act, the Electronic Fund Transfer Act, the Military Lending Act and the Servicemembers Civil Relief Act.

However, as the CFPB acknowledges, the anti-waiver provisions in these laws are by no means uniform. Section 987(e) of the Military Lending Act may be the broadest, in that it prohibits creditors from requiring a borrower protected under the MLA to waive any right to legal recourse granted under any federal or state law in connection with an extension of credit covered by the MLA.

Similarly, Section 914 of the Electronic Fund Transfer Act broadly prohibits waivers of rights conferred under the EFTA.

But there is no comparable statutory provision in the Truth in Lending Act and, while arbitration is not permitted in residential mortgage loans, there are circumstances where certain rights, such as a borrower's right to rescind a loan in which a security interest is or will be retained in the consumer's principal dwelling, can be waived or modified.

The Servicemembers Civil Relief Act is at the other end of the spectrum. Section 3918 of the SCRA expressly permits a servicemember to waive any of the rights and protections it provides, although Section 3918 does place conditions on how this can be done.

To provide an example of an unlawful waiver under the SCRA, the CFPB cites an unpublished decision from last year from the U.S. District Court for the Eastern District of North Carolina in Espin v. Citibank NA. The CFPB states that Espin "held that the [SCRA] renders unenforceable provisions in contracts with servicemembers that purport to waive their right to participate in class actions to enforce the SCRA."

In Espin, the court denied the defendant's motion to compel arbitration, finding that servicemembers have an unwaivable right to participate in class actions despite any contrary agreement. The CFPB does not elaborate on the decision, which in our view, runs completely counter to the controlling case law under the Federal Arbitration Act, which requires a statute to include an affirmative statutory provision expressly rejecting arbitration, and the CFPB also fails to mention that the decision is **pending appeal** to the U.S. Court of Appeals for the Fourth Circuit.

The circular goes on to assert that covered persons may violate the Consumer Financial Protection Act by including unenforceable material terms in a contract and that such a misleading practice cannot be cured by including a provision like "except where unenforceable" because consumers are misled into believing that a material contract provision is lawful and enforceable when that is not the case. The CFPB concluded:

> [C]onsumers are unlikely to be aware of the existence of laws that render the terms or conditions at issue unlawful or unenforceable, so in the event of a dispute, they are likely to conclude they lawfully agreed to waive their legal rights or protections

> after reviewing the contract on their own or when covered persons point out the existence of these contractual terms and conditions. Deceptive acts and practices such as these pose risk to consumers, whose rights are undermined as a result, and distort markets to the disadvantage of covered persons who abide by the law by including only lawful terms and conditions in their consumer contracts.

Conspicuously absent from this discussion is any reference to loan documents approved by other federal agencies and as well as government-sponsored enterprises.

For example, the uniform model forms for residential mortgage loans promulgated by Fannie Mae and Freddie Mac are replete with such language. In fact, the uniform mortgage for the state of Pennsylvania uses 19 separate instances of prefatory language, such as "if permitted under Applicable Law," "to the extent permitted by Applicable Law," "unless Applicable Law expressly requires otherwise," and "Lender will not exercise this option if such exercise is prohibited by Applicable Law."

The U.S. Department of Housing and Urban Development's Federal Housing Administration model note includes "to the extent not prohibited by applicable law." And the U.S. Department of Education's master promissory note used for direct federal student loans also includes "permitted by law," "unless federal law preempts a state law," "or any other payment authorized for offset under federal law," and "other federal or state payments as authorized by law." We note that the CFPB does not discuss any of these government forms.

The circular states that CFPB supervisory examiners have identified violations of the Consumer Financial Protection Act's prohibition on deception stemming from covered persons' use of contract terms that the CFPB asserts are unlawful or unenforceable and that set conditions that the CFPB asserts improperly limit consumer rights and protections afforded by federal or state law.

The CFPB provided examples related to limiting the right to contest garnishments, creating misimpression that consumers could not exercise bankruptcy protection rights, waiving the right to retain counsel, and misrepresenting consumer protections available under laws. But few, if any, of these assertions have been tested in court.

Under the circumstances, we recommend that companies review their consumer financial products and services contracts to identify and modify any contract terms that may violate the Consumer Financial Protection Act's prohibition on deceptive acts and practices even though it is often not an easy task to identify contract terms that violate federal or state laws.

Companies must carefully scrutinize all consumer contracts to identify contract provisions that expressly or implicitly waive consumer rights or increase consumer obligations above what the law may allow, research the legality of such contract provisions, and excise provisions that violate and even arguably violate federal or state law.

This is by no means a simple project. The task will be more daunting for longer-term loans, like mortgages, where laws could change years later during the term of a 20- or 30-year note. Companies will need to review consumer contracts to identify any potential UDAAP concerns.

Although some have questioned whether the issuance of this circular one day after the release of the final rule for the Registry of Nonbank Covered Persons Subject to Certain

Agency and Court Orders may mean that the CFPB has decided to abandon finalizing the proposed registry of form contracts used by certain non-banks, we believe that the CFPB has not abandoned the registry.

In the proposal for the registry, the CFPB included the following contract terms, some of which may not be covered by the circular because they are lawful:

- Precluding the consumer from bringing a legal action after a certain period of time;
- Specifying a forum or venue where a consumer must bring a legal action in court;
- Limiting the ability of the consumer to file a legal action seeking relief for other consumers or to seek to participate in a legal action filed by others;
- Limiting liability to the consumer in a legal action, including by capping the amount of recovery or type of remedy;
- Waiving a cause of legal action by the consumer, including by stating a person is not responsible to the consumer for a harm or violation of law;
- Limiting the ability of the consumer to make any written, oral or pictorial review, assessment, complaint, or other similar analysis or statement concerning the offering provision of consumer financial products or services by the supervised registrant;
- Waiving, whether by extinguishing or causing the consumer to relinquish or agree not to assert, any other identified consumer legal protection, including any specified right, defense or protection afforded to the consumer under constitutional law, a statute or regulation, or common law; or
- Requiring that a consumer bring any type of legal action in arbitration.

We think it highly likely that the circular, which is likely to be treated as an interpretative regulation under the Administrative Procedure Act, and any registry of form contracts will be challenged in court as exceeding the scope of the authority granted to the CFPB under the Dodd-Frank Act, particularly since the U.S. Supreme Court just held in Loper Bright Enterprises v. Raimondo that **agencies are not entitled to deference**, overruling its 1984 decision in Chevron USA Inc. v. National Resources Defense Council Inc.

Chevron had required courts to accept an agency's interpretation of federal law if indicated by the outcome of a two-step analysis set forth in the decision.

In step one, the court looked at whether the statute directly addressed the precise question before the court. If the statute was silent or ambiguous, the court would proceed to step two and determine whether the agency's interpretation was reasonable. If it determined that the interpretation was reasonable, even if not the best interpretation, Chevron deference instructed the court to defer to the agency's interpretation.

The court's decision overriding Chevron deference limits the potential impact any policy statements, such as the CFPB circular, may have on financial institutions.

Until those potential challenges, we expect that the CFPB and other federal and state enforcement authorities will give the circular the same effect as a law or regulation in examinations. We have observed the CFPB and other federal and state examiners take a similar approach with other policy statements in our clients' examinations.

For example, the CFPB entered into a consent order one month prior to and a consent order one month after publishing its Circular 2022-06 on unanticipated overdraft fee assessment practices.

In recent examinations, the CFPB and federal regulators are examining fee practices based on the foregoing overdraft fee circular, the CFPB Bulletin 2022-06 on unfair returned deposit item fees, the CFPB's public criticism and other federal regulatory guidance on multiple nonsufficient funds fees, and the CFPB's advisory opinion on consumer requests for account information under Section 1034(c).

Financial institutions should expect and prepare for a similar examination approach to contract terms under this circular.

Kristen E. Larson is of counsel, John L. Culhane Jr. is a partner and Alan S. Kaplinsky is senior counsel at Ballard Spahr LLP.