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Small-Dollar Lenders Under Fire From AGs And CFPB

Law360, New York (February 20, 2014, 4:29 PM ET) -- State and federal regulators are on the march against small-dollar lenders (e.g. payday or installment loan lenders) and it seems they intend to leave as few unscathed as possible. Recent actions have targeted those lenders who choose not obtain a state license in every state from which the lender has customers. Such lenders instead rely on jurisdictional principles like choice of law analysis or federal preemption as the basis for lending in one jurisdiction, but adopting the more favorable laws (and licensing and usury limits) of another.

For one group of lenders attempting to follow this model, regulators moved to end their out-of-state lending, and the end result has been a series of expensive settlements, likely with more to come.

On Jan. 24, 2014, New York Attorney General Eric Schneiderman announced that he reached a settlement agreement with several online payday lenders, including Western Sky Financial, CashCall Inc. and WS Funding for alleged violations of New York's usury and licensed lenders laws.

The legal issue with the two primary payday lenders involved in the settlement, Cashcall Inc. and Western Sky Financial, arose because both companies and their related entities solicited New York borrowers, but ran their operations entirely outside of New York. Schneiderman alleged that the companies "targeted" New York borrowers with Internet and television advertising, but then took the position that New York law did not apply to the customers' transactions.

The lenders countered that all of the essential elements of the borrowers' transactions took place outside of New York so New York law should not apply, but they eventually settled with the state. The terms of the settlement require the lenders to pay civil money penalties, modify existing loans, cease collections of loans where principal has been repaid and cease collection of outstanding interest.

New York is not alone in cracking down on out of state lenders doing business with in-state customers. Two days before New York's announcement, the Colorado Attorney General John Suthers announced he had reached a settlement agreement with some of the same lenders for allegedly making unlicensed, high-cost loans to consumers in Colorado.

In a January 2011 lawsuit, the state alleged that Western Sky Financial, Payday Financial (doing business as Lakota Cash and Big Sky Cash), Great Sky Finance, Green Billow (doing business as Four Seasons Cash) and Red Stone Financial made loans to Colorado residents without a license and in violation of the state's usury laws.

In the Colorado case, the complaint alleges that the owner of the payday lending company is Native American and purported to operate his businesses from a reservation. The companies took the position that they were not subject to Colorado law by reason of tribal immunity and preemption. Last spring, the Colorado courts disagreed and found that the lenders, by making unlicensed loans to Colorado consumers, were subject to and violated Colorado's consumer credit protection laws notwithstanding their connection to tribal land.

The terms of the settlement require the lenders to pay a civil monetary penalty and prohibit the lenders from making any consumer loans in Colorado, collecting on any already made loans to consumers, or selling these loans to third parties. The settlement also expressly ordered the lenders to "discharge, cancel, release, forgive and adjust to a zero balance all" consumer loans made in Colorado.

The Consumer Financial Protection Bureau also joined in the attack back in December 2013, bringing a lawsuit in Massachusetts federal court against the same entities, CashCall Inc., WS Funding, and Delbert Services Corp., who worked together to market and originate installment loans.

Unlike other CFPB enforcement actions involving payday lenders and alleged direct violations of the Consumer Financial Protection Act, this one was premised on violation of state usury laws. The complaint alleged that "Defendants purchased, serviced and collected consumer-installment loans that state laws rendered void or limited the consumer's obligation to repay."

Targeting the same practices as the state attorneys general above, the CFPB alleged that the companies made loans in Arkansas, Arizona, Colorado, Indiana, Massachusetts, New Hampshire, New York and North Carolina without obtaining state licenses in those states, thereby violating state law usury limits. The case remains pending.

The easy lesson for lenders here is simple: In an era of extreme regulatory scrutiny, creativity in avoiding state-by-state licensing can be surprisingly expensive. Right now, lenders of all types and sizes are subject to the inexperienced but heavy hand of the CFPB — and that's just to navigate examinations and comply with existing law and new regulations. Enforcement actions are on the rise, and small-dollar lenders who operate without state-issued licenses, under any theory, make for easy targets. State-by-state licensing may seem like the long and expensive way, but lending in a state without the corresponding state license, it turns out, is actually the long and expensive way.

That being said, these enforcement actions do highlight issues for lenders who are using, or contemplating, an alternative to state licensing.

First, though the lending company may be owned and operated by a Native American, it is the tribes or tribal entities that hold the immunity necessary to preempt state law licensing requirements. Next, regulators also care about where the particulars of the loan transactions take place — and they will claim the transaction takes place in the state where the consumer resides. As a result, relying on tribal law may gain the lender nothing if the transactions do not take place on tribal land. For this reason, lenders asserting that an web-based loan transaction is actually made on tribal land will have a tough road in arguing this to regulators and courts that are not especially Internet-savvy, and should be prepared for this battle.

Finally, regulators will always argue that the funds for repayment of the loans were taken from bank accounts held by consumers in the states where they live. Lenders could be successful in overcoming this argument since it should not matter that the funds were repaid from an in-state bank account from a jurisdictional perspective, and in the case of most large banks, it is not true that the funds were held in in-state bank accounts in the first instance. Nonetheless, when considering alternative lending models, lenders should be prepared to explain this to regulators in simple, but thorough detail.

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