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I. INTRODUCTION: A STUDY AT THE INTERSECTION OF LAW, POLITICS, MORALITY AND ECONOMICS

At the dawn of the twenty-first century, in many respects our society would be astounding to those who watched the last century turn. Technological and scientific developments have changed the face of life in ways unimaginable a hundred years ago. But in at least one respect, the turning of this century would

seem almost eerily familiar to people like F.B. Hubachek, who became General Counsel to Household Finance in 1930 and a well-known name in the new consumer finance industry.[1] What we today call the "prime" consumer credit market—purchase money home mortgages and the secondary mortgage market,[2] home equity loans, credit cards, automobile loans and leases that finance the American Dream for most of the middle- and upper-economic quintiles—is a world away from that of 1900. But for parts of what is now called the "subprime" consumer credit market, the century is ending much as it began. After interim decades of reform, some of the credit products in the small-dollar end of this market are throwbacks to that earlier era, and the debate they generated then echoes today.

Known as the "alternative financial services" (AFS) or "fringe banking" sector,[3] this market has become a major source of traditional banking services for low-income and working poor consumers, residents of minority neighborhoods, and people with blemished credit histories. Those who have no concerns about the emergence of this market consider it simply part of a trend toward niche marketing offering a needed and desired service to people previously unable to participate in the credit society—in short, the "democratization of credit."[4] Critics of the phenomenon, on the other hand, call the trend "financial apartheid"[5] or the "second-class" marketplace.

This Article does not attempt to trace the rise of the fringe banking market over the course of this century. One factor in its development, however, has undoubtedly been the emergence of consumer credit as a driving force in the economy. By one gross measure, aggregate household debt[6] rose from $653.9

1. *See generally* F. B. HUBACHEK, ANNOTATIONS ON SMALL LOAN LAWS (1938) [hereinafter HUBACHEK, ANNOTATIONS]; F. B. HUBACHEK, *The Development of Regulatory Small Loan Laws*, 8 LAW & CONTEMP. PROBS. 108 (1941) [hereinafter Hubachek, *Development*].

2. The thirty-year amortizing mortgage is a twentieth century creation, as are the secondary market for mortgages and the more recent mortgage-backed security. Today, in fact, most purchase money mortgages are sold by their originators to investors on a secondary market, rather than being held for the life of the loan. This sale gives the direct lenders a constant infusion of new money, enabling them to originate more loans.

3. *See, e.g.*, JOHN P. CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNSHOPS, AND THE POOR 1, (1994) [hereinafter CASKEY, FRINGE BANKING]; John Burton et al., *The Alternative Financial Sector: Policy Implications for Poor Households*, 42 CONSUMER INTERESTS ANN. 279, 279 (1996); Roger Swagler et al., *The Alternative Financial Sector: An Overview*, 7 ADVANCING THE CONSUMER INTEREST 7, 7 (1995) [hereinafter *AFS Overview*].

4. Henry J. Sommer, *Causes of the Consumer Bankruptcy Explosion: Debtor Abuse or Easy Credit?*, 27 HOFSTRA L. REV. 33, 37 (1998).

5. *See e.g.*, Jane Bryant Quinn, *Banks Infringe on "Fringe Bank" Specialties*, CHI. TRIB., June 13, 1999, at 3.

6. As used here, "household debt" combines two debt figures reported monthly by the Federal Reserve Board: (1) outstanding mortgages on one- to four-family residences, and "consumer installment debt," which includes auto loans, student loans, credit card debt, personal loans and other nonmortgage credit.

billion in 1975[7] to $4.7 trillion in 1995[8] and $5.6 trillion in 1998.[9] Comparing those figures to aggregate annual household income, the 1975 ratio was 24%; in 1995 and 1998, the ratios were an astounding 104%.[10]

This growth is a two-edged sword, reflecting the dual character of debt.

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7. *Financial and Business Statistics*, 62 FED. RES. BULL. A1, A42 (1976) (one- to four-family mortgages: $491.7 billion); *Id.* at A46 (consumer installment credit: $162.2 billion).

8. *Financial and Business Statistics*, 82 FED. RES. BULL. A1, A35 tbl.1.54 (1996) (one- to four-family mortgages: $3.6 trillion); *id.* at A36 tbl.1.55 (consumer installment credit: $1.1 trillion).

9. *Financial and Business Statistics*, 85 FED. RES. BULL. A1, A35 tbl.1.54 (1999) (one- to four-family mortgages: $4.3 trillion); *id.* at A36 tbl.1.55 (consumer installment credit: $1.3 trillion).

While household debt figures are imprecise, the comparison of consistent benchmarks over time is telling. The Federal Reserve Board (FRB) mortgage figures do not distinguish mortgages taken out for personal, family, or household purposes—i.e. "consumer" debt, as defined at 15 U.S.C. § 1602(h) (1994)—from mortgages on investment property. Other FRB data indicates that about 15% of American households borrowed for real estate investment purposes in 1995. Arthur B. Kennickell et al., *Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances*, 83 FED. RES. BULL. 1, 20 tbl.12 (1997) [hereinafter Kennickell, et al., *Family Finances*].

On the other hand, these household debt figures may be understated, as they do not appear to include the type of household debt from the credit markets described in this Article, nor some of the nontraditional financing used to purchase homes, such as seller-held contracts. Also, auto leases are not included. Indeed, increases in auto leasing would actually show up as a decrease in consumer installment debt, *id.* at 17, though the impact on the household budget is the same.

10. Income figures were obtained from the Census Bureau's Current Population Reports: Consumer Income, by multiplying the mean household income by the number of households. *See* U.S. CENSUS BUREAU, CURRENT POPULATION REPORTS: CONSUMER INCOME tbls. B.2 (1975-$2.7 trillion), 2 (1995-$4.5 trillion and 1998-$5.4 trillion) (Mar. 1999).

This ratio is not a "debt-to-income" ratio as that term is commonly used. Debt-to-income measures monthly debt service payments in relation to monthly income. Among families with debt, that figure has gone from just 15.9% in 1989 to 17.6% in 1998. Arthur B. Kennickell et al., *Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances*, 86 FED. RES. BULL. 1, 26 (2000) [hereinafter Kennickell et al, *Recent Changes 2000*]. The above ratios nonetheless show a remarkable shift in the attitude and economics of America's households. And unlike the monthly debt-service figures, the outstanding balance figures hint at the longer time horizons facing the indebted household—longer horizons that limit the flexibility of the household to adjust to changing economic conditions or personal circumstances. For example, paying off a vehicle takes longer: in 1975, FRB figures used thirty-six months as the standard auto loan term; the average term for a new car loan in 1998 was fifty-two months. *Compare Financial Business Statistics*, 62 FED. RES. BULL. A1, A45 (1975) (Finance Rates on Selected Type of Instalment Credit) *with Financial Business Statistics* 85 FED. RES. BULL. A1, A36 tbl.1.56 (1999). If credit card payments are kept constant—for example, at $100 per month on 15% balances—the time necessary to pay off the growing outstanding credit card balances is far more dramatic. According to estimates prepared by the Consumer Federation of America, the average 1989 balance was $2100, compared to $6500 in 1996. Stephen Brobeck, *The Consumer Impacts of Expanding Credit Card Debt*, 1997 CONSUMER FED'N OF AM. REP., 5. This report shows higher balance figures higher than FRB data, but the FRB debt data is obtained from self-reporting surveys, which may understate debt. *Id.* Keeping the monthly payments constant expands that time horizon to pay off those balances from two years to over eleven years. *Id.*

Even the two names we give to this product reflect this dual character: "credit" has a positive connotation, but "debt" still rings with a negative one.[11] Credit can be used for productive investment for the household. Without question, a large portion of the increased ratio of aggregate annual income to debt load from 1975 is positive. The level of homeownership in this country has risen to historic highs—66% in 1998[12]—a fact reflected in of the higher level of mortgage debt.[13] It also reflects a rapid acceleration in attitude changes about debt.[14] There is an increasing willingness to "hock" the home through home equity lending, sometimes for long-term investment purposes such as education or home improvements, and sometimes for consumption—vacations or consolidation of credit card debt.[15] Credit card debt, which grew from $19.5 billion in 1975[16] to $586.5 billion in 1998,[17] is now used partly for asset building (such as financing the purchase of consumer durables), partly for convenience (such as avoiding carrying cash), and partly to finance consumption (such as groceries, vacations, and restaurant meals). Longer terms on auto loans and the advent of auto leases have encouraged us to buy more expensive vehicles more often.[18] However, debt can also be destructive, as

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11. *See* MERRIAM WEBSTER'S COLLEGIATE DICTIONARY 297 (10th ed. 1993) (listing the first meaning for "debt" as "sin, trespass").

12. Kennickell et al, *Recent Changes 2000, supra* note 10 at 15-18.

13. In addition to more families holding purchase money mortgages, the increased mortgage debt also reflects higher home prices. Overall, increased debt reflects acquisition of an asset of greater worth, though that worth is subject to the vagaries of the economy. The principal balance of a purchase money home loan does not decline if a regional recession lowers the value of the home.

14. Some of those changing attitudes may be driven by more aggressive marketing for debt and credit, as well.

15. The FRB estimates $420 billion in home equity loans in 1997. Glenn B. Canner et al., *Recent Developments in Home Equity Lending*, 84 FED. RES. BULL. 241, 242 (1998). The portion of households with equity loans rose from 5% in 1977 to 13% in 1997. *Id.* at 243. One commentator has suggested that government policies on using home equity to leverage debt should be neutral, rather than encouraging the practice through a variety of laws. Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TULANE L. REV. 373, 375 (1994).

16. *Financial and Business Statistics*, 62 FED. RES. BULL. A1, A46 (1976).

17. *Financial and Business Statistics*, 85 FED. RES. BULL. A1, A36 tbl.1.55 (1999).

18. Ana Azicorbe & Martha Stoor-McCluer, *Vehicle Ownership, Purchases, and Leasing: Consumer Survey Data*, 120 MONTHLY LAB. REV.34, 34, (1997). As with homes, the degree to which the indebtedness level relates to the acquired asset's value varies. The phenomenal growth of auto leases, of course, reflects an indebtedness that only buys the use of transportation, not the asset itself. Moreover, principal loan balances on automobile loans may be much higher than the value of the asset. Vehicles and mobile homes depreciate very rapidly, at a pace that often moves faster than the loan's declining principal balance. Consumers may thus be "upside down" on the loan (i.e. they may have debt exceeding the collateral's value) Such a circumstance can also arise for reasons unrelated to depreciation. For example, whether they understand it or not, many Americans have financed the purchase of new cars with loans that also refinanced remaining debt on the vehicle they traded in. This "negative equity" means that the debt exceeds the value of the asset acquired with it from the outset, totally apart from the matter of depreciation.

those who have lost their homes to foreclosure from "equity skimming" loans,[19] or those whose use of a high-rate, short-term lender has led to bankruptcy, can attest.[20]

For good and bad, the increasing willingness of Americans to go into debt has been part of the engine driving economic growth in the 1990s. But the rising debt load creates some challenges for credit providers as well. Growth is a goal of many businesses, and unless a credit provider diversifies,[21] growth comes by keeping its customers in debt, getting them deeper in debt, or getting more people in debt. Though the saturation point for debt—from a macroeconomic perspective—is unknown, the higher debt loads go, the more of a challenge it is for businesses that "sell debt" to grow.

All of these strategies have played a role in the development of the subprime consumer credit market, both directly and indirectly. As the "prime" market for credit became increasingly saturated, the "subprime" credit industry developed to move into markets previously considered to be high risk due to lack of credit histories, bad credit histories, inadequate income, or excessive demands on income. In the early part of this new wave, opportunities in this market were created by the absence of traditional lenders. Even the finance company industry, which historically had focused on the theoretically higher-risk, lower-balance loans, moved into higher-balance home equity loans and moved upscale in the process,[22] leaving the small loan territory open.

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19. "Equity-skimming" loans are home-secured loans that are typically very expensive (often in ways not reflected by the loan's price tag) and out of proportion to the value given. They are all too often made without regard to whether there is a realistic probability that the borrower can repay. For a general discussion of "equity skimming" loans and the threat to homeownership, see *Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong. (1993); *Home Ownership and Equity Protection Act: Hearing on S. 924 Before the Senate Banking Comm.*, 103d Cong. (1993); *The Home Equity Protection Act of 1993: Hearings on H.R. 3153 Before the Subcomm. on Consumer Credit and Ins. of the House Comm. on Banking, Finance, and Urban Affairs*, 103d Cong. (1994); *Community Development Institutions: Hearings Before the House Subcomm. on Fin. Insts. Supervision, Regulation and Deposit Ins. of the Comm on Banking, Finance, and Urban Affairs*, 103d Cong. (1993); *Equity Predators: Stripping, Flipping and Packing Their Way to Profits: Hearing Before the Senate Special Comm. on Aging*, 105th Cong. (1998); MICHAEL HUDSON, AMERICAN ASS'N OF RETIRED PERSONS, PREDATORY FINANCIAL PRACTICES: HOW CAN CONSUMERS BE PROTECTED? (1998); Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved With Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473 (2000). [hereinafter Mansfield].

20. *See infra* Part II.B.3.

21. The Financial Modernization Act of 1999, sought long and hard by the banking industry, permits their entry into the insurance and securities industries, avenues closed to them since the Great Depression. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999). The credit card industry's increasing use of cross-marketing to sell a variety of other products is undoubtedly part of this strategy as well.

22. *See infra* Part III.B. However, finance companies still hold a considerable share of the subprime mortgage market. As to the risk factor, some studies around the 1970s failed to find evidence to support the notion of risk segmentation. NATIONAL CONSUMER LAW CTR., THE

The subprime credit market runs the gamut from very small "micro" loans, through auto financing, and into high-dollar home equity lending.[23] Each segment of the subprime market—auto financing, home equity lending, and the relatively unexplored territory of subprime home purchase credit—could be the subject of its own study.[24] This Article, however, focuses solely on the small-sum, short-term segment of the subprime credit market (the "fringe" market). Part II will first describe the credit products offered in the fringe banking market: payday loans, refund anticipation loans, pawns and title pawns for cash advances, and rent-to-own products for retail sale. Part III will discuss their historical antecedents, and Part IV will discuss their market demographics. Litigation and legislative campaigns surrounding some of the products offered in the fringe market are discussed in Parts V and VI. Part VII examines the multiple purposes behind usury laws, which historically have been moral and social as well as economic. Part VII also analyzes the fringe banking marketplace in light of those purposes and notes some of the questions that have arisen about that segment of the market. Finally, Part VIII briefly surveys some possible alternatives to fringe credit products. This Article also asks whether fringe lenders genuinely price for risk, or instead *create* risk and take advantage of imperfect market conditions. These are questions that must be asked and examined by disinterested parties, not taken on faith.[25]

II. AN INTRODUCTION TO THE PLAYERS IN THE FRINGE BANKING SECTOR

The fringe banking system encompasses most of the functions of the mainstream banking system. This marketplace offers check cashing and payment services that parallel checking accounts in the mainstream system. It also offers the option to obtain cash and defer repayment or purchase goods and defer repayment—in short, credit capacity.[26] Significantly, however, the system does not offer a savings function[27] or the opportunity to create a positive credit

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COST OF CREDIT: REGULATIONS AND LEGAL CHALLENGES, § 11.1.1.2 n.14 (1995 and Supp. 1997) [hereinafter COST OF CREDIT] (citing numerous sources).

23. *See generally* Mansfield, *supra* note 19 (discussing the subprime home equity market).

24. COST OF CREDIT, *supra* note 22, at § 11.2 (discussing some of the issues in the subprime auto finance market). Generally speaking, purchase money home lending does not see the level of abuses that home equity lending does, but some devices that can be misused, such as the sale/leaseback, occasionally surface.

25. There is another question: how well does the market channel customers into the "appropriate" category? This Article touches on that question only incidentally, but the question also arises in the subprime mortgage context, and is generally discussed in Mansfield, *supra* note 19; FREDDIE MAC, OPENING DOORS: SERVING MORE OF AMERICA'S FAMILIES (1998).

26. "Credit" is defined by the Truth in Lending Act as "the right granted by a creditor to a debtor to defer payment of debt or to incur debt and defer its payment." 15 U.S.C. § 1602(e) (1994); *See also* Reg. Z, 12 C.F.R. § 226.2(a)(14) (1999) (containing an almost identical definition). As used in this section, "credit" is given this functional definition.

27. *See infra* Part VIII.

history.

The products in this sector share some common characteristics, the most immediately obvious one being that they are all very expensive. A particularly important characteristic of the credit-providing segments is that their product designs are rooted in an effort to enable the provider to argue that they are not extending "credit."[28] This strategy may allow fringe lenders to avoid several consumer protection and "market-perfecting" laws that protect other borrowing consumers, such as the federal Truth in Lending Act. Further, this strategy may allow fringe lenders to avoid price limits imposed by a state's interest rate ceiling on loans or credit sales; other regulation, including licensing and bonding, can be evaded as well. Finally, such a strategy may successfully dodge regulations that require the disclosure of annual percentage rates (APRs)—rates that may reach triple or quadruple digits on fringe loans.

A. *Check Cashers and Currency Exchanges*

The fringe banking financial system offers a rough parallel to mainstream checking accounts through check cashing outlets (CCOs) or currency exchanges (CEs). These businesses cash checks, including paychecks and benefit checks, for a per-check fee. They also sell money orders or wire transfers that customers can use to pay their bills. Banking services obtained through these outlets often cost around four times as much as those obtained from mainstream banks.[29]

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28. While much of the consumer credit marketplace was deregulated in the 1980s and 1990s, particularly mortgage lending and credit cards, in many states usury ceilings were retained on small loans and retail installment credit. Even in states like Illinois, where ceilings were removed completely, use of an evasive design enabled the creditor to argue that the Truth in Lending Act disclosure rules did not apply. Much of the rationale for deregulation is that disclosure will suffice and the market will decide the proper price. The First Circuit has noted that accurate disclosures take on even greater importance in a deregulated market. Chroniak v. Golden Inv. Corp., 983 F. 2d 1140, 1147 (1st Cir. 1993).

29. CASKEY, FRINGE BANKING, *supra* note 3, at 7. A study by the Chicago-based Woodstock Institute modeled costs for households of three different income levels; all paid more, and two of the three model households paid *"nearly four times as much"* for currency exchange services. WOODSTOCK INST., REINVESTMENT ALERT: CURRENCY EXCHANGES ADD TO POVERTY SURCHARGE FOR LOW-INCOME RESIDENTS 7 (No. 10, 1997) [hereinafter WOODSTOCK INST., CURRENCY EXCHANGES]. A Boston study's model found that a family with $1050 after-tax monthly income would pay $219 a year at a check casher in a state where basic banking account fees would cost approximately $36 per year. Lesly Jean-Paul & Luxman Nathan, *Check Cashers: Moving from the Fringe to the Financial Mainstream*, COMMUNITIES AND BANKING (Federal Reserve Bank of Boston) Summer 1999 at 2, 10.

A Consumer Federation of America (CFA) study noted that the average cost of cashing a social security check at a CCO rose 37% between 1987 and 1997. *The High Cost of Banking at the Corner Check Casher: Check Cashing Outlet Fees and Payday Loans*, 1997 CONSUMER FED'N OF AM. REP. This occurred despite the increased "competition" that the proliferation should have brought, which highlights one of the problems the AFS sector presents for economists—that competition has not worked to lower prices for customers in this sector for a wide variety of reasons. *See infra* Part VII.

Some CCOs and CEs now offer fringe credit products as well. Trade association figures indicate that one-half of CCOs currently offer payday loan services, a figure which should increase to two-thirds in 2000.[30]

B. Cash Advance Providers[31]

The credit function is currently divided among four basic models. Three types of fringe market providers focus on short-term cash advances in small amounts, while a fourth, rent-to-own, serves as the fringe market's version of retail installment sales credit. The advantages stressed by these providers are easy and quick access, even for those with blemished credit histories.[32] Some claim not to pull credit reports, though some fringe lenders do use a specialized fringe credit reporting system.[33]

1. Pawns, "Auto-Title Pawns," and "Title Loans"

While pawnbroking is certainly not a new source of credit for the economically marginalized, the latter part of the twentieth century saw both a resurgence of the model and the emergence of a few new twists. A 1994 study of pawnbrokers notes that the number of pawnshops listed in America's Yellow Pages jumped from 4849 in 1985 to 8787 in 1992.[34] The nature of the pawn business also changed. The corner pawnbroker was joined by a corporate presence, and the industry began to look for "merchandising respect."[35] Most significantly for the two-tier marketplace, the industry added a new twist—the auto-pawn, in which the consumer "pawns the title, keeps the car." In all practical respects, such title-pawns offer a species of small loans secured by a nonpurchase money interest in the borrower's car.

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30. *Forum on Short-Term High-Interest Paycheck Advances*, convened by Sen. Joseph Lieberman, ranking minority member, U.S. Senate Comm. on Governmental Affairs (Dec. 15, 1999) (written testimony of Robert E. Rochford, Dep. Gen. Counsel for the Financial Serv. Ctrs. of Am.), at 4 [hereinafter Lieberman Forum (Rochford testimony)]; *id.* (written testimony of Leslie J. Pettijohn, Comm'r, Office of Tex. Consumer Credit Comm'n), at 1. [hereinafter Lieberman Forum (Pettijohn testimony)].

31. As used in these descriptions, credit is used in its functional sense. See *infra* Part V for a separate discussion of legal characterization of the products.

32. A typical ad may read: "CA$H LOANS FOR YOUR CAR TITLE, $$ IMMEDIATE CASH $$, BRING YOUR TITLE, KEEP YOUR CAR, NO CREDIT CHECK,"or "CASH FOR CAR TITLES, CASH INSTANTLY, BORROW $450 to $10,000." One of the downsides of such quick and easy access is that the transaction's terms may be presented without meaningful disclosure.

33. *See infra* Part VII.B (regarding credit reporting in the AFS); *see also* ILLINOIS DEPT. OF FIN. INST., SHORT-TERM LENDING: FINAL REPORT, *available at* <http://www.state.il.us.dfie/publications.htm>(visited Feb. 18, 2000) 28 [hereinafter DFI REPORT].

34. CASKEY, FRINGE BANKING, *supra* note 3, at 46.

35. Michael Hudson, *The New Loan Sharks*, DOLLARS & SENSE, July 17, 1997, at 14, 17.

Traditional pawns are structured as pledges, "sales," or "conditional sales" of the borrower's property to the pawnbroker, subject to the right of redemption. The pawnbroker takes physical possession of the pledged property, paying the customer for it. The consumer may redeem the property by paying a higher amount later, usually in one month. In theory, there is no legal obligation to pay the redemption amount. Pawnbrokers generally are not treated as lenders for purposes of the statutes governing small loans.[36] In some states pawnbrokers are totally exempt from usury ceilings, while in others special rate ceilings apply to them.[37]

The auto and auto-title pawn loans were designed to take advantage of this special treatment afforded pawn transactions while enjoying the security afforded by taking the consumer's transportation as collateral for a very small cash loan. While a few auto pawnbrokers demand physical possession of the vehicle, such practice obviously creates greater sales resistance. Thus was born the auto-title pawn, or "title loan." The first incarnation echoed the sale/leaseback schemes that have long been used to dodge usury laws.[38] The borrower pledges the title, and the pawnbroker "leases" the vehicle back to the consumer. Some lenders require the customer to turn over a key to the car to facilitate repossession.[39] They commonly limit the loan amount to one-third of the book value of the car, making the loans more than fully secured.[40] While some transactions may involve weekly installments, the typical title loan is a one month, single payment loan.

The APR price tag for such a transaction is typically in the triple digits. For example, in *Pendleton v. American Title Brokers, Inc.*,[41] the consumer took out an auto-title loan and received two advances for $100 and $400. Her pawn/loan

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36. Though they are generally exempt from state loan licensing requirements, pawnbrokers are commonly licensed at the municipal level instead. In Florida, this practice led to a shift of legislative focus from the state legislature to city councils. *See infra* Part VI.C.

37. *See, e.g.*, COLO REV. STAT. § 5-1-202(4) (1999) (providing that the Colorado Consumer Credit Code rates, charges, and disclosure requirements do not apply to pawnbrokers); FLA. STAT. ANN. § 539.001 (West 1994) (subjecting pawnbrokers to special rules and rate ceilings); GA. CODE ANN. §44-12-131 (1982) (providing special pawnbroker rates).

38. Sale/leaseback schemes involve borrowers (debtors) "selling" their property (their home or personal property) to a "buyer," who then offers either to "sell" it back to or "lease" it to the borrower with a repurchase option. For example, in Bantuelle v. Williams, 667 S.W.2d 810 (Tex. App. 1983), the borrowers "sold" their home for $1342 (coincidentally the amount delinquent on their first mortgage) and received an option to repurchase it for $2342 within two months—an effective APR of 444%. Courts review such transactions carefully, looking to a variety of factors to determine when a sale/leaseback or sale/repurchase agreement is functionally a secured loan, disguised in order to evade credit regulation. *See generally* COST OF CREDIT, *supra* note 22, at §§ 7.5.2.1-.2 (collecting cases involving challenges to sale/repurchase and sale/leaseback schemes).

39. Some fringe auto sales and finance companies reportedly keep a key to the vehicles they sell for the same reason.

40. DFI REPORT, *supra* note 33, at 4; Joseph B. Cahill, *License to Owe: Title-Loan Firms Offer Car Owners a Solution That Often Backfires*, WALL ST. J., Mar. 3, 1999, at A1.

41. 754 F. Supp. 860 (S.D. Ala. 1991).

contract made the loans repayable with interest in weekly installments. She also signed attached leaseback agreements by which the pawnbroker leased back her vehicle under a concurrently running contract. The weekly rental amount equaled 10% of the loan, along with credit insurance and other fees. When all the incidental credit-related charges were tallied, the transactions carried effective APRs of 902% and 977%.[42]

The more typical rates on these secured loans are in the 200% to 300% range. The Illinois Department of Financial Institutions recently completed a survey of short-term lending, reporting an average APR of 290% among its licensed title loan companies.[43] A 1998 Florida Public Interest Research Group (PIRG) survey of title lenders found an average APR of 273%. The most common charge for a $400 loan was $88 a month, or 264% APR.[44] Fees are typically a percentage of the amount borrowed for the one-month loan term. In Florida, where title loans are legal, the percentage is capped at 22%—that is, 22% a *month*, which translates to 264% a year.[45] Borrowers, however, may believe that their annual rate is capped at 22%.[46] The industry-drafted law may encourage this misperception by requiring that the borrower initial the 22% fee language, but not the language disclosing the APR.

Because auto-title loans routinely require repayment soon after the transaction is completed, many customers cannot make the full principal and interest payment when it comes due. As a result, the loan is often extended for another fee (some contracts allow the lender to do so unilaterally). This cycle of renewals can create a "debt treadmill" or downward spiral effect that is at the root of much of the concern about cash lending in the fringe market.[47] Such a practice also complicates objective assessment of the industry's justification for

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42. *Id.* at 862. The ten-week repayment term for the $100 loan at $22.88 weekly yields an effective APR of 977%. Weekly charges on the $400 loan worked out to $87, which yields an effective 902% APR for a ten-week term. *Id.*

43. DFI REPORT, *supra* note 33, at 26; *see also* Cahill, *supra* note 40 (citing a 260% APR). The latter figure of 260% may understate the cost of the loan featured in that report. One of the authors, who represented the consumer, calculated a 450% APR. Amended Complaint, Churchwell v. National Title Loan, Inc., No. 96-5098-CA (4th Cir., Fla. Cir. Ct., filed Sept. 27, 1996).

An Illinois attorney who represents AFS borrowers in a number of class actions indicates a typical title loan range of 200% to 300%, as well. *Payday and Title Loans: Hearing Before the Illinois Senate Fin. Comm.* (1999) (prepared testimony of Daniel A. Edelman, et al. on behalf of the Illinois Consumer Justice Council, Inc.) [hereinafter Edelman testimony].

44. *New Survey Shows Outrageous Interest Rates Charged by Florida Title Loan Companies* (visited Feb. 18, 2000) <http://www.igc.org/pirg/floridapirg/consumer/loan98.htm>.

45. FLA. STAT. ch. 538.06(e) (1995).

46. In fact, the legislature that enacted the law may have thought the same thing. *See infra* Part VI.

The CBS news magazine *60 Minutes* investigated title lending in Florida. *60 Minutes: Need Cash?* (CBS television broadcast, Jan. 2, 2000), *available in* LEXIS, Burelle's Information Services, CBS News Transcripts. One of the customers interviewed explained she believed the rate was 22% a year. *Id.*

47. *See infra* Part II.B.3.

pricing based on "risk" and default rates.[48]

Some title lenders obtain used car dealer licenses in order to sell the repossessed cars to other consumers on the retail market. Otherwise, vehicles may be disposed of through wholesale auto auctions. "Pawn" laws may not require that surpluses from the sale of a pawned item be returned to the customer, but even if they do, return of a surplus is rare.[49]

While pawnbroking is an ancient form of lending, many people believe that title loans (by whatever name) are qualitatively different. Except in a few cities with good mass transit systems, most people need cars to get to work, take their children to day care, or to go to school. For this reason, there is a schism even between traditional pawnbrokers and the title loan industry.[50] "'Somebody forfeits their VCR—life goes on. But you lose your car—that's a different ballgame. Now you're talking about somebody's livelihood.'"[51] Florida's Attorney General Robert A. Butterworth, an outspoken critic of title loans, has also commented on the high stakes involved in the title loan industry. In reference to Florida's legalized 264% rate, he told a national television audience "We've legalized loan sharking. We've made even the Mafia look good."[52]

The title pawn industry has grown immensely in the relatively short time it has been around, though it is legally sanctioned in only a few states.[53] Illinois currently has ninety licensed title lenders, most located in the Chicago area.[54] In Florida, one of the states where title lending is most entrenched, title lenders write approximately $225 million in loans annually.[55] It is impossible to know how much title lending is going on illegally.

2. *Payday, Check, or "Deferred Deposit Services" Loans*

Payday lenders make short-term cash loans—generally by taking a post-dated check from which they withhold a fee, and advance the remainder in

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48. *See infra* Part II.D.

49. CASKEY, FRINGE BANKING, *supra* note 3, at 40-41. Keep in mind that most auto title loan amounts are limited to one-third of the value of the car. *But see* Part V (discussing a recent decision of the Florida Attorney General on surpluses under Florida's title loan law).

50. *See infra* Part VI.

51. Cahill, *supra* note 40 (quoting an official of a large pawn chain). Florida pawnbrokers lobbied to prevent auto title lenders from using the pawn name. *See infra* Part VI.C.

52. *60 Minutes*, *supra* note 50, at 2.

53. Some of these state laws include FLA. STAT ch. 538.03, 538.06(5) (1995); GA. CODE ANN. § 44-12-130(5) (Supp. 1999); KY. REV. STAT. ANN. §§ 368.200-368.285, 368.991 (Michie 1998); MINN. STAT. § 325J.095 (Supp. 2000); MISS. CODE ANN. §75-67-401 to -433 (Supp. 1999); MO. REV. STAT. § 367.500-533; TENN. CODE ANN. § 45-15-101 to -120 (Supp. 1999); *see also* LA. REV. STAT. ANN. § 37:1781-1808 (West Supp. 2000) (defining "pawn" broadly); *State of Nevada—Attorney General/1995 AG Opinions: Opinion* (visited Feb 13, 2000) <http://www.state.nv.us/ag/>.

54. DFI REPORT, *supra* note 33, at 11-12.

55. Cahill, *supra* note 40.

cash. Some transactions use delayed automatic debit agreements instead of checks. Deposit of the check or automatic debit is deferred for an agreed-upon time, which may be tied to the next payday (even if only a matter of days), or for a scheduled period of time up to a month. The process works like this: If you want to borrow $100 and the fee is $15, you give the lender a check for $115, postdated to the end of the loan term. The lender gives you back $100 in cash.[56] When the loan comes due, you can go back and give the lender $115 in cash or money order to redeem the check, or you can let the lender deposit your check to pay it off. If you cannot pay it back in the short turnaround time, you can pay another $15 fee to extend it.[57] To avoid appearing to roll over the debt, the lender may ask you to take out a "new loan," in which case you pay the $15 fee, but write another check for $115. In a practice called "touch and go,"[58] lenders may take a cash "payoff" for the old loan that they immediately reloan with new loan funds. Irrespective of whether the repeat transactions are cast as "renewals," "extensions," or "new loans," the result is a continuous flow of interest-only payments at very short intervals that never reduces the principal. For customers who "borrow from Peter to pay Paul" by going to another lender to get the cash to pay off the first loan, this can result in a pyramid effect. To keep Lender Paul's $115 check from bouncing, the borrower may end up writing a new check to Lender Peter for over $130. The new loan principal is now $115 ($100 principal plus $15 interest on Paul's loan), plus Lender Peter's new fee for a $115 loan (which may be higher than the $15 fee for a $100 loan). This refinancing cycle can snowball the original debt.[59] Upon default, some lenders deposit the check, generating bounced check fees and perhaps a civil bad check penalty, which can be three times the amount of the check

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56. One Florida ad observed by the authors explains these requirements: "MUST SHOW YOU HAVE A FULL TIME JOB, OPEN CHECKING ACCOUNT, WITH LAST TWO RECENT STATEMENTS, WORKING HOME TELEPHONE, LAST TWO PAY STUBS, VALID FLORIDA DRIVER'S LICENSE OR STATE I.D." *See also* DFI REPORT, *supra* note 33, at 28.

57. The Illinois Department of Financial Institutions reports that the checks are rarely cashed, as many bounce. Customers are instead asked to bring cash payments every two weeks, though this violates Illinois law. DFI REPORT, *supra* note 33, at 8. *But see infra*, Part II.B.3.

58. *Forum on Short-Term High-Interest Paycheck Advances*, convened by Sen. Joseph Lieberman, ranking minority member, U.S. Senate Comm. on Governmental Affaris (Dec. 15, 1999) (written testimony of Edward J. Gallagly, Pres., Fla. Cent. Credit Union), at 2 [hereinafter Lieberman Forum (Gallagly testimony)].

59. Iowa's Delayed Deposit Services Licensing Act authorizes a $15 fee for the first $100 and $10 per $100, pro rata, thereafter. IOWA CODE ANN. § 533D.9 (West 1999).

On the recycling of debt, see, for example, *Forum on Short-Term High-Interest Paycheck Advances*, convened by Sen. Joseph Lieberman, ranking minority member, U.S. Senate Comm. on Governmental Affairs (Dec. 15, 1999) (written testimony of Capt. Robert W. Andersen, Commanding Officer, U.S. Navy Patrol Squadron 30), at 2 [hereinafter Lieberman Forum(Anderson testimony)]; *id.* (written testimony of Mark Tarpey, Ind. Dept. of Fin. Institutions) [hereinafter Lieberman Forum (Tarpey testimony)]; Lieberman Forum (Gallagly testimony) *supra* note 62, at 1-2. See generally *infra* Part II.B.3 on the debt treadmill.

under some state laws.[60] According to an attorney who has represented Texas payday loan customers, some payday lenders compound the bad check fees by having the customers break one loan into several small checks, so that several bounced check fees can be charged if the customer defaults.[61]

The most common term for a payday loan is two weeks, and loan amounts are generally under $1000. In states that have authorized payday lending, the maximum loan amounts permitted range from $300 to $1000, with $500 being a common cap.[62] A survey by the Indiana Department of Financial Institutions, which regulates payday lending in that state, found an average loan amount of $165.[63] Fees may be a percentage of the loan amount, as with title loans, or they may be a flat fee. A few states, such as Indiana, do not have legislation explicitly addressing payday lending, but may have a statutory minimum finance charge comparable to other payday loan fees. Payday lenders in Indiana have been operating under the assumption that a $33 minimum finance charge permissible under the Indiana Consumer Credit Code sanctioned their business.[64] A recent Attorney General's opinion disagrees.[65] In states that have no usury ceilings on small loans, payday lenders can operate under existing lending law without need for special authorizing legislation, as is the case with Illinois.[66] The fees for a $100 loan range from $15 to $33.50.[67] For the most common two-week loan term, those APRs range from 390% to 871%.[68] Surveys by regulators in Illinois and Indiana found average payday loan APRs of 533% and 499%, respectively.[69]

Because most of these are flat fees, making the loan term shorter than two weeks will raise the APR. The highest-priced payday loan the Indiana

60. *See infra* Part II.B.4.

61. According to this attorney, one lender made the borrowers write a check for each $100 increment of the loan, plus a separate one for the fee. Thus, a $400 loan consisted of four $100 checks, plus a fifth for $132 in fees ($33 in fees per $100 of loan). If the debtor defaulted, the lender would charge $125 in NSF fees—$25 for each check.

62. The status of payday lending under state law is currently highly fluid, as each legislative session brings efforts in several states. The Consumer Federation of America, which monitors the payday lending industry, has published annual reports since 1997 which include surveys of state laws applicable to payday lending. *See* Jean Ann Fox, *Safe Harbor for Usury: Recent Developments in Payday Lending*, 1999 CONSUMER FED'N OF AM. REP. 1, 11, app. A, *available at* <http://www.consumerfed.org/safeharbor.pdf> (visited Sept. 1999); *see also* COST OF CREDIT, *supra* note 22, at app. A (including citations to state laws regulating consumer credit). This article also provides a list current through the 1999 legislative season. *See infra* note 410.

63. Lieberman Forum (Tarpey testimony), *supra* note 59, exhibit B, at 1.

64. IND. CODE ANN. § 24-4.5-3-508(7) (Michie 1996); *see infra* Part V.

65. Ind. Op. Att'y Gen. No. 2000-1 (Jan. 19, 2000).

66. Illinois Consumer Installment Loan Act, 205 ILL. COMP. STAT. ANN. 670/1-24.5 (West 1993 & Supp. 1999). Payday lenders are "regulated" and must be licensed, DFI REPORT, *supra* note 33, at 3, but there is no legal cap on interest, *id.* at 19.

67. Fox, *supra* note 62, at 11.

68. *Id.*

69. DFI REPORT, *supra* note 33, at 26; Lieberman Forum (Tarpey testimony), *supra* note 59, exhibit B, at 1.

regulators found was $20 on a one-day $100 loan—a 7300% APR.[70] This element of an APR price tag leads some in the industry (and outside) to argue that APR disclosure is "inappropriate" for short-term loans: [71] "The consumer wouldn't pay 1,800 percent a year to borrow $100. But if you tell the consumer that it costs $18 to borrow that $100 for a period of fourteen days, then it seems fair to them."[72] There are a number of responses to that criticism. First, it ignores the fact that the Truth in Lending Act was enacted to establish a standardized price tag that consumers could use to comparison shop.[73] People think of credit rates in "per year" terms, and the Truth in Lending Act (TILA) requires that all lenders use this standard unit pricing to prevent some lenders from using low-ball quotes to make their higher-priced debt look cheaper.[74] Second, disclosing a loan's APR is important in order to fully inform consumers about the price they pay to rent money. Consider an analogous hypothetical: an apartment renting for $500 a month is clearly cheaper than one renting for $500 a night. A place to sleep for the whole month of April costs $500 from the first landlord, but $15,000 from the second.[75] Thus, disclosing the long-term cost of the transaction enables the consumer to readily compare its relative advantages against other available alternatives.[76]

However, even with accurate APR disclosure, the already short loan terms of most fringe loans can be manipulated to make these transactions more costly to the consumer than the APR would reflect. This is possible because while over half of the states authorizing payday loans have maximum loan terms, only four have minimum loan terms.[77] Thus, lenders can usually truncate loan terms to maximize costs. For example, a $20 flat fee for a $100 loan with

70. Lieberman Forum (Tarpey testimony), *supra* note 59, exhibit B, at 1. Illinois attorneys who represent AFS borrowers in a number of class actions report 2000% APRs. *See* Edelman testimony, *supra* note 43.

71. *See, e.g.*, Lieberman Forum (Rochford testimony), *supra* note 30, at 15 (suggesting that applying APR analysis to payday loans is "quite inappropriate").

72. Jean-Paul & Nathan, *supra* note 29, at 12 (quoting Abby Hans, an official of the National Check Cashers Association (NaCCA), now renamed Financial Service Centers of America (FiSCA)).

73. *See, e.g.*, Mourning v. Family Publications Serv., 411 U.S. 356, 363-64 (1973) (noting the "divergent, and at times fraudulent, practices by which consumers were informed of the terms of the credit extended to them" as the reason for TILA).

74. Prior to TILA, lenders quoted rates in different measures. For example, a "6%" loan could actually be considerably more expensive than a "10%" loan if the former was a discount rate and the latter an actuarial rate. NATIONAL CONSUMER LAW CTR., TRUTH IN LENDING § 1.1.1 (4th ed. 1999).

75. And those who take the one-night $500 apartment have to come up with another $500 twenty-four hours later, not thirty days later—which comes full circle back to the debt-treadmill problem, an insidious feature of short-term lending. *See infra* Part II.B.3. It also illustrates the importance of the demographics of the customer base. A Los Angeles lawyer may not mind a $500 per night hotel while he is in New York for one night, but a trucker who regularly needs a place to stay in New York will soon find that rate a significant drain on his resources.

76. This includes the consumer's option to enter into no transaction at all.

77. Fox, *supra* note 62, app. A.

a one-month fixed term would cost $20. But if the lender writes the same loan for a two week term and then renews it, the debtor will use the same $100 for the same length of time, but at a price of $40.[78] This may help explain why two weeks is the most common term for payday loans. The Indiana DFI found evidence of this abusive practice when it found loans with initial fourteen-day terms being reduced to seven-day terms upon renewal. Some lenders reduce loan terms even when the borrower's pay period is bi-weekly, making it less likely the borrower will pay it off when due.[79]

As with auto-title pawns, payday lenders initially took the position that credit regulatory and disclosure laws did not apply to them. Their argument was (and, in some cases, still is) that their fee is for "cashing a check," not for extending credit. As the legal and regulatory response to this stance has been almost universally unfavorable,[80] some other "new" variations in form are surfacing (or resurfacing, to be more precise). Texas, in particular, is home to payday lenders eager to avoid credit laws through artful dodges. One example involves an ad that reads "Cash in Minutes—Checking Account Required. Not a Loan. 15 Min. approval. No credit check. No hassle." Consumers who respond to the ad pay $33 per $100 borrowed for two weeks. The fee is purportedly applied toward the "purchase" of one twenty-character "ad." They get to choose the "ad" from a laundry list, including "Go Cowboys" and "Jesus Loves You." The ad is supposed to be placed in a publication distributed by the lender to its customers. After six "cashback ad" purchases, the lender magnanimously guarantees no further ad purchases will be necessary. The APR on these "ad" loans is 860%.[81] A similar scheme ties the loan to the required purchase of a "gift certificate" that must be used to order something of "questionable value" from the lender's catalog.[82]

This segment of the fringe credit market has grown quickly. Payday lending was authorized in Iowa in 1995, and by 1999 had eighty licensees.[83] In the decade or so since the postdated check loan business first appeared

78. Truth in Lending is not a help in this regard. If handled as an extension or deferral, it does not trigger new TILA disclosures, Reg. Z, 12 C.F.R. § 226.20(a)(1) (1998). If a "new loan" is written for two weeks, it will still disclose a price tag based on the two-week term.

79. Lieberman Forum (Tarpey testimony), *supra* note 59, at 3

80. *See infra* Part V.

81. Details are from Memorandum in Support of Plaintiffs' Motion for Class Certification, Rodriguez et al v. Cash Today, Inc., No. C-99-305 (S.D. Tex., filed ****). The Texas Attorney General sued this lender. Texas v. Cash Today, Tex. Dist. Ct. No. 99-02673 (Dec. 17, 1999); *see infra* Part V.

82. Lieberman Forum (Pettijohn testimony), *supra* note 30, at 3.

83. DIVISION OF BANKING, IOWA DEPT. OF COMMERCE, 1999 ANNUAL REPORT OF THE SUPERINTENDENT 86-89 (1999).

(illegally)[84] it has become a growth industry, complete with national chains.[85] About half the states now authorize payday loan services,[86] and the number of licensees nationwide is estimated to be between 6000 and 9000.[87] The industry reported $810 million in fee income for 1998 and it projects $2 billion in 2000.[88]

As noted earlier, in addition to the nationwide chains of payday lenders, check-cashing outlets are expanding into the business. Such lending is even expanding into states in which payday lending has not been legislatively authorized, or under terms that would not be legal under state payday lending laws. Some payday lenders have teamed up with depository institutions based in states with low (or no) interest rate regulation. Because federal law gives national banks and some other depository institutions the right to "export" the law of their home state nationwide, lenders argue that these loans may be made in states in which their terms would be illegal if made directly. Such so-called "rent-a-bank" or "rent-a-charter" payday lending may become a significant barrier to state regulation of fringe market lending.[89]

3. *The "Debt-Treadmill": Roll Overs and Renewals*

Many readers may be too young to remember the old Tennessee Ernie Ford song, "Sixteen Tons," with the lyrics "another day older and deeper in debt."[90] Much of the concern about short-term fringe lending arises over the question of whether it is, at best, a "debt treadmill" or at worst, a downward spiral. The industry argues that it is neither, instead viewing such lending as a bridge enabling passage through temporary setbacks, and these lenders deny that roll

84. Joe Stephens, *Postdated Check Firms May Violate Usury Laws*, KAN. CITY STAR, Oct. 23, 1988, at A1. It also took hold in other states before it was legal. *See infra* Part V.

85. Peter T. Kilborn, *Lenders With Huge Fees Thrive on Workers With Debts*, N.Y. Times, June 18, 1999, at A1; Jean Ann Fox, CONSUMER FEDERATION OF AMERICA, THE GROWTH OF LEGAL LOAN SHARKING: A REPORT ON THE PAYDAY LOAN INDUSTRY, (1998) [hereinafter LEGAL LOAN SHARKING].

86. *See infra*, Part VI; *see also* Fox, *supra* note 62, at 5 (citing twenty-three states that permit payday loans).

87. *Forum on Short-Term High-Interest Paycheck Advances*, convened by Sen. Joseph Lieberman, ranking minority member. U.S. Senate Comm. on Governmental Affairs (Dec. 15, 1999) (transcript), *available at* 1999 WL 1242421, at 62 [hereinafter Lieberman Forum Transcript]; *id.* at 2(written testimony of Billy Webster, President-Elect, Community Fin. Servs. Ass'n (CFSA)) [hereinafter Lieberman Forum (Webster testimony)].

88. Lieberman Forum (Rochford testimony), *supra* note 30, at 12.

89. *See e.g.*, Lieberman Forum (Pettijohn testimony), *supra* note 30, at 3-4. Exportation is a factor in the Refund Anticipation Loan (RAL) market, as well, see *infra* Part II.B.5, and there are concerns it may crop up in the title loan market, too. For more discussion on the legal aspects of exportion, see *infra* Part V.

90. Tennessee Ernie Ford, *Sixteen Tons*, *on* SIXTEEN TONS (Capitol Nashville Records 1960).

overs are a significant problem.[91] The lenders focus on the convenience of short-term lending: it is handy, quick, and hassle-free; there are no obstacles such as bad credit records.[92] Moreover, payday lenders deny targeting lower-income customers, pointing to the increase in such lending in the suburbs and among higher-income groups.[93]

Another justification advanced by the industry is that these loans enable people to avoid the high costs of bounced checks. Both trade association spokesmen testifying at the Lieberman Forum argued that the cost of payday lending is cheaper than bouncing checks. Their position: against the potential insufficient fund fees for bouncing a $100 check, which could total $50 (one from the merchant and one from the bank), a $20 payday loan fee is a bargain. Compared to bouncing four checks to four merchants, the resulting $100 to $150 insufficient fund fees would dwarf the $15 to $20 payday loan fee. Furthermore, lenders argue that a bank may close a bank account as a result of bounced checks. Bounced checks and closed accounts "will affect adversely the consumer's credit-worthiness and can create a snowball effect of negative economic impacts."[94] Critics find this argument unpersuasive because most people do not write bad checks when they are strapped for cash. Moreover, the comparison is misleading because resorting to a payday lender often only defers the bounced check charges. In fact, it can compound the problem because some of these lenders use threats of criminal prosecution as a collection tactic or seek treble-damage bad check penalties when these loans default.[95]

But whatever weight such arguments bear for the occasional customer, they do not suffice for the repeat customer. Critics of the fringe lending industry fear that it is the industry itself that is likely to create a "snowball effect of negative economic impacts" from servicing high cost, short-term debt.[96] Several egregious examples of abuse illustrate the snowball effect:

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91. "I look at us like the last rung on the ladder. . . . They can use it to go up or down." Cahill, *supra* note 40. One of the trade association spokesmen told the Lieberman Forum that "only a *tiny* number of transactions result in more than one rollover, of the perhaps 10% of transactions that result in any rollovers at all." Lieberman Forum (Rochford testimony), *supra* note 31, at 18.

92. *See, e.g.*, National Check Cashers Association, Inc., *Freedom of Choice for Consumers: The Truth About Deferred Deposit Services—A Reasoned Response to the CFA's Misrepresentations* (visited May 1999) <http://www.nacca.org/ddresponse.htm>.

93. Lieberman Forum (Rochford testimony), *supra* note 30, at 3.

94. *Id.* at 11-12; Lieberman Forum (Webster testimony), *supra* note 87, at 7.

95. *See infra* Part II.B.4. Not surprisingly, legal services attorneys working with payday loan borrowers report that banks close accounts for those who have defaulted on payday loans. Since many banks will not open accounts for those who have had accounts closed elsewhere, the payday loan experience may turn a "banked" customer into one of the "unbanked."

96. *See, e.g.*, Lieberman Forum (Andersen testimony), *supra* note 59, at 2 ("[T]he [borrower] living payday to payday will be short for normal bills due to his previously written cash advance check and the fees associated with the advances. So now he will go to another cash advance or the same one (as the lender hopes) to cover the next bills for more than the previous

* A *Wall Street Journal* article on title pawns reported on a woman who lost her car to repossession after paying $400 in interest on a $250 loan.[97]
* The *60 Minutes* segment on title lending featured a customer who had borrowed $400 for legal fees in a custody matter and had paid $88 a month for fourteen months, totaling $1246, to service that $400 debt—and still owed $330.[98]
* Another customer with an income of only $600 from social security disability borrowed $500 to pay medical bills; after more than $2000 in interest payments over the course of a year and a half, he still owed $612, and feared he had no choice but to let the lender take his truck.[99]
* One Navy household borrowed $1700 for mortgage payments: 20 months of $370 payments later ($7400), the borrower still owed the full principal and interest. Another $2070 would be required to retire that debt and protect the family car from repossession by the title lender.[100]
* In Kentucky, payment of $1000 in fees over six months made no progress in reducing $150 of loan principal; in Tennessee $1364 over fifteen months paid down only $152 of a $400 loan.[101]
* A Navy captain told the Lieberman Forum of a sailor writing $2,893 in checks to cover $2,550 in cash advances.[102]

Precisely to avoid the treadmill trap, some states prohibit or limit renewals or refinancings on payday loans,[103] but enforcement is difficult. As described

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cash amount. This culminates in a snowball effect or financial death spiral they cannot recover from.").

In economic terms, this compounding effect that feeds on itself is a "self-reinforcing feedback loop." While the general tendency today is to think about market dynamics in terms of moving toward "equilibrium," self-reinforcing feedback loops can have a direction. That direction can be negative as well as positive. *See infra* Part VII.A.

97. Cahill, *supra* note 40.

98. *60 Minutes*, *supra* note 46, at 2.

99. *Id.*

100. That would be a total of $9470 to borrow $1700 for a little over one-and-a-half years—for a military family for whom interest-free loans are available. Letter from Rear Admiral K.C. Belisle, U.S. Naval Reserve, Commander, Naval Base, Jacksonville, Fla., to John Delaney, Mayor of Jacksonville, (Nov. 3, 1998) (on file with author); John Fritz, *Navy Targets Personal Finance*, FLORIDA TIMES-UNION, Oct. 9, 1998, at B-1.

101. LEGAL LOAN SHARKING, *supra* note 85; *see also* Kilborn, *supra* note 85 (reporting of a single mother making $25,000 per year who turned to payday lenders when her child support stopped; in 6 months "she owed $1,900 and was paying fees at a rate of $6,006 a year").

102. Lieberman Forum (Andersen testimony), *supra* note 59, at 2. Another sailor trying to juggle biweekly interest checks to four lenders was writing $1602.94 in checks to get $1396 in loan "income." (He had gone to the lenders in the wake of a divorce.) Juggling the payday loan cycle and his regular expenses of $850 against his income left him $257 in the hole a month. This is a real life example of the budget deficit analysis performed by the staff for the Lieberman Forum, see *infra* Part IV.

103. *See, e.g.*, IOWA CODE ANN. § 533D.10.1.e (West Supp.1999).

earlier, lenders use "new loans" in a variety of forms to evade this restriction.[104] The Iowa Banking Department has issued an interpretation informing lenders that the prohibition on roll overs means there must be at least a day between loans, but even that has not been a complete success.[105] Finally, even when renewal limitations are observed by lenders, the economic impact on the customer who borrows from Peter to pay Paul is exactly the same.

This recycling of high-rate debt makes it difficult to get a firm grip on the renewal problem. Nonetheless, the findings of regulators in Illinois and Indiana give credence to the concerns about roll overs. Indiana's survey found a 77% renewal rate, with the average customer renewing ten times and a high of sixty-six times.[106] As the Department of Financial Institutions' Consumer Credit Division supervisor explained, "There is no incentive for the lender to not allow the customer [roll over] since it results in continuing fee income and more repeat business."[107] The Illinois study similarly reported that the single use customer is rare. "[I]n fact, repeat business is the main source of revenue."[108] The Illinois DFI found an average of thirteen contracts per payday loan customer, for an average time horizon of six months. For title loan customers, the average time horizon is 3.5 to 4.5 months, with 2.5 roll overs.[109]

An industry survey of high-rate, short-term, low-principal loans in Oklahoma found that 82.4% of the 1994 loans were made to repeat or regular customers. The average amount of these loans was $284, at an average APR of 142%.[110] These repeat customers were indeed long-term: 53% had been doing business with the same lenders for one to five years, and 29% for more than five years.[111] This was characterized in the study as a sign of "customer

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104. Lieberman Forum (Tarpey testimony), *supra* note 59, at 3; Lieberman Forum (Gallagly testimony), *supra* note 58, at 2; DFI REPORT, *supra* note 33, at 34 (finding Illinois's "three roll over rule" ineffective in preventing short-term loans from turning into "long-term headaches" because the industry thwarts the state's roll over rule with payoffs from the proceeds of "new loans").

105. LARRY D. KINGERY, IOWA DIV. OF BANKING, DELAYED DEPOSIT SERVICES LICENSES, INTERPRETIVE BULLETIN #1 (Sept. 16, 1997). One problem is that Iowa law, which has a $500 maximum loan amount, permits two loans to be outstanding. Thus, one $150 loan can be repaid by a second check and still be within the strict letter of the law. Despite this imperfection, both the Indiana and the Illinois departments recommend cooling-off periods between loans as a circuit breaker for the debt treadmill. Lieberman Forum (Tarpey testimony), *supra* note 59, at 6; DFI REPORT, *supra* note 33, at 44.

106. Lieberman Forum (Tarpey testimony), *supra* note 59, at exhibits B, C.

107. *Id.* at 3.

108. DFI REPORT, *supra* note 33, at 6.

109. *Id.* at 21, 26.

110. Willis J. Wheat, *A Study on the Status of the Class 'B' Lending Industry in the State of Oklahoma*, 50 CONSUMER FIN. L. Q. REP. 452, 455 (1996). Oklahoma's laws do not really render it a full-fledged payday loan state. Oklahoma's "Class B" small loan lenders may make small loans under a fee structure that allows for triple-digit APRs, but they cannot make the loans for the extremely short terms that the standard model payday lender makes. There is a minimum term of thirty days for loans under approximately $100 and a minimum term of sixty days for loans over $100. OKLA. STAT. ANN. tit. 14A § 3-508B (West Supp. 2000).

111. Wheat, *supra* note 110, at 455.

satisfaction," not as evidence of a debt treadmill.[112] The survey also looked positively at the practice of "clustering" these offices, noting the economies realized by a common owner and the convenience to the borrower.[113] However, clustering of commonly owned shops also facilitates evasion of rules enacted to limit the debt treadmill: limits on renewals, limits on multiple loans outstanding at once, and prohibitions on splitting a loan into two smaller loans to get higher fees.[114]

The industry's justification of these loans as a "bridge" during "temporary setbacks" ignores the fact that the loan terms often prolong such setbacks. As the Illinois DFI explains:

> What [the industry has] failed to mention was that the financial strains placed on consumers were rarely short-lived. Customers playing catch-up with their expenses do not have the ability to overcome unexpected financial hardships because their budgets are usually limited. The high expense of a short term loan depletes the customer's ability to catch-up, therefore making the customer "captive" to the lender.[115]

For some, the end result of this "snowball of negative consequences" may be bankruptcy, as borrowers are unable to continue paying renewal fees to keep their check afloat while still meeting other obligations.

The collection tactics used by some fringe market lenders[116] may also play a role in a consumer's decision to seek relief in the bankruptcy courts. Those familiar with bankruptcy courts in Tennessee, a state with one of the oldest and most concentrated payday loan industries,[117] see the industry as a contributing factor in Tennessee's high bankruptcy rates.[118] And even though the Oklahoma survey cast long-term relationships with triple-digit lenders in terms of "satisfied customers," it also noted the high number of bankruptcies listing

112. *Id. But see infra* note 118 and accompanying text (discussing the number of bankruptcies involving these loans).

113. Wheat, *supra* note 110, at 456-57.

114. There had been allegations in Oklahoma that commonly owned shops operating under different names were referring customers to one another for such purposes. *Id.* at 457.

115. DFI REPORT, *supra* note 33, at 30. The report noted that the DFI found customers who were borrowing constantly for over a year. *Id.*

116. *See infra* Part II.B.4.

117. *See infra* Part IV.

118. Sheila Wissner, *Thriving Loan Industry's Secrecy Worries Officials*, THE TENNESSEAN, April 18, 1999, at 1A. The article provides statistics for payday lending in Chapter 13 filings: 413 out of 12,400 filings "show debts to 'payday loan' businesses." *Id.* That number could well be misleadingly low, as Chapter 7 filings are much more prevalent, and payday loan borrowers may be more likely to be Chapter 7 filers. This may account for the difference between this quoted Tennessee figure and the Oklahoma figure cited below.

fringe lenders as creditors—13,379 in 1994.[119] Bankruptcy filings in the Northern District of Illinois, home of the majority of Illinois' short-term lenders, show "significant payday loan debts" on 20% to 25% of filings, and press reports from Indiana and California also relate payday loans to bankruptcies.[120] Though most of the recent public debates over proposed revisions to the bankruptcy code have centered on credit card debt as a contributing cause, the correlation between bankruptcy and fringe market debt also warrants some objective research analysis.

4. *Collection Practices of Title Lenders and Payday Lenders*

The structure of most title and postdated check loans lends itself to more than the usual array of collection abuses. The payday loan business is, in substance, a traffic in cold checks. Default on consumer debt is not a crime—we are past the days of Dickensian debtors' prisons. Default on a car loan or a credit card debt rarely raises the specter of criminal prosecution. But it is accepted knowledge that writing "cold checks" is a crime. Some payday lenders use the threat of prosecution as a collection tactic, though the trade associations' "best practices code" prohibits it, as do the front-office policies of some of the major national payday lenders.[121] Worse, some lenders do not limit themselves to merely threatening criminal prosecution. Payday lenders filed over 13,000 criminal charges with law enforcement officials against their customers in just one Dallas, Texas precinct in one year.[122] Abuse of this "criminal" aspect of writing cold checks in Kentucky was so great that the state's payday loan statute was amended to require posted notice telling

119. Wheat, *supra* note 110, at 455. The study never considered whether there might be a causal link between the 82.4% of customers who did business with these lenders for over a year and those bankruptcies.

120. Edelman testimony, *supra* note 43, at 2 & nn.11-12.

121. The authors have seen letters threatening criminal consequences from local offices of chains whose official policy was not to use such threats. *See also Forum on Short-Term High-Interest Paycheck Advances*, convened by Sen. Joseph Lieberman, ranking minority member, U.S. Senate Comm. on Governmental Affairs (Dec. 15, 1999), at 9 (written testimony of Jean Ann Fox, Dir. of Consumer Protection, Consumer Fed'n of Am.) [hereinafter Lieberman Forum (Fox testimony)] (describing a single mother paying $644 a month in loan fees who let one payday loan bounce; the lender told her she would be arrested and that her daughter, who had cerebral palsy, would be put in a foster home for Christmas); Alex Lyda, *Payday Loan Company Faces Legal Trouble as State's Attorney Files Suit*, AP (Sept. 10, 1999) (reporting one company's practice of calling debtor's references, which were requested on applications primarily for collection purposes, and telling them a warrant would be issued for the debtor's arrest).

122. Lieberman Forum (Pettijohn testimony), *supra* note 30, at 2; *see also* Watson v. State, 509 S.E.2d 87 (Ga. Ct. App. 1998) (affirming the conviction of a payday lender prosecuted for perjury in connection with statements made to law enforcement officials in seeking warrants to have his customers arrested for bad checks).

customers that they cannot be criminally prosecuted.[123]

What is not common knowledge among payday loan borrowers is that a postdated check given to someone who knows that it will not clear rarely supports criminal prosecution. Indeed, in some states, such postdated checks cannot support criminal charges at all.

> Absent fraudulent intent, the transaction becomes essentially one of extending credit to the drawer. If the payee of a postdated, worthless check indicates in some manner that his or her acceptance of the check constitutes an extension of credit to the maker, the transaction does not violate the bad check statute.[124]

As a federal district court in Tennessee once noted, one can assume that the borrower does not have enough money in the bank to cover the check—otherwise she simply would not be there.[125] Certainly a lender's exaction of a fee to "defer" deposit signifies the requisite acceptance on his part necessary to remove the transaction from the realm of the criminal bad check statute.

Even in the absence of criminal prosecution threats, however, civil bad check charges can be punitive. Though default on a normal consumer credit debt may trigger delinquency fees and collection fees, check loans are the only type of consumer debt we know of which conceivably trigger treble-damages penalties upon default—penalties established by the civil bad check laws of some states.[126] Thus a lender might seek judgment for repayment of the principal and interest, the regular bounced check fees, triple the check amount

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123. KY. REV. STAT. ANN. § 368.100(18) (Michie 1998). Most magistrates and prosecutors in Kentucky held the position that these transactions were not subject to bad check laws, but a few warrants were issued, and a few borrowers were jailed. Payday lenders had also used the "bad check" label to argue that these loans were criminal matters for bankruptcy purposes and sought to continue collection efforts against bankruptcy debtors. The problems were so great that the bankruptcy trustee became the real party in interest in a class action filed against payday lenders. Interview with Sidney White, Trustee (Nov. 19, 1998). In early debates on payday lending, one state (Georgia) considered prohibiting the use of checks as "collateral" for these loans. However, Georgia did not amend its Industrial Loan Act, GA. CODE ANN. §§ 7-3-1 to -29 (1997), to allow payday lending at all, so the issue became moot.

124. 32 AM. JUR. 2D *False Pretenses* § 73 (footnote omitted); *see also* Turner v. E-Z Check Cashing of Cookeville, TN, Inc. 35 F. Supp. 2d 1042, 1048 (M.D. Tenn. 1999) (holding that "deferred presentment" transactions are extensions of credit); *cf.* Watson v. State, 509 S.E.2d 87 (Ga. Ct. App. 1998) (affirming the conviction of a payday lender for perjury arising out of statements made to law enforcement officials in seeking warrants to have customers arrested for bad checks).

125. *Turner*, 35 F. Supp. 2d at 1051. The Tennessee court held that threats of criminal prosecution also violate the state Consumer Protection Act because criminal prosecution is the prerogative of the state, not a private remedy. *Id.*

126. *See, e.g.*, 720 ILL. COMP. STAT. ANN. 5/17-1a (West Supp. 1999). Whether such penalties can properly be invoked by payday lenders, however, remains undecided.

as a penalty, and perhaps other collection fees.[127] The Indiana Department of Financial Institutions reported that at least three lenders filed 700 such lawsuits in two years.[128]

The Texas Credit Code Commissioner reports another collection abuse arising from using a check as both a loan instrument and as loan collateral: the lender reports the "bounced check" to a private check collection service to which other merchants subscribe. A customer on a bad check list from such services cannot write checks at these merchants' businesses, such as the neighborhood grocery store, until the customer pays the debt, perhaps including the collection fee.[129]

5. *Refund Anticipation Loans (RALs)*

Refund anticipation lenders advance cash against the borrower's expected income tax refund. They are available through tax preparers, such as H & R Block, or even from used car dealers.[130] Some versions of the refund anticipation loan, especially the early ones, were constructed as a sale or assignment of the right to the anticipated refund. As with other fringe loan forms, RAL lenders designed these transactions in an effort to avoid credit regulation.[131] The overwhelming majority of RAL lending is now performed by major depository lending institutions, including bank subsidiaries of major finance companies.[132] Most RAL lenders do not comply with state usury laws

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127. The Illinois Consumer Justice Council testimony describes a borrower who defaulted on a $240 check loan ($200 loan, $40 fee), and was sued for the $240 plus treble damages under the bad check law ($720), plus $300 for attorney's fees. The lender sought a $1260 judgment for default on a $200 loan. Edelman testimony, *supra* note 43; *see also* Kilborn, *supra* note 85 (describing a payday loan customer who owed $1280 on payday loan of $330 (loan of $300, $30 fee): $80 in bounced check charges, treble damages of $330, $150 for the lender's attorney fees and $60 for court costs).

128. Lieberman Forum (Tarpey testimony), *supra* note 59, at 3.

129. Lieberman Forum (Pettijohn testimony), *supra* note 30, at 2.

130. Some used car dealers offer tax preparation services during tax season, featuring quick refunds that the customer may credit toward the down payment on a car. The quick refund, while sometimes simply an electronically-filed tax return, may well be a refund anticipation loan.

131. *See infra* Part V.

132. When banks entered the refund anticipation business, they made no effort to deny that the transactions were loans. But that is not to say that they initially complied with the Truth in Lending Act requirement of giving a meaningful APR price tag. Instead they used a loophole in TILA to disclose artificially low APRs, sometimes as low as 3%.Under the system used for RALs, the reasonably expected time the loan is outstanding is approximately two weeks, as the lender is repaid when the IRS direct deposits the refund into the account at the lending bank. The banks, however, constructed the note as a demand note with no explicit repayment date. This strategy allowed the lenders to take advantage of TILA's Reg. Z, 12 C.F.R. § 226.17(c)(5) (1999), a provision that lets a lender assume a one-year repayment period for a demand note. This practice was unsuccessfully challenged in Cades v. H & R Block, Inc., 43 F.3d 869, 875 (4th Cir. 1994). However a later amendment to the regulation's Commentary provides that if repayment is required when the refund is received "such as by deposit into the consumer's account," then the estimated date of repayment, not the one-year assumption, should

governing small loans in the borrower's state because they were the first of the fringe lenders to take advantage of a bank's opportunity to issue loans with rates based exclusively on the law of the lender's home state. Not surprisingly, many RAL lenders are located in states with low or non-existent interest rate ceilings.[133]

RAL lenders require the taxpayer to file her tax return with the IRS electronically. Tax preparers often charge a fee for electronically filing the tax return itself, typically $20 to $35, though the range in 1999 spanned from $0 to $68. Electronically filing the tax return alone will typically cut in half the time a taxpayer must wait for her refund, from approximately four to six weeks to two to three weeks (or even less). The RAL puts the refund, less fees, into the taxpayer's hands in two to three days. Amounts withheld from the proceeds include the loan fee, the tax preparation fee, and the tax preparer's fee for electronically filing the return. Loan fees are typically flat fees, set on a sliding scale based on the amount of the expected refund.

Here is an example of how loan works: TaxxMann, in Lake Woebegon, Minnesota, takes the application from the taxpayer and forwards it to its RAL partner, Seventh Sixth Bank of Delaware. The paperwork signed by the borrower authorizes the lender to open up an account at the bank in Delaware and instructs the IRS to direct deposit the refund into that account. The consumer picks up the loan proceeds, via the tax preparer, in two to three days. The contract includes a right of setoff, so the lender is repaid when the IRS directly deposits the refund into the account (generally within two weeks). The loan is a demand note; thus even if something such as a tax intercept occurs, the consumer is still contractually bound.

The refund anticipation loan offered in 1999 by the nation's largest RAL program, Household National Bank[134] (offered through H & R Block) charged a sliding scale of fees ranging from $39.95 for refunds up to $750 to $89.95 for refunds over $2000.[135] Fees in this range translate into APRs ranging from 67%

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be used in calculating the APR. Federal Reserve Board Comment 17(c)(1)-17, 1 Consumer Cred. Guide (CCH) at 3465-66 (April 1, 1990). Today, the major RAL lenders use the more accurate truncated repayment terms when disclosing refund anticipation loan APRs.

133. *See infra* Part V.

134. Beneficial National Bank was once the largest RAL lender, but it has merged with Household, which now administers the program.

135. The 1999 scale was $39.95 for refunds up to $750; $49.95 up to $1000, $59.95 up to $1500, $79.95 up to $2000, and $89.95 for refunds over $2000. Telephone Interview with unknown person at H & R Block, Des Moines, Iowa (Mar. 1999). For 2000, the scale ranges from $29.95 to $59.95, plus a $35 electronic tax filing fee. Telephone Interview with unknown person at H & R Block, Des Moines, Iowa (Jan. 2000). A phone inquiry to another tax preparer found a sliding scale of fees from $63 to $161, with a $50 electronic filing fee. If a tax preparer's charge for electronic filing the tax return is the same amount, irrespective of whether customer takes the RAL, that fee is not a finance charge under the Truth in Lending Act. Federal Reserve Board Comment 17(c)(1)-17, 1 Consumer Cred. Guide (CCH) at 3465-66 (Apr. 1, 1990).

to 768% for the anticipated two-week loan term.[136]

One of the problems with RALs is that people may not understand that they could get their refund in about two weeks or less without the loan by electronically filing the return themselves. More critically, some do not even understand a loan is involved because the loans may be marketed through a misleading catchphrase such as "rapid refund" or "quick refund."[137] Though some tax preparers discourage RALs, given the almost pointless expense compared to electronic filing alone, other tax preparers have financial incentives to push such loans. The used car dealer is one example; the RAL facilitates the car sale. A recent case reinstating claims against H & R Block identified ways in which the tax preparer allegedly profited from RALs, including earning a fee from the lender for each loan referred and the repurchase of a portion of RAL receivables through a subsidiary.[138]

The fine print in contemporary RAL contracts contains a hidden collection trap for users. The boilerplate language not only gives the lender a right of setoff against the refund to collect the instant loan (and any prior RAL to the lender that may remain unsatisfied), but also any debts owed to any affiliate of the lender (such as an affiliated finance company's loan), and any RALs still owed to a laundry list of *unrelated* RAL lenders.[139]

D. Installment Purchases: Rent-to-Own

The most mature of the late twentieth century fringe credit segments is the rent-to-own (RTO) industry. Rent-to-own businesses offer consumers the option to acquire household goods, appliances, and electronics through installment payments.[140] The RTO industry is estimated to be worth nearly $4 billion annually.[141] Like other alternative financial services transactions, the cost of a rent-to-own bargain is considerably higher than a mainstream retail installment sales price. A consumer buying a $300 washing machine from an

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136. *See* Brief of Amicus Curiae in Support of Appellants at attachment B-2, State v. The Cash Now Store, Inc., (Colo. Ct. App. 2000) (No. 98 CA 2380) (consisting of Beneficial's 1998 disclosure form). This case involves a provider who cast the transaction as a "purchase" of tax refunds, instead of a loan, typically for about fifty cents on the dollar. In the case of a customer noted in the trial record, the effective APR was approximately 3055%. *Id.* at 17.

137. *See, e.g.*, Joan Koonce Lewis et al., *Refund Anticipation Loans and the Consumer Interest: A Preliminary Investigation*, 42 CONSUMER INTERESTS ANN. 167, 169 (1996) (reporting that nearly half the sample did not realize "quick refunds" were actually loans).

138. *See* Green v. H & R Block, Inc., 735 A.2d 1039, 1057, 1059, 1060 (Md. 1999) (reversing the trial court's dismissal of the plaintiff's claims for breach of fiduciary duty, fraudulent concealment, and violation of Consumer Protection Act). Developments on this issue are followed in COST OF CREDIT, *supra* note 22, at § 7.5.4.

139. The list in one contract reviewed includes eight lenders, including most of the major financial institutions making RALs. This appears to stretch the concept of the banker's right of setoff past recognition, and certainly past its rationale.

140. *AFS Overview*, *supra* note 3.

141. *Poverty, Inc.*, CONSUMER REPORTS, July 1998, at 29, 32.

RTO retailer may pay something on the order of fifty-two weekly payments of $16 (a total of $832) which means the undisclosed APR is over 250%.[142]

The method used by the rent-to-own industry to avoid state interest rate caps or APR disclosure requirements involves characterizing the transaction as a lease "terminable at will." Industry-drafted legislation, adopted for the most part in forty-five states, has been largely successful in carving RTO transactions out from state laws governing credit sales.[143]

The industry and its critics dispute the extent to which the "rent" function dominates over the "own" function. The industry says that fewer than 25% of its customers rent long enough to become owners,[144] while critics cite data suggesting that 87% of customers purchase the merchandise. Documents obtained in litigation against one major RTO company found that 66% of one year's inventory was sold, and some analyses indicate that more than three-fourths of revenue comes from sales.[145] Rent-to-own customers, however, generally do not get the credit price tags that installment purchasers in the mainstream sales finance market receive. Few exceptions exist to this rule because only a handful of states have found these transactions to be within the definition of credit sales.[146] In Vermont consumers can view the credit price tag because Attorney General regulations under the state unfair and deceptive acts and practices (UDAP) law require disclosure of an effective APR (EAPR).[147]

Most state RTO legislation requires dealers to disclose both a "cash price" and "total cost to own" if paid in installments. However, most of these laws sanction a deceptive price tag: the "cash price" can be—and most often

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142. For examples of RTO prices, see *id.* at 32; Alix M. Freedman, *Peddling Dreams: A Market Giant Uses Its Sales Prowess to Profit on Poverty*, WALL ST. J., Sept. 22, 1993, *reprinted in* MERCHANTS OF MISERY 153, 155-57 (Michael Hudson, ed. 1996); Michael Hudson, *Rent-to-Own: The Slick Cousin of Paying on Time, in* MERCHANTS OF MISERY 146, 146-47 (Michael Hudson, ed. 1996)

As a result of a New Jersey case finding RTO transactions to be credit sales, the industry is seeking legislation in that state. The Consumers League of New Jersey opposes the industry-backed bill, and its press release reports that even the higher priced competitors, small inner city merchants, stay within New Jersey's 30% criminal usury cap. Consumers League of New Jersey, *All New Jersey Court Decisions Found that Rent to Own Violated the New Jersey Consumer Fraud Act* (visited Feb 9, 2000) <http://www.clnj.org/rto_ct.htm>.

143. *See, e.g.*, COLO. REV. STAT. § 5-10-101 to -1001 (1999); FLA. STAT. ANN. § 559.9231 to .9241 (West 1997 & Supp. 2000); IOWA CODE ANN. § 537.3601 to .3624 (West 1997); COST OF CREDIT, *supra* note 22, at § 7.5.3.2.

144. Association of Progressive Rental Organization (APRO), *What Is Rent-to-Own?* (visited Feb. 9, 2000) <http//www.apro.rto.com/content/whatisrto.asp>.

145. COST OF CREDIT, *supra* note 22, at § 7.5.3.2.1 n.240; *see also* David L. Ramp, *Renting to Own in the United States*, 24 CLEARINGHOUSE REV. 797, 798 (1990) (stating that the figures offered by the RTO industry are "either grossly misleading or simply untrue"); David L. Ramp, From Rags Come Riches (paper presented at meeting of the Consumer Fin. Servs. Comm., Business Law Section, ABA meeting, Aug. 6, 1995).

146. *See infra* Part V.

147. *Subject: Consumer Fraud—Rent-to-Own Disclosures; Attorney General—Consumer Protection Section Adopted Pursuant to 9 V.S.A. § 41b: Rule CF 115* (visited Jan. 14, 2000) <http://www.state.vt.us/atg/rule%20cf115.htm>.

is—unrelated to fair market value. Consequently, the "total cost to own" may be double the "cash price" of the goods, but effectively four times the true market value of the goods acquired.[148] Other charges may be permitted, such as security deposits, administrative fees, delivery charges, "pick-up payment" charges, late fees, insurance charges, and liability damage waiver fees.[149]

Because it is a "rental," the goods may be repossessed and all equity forfeited. Acquiring goods through rent-to-own can be a Sisyphean task. For example, the RTO "total to purchase" a $650 retail washer and dryer might be $1500.[150] If the consumer misses a $19 weekly payment after a year of payments totaling $950, she may lose the washer and dryer and have nothing to show for her $950 investment. By contrast, she would have owned the goods if she had signed a contract to purchase them at retail price through fifty-two weekly installments of $19 at 89.3% APR.

Even assuming that the consumer successfully completes the RTO transaction, such successes will not her an improved ability to move into the lower-priced mainstream credit market because credit reports do not reflect positive RTO history.

E. Risk and Profitability

Each segment of the fringe credit market justifies its costs in part by its higher transaction costs and in part by the higher level of risk assumed to be associated with lending to fringe market borrowers. The transaction costs are indeed higher,[151] but how much of the differential is compensatory and how much consists of simple opportunism is unclear. The validity of the risk-assumption rationale is likewise uncertain. First, one must consider the possibility that default rates do not correspond with actual loss to fringe market lenders. Second, one must ask whether these transactions in fact create risk, rather than compensate for it.

In the *Wall Street Journal* and on *60 Minutes*, the title loan industry cited

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148. *See, e.g.*, COLO. REV. STAT. § 5-10-301(c) (1999) (defining "cash price" as "the price at which a lessor in the ordinary course of business would offer the property . . . for cash on the date of the execution of the rental purchase agreement"). A visit to a local RTO store in Iowa found a posted "cash price" for a thirteen inch TV-VCR to be $764, though a comparable model was available at a local retailer for $280. The RTO "total to purchase" the $280 TV was $1217, four times the value of the good acquired.

149. *See, e.g.*, IOWA CODE ANN. § 537.3612 (West 1997) (permitting RTO lessors to charge such fees).

150. At a local RTO, the "cash price" listed on the $650 retail pair was $880. The RTO terms offered were $18.99 per week for seventy-eight weeks, or $1481.22. These figures assume the goods are new. RTO laws may require labeling of used goods, though compliance may not always occur.

151. *See, e.g.*, CASKEY, FRINGE BANKING, *supra* note 3, at 111-12 (finding higher transactional costs in pawnshop loans and check cashing outlets). This study did not examine title pawns, payday lenders, or RTO companies. *Id.* at 111. *See infra* Part VIII for a brief account of some efforts at providing alternatives that may provide some basis for comparison.

a 10% delinquency and repossession rate, compared to a repo rate of less than 2% for auto sale financers.[152] According to Mike Coniglio, president of the Southern Association of Title Lenders, "Our past due accounts and our repossession accounts are 10 times that of a General Motors Acceptance or Ford Motor Credit. And our rates are not 10 times their rates."[153] However, the average title lender only lends about one-third the value of the used car to begin with, in contrast to the 90% loan-to-value ratio typically found in a prime market used car loan.[154] Moreover, title lenders fail to account for the effect of renewals and their retention of the surplus from any repossession sale. Take the example of Annie Churchwell. Ms. Chuchwell paid $2800 over a period of six months on a $2000 loan without reducing her debt. The payments she had made were enough for the lender to realize a 127% return on his $2000 investment. Further, if the care were then repossessed, the lender would keep the proceeds of the repossession sale–a gain of $6,000 in Ms. Churchwell's case. Fortunately, Ms. Churchwell avoided becoming part of that 10% repo figure by deciding to fight back instead of walking away.[155] One of the customers interviewed on *60 Minutes* had already paid $2000 on a $500 loan, but felt he was going to have to let them take the truck back because he could not keep the payments up.[156] The same factor is at play for payday loans and RTO.[157] Because payday loans are not amortized, and because renewal or refinancing costs descend upon borrowers so quickly, a borrower may pay the equivalent of principal plus 217% interest and still default on the loan. Nevertheless, a small claims collection action could seek the full principal and interest, in addition to the NSF fees, and perhaps treble damages and additional collection costs.[158]

For these reasons, default rates are not necessarily good indicators of whether the high cost of most fringe market loans is justified.[159] It may be more appropriate to look at profitability by comparing rates of return in these industries to those of standard businesses. If higher prices are to compensate for

152. Cahill, *supra* note 40, at A13; *60 Minutes*, *supra* note 46, at 5-6.

153. *60 Minutes*, *supra* note 46. Actually, Mr. Coniglio has that wrong. Their 264% APR is more than twenty times higher than the average used car financing rate in 1998, which was 12.64%. *Financial and Business Statistics*, 86 FED. RES. BULL. A1, A36 tbl.1.56 (1999).

154. Loan-to-values on used cars in 1998 were 99%. *Financial and Business Statistics*, 86 FED. RES. BULL. A1, A36 tbl.1.56 (1999). Remember, too, that surpluses from disposition may not be returned to the consumer.

155. Cahill, *supra* note 40. Lynn Drysdale, one of the authors, represents Ms. Churchwell and other title loan customers whose stories are cited here.

156. *60 Minutes*, *supra* note 46, at 8.

157. *See supra* Part II.D for an example in the RTO context.

158. If a consumer pays a $15 fee to renew an $85 loan every two weeks for four months, she has paid $120 total. The lender has received enough to repay the principal plus a 217% yield on that four-month $85 loan, but if the borrower defaults, the full principal is still owed. Lieberman Forum (Fox testimony), *supra* note 128, at 8; *see also supra* Part II.B.4.

159. *See infra* Part VII (discussing the issue of whether the high prices create risk, rather than compensating for it).

higher transaction costs and higher risk, then it stands to reason that compensatory pricing should yield lender profitability comparable with that of the lower risk, less costly provider. The *Wall Street Journal* reports a 12% return for one title lender, whereas "[m]ost bankers, by contrast, are happy with a 1.5% return on assets."[160] Likewise, the Consumer Federation of America cites an investment analyst who follows the payday loan business as reporting a 48% unleveraged return on investment, and also cites a study from the Tennessee Department of Financial Institutions finding that payday lenders enjoy a 22.72% return on assets and 30.37% return on equity.[161] While these figures raise the possibility that the standard justifications for high-priced fringe market loans are not as solid as they seem, further study and evaluation is warranted before any final conclusions are drawn.[162]

III. THE EARLY ANTECEDENTS TO TODAY'S FRINGE BANKING MARKET

A. *The First Half of the Century*[163]

1. *Cash Loans*

As the nineteenth century phased into the twentieth, industrialization in America gave rise to a number of social problems which triggered the reforms of the Progressive Era. Among them, the consumer credit market began to attract the attention of reformers. As wages increased to a point beyond that required for basic necessities, some was left over for repayment of debt. Likewise, the current wave of short-term, small-principal loans "thrives upon high wages and rising standards of living and not upon abject poverty."[164]

Many of the credit products offered in today's fringe market have direct antecedents in the late nineteenth and early twentieth centuries. For example, "salary lenders" advanced cash in small amounts for short terms against the debtor's next paycheck. The "5 for 6 boys" lent five dollars at the beginning of the week, to be repaid with six dollars on payday a week or two hence. "Salary buyers" would "buy" the next wage packet at a discount—for example,

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160. Cahill, *supra* note 40. This is not to assume that banks' return on assets is the best point of comparison.

161. Fox, *supra* note 62, at 9. Tennessee is one of the states with a very high concentration of payday lenders. The Tennessee study looked at the first nine months of legal operation. Because payday lending was going on prior to its legalization, there were class actions against lenders, and the DFI properly excluded the litigation costs from their analysis.

162. The same is true throughout the subprime market. For a discussion of the issue in the subprime mortgage market, see Mansfield, *supra* note 19.

163. Portions of this section first appeared in Lieberman Forum (Fox testimony), *supra* note 121; *see also* COST OF CREDIT, *supra* note 22, §§ 2.2.3.1, 2.5 (discussing small loan businesses in the first half of the century).

164. Rolf Nugent, *The Loan-Shark Problem*, 8 LAW & CONTEMP. PROBS. 3, 4 (1941). The article was part of a series published collectively in a symposium in that issue. Symposium, *Combating the Loan Shark*, 8 LAW & CONTEMP. PROBS. 1 (1941).

advancing $22.50 on January 15 in exchange for the "sale" of the $25 paycheck due January 28 (an effective 311% APR).[165] Some loans were secured by wage assignments, while others involved unsecured notes backed by threats of garnishment (which at the time could result in dismissal).[166] Indeed, there was even a direct antecedent of today's postdated check loan: some early salary lenders convinced borrowers to sign a bank check in the amount of the loan's principal and interest, even though the borrower had no bank account. The lender explained the check to the borrower as "security." In the event of default, the lender deposited the check, which of course, bounced. The lender then threatened criminal prosecution unless the debt was paid.[167] Today's title loans had their analogues during this early period, as well: borrowers "sold" their cars, which were then "leased" back to them, and collection was facilitated by threatened—or actual—repossession.[168]

As now, the loans in this period were short-term, ranging from one week to one month, with two weeks being most prevalent.[169] Price tags were comparable as well. One study in South Carolina found interest rates for white borrowers ranging from 270% to 559%, with black borrowers paying rates ranging from 322% to 955%.[170] While such interest rates were usurious, there was little enforcement because the borrowers had little access to the courts and little understanding of their rights in any event. "[T]he one who suffers most

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165. Compare this device to the current practice of "selling" the consumer's right to an income tax refund. *See supra* Part II.C; *see also supra* Part II.B.2 (describing today's Texas schemes).

166. Jackson R. Collins, *Evasion and Avoidance of Usury Laws*, 8 LAW & CONTEMP. PROBS. 54, 55-58 (1941); Nugent, *supra* note 164, at 5. A later reform movement curtailed the use of these devices after the abuse of them and the consequences of such abuse became apparent. States prohibited or curtailed them by the 1960s. A series of hearings was held around the country by the Federal Trade Commission in the mid-1970s in which problems with these and other overreaching contract terms were documented. FEDERAL TRADE COMM., CREDIT PRACTICES: STAFF REPORT AND RECOMMENDATIONS ON PROPOSED TRADE REGULATION RULE 16 CFR PART 444: PUBLIC RECORD 215-42 (August 1980). Based upon that record, the use of such terms in consumer credit contracts was curtailed at the federal level by the FTC Credit Practices Rule, 16 C.F.R. § 444 (1999). Garnishment abuses and their negative effects on families were addressed both by state legislation and by the Federal Garnishment Act, 15 U.S.C. §§ 1671-1681t (1994), and the Fair Debt Collection Practices Act, 15 U.S.C. §§ 1692 -1692o (1994).

167. A salary lender in Kansas City used this system, as described in the 1941 Symposium. Joe B. Birkhead, *Collection Tactics of Illegal Lenders*, 8 LAW & CONTEMP. PROBS. 78, 86 (1941). Perhaps not coincidentally, one of the earliest reports of the modern payday lender using the post-dated check scheme to try to evade usury and credit disclosure laws came from Kansas City. Joe Stephens, *Postdated Check Firms May Violate Usury Laws*, KANS. CITY STAR, Oct. 23, 1988, at 1A. See *supra* Part II.B.4 for a discussion of the threat of criminal prosecution as a collection tactic in this second wave.

168. Collins, *supra* note 166, at 65.

169. William Hays Simpson, *Cost of Loans to Borrowers Under Unregulated Lending*, 8 LAW & CONTEMP. PROBS. 73, 73 (1941).

170. *Id.* at 74-75. This is comparable to the range for today's low-end loan amounts, at 261% to 625%. *See supra* Section II.B.2. *Compare* Michael L. Walden, *The Economics of Rent-to-Own Contracts*, 24 J. CONSUMER AFF., 326, 334-35 (1990) (finding RTO prices inversely related to the income level of the census tract).

at the hands of high-rate lenders is the borrower, yet he is almost the only member of society who has done nothing about his plight.... The economic condition of the loan shark victim explains much, but not all, of this situation."[171] Social workers, legal aid societies, labor unions, and some well-intentioned businessmen and professionals bore witness to the toll these high-rate loans took on the borrowers.[172] Then, as now, real economic distress accompanied the renewal of midget loans with giant price tags and the related problem of trying to juggle debt—i.e., borrowing from Peter to pay Paul.[173] In sum, the stories of the borrowers on the downward spiral in this "first wave" of fringe lending are not substantially different than those told by fringe borrowers today.[174]

The resulting efforts at "combating the loan shark,"[175] as this type of lender was unashamedly called then, took several forms. There were, of course, efforts to enforce the usury laws.[176] But that approach deals with symptoms, not causes, so there began a search for nonexploitive alternatives to fringe lending. This effort took place over a reform period spanning approximately half a century—up to World War II. Provident lending societies and credit unions originated in this period, representing the "philanthropic" and "cooperative" approaches.[177] A third avenue sought to develop a framework for a viable commercial industry that would serve the needs of the small borrower. But the reformers recognized that the marketplace of the small borrower was an "imperfect market," making it unlikely that deregulation (then, too, touted by economists) would curb the abuses of the loan shark.[178]

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171. George L. Gisler, *Organization of Public Opinion for Effective Measures Against Loan Sharks*, 8 LAW & CONTEMP. PROBS. 182, 182 (1941). This, too, has changed little. *See infra* Part IV.

172. Gisler, *supra* note 171, at 182; *see also* Nugent, *supra* note 166, at 13; Robert W. Kelso, *Social and Economic Background of the Small Loan Problem*, 8 LAW & CONTEMP. PROBS. 14, 15 (1941). One wonders if they were dismissed as "paternalistic do-gooders," as today's critics are. *See* Lieberman Forum (Rochford testimony), *supra* note 30, at 14.

173. Nugent, *supra* note 166, at 5; *cf. supra* Part II.B.3.

174. For example, one borrower, making $35 a week, borrowed a total $83 from four different lenders as a result of family sickness. To service that $83 loan, he paid those four lenders $16 per month. At the end of a year, he had paid $192 in interest, but still owed the $83. Similarly, a mill employee, with a $25 a week salary, borrowed a total of $55 from four different loan companies. After paying $69.40 in interest for a year, he still owed the original $55. Simpson, *supra* note 181, at 74-75.

175. Paul H. Sanders, *Foreword* to Symposium, *supra* note 164, at 1.

176. *See generally* HUBACHEK, ANNOTATIONS, *supra* note 1, at 1-10 (describing stages in the evolution of small loan laws); Emmet R. Field, *Injunction and Receivership Proceedings Against Illegal Lenders*, 8 LAW AND CONTEMP. PROBS. 100, 100 (1941) (explaining the need for "vigorous and continuing policing action" to accompany usury laws); Charles S. Kelly, *Legal Techniques for Combating Loan Sharks*, 8 LAW & CONTEMP. PROBS 88, 93-99 (1941) (suggesting remedies other than small loan laws for states that do not have adequate laws in place).

177. For a brief overview of the cooperative and philanthropic models, see COST OF CREDIT, *supra* note 22, at § 2.2.3.1 and sources cited therein. *See also* CASKEY, FRINGE BANKING, *supra* note 3, at 23-26 (discussing "philanthropic pawnshops").

178. Nugent, *supra* note 166, at 12.

The approach ultimately adopted involved the creation of a legal framework that permitted a return high enough to attract legitimate businesses into the small borrower market, but also included sufficient safeguards to prevent the kind of abuses that were all too evident in the "loan shark" market.[179] The resulting product of this approach was the first draft of a Model Uniform Small Loan Act, which appeared in 1916.[180] The Act applied to small loans of $300 or less and allowed for a high rate of return, with a recommended top rate of 42%[181] annually recommended on the smallest loan amounts (later reduced to 36%).[182] But the trade-off for that high rate was strict regulation. To reduce evasions, the Uniform Act had an all-inclusive definition of interest[183] and a provision that codified the common law principle that the law applied no matter what evasive devices were attempted.[184] Deterrence was built into the Act by requiring lenders to forfeit all principal and interest if they charged excessive rates. Additionally, lenders were made subject to criminal penalties for violations of the Act.[185] To address the problem of indefinite payments that never reduced the principal, roughly equal installments were required, which effectively precluded balloon payments.[186]

Ultimately, every state except Arkansas enacted small loan laws.[187] By 1930, the resulting small loan industry was estimated to be a $255 million industry, making loans averaging $140. Over half the states had adopted some version of the Uniform Act by 1930, and there were 3,667 licensees by August 1932.[188]

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179. HUBACHEK, ANNOTATIONS, *supra* note 1, at 1-3 (discussing the appearance of greater regulation of small loans); *see generally* LENDOL CALDER, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT 124-35 (1999) (providing historical background).

180. The act underwent periodic revisions into the early days of World War II. The seventh draft, as revised June 1, 1942, appears in BARBARA CURRAN, TRENDS IN CONSUMER CREDIT REGULATION 144-57 (1965).

181. *See* HUBACHEK, DEVELOPMENT, *supra* note 1, at 119-21.

182. CURRAN, *supra* note 180, at 152-53 (citing the seventh draft at § 13(a)). Consumer loans above $300 were written under Industrial Loan Acts. *Id.* at 52-60 (discussing the history of industrial bank loans). Many companies obtained dual licenses. Even today there is considerable overlap among licensees under the Iowa Regulated Loan Act (formerly the Iowa Small Loan Act) and the Iowa Industrial Loan Act. *See* IOWA DEPT. OF COMMERCE DIV. OF BANKING, 1999 ANN. REP. OF THE SUPERINTENDENT 65-70 (listing both "Industrial Loan Licensees" and "Regulated Loan Licensees").

The Russell Sage research effort concluded that a 3% per month return (36%) would bring a 6% return to investors, but the 3.5% (42%) was the result of compromise with a segment of the lending industry that emerged as the force for reform from within. CALDER, *supra* note 179, at 131-33.

183. CURRAN, *supra* note 180, at 144-45, 53 (citing the seventh draft at §§ 1(a)(4), 2(a), 13(c)).

184. *Id.* at 146 (citing § 2(c)).

185. *Id.* at 153 (citing § 13(c)).

186. *Id.* at 154 (citing § 14(c)).

187. Arkansas has an interest rate ceiling in its constitution. *Id.* at 16, 26 n.94.

188. CALDER, *supra* note 179, at 147.

2. *Retail Sales and the Installment Plan*

Industrialization played a more direct role in the development of installment purchases of consumer goods. While furniture and pianos had been brought into some nineteenth century American homes with the help of installment buying, it was the I.M. Singer & Company's successful effort to get sewing machines into the home that appears to have launched the modern era of installment purchases for expensive consumer durables.[189] The Singer Company's newsletter first suggested the concept of "renting" a sewing machine to housewives and applying the rental fee to the purchase in 1856.[190] Credit later came into its own as a mass-marketing tool with the automobile as auto manufacturers developed financing arms that facilitated sales to mainstream America.[191] By 1930 most durable goods were purchased through installment credit.[192]

A desire to evade usury laws was probably not the motivation for the original rent-to-own contracts,[193] because installment purchase credit generally was not subject to interest rate caps at that time. This exception was due to the time price doctrine for the sale of goods. The higher price differential charged to those deferring payment for the purchase over time was not considered "interest" for purposes of usury laws.[194] However, through the middle part of the century, most states enacted retail installment sales acts (RISAs). Many RISAs included rate ceilings applicable specifically to retail installment sales, though sometimes maintaining the terminology of "time price differential."[195] Either implicitly through enactment of such legislation or through judicial decisions, most states have now restricted the time price doctrine, bringing most consumer installment purchases under state credit regulatory schemes.[196] Moreover, the price tag disclosures required by the Truth in Lending Act upon its enactment in 1969 made no distinction between "interest" and "time price

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189. *Id.* at 164-65.

190. *Id.* at 164. The English "hire-purchase" system of installment buying, like the rent-to-own system, leaves title in the seller's name until the contract is complete. Calder notes that the concept apparently originated with a countess negotiating with a furniture dealer in 1830. *Id.* at 158.

191. *See generally* MARTHA L. OLNEY, BUY NOW, PAY LATER: ADVERTISING, CREDIT AND CONSUMER DURABLES IN THE 1920S (1991) (discussing the role of credit in marketing automobiles). Olney believes that manufacturers' financing was not directly a retail marketing plan, but rather a solution to dealers' financing problems.

192. CALDER, *supra* note 179, at 201. The percentages included 60-75% of automobiles, 80-90% of furniture, and 65% of vacuum cleaners. *Id.*

193. *But see* Singer Mfg. Co. v. Smith, 40 S.C. 529, 532, 19 S.E.132, 134 (1894); Singer Sewing Mach. Co. v. Holcomb, 40 Iowa 33 (1874).

194. *See generally* COST OF CREDIT, *supra* note 22, § 10.3.2.1.1, at 339 (discussing retail installment sales acts in historical context); CURRAN, *supra* note 196, at 13.

195. CURRAN, *supra* note 180, at 83-123.

196. *See generally* THE COST OF CREDIT, *supra* note 22, § 10.3.2.1.2, at 341 (citing cases on the erosion of the time-price doctrine).

differential;" both are a cost incident to credit and must be disclosed as part of the credit pricetag.[197] By the time the modern rent-to-own industry began to grow, credit installment sales were subject to regulation. Therefore, the second wave of fringe lenders were confronted with a regulatory system to evade.

B. *The Credit Boom: The Small Loan Lenders Move Upstream*

In the 1960s, small loan licensees still made "small" loans, though the maximum loan amount by then ranged from $200 to $5000.[198] However, bigger-ticket loans began to take an increasing share of the small loan finance company industry's holdings.[199] Today the adjective "personal" no longer defines what used to be called the personal finance industry. Several factors have led to this transformation. Business lending pulled ahead of consumer lending in the mid-70s, and has remained ahead since then.[200] Auto finance, always an important part of the personal finance industry's market, grew from a 23% share of consumer receivables in 1975 to 79% in 1996.[201] Additionally, consumer lending moved from smaller-dollar personal loans to larger-balance home equity loans.[202] The increase in borrowing *against* the home, as opposed to merely borrowing to *acquire* the home,[203] was fueled by (1) deregulation of the mortgage market, including home equity loans as well as purchase money loans;[204] (2) new developments in the secondary market for mortgages;[205] (3) appreciation in real estate values in many parts of the country; and (4) the 1986 tax code revision, which eliminated the interest deduction for all debt except

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197. 15 U.S.C. § 1605(a)(1) (1994); Reg. Z, 12 C.F.R. § 226.4(b)(1) (1999) (stating that finance charges include the time-price differential).

198. CURRAN, *supra* note 180, at 21. Mississippi had no loan amount cap. *Id.* at 21 n.59.

199. CALDER, *supra* note 179, at 148. Calder reports that among the major chain lenders, this process of moving upstream actually began very early, when Household Finance Corp. lowered its rates from 3.5% to 2.5% by setting a loan amount floor at $100. *Id.* "Since larger loans were generally made to borrowers with larger incomes and assets, this was a sign that the larger chains at least were going after a new kind of borrower, leaving less well off borrowers to illegal lenders willing to take the higher risk." *Id.*; *see also supra* Part II.D (discussing risk and profitability).

200. James D. August et al., *Survey of Finance Companies, 1996*, 83 FED. RES. BULL. 543, 544 (1997). Business lending was 44% of industry receivables in 1996, compared to 42% for nonmortgage consumer receivables. *Id.* at 544 tbl.1.

201. Evelyn M. Hurley, *Survey of Finance Companies, 1975*, 62 FED. RES. BULL. 197, 199 tbl.1 (1976); August, *supra* note 200, at 547 tbl.4.

202. *See generally* OLNEY, *supra* note 191 (discussing the growth of automobile sales financing).

203. Home-secured lending by finance companies is almost all equity lending, rather than purchase money lending, though the industry does finance mobile home purchases. August, *supra* note 200, at 548.

204. For a review of the deregulation of the home mortgage market, see Mansfield, *supra* note 19.

205. Mortgage-backed securities appeared during this period.

home-secured debt.[206]

Because profit margins on small sum borrowing are smaller than on larger loans, and home-secured loans are the most secure in the consumer credit marketplace, the small loan finance company industry moved onward and upward. Subsequently, around the country maximum loan amounts under the old Small Loan Acts were raised or eliminated entirely.[207] When small loan amount ceilings were still relatively low, dual licenses under the small loan acts and Industrial Loan Acts, along with the creation of new affiliated entities to engage in different types of lending enabled small loan finance companies to operate in this higher-ticket market. While finance companies had only a small market share of the $5 trillion real estate credit market, mortgage lending still made up 13.5% of their receivables by 1996.[208] In contrast, personal consumer loans were less than 8% of total receivables,[209] whereas in 1975 personal cash loans were 17% of total receivables.[210]

In today's market, the finance company's small loan customer often becomes a big loan borrower quickly, sometimes through practices which have drawn criticism. For example, one source of personal finance loan customers has always been the sales-finance transaction. In this type of transaction, a seller sells an item—furniture, a washer, a computer—"on time." The retail installment sales contract between the seller and the buyer is immediately assigned to a finance company. Once the finance company acquires a customer this way, it sometimes tries to turn that person into a longer-term customer by extending new credit: refinancing the original retail installment contract into

206. Kennickell et al., *Family Finances*, *supra* note 9, at 1, 16.

207. In the course of raising maximum loan amounts, some states changed the name of the law from "Small Loan Act" to other names, such as "Regulated Loan Act" or "Consumer Finance Act." Commerce Clearing House's Consumer Credit Guide details the current maximum loan amounts authorized by state small loan laws, by whatever name they are called today. Small Loan Acts, 1 Consumer Credit Guide (CCH) ¶ 540 (Feb. 24, 1988).

208. August, *supra* note 200, at 548. Real estate lending includes both commercial and residential. Total industry receivables were about $771 billion, of which there were $103.8 billion total real estate receivables. $71 billion (or 68%) of the real estate receivables represented loans to individuals, primarily home equity loans. This is about 9% of the total $771 billion in industry receivables. *Id.* at 544, 548.

209. *Id.* at 548. "Other" consumer receivables include personal cash loans, sales finance (nonmotor vehicle), and mobile homes (which would be big-ticket loans). This category comprised 19.2% of consumer receivables ($62.5 billion). *Id.* at 544, 547-48. In turn, consumer receivables comprised only 42.3% of the industry's total receivables. *Id.* at 544. Personal cash loans, then, would be only a portion of the $62.5 billion "other" category, and therefore probably less than 8% of the $771 billion in total industry receivables.

210. Hurley, *supra* note 201, at 199 tbl.1. The 1975 survey did not include a separate category for real estate lending, but the figures can be derived. Out of total gross receivables of $86 billion, only $1.9 billion of the $16.7 billion in personal cash loans were secured by a second mortgage. *Id.* Thus nonmortgage personal cash loans ($14.8 billion) constituted 17% of gross receivables and home equity loans constituted 2%.

a loan under the state small loan act.[211] As one industry analyst described the practice in a conversation with one of the authors, the finance company industry's game plan is not to serve the small loan market, but rather to move the small loan borrower up the "food chain" from the feeder merchant's sales finance contract to a home equity loan.[212]

While the finance companies began the move towards high-dollar lending, credit cards began to supplant (and expand) the market for small dollar credit. As the rise in credit card debt from $287 billion at the end of 1993[213] to $588.7 billion in August 1999[214] illustrates, credit cards are what most Americans now use for short-term, small dollar credit, whether for convenience, need, or asset acquisition.

While there are undoubtedly a complex combination of factors at play, it seems plausible that the abandonment of the small loan marketplace by the traditional small loan lenders on the one hand, and the adequacy of the credit card to serve the majority of America's small-dollar credit needs on the other, created a void that grew under the radar screen of regulators, policy makers, and, for a time, even the mainstream industry. In this void, an industry resurfaced that the first few decades of the century were spent trying to stamp out. That vacuum of intangibles is matched, at least in some communities, by a parallel physical vacuum as some low-income and minority communities remained underserved by traditional banks, or became underserved as a result

211. Except in states that have followed this current wave of deregulation, RISA rates are typically lower than small loan rates. Refinancing those transactions, then, often turns 18% or 21% sales credit into loan credit that could charge small loan rates of up to 36%. *See generally* COST OF CREDIT, *supra* note 22, § 6.4.3, at 196 (discussing "flipping" of lower rate sales financing into higher rate loans).

When moving the loan balance upstream, the rate can be lowered while the overall cost is raised. Bigger principals mean more interest, as do longer terms. In some cases, packing the loan principal with high fees and charges can even mean that a large part of the loan "principal" consists of loan costs. *See generally id.* § 6.1 (discussing problems associated with refinancing); Gene A. Marsh, *The Hard Sell in Consumer Credit: How the Folks in Marketing Can Put You in Court*, 52 CONSUMER FIN. L. Q. REP. 295, 296-97 (1998) (discussing problems associated with loan renewals).

212. A notorious example of a small sales finance contract from a "feeder merchant" that was moved up the "food chain" to an unconscionable home equity loan through eleven loans in four years—with ten points charged each time—was featured in both the *Wall Street Journal* and on television's *PrimeTime Live*. Jeff Bailey, *A Man and His Loan: Why Bennie Roberts Refinanced 10 Times*, WALL ST. J., Apr. 23, 1997, at 1; NATIONAL CONSUMER LAW CENTER, CONSUMER LAW PLEADINGS 49, 49-55 (1997) (describing the specifics of this situation); *see also* COST OF CREDIT, *supra* note 22, at 183, (providing an example, based on an actual case, of how a small loan borrower can borrow $6000 at the maximum small loan rate and end up paying either $6900 or $16,000); Michael Hudson, *Loan Scams*, *in* MERCHANTS OF MISERY 72, 72-79 (Michael Hudson, ed. 1996) (discussing targeted widespread home equity scams).

213. *Financial and Business Statistics*, 82 FED. RES. BULL. A1, A36 tbl.1.55 (1996).

214. *Financial and Business Statistics*, 85 FED. RES. BULL. A1, A36 tbl.1.55 (1999).

of branch closings.[215]

IV. THE MARKET FOR FRINGE PRODUCTS AND SERVICES

During periods in which the politically dominant preference is to rely more on the market than legal constraints, it is important to understand whether a particular industry operates under conditions necessary for the proper function of market forces. If smoothly functioning market forces require relative equality of bargaining power, relatively equal access to and comprehension of relevant information, opportunities for meaningful choice, and a basic level of good faith, then a marketplace which lacks such elements raises serious policy questions.[216] It is important, then, to understand who are the customers of the fringe banking marketplace.

The marketplace is not homogenous. For example, the check cashers are more likely to cater to those without bank accounts (though certainly "banked" consumers use check cashers as well),[217] while the payday lenders who take post dated checks or debit authorizations will by definition deal with those who have bank accounts.[218] But the broad outlines suggest that, while some middle class consumers may turn to the fringe banking system for convenience or because of temporary setbacks,[219] the primary target market for the fringe

215. The 1977 Community Reinvestment Act was enacted in an effort to encourage greater attention by banks to the needs of all of the local communities. 12 U.S.C. § 2901(a)(3) (1994).

216. It is generally recognized that in consumer transactions, there is unequal economic power, unequal bargaining power, and unequal "knowledge, experience, and sophistication." CURRAN, *supra* note 180, at 83. One economist has raised the point of good faith in this manner: "There is some truth in the allegation that unregulated competition places a premium on deceit and corruption." FRANK HYNEMAN KNIGHT, THE ETHICS OF COMPETITION AND OTHER ESSAYS 42 (1935); *see also* Pinkett v. Moolah Loan Comp., No. 99C2700, 1999 WL 1080596, at *5-6 (N.D. Ill. Nov. 2, 1999) (looking at the gross disparity in bargaining positions between the parties and the borrower's lack of choice when presented with unfavorable terms); State *ex rel.* Bryant v. R & A Investment Co., 985 S.W.2d 299, 303 (Ark. 1999) (finding unconscionability and violations of the Deceptive Trade Practices Act by a title loan company).

217. The demographics of the noncredit AFS user (the check cashing customer) have been more thoroughly studied, having a longer track record than payday lenders or title lenders. CCO customers tend to have lower incomes. One industry survey, which Caskey reported would overrepresent the more affluent customers, nonetheless found a median income of $20,400, compared to the then national income median of $30,500. CASKEY, FRINGE BANKING, *supra* note 3, at 73-78; *see also* Jean-Paul, *supra* note 29, at 4 (stating that those without checking accounts have disproportionately low income); Kennickell et al, *Recent Changes 2000*, *supra* note 9, at 9 (noting the increase in families with transaction accounts); *see generally* Jeanne M. Hogarth & Kevin O'Donnell, *Banking Relationships of Lower-Income Families and the Governmental Trend Toward Electronic Payment*, 85 FED. RES. BULL. 459 (1999) (discussing the federal government's role in expanding electronic payment systems and its potential effects on low income families).

218. *See supra* Part II.B.2.

219. Lieberman Forum (Rochford testimony), *supra* note 30, at 3. Driving through Beverly Hills a few years ago, one of the authors spotted a sleek chrome sign in a smart district that read "Collateral Lending." It took a moment to register as an upscale pawn shop.

banking system is one in which market forces may not work well.

The question of who best epitomizes the payday loan customer is the subject of some dispute. Industry data indicates that payday lending is currently concentrated in six states: 3000 of the 6000 licensees reported by the Financial Service Centers of America (FiSCA) are found in Kentucky, Tennessee, Missouri, Mississippi, North Carolina, and South Carolina.[220] All six states are below the median income for the United States,[221] and four have above-average poverty rates.[222]

The president-elect of a recently formed trade association for payday lenders, the Community Financial Services Association of America (CFSA),[223] reported the following to a 1999 public forum sponsored by United States Senator Joseph Lieberman:

> The typical payday advance customer is a responsible, hardworking middle class American. The
>
> - Average age is 35 years old
> - Average annual household income is $33,000.00
> - Average time in current residence is 4.5 years
> - Average time in current job is 4 years
> - 33% own their own home
>
> All of them have a current checking account and a regular source of income.
>
> Our customer represents the heart of the working middle class—teachers, nurses, construction workers, state and federal employees and the like.
>
> These are not "poor, disadvantaged" people as is often alleged; these are good people, with a short term financial need.[224]

Likewise, the representative of the check casher's trade association (newly

220. *Id.* at 9.

221. The 1996 to1998 three-year average median income for the United States was $37,779. Median income for the six states home to half of the payday lenders are: $37,640 (Missouri), $36,407 (North Carolina), $34,692 (South Carolina), $34,633 (Kentucky), $32,397 (Tennessee), $28,592 (Mississippi). U.S. CENSUS BUREAU, CURRENT POPULATION SURVEY, xvi tbl.D, xviii fig.7 (Mar. 1999).

222. The 1996 to1998 three-year poverty rate for the United States was 13.2%. South Carolina's was 13.3%, Tennessee's was 14.5%, Kentucky's was 15.8%, and Mississippi's was 18.3%. U.S. Census Bureau, *Poverty 1998* (visited Jan. 2000) <http://www.census.gov/hhes/poverty/poverty98/pv98state.html>.

223. The trade association was formed in 1999 to be the payday loan industry's national trade group. *See infra* Part VI (discussing legislative and public relations campaigns in the fringe marketplace).

224. Lieberman Forum (Webster testimony) *supra* note 87, at 5-6.

renamed the Financial Services Centers of America (FiSCA))[225] told the forum that "[t]here is no 'target' market for the industry or FiSCA members who provide this financial product," citing data indicating household incomes "from \$20,000 to \$25,000 on the low side to \$35,000 to \$45,000 on the high side."[226]

On its face, the study of the short-term loan industry conducted by the Illinois Department of Financial Institutions at the behest of the state legislature supports FiSCA's position. The report claims the following:

> [T]he short term loan industry is not targeting areas of specific personal income levels. We have combined data generated from the U.S. Census Bureau and the Bureau of Economic Analysis to verify that areas with the lowest personal income levels are not being inundated by the presence of these businesses. The counties with the densest population of short term lenders are usually the counties with the highest average personal income levels.[227]

However, even a cursory examination of this statement raises questions. Not surprisingly, Cook County, home to Chicago and over 40% of the state's population, is the fringe-lending capital of the state. It sports 202 of the state's 455 payday lenders (44.4%) and forty-seven of the state's ninety licensed title lenders (52%).[228] The Illinois DFI reached the above conclusion by using the county's 1997 average personal income of \$29,343—one of the higher county averages.[229] But a county is a broad sample, particularly Cook County, and averages hide the extremes. Chicago's neighborhoods run the gamut from the South Side to the Gold Coast, with a wide range of median income levels.[230] Thus the high county-wide average income may not reflect the true composition of Cook County's fringe banking customers.

Some studies examining the geographic distribution of the check cashing outlet (CCO) and currency exchange (CE) providers on a narrower scale raise a question about the weight that should be given to the Illinois DFI's location-

225. This trade association was formerly known as the National Check Cashers Association (NaCCA). The change reflects the expansion of the CCOs into the short-term lending business.

226. Lieberman Forum (Rochford testimony), *supra* note 30, at 12-14. Rochford also cited the results of a focus group showing interest among households in the \$25,000 to \$50,000 range, though the focus group apparently did not consist of customers. *Id.* at 13.

227. DFI REPORT, *supra* note 33, at 10.

228. *Id.* at 11-12.

229. *Id.* at 11.

230. A 1997 study cites a \$7900 median income in one of the lowest-income communities in Chicago, compared to a median income for the city as a whole of \$37,824. WOODSTOCK INST., CURRENCY EXCHANGES, *supra* note 29, at 3.

based findings.[231] For example, the Federal Reserve Bank of Boston looked at multi-census tract areas in cities in New England where check cashers were most densely clustered—Boston, Hartford, and Providence.[232] The Boston study found that the cities with high CCO clusters tended "to have high percentages of low- and moderate-income census tracts and households,"[233] high percentages of households below the poverty level, and higher shares of households on fixed incomes (either public assistance or social security).[234] More dramatic is the Woodstock Institute's study of the relative distribution of banks and CCOs/CEs in Chicago, which examines specific census tracts. This study found that the currency exchanges are predominately located in lower income, minority communities. The currency exchange to bank ratio in five predominately minority communities with median household incomes below $22,000 exceeded ten to one. The lowest income communities, with median incomes of $7908 and $12,570, each had twelve check cashers for every one or two banks.[235] A separate rent-to-own study suggests another reason to look carefully at fringe lender locations on a neighborhood basis, for it found that variations in rent-to-own prices were inversely related to the average income level of the census tract in which the rent-to-own was located: the poorest paid the most.[236]

Military officials, who are seriously concerned about the impact of fringe banking credit on servicemen, have noted the importance of location: "These high visibility, flashy, neon sign adorned buildings line the roadways

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231. Some check cashers also provide short-term credit, directly or as conduits for third parties. *See supra* Part II.A. Because one of the reasons posited for the use of CCOs/CEs for noncredit banking services is the absence of bank locations in the neighborhood, these studies looked at the relative distribution of the CCOs/CEs and bank branches. Generally, the convenience of the location is not cited as a major factor for choosing CCOs over banks for non-credit services. JOHN P. CASKEY, BEYOND CASH-AND-CARRY: FINANCIAL SAVINGS, FINANCIAL SERVICES, AND LOW-INCOME HOUSEHOLDS IN TWO COMMUNITIES (1997) [hereinafter CASKEY, CASH-AND-CARRY], but other more intangible reasons sometimes cited may relate to location. If people (with and without bank accounts) feel "more comfortable" with CCOs, *id.* at 31, this could relate to the CCO making itself more of a familiar face in the neighborhood. If 23% of people without checking accounts "don't like dealing with banks" (rising from 15% between 1992 and 1995), Kennickell, *Family Finances*, *supra* note 10, at 7, this could relate in part to the way different kinds of providers try to integrate into the fabric of a neighborhood.

232. Jean-Paul & Nathan, *supra* note 29, at 5. The check cashing industry says that the CCO customer base is "somewhat different" from the payday loan customer base. Lieberman Forum (Rochford testimony), *supra* note 30, at 2. But as CCOs offer payday loan services either directly or indirectly, their location may be increasingly important in looking at both the check cashing sector and the cash loan sector.

233. Jean-Paul & Nathan, *supra* note 29, at 5.

234. *Id.* at 8. The study also found that those areas where not necessarily "underbanked" in terms of physical access to depository institutions. *Id.* As to the type of credit offered by AFS credit providers, of course, banks and the fringe bankers are not in competition.

235. WOODSTOCK INST., CURRENCY EXCHANGES, *supra* note 29, at 3.

236. Michael Walden, *The Economics of Rent-to-Own Contracts*, 24 J. CONSUMER AFF. 326, 336 (1990).

surrounding the military bases, obviously targeting the serviceman."[237] Testimony of the Illinois Consumer Justice Council before the Illinois State Senate Financial Institutions Committee cites a corporate payday lender's press release: "'We target stores in working-class neighborhoods. All things being equal, the higher the concentration of our target demographic in the neighborhood, the more productive the store location will be.'"[238] The testimony also included ads specifically targeted at social security recipients.[239]

Turning from the character of the neighborhoods to the characteristics of payday and title loan borrowers, one finds more disagreement with the picture given by the payday loan industry. Though some military personnel are officially considered "neither as 'poor' nor as 'non-poor'" for census purposes,[240] it is clear that many have little expendable income.[241] For example, a sailor, third-class rank, with a spouse and one child, has a surplus of $135 a month after normal bills to meet unexpected expenses.[242] The *60 Minutes* story on auto title loans includes a caution from military critics of the industry who have testified in legislative hearings that so many young sailors are worried about their cars being repossessed that it has adversely affected military readiness.[243] The Illinois DFI also noted ads targeting college students and young high school graduates, referencing studies indicating low levels of financial literacy among students. The DFI also found that "[p]eople living on fixed incomes are also targeted due to their inability to keep pace in a world of rising costs."[244]

The military customers demonstrate the power of generated demand: [245] active duty military personnel can receive interest-free emergency loans to meet financial needs,[246] yet they still turn to fast cash providers in enough numbers to worry military leaders about the fringe lending industry's impact on national defense. While a base commander recognizes that education is part of the problem, the "powerful marketing campaigns these companies have

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237. Lieberman Forum (Andersen testimony), *supra* note 59, at 1.

238. Edelman testimony, *supra* note 43, at 3 (quoting a press release from Sonoma Holding Corporation on Business Wire, issued Feb. 3, 1998).

239. *Id.* at 4.

240. Military personnel in barracks are not counted for purposes of poverty statistics. U.S. Census Bureau, *Poverty 1998*, *supra* note 222

241. *See, e.g.*, Michael Singletary, *Our Defenders Have Earned a Better Life*, WASH. POST, April 18, 1999, at H01.

242. Lieberman forum (Anderson testimony), *supra* note 59, at 2.

243. *60 Minutes*, *supra* note 46, at 8.

244. DFI REPORT, *supra* note 33, at 27.

245. As said in FIELD OF DREAMS (MCA/Universal 1989), "If you build it, they will come."

246. For example, Army Emergency Relief (AER) provides active-duty servicemen with emergency loans for (1) food, rent, or utilities, (2) emergency vehicle repair, (3) funeral expenses, (4) medical expenses or (5) personal needs when pay is delayed or stolen. *See* Army Emergency Relief, *Questions and Answers about AER* (visited 28 April 2000) <http://www.aerhq/questions.htm>.

which make them sound 'too good to be true'" is also a big contributor.[247]

Whether there is targeting or not, either through location or advertising, the actual customer profile drawn by the payday loan industry's trade association does not match the profile found in the Illinois DFI survey. The average salary in Illinois is $25,131 for payday loan customers and $19,808 for title loan customers.[248] This puts the payday customer at 60% of Illinois' median income of $42,065 and the title loan borrower at less than half (47%) of median income.[249] Given the concentration of the state's industry in Cook County, presumably the majority of Illinois' fringe-loan customers are also there, where the payday borrower would be at 66% of the county's median income, and the title loan borrower at 52%.[250] People on fixed incomes also comprise part of the payday demographic, at least in California, supporting the Illinois DFI's finding on targeting that group.[251] The results of a Consumers Union analysis of occupational data for payday loan customers was consistent with the Illinois findings both as to income and as to the apparent targeting of people on fixed incomes.[252] Of the 83% of the payday loan customers in the paid work force in the population reviewed, Consumers Union found an average annual income of $25,417.[253] Two of the top five categories of occupations listed on the self-reported data reviewed were fixed income:

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247. Letter from Rear Admiral K.C. Belisle to Mayor John Delaney (Nov. 3, 1998) (on file with authors).

248. DFI REPORT, *supra* note 33, at 26.

249. U.S. Census Bureau, *Income 1998* (last modified Sept. 30, 1999) <http://www.census.gov/hhes/income/income98/in98med.html> (reporting that the Illinois median income of $42,065 is the three year average, 1996 to 1998). Low to moderate income is generally considered to be 80% of median income. Hogarth & O'Donnell, *supra* note 217, at 460. The second highest concentration of title lenders in Illinois (five) is in St. Clair County, home to East St. Louis. DFI REPORT, *supra* note 33, at 12. That county's median income is more than $9500 below the state median income.

250. U.S. Census Bureau, *Small Area Income and Poverty Estimates*, model-based estimates for Cook County in 1995 (visited Mar. 31, 2000) <http://www.census.gov/hhes/saipe/estimate/cty/cty17031.htm> (estimating median income at $37,824). The Illinois DFI Report used *average* income. An evaluation of the data released as this article was going to press placed the *median* income payday loan borrower at only 40% of the 1998 median family income for the Chicago-metro area. WOODSTOCK INSTITUTE, CURRENCY EXCHANGES, *supra* note 29, at 6.

251. Data analyzed by Consumers Union, San Francisco, Calif., (Nov. 1999) (on file with authors). When a bill relating to payday lending was introduced in the California legislature, S.B. 834, payday lenders gave their patrons form letters to send to the legislators. The forms included a space for the patrons to list their occupations. Consumers Union divided these letters into geographic regions of California, selected 1741 random letters from within those regions, and used Bureau of Labor statistics to derive income data. The largest category of occupations represented (28.37%) was administrative support, including clerks. Though the "professional, technical and related"category, with mean weekly earnings of $831, comprised 12.4% of the sample, 60.1% of those in the pool were in occupations with mean earnings of less than $500 per week ($25,000 for a fifty-week year).

252. *Id.*

253. *Id.*

1 - retired (6%),
2 - sales/retail (6%),
3 - disability/SSI (5%),
4 - clerks (5%), and
5 - managers/supervisors (5%).[254]

The survey of customers of Oklahoma's version of the payday loan industry found the following demographic data:

Education:	73%—12 years or less
	27%—some additional trade school or college
Income:	48%—Under $15,000
	30%—$15,000-20,000
	17%—$20,000-25,000
	5%—Over $25,000[255]

Additional income in the form of "Social Security, Social Security Disability, welfare, Aid to Dependent Children, Oklahoma National Guard, and for students, grants and scholarships" was reported by 18% of the survey respondents.[256]

Though these loans are in theory "tide over" advances designed to take the customer to the next payday, these income levels point out a fundamental fallacy in that characterization. A budget analysis helps explain how and why these short-term loans so often lead to the debt treadmill.[257] Senator Lieberman's staff prepared an "Ability to Repay" budget analysis based on both the $25,000 and $35,000 average income levels.[258] Subtracting only "essential" expenditures from the net two-week paycheck—food, housing, utilities, transportation, and healthcare—left a $28 deficit at the $25,000 income level, and a $134 surplus at the $35,000.[259] Factoring in the average payday loan debt (with full pay off, not a renewal fee) due at the end of the pay period, there was a $196 deficit at the $25,000 and a $34 deficit at the $35,000 level.[260] Doing the same for the maximum allowable payday loans, the bottom line deficits would be $407 and $396, respectively.[261] This analysis demonstrates how the short time frames on these loans leave no time to

254. *Id.*

255. Wheat, *supra* note 110, at 454-55. See *supra* note 110 for an explanation of Oklahoma's "quasi-payday" lenders.

256. *Id.* at 455.

257. *See supra* Part II.B.3.

258. *Forum on Short-Term High-Interest Paycheck Advances*, convened by Sen. Joseph Lieberman, ranking minority member, U.S. Senate Comm. on Governmental Affairs (Dec. 15, 1999), comm. charts [hereinafter Lieberman Forum Charts].

259. *Id.*

260. *Id.*

261. *Id.*

accumulate any surplus from which to repay a debt, which in turn leads to the insidious downward spiral of renewals.[262]

The Illinois DFI study found that title loan borrowers were equally divided between men and women, but that 60% of the payday loan borrowers were women, and both types of borrowers were on average in their mid-thirties.[263] Among payday loan customers, 75% were renters, 15% homeowners, and 10% "other."[264] For title loan borrowers, 80% were renters, 10% homeowners, and 10% "other."[265] As noted earlier, these customers are not one-time users, but rather renewing customers. In Indiana, for example, the customers average about 4.5 to 5 months.[266] A report of an informal survey indicates the average payday loan customer is a twenty-eight-year-old white female with an annual income of $14,500 to $20,000, employed in a service industry.

The Illinois DFI study collected no data on household size, nor did it examine the racial composition of the payday loan borrower.[267] Without the information on the former, it is impossible to determine where the average payday loan borrower falls on the poverty scale.[268] However, the age and gender findings of the Illinois DFI study and the informal survey cited raise the question of whether single mothers are turning to payday lenders to meet

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262. *See supra* Part II.B.3; Lieberman Forum (Tarpey testimony), *supra* note 59, at 3; Lieberman Forum (Gallagly testimony), *supra* note 59, at 1; Lieberman Forum (Andersen testimony), *supra* note 59, at 2.

263. DFI REPORT, *supra* note 33, at 26.

264. *Id.*

265. *Id.*

266. Lieberman Forum (Tarpey testimony), *supra* note 59, at exhibits B, C. (revealing that the average term was two weeks and the average number of renewals was ten).

267. Current law forbids taking racial data on borrowers in nonmortgage credit. Equal Credit Opportunity Act, Reg. B, 12 C.F.R. § 202.5(d)(5) (1999). The theory was that if the lender did not know the race of the borrower, the lender could not discriminate on the basis of race. At the time, the primary concern was that credit would be improperly denied as a result of discrimination. But wherever there is in-person contact between a borrower and lender or lender's agent, race generally will be known. Given the increasing concern in the past decade about "reverse redlining," or discriminatory pricing of credit that is granted, there is currently a proposed amendment to allow the gathering of race information to make it possible to monitor any discriminatory pricing. 64 Fed. Reg. 44,596 (1999).

Redlining refers to the old practice of insurance companies and banks of literally drawing a red line around certain neighborhoods in which they would not do business. In recent years, there has been increasing focus on a kind of market pathology in which, in the absence of lending from mainstream lenders in some neighborhoods, "predatory" lenders move into the vacuum with very high-priced credit—which to some degree may be the result of discriminatory pricing, rather than the "risk pricing" that is used to justify it. *See generally* DANIEL IMMERGLUCK & MARTI WILES, WOODSTOCK INST., TWO STEPS BACK: THE DUAL MORTGAGE MARKET, PREDATORY LENDING, AND THE UNDOING OF COMMUNITY DEVELOPMENT 1-2 (1999); NATIONAL CONSUMER LAW CTR., CREDIT DISCRIMINATION §§ 4.2.10-11 (2d. ed. 1998).

268. For example, the average title loan borrower in Illinois makes $19,808. DFI REPORT, *supra* note 33, at 26. This income would be at the approximate poverty level if for a five-person household, but at 143% of poverty level if from a three-person household. 1999 HHS Poverty Guidelines, 64 Fed. Reg. 13,428 (1999).

financial needs.[269] And the specter of "reverse redlining"—high-priced financial services providing most credit and banking services in minority communities—raises much deeper policy concerns.[270]

Refund anticipation loans (RALs) have a marketing and distribution system significantly different from the other fringe market products. Obviously RALs are a once-a-year opportunity, and they are not directly available from the lenders. Instead, tax preparers typically market the RALs.[271] Given that a major concern about fringe market lending is the debt treadmill, not the one-shot usage, it would seem at first blush that the one-shot RAL would engender less concern. However, the fact that the high-priced RAL can substantially reduce the Earned Income Tax Credit (EITC) offsets complacency about the natural annual limitation.[272]

The recent RAL practice of including a boilerplate right to set off the refund against debts owed to other lenders is also troublesome because the consumer can lose her entire refund without having the right to a court hearing to present any defenses. Thus this practice amounts to a private prejudgment garnishment without an opportunity for notice and hearing.[273]

A Georgia study identified users of refund anticipation loans as primarily "low-income, nonwhite and female."[274] The authors of the study point out that "[i]ncome is of special note; over half of the sample was in the lowest quintile of income distribution." Median income for the sample was below the poverty line for a family of three."[275] The authors believed that "[t]he most striking

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269. *See supra* notes 263-65 and accompanying text; note 251 and accompanying text (showing that two of the top five occupational categories among California payday loan borrowers in one review were sales/retail and clerks).

270. *See, e.g.*, IMMERGLUCK & WILES, *supra* note 267.

271. *See supra* Part II.5, at 63-66 (regarding the tax preparers' incentives to sell the RALs).

272. *See* I.R.C. § 32 (1994). The EITC is a tax program to benefit the working poor. If the credit exceeds the tax obligation, the excess is added to the taxpayers refund. The EITC is one of the antipoverty programs that has generally enjoyed bipartisan support.

273. *See supra* Part II.5.

274. Joan Koonce Lewis et al., *Refund Anticipation Loans and the Consumer Interest: A Preliminary Investigation*, 42 CONSUMER INTERESTS ANN. 167, 168 (1996) [hereinafter *RAL Investigation*]. (The authors caution that this was a nonrandom, small-sample survey.) In a case currently pending in Colorado, the state sued a "tax-refund buyer" that the state alleges to be engaging in lending. *See* Brief of Amicus Curiae in Support of Appellants at 12, n.28, State v. The Cash Now Store, Inc. (Colo. Ct. App. 2000) (No. 98 CV 6898). The state argues, in part, that the company's marketing targets people "strapped for cash." *See* Amicus Brief at 12, note 28, *Colorado v. Cash Now*; *see also* Jason DeParle, *On a Once Forlorn Avenue, Tax Preparers Now Flourish*, N. Y. TIMES, Mar. 21, 1999, at 1, 20 (noting the influx of the business to serve first-time filers as part of its "life after welfare" series and discussing the availability of RALs, reporting that "[d]esparate to pay the rent, clients occasionally surrendered nearly $200 in interest and preparation fees on a $500 refund"); Beth Kobliner, *Tax Giant's Loan Deals Stir Dispute*, N. Y. TIMES, Apr. 12, 1998, at § 3, at 9 (quoting a spokesman for the Center on Budget and Policy Priorities who noted that RALs are "attractive to lower-income folks . . . [who] are certainly less likely to afford the high interest rates").

275. *RAL Investigation*, *supra* note 274, at 168.

finding from the study concerned consumer misinformation.[276] Nearly half the sample did *not* realize that 'quick' refunds were actually loans, although all applicants presumably had to complete truth-in-lending forms."[277] If this kind of correlation between RAL usage and low income levels is representative, a relatively high portion of RAL users may also be eligible for the EITC: over half of those in the Georgia survey were eligible.[278] The study further notes that

> The insidious nature of RALs was emphasized by a financial counselor who works with public housing tenants. She noted that the annual federal income tax refund was the only chance many low-income families had to accumulate cash. This is especially significant for families receiving the Earned Income Credit (EIC). With a refund, the family simply gets its own money back, but the EIC represents a net gain. The RAL fee erodes any benefit the family may gain from the EIC.[279]

An ethnographic study of the financial practices of low-income households reinforces concerns over diverting big chunks of the tax refund and EITC to triple-digit (or quadruple-digit, as the case may be) APR loan fees.[280] The study found that the reliance on the EITC to stabilize these families' finances was "striking."[281]

As with the payday loan customer, there are competing profiles of the rent-to-own (RTO) customer. The RTO trade association's website provides this income picture of the RTO customer:

> 6.3%—under $15,000 income
> 23%—$15,000 - $23,999
> 36.67%—$24,000 - $35,999
> 32.17%—$36,000- $49,999
> 1.83%—$50,000- $74,999[282]

However, a 1994 study of Rent-A-Center's customers shows a different profile. At the time, Rent-A-Center held 25% of the RTO market share in the

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276. *Id.*

277. *Id.* at 169 (citation omitted). The authors of the study may have been generous in their assumption about whether the lenders gave TILA disclosures.

278. *Id.* The survey found that EIC recipients were more aware that the RAL was a loan than non-EIC recipients.

279. *Id.* at 168 (citation omitted).

280. CASKEY, CASH-AND-CARRY, *supra* note 231, at 21.

281. *Id.*

282. Association of Progressive Rental Organizations (APRO), *What Is Rent-to-Own?* (statistics of 1999) (visited Feb. 9, 2000) <http://www.apro-rto-com/content/whatisrto.asp>.

United States. Following an unflattering expose' in the *Wall Street Journal*,[283] Rent-A-Center retained former Senator Warren Rudman, who commissioned a survey of Rent-A-Center's customers.[284] The survey found income figures for Rent-A-Center's customers "well below median household income for the US population" and concluded that demographically "[t]his sample might best be described as representative of the working poor, whose incomes are on the margin of economic stability."[285]

Existing data about the fringe banking cash credit market can be interpreted in different lights. While a marketing professor interprets long-term relationships with high-rate lenders as a sign of "customer satisfaction," others may view it as evidence of customers becoming captive to the debt treadmill.[286] Industry spokespersons point to an absence of complaints to regulators as a sign that there is no need for further regulation.[287] But those who have worked with low and moderate income clients believe the absence of complaints is misleading.[288] Myriad complex reasons may inspire customers not to take affirmative action. First, complaining to regulators—particularly financial services regulators—is a relatively rare response by consumers generally, and an extremely rare response among low and moderate income consumers. A far more common reaction is simple resignation.[289] Second, in states in which the high rates are legal, customer calls indicating dissatisfaction with fringe lenders may not even be recorded as complaints or may be deemed "unfounded" because of permissive legislation. Therefore, debt counselors, the bankruptcy system, and small claims filings are more appropriate sources to look to for signs of problems. Large numbers of default judgments against

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283. Freedman, *supra* note 142.

284. Carl C. Hoffmann & Robert L. Lovler, *Rent-A-Center: Final Report*, at 14, 15 (February 9, 1994).

285. *Id.* Additional demographics from the sample were noted: 67% have a high school education or less, and 44% have a high school diploma; the sample contained "substantially more minorities than are present in our general population. Thirty-one percent (31%) of our sample was receiving some form of public assistance . . . . Finally, 25% of our sample reported that they were currently unemployed." *Id.* at 15.

286. *See supra* Part II.B.3.

287. *See, e.g.*, Lieberman Forum (Rochford testimony), *supra* note 30, at 18.

288. The silence is comparable to that noted in the first wave of fringe banking, and no doubt attributable to the same factors. *See supra* Part III.A.

289. The authors' combined experience of over forty years working with low- and moderate-income consumers suggests that this is the case. *Cf.* State ex rel. Bryant v. R & A Investment Co., 985 S.W.2d 299, 303 (Ark. 1999) (finding the attorney general had standing to challenge title lender's usurious, unconscionable, and deceptive practices and noting that the state could invoke its UDAP statute to make the law's provisions "effective for consumers who are not likely to have the financial means to obtain legal assistance to bring individual actions, who are unlikely to be aware of their legal rights, and who have no choice but to continue paying illegal rates"); DFI REPORT, *supra* note 33, at 32 (stating that complaints may be low because customers are unaware of the Department's regulatory responsibilities, unaware of the process for complaining, or may "lack the proper understanding of the consumer lending laws and [do] not realize that violations have occurred").

payday loan borrowers (particularly judgments enlarged with collection fees and treble bad check damages) are probably more realistic sources for information about the depth and breadth of problems.

V. LITIGATION CHALLENGING FRINGE CREDIT PRODUCTS

As previously noted, fringe credit products were generally designed with the goal of enabling providers to argue that credit laws do not apply to them. Not surprisingly, this approach has generated both private litigation and public enforcement efforts. The weight of authority involving the cash-loan sector rejects the industry's efforts to recharacterize these credit products as something else.[290] In contrast, the weight of judicial authority has favored the rent-to-own industry's efforts at recharacterization.[291]

It is a long-standing judicial principle that substance, not form, dictates whether a transaction is a loan subject to usury laws.[292] Courts follow this principle in an attempt to prevent "the betrayal of justice by the cloak of words, the contrivances of form, or the paper tigers of the crafty."[293] As a Kentucky district court stated:

> The cupidity of lenders, and the willingness of borrowers

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290. *See infra* Part V.

291. In part, the difference might be an unconscious legacy both of earlier attitudes and earlier laws. Installment sales were viewed more positively than cash loans, as they more clearly relate to asset acquisition, and generally are thought to be more discretionary. However, the perception of what "discretionary" may vary: how discretionary are a washer and dryer in a household with kids in a neighborhood with no laundromat. *See generally* CALDER, *supra* note 179, at 156 (discussing how merchants making installment sales were proud instigators of this "mass consumption society"). And, as noted above, installment sales were previously treated as creatures apart under usury statutes. *See supra* Part III.A.

Courts in Minnesota, New Jersey, and Wisconsin, have found RTO transactions to be credit sales under their respective statutes. *See* Fogie v. Thorn Americas, Inc., 95 F.3d 645, 654 (8th Cir. 1996); Miller v. Colortyme, Inc., 518 N.W.2d 544, 547-48 (Minn. 1994); Green v. Continental Rentals, 678 A.2d 759, 761-62 (N.J. Super. Ct. Law Div. 1994); LeBakken Rent-to-Own v. Warnell, 589 N.W.2d 425, 430 (Wis. Ct. App. 1998); Rent-A-Center v. Hall, 510 N.W.2d 789, 792-93 (Wis. Ct. App. 1993). *But cf.* Ortiz v. Rental Management, Inc., 65 F.3d 335, 341 (3rd Cir. 1995) (declining to follow *Green* regarding the applicability of TILA). Additionally, the Vermont Attorney General promulgated regulations under its state UDAP statute requiring disclosure of the effective APR, Vt. Rule CF § 115, a rule which survived an industry challenge. *See supra* note 147 and accompanying text.

292. *See, e.g.*, Wilcox v. Moore, 93 N.W.2d 288, 291 (Mich. 1958) (stating "a court must look squarely at the real nature of the transaction"); Floyer v. Edwards, 98 Eng. Rep. 995, 997 (K.B. 1774) ("[W]here the real truth is a loan of money, the wit of a man cannot find a shift to take it out of the statute."); 45 AM. JUR. 2D *Interest and Usury* § 88 (1999) (stating that usury is not necessarily what the parties represent); 47 C.J.S. *Interest and Usury* § 100(c) (1982) (explaining that courts will look to circumstances of whole transactions); *see also* Adams v. Plaza Finance Co., Inc., 168 F.3d 932, 936-37 (7th Cir. 1999); Edwards v. Your Credit, Inc., 148 F.3d 427, 436-37 (5th Cir.1998) (both cases stating that substance, not form, dictates whether purported "non-filing" insurance is a hidden finance charge under TILA).

293. *Wilcox*, 93 N.W.2d at 291.

> to concede whatever may be demanded or to promise whatever may be exacted in order to obtain temporary relief from financial embarrassment, as would naturally be expected, have resulted in a great variety of devices to evade the usury laws; and to frustrate such evasions the courts have been compelled to look beyond the form of a transaction to its substance, and they have laid it down as an inflexible rule that the mere form is immaterial, but that it is the substance which must be considered. No case is to be judged by what the parties appear to be or represent themselves to be doing, but by the transaction as disclosed by the whole evidence; and, if from that it is in substance a receiving or contracting for the receiving of usurious interest for a loan or forbearance of money the parties are subject to the statutory consequences, no matter what device they may have employed to conceal the true character of their dealings.[294]

Moreover, most consumer protection statutes invoked in challenges to fringe lenders must be liberally construed to effectuate their purposes,[295] among which is the protection of less sophisticated borrowers from more sophisticated lenders.[296] Underpinning these principles is the recognition that

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294. Hamilton v. York, 987 F. Supp. 953, 955 (E.D. Ky. 1997), *quoting* Hurt v. Crystal Ice & Cold Storage Co., 286 S.W. 1055, 1056-57 (Ky. 1926).

295. *See, e.g.*, Rodash v. AIB Mortgage Co., 16 F.3d 1142 (11th Cir. 1994) ("[W]e liberally construe its [TILA's] language in favor of the consumer."); *see also* COLO. REV. STAT. § 5-1-102(1) (1999) (providing that the Colorado Uniform Consumer Credit Code "shall be liberally construed and applied to promote its underlying purposes and policies"); Mourning v. Family Publications Serv., Inc., 411 U.S. 356, 363-65 (1973) (noting the "divergent and at times fraudulent practices by which consumers were informed of the cost of their credit" as the reason for TILA, and giving the FRB discretion to address the "myriad forms" of credit extant and which would be devised in the future); Yazzie v. Ray Vicker's Special Cars, 12 F.Supp. 3d 1230, 1233 (D.N.M. 1998) (explaining the New Mexico Pawnbrokers Act's protection of customers from "exploitation, abuse or [their] own improvidence"); Brown v. Courtesy Consumer Discount Co., 134 B.R. 134, 143 (Bankr. E.D. Pa. 1991) (laws must be interpreted with flexibility necessary to preserve their spirit due to the "fertility of the minds of those who would devise schemes to circumvent remedial consumer protection laws"); Valley Acceptance Corp. v. Glasby, 337 S.E.2d 291, 295 (Va. 1985) (maintaining that the Virginia Small Loan Act, because "remedial in nature," should be "liberally construed").

There is a tension in courts' treatment of usury laws as either remedial consumer protection laws to be read broadly, or as "penal" statutes to be construed strictly. The latter approach, to some extent, is based upon a misreading of the history of usury laws and the aspects of such laws that are in "derogation of common law." The common law was that taking interest was not permitted at all, so the portion of usury statutes that are in derogation of common law is the part that *permits* interest, not the part that *restricts* interest. A discussion of relevant case law and these colliding principles is found in COST OF CREDIT, *supra* note 22, at §9.3.1.1.

296. *See* Dikeou v. Dikeou, 928 P.2d 1286, 1293 (Colo. 1996) (discussing the UCCC limitations); *see also* Semar v. Platte Valley Fed. Sav. & Loan Ass'n, 791 F.2d 699, 705 (9th Cir. 1986) (stating that TILA was designed to protect borrowers who are at an inherent disadvantage

the central premise of standard contract doctrine—that enforceable contracts are mutual, freely negotiated agreements between parties on a level playing field of understanding—do not reflect reality in the complex consumer credit marketplace.

Following these principles, most courts and regulators find the payday and title lenders subject to credit regulation except where specific authorizing legislation has been enacted.

A. Title Loans

Litigation over title pawns has been concentrated in the South, where the industry seems to have first taken hold. In the absence of specific legislation (or in Georgia's case, even in the presence of it for a while), efforts to invoke pawnbroker exceptions to usury ceilings and licensing laws have not been successful for title lenders.[297] The Arkansas Supreme Court upheld the state's challenge to auto-title lending based on the unconscionability doctrine. The court also upheld the state's usury and UDAP claims.[298] Likewise, an Alabama federal court concluded in January 1991 that a title pawn/leaseback arrangement was an extension of credit under both TILA and state law.[299] On the pendent state claim under Alabama's Small Loan Act[300] the court held that the pawnbroker exception to the Act did not apply: a true pawn requires that physical possession of the pawned item be taken; thus a transaction in which

in credit transactions); Equity Plus Consumer Fin. & Mortgage Co., Ltd. v. Howes, 861 P.2d 214, 216 (N.M. 1993) (stating that TILA is designed to protect borrowers who are not on an equal footing with creditors, either in bargaining power or with respect to knowledge of credit terms).

297. *See, e.g.*, Pendleton v. American Title Brokers, Inc., 754 F. Supp. 860, 864 (S.D. Ala. 1991) (finding that the "practice of leasing the automobile back to the client is contrary to the traditional practice of pawnbroking"); Lynn v. Financial Solutions Corp. (*In re* Lynn), 173 B.R. 894, 898 (Bankr. M.D. Tenn. 1994) (holding that a title loan was not a "pawn transaction" because the broker did not obtain possession of the car); State *ex rel.* Bryant v. R & A Inv. Co., 985 S.W.2d 299, 302-03 (Ark. 1999) (holding that the title lender violated the state usury prohibition, the state Deceptive Trade Practices Act, and the common law rules against unconscionability); State *ex rel.* McGraw v. Pawn Am., 518 S.E.2d 859, 862 (W. Va. 1998) (holding that a title pawn was a not true pawn and thus was not entitled to a pawnbroker exception to the state consumer credit act); Neb. Op. Atty. Gen. No. 98027, 1998 WL 344508, at *1 (June 19, 1998) ("[W]e believe that a pawnbroker is required to have actual posession of the automobile in order for the lending arrangement to constitute a pawnbroking transaction under Nebraska law."); Quick Cash v. Department of Ag., 605 So. 2d 898, 902-03 (Fla. Dist. Ct. App. 1992) (finding that unusual automobile loan/lease agreement was not exempt from usury laws and remanding to permit agency to proceed against pawnshop). *But see* Nev. Op. Att'y. Gen. No. 95-20 (Nov. 17, 1995), Consumer Cred. Guide (CCH) ¶ 95,348, at 95,348 (finding that title pawns are pawnbroking transactions and thus one who makes them is "exempt from licensing as an installment lender).

298. State *ex rel* Bryant v. R & A Investment Co., Inc, 985 S.W.2d 299, 302-03 (Ark. 1999).

299. Pendleton v. American Title Brokers, 754 F. Supp. 860, 864 (S.D. Ala. 1991).

300. ALA. CODE §§ 5-18-1 to -24 (1996).

possession of only the title is taken does not qualify.[301] The Alabama legislature subsequently enacted the Alabama Pawnshop Act,[302] which became effective in May 1992.[303] Regulators in Alabama believed that title pawns still did not qualify for the pawnbroker exception under the new Act, leading a title lender to sue the Banking Department for a declaratory ruling.[304] In a five-to-two decision that the majority admitted was a close question, the Alabama Supreme Court held that an auto-title pawn fell within the 1992 pawnbroker statute.[305]

Even when the issue of whether a title loan is a legitimate "pawn" is not in question, some courts have found charges to violate state law. For example, in 1992 the Georgia title loan industry obtained legislative approval to place title pawns within the state pawnbroker statute,[306] but a subsequent federal court decision held that the state's 60% criminal usury statute[307] applied to pawn transactions.[308] Moreover, charges allowable under pawnbroker statutes may themselves include a limit, including a reasonableness standard, that an auto pawn or auto-title pawn may violate.[309]

The applicability of the Truth in Lending Act to these transactions is, of course, not altered by changes in state pawnbroker laws. Pawn transactions are generally held subject to TILA credit disclosures, as both case law[310] and a 1996 clarifying amendment to the Official Staff Commentary to Regulation Z

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301. *Pendleton*, 754 F. Supp. at 864.

302. ALA. CODE §§ 5-19A-1 to -20 (1996).

303. 1992 Ala. Acts 92-597. A bankruptcy court in Alabama noted that "growth of the title pawn industry was a precipitating factor for passage of Alabama's new pawnshop act." Mattheiss v. Title Loan Express (*In Re* Mattheiss) 214 B.R. 20, 29 (Bankr. N.D. Ala. 1997).

304. Floyd v. Title Exch. & Pawn, Inc., 620 So. 2d 576, 577 (Ala. 1993).

305. *Id.* at 579.

306. Act No. 1426, 1992 Ga. Laws 3245 (codified as amended in part at GA. CODE ANN. § 44-12-130(5) (Supp. 1999)).

307. GA. CODE ANN. § 7-4-18 (1997).

308. Fryer v. Easy Money Title Pawn, Inc., 183 B.R. 322, 326-27 (Bankr. S.D. Ga. 1995). However, the Georgia Supreme Court recently rejected this position over a strong dissent, holding that the pawnbroker statute alone governed. Glinton v. And R, Inc., 524 S.E.2d 481, 482-83 (1999).

309. *See* Yazzie v. Ray Vicker's Special Cars, Inc., 12 F. Supp. 2d 1230, 1234 (D.N.M. 1998) (finding that when a vehicle was pawned and a storage fee was charged, the storage fee constituted statutorily limited pawn "service charges," and that the charges in question exceeded the limit); Fryer, 183 B.R. at 326-27 (finding that the charges at issue were not "actually incurred" and were thus not classified as "pawnshop charges" under the pawnshop statute; however, when the service charges were added to the "interest" charged, the total interest exceeded the criminal usury ceiling); Lynn v. Financial Solutions Corp. (*In re* Lynn), 173 B.R. 894 (Bankr. M.D. Tenn. 1994) (finding that even if the title pawn were a true pawn, the charges violated the reasonableness limit under the pawnbroker statute); *see also* Fla. Op. Att'y. Gen. No. 99-38 (June 14,1999), discussed below. *See infra* notes 319-320 and accompanying text.

310. *See, e.g.*, Burnett v. Ala Moana Pawn Shop, 3 F.3d 1261, 1262 (9th Cir. 1993); Barlow v. Evans, 992 F. Supp. 1299, 1306 (M.D. Ala. 1997); Wiley v. Earl's Pawn & Jewelry, Inc., 950 F. Supp. 1108, 1112-13 (S.D. Ala. 1997); Dennis v. Handley 453 F. Supp. 833, 836 (N.D. Ala. 1978); *cf.* Pendleton v. American Title Brokers, Inc., 754 F. Supp. 860, 863-64 (S.D. Ala. 1991) (holding that a title pawn/leaseback transaction was subject to TILA, and that the transaction was not a true pawn).

make clear.[311]

On the back end of an auto pawn or title loan, lenders are beginning to see some constriction in their ability to use advantages sought by resorting to the pawn model. Traditional pawns give pawnbrokers the right to sell the collateral if it is not redeemed without following Uniform Commercial Code (UCC) Article 9 procedures.[312] Even where pawnbroker statutes require return of any surplus, such requirements are rarely followed.[313] However, a bankruptcy court in Alabama noted that neither the state's 1992 Pawnbroker Act nor the appellate decisions interpreting it mentioned the UCC.[314] In the absence of an exclusion, the bankruptcy court applied the UCC to the transaction and held that the title lender had not perfected its security interest.[315] This ruling may inspire arguments regarding the applicability of other UCC Article 9 provisions.

In 1995 Florida enacted a specific title lending statute to authorize that business.[316] The statute allows a 22%-a-month "fee" (264% APR), but specifies that "no other charges" are allowed.[317] The title lending legislation also refers to "repossession" of the collateral instead of the traditional pawn language vesting title to the pledged property in the pawnbroker upon default.[318] The Florida Attorney General issued an opinion interpreting the "no other charges" language as precluding title lenders from imposing repossession charges and mandating return of the surplus.[319] According to the opinion, title lenders violating that provision can be prosecuted not only for violating the title loan statute, but also for usury, theft, and racketeering.[320]

B. *Payday Loans*[321]

The argument originally advanced by payday lenders—that they are simply "check cashers," not lenders, and that their fees were not interest but simply

311. Federal Reserve Board Official Staff Commentary, § 226.17(c) cmts. 17(c)(1)-18 [1981-1999 Transfer Binder] Consumer Cred. Guide (CCH) ¶ 3363 at 3465-66 -67 (Apr. 1, 1996). The commentary demonstrates how to calculate the finance charges on a pawn. *See generally* NATIONAL CONSUMER LAW CTR., TRUTH IN LENDING §§ 2.2.4.3.2, 3.6.4 (4th ed. 1999).

312. *See, e.g.*, FLA. STAT. ANN. § 539.001(10) (West 1997 & Supp. 2000).

313. CASKEY, FRINGE BANKING, *supra* note 3, at 41.

314. Mattheiss v. Title Loan Express (*In re* Mattheiss), 214 B.R. 20, 24-25 (Bankr. N.D. Ala. 1997)

315. *Id.* at 24-31 (applying UCC to title pawn for purposes of attachment and perfection). *But cf. In re* Walker, 204 B.R. 812, 816 (Bankr. M.D. Fla. 1997) (considering the postrepossession redemption right in bankruptcy).

316. 1995 Fla. Laws ch. 95-287, § 2 (codified at FLA. STAT. ANN. § 538.06 (West 1997)). *See infra* Part VI (discussing this legislative effort).

317. FLA. STAT. ANN. § 538.06(5)(e)(f) (West 1997).

318. *Id.* § 538.06(d).

319. Fla. Op. Att'y Gen. 99-38 (June 14, 1999).

320. *Id.*

321. *See supra* Part II.B.4 (examining cases involving collection abuses).

check cashing charges—has not met with universal success. The first appearance of these transactions in the modern era of fringe lending seems to have been in Kansas City. Soon after their arrival, state regulators sought to shut the operators down for illegal lending.[322] Law enforcement authorities in Virginia and West Virginia also took action against payday lenders, alleging they were making unlicensed and usurious small loans.[323] A federal court in Kentucky had no trouble finding the transactions to be loans subject to both the Truth in Lending Act and state usury laws.[324] Subsequently, the Kentucky Supreme Court agreed.[325] Trying to collect a usurious debt at twice the enforceable rate is a predicate act under RICO, which led one court to grant summary judgment on a treble damages RICO claim against payday lenders operating in Kentucky.[326]

Indiana's Attorney General has issued an opinion that payday loans violate state usury law and the criminal loansharking law.[327] Indiana payday lenders had been operating under the assumption that a provision of the Indiana Consumer Credit Code authorizing a $33 finance charge sanctioned their rates, but the Attorney General's opinion harmonized that provision with Indiana's 36% rate ceiling rather than viewing it as an exception. Payday loans that charge rates more than twice that amount may implicate the loansharking statute as well.[328] In Illinois, a deregulated state, a class has been certified in a case that alleges both TILA and unconscionability claims.[329] The defendant had argued that the unconscionability claim defeated the requirements of

322. *See* Stephens, *supra* note 84, at 1A. The Missouri legislature subsequently enacted a payday loan act in 1990. *See* MO. REV. ANN. STAT. § 408.500 (West Supp. 2000).

323. *See, e.g.*, Commonwealth v. Bar D Fin. Servs., 1994 WL 1031102 (Va. Cir. Ct. Mar. 21, 1994).

324. Hamilton v. York, 987 F. Supp. 953, 955-58 (E.D. Ky. 1997); cf. In re Brigance, 219 B.R. 486, 492-93 (Bankr. W.D. Tenn. 1998) (involving loans made prior to enactment date of Tennessee payday loan act; the court held that the check loan cannot simultaneously be secured by the check as collateral, so the loans were unsecured; one debtor had paid $1,026 in interest on a $600 advance), *aff'd*, 234 B.R. 401 (W.D. Tenn. 1999).

325. White v. Check Holders, Inc., 996 S.W.2d 496, 500 (Ky. 1999). Violation of these provisions conceivably could trigger the statutory remedy of forfeiture of interest. *See* KY. REV. STAT. ANN. § 360.020(1) (Michie 1996).

326. Burden v. York, Civ. No. 98-268 (E.D. Ky, Sept. 29, 1999), applying 18 U.S.C. § 1962(c) (1994) to payday loans. *But see* State v. Roderick, 704 So. 2d 49, 53-55 (Miss. 1997) (refusing to apply RICO to a payday lender because usury is not a crime under state law, and the lender's prior contact with the Attorney General's office may have given it grounds to believe its business was legal).

327. Ind. Op. Att'y Gen. No. 2000-1 (Jan. 19, 2000) (interpreting IND. CODE ANN. §§ 24-4.5-3-508(2), -508(7) (Michie 1996) (Indiana Uniform Consumer Credit Code); *Id.* §§ 35-45-7-2, -4). The opinion notes that the loansharking statute cannot be avoided by labeling the charge as something other than interest. The New York Banking Department also has taken the position that New York's 25% criminal usury ceiling applies to payday loans. Letter from New York State Banking Dept. to Financial Inst. (June 29, 1999) (on file with authors).

328. *Id.*

329. Pinkett v. Moolah Loan Co., No 99C2700, 1999 WL 1080596 (N.D. Ill. Nov. 2, 1999).

commonality and typicality, an argument the court rejected:

> [T]he plaintiff, and other putative class members, took out payday loans at astoundingly high interest rates from the defendants. The defendants have not argued, nor in this Court's opinion can they argue, that the plaintiff and the other potential members were sophisticated consumers. Without a doubt, there is gross disparity in the bargaining positions of the parties. Likewise, the commercial experience of the plaintiff dictates that he was not faced with a meaningful choice when faced with the unreasonable and unfavorable terms of the promissory note. It is the very nature of "payday loans" that members of the population with no other means of securing credit seek out these loans with exorbitant, extreme, and untenable interest rates in excess of 300%. It is because the plaintiff and other putative class members were "forced to swallow unpalatable terms" . . . that the inference of unconscionability may be made.[330]

As with title pawns and title loans, courts have held payday loans to be credit transactions requiring TILA disclosures.[331] The Federal Reserve Board has issued an amendment to TILA's Official Staff Commentary that clarifies that deferred payment checks are loans subject to TILA.[332]

Litigation has challenged the "new" payday loan dodges such as "cash back ad," "catalogue," and "gift certificate" sales.[333] Regulators in Texas, Virginia, and Alabama have successfully challenged these dodges,[334] and class

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330. *Id.* at *5 (citation omitted) (quoting Original Great Am. Chocolate Chip Cookie v. River Valley, 970 F.2d 273, 281 (7th Cir. 1992)).

331. Turner v. E-Z Check Cashing, Inc., 35 F. Supp. 2d 1042, 1048 (M.D. Tenn. 1999); Hamilton v. York, 987 F. Supp. 953, 957 (E.D. Ky 1997).

A series of cases in the Northern District of Illinois challenging the adequacy of the TILA disclosures is meeting with more mixed success. *See, e.g.*, Smith v. Cash Store Management, 195 F.3d 325 (7th Cir. 1999) (involving security interest disclosure under TILA); Laws v. Payday Loan Corp. of Ill., No. 98-C5562, 1999 WL 966964 (N.D. Ill. Oct. 1, 1999) (discussing the conspicuousness of finance charges and APR).

332. 65 Fed. Reg. 17129 (2000).

333. *See supra* Part II.B.2. Older cases deal with such devices, as well. *See, e.g.*, Willis v. Buchman, 199 So. 886, 895 (Ala. Ct. App. 1940), *rev'd on other grounds*, 199 So. 892 (Ala. 1940) (addressing merchandise coupons as a scheme to evade usury laws). Collateral sales agreements have also been used as a device to evade credit requirements. *See, e.g.*, Ransom v. S & S Food Ctr., Inc., 700 F.2d 670, 673-74 (11th Cir. 1983); Berryhill v. Rich Plan, 578 F.2d 1092, 1098-99 (5th Cir. 1978); Carney v. Worthmore Furniture, 561 F.2d 1100, 1103 (4th Cir. 1977); T.J. Oliver, Annotation, *Payments Under (Ostensibly) Independent Contract as Usury*, 81 A.L.R.2d 1280, 1283-86 (1962).

334. *See, e.g.*, Commonwealth v. Express Checking, No. HD-44-1 (Cir. Ct., Richmond, Va., Oct. 20, 1995) (involving the use of gift certificates), *cited in* Commonwealth v. Greenburg, No. HE-12-3, 1997 WL 1070573, at *1 (Cir. Ct. Va., Apr. 15, 1997). In the wake

actions are pending in Texas and Alabama.[335]

C. Refund Anticipation Loans (RALs)

Between 1982 and 1992, three judicial and regulatory decisions addressed the question of whether the "assignment" or "sale" of the right to an anticipated tax refund constituted a disguised loan subject to credit regulation. Two found such transactions to be loans, while one found them to be sales. The latter decision was a 1986 Georgia Court of Appeals case, interpreting the Georgia Industrial Loan Act and Truth in Lending Act, and concluding that such transactions were not credit under either statute.[336] However, an earlier Kentucky Attorney General's opinion had held that "assigned" tax refunds were in fact loans subject to the usury law.[337] Similarly, rejecting and distinguishing *Cullen,* a South Carolina court upheld a state regulator's enforcement action against a tax refund "buyer" for violations of the state credit code in 1992.[338] In the intervening years, there has been little litigation about tax refund "sales" as disguised loans, as the majority of RAL cash advances have been extended as loans in name as well as substance. However, some independent small lenders apparently continue to use the tax refund "sale" or "assignment" format to try to avoid credit laws. The Colorado Attorney

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of the Alabama Banking division taking enforcement action, the trade association filed an action for declaratory judgment in *Alabama Check Cashers Ass'n v. State Banking Dep't,* No. CV-98-1555 (Mar. 1, 1999) (issuing an order granting consumers the right to intervene). *See also* Texas v. Cash Today, No. 99-02673 (Tex. Dist. Ct. Dec. 17, 1999); Susanne Pagano, *Texas Lender Will Pay $1 Million to Settle Claims by Attorney General,* 74 Banking Report (BNA) 76 (January 10, 2000).

335. *See, e.g.,* Memorandum in support of Plaintiff's motion for class certification, Rodriquez v. Cash Today, Inc., No. C-99-305 (S.D. Tex. 1999) (cash back ads); complaint, Harris v. Montgomery Catalog Sales, (Cir. Ala. Ct. filed Dec. 29, 1998).

336. Cullen v. Bragg, 350 S.E.2d 798 (Ga. App. 1986). In reaching its decision, the *Cullen* court chose to construe the Georgia Industrial Loan Act narrowly against borrowers, stating that usury statutes are in derogation of common law. As discussed in note 295, *supra,* this is a misconception, though a common one. Common law prohibited the charging of interest, *see, e.g.,* Dennis v. Bradbury, 236 F. Supp. 683, 689 (D.Colo. 1964), *aff'd,* 368 F.2d 905 (10th Cir. 1966), and those statutes allowing interest, beginning with 37 Hen. VIII, C.9 (1545), are the ones in derogation of common law. Benjamin S. Horack, *A Survey of the General Usury Laws,* 8 LAW & CONTEMP. PROBS. 36, 37 n.11 (1941). The *Cullen* court, though not alone in doing so, thus applied this statutory construction principle backwards.

In what was perhaps the earliest case involving RALs, Beneficial Corporation was sued by a man claiming to have conceived of the idea of assigning tax refunds as a form of "collateral security" for "loans." *See* Freedman v. Beneficial Corp., 406 F. Supp. 917, 920 (D. Del. 1975).

337. Ky. Op. Att'y Gen. 2-260 (1982). For discussion of some of the early cases on this type of "sale" or "assignment" as a device to evade usury laws, see H.D. Warren, Annotation, *Usury as Predicable upon Transaction in Form a* [sic] *Sale or Exchange of Commercial Paper or other Choices in Action,* 165 A.L.R. 626 (1946).

338. *See* Income Tax Buyers, Inc. v. Hamm, C/A No. 91-CP-403193 (S.C. Ct. Common Pleas, Jan. 14, 1992).

General and the Administrator of the Colorado Uniform Consumer Credit Code brought an action for a preliminary injunction against a firm casting its cash advances against anticipated tax refunds in the old style—"purchasing" the refund for about fifty cents on the dollar. The Colorado Court of Appeals recently ruled against the state in *Colorado v. The Cash Now Store, Inc.*, relying on *Cullen* and one other non-RAL case.[339] Its analysis seems to put the cart before the horse, concluding first that there was no loan, so that it was "not necessary to conduct an extended disguised loan analysis."[340]

The facts in the *Cash Now* case highlight the importance of vigorous enforcement of existing credit regulation in assuring the integrity of the marketplace and protecting honest competitors, as well as consumers. In substance, there was no meaningful distinction between the admitted refund anticipation loans on the market and Cash Now's "assignment" of anticipated tax refunds. Had the Cash Now customer discussed in the trial record gone to one of Cash Now's competitors instead, she would have paid a $59.95 finance charge out of her $1099 refund and been entitled to a Truth in Lending disclosure telling her that the transaction carried an APR of 159%. While that may not seem like a bargain, her cost from Cash Now was $525 withheld from the $1099 refund—a whopping (but undisclosed) 3055% APR.[341] This situation demonstrates why it is imperative that courts look to substance, not form, to

339. Colorado v. The Cash Now Store, Inc., No. 98 CA 2380, 2000 Colo. App. LEXIS 374 (Colo. Ct. App., March 17, 2000), *motion for rehearing pending* (The authors were counsel of record on an amicus brief filed in support of Colorado's position in this case).

340. *Id.* at *16. The court held that there was no "unconditional obligation to repay," and hence there was no need to evaluate the extensive body of law on disguised loans. The decision seems to take the position that the distinct elements of a "loan or forbearance"—in this case the element of an "unconditional obligation to repay"—cannot themselves be disguised, which is contrary to long-standing precedent. "If the express stipulation for the repayment of the sum advanced be indispensable to the existence of usury, he must be a bungler indeed, who frames his contract on such terms as to expose himself to the penalties of the law." Scott v. Lloyd, 34 U.S. 418, 447 (1835).

A motion for rehearing has been filed in *Cash Now*. Whether *Cash Now* begins a trend toward reduced scrutiny of disguised loans, or stands in isolation remains to be seen. What is clear is that it is counter to the trend of other courts which have been fairly vigorous in looking at form, not substance in the current cash advance segments of the fringe lending market. Indeed, it is instructive to compare the Colorado Court of Appeals analysis with that of a federal district court decision issued just three days later in Georgia, finding an "obligation to repay" in the context of a fringe lender "selling" delayed deposit cashing services, along with gift certificates for catalog merchandise. That "seller," too, denied that he was in the loan business. The Georgia court recognized that a loan can be express *or implied*, and held that agreeing to defer deposit of a check constitutes forbearance, and hence was a "loan requiring repayment." Cashback Catalog Sales, Inc. v. Prince, CV199-120 (S.D. Ga., order denying plaintiff's motion for summary judgement on the legitimacy of its "gift certificate sales" was also denied.) Interestingly, both Cash Now and Cashback Catalog Sales advertised in the yellow pages under "loans." The Georgia court noted that in its description of the factual background of the case, while the Colorado court did not mention it.

341. Brief of Amicus at 16-17, Colorado v. The Cash Now Store, Inc., No. 98 CA 2380, 2000 Colo. App. LEXIS 374 (Colo. Ct. App., March 17, 2000).

assure a level playing field in the marketplace for ethical businesses, as well as the protection of consumers.

The status of transactions like these as credit under the Truth in Lending Act is determined independently of state law characterizations. In 1990, the Federal Reserve Board noted in its Official Staff Commentary that RALs are subject to Truth in Lending; hence the TIL litigation has focused more on how to make the disclosures than on contesting whether any disclosures must be made at all.[342] Similarly, in the absence of the disguised loan issue in the majority of RAL lending, the non-TIL litigation in recent years in this segment of the alternate financial services marketplace has focused more on the marketing of RALs and allegations that some of the tax preparers who sell them act improperly.[343]

D. Exportation

A significant area of litigation relates to the right of lenders holding certain kinds of charters to "export" the law of their home state. Because these lenders choose home states with little or no regulation, if such exportations are successful they and their local partners may extend credit without regard to the laws of the borrower's home state. If lenders can make exportation work, there is no need for them to design products that can evade state usury laws; they can simply offer their products openly under the banner of federal preemption.

Under the National Bank Act, a national bank is permitted to export the law of its home state nationwide, preempting any state laws restricting "interest" (defined very broadly) in the borrower's state.[344] The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA)[345] put federally insured depositories, including those chartered by states, on a "level playing field" with national banks. Consequently, state chartered institutions assert exportation rights along with the national banks.[346] The RAL lenders were the first fringe lenders to successfully use this vehicle to get around state

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342. Federal Reserve Board Official Staff Commentary, § 226.17(c)(1)-17, *published in* 55 Fed. Reg. 13,103, 13106 (1990). *Cullen*'s precedential value, at least with respect to its TIL ruling, is dubious, given the subsequent Commentary amendment and the deference that courts are to give the FRB's interpretation of TILA under *Ford Motor Credit Co. v. Milhollin*, 444 U.S. 555, 565 (1980). See *supra* Part II.B.5 for a discussion of TILA rules for calculating the APR on RALs.

343. *See supra* Part II.B.5.

344. 12 U.S.C. § 85 (1994); 12 C.F.R. §7.4001 (1999) (Office of the Comptroller of the Currency regulation defining interest); *see* Smiley v. Citibank (South Dakota), N.A., 517 U.S. 735, 739 (1996).

345. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 521, 94 Stat. 164 (codified at 12 U.S.C. § 1831d (1994)).

346. Unlike the National Bank Act, states were given a right to opt out of DIDMCA, and Iowa and Puerto Rico did so. While there is no case law on the topic, the opt out presumably protects citizens in those jurisdictions from exportation by nonnational banks. *See generally* COST OF CREDIT, *supra* note 22, at § 3.55; Mansfield, *supra* note 19.

usury laws, using tax preparers in the borrowers' states as their local distribution partners.[347]

Some payday lenders have followed, obtaining charters in states with no payday loan regulation and teaming up with local distribution partners in states in which their terms would otherwise be illegal.[348] Banks or other institutions holding these "privileged" charters reportedly immediately sell these accounts receivable back to the local partner, taking the accounts off their books.[349] An action pending in California is challenging this "rent-a-bank" payday loan structure.[350]

VI. LEGISLATIVE CAMPAIGNS SURROUNDING FRINGE CREDIT PRODUCTS

Efforts to evade consumer protection and credit regulation invite litigation. Consequently, legislative and regulatory bodies are in the center of the controversy surrounding fringe lending. Fringe lenders have organized nationwide legislative and public relations campaigns, as well as support and advocacy groups, to influence the debate over fringe lending.

A. Rent-to-Own (RTO)

In this regard, the RTO segment is the most mature among the credit poviders in the fringe market. The Association of Progressive Rental Organizations (APRO) is the "national non-profit trade association for the rental-purchase . . . (RTO) industry."[351] According to APRO literature:

> During the past 15 years, APRO has actively worked to help shape public policy in state legislatures and the U.S. Congress. To date, 46 state laws have passed with APRO's support and input. Since its organization by a handful of company owners in 1980, APRO has become the voice of the industry before government and the public around the

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347. *See* Cades v. H & R Block, Inc., 43 F.3d 869, 874 (4th Cir. 1994); Christiansen v. Beneficial Nat'l Bank, 972 F. Supp. 681, 684 (S.D. Ga. 1997).

348. *See, e.g.*, Lieberman Forum (Pettijohn testimony), *supra* note 30, at 3-4 (noting that payday lenders can avoid regulation); Fox, *supra* note 62, at 8-9.

349. Under Utah law, Utah Industrial Loan licensees purport to qualify for the right to export Utah law under § 521 of DIDMCA. These lenders presumably take the portfolio off their books immediately in order to remove any "safety and soundness" red flags it might raise to their examiners, as these exporters are federally insured depository institutions.

350. Josh R. Phanco v. Dollar Financial Group, Inc., No. CV99-1281DDP (C.D. Cal., filed Feb. 5, 1999).

351. APRO—Association of Progressive Rental Organizations, *Government Affairs* (visited Mar. 19, 2000) <http://www.apro-rto.com>.

country.[352]

Most of the state laws were enacted in the late 1980s, and "through mid-1987 . . . state legislative efforts cost between $25,000 and $40,000 each, not including campaign contributions by individual dealers to legislators running for office."[353]

Minnesota, in many respects, has been ground zero for RTO clashes. Both judicial and legislative battles have been hard fought. APRO participated as amicus in *Miller v. Colortyme, Inc.*, a case in which the Minnesota Supreme Court interpreted rent-to-own transactions as credit sales subject to the Minnesota Consumer Credit Sales Act and state usury laws.[354] Following the loss, the trade association's corporate counsel reported to members that "if the industry can be successful this year or next in D.C., it may be able to get Congress to overrule this one aberrant state whose supreme court has refused to acknowledge the true nature of the rental-purchase transaction."[355]

While the *Miller* case was proceeding, efforts were ongoing in Congress to reform the rent-to-own laws nationwide. Congressman Gonzalez and Senator Metzenbaum introduced legislation which would have applied to RTO transactions important federal consumer protection laws like the federal Truth in Lending Act, the Equal Credit Opportunity Act, the Fair Debt Collection Practices Act, and the Fair Credit Reporting Act.[356] This result would have been achieved by treating the RTO transaction as a credit transaction with all of the attendant protections.[357] Also, the bill contained a provision that would have required the lender to disclose to consumers the "cash price" of an item, defined as the "bona fide retail price" that an RTO dealer charged someone in an outright (non-RTO) sale; for dealers who do not make such sales, the "cash price" was defined as "the average cash price of the item or a similar item in

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352. *Id.* ("At the federal level, APRO led a proactive dealer grassroots campaign that resulted in an Internal Revenue Service 1995 ruling that defined the RTO transaction as a lease, not a sale, for tax purposes. This saved rental-purchase dealers an estimated $1 billion in additional taxes per year.").

353. James P. Nehf, *Effective Regulation of Rent-to-Own Contracts*, 52 OHIO ST. L.J. 751, 821 n.304 (1991). Nehf also notes that "[b]usiness interests often prevail in [legislative] confrontations, in large part because industry trade associations generally have greater financial resources, better organized political action groups, and more powerful lobbyists." *Id.* Prior to joining academia, Nehf was a member of a law firm that represented APRO and a major RTO company and had been involved in drafting industry bills. *See* COST OF CREDIT, *supra* note 22, at § 7.5.3.2.3.

354. 518 N.W.2d 544, 548, 550 (Minn. 1994).

355. ED WINN III, APRO, REVERSAL IN PENNSYLVANIA, PROGRESSIVE RENTALS 4 (June/July 1996) (visited Apr. 7, 2000) <http://www.aprorto.com/contents/publications/june962.asp>.

356. H.R. 3136, 103d Cong. § 1005 (1993); S. 1566, 103d Cong. §1005 (1993). *See also* Susan Lorde Martin & Nancy White Huckins, *Consumer Advocates vs. the Rent-to-Own Industry: Reaching a Reasonable Accommodation*, 34 AM. BUS. L. J. 385, 392-93 (1997) (discussing the proposed legislation).

357. H.R. 3136, 103d Cong. §1003(4); S. 1566, §1003(4).

the community."[358]

The RTO industry supported an alternative proposal introduced by Congressman LaRocco and Senator Shelby.[359] The LaRocco/Shelby proposals differed from the Gonzalez/Metzenbaum bills in that they did not contain a requirement to disclose the APR.[360] It was the industry's position that it should not be subject to rules binding banks because RTO dealers provide no "banking services."[361]

RTO may be on the agenda in Washington again in the near future. The Federal Trade Commission is conducting a study of the industry and "the Clinton-Gore Plan for Financial Privacy and Consumer Protection in the 21st Century" anticipates supporting a legislative response.[362]

B. *Payday Lenders*

1. *National Legislative and Regulatory Efforts*

The National Check Cashers Association ("NaCCA"), now renamed the Financial Service Centers of America (FiSCA), is the "professional organization representing the ever expanding growth industry of check cashing which provides financial services for America's local communities."[363] The NaCCA engages in a campaign of public relations and legislative advocacy through its deferred deposit services.[364] A second payday loan trade association was formed in 1999, the Community Financial Services Association of America (CFSA).[365] Additionally, the industry has hired highly influential people to aid in its political efforts.[366] The CFSA has developed a "best

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358. H.R. 3136, 103d Cong. §1003(1); S. 1566, §1003(1). See *supra* Part II.D for a discussion of the significance of that provision.

359. H.R. 2803, 103d Cong. (1993); S. 1956, 103d Cong. (1994).

360. H.R. 2803 (1993); S. 1956 (1994).

361. In distinguishing RTO dealers from the other "predatory" "fringe banking" resources, APRO corporate counsel Ed Winn argues that RTO dealers "do nothing that banks do." ED WINN III, APRO, FRINGE BANKING, PROGRESSIVE RENTALS 3 (June/July 1996) (visited Apr. 7, 2000) <http://www.apro-rto.com/content/publications/june961.asp>.

362. The White House Office of the Press Secretary, *The Clinton-Gore Plan for Financial Privacy and Consumer Protection in the 21st Century Detailed Proposal Summary*, 4 (May 4, 1999) (visited Apr. 7, 2000) <http://www.pub.whitehouse.gov/retreive-documents.html>.

363. *NaCCA: National Check Cashers Ass'n, Inc.* (visited April 7, 2000) <http://www.nacca.org/about.htm>.

364. *NaCCA: National Check Cashers Ass'n, Inc.* (visited May 8, 2000) <http://www.nacca.org/defdep.htm>.

365. Representatives of both groups testified at the recent congressional forum on payday lending. *See* Lieberman Forum (Rochford testimony), *supra* note 30, at 29; Lieberman forum (Webster testimony), *supra* note 87, at 17.

366. One such influential person is the 1999-2000 President-elect of the American Bar Association, Martha W. Barnett. *See* Helen Huntley, *Payday Lenders Seek Protection in Tallahassee*, ST. PETERSBURG TIMES, Mar. 6, 1999, at 1E.

practices" code and released a model law in early 2000.[367] This proposed legislation does not address the price issue, however, and authorizes a maximum fee of 20% of the loan amount, which "shall not be deemed interest for any purpose of law."[368] For a typical two-week loan of $165, that would be a $33 finance charge, for an APR of 520%. The model law's answer to the debt treadmill problem is to require a disclosure to consumers stating that payday loans should be used for short-term, not long-term needs, and that "renewing a deferred presentment service transaction is not advisable and may cause financial hardship for the maker."[369] The law would allow attorneys' fees and court costs, authorize criminal cold check penalties if the account was closed before the due date,[370] and limit extensions on a single transaction to three consecutive renewals, still leaving the "touch-and-go" loophole in place.[371] It would authorize a one-day rescission right, which would seem to preclude the 7300% one-day loans found in Indiana; however, there is no requirement that the consumer be notified of this right.[372]

The bill does not clearly address the problem of debts to multiple payday lenders. It limits aggregate loans to $500, but is ambiguous as to whether the limit applies to a single lender or to all of a borrower's loans with all payday lenders.[373] In any event, the bill places no underwriting duties on the lender to use the existing technology to learn of outstanding payday loans elsewhere.[374]

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367. This model law may have been released to provide a counterproposal to the consumer protection-oriented model bill, discussed below, that was released in 1998 by the Consumer Federation of America and the National Consumer Law Center.

368. CFSA, DEFERRED PRESENTMENT SERVICES ACT § 113(b) (2000) (Proposed Model Legislation).

369. *Id.* § 113(a)(4).

370. *Id.* § 113(i)-(j).

371. *Id.* § 113(n). This section permits a licensee to make a new agreement after a transaction is "completed," which occurs "when a check is presented for payment, deposited, or redeemed by the maker by payment in full in cash to the licensee." *Id.* Payment in cash that is immediately re-lent with a new agreement is the "touch-and-go" practice used to circumvent existing limits on renewals. *See supra* Part II.B.3.

372. CFSA, DEFERRED PRESENTMENT SERVICES ACT § 113(q) (2000) (proposed model legislation).

373. *Id.* § 113 (d).

374. *See id.* § 113(d),(p) (stating that a lender is simply required to notify the borrower of the prohibition against having outstanding deferred payment transactions totaling more than $500 at any one time). Some existing laws prohibit any licensee from having checks from a borrower that, in the aggregate, exceed the maximum loan amount allowable under the statute. *See, e.g.*, IOWA CODE ANN. § 533D.10(1)(b) (West 1999) (prohibiting a lender from holding from any one maker a check(s) in an aggregate face amount greater than $500). The model bill has a maximum loan amount of $500, and one could interpret the proposed legislation as providing the same effect as the Iowa law. CFSA, DEFERRED PRESENTMENT SERVICES ACT § 113(d) (2000) (Proposed Model Legislation). But one could interpret other references in the proposed legislation as meaning that the $500 limit is per borrower, not per lender. *Id.* § 113(p). Applying the $500 limit per borrower would more directly address the problem. Furthermore, failing to place any underwriting duties on the lender, relying instead on "written representations," creates the risk of having the restriction become meaningless, as the representation may simply become boilerplate on the documents. The technology is available

Finally, the model bill does not provide for a private right of action, which would limit the enforceability of the law.

While the trade associations have begun to express support for Truth in Lending disclosures on payday loans,[375] whether this will translate into meaningful disclosure at the point of contact with consumers is hard to predict. Those within the industry think of the cost of payday loans as a "fee," not as "interest,"[376] and believe that applying APRs to payday loans is actually misleading because of the short terms involved.[377] Even if accurate written disclosures are given, such paper disclosures may be useless to promote consumer understanding and comparison shopping if accompanied by on-site explanations to the customer that the rate " isn't really that high, because you don't have the loan for a year," or "it's like taking a cab across town instead of cross-country."[378] Furthermore, the ads for these lenders focus only on quick and easy cash; they generally do not employ any of the "trigger terms" that would require advertising the APR.[379]

Consumer advocates have been active as well. The Consumer Federation of America (CFA) and the National Consumer Law Center (NCLC) released model federal legislation in 1998 that would provide for minimum loan terms, maximum fees and charges, enhanced disclosure, and consumer protections in states that allow payday lending.[380] This legislation would also require a check to be branded as a deferred deposit loan check subject to claims and

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to tell a lender almost instantly whether other payday loans are outstanding. *See* DFI REPORT, *supra* note 33, at 28. The report notes that not all lenders subscribe—some wanting to avoid the cost, and others "so as not to lose the added volume." *Id.* at 28. It is certainly not a radical concept for lenders to undertake some underwriting steps, including checking for excessive indebtednes.

375. Lieberman Forum (Rochford testimony), *supra* note 30, at 33; Lieberman Forum (Webster testimony), *supra* note 87, at 17; *see also* CFSA DEFERRED PRESENTMENT SERVICES ACT § 113(f) (2000) (proposed model legislation) (proposing the required disclosure of the total amount of fees charged, expressed as both dollar amount and as an annual percentage rate).

376. *See* Lieberman Forum (Pettijohn testimony), *supra* note 30, at 2 (addressing this "wordplay" as clouding the definition of a loan).

377. *See supra* Part II.B.2.

378. *See* Lieberman Forum (Rochford testimony), *supra* note 30, at 15 ("One could flag a taxi in New York City and ask what the cab fare would be for a ride to San Francisco. There is a theoretical fare, but it would never be paid because no consumer would be stupid enough to use this short distance service for a long distance trip.") This, of course, was the point of enacting a standard price system. *See supra* Part II.B.2. This problem of undermining the validity of the APR as a standardized and fully-loaded price tag is not limited to payday lenders. One of the authors was told that the APR on a car loan was "not really the rate. It's just something the government makes us put down." The "real" rate he then quoted was totally fictitious, and was half of the APR.

379. Only if the ad states a rate of charge does TILA require that the rate be stated as an APR. Reg. Z, 12 C.F.R. § 226.16 (1999).

380. MODEL DEFERRED DEPOSIT LOAN ACT (1998) (CFA & NCLC, Proposed Legislation). A copy of the model act may be obtained from Consumer Federation of America, 1424 16th St., N.W., Suite 604, Washington, D.C. 20036 or from the National Consumer Law Center, 18 Tremont Street, Suite 400, Boston, MA 02108.

defenses.[381] Such branding should prevent small claims courts or prosecutors from treating defaulted payday loans under bad check laws,[382] as would the model act's requirement of a posted notice saying that the criminal process cannot be used to collect the debt.[383] The act would also permit no-cost extensions for thirty days, but inserts a thirty-day interregnum to assure that the "new loan" device is not used to evade the renewal limits.[384] The legislation clearly caps the maximum payday loan amount per borrower, rather than per lender, and requires the lender to ask affirmatively about other outstanding loans.[385] The model act also closes the exportation loophole by making all provisions except licensing applicable to depository institutions making payday loans, and the act also authorizes private remedies to facilitate enforcement.[386]

Consumer advocates hoped that the Office of the Comptroller of the Currency (OCC) would be responsive to consumer advocates' concerns that national banks were avoiding compliance with the Community Reinvestment Act by exporting payday loan interest rates through subsidiaries or partners. A coalition of consumer groups jointly challenged the Comptroller's "satisfactory" Community Reinvestment Act rating of Eagle National Bank, which engages in a $31 million exportation payday loan business. However, the OCC's response indicates that it views any responsibility to stop exportation to be in Congress's hands.[387]

President Clinton also addressed the issue of payday lending in announcing *The Clinton-Gore Plan for Financial Privacy and Consumer Protection in the 21st Century*.[388] This agenda, in combination with Senator Lieberman's December 1999 forum, the controversy over the use of bank charters to circumvent state laws, and the military's concern over fringe lending, may set the stage to move the legislative debate from the states to Congress during the

381. *Id.* § 6(g).

382. Another possible remedy is to prohibit the use of checks entirely and requiring written contracts would also address such a problem. Lenders would be permitted to sue only on the note, not under bad check laws. Lieberman Forum (Tarpey testimony), *supra* note 59, at 6.

383. CFA & NCLC, MODEL DEFERRED DEPOSIT LOAN ACT § 7(c)(1) (1998) (Proposed Legislation). *See supra* Part II.B.4.

384. CFA & NCLC, MODEL DEFERRED DEPOSIT LOAN ACT § 9(l) (1998) (Proposed Legislation).

385. *Id.* § 9(k).

386. *Id.* § 2(c), 10. In 1999 Congressman Bobby Rush introduced House Bill number 1684, which also addressed exportation and provided for a number of important consumer protections. H.R. 1684, 106th Cong. §§ 2(e)(2), 4.

387. Letter from the Office of the Comptroller of the Currency to the Consumer's Union, the Consumer Federation of America, the United States Public Interest Group, & the National Consumer Law Center (on file with authors).

388. The White House Office of the Press Secretary, *The Clinton-Gore Plan for Financial Privacy and Consumer Protection in the 21st Century*, 1 (May 4, 1999) (visited Apr. 7, 2000) <http://www.pub.whitehouse.gov/retrieve-documents.html>.

next few years.[389]

2. State Efforts

As with the RTO industry, the payday loan industry sought state legislation sanctioning its business following early adverse actions by courts and regulators treating payday transactions as disguised loans.[390] An Associated Press wire story reports that Tennessee's early legislative effort brought out a "Noah's Ark" of industry lobbyists and at least $105,750 in campaign donations between 1996 and 1998, not counting soft money contributions.[391] The state trade association in Kentucky spent over $102,000 on lobbying in the eight-month period before to the enactment of that state's pro-lender law. Among the lobbyists hired in those two states and in Louisiana were former politicians or those with political connections.[392] Currently nearly half the states now have specific legislation addressing payday loans.[393]

The industry's regulatory efforts in a few states have resulted in favorable treatment of payday lenders. Check cashers in Florida, for example, have adroitly utilized the state administrative process to carve a niche within which it can operate outside of traditional lenders' constraints.[394] In Florida check cashers operate under the Florida Money Transmitters' Code.[395] This Code was intended to apply to businesses that electronically transmit funds from one location to another, or "payment instrument sellers," as well as those that cash

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389. This issue places Defense Department concerns about the well-being of enlisted military personnel at odds with the Treasury Department's concerns (through the OCC) about the well-being of those holding national bank charters.

390. Kansas and Nebraska enacted payday loan laws in 1993 and 1994, respectively. KAN. STAT. ANN. §16a-2-404 (1999); NEB. REV. STAT. ANN. §45-901-929 (Michie 1994).

391. John Hendren, *Lobbying, Money Helping to Persuade Legislators to Legalize Payday Loans*, J. REC. (Okla. City), Feb. 23, 1999, *available at* 1999 WL 9843431, at 1.

392. *Id.* A Tennessee state senator summed up the problem this way: "Legislatures work pretty well if you have good lobbyists on both sides . . . . Where the system breaks down is where you have a crew of highly effective and capable lobbyists on one side and only five-and-a-half million silent Tennesseans on the other side. Then the result is not always justice." *Id.* at 2.

393. CAL. CIV. CODE § 1789.33 (West 1999); COLO. REV. STAT., §§ 5-3-501 to -605 (1999); D.C. CODE ANN. §§ 28-4701 to -4712 (Supp. 1999); FLA. STAT. ANN. §§ 560.301-.310 (West Supp. 1999); IOWA CODE §§ 533D.1 to 533D.16 (Supp. 1999); KAN. STAT. ANN. § 16a-2-404 (1999); KY. REV. STAT. ANN. §§ 368.010 to -.991 (Michie Supp. 1998); LA. REV. STAT. ANN. §§ 9:3577.1-.8 (West 2000); MINN. STAT. ANN. § 47.60-.605 (West Supp. 2000); MO. ANN. STAT. § 408.500 (West 1999); NEB. REV. STAT. §§ 45-901 to -929 (1999); NEV. REV. STAT. ANN. §§ 604.010 -.170 (Michie 1999); N.C. GEN. STAT. §§ 53-275 (1999); OHIO REV. CODE ANN. §§1315.35-.44 (West Supp. 1999); S.C. CODE ANN. §§ 34-39-10 to -260 (West Supp. 1999); TENN. CODE ANN. §§ 45-17-101 to -119 (Supp. 1999); WASH. REV. CODE ANN. §§ 31.45.010 - .900 (Supp. 2000); WYO. STAT. ANN §§ 40-14-362 to -364 (Michie 1999).

394. *See supra* Part V (discussing the contrary weight of authority in courts, and other regulators).

395. FLA. STAT. ANN. §§ 560-560.310 (West 1997 & Supp. 1999).

checks and immediately deposit them.[396] Under the Money Transmitters' Code, check cashers may charge a flat fee that cannot exceed 10% of the check's face value.[397]

C. Automobile Title Loans

Legislative efforts in the title pawn arena followed quickly after adverse court decisions against title lenders. For example, hard on the heels of a Tennessee court's 1994 holding that title pawns were not true pawns,[398] the Tennessee legislature passed its Title Pledge Act in 1995.[399] Rather than maintaining a single strong industry advocacy group, the title loan or title pawn industry's legislative efforts have been predominately maintained by a private nationwide title lending company based in Atlanta, Georgia called Title Loans of America, Inc. (TLOA). Public political campaign contributions, lobbyist's lists, and other reports reveal this company has been active in the legislative process all over the country.[400] States in which TLOA has successfully supported triple-digit title loan legislation include Georgia, Florida, and Tennessee.[401] However, TLOA's legislative efforts have not always been successful. In Oklahoma, California, West Virginia, and Kentucky state legislators and officials have refused, limited, or repealed laws allowing high-interest, fully-secured title loans.[402] Presently, TLOA lobbyists are active in states including California[403] and Florida in supporting legislation that will allow high interest title loans.[404]

Since their efforts began, TLOA has lost the support of some of the legislators who previously supported the business. For example, Florida

396. *Id.* §§ 560.102 to -.103.

397. *Id.* § 506.309(4)(c).

398. *See* Henley v. Cameron Auto Pawn, 228 B.R. 425, 426 n.5 (Bankr. E.D. Ark. 1998) (discussing Lynn v. Financial Solutions Corp. (*In re* Lynn), 173 B.R. 894 (Bankr. M.D. Tenn. 1994)).

399. TENN. CODE ANN. § 45-15-101 to -120 (Supp. 1999).

400. *See, e.g., Poverty, Inc., supra* note 141, at 29, 31; Mick Hinton, *House Mulls Rates, Car Title Rule for Lenders*, DAILY OKLAHOMAN (City Edition), Mar. 10, 1998, at 5; Capitol Media Services, *Loans at 25% Monthly Interest Find Earnest Foe in Key Senator Howard Fischer*, THE ARIZONA DAILY STAR, Mar. 22, 1998; Adam C. Smith, *Price of Fast Car Cash Can Put Unwary on Foot*, ST. PETERSBURG TIMES, Jan. 24, 1999, at 1A; Wissner, *supra* note 123, at 1A; *see also 60 Minutes, supra* note 46, at 6-7 (discussing TLOA and interviewing its President, Bob Reich).

401. Cahill, *supra* note 40, at A1.

402. West Virginia *ex rel* Mc Graw v. Pawn Am., 518 S.E.2d 859, 862 (W. Va. 1998); Cahill, *supra* note 40, at A1; Capitol Bureau, *Car Title, Loan Plan Withdrawn*, DAILY OKLAHOMAN (City Edition), Mar. 11,1998, at 3; *60 Minutes, supra* note 46; Smith, *supra* note 401, at 1A.

403. California Sec. of State Bill Jones, *1999-2000 Directory of Lobbyists, Lobbying Firms, and Lobbyist Employees* (visited Apr. 7, 2000) <http://www.ss.ca.gov>.

404. Florida Dept. of State Div. of Elections, *Campaign Financing* (visited Apr. 7, 2000) <http://www.election.dos>.

Representative Ed Healey, who sponsored the Florida title loan law, said of his participation in the introduction and passage of the law: "It's the only blemish I have after 24 years."[405] State officials and lobbyists are also distancing themselves from TLOA as a result of rumors relating to Alvin Malnik's alleged Mafia connections.[406] Florida legislators have admitted error in passing title loan laws in the confusion of the last hour of the 1995 session. They thought the 22% interest rate was an annual, not monthly, rate.[407] A legislatively-created study commission recommended a repeal of the title loan laws completely.[408] Nevertheless, after a substantial infusion of cash into individual and party campaign accounts, efforts to enact curative legislation stalled in the following four legislative sessions.[409]

As a result of this inaction, Florida counties and cities began to consider and pass legislation providing much needed reform.[410] Florida's local governments have the authority to consider their own ordinances because the title loan laws were incorporated into the pawnbrokers statute, which allows local government to enact "more restrictive legislation."[411]

The City Council of Jacksonville, Florida first introduced a proposed ordinance that contained many reforms, such as requiring lender licensing and oversight, the return of surpluses after repossession and sale, and an 18%—rather than 264%—annual percentage rate. A year of committee

405. Marcia Gelbart, *Meyer Lansky, Lawyer Now Title Loan King*, PALM BEACH POST, Mar. 3, 1999, at 1A (describing how an old friend and former House Speaker Donald Tucker, as TLOA's lobbyist, ran up to Rep. Healey as he walked into the Senate on the last day of the session and asked Healy to submit a bill; Healy said he knew the subject matter but never read the details).

406. Tom Humphrey, *Top Lobbyist Drops Car Title Loan Firm After Mob Ties Story*, KNOXVILLE NEWS-SENTINEL, Mar. 19, 1999, at A3; Pat Kossan, *Bill Flirted With Accused Mob Figures*, ARIZONA REPUBLIC, Feb. 14, 1999, at A1; *Poverty, Inc.*, *supra* note 141, at 30 (noting that Mr. Malnik has never been convicted of a crime); Wissner, *supra* note 123, at 1A. (discussing organized crime connections to pay day lending); *60 Minutes*, *supra* note 46, at 6-7 (highlighting an interview with TLOA president, Robert Reich, describing Alvin Malnik as a silent investor).

407. *See, e.g.*, *60 Minutes*, *supra* note 46, at 7-8 (interviewing Florida Representative William Sublete, who commented that the title loan bill was one of 145 votes taken on the last day of session: "I think I speak for the entire Florida House at the time. And universally, without exception, each of those members had said that they had no idea what they were voting on, or what was being pushed through that day.").

408. Letter from Craig A. Meyer, Vehicle Title Loan Task Force to Toni Jennings, President, Florida Senate and Daniel Webster, Speaker, Florida House of Representatives (Feb. 28, 1997) (on file with authors).

409. H. 299, 1st Leg. Sess. (Fla. 1999); S. 898, 1st Leg. Sess. (Fla. 1999); S. 868, 1st Leg. Sess. (Fla. 1999); H. 795, 2d Leg. Sess. (Fla. 1998); H. 3955, 2d Leg. Sess. (Fla. 1998); S. 194, 2d Leg. Sess. (Fla. 1998); S. 258, 2d Leg. Sess. (Fla. 1998); H. 431, 1st Leg. Sess. (Fla. 1997); H. 659, 1st Leg. Sess. (Fla. 1997); S. 1176, 2d Leg. Sess. (Fla. 1996); H. 1027, 2d Leg. Sess. (Fla. 1996).

410. Authority to pass these laws derives from FLA. STAT. ANN. § 538.17 (West 1997) (allowing the licensing of pawnbrokers at the municipal level).

411. *Id.* § 538.17.

meetings, public hearings, negotiations, and standard industry stalling techniques ensued. The same industry representatives who can be found in the legislative halls of state legislative bodies in Florida, Mississippi, Illinois, Kentucky, and Tennessee came to Jacksonville to take part in local legislative efforts and to contribute to local political campaigns. Advocating better local controls, Florida's Attorney General and the Florida Comptroller even came and spoke to the Jacksonville City Council, urging the council members to act where the state legislators had failed. Again, consumer advocates and the industry agreed on the reforms but failed to come close to reaching agreement regarding the interest rate. In the end, despite the industry's consistent claim it could not make a profit with less than triple-digit annual interest rates, the Jacksonville City Council passed its title loan reform ordinance.[412]

While the state legislature wrangled for the fourth year in a row with the title loan question, the three beach cities adjoining Jacksonville—Jacksonville Beach, Atlantic Beach, and Neptune Beach—each proposed and quickly passed similar reform ordinances with an annual interest rate cap of 30%.[413] Next, the adjoining counties—Clay and St. John's—passed reform ordinances limiting the interest rate to 30%.[414] The title loan reform movement then headed to south Florida where Palm Beach and Broward Counties passed ordinances with 30% interest rate caps, while Miami-Dade County reduced the rate to 18% per annum. Hillsborough, Orange, Seminole, Volusia, Osceola, and Martin Counties later enacted similar consumer legislation; to date, a large percentage of Florida's sixty-seven counties have done what the state has refused to do by reducing title loan interest rates to 30% or less per annum and enacting other consumer protection reforms.[415]

D. Public Relations

In addition to legislative efforts, fringe credit trade groups also engage in nationwide public relations campaigns.[416] As a part of this effort, some fringe lenders seek to distinguish themselves from other players in the fringe market.[417] The APRO argues that the rent-to-own industry does not fall into the category with other fringe lenders because it provides no banking services.[418] Similarly, the pawnbrokers lobby strongly opposed the inclusion of automobile title pawns in the "pawn" category for fear it would give pawnbrokers a bad

412. One of the authors was continuously involved in these processes and participated in legislative committee meetings and legislative and judicial hearings, working directly with the city and the industry on the compromise legislation.

413. One of the authors was continually involved in these processes.

414. One of the authors was continually involved in the Clay county process.

415. Our Views, *Fleeced in Florida*, ORLANDO SENTINEL, Nov. 7, 1999.

416. WINN, *supra* note 362.

417. *Id.*

418. *Id.*

name.[419] In Florida, when the legislature was adding title pawns to the pawnbrokers chapter, the pawnbrokers association insisted on including a provision that title pawn lenders could not use the term "pawn" in connection with their loan transactions.[420] The industry threatened to sue a television station that refused to "correct" a story referring to the transactions as "automobile title pawns." Representatives of some parts of the fringe marketplace fear the use of these labels will "draw exponentially more attention to the plight of the poor."[421] As one commentator has put it:

> [I]f the picture can be painted that there is an orchestrated effort to impale the working poor on the prongs of a gigantic evil complex of fringe banking services and there is nowhere for them to turn and no escape, then suddenly there is a story to tell and a bigger enemy to attack.[422]

VII. USURY POLICY AND THE TWO-TIERED SYSTEM

A. *The Multiple Purposes for Usury Laws*

There are many good reasons unrelated to the usury debate to subject the two-tiered financial services system to public scrutiny. However, for the purposes of this focus edition on usury law, it is appropriate to consider the fringe marketplace in that context.[423]

1. *The Moral Predicate*

Usury laws are, at core, the earliest form of consumer protection law. They have been observed over millennia and across a wide variety of cultures—in order, it may be said, to protect the needy from the greedy.[424] Arguably,

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419. *Id.*
420. FLA. STAT. ANN. § 538.15(5) (West Supp. 2000).
421. WINN, *supra* note 362, at 3.
422. *Id.*
423. While some second-tier lending is regulated, including some price restrictions, the allowable price tags are such that the policy issues presented do not differ significantly from those presented by a deregulated market.
424. See, for example, *Whitworth & Yancy v. Adams*, 26 Va. (5 Rand.) 333 (1827), in which the court noted

> These statutes were made to protect needy and necessitous persons from the oppression of usurers and monied men, who are eager to take advantage of the distress of others; while they, on the other hand, from the pressure of their distress, are ready to come to any terms; and with their eyes open, not only break the law, but complete their ruin.

however, the more a population uses credit for convenience, lifestyle, and "wants," the more public concern over borrowers who go into debt as a result of necessity wanes.[425] This result, in turn, erodes agreement among the majority about the moral purpose underlying usury laws. Moreover, in a society with standards of living among the top tier of the world's nations, the distinction between wants and needs can itself become a point of dispute; beyond the unquestionable basics, the concept of need—even poverty itself—may be relative.[426] Finally, at different times, a culture places different levels of emphasis on the balance between "individualism" or "individual responsibility" and a more shared vision of common purpose and responsibility. Here, too, twentieth-century America arguably resembles nineteenth-century America just

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Id. at 416. Likewise, in Schneider v. Phelps, 359 N.E.2d 1361 (N.Y. 1977), the court explained that

> The purpose of usury laws, from time immemorial, has been to protect desperately poor people from the consequences of their own desperation. Law-making authorities in almost all civilizations have recognized that the crush of financial burdens causes people to agree to almost any conditions of the lender and to consent to even the most improvident loans. Lenders, with the money, have all the leverage; borrowers, in dire need of money, have none.

Id. at 1365. In commonwealth v. Donoghue, 63 S.W.2d 3 (Ky. 1933), the court noted

> We think a better comparison or analogy is to look upon the offense [of usury] as fraud, deceit, cheating and kindred wrongs are viewed. Many courts, if not the economists, still feel that the debtor is held in financial peonage and that general usury laws are necessary to protect him from the greed of the oppressive lender and still think of the creditor who willfully attempts to take more than the law allows as a Shylock exacting his pound of flesh.

Id. at 9, *quoted in* Benj. S. Horack, A Survey of the General Usury Laws, 8 LAW & CONTEMP. PROBS. 36, 40 (1941) (discussing moral versus legal usury); *see also* Edward L. Glaeser & Jose Scheinkman, *Neither a Borrower Nor a Lender Be: An Economic Analysis of Interest Restrictions and Usury Laws*, 41 J.L. & ECON. 1, 1 (1998) (noting that Dante put usurers "in the same area of hell as denizens of Sodom"); George J. Wallace, *The Uses of Usury: Low Rate Ceilings Reexamined*, 56 B.U. L. REV. 451 (1976) (discussing the advantages of and providing ethical support for low consumer rate ceilings); Pope John Paul II , Address to the National Council of Anti-Usury Foundations (Apr. 14, 1999), *quoted in* Dorothy Day, *Peter Maurin and the Catholic Worker Movement: John Paul II Calls for an End to Usury*, HOUS. CATH. WORKER NEWSPAPER (visited April 9, 2000) <http://www.cjd.org/paper/usury.html> (encouraging members to combat usury); *see generally* Glaeser & Scheinkman, *supra*, at 19 (providing a brief overview of some of the historical and cross-cultural treatments of usury); COST OF CREDIT, *supra* note 22 (supplying references to more detailed historical treatments).

425. The challenges created by this dual nature of the credit marketplace were noted in the first wave of reform. *See* Hubachek, *Development*, *supra* note 1, at 129-131.

426. "Low-to-moderate" income, for example, is defined in relation to the median income—a relative measure. *See* Hogarth & O'Donnell, *supra* note 217, at 460. A brief news report on the current debate is found in Laura Maggi, *Devil in the Details: The Poor Count*, AM. PROSPECT, Feb. 14, 2000, at 1.

before the first wave of reform. In describing the strategy of one segment of the small loan reform movement during the early twentieth century, Lendol Calder explains that "[d]uring the Progressive Era, ideals of social harmony became popular as many Americans turned away from the excessive individualism of late nineteenth-century Social Darwinism," and those ideals were invoked in the reform campaign.[427] While the moral basis for usury regulation may be out of fashion at the moment, the AFS industry unquestionably touches this concern.[428]

2. *The Economic Predicate(s)*

The most frequently articulated view of usury laws from today's dominant economic perspective posits a negative role for usury laws—they interfere with matters best left to "The Market."[429] Thomas A. Durkin, a staff economist from the Federal Reserve Board presented "An Economic Perspective on Interest Rate Limitations" at a conference a few years ago in which he catalogues the

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427. CALDER, *supra* note 179, at 141. Similarly, the current climate is described (admittedly by one of the authors) as one of "economic Darwinism." *Poverty, Inc.*, *supra* note 141, at 29 (quoting Kathleen Keest). Though there is a distinction between the concepts of "individual responsibility" and "every man for himself," at times the former is used to rationalize the latter.

As a practical matter, the degree of individualism that a society as a whole believes in may depend on how widespread socioeconomic comfort is. Those who articulate an "individual responsibility" view in the abstract feel differently when the consumer in question is an elderly relative or an inexperienced twenty-year-old offspring. If this is the case, the relative weight given to the moral purpose of usury laws will vary as well, depending on overall conditions in the economy.

428. Navy Captain Robert Andersen's concluding remarks at the Lieberman Forum reflect this fact: "It is disturbing . . . that there are companies feeding off the poor. The people who can least afford these loans are the ones falling prey. It is critical that we focus on making ethical decisions based on what['s] best for America and not what is best for lining our pockets." Lieberman Forum (Andersen testimony), *supra* note 59, at 3.

The consequences of the current wave of deregulation led some courts to allude to the earlier experiments with deregulation; these experiments were short-lived because abuses arose in the absence of usury laws. *See, e.g.*, *In re* Coxson, 43 F.3d 189, 191 n.2 (5th Cir. 1995) (noting that Texas's abandonment of usury laws during Reconstruction was reversed because of the resulting credit abuses); Paulman v. Filtercorp, 899 P.2d 1259, 1264-65 (Wash. 1995) (Talmadge, J., concurring) (calling on the legislature to revisit whether the exemption from usury laws for small business loans is "just" in view of a loan that "would have made a loan shark proud").

429. One theologian, seemingly only partially tongue-in-cheek, detects distinct theological overtones in our view of "The Market" today—"omnipotent . . . omniscient . . . and omnipresent." Harvey Cox, *The Market As God*, ATLANTIC MONTHLY, Mar. 1999, at 19.

Even economists are beginning to discuss whether the discipline is currently too divorced from ethics. See, for example, a work by the 1998 Nobel Prize winner in economics, AMARTYA SEN, ON ETHICS AND ECONOMICS 7 (1988) ("[T]he nature of modern economics has been substantially impoverished by the distance that has grown between economics and ethics.").

ways economists believe interest rate ceilings distort financial markets.[430] However, some of the same outcomes Durkin attributes to price regulation have arguably come to pass in the current, largely deregulated, consumer credit market.[431] One statement in particular is strikingly ironic. Though speaking of credit sales rather than loans, Durkin predicts that "[t]he likely result of the rate ceiling would be development of a class of stores which sell credit goods largely to poor risks but at higher prices. . . . [M]arket segmentation would increase and competitive forces decline."[432] In more areas than just credit sales, this is precisely what is happening to credit even in the presence of deregulation.[433] Further, increased business within each segment of this second-tier marketplace has not resulted in the kind of competition that genuinely lowers the prices of these products.[434]

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430. Thomas A. Durkin, *An Economic Perspective on Interest Rate Limitations*, 9 GA. ST. U. L. REV. 821 (1993).

431. For example, in discussing the argument that ceilings restrict the availability of credit, thus acting as a rationing device, Durkin argues that "[c]reditors might . . . impose fees and raise uncontrolled aspects of the price and eliminate or reduce grace periods." *Id.* at 825. But the overwhelming majority of credit card business in this country has been deregulated for a decade or more—and these events have happened to a greater degree than when it was regulated. Several explanations exist for this, one of which is that by increasing revenues on the back end of a transaction (e.g., overuse fees, underuse fees, late fees, and "we deem ourselves insecure" penalty rates), the advertising can focus on "competitive" front-end pricing, such as low teaser rates.

Another argument Durkin posits is that ceilings have a negative macroeconomic impact. By keeping interest rates below the "free market equilibrium rate," rate ceilings reduce savings. *Id.* at 829. But our savings rate is low despite deregulation of the largest sectors of the consumer credit market. (Spending, spurred in part by the availability of credit, may well also reduce savings, as people "buy now, pay later" instead of saving for the purchase or for the "rainy day.")

A third adverse effect of ceilings Durkin advances is that they waste resources, as business resources are devoted to "the 3 Ls—lawyers, litigation, and legislation." *Id.* at 828. But deregulation can also lead to deceptive and unfair practices in efforts to gain competitive advantage, and overreaching occurs in a deregulated market. *See supra* note 28 and accompanying text. As long as fundamental concepts of fairness are part of our body politic, the "3 Ls" are as likely to be consequences of deregulation as they are of regulation. Indeed, a society that becomes too one-sided in terms of access to lawyers, courts, and legislatures is not likely to be a truly democratic society for long. For an extensive examination of the economic perspective on usury, *see* Wallace, *supra* note 425

432. Durkin, *supra* note 431, at 836.

433. As noted earlier, this segmentation has likewise developed in the deregulated mortgage market as well. *See* Mansfield, *supra* note 19. These outcomes invite speculation as to whether deregulation in fact encourages segmentation.

434. One of the trade association spokesmen told the Lieberman Forum that because the payday loan industry is highly competitive,

> [t]his has reduced prices and it will continue to drive down the cost of this financial product to marginal cost, in accordance with standard economic theory. Ultimately, the best consumer protection is full disclosure of interest charges under TILA and the operation of the well tested American free enterprise

In fairness to market theorists, market forces work better in some parts of the consumer credit marketplace than in others. But the basic threshold question must always be whether the particular marketplace under scrutiny is one in which market forces work well, and the fringe market raises serious questions in this regard.[435] During the first wave of small loan reform, one author described the limited benefits in terms of lower prices that competition brings in this kind of marketplace as follows:

> A time came when there were too many licensed lenders and too many dollars seeking to be lent. Competition so far had been effective only to a very limited extent in reducing the rates of charge. Instead, it took the form of excessive solicitation and overlending. This in turn led to the borrower's delinquency which fostered collection abuses.[436]

Juxtaposing this commentator's analysis against the contemporary marketplace described in Part II, one suspects the author would repeat those words today.

One overview of the deregulatory efforts in the 1980s surveys both sides of the usury law debate.[437] Regarding the argument that rate caps restrict the availability of credit, the overview notes that the number of borrowers cut out of the credit market by any "rationing" may not be large.[438] Further, this outcome should be balanced against the number of people who would pay higher rates in the absence of reasonable ceilings.[439] Greater risk and higher transaction costs are reasons generally advanced for high prices in the fringe market, and to some extent, both are present.[440] However, the question is how much of the higher price is compensation and how much instead may be opportunistic pricing. Opportunism may distort the market process because of unequal bargaining power, "information asymmetries" (unequal information

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> system, in which the most efficient business survive
> to provide products to consumers at the least expense.

Lieberman Forum (Rochford testimony), *supra* note 30, at 19. This view is disputed. Others see little sign that user costs have declined in the AFS marketplace, even as it has grown. RTO and check cashing costs have not declined noticeably despite growth. See *supra* note 29 as to the rise in the cost of cashing a social security check even as competition increased. *See also* Lieberman Forum (Fox testimony), *supra* note 121, at 7 (explaining why competition between lenders will not provide consumers with lower prices). It is critical to look at the actual track record before taking this rationale on faith in the AFS marketplace.

435. *See supra* Part IV.

436. Hubachek, *Development*, *supra* note 1, at 121-22.

437. COST OF CREDIT, *supra* note 22, at § 2.4.1.

438. *Id.*

439. *Id.* at 56; *see also* Wallace, *supra* note 425 (discussing how low ceilings protect consumers).

440. Regarding traditional pawnbrokers and standard check cashers, see CASKEY, FRINGE BANKING, *supra* note 3, at 111. (Note that Caskey conducted this study before the boom in auto title loans and payday loans and thus did not examine those providers.)

and understanding), and actual or perceived absence of choice.[441]

The fringe market presents a tension regarding the issue of choices. One justification offered for these products is that the targeted customers are facing financial emergencies and have nowhere else to go.[442] On the other hand, that need is precisely what gives the lender greater leverage.[443] These justifications can backfire, because they implicate the moral justification for usury laws and undermine the economic justification for "leaving it to the market."[444]

Risk-based pricing as a rationale also begs a chicken-and-egg question: to what extent does high cost create the risk, rather than compensate for it? Advocates have seen many individual credit transactions in which the consumer's budget could have supported a reasonably priced loan, but the high fringe credit price tag stretched this capacity too far.[445] On an aggregate basis, segmentation would seem to exacerbate the problem. The industry may respond that overall default rates require them to raise the costs for their whole customer base: "It's a shame, but the 80% of our customers who do pay have

441. One complication of relying on disclosure rather than substance is that creditors can choose either to exploit or bridge information asymmetries. *See, e.g.*, Emery v. American Gen. Fin. Co., 71 F.3d 1343, 1346 (7th Cir. 1995) (reciting facts of a case in which a woman was not told that borrowing $300 would result in about $1200 in fees; the court said, "[s]o much for the Truth in Lending Act as a protection for borrowers"). Apart from the distortions that misleading oral "explanations" of disclosures create (or perhaps because they are more prevalent than we know), one study found that only 37% of consumers understood the concept of the APR as the primary indicator of credit price, although over 70% knew what the letters stood for. EDUC. TESTING SERV. FOR THE CONSUMER FED'N OF AM. & TRW, U.S. KNOWLEDGE: THE RESULTS OF A NATIONWIDE TEST (1990).

442. *See, e.g.*, Cahill, *supra* note 40 (reporting that "[t]itle lenders say critics misunderstand their mission. They say they serve people with nowhere else to turn.").

443. *See* Aldens, Inc. v. Miller, 466 F. Supp. 379 (S.D. Iowa 1979). In *Aldens*, the court noted that within "the power of the lender to relieve the wants of the borrower lies the germ of oppression." *Alders*, 466 F. Supp. at 384 (quoting 45 AM. JUR. 2D *Interest and Usury* § 4 (1969)).

444. *See, e.g.*, Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 449 (D.C. Cir. 1965) (explaining that "absence of meaningful choice" is a element of unconscionability, not an explanation for it); Craig Horowitz, Comment, *Reviving the Law of Substantive Unconscionability: Applying the Implied Covenant of Good Faith and Fair Dealing to Excessively Priced Consumer Credit Contracts*, 33 UCLA L. REV. 940, 944-45 (1986) (discussing oppressive contracts). Pawnbrokers understand the double-edged force of this argument. *See* CASKEY, FRINGE BANKING, *supra* note 3 at 71 n.1.

445. In the subprime mortgage area, the prevalence of the problem led to the Home Ownership and Equity Protection Act (HOEPA) prohibition against engaging in a pattern and practice of making high-cost mortgages without regard to the ability to pay from current and expected income. *See* 15 U.S.C. § 1639(h) (1994); Reg. Z, 12 C.F.R. § 226.32(e)(1) (1999); Newton v. United Cos. Fin. Corp., 24 F. Supp. 2d 444, 456 (E.D. Pa. 1998) (stating that "[t]he mere existence of some set of guidelines does not make a lender in compliance if the guidelines are in fact deficient"). In the AFS midget loan area, see the Lieberman Forum's "ability to pay" charts. Lieberman Forum Charts, *supra* note 258; *see also* IOWA CODE ANN. § 537.5108(4)(a) (West 1997) (codifying the unconscionability principle that it is unconscionable to sell, lend, or lease to someone believing that "there is no reasonable probability of payment in full," except for an RTO total sales price, an amendment enacted when Iowa's RTO statute was passed).

to pay for the 20% of our customers who do not." However, when an entire customer base is drawn from a comparatively narrow economic base, particularly one in the lower quintiles, is it possible that higher prices create a higher failure rate, thus creating a negative feedback loop that ensnares customers–ones who might have otherwise been on the performing side of the divide? Could usury ceilings conceivably play the role of a circuit breaker if such negative feedback loops are the operative economic forces in this marketplace?[446]

Usury ceilings can play preventive roles. While some economists argue that such ceilings create entry barriers, thus discouraging competition,[447] there may be a positive side to this coin. It is good to discourage the entry of the unscrupulous lender likely to become a profiteering predatory lender. Reverse redlining, or discriminatory pricing, raises another potential preventive role for ceilings. Discretionary pricing can also be discriminatory pricing; ceilings can at least help indirectly by placing an outside limit on discriminatory harm.

The argument that ceilings restrict credit availability may have a positive bent as well.[448] Prevention is not necessarily a bad policy when unfettered freedom of choice presents potentially serious negative consequences. Any number of laws that people routinely accept fall into this category (e.g., seat belt laws, helmet laws, vaccination requirements, speed limits, and anti-pollution laws). The fact that financial and consequent family worries flowing from fringe debt has been viewed as a threat to military readiness[449] suggests that such debt problems are more than a matter of simply making individuals pay the consequences for bad choices in good times. And good times ebb and flow. Regarding the rise in consumer installment debt during one of the recessions in the past two decades, Robin Morris has noted that overleveraged households suffer most in a recession, and that usury ceilings can mitigate the

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446. To the best of our knowledge, no economists studying feedback loops have examined the fringe consumer credit marketplace; this may be an interesting case study for an interdisciplinary examination.

A related question is how well a market specializing in products with higher transaction costs (to whatever degree they truly are higher) that markets those products to a comparatively narrow base serves the low-to-moderate income credit market. Today's orthodoxy is that cross-subsidization is a bad thing, yet it has some benefits, one of which might be that it drags the negative loop, if indeed this is the model at work. The benefits of permitting lower-margin transactions to cross-subsidize higher margin transactions were noted in the first wave of reform: "in commercial banking for generations $1,000 and $5,000 business loans at reasonable rates have been made possible because loans of $50,000 and $100,000 were being made." HUBACHEK, DEVELOPMENT, *supra* note 1, at 131.

447. *See, e.g.*, Durkin, *supra* note 431, at 827 (stating that "[i]nterest rate ceilings . . . produce a barrier to entry and reduce the likelihood of competitive conditions.")

448. *See generally* Wallace, *supra* note 425 (discussing benefits of low consumer credit rate ceilings).

449. *See supra* note 241-243 and accompanying text.

problems consumers and society suffer in a recession.[450] Two economists looking at the historical and cross-cultural roles of usury laws may be speaking of a related concept when they posit ceilings as a "primitive" form of social insurance for those who suffer from temporary "negative income shocks."[451] They also suggest that limiting the degree to which a person could become over-indebted may serve the interests of the larger community, such as the interest in avoiding an enhanced risk of bankruptcy.[452] Though we do not foist the "care of the bankrupt" on society today, bankruptcy risks created by indebtedness to high-rate lenders arguably hurt other creditors, such as medical care providers. Even in the absence of the debtor's bankruptcy, other businesses may suffer. The money a household spends servicing high-cost debt in the second-tier marketplace is not available for spending at the neighborhood grocery stores, service stations, pharmacies, or other local businesses.[453]

B. *Potential Social and Economic Costs of a Two-Tiered System*

The beginning of this Article noted that the two-tiered system runs the gamut from one-day small loans to mortgage loans. The limitations of current market theory may be most visible in the consumer credit marketplace because the forces of distortion are prevalent and are exacerbated in the second-tier

450. Robin A. Morris, *Consumer Debt and Usury: A New Rationale for Usury*, 15 PEPP. L. REV. 151, 177-78 (1988). This observation suggests another unexplored connection for a possible macroeconomic preventive function for usury laws in limiting excessive debt. The debt deflation theory suggests that excessive debt burdens can restrict demand in a recession, which, in turn, can trigger deflation—worsening the recession. The fringe credit volume is a drop in the bucket of America's economy, and even the entire $5.6 trillion in household debt may be too small to pose a threat. However, today we speak of "consumer spending" driving this period of record growth, suggesting it is large enough to have a macroeconomic impact. One economic historian has speculated whether the fact that consumer debt became a household phenomenon for the first time in the 1920s contributed to the 1930 consumption collapse. *See* OLNEY, *supra* note 191, at 187-89. A contemporary look suggests that more study of the debt deflation theory is warranted because there is at least a possibility that it is "not just a theoretical curiosity, nor . . . a relic of the Great Depression." John P. Caskey & Steven M. Fazzari, *Debt, Price Flexibility and Aggregate Stability*, 102 REV. D'ECONOMIE POLITIQUE 519, 540 (1992).

451. Glaeser & Scheinkman, *supra* note 425, at 3, 26. Although Glaeser and Scheinkman purport to look at consumer finance laws in the United States on pages 12-13, the rate ceilings they actually used appear to be the general usury ceilings (see page 14), not the higher rates applicable to most consumer finance. For a discussion of general and special usury ceilings, see COST OF CREDIT, *supra* note 22, at § 2.2. It is unknown whether using the rates applicable to consumer credit transactions would have changed their analysis.

452. Glaeser & Scheinkman, *supra* note 425, at 27.

453. Place the fringe credit marketplace in the context of the following examination of industries that "create" wealth by exploiting "sociological disequilibriums": "Entrepreneurs see sociological opportunities to change human habits. . . .[examples used are Starbucks coffee and the cruise industry]. . . . The problem with wealth generated this way is that sociological disequilibriums usually reflect a transfer of existing wealth rather than the generation of new wealth." Lester C. Thurow, *Building Wealth*, ATLANTIC MONTHLY, June 1999, at 57, 60. The fringe credit marketplace seems to fit well within this analysis.

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Though the expansion of credit in the fringe marketplace is sometimes euphemistically cast as the "democratization of credit," it is imperative to examine whether too much of this is destructive debt rather than productive credit. According to one overview, "[c]onsumers who pay the high [fringe] rates have such a hard time simply keeping up payments that getting ahead becomes almost impossible. As a result, the *status quo* is perpetuated and it becomes more difficult for lower income consumers to improve their status."[454] If these consumers fail, they never get a chance to prove that they may have been able to manage affordable credit. And participation in multiple sectors of the second-tier marketplace exposes them to a greater risk of failure. For example, distortions in fringe auto financing results in these customers paying seriously inflated prices for second-rate cars at high interest rates. Because those payments (often due weekly or biweekly) take a chunk out of the budget, when the car breaks down, customers who turn to a payday lender for the repair funds face an enhanced likelihood of failure on both debts. Meanwhile the household's capacity to meet other expenses is further strained, perpetuating the feedback loop to which this Article has previously alluded. Equally insidious is the fact that borrowers who successfully pay off their fringe loans—unlike consumers in the prime market—may not get the benefit of a positive credit report. Successfully completed fringe credit transactions often do not become part of the consumer's credit history, and thus cannot be used to help establish the creditworthiness that would allow access to the mainstream financial marketplace.[455] Indeed, one Internet site for a specialized reporting service explains to its prospective fringe credit industry customers that "[u]nlike traditional consumer reporting companies, our database contains only negative information."[456]

In recent years, there has been concern about the widening income and wealth disparities in this country[457] and about the troubling role of race in those disparities.[458] Credit can be a part of the solution or part of the problem. One

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454. *AFS Overview, supra* note 3, at 9.

455. *Id.* at 9.

456. *The Difference in Sub-prime Consumer Information from Tele-Track* (visited Apr. 9, 2000) <http://www.tele-track.com/differen.htm>.

457. *See, e.g.*, Richard W. Stevenson, *In a Time of Plenty, The Poor Are Still Poor*, N. Y. TIMES, Jan. 23, 2000, at Wk-3 (reporting that the "[a]verage income for families in the bottom fifth of the income scale fell 5 percent between the late 1970's and the late 1990's" while "income among the top fifth of families rose 33 percent," and noting that "the median value of assets owned by families with incomes less than $25,000 . . . fell between 1995 and 1998").

In 1998 the share of aggregate household income coming into the lowest quintile was 3.6%, and 49.2% went into the top quintile. The lowest three quintiles received only 27.6%. U.S. CENSUS BUREAU, CURRENT POPULATION SURVEY, Fig. 5 (Mar. 1999).

458. A study on low-income households done for the credit unions begins with the following data on "net worth" (defined as assets less liabilities) and "financial wealth" (defined as net worth minus net equity in the home):

title lender is quoted earlier as saying he views his business as a ladder: people can use it to go up or go down.[459] But in the fringe market the challenge is to explore whether the forces at play make such loans more like trying to go up a descending escalator—the fringe customer has to fight hard just to stay in place, and stopping for breath means a ride to the bottom.[460]

VIII. ALTERNATIVES BEING EXPLORED

Considering alternatives for the small-dollar end of the fringe market has the advantage of including savings options as well as alternative credit options. Certainly there are cultural barriers to savings beyond the reach of politics and law.[461] But if there are institutional barriers, it is appropriate to consider whether they can be reduced. The minimum deposit, minimum balances, and high maintenance fees of retail banks are one institutional barrier to savings. It can be difficult to save in small increments with minimum opening balances; moreover, monthly service fees on small accounts can not only exceed the interest payable, but can actually cost the saver. Once again, credit unions are turning their attention to this market. Their policies typically do not pose such financial hurdles to small, incremental savings, and they can offer programs to make savings more attractive to the fringe banking customer.

A Florida credit union is developing a package of the kind of services

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	Net Worth	Financial Wealth
Median of all households	$45,630	$9,950
Non-Hispanic white households	$61,000	$18,100
Non-hispanic black households	$7,400	$200
Mean net worth of all households in bottom 40% of households by net worth	$900	($10,600)

JOHN P. CASKEY & DAVID B. HUMPHREY, CREDIT UNIONS AND ASSET ACCUMULATION BY LOWER-INCOME HOUSEHOLDS 7 (1999).

459. *See supra* note 91.

460. *Cf.* Kelly, *supra* note 176, at 90-91 (explaining that "[i]n view of these consequences [to families and communities], it is not possible to conclude that such lenders justify their existence by contributing a valuable service; to the contrary their excesses add to rather than subtract from the sum total of economic maladjustment").

461. *See generally* JULIET B. SCHOR, THE OVERSPENT AMERICAN: WHY WE WANT WHAT WE DON'T NEED (1998) (reporting on the middle class); CASKEY, CASH-AND-CARRY, *supra* note 231 (reporting on lower income households).

typically offered by fringe providers, including payday loans. The Florida credit union believes that rates between 20% and 45% should be adequate, which will test the payday loan industry's justification for its prices.[462] It will avoid the roll-over problem on the payday loan product by offering reasonable repayment terms at the outset.[463] The Florida Central Credit Union making this effort is one of a number of credit unions whose efforts to reach low-to-moderate income communities are described in a recent survey. The Florida Central Credit Union approach tracks the study's recommendations, including partnering with well-managed nonprofit agencies with close ties to the community to facilitate outreach, education, and trust, while offering products and services geared to the needs and desires of those communities.[464]

One commentator suggests a way of reducing institutional barriers to savings by welfare households as an alternative to RTO. Individual Development Accounts (IDAs) are restricted-use savings accounts that are designed to encourage accumulation of assets by welfare households. By expanding the list of permissible uses of IDAs to include acquiring consumer durables, welfare households may be encouraged (or at least not penalized) for saving to buy a washing machine and dryer instead of patronizing the RTO store.[465]

Depending on the purpose of the borrowing, some philanthropic models may be considered or public policy decisions revisited. If people are turning to 400% payday lenders to pay utility bills (one of the financial emergencies sometimes cited by the industry), might that suggest that it is time to revisit the cutbacks to the Low-Income Energy Assistance Program (LIHEAP)? Without adequate funding for this program, some utilities offer their own charitable programs for help. The McKnight Foundation has developed a revolving low-interest small loan fund to help meet needs such as auto repairs or other transportation-related needs, child care, education, and similar investment purposes for its home base in Minnesota in 1985, and expansion pilots have been established in other communities through Family Service America, a Milwaukee-based nonprofit agency.[466]

Finally, this year will determine where the government will go on a controversial policy decision that touches some portions of the fringe banking marketplace. Over a decade ago, the decision was made to move toward the electronic delivery of government benefits, now called EBT (Electronic Benefits Transfer). These benefits cover a broad economic spectrum, from

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462. *See* Lieberman Forum (Gallagly testimony), *supra* note 58, at 5.

463. *Id.*

464. *See* CASKEY & HUMPHREY, *supra* note 459, at 30-35; *see also id.* at 14-20, 61-65 (providing suggestions for serving this market).

465. Creola Johnson, Intersection of Rent-To-Own and Welfare Reform: A Missing Component—The Acquisition of the Basic Household Durables at Affordable Prices (June 19, 1999) (unpublished manuscript on file with authors).

466. A very brief overview of this program and other suggestions for fringe banking alternatives appear in HUDSON, *supra* note 19, at 41-45.

pensions for retired presidents and senators to payments for VA benefits, social security, social security disability, and supplemental security income (SSI)—a needs-based program. The primary purpose of EBT was to save money—to reduce operational costs by utilizing the efficiency of new technologies. But EBT was also conceived as an opportunity to move some of the "unbanked" into the mainstream financial system. If one of the factors that make people turn to fringe providers is a greater sense of familiarity (and hence comfort) with the fringe system, then making EBT available through widely-used ATM networks may serve as a bridge to the financial mainstream. Banks, in turn, benefit from bulk deposits under the program and are given the added prospect of an expanded customer base.

But perversely, some banks have instead formed partnerships with fringe providers, so that the fringe provider has become the distribution point. These agreements have not only impeded the goal of "mainstreaming" recipients by making the fringe provider the point of contact with the recipient, but these arrangements also add an extra layer of expensive fees payable to the fringe provider by the recipient. In what would seem to be a classic illustration of exploiting "sociological disequilibriums," the extra layer of fees *reduces* the recipients' benefits and transfers them instead to this new middleman.[467] Further, with fringe providers as the contact point the products and services cross-marketed to recipients are not mainstream banking services (including savings opportunities), but rather payday loans and high-priced payment services.[468] The Department of Treasury has issued an Advanced Notice of Proposed Rulemaking (ANPRM) for public comment on whether such "conduit" systems should be permitted, and, if so, whether and how they should be restricted.[469]

IX. CONCLUSION

When the current wave of deregulation began there was little thought of where it would end, other than the expressed faith that "the Market" would work. But with the benefit of experience, a look back at some of the economic arguments against rate ceilings suggests that they have more to do with theory than empirical evidence. Nor is there any evidence that the data will change anytime soon. Indeed, the similarity of the currently developing fringe banking market to the one that proved dysfunctional at the beginning of this century

467. *See* Comments of Attorneys General of Arizona, California, Iowa, Maryland, Oklahoma, and Rhode Island on Dept. of the Treas. Fisc. Serv. ANPRM, RIN 15055-AA74 (Apr., 1999); NATIONAL CONSUMER LAW CTR., POSSIBLE REGULATION REGARDING ACCESS TO ACCOUNTS AT FINANCIAL INSTITUTIONS THROUGH PAYMENT SERVICE PROVIDERS (1999); *see also* Thurow, *supra* note 482, at 60 (discussing "sociological disequilibriums").

468. One such proposal was to offer advances at a mere 200% on the security of the next social security check. Fox, *supra* note 66, at 9. What a deal!

469. Possible Regulation Regarding Access to Accounts at Financial Institutions Through Payment Service Providers, 64 Fed. Reg. 1149 (1999).

gives little reason to believe that anything will be different this time. Our experience shows that a two-tiered marketplace simply runs the risk of becoming a second-class marketplace in too many respects—value, pricing, and even legal protections—to warrant the freedom from scrutiny that marks today's regulatory environment. And in giving it such scrutiny, it is necessary to explore the larger question of whether the two-tier marketplace also runs the risk of contributing to a widening gap between "haves" and "have-nots."

In 1963 David Caplovitz studied sales and credit markets around low-income housing projects and observed that the system "is in many respects a deviant one, in which unethical and illegal practices abound. Nevertheless, it can persist because it fulfills social functions that are presently not fulfilled by more legitimate institutions."[470] An obvious need for more attention to positive alternatives exists. In this regard, it is encouraging that some credit unions are showing an interest in offering alternatives, including savings opportunities, that are targeted to fringe banking customers. With some effort, perhaps the abuses of the fringe banking sector will not be seen as a "contemporary social problem" at the beginning of the next century.

470. DAVID CAPLOVITZ, THE POOR PAY MORE: CONSUMER PRACTICES OF LOW INCOME FAMILIES 180 (1963).