CASE NO. 08-164

IN THE ARKANSAS SUPREME COURT

SHARON MCGHEE, *et al.*,

Appellants,

vs.

ARKANSAS STATE BOARD
OF COLLECTION AGENCIES, *et al.*,

Appellees.

On Appeal From The
Circuit Court Of Pulaski County, Arkansas
Seventh Division
Case No. CV 2003-4837

HONORABLE BARRY SIMS, CIRCUIT JUDGE

BRIEF *AMICI CURIAE* OF AARP, ARKANSAS ADVOCATES FOR CHILDREN AND FAMILIES, AND CENTER FOR RESPONSIBLE LENDING IN SUPPORT OF APPELLANTS

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STATEMENT OF INTEREST

AARP, Arkansas Advocates for Children and Families, and the Center for Responsible Lending ("*amici*"), are non-profit organizations that advocate for the protection of consumers and families, including the enactment and enforcement of strong state laws that protect them from exploitation in the marketplace and enhance their economic well-being. *Amici* are particularly concerned about high-cost lenders and non-traditional sources of credit that target low- and moderate-income consumers, those on fixed incomes, including people dependent on Social Security benefits, and those with impaired credit who cannot access traditional sources of credit. These lenders, often referred to as the "fringe banking" or "alternative financial services" (AFS) industry, take advantage of borrowers already in financial distress by imposing exploitative terms such as astronomical annual percentage rates (APRs) and extreme default penalties, and engaging in oppressive collection practices. Payday loans are just one in an array of products marketed by a burgeoning industry that targets necessitous borrowers, the very people for whose benefit usury and other interest rate limits exist. *Amici* are concerned that payday lenders have, for many years, found refuge under the Check Cashers Act to evade the Arkansas Constitution's usury cap.

AARP is a non-partisan, non-profit organization with nearly 40 million members, approximately 372,000 of whom live in Arkansas. As the leading organization representing the interests of people aged 50 and older, AARP has a keen interest in stopping unfair and deceptive practices in consumer lending since many of these practices have a disproportionate impact on older people. Because fringe banking products are particularly exploitative, AARP has assisted in state legislative efforts to enact protections for borrowers, and has filed *amicus curiae* briefs in many cases, including the prior appeals before the Court in this case, urging courts to uphold and enforce these protections. *See, e.g., BankWest, Inc. v. Baker, Att'y Gen.*, 446 F.3d 1358 (11th Cir.

2006); *Wis. Auto Title Loans, Inc. v. Jones*, 714 N.W.2d 155 (Wis. 2006); *McKenzie Check Advance of Fla., LLC v. Betts*, 928 So. 2d 1204 (Fla. 2006). In addition, AARP attorneys are counsel in a class action alleging that a payday lender that charges in excess of 700% APR is violating Pennsylvania's usury and consumer protection statutes. *King v. Advance America*, C.A. 07-cv-237 (E.D. Pa. compl. filed Jan. 18, 2007). *See also Favors v. Stewart Fin. Co.*, No. 2002-CV-55526 (Ga. Super. Ct. filed July 9, 2002) (represented payday borrowers alleging a predatory scheme targeting Social Security and Supplemental Security Income recipients) and *Purdie v. ACE Cash Express, Inc.*, Civ. A. No. 301CV1754L, 2003 WL 22976611 (N.D. Tex. Dec. 11, 2003) (class counsel in case alleging payday lender's practices violated federal and state laws and that lender partnered with national bank to evade state usury and other laws).

Since 2004, AARP Arkansas has been the lead organization of Arkansans Against Abusive Payday Lending (AAAPL), a broad coalition dedicated to improving the lives of Arkansans, particularly the working poor, by removing abusive payday lending from the state. Among its activities, AAAPL published a report concerning payday lender practices and the extent to which Appellee, the State Board of Collection Agencies, does not adequately license or regulate lenders. *Payday Lenders in Arkansas: The Regulated and the Unregulated, An Updated Study* (Feb. 2006), http://www.stoppaydaypredators.org/pdfs/news%20articles/06_0200_Payday_U_Study.pdf. AARP members in Arkansas expressed concerned that payday lenders target unsophisticated borrowers, and reported that older people often are called upon to help when their children or grandchildren are caught in a payday debt trap. Based on members' interest in protecting consumers from lenders' exploitation, *see* Joanne Binette, AARP, *Payday Loans in Arkansas: A Survey of AARP Members* (Dec. 2005) (on file with AARP), AARP Arkansas has worked to highlight industry abuses before the state legislature, supported efforts to revoke the

Check Cashers Act, and advocated for Appellee to more aggressively enforce the statute's minimal restrictions.

Arkansas Advocates for Children and Families (AACF) is a respected Arkansas organization founded in 1977 to ensure that all children and their families have the resources and opportunities to lead healthy and productive lives and to realize their full potential. AACF accomplishes this mission by using research, advocacy, and public engagement to shape public policies and programs affecting children. Throughout AACF's history, the government has sought its assistance and advice in determining the effectiveness of services and in examining emerging issues that might assist or have an impact on children. Payday lending is one of those issues.

AACF has published many reports on these issues through the years including, since 2005, three research-based briefs on the payday lending industry, all of which cited relevant and scholarly data to support its position that the industry is harming Arkansas' low- and middle-income families by pushing them into a cycle of debt that has lasting effects on their economic well-being. AACF's rich tradition of reasoned, pragmatic solutions for dilemmas confronting the state pertaining to children obligates it to assist the Court to assess the critical issues in this case.

The Center for Responsible Lending (CRL) has done extensive empirical research and policy work on issues related to payday lending, predatory lending, discrimination in credit markets, and other banking services. CRL's parent organization is the Center for Community Self-Help whose mission is to create ownership and economic opportunities for minorities, women, rural residents, and low-wealth families.

Consumers targeted by payday lenders are among those with the greatest need for a market that operates with integrity, subject to enforcement of usury limits and other laws intended to

prevent exploitation and the rejection of efforts to evade these protections. Arkansas courts recognize the role played by the state Constitution's usury limit to protect borrowers, as well as the importance of looking at the substance of a transaction to determine if it is designed to evade such limits. *Amici* submit this brief to inform the Court about the nature of the payday loan industry in order to provide a context within which to view the validity of the Check Cashers Act and the harm that will continue to affect vulnerable Arkansas borrowers if the Court does not reverse the trial court and rule that the Act is unconstitutional.

ARGUMENT

I. ARKANSAS LAW RECOGNIZES THE IMPORTANCE OF PROTECTING CONSUMERS FROM USURIOUS LOANS.

Arkansas law, indeed the Constitution itself, recognizes the importance of protecting Arkansas consumers from usurious loans. The growth of the fringe banking industry in Arkansas, targeting consumers most vulnerable to predatory practices and least able to protect themselves from exploitation, warrants stronger regulation and the rejection of lenders' attempts to evade the protections afforded by usury laws which have, for hundreds of years, been enforced to "protect the needy from the greedy." *See* Lynn Drysdale & Kathleen Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and its Challenge to Current Thinking About the Role of Usury Laws in Today's Society*, 51 S.C. L. Rev. 589, 657 (2000) [hereinafter *Two-Tiered Marketplace*]. Arkansas has recognized the need for usury laws since 1836, when the legislature first limited the interest rate lenders could charge. *See* Kenneth E. Galchus et al., *A History of Usury Law In Arkansas: 1836-1990*, 12 U. Ark. Little Rock L.J. 695, 695 (1989-90). The statutory limit was adopted by the state constitutional convention in 1874. *Id.* at 696. Despite the clear language of the constitution, "some moneylenders of Arkansas have

engaged in a[] . . . battle with the courts and borrowers in attempts to find and utilize loopholes in the constitutional declaration and its supporting statutes. . . . [E]ach of these evasions has, for the most part, been discerned, properly labeled usury, and rendered useless by the courts." George B. Collins & Virginia H. Ham, *The Usury Law of Arkansas: A Study in Evasion*, 8 Ark. L. Rev. 399, 401 (1954).

This Court has repeatedly noted the important purpose underlying this limit. For example, in *State ex rel. Bryant, Att'y Gen. v. R&A Inv. Co.*, the Court recognized "the purpose of Arkansas's strong anti-usury policy, as reflected by the prohibition of usury in our constitution, is to protect borrowers from excessive interest rates." 336 Ark. 289, 296, 985 S.W.2d 299, 303 (1999). The Court relied on its earlier ruling in *Quinn-Moore v. Lambert*, where it noted that usury laws "are based upon a universally recognized public policy that protects necessitous borrowers from the exaction of exorbitant interest by unscrupulous lenders." 272 Ark. 324, 328, 614 S.W.2d 230, 232 (1981).

Moreover, the Court has recognized the importance of preserving the Constitution's usury cap. In declaring provisions of the state Installment Loan Law, commonly referred to as the Small Loans Act, unconstitutional, the Court said: "We unhesitatingly declare that any provisions in the said Act 203 which attempt, in any guise whatsoever, to permit an evasion of the Constitution, are null and void." *Winston v. Pers. Fin. Co.*, 220 Ark. 580, 588, 249 S.W.2d 315, 319 (1952). The Court rejected the argument that "the general welfare of poor people will be protected by upholding" the challenged sections. *Id.* at 589, 249 S.W.2d at 320.

> We hold that the welfare of all people, the poor in particular, is best served by the court decisions which uphold the Constitution as the bedrock of the rights and protections of people, rather than by court

> decisions which, on the ground of expediency or welfare, allow the Constitution to be violated or evaded. We stand on the Constitution.

Id. *See also Pakay v. Davis*, 367 Ark. 421, 426, 241 S.W.3d 257, 261 (2006) (stating that "Without question, when the people of this State adopted [the usury cap], their intent was to implement limits on interest rates, not eliminate such limits. [The] plain language illustrates that intent by establishing an objective gauge in order to determine what is usurious under the law.").

The Court recently reiterated this principle in finding payday borrowers could make claims against a surety bond:

> The usury laws of this state, including what constitutes interest or fees, have been part of our constitution, statutory law, and case law for decades. It was incumbent upon [the surety company] to know and abide by the clear public policy of this state as expressed by the Arkansas people in the Arkansas Constitution regardless of one legislative act (the Check-Casher Act) that runs counter to that public policy.

Ark. Bd. of Collection Agencies v. McGhee, Case No. 07-129, 2008 WL 151612, at *14 (Ark. Jan. 17, 2008). *See also Staton v. Ark. Bd. of Collection Agencies*, No. 07-53, 2008 WL 451226 (Ark. Feb. 21, 2008) (finding payday borrowers were entitled to proceeds from surety bonds where consent judgment was evidence lender violated constitutional usury cap and regulation prohibiting check casher from engaging in deceptive practices).

Based on these rulings, the Arkansas Attorney General sent letters telling payday lenders licensed by Appellee to "stop the practice immediately," advising them that "charging exorbitant interest rates on these loans violates both the constitutional limit and the Arkansas Deceptive Trade Practices Act . . . ." In announcing his action, the Attorney General stated: "'These businesses have made a lot of money on the backs of Arkansas consumers, mostly the working poor. Charging consumers interest in the range of 300 to 500 percent is unlawful and

unconscionable, and it is time that it stops.'" Press Release, Att'y Gen. of Ark., McDaniel Demands Termination of Payday Lending in Arkansas (Mar. 18, 2008), http://ag.arkansas.gov/newsroom/index.php?do:newsDetail=1&news_id=156. The letters note that "Arkansas has a strong public policy against usury" and, in addition to calling upon the lenders to stop making loans in violation of the state Constitution's usury cap, also demanded that they void all outstanding borrower obligations and refrain from any collection activities related to these loans. Letter from Dustin McDaniel, Att'y Gen., to payday lenders (Mar. 18, 2008) (on file with AARP).

The Court likewise has a long history of looking behind a lender's characterization of a transaction to determine its true nature and whether it is usurious. For example, in 1886, this Court cited *Scott v. Lloyd*, 34 U.S. 418, 9 Pet. 418, 446-47 (1835), in which Chief Justice Marshall considered the purchase of an annuity or rent-charge, and stated

> "Yet it is apparent that if giving this form to the contract will afford a cover which conceals it from judicial investigation, the statute would become a dead letter. Courts, therefore, perceived the necessity of disregarding the form, and examining into the real nature of the transaction. If that be in fact a loan, no shift or device will protect it."

Tillar v. Cleveland, 47 Ark. 287, 292, 1 S.W. 516, 517 (1886). *See also Ellenbogen v. Griffey*, 55 Ark. 268, 270, 18 S.W. 126, 126 (1892) (stating "if the sale is a mere device to cover a loan, and exact excessive interest, it will not be protected by its false cover.").

Perhaps Justice Wood put it most eloquently when he stated:

> The law shells the covering, and extracts the kernel. Names amount to nothing when they fail to designate the facts. We are of the opinion that the court was justified in concluding that the papers called "bill of sale" and "sales tickets" were nothing more or less than a shift for a usurious loan of money.

Sparks v. Robinson, 66 Ark. 460, 463-64, 51 S.W. 460, 464 (1899).

The Court has held fast to this principle throughout the centuries. For example, in *Habach v. Johnson*, 132 Ark. 374, 377, 201 S.W. 286, 287 (1918), the Court stated that the "form of the contract is not material, but the transaction will be held usurious, if, from all the facts and circumstances in the case, it appears that an intent existed at the time the contract was made to take and receive, by way of interest, a sum of money" that exceeded the legal limit. The Court emphatically reiterated this view stating, in *Hogan v. Thompson*,

> by section 13 of article 19 of the Constitution, all contracts for a greater rate of interest are declared to be void. This constitutional inhibition cannot be avoided by any trick or device, and the courts will closely scrutinize every suspicious transaction in order to ascertain its real nature, and, if it appears that the contract is merely one for the loan of money with the intention on the part of the lender to exact more than the lawful rate of interest, the contract will be declared usurious and void.

186 Ark. 497, 498, 54 S.W.2d 303, 303 (1932). *See also Armstrong v. McCluskey*, 188 Ark. 406, 411, 65 S.W.2d 558, 560 (1933) (stating "there can be no device or trickery on the part of the lender to evade the statute against usury under, or behind which, the law will not look in order to learn the real nature of the transaction . . . ."); *Wilson v. Whitworth*, 197 Ark. 675, 679, 125 S.W.2d 112, 114 (1939) (""'"It is impossible to wink so hard as not to see," what was expected by this contract – that its end was more interest on the money advanced than the law authorized.'") (citation omitted); *Bunn v. Weyerhaeuser Co.*, 268 Ark. 445, 450, 598 S.W.2d 54, 57 (1980) ("It does not matter whether the added charges are called a 'penalty,' 'late charge,' 'service charge,' or some other name. We look to the facts of each case to determine whether the additional charges are a cloak for usury; and, if they are, the contract is void.").

More than a century after Chief Justice Marshall's pronouncement in *Scott v. Lloyd*, the Court continued to rely upon his reasoning, affirming a chancellor's finding that a "purported sale

and option to repurchase were nothing more than a cloaking device to hide the true transaction – a loan. . . . Such a transaction has been historically recognized as one of several simple devices to evade Arkansas usury laws." *McElroy v. C.C. Grisham*, 306 Ark. 4, 9, 810 S.W.2d 933, 936 (1991). Similarly, in the Attorney General's challenge to a title pawn company, the Court found the Deceptive Trade Practices Act was broad enough to cover defendant's "scheme, which is contrary to Arkansas's policy against usury, and is, in fact, designed not merely to evade the law, but to intentionally and deliberately violate our constitutional prohibition against usury." *R&A Inv. Co.*, 336 Ark. at 296-97, 985 S.W.2d at 303.

This principle was at play more recently, when the Court ruled that the Check Cashers Act violated the state Constitution by providing that deferred presentment transactions (e.g., payday loans) were not loans. *Luebbers v. Money Store, Inc.*, 344 Ark. 232, 40 S.W.3d 745 (2001). The Act provided that fees charged for deferred presentments were not interest and that the transactions were not loans, but the Court held that "whether a transaction is usurious is a question arising under the Constitution, Art. 19, § 13, and is therefore for the courts rather than the legislature." *Id.* at 237, 40 S.W.3d at 748. Moreover,

> the form of the contract is not material. . . . The mere fact that the transaction has been given a certain form by the General Assembly will not exempt it from the scrutiny of the court, which is bound to exercise its judgment in determining whether or not the form of the transaction is a device to cover usury. . . . It does not matter what the added charges are called, because the courts look to the facts of each case to determine whether the additional charges are a cloak for usury. . . .

Id. at 239, 40 S.W.3d at 749-50 (citations omitted). *See also Smith v. Eisen*, 97 Ark. App. 130, 144 (2006) (citing *Carter v. Four Seasons Funding Corp.*, 351 Ark. 637, 97 S.W.2d 387 (2003)) (finding purported sale with option to buy was, in fact, a usurious loan, noting Arkansas courts

"are obligated to look beyond the four corners of the document in question to determine, considering all of the attendant facts and circumstances, if the contract is usurious in effect.").

The cease and desist letter Arkansas' Attorney General recently sent payday lenders cited *Luebbers* as one indication that "[t]o the extent that your organization may have relied upon licensure under the Arkansas Check-Cashers Act of 1999 as a defense against usury, which is prohibited by the Arkansas Constitution, and claims under other applicable Arkansas laws, we believe that such reliance is misplaced." Letter from Dustin McDaniel, Att'y Gen. to payday lenders (Mar. 18, 2008). *Luebbers*, as well as *Ark. Bd. of Collections Agencies v. McGhee*, No. 07-129, 2008 WL 151612 (Ark. Jan. 17, 2008), and *Staton v. Ark. Bd. of Collection Agencies*, No. 07-53, 2008 WL 451226 (Ark. Feb. 21, 2008), "make it clear that payday lending transactions, where the effective interest rate is greater than that allowed by the Arkansas Constitution, are prohibited." Letter from Dustin McDaniel, *supra*.

Usury and other consumer protection laws reflect that the consumer credit marketplace lacks equal bargaining power, equal knowledge, and a level playing field with respect to negotiating leverage. These inequalities between borrowers and lenders are more pronounced in the fringe banking market than in the mainstream consumer credit market, and consumers who resort to these products are among those with the greatest need for a marketplace that operates with integrity and the enforcement of laws that state legislatures enacted for their protection. The Court should continue its strict interpretation of the constitutional usury limit to effectuate its purpose to protect Appellants and other similarly situated Arkansans. *See Walton v. Ark. Constr. Comm'n*, 190 Ark. 775, 779, 80 S.W.2d 927, 929 (1935) (noting it is always "the purpose to construe or apply any provision of the Constitution to effectuate, as nearly as possible, the intent

of the people as it may be interpreted from the measure, and, when necessary for that purpose, a liberal interpretation will be warranted.").

II. THE "FRINGE BANKING" INDUSTRY EXPLOITS VULNERABLE CONSUMERS.

A. The Nature of the Marketplace.

Arkansas' history of protecting consumers from usurious interest rates is particularly important in light of the nature of the market in which payday loans are made. Payday loans are part of an industry popularly referred to as "fringe banking" or the "alternative financial sector" (AFS). *See* Roger Swagler et al., *The Alternative Financial Sector: An Overview*, 7 Advancing the Consumer Interest 7, 7 (1995); John R. Burton et al., *The Alternative Financial Sector: Policy Implications for Poor Households*, 42 Consumer Interests Annual 279, 279 (1996). Fringe bankers target low-income, working poor, and minority consumers, persons on fixed incomes, those dependent on Social Security benefits, and those with blemished credit histories, who cannot access traditional sources of money, credit, or certain consumer goods. Many consumers have other ways to obtain short-term, unsecured loans, such as credit cards and checking accounts with overdraft lines of credit, but the poor and near-poor cannot obtain these services. Coupled with the decline in the availability of small, unsecured loans from banks and finance companies, many consumers with modest incomes or impaired credit find fringe bankers their only option. This has created a two-tiered economy, often referred to as "financial apartheid" or a "second-class" market, in which middle-income and affluent consumers are served by federally-insured and regulated banks and other lenders, and the poor and near-poor are relegated to expensive and, as in this case, poorly regulated alternatives. *See Two-Tiered Marketplace*, *supra*, at 591.

The fringe market offers loans that allow consumers to obtain a relatively small amount of

cash with repayment deferred for a relatively short period, usually two weeks. The three main forms of fringe banking cash advances -- payday loans, refund anticipation loans (RALs), auto title pawns -- are extremely expensive, typically imposing triple digit annual percentage rates (APRs), far above state usury and small loan limits. Even in states with permissive payday loan laws, the industry seems unable to comply with federal and state laws, or even the industry's own "best practices." *See* Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 Minn. L. Rev. 1, 26-98 (2002). *See also* Elizabeth Renuart & Kathleen E. Keest, Nat'l Consumer Law Ctr., *The Cost of Credit: Regulation, Preemption, and Industry Abuses* § 7.5.5.6, at 302 n.507 (3d ed. 2005).

B. The Evolution of Payday Loans Demonstrates Their Abusive Nature.

1. Payday Lenders and Their Antecedents Exploit Borrowers

Payday loans have direct precursors in loans made against a borrower's wages. As salaries increased to the point they covered necessities and left a surplus to pay principal and interest on debts, "prospective salaries and wages became assets, however inchoate, against which loans could be made." Rolf Nugent, *The Loan-Shark Problem*, 8 Law & Contemp. Probs. 3, 4 (1941). The "five-for-six-boys" lent $5.00 at the beginning of the week, to be repaid with $6.00 on the borrower's payday, one or two weeks later. *See Two-Tiered Marketplace*, *supra*, at 618. In some instances, "salary buyers" would "buy" the borrower's next wage packet at a discount, for example advancing $22.50 for the "sale" of a $25.00 paycheck two weeks later (with an APR of 311%). *Id.* at 618-19.

Despite the high cost, people in financial distress renewed these loans, entering a downward spiral mirrored by today's payday borrowers. *Id.* at 620. The borrowers' dire situations led to legislation to regulate the lenders, producing a legal framework that permitted a

high enough return to attract legitimate businesses into the small loan market, with sufficient safeguards to prevent abuses seen among "loan sharks." *Id.* at 621. Lenders argued that these transactions involved property purchases that were not subject to usury laws, but the Uniform Small Loan Laws adopted by many states between 1916 and 1935 defined them as cash lending subject to small loan regulation. *See* John P. Caskey, *Fringe Banking: Check Cashing Outlets, Pawn Shops, and the Poor* 31-32 (1994). Every state enacted a small loan law, with Arkansas capping interest in its Constitution. Ark. Const. art. 19, § 13(b). *See Two-Tiered Marketplace, supra*, at 621.

2. Payday Lenders Earn Large Profits But Borrowers Pay High Costs and Get Caught in a Debt Trap.

Payday lending experienced an explosive growth since the industry's emergence in the early 1990s. *See* Scott A. Schaaf, *From Checks to Cash: The Regulation of the Payday Lending Industry*, 5 N.C. Banking Inst. 339, 339 (2001) [hereinafter *From Checks to Cash*]. An Arkansas investment firm recently estimated a base of 24,200 stores generating income of $7.9 billion annually *in fees alone* on loan volume of $47.65 billion. Dennis Telzrow, Stephens Inc., *Payday Loan Industry, Industry Report* 4 (Mar. 27, 2007). This growth has been tied to the deregulation of the banking industry, the absence of traditional lenders in the small loan, short-term credit market, enactment of state laws with safe harbor provisions, and the elimination of interest rate caps. *See* Lisa B. Moss, *Modern Day Loan Sharking: Deferred Presentment Transactions & The Need For Regulation*, 51 Ala. L. Rev. 1725, 1732 (2000) [hereinafter *Modern Day Loan Sharking*]. As mainstream institutions moved out of this market due to higher returns on larger loans, payday lenders filled the void. *Id. See also From Checks to Cash, supra*, at 340-41. Fringe bankers maintain they do nothing wrong and, in fact, provide a benefit by merely filling the

gap left by traditional lenders. Even if this were a legitimate argument, and *amici* do not concede that it is, the provision of a needed service neither justifies the practices that harm the consumers these lenders purport to help nor warrants reducing consumer protections or sanctioning lenders' efforts to evade existing protections.

Payday loans typically involve the borrower writing a personal check payable to the lender and receiving cash minus a fee. The borrower and lender both know the borrower's account does not have sufficient funds to cover the check, and the lender agrees to hold the check until the borrower's next payday or another designated date. At the end of the loan term, usually one or two weeks, the borrower can redeem the check by paying the face amount, allow the check to be cashed, or refinance ("roll over") the loan by paying another fee. Payday loans are marketed as a quick, easy way to obtain cash. Borrowers need only maintain a personal checking account, be employed for a specified period with their current employer, and show a pay stub and bank statement. Payday lenders do not conduct inquiries routinely made by mainstream lenders, *e.g.*, credit checks, borrower's ability to repay, debt-income ratio, or even a list of other debts and payments. Key elements of these loans are extremely high interest rates and associated costs. A recent report found typical APRs on two-week loans ranging from 390% to 780%, despite much lower state interest caps. Jean Ann Fox, Consumer Fed'n of Am., *Unsafe and Unsound: Payday Lenders Hide Behind FDIC Bank Charters to Peddle Usury* 2 (2004).

In addition to high APRs, fees paid for "roll overs," when the borrower cannot repay the loan and pays another fee to extend the loan period, lead to significantly higher costs that borrowers can ill afford, and to an even greater gap between the cost of these loans and mainstream sources of credit. *See* Woodstock Inst., *Unregulated Payday Lending Pulls Vulnerable Consumers Into Spiraling Debt*, Reinvestment Alert, Mar. 2000, at 4. Rollovers often

result in finance charges that exceed the original amount borrowed, and the borrower still owes the face amount of the check presented to obtain the loan. This was seen in *Turner v. E-Z Check Cashing of Cookeville, TN, Inc.*, 35 F. Supp. 2d 1042 (M.D. Tenn. 1999), where a payday lender advanced $300 in return for the consumer's $405 check, which covered the $300 advance and a $105 service fee. The borrower could not repay $405 at the end of one month, and paid a monthly service charge of $105 for each of the next eight months ($840) because she could not repay the original $405 debt. Another borrower wrote a post-dated check for $575, received $500, and did fifteen rollovers in seven months, each time paying $75. She paid $1125 *in fees alone* for a $500 loan. *Johnson v. The Cash Store*, 68 P.3d 1099 (Wash. Ct. App. 2003).

Senator Joseph Lieberman hosted a December 1999 payday lending forum and unveiled two charts which showed it is virtually impossible for an average family to repay a payday loan when it comes due. One chart showed that a family with a household income of $35,000 and typical deductions (*e.g.*, taxes) and expenses (*e.g.*, food, housing) could not repay a loan as small as $168 at the end of two weeks. *See* Nat'l Consumer Law Ctr., 18 *NCLC Reports: Consumer Credit and Usury Ed.* 13-14 (Jan./Feb. 2000). This illustrates the fiction that lenders intend the loans to be repaid in two weeks; in fact, the industry is based on the knowledge that rollovers will be necessary and the fees paid for rollovers account for the industry's huge profits.

The combination of high interest rates and rollovers produce extraordinary costs that borrowers can ill afford and create a "debt treadmill" that exacerbates the borrower's financial situation. A recent study found that the typical payday borrower ends up paying back $793.00 for a standard $325.00 loan; in other words, the average payday borrower pays $468.00 in interest for the privilege of a one-time $325.00 two-week advance on his or her paycheck. Uriah King et al., Ctr. for Responsible Lending, *Financial Quicksand: Payday Lending Sinks Borrowers in Debt*

with $4.2 Billion in Predatory Fees Every Year 7-8 (2006), *available at* http://www.responsible lending.org/pdfs/rr012-Financial_Quicksand-1106.pdf. It therefore is not surprising that the authors of another recent study concluded that "the business practices pursued by many payday loan companies can have the same wealth-depleting effect on financially fragile families as other abusive consumer credit practices." Michael A. Stegman & Robert Faris, *Payday Lending: A Business Model that Encourages Chronic Borrowing*, 17 Econ. Dev. Q. 8, 25 (2003) [hereinafter *Chronic Borrowing*].

Similar problems result when lenders, sometimes to circumvent state restrictions on rollovers, allow "back-to-back" transactions in which borrowers pay off their first loan but must immediately take out a new loan to meet their financial needs until their next payday. *See* Keith Ernst et al., Ctr. for Responsible Lending, *Quantifying the Economic Cost of Predatory Payday Lending* 3-4 (2004), *available at* www.responsiblelending.org/pdfs/CRLpaydaylendingstudy 121803.pdf. The authors found that 91% of all payday loans were made to borrowers with five or more payday loans per year; two in three (66%) borrowers received five or more payday loans per year and nearly one in three (31%) received twelve or more per year; on average, borrowers received eight to thirteen payday loans per year. *Id.* at 2. The study concluded that "payday lenders collect the vast majority of their fees from borrowers trapped in a cycle of repeated transactions. . . . This cycle (the 'debt trap') locks borrowers into revolving, high-priced short-term credit instead of meeting the need for reasonably priced, longer-term credit." *Id.* If these loans really were meant to address a temporary need for a small amount of money "one would expect to see industry revenues driven by one-time or other limited-use borrowers. For borrowers taking out five, ten, or even twenty or more loans per year, payday lending functions as chronic debt, instead of helpful credit." *Id.* at 6 (footnotes omitted). *See also Chronic Borrowing, supra,*

at 25 ("despite its expanding customer base and notwithstanding industry denials, the financial performance of the payday loan industry . . . is significantly enhanced by the successful conversion of more and more occasional users into chronic borrowers.").

III. PAYDAY LENDERS REGULARLY MISCHARACTERIZE THE NATURE OF TRANSACTIONS AND ENGAGE IN OTHER RUSES TO EVADE STATE INTEREST LIMITS.

This case represents yet another in a series of attempts by payday lenders to devise a contrivance to support their assertions that usury and other interest caps do not apply to them. The Court should follow the many courts that have rejected payday lenders' prior schemes.

Initially, many lenders argued they did not make loans or charge interest at all, but simply charged "fees" to cash checks. Courts uniformly rejected the pretense that payday lenders were not making loans when they delayed depositing a consumer's check in exchange for a fee. *See, e.g.*, *Hamilton v. York*, 987 F. Supp. 953 (E.D. Ky. 1997); *Livingston v. Fast Cash USA, Inc.*, 753 N.E.2d 572 (Ind. 2001); *White v. Check Holders, Inc.*, 996 S.W.2d 496 (Ky. 1999). The U.S. Federal Reserve Board erased any doubt that it deemed these transactions credit covered by the Truth in Lending Act when it revised its Official Staff Commentary "to clarify that payday loans,, and similar transactions where there is an agreement to defer payment of a debt, constitute credit for purposes of TILA"; this is true "regardless of the label used to describe them." The FRB noted its "comment does not represent a change in the law." Official Staff Commentary, 12 C.F.R § 226.2(a)(14)-2, *as published at* 65 Fed. Reg. 17,129-17,130 (Mar. 31, 2000), 12 C.F.R. Pt. 226 (Supp. I, Cmt. 226.2(a)(14)-2).

As courts and regulators rejected the pretense that these transactions were not loans involving interest charges, the industry developed new schemes. In the modern equivalent of a scam used in the 1930's and 1940's by lenders trying to charge usurious interest rates, *see Willis v.*

Buchman, 199 So. 886 (Ala. Ct. App.), *rev'd for mootness*, 199 So. 892 (Ala. 1940), some payday lenders labeled their loans as "catalog sales" or "gift certificates." In a typical transaction the borrower gave the lender a post-dated check for $130.00 The lender agreed to hold the check for two weeks and gave the borrower $100.00 in cash and $30.00 worth of gift certificates or merchandise coupons. Borrowers who wanted to redeem the coupons or certificates had to return to the lender to place the order, at which time the lender charged them additional fees. The lender would not receive these add-ons if the consumer made the same purchase directly from the catalog wholesaler, and the added charges often made the merchandise unaffordable so the consumer never redeemed the coupons or certificates and the lender kept their full value as profit. *See Modern Day Loan Sharking*, *supra*, at 1729-30. On the two-week $100.00 loan, the $30.00 certificates translated to an APR of 780%. *See also Upshaw v. Georgia Catalog Sales, Inc.*, 206 F.R.D. 694, 697 (M.D. Ga. 2002) (certifying a class of borrowers, finding a "jury question exists on whether the certificates have any value and thus whether the difference in the amount of the cash advance and the amount of the customer's check is usurious interest."); *Cashback Catalog Sales, Inc. v. Price*, 102 F. Supp. 2d 1375, 1380 (S.D. Ga. 2000) (finding reasonable trier of fact could conclude gift certificates are usurious interest. "If the gift certificates are practically worthless . . . it stands to reason that many of Cashback's customers will fail to redeem them. If the gift certificates go unredeemed, their face value presumably inures to Cashback and becomes a cost of the loan."); *State v. JAG NY, LLC*, 794 N.Y.S.2d 488 (N.Y. App. Div. 2005) (rejecting lender's claim that transactions were not loans and that it "was simply a catalog business entity that made money off the profit generated by the sale of merchandise in their catalogs," finding instead that the "sale of the gift certificates constituted disguised interest far in excess of that permitted by law.").

"Sale/leaseback" transactions are another attempt to disguise payday loans. Recently, a Georgia court upheld the state's finding that such transactions, in which "customers purportedly sold personal property items to appellants, then immediately leased the items back from appellants . . . were nothing more than disguised, illegal payday loans." *Clay v. Oxendine*, 645 S.E.2d 553, 555 (Ga. Ct. App. 2007). The court was not fooled by the labels assigned by the lender, noting

> the terms of their written lease with customers are not talismanic in this context. [W]hether a given transaction is a purchase . . . or a loan of money . . . depends, not upon the form of words used in contracting, but upon the real intent and understanding of the parties. No disguise of language can avail for covering up usury, or glossing over an usurious contract. The theory that a contract will be usurious or not, according to the more or less ingenious phrases made use of in negotiating it, is altogether erroneous. The law intends that a search for usury shall penetrate to the substance.

Id. at 556-57. *See also Aple Auto Cash Express, Inc. v. State*, 78 P.3d 1231, 1237 (Okla. 2003) (finding company that provided "fast cash" in exchange for purported car rental-purchase agreement was "nothing more than an illusory attempt by a business to avoid lender usury laws by merely labeling the transaction a 'rental agreement.'").

Another modern ruse involves purported "Internet Service" deals, illustrated by several cases brought by the Arkansas Attorney General alleging the defendants made high interest loans under the pretext of offering cash "rebates" through the sale of Internet access accounts. According to the Attorney General, several companies operating under names such as Money In A Flash.net of Arkansas and Dialing4Dollars.net made "loans of up to $300 under the pretext of providing instant cash 'rebates' on the sale of Internet access contracts." *State ex rel. McDaniel, Att'y Gen. v. Money In A Flash.Net*, No. CV-2006-10333, at *4 (Ark. Cir. Ct. consent judgment filed Dec. 10, 2007), *available at* http://www.stoppaydaypredators.org/pdfs2/07_1210_consent.pdf. Customers would receive $100 for each Internet account they opened, but would not

receive any added value from opening more accounts, other than obtaining additional $100 loans. "Instead of calling the transaction a loan, the Defendants use the term 'rebate' in a thinly disguised effort to avoid Arkansas' prohibition against usury, and to avoid the application of the requirements and prohibitions of the Arkansas Deceptive trade practices Act." *Id.* Customers agreed to make bi-weekly payments of $20 for each account for one year; they could terminate their accounts by repaying the amount of the rebate plus any remaining payments due at the time of cancellation. Customers often ended "a contract only to simultaneously enter into new or additional Internet contracts and new loans. Numerous customers entered into multiple contracts in the single twelve month period of the first contract, and thus obtained numerous loans from the Defendants." *Id.* at 5. Moreover, very few customers ever made use of the Internet services provided by defendants, but used the "service primarily to obtain cash loans and . . . Defendants intended their service as an alternative to what is commonly called a 'payday loan.'" *Id.*

The consent judgment enjoined defendants from collecting payments on any transactions that, regardless of their label, "are, in reality, loans, and which payments are, in reality, interest in excess of that allowed by the Arkansas Constitution . . . or other applicable Arkansas law." *Id.* at 7. In addition, all outstanding contracts for the challenged services were declared void, and defendants agreed to pay $1 million, $800,000 of which was for consumer restitution. *Id.* at 8. *See also Short on Cash.net v. Dep't of Fin. Insts.*, 811 N.E.2d 819, 822, 825 (Ind. Ct. App. 2004) (upholding injunction against company "making payday or small loans under the guise of Internet service contracts" until it obtained a loan license, noting lender allowed customers to open as many Internet accounts as they liked and, aside from the immediate receipt of "the one hundred dollar rebate *per account opened*, we can glean no legitimate reason for a customer to purchase more than one Internet account."); *State ex rel. Cooper, Att'y Gen. v. NCCS Loans, Inc.*, 624

S.E.2d 371 (N.C. Ct. App. 2005) (finding company's practice of offering customers cash rebates and the opportunity to use its computers to access the Internet for a few hours a week, in exchange for a one-year obligation to make payments equal to five times the amount of the rebate, was an unfair and deceptive practice and violated state usury and consumer finance laws).

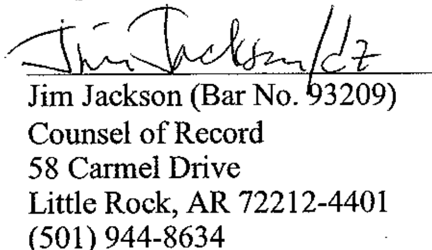
The payday lenders' justifications for their unconstitutionally usurious interest rates in this case are just the latest round of such subterfuges. And, as extensively explained in Appellants' brief, the payday lenders' arguments in this case similarly fail to withstand legal scrutiny. No amount of creative legal argument by payday lenders justifies their failure to follow the Arkansas Constitution's straightforward usury prohibition.

CONCLUSION

Amici respectfully urge the Court to reverse the lower court and find that the Check Cashers Act is unconstitutional.

Dated: March 21, 2008

Respectfully submitted,



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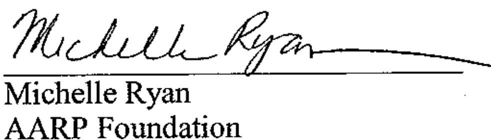

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