



9575 Katy Freeway, Suite 300

Houston, TX 77024

Phone: 713-871-0005

Fax: 713-871-1358

Thomas E. Black, Jr., P. C. *

Calvin C. Mann, Jr., P. C.

Gregory S. Graham, P. C.

David F. Dulock

Diane M. Gleason

Benjamin R. Idziak **

Shawn P. Black **

Regina M. Uhl

Peter B. Idziak**

Kathryn A. Williams

Of Counsel

David M. Tritter

* Also Licensed in New York, Washington,
West Virginia and Iowa

** Also Licensed in New York

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To: Clients and Friends

From: David F. Dulock

Subject: New Regulation Z Requirements Effective June 1, 2013 - Prohibition on Mandatory Arbitration Clauses and Waivers of Consumer Rights; and Prohibition on Financing Single-premium Credit Insurance

Effective June 1, 2013, for certain consumer credit transactions for which a creditor receives an application on or after that date, the Consumer Financial Protection Bureau (CFPB) amends Section 1026.36 of Regulation Z by adding paragraphs (h) and (i):

(h) *Prohibition on mandatory arbitration clauses and waivers of certain consumer rights.*

(1) *Arbitration.* A contract or other agreement for a consumer credit transaction secured by a dwelling (including a home equity line of credit secured by the consumer's principal dwelling) may not include terms that require arbitration or any other non-judicial procedure to resolve any controversy or settle any claims arising out of the transaction. This prohibition does not limit a consumer and creditor or any assignee from agreeing, after a dispute or claim under the transaction arises, to settle or use arbitration or other non-judicial procedure to resolve that dispute or claim.

(2) *No waivers of Federal statutory causes of action.* A contract or other agreement relating to a consumer credit transaction secured by a dwelling (including a home equity line of credit secured by the consumer's principal dwelling) may not be applied or interpreted to bar a consumer from bringing a claim in court pursuant to any provision of law for damages or other relief in connection with any alleged violation of any Federal law. This prohibition does not limit a consumer and creditor or any assignee from agreeing, after a dispute or claim under the transaction arises, to settle or use arbitration or other non-judicial procedure to resolve that dispute or claim.

(i) *Prohibition on financing single-premium credit insurance.*

(1) A creditor may not finance, directly or indirectly, any premiums or fees for credit insurance in connection with a consumer credit transaction secured by a dwelling (including a home equity line of credit secured by the consumer's principal dwelling). This prohibition does not apply to credit insurance for which premiums or fees are calculated and paid in full on a monthly basis.

(2) For purposes of this paragraph (i), "credit insurance":

(i) Means credit life, credit disability, credit unemployment, or credit property insurance, or any other accident, loss-of-income, life, or health insurance, or any payments directly or indirectly for any debt cancellation or suspension agreement or contract, but

(ii) Excludes credit unemployment insurance for which the unemployment insurance premiums are reasonable, the creditor receives no direct or indirect compensation in connection with the unemployment insurance premiums, and the unemployment insurance premiums are paid pursuant to a separate insurance contract and are not paid to an affiliate of the creditor.

New paragraphs (h) and (i) to Section 1026.36 are part of a final rule published by the CFPB in the February 15, 2013 *Federal Register* (Vol. 78, No. 32) concerning loan originator compensation; loan originator qualification, registration and licensing; loan originator loan document identifier requirements; compliance procedures for depository institutions; and the mandatory arbitration and financing single-premium credit insurance prohibitions in new paragraphs (h) and (i) discussed in this memorandum.

In conjunction with the revisions to Section 1026.36 made by the final rule, as noted above, the final rule also revises Supplement I to Part 1026-Official Interpretations in order to provide official interpretations of its revisions to Section 1026.36. These revisions to Supplement I do not include any official interpretations for paragraphs (h) and (i). The CFPB preamble published with the final rule, however, does informally interpret paragraphs (h) and (i) (*see* pages 11386 to 11389 of the above *Federal Register*) by providing the following clarifications:

Paragraph (h):

- It does not limit waivers of rights to a jury trial because bench trials are judicial procedures.
- It does not limit a deed of trust providing for non-judicial foreclosure because (i) a deed of trust is not an agreement to use non-judicial procedures to resolve controversies or settle claims arising out of the transaction and (ii) a non-judicial foreclosure still allows a consumer to bring an action in court alleging violations of Federal law.
- It does not bar settlement agreements. Instead, according to the CFPB, if a consumer and creditor agree, after a dispute or claim arises, to use arbitration or other non-judicial procedure to settle that dispute or claim, the settlement agreement may be applied or interpreted to waive the consumer's right to bring *that* dispute or claim in court, even if it is a Federal law claim; however, the settlement agreement may not be applied or interpreted to bar the consumer from bringing an action in court for *any other* alleged violation of Federal law.
- The prohibition on agreements to use mandatory arbitration does not apply only to the note itself, as the terms of consumer credit transactions are often memorialized in multiple documents – *i.e.*, the prohibition cannot be evaded simply by including a provision for mandatory arbitration in a document other than the note if that document is executed as part of the transaction. The prohibition applies to the terms of the whole transaction, regardless of which particular document contains those terms.

Paragraph (i):

- It does not apply to mortgage insurance (*i.e.* – insurance to insure a creditor against loss in the event of default by the consumer or in other specified events.)
- The types of insurance listed in subparagraph (i)(2)(i) are exclusive and are what credit insurance “means” (not just what is included) for the purposes of paragraph (i).
- The term “reasonable” in subparagraph (i)(2)(ii) is not defined and the CFPB states that it “declines to define at this time what insurance premiums are ‘reasonable’ for purposes of the exception for certain credit unemployment insurance products because the [CFPB] does not currently have sufficient data and other information to make this judgment for a rule of general applicability.”

- Charging a fixed monthly payment for credit insurance that does not decrease as the principal is paid off or adding the monthly charge for credit insurance to the loan balance would directly violate the prohibition in paragraph (i) for the following reasons:
 - o Charging a fixed monthly charge for the credit insurance that does not decline as the loan balance declines would fail to meet the requirement for the premium to be “calculated ... on a monthly basis.”
 - o Adding a monthly charge for the credit insurance to the loan balance would amount to financing the premiums for credit insurance rather than paying them in full on a monthly basis.

New paragraphs (h) and (i) to Section 1026.36 are effective June 1, 2013, and apply to the applicable consumer credit transactions for which a creditor receives an application on or after that date. All other revisions to Section 1036 made by the final rule will be effective on January 10, 2014.

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