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Consumer Federation of America

November 9, 2005

Regulator Name
Address

Re: Regulatory Alert

Dear _____:

The National Consumer Law Center (NCLC) and the Consumer Federation of America (CFA) are deeply involved in monitoring, reporting, and advocating on behalf of consumers regarding payday and small loan lending at both the state and federal levels.

We are writing in order to share with you certain legal developments that affect your ability to regulate state-chartered banks and non-depository lenders involved in this type of lending. As you know, the abuses and exorbitant cost of payday lending are well documented.¹ It is also clear that payday lenders target military personnel,² low-income, and minority neighborhoods.³ Payday lenders are big business and operate through local storefronts or via the internet in states that permit this type of lending. In states that have not relaxed their usury caps, these companies sell loans over the internet, partner with banks, or create other arrangements to evade state law.

¹ For reports on this subject, see CFA's website at www.consumerfed.org.

² See Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of "Payday" Loans in Military Towns* (March 29, 2005), available at <http://www.responsiblelending.org/research/index.cfm?tid=2&tyid=2>; Steve Tripoli & Amy Mix, National Consumer Law Center, *In Harm's Way--At Home: Consumer Scams and the Direct Targeting of America's Military and Veterans* (May 2003), available at <http://www.nclc.org> (look under "Special Reports"); see also Mark Muecke, Consumers Union, *Payday Lenders Burden Working Families and the U.S. Armed Forces 2* (July 2003).

³ Uriah King, Wei Li, Delvin Davis & Keith Ernst, *Race Matters: The Concentration of Payday Lenders in African-American Neighborhoods in North Carolina* (Center for Responsible Lending March 22, 2005), available at <http://www.responsiblelending.org/research/index.cfm?tid=2&tyid=2>.

Specifically, we highlight that, with the exception of any interest rate or fee caps,⁴ your state payday or small loan law applies to state chartered banks, unless your state law explicitly exempts out-of-state banks from coverage. Next, we alert you to two new attempts by payday lenders to evade state payday or small loan laws: registration under the state credit repair organization acts and the reliance on “choice of law” provisions in the loan contract to create “rent-a-finance company” arrangements.

I. Most of Your State Law May Apply to Out-of State State-Chartered Banks

In states which maintain usury caps that effectively prohibit high cost small loans, payday lenders may operate through out-of-state state-chartered banks.⁵ Even in states that permit payday lending, arrangements with state-chartered banks can be used to circumvent state law.

Under these arrangements, the bank purports to make the loan through its “agent” at the storefront. Either the bank sells the loan immediately to the payday company and retains a “participation” interest or the bank pays the payday company a fee which is a percentage of the revenue from the loan. In both situations, the payday company agrees to indemnify the bank for losses up to a certain amount.

These types of arrangements (called “rent-a-bank”) can be very lucrative for the payday lenders because they allow these companies to enter markets that are otherwise forbidden to them. For example, one payday company, Advance America, partners with four different banks to do business in five states.⁶ This lender also maintains payday storefronts to make direct loans in twenty-eight other states. The revenue from just these five states accounted for about 30% of all revenues in 2003, 25.6% of all revenue as of March 30, 2004, and 24% of all revenue as of March 30, 2005. However, of a total of 2,424 stores nationwide, the payday company’s rent-a-bank model occurs in 544 of these stores, which is 22% of the total.

The rent-a-bank model has created quite a bit of controversy with the Office of the Comptroller of the Currency, many state regulators, and state attorneys general. As you know, the OCC put its foot down and national banks no longer make payday loans through agents. Meanwhile, the FDIC issued “guidance” to state-chartered banks in

⁴ Fee caps are preempted but only if the type of fee constitutes “interest” under the OCC’s definition in 12 C.F.R. § 7.4001.

⁵ These states are: Arkansas, Connecticut, Georgia, Maine, Maryland, Massachusetts, Michigan, New Jersey, New York, North Carolina, Pennsylvania, Puerto Rico, Vermont, Virgin Islands, and West Virginia. However, in New York, New Jersey, Connecticut, and Massachusetts, banks appear to be operating without storefronts through toll-free numbers or via the internet.

⁶ ADVANCE AMERICA: INFORMATION FROM SEC 10-Q FILING OF 3/31/05, available at http://www.sec.gov/Archives/edgar/data/1299704/000110465905023837/a05-9193_110q.htm. NOTE: This data preceded the closing of Advance America’s rent-a-bank business in North Carolina. Compare ADVANCE AMERICA FORM S-1 SEC REGISTRATION STATEMENT OF 8/13/04, available at www.sec.gov/Archives/edgar/data/1299704/000104746904026511/a2141558zs-1.htm.

2003 and significantly strengthened it in early 2005. Attorneys general in Georgia, Colorado, North Carolina, Ohio, and Florida have initiated investigations and enforcement actions to stop this activity. Virginia, Maryland, and Oklahoma amended their laws to prohibit the brokering of payday loans. Most recently, the Georgia Legislature passed a law in 2004 to prohibit the payday companies from acting as agents of banks where the companies receive a predominate share of the revenue from the loans made through their offices. State-chartered banks and their local agents challenged this law but the trial and appellate courts upheld it.⁷

Notably, in describing the nature and scope of preemption accorded to state-chartered banks, the Eleventh Circuit stated:

In the case of state-chartered banks, the FDIA itself makes it clear that while state banks are subject to some federal regulation, the *states* remain the "primary regulatory authority" over state banks participating in the FDIC's deposit insurance program.... Although § 27(a) authorizes state banks to export their home interest rate to another state, the FDIA expressly acknowledges that the *host* state's consumer and fraud laws still apply to the exporting state banks.... Indeed, the activities of state banks are areas that traditionally have been regulated by the states.⁸

The Chairman of the FDIC, Donald E. Powell, reinforced this view in a letter to Attorney General Roy Cooper of North Carolina dated April 27, 2005.⁹ There, Chairman Powell stated:

As you note, federal law authorizes federal and state-chartered insured depository institutions making loans to borrowers in other states to "export" interest rates allowed by the state where the insured depository institution is located. This authorization does not prevent states from enforcing consumer protection and lending laws other than interest-related limitations.

We urge you to review the lending laws of your state to determine which provisions, other than interest-related limitations, exist and apply them to state-chartered banks doing business in your state either through "agent" arrangements, directly through the internet,¹⁰ or through other conduits.¹¹ Examples of applicable state laws include restrictions on the terms of credit, including the loan size, schedule for repayment, payments due; on fees that do not constitute interest; on the sale of ancillary products; on the type of permissible collateral; and on disclosures and

⁷ BankWest, Inc. v. Baker, 324 F. Supp. 2d 1333 (N.D. Ga. 2004), *aff'd.*, 411 F.3d 1289 (11th Cir. 2005).

⁸ BankWest, Inc. , 411 F.3d 1289, 1301-1302 (citations omitted)(emphasis added).

⁹ This letter is attached.

¹⁰ Republic Bank & Trust Company of Indiana is offering payday loans directly to consumers via the Internet, and applies Indiana limits to loans. See www.republicbankpayday.com. The bank claims to have borrowers in nearly every state.

¹¹ This discussion assumes that the out-of-state bank is not operating out of a branch in your state. In that situation, the analysis is complicated by the Riegle-Neal Act and the 1997 amendments. In addition, your state lending laws may expressly exempt state banks from coverage.

advertising. Rent-a-bank and internet payday loans usually do not conform to one or more of these constraints. Enforcement of state law should limit the most egregious forms of payday lending in your state.

II. Payday Loan Companies May Exploit Your State Credit Repair Organizations Acts to Evade State Usury or Fee Caps

Recognizing that federal and state agencies and the courts are not supporting the “rent-a-bank” model of doing business, all but one of the major payday loan companies operating in Texas decided to adopt a new business model in an attempt to immunize themselves from Texas usury restrictions. These companies registered under the Texas Credit Services Organizations Act (TCSOA) and claim that by acting as “loan brokers” their fees are not “interest” under state law.

This business model relies upon a ruling of the Fifth Circuit Court of Appeals in *Lovick v. Ritemoney* which interpreted Texas law in a case involving an auto title loan.¹² In that case, a company advertised loans secured by the consumer’s car. However, when the consumer went into its offices, she ended up with a loan from a different company. The storefront operated as a “broker” and charged the consumer a fee to “arrange” a loan of \$2,013. Of this principal amount, the consumer received only \$500, the “broker” got \$1,500 (almost 75% of the loan amount), and \$13 went to cover the security interest filing fee. The “lender” charged interest at the rate of 10%, the legal rate under Texas usury law. The “broker” had registered under the TCSOA. The court held, over a dissent, that the TCSOA trumped the state’s usury law. Since the TCSOA did not limit the size of the “broker” fee, the \$1,500 charge was legal.

The dissenting judge smelled a rat. Judge Jolly argued that the case should not be dismissed before discovery could be conducted to show if any of the \$1,500 made its way into the pockets of the lender. Further, the consumer had, in the judge’s opinion, stated a case that the “broker” actually was the lender, given all of the activities it performed and the amount of overhead that the “broker” carried in relation to the lender. Texas regulators are concerned that this decision subverts the state’s usury laws. Further developments are anticipated from Texas on this issue.

It should come as no surprise that payday companies have carried this artifice to other states. At this point, we are aware of claims by industry analysts that Cash America is using the credit services organization model in Florida a state where payday lending is authorized under state law, and Michigan, a state where it is not currently authorized (though a payday lending bill is pending). Using this arrangement, the payday industry is likely to charge more than even payday lending laws allow and ten to twenty times what traditional small loan laws permit.

We urge you to watch out for this development in your state, if your legislature enacted a similar credit repair organizations act. Our preliminary analysis indicates

¹² *Lovick v. Ritemoney*, 378 F.3d 433 (5th Cir. 2004).

that approximately 20 states, as well as Guam and Puerto Rico, do not have a “*Lovick*” problem, either because these jurisdictions have not enacted credit repair laws¹³ or because their credit repair laws do not cover broker activities or they exempt licensed brokers from coverage.¹⁴

In the remaining states, whether these are mere shams or whether the CROAs trump your state’s payday or small loan law can depend upon how your courts have interpreted the definition of “interest” under your usury laws. If broker fees constitute interest, state CROAs do not change that analysis because they simply do not address it.

Moreover, of the state CROAs that extend to broker activity, *i.e.*, obtaining an extension of credit, many are explicit that the extension of credit must be obtained from an entity other than the CROA. At a minimum, this should mean that the broker cannot retain or obtain the predominant economic interest in the loan revenue---or any economic interest in it. Nor can the “broker” and “lender” be related. Otherwise, the state CROA could be used as a cloak for usury.

If your CROA is not explicit on this point, we suggest that you or the appropriate agency issue a regulation or interpretation requiring that the loan be made by an entirely separate entity (no common ownership or overlapping directors, for example) and that the “broker” have no economic interest in the transaction, including no sharing of fees, kickbacks, or servicing of the loan (*i.e.*, collection of payments). If you conclude that the *Lovick* analysis poses a problem for your state, we can suggest specific regulatory and legislative language.

Finally, it is important to note that the *Lovick* decision only addressed Texas law and is not mandatory precedent in your state.

III. Payday Companies May Use Choice of Law Provisions in the Loan Contract to Engage in “Rent-a-Finance Company” Shams

In Arkansas, at least three out-of-state finance companies are partnering with several Arkansas check cashing and payday loan companies to make payday loans in Arkansas with interest and fees that far exceed the Arkansas constitutional cap. These foreign finance companies place a non-negotiable “choice of law” provision in the loan contract that selects the law of the state where they are located. However, the consumers reside in Arkansas and apply for loans, receive loan proceeds, and make payments there. In the case of one of the companies, it is incorporated in South Dakota but, to our knowledge, makes no loans in that state.

Non-depository financial institutions do not enjoy *any* preemption rights in the non-mortgage loan context. The only way for these companies to achieve some control

¹³ These states are: Alabama, Alaska, Kentucky, Mississippi, Montana, New Jersey, New Mexico, North Dakota, Rhode Island, South Carolina, South Dakota, Vermont, and Wyoming.

¹⁴ These states are: Colorado, Connecticut, Hawaii, Idaho, Kansas, Louisiana, and New York.

over which state's usury regime applies is to insert a self-serving choice of law provision in the contract. However, consumer loan contracts are widely regarded as contracts of adhesion since they are written by the lenders and consumers may not negotiate the terms.

Whether choice of law provisions are legal in the context we describe depends on the law of your state. First, a state statute may decide this issue. For example, a Washington statute applies the law of Washington to any loan made to person residing in that state.¹⁵ Second, in the absence of a Washington-type law and judicial precedent on this issue, The Restatement of Conflict of Laws is helpful. Section 203 states:

The validity of a contract will be sustained against the charge of usury if it provides for a rate of interest that is permissible in a state to which the contract has a substantial relationship and is not *greatly* in excess of the rate permitted by the general usury law of the state of the otherwise applicable law..."¹⁶

Since the loan agreement will have a substantial relationship to your state, the public policy expressed by your state's usury law is significant, and the interest rate charged in the loan agreement will be a great deal higher than permitted under your state law, the Restatement test results in invalidating such choice of law provisions.¹⁷ If you conclude that enacting a stand-alone statute or an amendment to a current law to protect your citizens is advisable, we can suggest specific language.

We hope this information is helpful to you. We would appreciate hearing back from you regarding any action you might take in response to these legal and industry developments.

Thank you.

Sincerely,

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¹⁵ Wash. Rev. Code § 19.52.034.

¹⁶ The Restatement of Conflict of Laws 2d § 203.

¹⁷ Further, at the time this Restatement provision was adopted in 1969, the permissible rate of interest did not vary much from state to state. See The Restatement of Conflict of Laws 2d § 203, Comment b. Since 1969, some states significantly deregulated their usury laws making the differences among the state acute.