Modern-Day Loansharking and State Attorneys General: How AGs Shaped the Development of the Payday Lending Industry

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"You load sixteen tons, and whaddaya get?
Another day older and deeper in debt;
St. Peter don'cha call me, cause I can't go
I owe my soul to the company store."

--Merle Travis, "Sixteen Tons."

I. The History of Payday Lending

"Sixteen Tons," written by Merle Travis and made famous by "Tennessee" Ernie Ford, described the financial situation many working people found themselves in when they took advances against their next paycheck from their employer, their employer's company store, or a "salary lender," who charged them exorbitant interests rates disguised as "fees" for the service. These lenders emerged in the late nineteenth and early twentieth century by serving a clientele typically composed of employees of large government and industrial institutions, including "civil servants, railroad workers, streetcar motormen, and clerks in firms such as insurance companies."[1]

Such workers, often recent immigrants or former agricultural laborers, formed the foundation of the emerging lower middle class of urban American society.[2] They usually borrowed to meet unexpected needs, such as family illness or moving expenses, but held steady jobs and had family obligations which prevented them from simply skipping town.[3] Salary lenders targeted these workers because their steady supply of disposable income made them likely to repay, and their frequent minor income shocks made them likely to borrow.[4]

[1] Mark H. Haller & John V. Alviti, *Loansharking in American Cities: Historical Analysis of a Marginal Enterprise*, 21 AM. J. LEGAL HIST. 125, 128 (1977).
[2] *Id*. at 127, 129.
[3] *Id*. at 128-129.
[4] *Id*.

It was these salary lenders whom working class people in the United States first came to describe as "loan sharks."[5] Salary lending, however, was largely curtailed throughout the country for most of the twentieth century, due to a widespread movement that attacked the practice through legal advocacy, lobbying state legislatures to regulate such lenders, and providing low-cost charitable alternatives to these loans.[6]

Economic forces and legal changes in the 1970s and 1980s began to lay a foundation for a resurgence in salary lending.[7] Inflation forced the Federal Reserve Board to adopt monetary policy resulting in high long-term interest rates.[8] The high cost of funds made it difficult for banks, credit unions, and other mainstream lenders to loan money within the state interest rate caps which existed at the time.[9] Retail installment stores, pawnshops, and "rent-to-own" furnishing stores all successfully lobbied elected officials for special treatment.[10] Many state legislatures also raised, or even eliminated, their interest rate caps during this period.[11]

II. Payday Loans Today

[5] *Id*. at 125-126. In a typical transaction, a debtor would borrow five dollars and repay six within the next week or so. Very similar to today's payday loans, the charge of 20% of the loan principal amounted to around 520% per annum, assuming a two-week maturation period. *Id*. There were, of course, variations in loan terms. Many lenders used one-week balloon payments. *Id*. Also, often lenders charged African Americans rates twice as high in the same type of transaction, where a loan of five dollars was repaid with seven at the end of the week. *Id*. Newspapers of the day frequently gave anecdotal accounts of debtors trapped by their salary loans, such as "the employee of a New York publishing house who supported a large family on a salary of $22.50 per week and had been paying $5 per week to a salary lender for several years, until he had paid more than ten times the original loan." *Id*.

[6] Kathleen E. Keest & Elizabeth Renuart, National Consumer Law Center, The Cost of Credit: Regulation and Legal Challenges 38 (2d ed. 2000).

[7] *Id*. at 55.

[8] *Id*.

[9] *Id*.

[10] *Id*.

[11] *Id*.

As a result, the early 1990s saw the emergence of businesses offering "payday loans"—loans that were clearly a throw-back to the old salary lending business mostly stamped out 50 or so years before.[12] Businesses offering payday loans at this point were usually focused primarily on cashing paychecks for consumers who lacked traditional banking services. These businesses found that they could attract larger clientele and make staggering profits by agreeing to "cash" consumers' post-dated personal checks. If a consumer needed a loan, she could write a check for funds she did not actually have in her checking account.[13]

If the "check casher" agreed to wait two weeks before attempting to tender the check, then the consumer would have time to make some more money, deposit additional funds in her checking account, and thus cover the check by the agreed-upon date.[14] The term "payday loan" derived from this practice because the date consumers wrote on their checks almost always corresponded to their next payday.[15]

Today, the typical payday loan is issued for a seven- to fourteen-day period and carries a fee between fifteen dollars and thirty dollars per $100 borrowed.[16] A $300 loan, repaid within two weeks, will therefore normally cost between forty-five dollars and ninety dollars. These loan fees correspond to annual percentage rates (APR) of between 390% and 780%.[17]

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[12] *See* Gregory Elliehausen & Edward C. Lawrence, Payday Advance Credit in America: An Analysis of Customer Demand 2 (Credit Research Ctr., Georgetown Univ., Monograph No. 35, 2001), *available at* http://www.cfsa.net/mediares/Reports/GeorgetownStudy.pdf (last viewed Dec. 1, 2005).

[13] Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 Minn. L. Rev. 1, 12-13 (2002).

[14] *Id*.

[15] *Id*.

[16] *See* Jean Ann Fox, Consumer Fed'n of Am., Unsafe and Unsound: Payday Lenders Hide Behind FDIC Bank Charters to Peddle Usury 2 (2004), *available at* http://www.consumerfed.org/pdlrentabankreport.pdf (last viewed Nov. 28, 2005).

[17] Consumer Fed'n of Am. & U.S. Pub. Interest Res. Group, Rent-A-Bank Payday Lending: How Banks Help Payday Lenders Evade State Consumer Protections 4 (2001), *available at* http://www.consumerfed.org/paydayreport.pdf (last viewed Nov. 27, 2005). The single most common fee, charged by thirty percent of the 234 banks surveyed, was fifteen dollars per $100. *Id*. at 5.

Despite this high cost, payday loans are immensely popular. Although these loans first appeared relatively recently, in the 1990s,[18] by 2000 there were 12,000 such businesses, and in 2002 their number reached 15,000—a twenty-five percent increase in only two years.[19] During this same period, total revenue from loan fees tripled, from $1.4 billion to $4.3 billion.[20] Some states experienced more rapid growth than others. In North Carolina, payday lending outlets roughly quadrupled in four years, growing from 307 in 1997 to 1204 in 2000.[21] Iowa's payday lenders increased from eight to 64 in two years.[22] Attempting to put this shift in the financial services industry into perspective, the U.S. Comptroller of the Currency remarked in 1998 that "California alone has more payday loan offices (nearly 2,000) than it does McDonalds and Burger Kings."[23]

Before extending credit, payday lenders usually ask that applicants provide their last bank statement, their last pay stub, and some form of identification.[24] Payday lenders do not obtain credit bureau reports, although some use a special reporting service that tracks the consumer's recent use of payday loans.[25] Customers supply a postdated check in the amount of the loan plus the finance charge.[26] Alternatively, the lender may ask the customer to sign an agreement authorizing the lender to make an electronic withdrawal from his checking

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[18] *See* Elliehausen & Lawrence, supra note 12.
[19] *See* Fox, supra note 16, at 3-4.
[20] *Id*.
[21] Office of the Comm'r of Banks, Report to the General Assembly on Payday Lending, Feb. 22, 2001, at 3 (N.C. Feb. 22, 2001).
[22] Consumer Federation of America, The Growth of Legal Loan Sharking: A Report on the Payday Loan Industry 3 (Nov. 1998), *available at* http://www.consumerfed.org/The_Growth_of_Legal_Loan_Sharking_1998.pdf.
[23] Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 150 (2004) (quoting remarks by John D. Hawke, Jr., Comptroller of the Currency, before the ABA National Community and Economic Development Conference, Baltimore, MD, Mar. 18, 2002).
[24] See Elliehausen & Lawrence, supra note 12, at 3.
[25] *Id*.
[26] *Id*.

account on the loan's due date.[27] The postdated check both assists in collection and gives the lender leverage.

As long as the borrower has sufficient funds in his checking account on the loan due date, all the lender has to do to collect the loan is deposit the check.[28] The borrower therefore has a strong incentive to ensure sufficient funds are present or else to contact the lender and pay a rollover (i.e., loan renewal) fee.[29] Failure to do either typically results in "Not Sufficient Funds" (NSF) fees from both the bank and payday lender.

Thirty-three states have adopted legislation that specifically authorizes payday lending, and two additional states permit these loans via their general small loan laws.[30] Fifteen states currently have small loan interest rate caps that attempt to prohibit payday lending.[31] Despite these laws, payday lenders currently operate in every state thanks to a federal law that allows banks to be governed by the state law of their choosing and charter renting, a practice that allows nonbanks to take advantage of this law through contractual partnerships with banks.[32] Nearly half of the thirty-three states that explicitly authorize payday lending passed this legislation in the last five years,[33] even though there is widespread

[27] *See* Fox, supra note 16, at 6.
[28] *Id*.
[29] *Id*.
[30] States authorizing payday lenders' operations are: Alabama, Arizona, California, Colorado, Delaware, Florida, Hawaii, Idaho, Illinois, Iowa, Indiana, Kansas, Kentucky, Louisiana, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, North Dakota, Ohio, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, Wyoming, and (although not a state) the District of Columbia.
[31] *Id*. at 29. These states include Alaska, Arkansas, Connecticut, Georgia, Maine Maryland, Massachusetts, Michigan, New Jersey, New York, North Carolina, Pennsylvania, Rhode Island, Vermont and West Virginia. Payday loans are also statutorily prohibited in the Virgin Islands and Puerto Rico. *Id*.
[32]
[33] *See* Fox, supra note 16, at 30 n.110 (listing citations for the authorizing statutes from the thirty-three states that explicitly authorized payday lending as of March 2004). Two additional states allow payday lending through permissive small-loan laws rather than specific legislation. *Id*. at 30. In contrast, a 1999 memo from a credit-industry trade group listed only seventeen states that then had authorizing legislation. *See* Nat'l Check Cashers Ass'n, Freedom of Choice for Consumers: The Truth About Deferred Deposit Services--A Reasoned Response to the CFA's Misrepresentations pt. III (1999), *available at* http://www.fisca.org/ddresponse.htm.

disapproval of payday loans among state policymakers such as governors and legislators.[34] Federal preemption and the inability of states to enforce their own laws factored into these changes; the less stringent the law adopted by a state, the less likely that lenders will attempt various end-runs around it, and the more likely that a state will be able to keep track of the lenders operating within it.

Although the state schemes vary, a typical payday loan statute requires lenders to be licensed and restricts loan duration, size, renewal options, and fees. Loan size is typically limited to $500 or less, but five states set their limit between $500 and $1000, and four allow any amount.[35] Generally, the design of most state statutes that attempt to limit duration and loan renewals makes them incredibly easy to circumvent. The rate limitations vary significantly in structure (e.g., a schedule of fees, a flat fee per $100, or a flat fee plus percent of loan value)[36] but are uniformly permissive. Ten states allow any rate to be charged,[37] and even the most restrictive states allow APRs of 390%.[38] Although a limit of 390% is, arguably, better than no limitation whatsoever, it is still so lenient as to be essentially toothless.

Although payday loans are advertised as a short-term solution, they can quickly ensnare a debtor in long-term financial trouble. At the average rate of $18.28 per $100 borrowed for a two-week period (i.e., 475% APR),[39] it takes less than twelve weeks (or five

[34] *See* Fox, supra note 16, at 5.
[35] *See id*. at 31-33.
[36] *Id*.
[37] *Id*.
[38] *Id*.
[39] CFA/PIRG Report 2001, supra note 17, at 4. The advertised rate of $18.28 per $100 can be converted into an approximate APR by dividing 365 days by the length of the loan period (i.e., fourteen days) to determine the number of loan periods in a year, then multiplying this result by the advertised rate. For example, 365/14 = 26 x 18.28 = 475%. This calculation does not include compound interest because debtors pay interest in the form of renewal fees at the end of each loan period.

“rollovers”) for the amount of loan fees paid by a customer to exceed the amount borrowed.[40] If a loan were allowed to continue at this rate for a full year, the consumer would pay $4.75 in interest for every dollar borrowed without getting any closer to paying off the loan.

The payday lending industry insists that analyzing the fees for short-term loans in terms of an APR and examining the long-term consequences of borrowing at those rates is “grossly inappropriate.”[41] The industry’s largest trade association has likened APR disclosure to “a pedestrian in New York City hailing a cab and asking about the fare to San Francisco.”[42] Creditors prefer to focus on the narrow circumstances in which borrowers find themselves in a bind, take out a loan to avoid late fees, promptly repay the loan in two weeks, and come out ahead financially[43]—when in fact, this scenario is rare in practice.

Empirical research, however, reveals that the vast majority of payday loan customers extend their loans beyond the initial two-week period and take out new loans frequently.[44] In 2003, Iowa regulators reported that nearly half of customers had twelve or more loans from the same lender in 2003.[45] A nationwide survey conducted by the Consumer Research Center (CRC) found that three-fourths of customers nationwide had rolled over a loan at least once in the prior year and that one-fourth had loans outstanding for more than half the year.[46] The

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[40] To determine how long it will take for interest payments to exceed the face amount of a loan, calculate: 1/i x 365 days, where i = the loan’s interest rate expressed as a decimal (i.e., a twenty-five percent APR is equivalent to 0.25). At a rate of 475% (i = 4.75), it would take only seventy-seven days—two and a half months—for interest to exceed principal (365/4.75 = . 2105 x 365 = 77).

[41] *See* Nat’l Check Cashers Ass’n, supra note X, pt. V (referring, un-ironically, to the use of APRs in discussing payday loan fees as “virtually fraudulent”). The National Check Cashers Association, which subsequently renamed itself the Financial Service Centers of America (FiSCA), represented approximately 3,600 of the 6,000 check cashing locations in existence at the time of the report. *Id*. pt. I; see also Drysdale & Keest, supra note 6, at 606 (discussing the benefits claimed by the fringe credit industry).

[42] Nat’l Check Cashers Ass’n, supra note 33, pt. V.

[43] *See id*., pt. III.

[44] *See* Drysdale & Keest, supra note 6, at 605-09 (summarizing studies of payday loan renewals and repeat business).

[45] Fox, supra note 16, at 3.

[46] *See* Elliehausen & Lawrence, supra note 12, at 38-39.

Coalition for Responsible Lending estimates that two-thirds of payday loan customers receive five or more loans per year and that this category of users generates ninety-one percent of the industry's fee revenue.[47] More than half of revenue is attributable to customers with thirteen loans or more.[48] These statistics not only suggest the debt trap is a real problem, but also cast doubt on the industry's ability to survive without the business of trapped customers.

Although demand for payday loans is very high, a large portion of this demand is attributable to hardships created by the loans themselves. One loan literally leads to another in a cycle of dependency usually seen only in substance abuse or gambling addiction. A payday borrower has only two weeks to earn sufficient funds to repay the loan principal and fees. Once he dedicates a large portion of his paycheck to repayment of the first loan, however, the borrower will likely find it difficult to stretch the remainder of the paycheck until the next payday while continuing to pay regular expenses. Whatever sparked the need for the first payday loan (car trouble, a sick family member, marital difficulties) may continue to generate unplanned expenses, making it more difficult for the borrower to scrape by until the next payday. If the borrower is unable to catch up, he will likely take out a new loan to bridge the gap. Unfortunately, the loan fees associated with this new loan will further jeopardize his ability to pay all of his bills in the next period, perpetuating the cycle of dependency.

Even borrowers who appear to temporarily break free from the debt cycle are vulnerable to relapse. During the period of indebtedness, a debtor who is trying to eliminate his payday loans as quickly as possible must dedicate every dollar of expendable income

[47] Keith Ernst et al., Ctr. for Responsible Lending, Quantifying the Economic Cost of Predatory Payday Lending 5 (2004), *available at* http:// www.responsiblelending.org/pdfs/CRLpaydaylendingstudy121803.pdf.
[48] *Id*. at 5.

towards interest payment, leaving no money for maintenance expenses or savings. Many expenses, such as those for medical care and routine home or car maintenance, can be delayed, but not avoided entirely. Failure to maintain one's health and property may lead to expensive repairs. Consumers who are caught in the debt trap may also abandon insurance payments to get out, resulting in a highly risky, and potentially disastrous, gamble.

Various state statutory schemes have attempted to protect consumers from this debt trap by regulating loan renewals. Eighteen states prohibit a customer from using the proceeds of a new payday loan to retire an existing one,[49] and five limit the number of rollovers to three per loan.[50] The goal of both types of regulation is easily circumvented, however, because consumers can take out a "new" loan minutes after they retire the first one.[51] Alternatively, customers may take out a loan from a second payday store to repay the loan owed to the first store—an option used by one-third of payday loan customers, according to some studies.[52] Even consumers who are not trying to circumvent rollover restrictions will frequently have short gaps between loans because they repay their loan on payday and then try, but fail, to make it two weeks on what remains of their paycheck.[53]

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[49] *See* Elliehausen & Lawrence, supra note 12, at 6.
[50] *Id*.
[51] Woodstock Inst., Reinvestment Alert No. 14, Unregulated Payday Lending Pulls Vulnerable Consumers into Spiraling Debt 8 (2000), *available at* http://woodstockinst.org/document/alert.pdf (noting that Illinois regulators find that the state's three-rollover limit is regularly circumvented in this manner).
[52] *See* Elliehausen & Lawrence, supra note 12, at 40
[53] States could limit this debt trap more effectively without regulating rates, by: (1) limiting the number of payday loans that an individual may receive from any lender during each three-month period; (2) treating each rollover as a separate loan; and (3) creating a mandatory reporting system to aid compliance and enforcement. Such legislation would, conceivably, reduce the amount of money a consumer can waste on payday loan fees and reinforce the idea that the high rates legally permitted for payday lenders are conditioned on their short-term nature. However, this type of legislation has two drawbacks. First, the costs of maintaining and enforcing the reporting system would either be borne by the government or passed along to borrowers by creditors. Second, if we assume that consumers would repay their payday loans if they could, then decreasing the number of permitted loans or rollovers will not prevent customers from defaulting, but rather will speed the default process along.

Each dollar a consumer dedicates to loan fees and interest payments is money that cannot be spent on current consumption, investment, or savings. When borrowers are trapped in payday loan debt, the effect is a reduction in disposable income that reduces their family's standard of living. Although all consumer debt can have this effect, payday loans are particularly damaging because the high loan fees charged represent a substantial fraction of the borrower's paycheck and borrowers are often deeply indebted prior to taking out the loan.[54] Living on the brink of insolvency causes many consumers to experience shame, guilt, and high levels of stress, which may negatively affect their mental and physical health, job performance, and family life.[55]

Payday lending companies systematically target the populations who are in most dire need of, but can least afford, their products.[56] Like the salary lending customers of the early twentieth century, payday lending customers typically have low to moderate incomes, full-time employment and no bank accounts.[57] A majority are African-American or members of another racial or ethnic minority.[58] Payday lenders have also begun to increase exponentially in towns where military bases are located, due to the large numbers of financially vulnerable, low and moderate-income families residing there.[59]

The costs of the debt trap, however, are not borne entirely by individual debtors, but also have a significant impact on society. The deregulation of the credit market led to a

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[54] *Id*. at 45. Half of all payday loan customers, and one-fourth of the United States adult population, have consumer debt burdens that require more than ten percent of their monthly income. Nearly one-fifth of payday loan customers have payment-to-income ratios above thirty percent.
[55] *See* George J. Wallace, *The Logic of Consumer Credit Reform*, 82 YALE L.J. 461, 472 (1973) (describing psychological consequences of defaulting on debt).
[56] Ronald H. Silverman, *Toward Curing Predatory Lending*, 122 BANKING L.J. 483, 488 (2005).
[57] *Id*.
[58] *Id*.
[59] *See generally* Stephen M. Graves and Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of "Payday" Loans in Military Towns*, 66 OHIO ST. L.J. 653 (2005).

significant increase in credit availability and aggregate consumer debt.[60] Furthermore, the increased availability of fringe credit has allowed consumers to become highly leveraged, meaning that their debt loads are high in comparison to their assets and earning potential.[61] Unfortunately, the high debt levels and high interest rates that exist in a deregulated credit market tend to (1) adversely affect creditors and consumers in the mainstream credit market, (2) decrease savings rates, (3) increase bankruptcy rates, and (4) increase the cost of government welfare programs.[62]

First, the availability of payday loans (and other high-interest, fringe credit products such as "Tax Refund Advance Loans" and auto title pawns) has a detrimental effect on creditors and consumers who do not even use these products.[63] An economically rational actor will devote his disposable income to paying off debt with high interest rates before that with low rates unless the creditors supplying the latter have more leverage (e.g., the ability to eject the borrower from his home, turn off his utilities, or repossess his car). Unfortunately, this means that the fringe creditors responsible for overextending credit may be the first to get paid out of each new paycheck, leaving creditors that charge relatively low rates holding the bag if the debtor becomes insolvent. Because creditors treat the write-off of bad debts as an expense, this cost is passed on to all customers in the form of higher prices.

Second, the widespread availability of emergency credit discourages savings. Between 1999 and 2003, Americans saved an average of only two percent of their disposable

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[60] *See* Fox, supra note 16, at 8.
[61] *Id*.
[62] *Id*.
[63] *See* Drysdale & Keest, supra note 6, at 664.

personal income as compared to 9.8% for the period between 1970 and 1984.[64] Personal savings rates have been decreasing steadily since 1984, regardless of the financial state of the economy, and hit a sixty-six-year low of one percent in 2004.[65] Meanwhile, the level of outstanding consumer debt in America has grown to $9.7 trillion, which is more than double the level of debt carried ten years earlier and is not far behind the U.S. gross domestic product of $11.6 trillion.[66]

Third, low savings rates coupled with high debt loads have played a significant role in the growing number of bankruptcies in this country. In 2003, more than 1.625 million Americans filed for bankruptcy, a seven-fold increase from the 259,160 that filed in 1980.[67] This growth in bankruptcies is highly correlated to growth in consumer debt levels.[68] The greater an individual's debt-to-income ratio, the more dependent he becomes on steady income. Where a consumer has both small amounts of disposable income each month and low levels of savings, he has no buffer to protect himself from unexpected expenses or temporary income loss.

A number of adverse events could push him into default. The consumer's high debt load would then make it difficult to recover as new bills continued to roll in. If the debtor resorts to bankruptcy or if lenders use the court systems to collect debt, society must pick up

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[64] Bureau of Econ. Analysis, U.S. Dep't of Commerce, The National Income and Product Accounts of the United States, tbl.2.1, at http:// bea.gov/bea/dn/nipaweb/SelectTable.asp?Selected=N#S5 (last revised Feb. 25, 2005) (listing the average annual personal savings rates for each year since 1929). The two percent figure is an average of the following annual rates: 2.4% (1999), 2.3% (2000), 1.8% (2001), 2.0% (2002), and 1.4% (2003).
[65] The personal savings rate as a percentage of disposable income was 10.8% in 1984 and one percent in 2004. *Id*.
[66] Agnes T. Crane, *Consumers Play Key Role in Rates*, WALL ST. J., Sept. 17, 2004, at C5. This debt figure includes mortgage debt as well as consumer credit. *Id*.
[67] Analytical Servs. Office, Admin. Office of U.S. Courts, Judicial Facts and Figures, tbl.5.2, at http:// www.uscourts.gov/judicialfactsfigures/table5.02.pdf (last modified Mar. 2003). This figure is expected to rise even higher, as Congress tightened restrictions on individual bankruptcy filings this year, essentially making it harder to discharge personal debts.
[68] *See* Paul C. Bishop, A Time Series Model of the U.S. Personal Bankruptcy Rate (Fed. Deposit Ins. Corp., Bank Trends No. 98-01, 1998), *available at* http://www.fdic.gov/bank/analytical/bank/bt_9801.pdf.

part of the tab in the form of salaries for the judges, administrators, enforcement officials, and clerical employees that run the courts.[69]

Fourth, even where payday loan customers avoid defaulting on their loans, public and/or private coffers may end up paying for items for which they failed to save. For instance, if individuals do not save money for retirement, this increases their reliance on Social Security. If they do not save for their children's education, there will be greater reliance on loans, scholarships, and government subsidies to send the next generation to college. If borrowers do not invest money in health insurance, hospitals will end up subsidizing their care and spreading the costs to others.

III. The Reaction of States' Attorneys General to the First Wave of Payday Lending

Therefore, it is not surprising that since the emergence of this modern-day loansharking, state attorneys general have tried various ways to curtail or eliminate these fringe credit practices. The first wave of activity mainly consisted of attorneys general prosecuting payday lending services for violating state usury or consumer financing laws.

In the early 1990s, for example, Virginia's then-Attorney General Mary Sue Terry brought a series of cases against check cashers making payday loans, charging unauthorized small loan lending in violation of the Virginia Consumer Finance Act,[70] a state statute which prohibits "lending any principal amounts to individuals for nonbusiness purposes, and charge, contract for, or receive, directly or indirectly, on or in connection with any loan, any interest,

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[69] *See*, e.g., Keest & Renuart, supra note 6, at 63 (noting that restricting high-risk credit benefits "traditional lenders or investors who are harmed by the consumer bankruptcies caused by predatory lending").
[70] Mike Hudson, *Going for the Broke; How the 'Fringe Banking' Boom Cashes in on the Poor*, WASHINGTON POST, Jan. 10, 1993, at C1.

charges, compensation, consideration or expense which in the aggregate" is greater than twelve percent per year, the interest cap set by state law.[71]

In sum, Virginia alleged that the commonly charged $56 fee for a 15-day, $200 loan represented an effective annual interest rate of 681 percent.[72] If the loan was for 10 days, the interest rate became 1,022 percent, and if the loan was for five days, the rate was 2,044 percent.[73] Not surprisingly, the payday lenders argued that because they had cleverly labeled these costs "fees" instead of "interest," they should be exempt from prosecution under the state usury laws.[74] However, the Virginia courts ruled that the practice of advancing cash against a customer's check dated for sometime in the future clearly constituted the making of loans and that the fees charged greatly exceeded the limits imposed by the CFA.[75] Because of this ruling, in 1994, the Attorney General's office, under Jerry Kilgore, reached a $2.5 million settlement with the state's largest payday lending firm, Cash Now Three.[76] Of the $2.5 million, $1.7 million was set aside immediately for restitution to Virginia residents who had taken out loans from Cash Now Three, and the remainder went to future restitution payments, legal fees and state penalties.[77]

The Attorney General's office in West Virginia successfully ran payday lenders out of the state, if only temporarily, in 1996. The state attorney general's office filed a lawsuit and requested a temporary injunction against "Cash-N-Go," a check cashing business which

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[71] Va. Code Ann. §§ 6.1-249, 6.1-330.55 (2005).
[72] Steve Bates, *Va. Suing Firms With Fast Money; Check-Cashing Offer Illegal, State Says*, WASHINGTON POST, Jul. 6, 1993, at D1.
[73] *Id*.
[74] *Va. Company Settles Suit*, WASHINGTON POST, Sept. 28, 1994 at B7.
[75] *Id*.
[76] *Id*.
[77] *Id*.

charged $20 per $100 advanced on a personal check that it would hold for two weeks.[78] Cash-N-Go was the first lender of its kind reported in the state during the late 1990s.[79]

As in Virginia, the lender claimed that their fees were not interest, and accordingly their activities could not be regulated by West Virginia's interest cap of eighteen percent.[80] The Attorney General's office argued that the fees amounted to an APR of 500 to 1,000 percent, depending on how long the checks were held.[81] The Attorney General also charged that the check cashing outfit violated other consumer protection laws by refusing to disclose their interest rates, and by charging $25 for bounced checks while state law limited that fee to $15.[82] Cash-N-Go settled almost immediately after the AG office filed charges; it agreed to pay the state $7,000 and stop doing business in West Virginia.[83] The settlement money was paid to customers of Cash-N-Go to reimburse them for any interest paid over the state's eighteen-percent limit.[84]

In 1997, Maryland's Attorney General ordered Kash-2-You Leasing and Cash-To-You Leasing, two Maryland companies that made loans at what amounted to interest rates of 780% APR, to stop doing business in the state.[85] That order, issued by the AG's Consumer Protection Division, charged that the company attempted to avoid Maryland's usury laws

[78] Cheryl Caswell, *State Sues Business; Officials Contend Cash-N-Go is Lending Without A License*, CHARLESTON DAILY MAIL, Nov. 14, 1996, at P1B.
[79] *Id*.
[80] *Id*.
[81] *Id*.
[82] *Id*.
[83] Julie R. Cryser, *Cash-N-Go Decides to Leave State as Part of Settlement*, CHARLESTON DAILY MAIL, Nov. 23, 1996, at P7A.
[84] *Id*.
[85] 772 PLI/Comm 987, 991 (1998).

which cap interest rates at 33% per year by having the consumer "sell" a household item, which the lenders then "leased" back.[86]

This "sale-leaseback" scheme operated thusly: the two companies advertised that consumers who needed cash quickly could get up to $200 with "no red tape."[87] Consumers were asked to provide the serial number of an item of personal property, such as a TV or VCR; the company "bought" the item, typically for $100.[88] The consumer then signed a lease agreement to pay "rent" on the item, typically $30 every 15 days, until he or she could repay the loan.[89] In 2002, the Baltimore City Circuit Court ordered the two companies to pay restitution to consumers who paid interest on the loans between January 1994 and January 1997, and to pay civil penalties of $591,400 and the costs of the Attorney General's investigation.[90] By the end of the 1990s, most states had taken action either through the efforts of their AG office or through their legislature, to regulate or prohibit payday lending.[91]

IV. The Charter Renting Ruse

So why, in spite of lawsuits by attorneys general against such lenders, are individuals still able to get advances on personal checks in every state in the United States today? Because enforcement actions at the state level by attorneys general prompted payday lenders, by the late 1990s and early 2000s, to engage in a practice known as "charter renting."[92] Under this arrangement, banks formed business relationships to make payday loans through

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[86] *Id*.
[87] Attorney General of Maryland Press Release, Aug. 15, 2002, *available at* http://www.oag.state.md.us/Press/2002/0815b02.htm.
[88] *Id*.
[89] *Id*.
[90] *Id*.
[91] Fox, supra note 16, at 19.
[92] *See* discussion at notes XX-XY and accompanying text.

payday companies which were usually located in other states.[93] In these transactions, which became standard in the industry, the payday loan company manages marketing, staff, locations, customer service, and loan applications, but the bank advances the loan funds to borrowers.[94]

On paper, every loan is "made" by the bank, but the name on the door is that of the payday loan company, and the only person the borrower ever sees is an employee of the payday lender.[95] By prior agreement, the payday loan company usually then immediately purchases the right to receive payment from consumers back from the bank.[96] Then, the payday loan company goes on to handle the most important aspect of the business, collections.[97] The bank, in effect, "rents" its charter powers either in exchange for a per loan fee or for ownership in a small percent of the proceeds of each loan.[98]

This charter renting was made possible by the United States Supreme Court's decision in Marquette National Bank v. First Omaha Service Corp.[99] and §521 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). In Marquette, the Supreme Court faced the novel question of which state's interest rate cap applies when a bank located in one state loans money across borders at an interest rate in excess of the state interest rate cap where the borrower lives.[100] The Marquette Court held that the National Bank Act, which originally "leveled the playing field" between federal and state banks,

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[93] Fox, supra note 16, at 11-12.
[94] Id.
[95] Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending Regulation*, 88 MINN. L. REV. 518, 583 (2004).
[96] *Id*.
[97] *Id*.
[98] *Id*. at 582-583.
[99] 439 U.S. 299 (1978).
[100] *Id*.

authorized federally chartered national banks to export the interest rate cap (or lack thereof) of a bank's home state to consumers in other jurisdictions.[101]

The Court's intervention in what had been state lawmaking started a corporate race to the bottom that significantly eroded the power of state governments to set meaningful interest rate caps.[102] Lenders quickly relocated in states with no interest rate caps such as Delaware and South Dakota and exported those laws to states that chose more aggressive price regulation.[103] States with interest rate caps became much more amenable to removing them in order to hold on to their financial services industry jobs.[104] Because the Marquette decision only applied to national banks, state chartered banks were at a significant competitive disadvantage.[105] Bowing to pressure by state banks, Congress included language in the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) that allowed state banks to charge interest at the rate allowed by the laws of the state where the bank is located.[106] Section 521 of this act granted exporting powers to state banks similar to those of national banks.[107] The entire point of the business relationship between payday lenders and banks, therefore, was to circumvent interest rate caps and other restrictions adopted by state legislatures.[108]

This didn't stop attorneys general in some states from trying to bring payday lenders' practices in line with state law. The first Attorney General to challenge federal charter-renting was Colorado's Ken Salazar, who in 2001 went after ACE Cash Express, one of the

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[101] *Id*. at 310-12.
[102] *See* James J. White, *The Usury Trompe l'Oeil*, 51 S.C. L. REV. 445, 450 (2000).
[103] *Id*. at 447-48.
[104] *Id*. at 454.
[105] *Id*.
[106] Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 521, 94 Stat. 132 (1980) (codified at 12 U.S.C. § 1831(d)(a) (2005)).
[107] *Id*.
[108] Schiltz, supra note 95, at 565-566.

nation's largest payday lenders.[109] ACE had a charter-renting agreement with California-based Goleta National Bank.[110] Predictably, ACE claimed immunity from state law because they were simply managing check cashing "outlets" for Goleta; Salazar countered that merely aligning themselves with a national bank did not entitle them to all the privileges enjoyed by one.[111] ACE tried unsuccessfully to remove the case to federal court.[112] Soon thereafter, ACE settled with the Attorney General's office.[113] Under the settlement, ACE agreed to refund $1.3 million in check-cashing fees to customers in Colorado within five months.[114] ACE also agreed to terminate its relationship with Goleta National Bank and comply with Colorado's consumer credit and payday lending laws.[115]

North Carolina Attorney General Roy Cooper also brought a lawsuit against ACE Cash Express, on the grounds that it violated state interest caps and consumer finance protections.[116] Cooper commenced the suit in January 2002;[117] at about the same time, the Office of the Comptroller of the Currency (OCC) signaled its willingness to use its oversight powers over federally chartered banks to start cracking down on charter-renting. Speaking of the Marquette doctrine in February of that year, the Comptroller of the Currency explained:

> Let me raise one . . . caution . . . . The benefit that national banks enjoy by reason of this important constitutional doctrine cannot be treated as a piece of disposable property that a bank may rent out to a third-party that is not a national bank. Preemption is not like excess space in a bank-owned office building. It is an inalienable right of the bank itself.

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[109] John Accola, *Check-Cashing Chain Must Refund Some Fees*, ROCKY MOUNTAIN NEWS, May 7, 2002, at 10B.
[110] *Id*.
[111] *Id*.
[112] David Milstead, *Suit vs. Payday Lenders Gets Nod; State Attorney General Wins Right to Keep Case in Denver District Court*, ROCKY MOUNTAIN NEWS, Jan. 29, 2002, at 1B.
[113] Howard Pankratz, *"Payday" Lender Lawsuit Settled; ACE to Refund $ 1.3 Million in Finance Charges*, DENVER POST, May 7, 2002, at B-01.
[114] *Id*.
[115] *Id*.
[116] Lynn Bonner, *State Sues to Block Payday Lender*, NEWS & OBSERVER (Raleigh, N.C.), Jan. 15, 2002, at A3.
[117] *Id*.

> . . .
> Indeed, the payday lending industry has expressly promoted such a "national bank strategy" as a way of evading state and local laws. Typically, these arrangements are originated by the payday lender, which attempts to clothe itself with the status of an "agent" of the national bank.
> . . .
> Not only do these arrangements constitute an abuse of the national charter, but they are highly conducive to the creation of safety and soundness problems at the bank, which may not have the capacity to manage effectively a multistate loan origination operation that is in reality the business of the payday lender. [118]

Soon thereafter, OCC gave negative oversight evaluations to every federally chartered bank involved in payday lending.[119] All federal banks which had been engaged in such transactions immediately terminated their charter-renting agreements with payday lenders, including ACE. In North Carolina, Cooper and ACE settled the case in October, with Cooper agreeing to end the suit against ACE and ACE agreeing to drop its federal preemption claim against North Carolina.[120] This settlement also forbade ACE from making any loans within the state for one year, and stipulated that the lender had to obtain a license and obey state laws regulating consumer loans if ACE reentered the loan business in North Carolina after that year.[121]

ACE's problems were not limited to Colorado and North Carolina, however. In Florida, ACE paid $250,000 to Florida's Department of Banking and Finance and $250,000 to the University of Florida's law school as part of a settlement with AG Robert Butterworth.[122]

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[118] John D. Hawke, Jr., Comptroller of the Currency, Remarks Before the Women in Housing and Finance (Feb. 12, 2002), *available at* http:// www.occ.treas.gov/ftp/release/2002-10a.txt.
[119] Fox, supra note 16, at 17-19.
[120] *ACE agrees to cease payday lending in N.C.*, CONSUMER FINANCIAL SERVICES LAW REPORT, Jan. 15, 2003.
[121] *Id*. At the same time, the OCC terminated ACE's relationship with Goleta by issuing a cease-and-desist order when it discovered 641 customer files from an ACE store discarded in a trash bin in Virginia. The comptroller warned national banks that this was the risk they exposed themselves to when they rented their charters to third-party vendors and allowed the third party to process the loans. ACE paid the OCC $250,000 in penalties for violating federal privacy laws. Anuradha Raghunathan, *ACE to settle with 2 states; Check-cashing chain makes strides to resolve issues over payday loans*, DALLAS MORNING NEWS, Jan. 3, 2003, at D1.
[122] *Id*.

ACE also agreed to obtain state licenses to make payday loans under state laws there.[123] Similarly, in Ohio, ACE promised to pay $16,000 in licensing fees, operate under the Ohio Small Loan Act, and send out $250,000 worth of coupons to nearly 15,000 customers.[124] These coupons were to be used as discounts toward future loans; the fact that such coupons would drum up more business for an exploitative entity like ACE was apparently not a pressing concern for the Ohio AG's office.

Although both the OCC and the banks themselves characterized national banks as the unknowing victims of the payday lenders' scheme, there was no question that the effectiveness of charter renting required active participation by both parties.[125] Indeed, during the period in which national banks were allowed to rent their charters to payday lenders, Wells Fargo, the seventh largest bank in the country, arranged more than $700 million in loans to three of the nation's largest check cashing companies.[126] Under threat of losing their bank charters, all national banks terminated their charter-renting relationships with payday loan companies.[127]

The combined efforts of state AGs and the Comptroller of the OCC did not halt payday lending for long. Almost immediately, the lenders moved on to charter-renting agreements with *state*-chartered banks which were not subject to the authority of the OCC. In North Carolina, for example, ACE Cash Express quickly reestablished itself by partnering with Fidelity Bank of Burke, South Dakota—a state with virtually no regulation of consumer

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[123] *Id*.
[124] *Id*.
[125] O. Dudley Gilbert, *Update on State and Federal Banking Regulations*, 58 CONSUMER FIN. L.Q. REP. 18, 19 (2004).
[126] Jabulani Leffall, *A Matter of Life and Debt: The Impact of Predatory Lending on the Black Community*, DOLLARS AND SENSE, Mar. 1, 2003, at 28.
[127] Gilbert, supra note 125, at 19.

finance businesses.[128] In Texas, Arkansas and Pennsylvania, ACE was able to offer payday loans through a Kentucky bank.[129]

Banks chartered by state governments are primarily regulated by that state's bank examiner or department of financial institutions, but also receive oversight from the Federal Deposit Insurance Corporation (FDIC), an independent federal agency created in 1933 in response to bank failures during the Great Depression.[130] State banks are under FDIC oversight because the banks purchase federal insurance from the FDIC to protect the bank accounts of their customers from theft and other losses.[131] Unlike the OCC, the FDIC until very recently turned a blind eye to charter-renting, taking the position that state bank charter-renting to payday loan companies is legal.[132] Consumer advocates responded by furiously accusing the FDIC of undemocratically undermining every usury law in the nation.[133] But the FDIC, which has an institutional history focused almost exclusively on preventing bank failures, continued to ignore the consumer protection concerns of payday lending critics.[134]

Thus, payday loan companies and state banks continued to claim a license to ignore state interest rate laws.[135] Under the interpretation of banking law advanced by the FDIC and payday lenders, so long as officials at the FDIC and one state government in the entire country refused to prevent high-interest loans, one state bank located in that one state allow payday loan companies to export the state's law (or lack thereof) to every borrower in the

[128] Erick Bergquist, *N.C. Order Puts Payday Firm in Limbo*, AMERICAN BANKER, Dec. 27, 2005 at 1.
[129] Raghunathan, supra note 121.
[130] Federal Deposit Insurance Corp., Who Is the FDIC?, available at http://www.fdic.gov/about/learn/symbol/index.html (last visited Nov. 27, 2005).
[131] *Id*.
[132] Fox, supra note 16, at 19-22.
[133] Id. at 29.
[134] By statute, the mission of the FDIC is to protect the safety and soundness of insured depository institutions. 12 U.S.C. §§ 1816, 1828(c)(1), 1831m-1, 1831p-1 (2005).
[135] Fox, supra note 16, at 29.

country.[136] Sheltered under this protective regulatory umbrella, twelve state banks of the more than 5200 institutions currently supervised by the FDIC continued to act as facilitators for many of the nation's payday loan companies.[137]

In March, 2005, the FDIC issued fairly weak guidelines, effective July 1st, which imposed significant responsibilities on state banks engaged in charter renting.[138] In response, the National Association of Attorneys General sent a letter to FDIC Chairman Donald Powell, sighed by AGs from thirty-seven states, criticizing the FDIC for not going farther.[139] The letter noted that despite the FDIC's recent issuance of new guidelines for state banks, the agency had entirely failed to address the issue of charter renting by payday lenders.[140] It also pointed out that that as soon as the OCC had issued its 2002 guidelines prohibiting federal charter renting, payday lenders simply migrated to state-chartered bank in an end-run around the OCC guidelines and many state consumer protection laws—and that the FDIC had not taken sufficient action to ameliorate this problem.[141]

V. Credit Service Organizations: Payday Lending's Current Guise

[136] *Id*.
[137] Press Release, Federal Deposit Insurance Corp., FDIC Revises Payday Lending Guidance (Mar. 2, 2005), http:// www.fdic.gov/news/news/press/2005/pr1905.html.
[138] Specifically, the guidelines instructed state banks renting charters to: (1) Limit the number and frequency of extensions, deferrals, renewals, and rewrites; (2) Prohibit additional advances to finance unpaid interest and fees and simultaneous loans to the same customer; (3) Ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained; (4) Establish appropriate "cooling off" or waiting periods between the time a payday loan is repaid and another application is made; (5) Establish the maximum number of loans per customer that are allowed within one calendar year or other designated time period; (6) Provide that no more than one payday loan is outstanding with the bank at a time to any one borrower; and (7) Ensure that payday loans are not provided to customers who had payday loans outstanding at any lender for a total of three months during the previous 12 months. Federal Deposit Insurance Corporation, "Guidelines for Payday Lending," (March, 2005), *available at* http://www.fdic.gov/news/news/financial/2005/fil1405a.html.
[139] Letter from the National Association of Attorneys General to FDIC Chairman Donald Powell, May 10, 2005, available at http://www.naag.org/news/pdf/20050510-FDIC-Letter.pdf.
[140] *Id*.
[141] *Id*.

Even though the FDIC had not eliminated state bank charter renting, as NAAG and many consumer watchdog organizations had advocated, after the March 2005 guidelines went into effect, payday lenders abandoned charter renting for a new business model: the Credit Service Organization (CSO).[142] Allowed in many states, a CSO either improves a person's credit rating by helping them pay down debt, but it can also make loans.[143] If it makes loans, a CSO is considered a broker, which, in this situation, initiates a loan but then finds another lender to carry it out and is paid handsomely for the work.[144] In many states there are no caps on broker fees, and as a "broker," the payday lender doesn't have to abide by the FDIC guidelines.[145] In fact, in most states, CSOs are largely unregulated.[146]

Tellingly, on June 30, Advance America, currently the largest payday lender in the United States, said it had abandoned its relationship with state banks and would act at its centers as a credit services organization.[147] First Cash Financial Services of Texas, a payday lender with more than 300 stores in 11 states and Mexico, said the same. One day later, another national payday lender, Cash America, followed suit and announced it would henceforth offer loans as a CSO.[148]

Conceivably, this move on the part of the payday lending industry invites another round of litigation from state attorneys general premised on state usury laws, or a new round of lawmaking by state legislatures, if state AGs cannot successfully argue that these new businesses are, essentially, payday lenders in CSO drag. Because this shift in the industry is

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[142] Chris Mahon, *Borrowing Against the Future*, BROWNSVILLE HERALD, Sept. 18, 2005, at A1.
[143] *Id*.
[144] Paul Kix, *Thinking About Taking Out a Payday Loan? Think Again, Sucker*, DALLAS OBSERVER, Sept. 8, 2005.
[145] *Id*.
[146] Erick Bergquist, *A Surprising Contrarian in Payday Trend*, AMERICAN BANKER, Oct. 24, 2005, at 9.
[147] *Id*.
[148] *Id*.

so recent, it remains to be seen what role state AGs will play in protecting their constituents from these modern-day loan sharks, and how payday lenders will, inevitably, reincarnate itself in some form that evades state law enforcement.