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Developments and Ideas For the Practice of Consumer Law

In This Issue

DOD Finalizes Military Lending Regulations

The Department of Defense has issued final regulations[1] to implement the Military Lending Act[2] passed last fall. Both the Act and the regulations just went into effect on October 1, 2007. The MLA statute imposes a 36 percent interest rate cap, bans mandatory arbitration, and imposes other restrictions on "consumer credit" other than residential mortgages and purchase money loans.

The regulations' primary impact is to narrow the definition of "consumer credit" to only three types of credit: payday, auto title and refund anticipation loans. Other credit is not covered or restricted.[3] The final regulations differ little from the draft regulations published last spring. DOD made no changes to address the loopholes consumer advocates identified, including concerns about other types of predatory credit, and about the ability of the targeted lenders to avoid the definitions.[4]

Payday Loans

Payday loans must have all of the following elements to be covered by the MLA:

- Closed-end credit; [5]
- With a term of 91 days or fewer; [6]
- Amount financed does not exceed $2,000; [7]
- The borrower, contemporaneously with receipt of funds, provides a check or other payment instrument or debit authorization that is deferred for more than one day.[8]

The 91-day and $2,000 requirements appear to be strict, so that a 92-day or $2,001 loan is likely exempt. The closed-end requirement is discussed separately below.

An agreement allowing a depository institution to offset fees against deposited funds, consistent with the depository's legal offset rights, is not considered a deferred payment instrument.[9] Thus, loans made as advances from bank accounts, such as direct deposit account advances or overdraft loans, are likely not covered, regardless of the interest rate. Moreover, any transaction not considered consumer credit under TILA or not subject to TILA's disclosure requirements (such as overdraft loans) is excluded.[10]

Payday lenders may manipulate the agreement paperwork to avoid the requirement that a deferred check or payment instrument be given "contemporaneously" with the loan proceeds. The regulations do not define "contemporaneously," but the term should certainly cover any agreement that is an integral part of the loan agreement, even if the loan proceeds are not paid out immediately.

Vehicle Title Loans

Vehicle title loans are covered by the MLA if they meet all of the following requirements:

- Term of 181 days or less;
- Closed-end;
- Secured by title to a registered motor vehicle owned by a covered borrower;
- Not a purchase-money loan.[11]

The regulations do not defined "secured," and advocates should interpret this consistent with the intent of the law to cover any mechanism that enables the lender to acquire the car to secure repayment.

Some vehicle title lenders may use a sale/leaseback transaction to attempt to fit within the exemption for purchase money loans. If the borrower previously owned the car, however, a look at the entire transaction will show that it was not truly made "to finance the purchase or lease of a motor vehicle" as required under the exemption.[12]

Refund Anticipation Loans

The regulations define a refund anticipation loan as:

- Closed-end credit;
- That is "expressly" repaid with the tax refund.[13]

This definition excludes loans made by tax preparers if the terms of the agreement do not expressly require it to be repaid by the anticipated tax refund. The commentary explains that loans are not covered if the borrower merely notes that the source of the repayment is the tax refund.[14]

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[1] Limitations on Terms of Consumer Credit Extended to Service Members and Dependents, 72 Fed. Reg. 50580 (Aug. 31, 2007), codified at 32 C.F.R. Part 232.
[2] Sen. John Warner National Defense Authorization Act, Section 670 (popularly known at the Talent/Nelson Amendment), codified at 10 U.S.C. § 987.
[3] Even if the credit meets one of those definitions, it is excluded if is secured by the borrower's dwelling; is secured by and used to purchase a vehicle or other personal property; is secured by a qualified retirement account; or is not subject to TILA or TILA's disclosure requirements. 10 U.S.C. § 987(i)(6); 32 C.F.R. § 232.3((b)(2).
[4] *See* NCLC Reports (March/April 2007).
[5] 32 C.F.R. § 232.3(b)(1)(i), *incorporating* 12 C.F.R. § 226.2(a)(10), (20) (TILA definition).
[6] 32 C.F.R. § 232.3(b)(1)(i).
[7] *Id.* "Amount financed" is not defined, but is expected to follow the TILA definition. *See* 72 Fed. Reg. 50585 (Aug. 31, 2007); 32 C.F.R. § 232.3(i).
[8] 32 C.F.R. § 232.3(b)(1)(i)(B).
[9] *Id.*
[10] 32 C.F.R. § 232.3(b)(2)(v).
[11] 10 U.S.C. § 987(i)(6); 32 C.F.R. § 232.3(b)(2)(ii).
[12] *Id.*
[13] 32 C.F.R. § 232.3(b)(1)(iii).
[14] 72 Fed. Reg. at 50586.

Attacking Spurious Open-End Credit

All three types of loans must be closed-end credit to be covered by the MLA. Some predatory lenders already structure their loans as open-end credit to try to avoid state laws and can be expected to do so to avoid the MLA as well.

The regulations follow TILA's definition of closed-end credit, which is defined by excluding all credit that does not meet TILA's definition of open-end credit. Open-end credit requires a plan that:

- Reasonably contemplates repeated transactions;
- Imposes a finance charge computed from time to time on an outstanding unpaid balance;
- Provides a replenishable credit line that is reusable without further approvals.[15]

The label of a plan or account is not determinative,[16] and courts have sometimes found credit to be spurious open-end credit, falling instead under TILA's closed-end credit rules.[17] Most caselaw dealing with spurious open-end credit relates to purchase financing (excluded from the MLA) and may not be especially helpful. Nonetheless, analysis of a loan agreement or usage pattern may show that supposedly open-end payday or auto title loans do not meet the regulatory definition.[18]

The payment structure may make it unlikely that the credit line will be replenished, so that repeat transactions are not reasonably contemplated. Repayments must generally replenish the credit line for the plan to qualify as open-end.[19] The borrower may not have full access to the credit line initially or subsequently without new approvals. A credit line is reusable, and thus open-end, only if new approvals are not needed.[20] Or the loan may be due in full, or virtually in full, in a finite period of time, so that it is actually a closed-end loan and not a plan permitting a balance that fluctuates, can rise and fall, and can be carried over time. For example, the Virginia attorney general sued some auto title lenders because their loans were due in full in one month and thus did not fall within the Virginia usury exception for open-end credit.

In addition, payday borrowers returning for new loans may not satisfy the "repeat transactions" requirement for open-end loans. New loans require new approvals and new fees not included in the original credit plan, and are not repeat transactions under an original open-end plan.

Refund anticipation lenders have a harder time using the open-end loophole. If the loan agreement contains an express requirement that the loan will be repaid with the tax refund—a one-time annual event—repeat transactions would not be reasonably contemplated and the finance charge will not be based on a fluctuating balance over time. Any new credit extensions after repayment of the tax refund should be seen as a new loan.

Identification of Covered Members and Dependents; Safe Harbor

The MLA covers credit extended to an individual who, at the time he or she becomes obligated, is an active duty member of the military, including those on Active Guard and Reserve duty, or the member's spouse, child or dependent.[21]

The regulations provide a safe harbor to creditors who unwittingly make a loan that violates the MLA to a borrower whom the creditor does not realize is a covered borrower. To fall within this safe harbor, both of the following conditions must be met:

- The applicant signed a statement in the form provided in the regulations stating that he or she is not a covered borrower;[22] and
- "The creditor has not determined, pursuant to the optional verification procedures in paragraph (b) of this section, that any such applicant is a covered borrower."[23]

This safe harbor also applies to renewals or refinancings if the borrower was not a covered borrower at the time of the original credit transaction.[24]

"Paragraph (b)"[25] permits creditors to verify military status by a military leave and earning statement, military identification card, military orders, or the military's website. Predatory lenders may argue that the safe harbor applies even if the lender is aware that the borrower's statement is false, as long as that knowledge comes from a source other than those specified in paragraph (b). For example, the applicant may orally disclose military status, be in military uniform, or provide a bank statement showing a military direct deposit.

However, DOD's commentary preceding the regulations states that creditors lose the protection of the safe harbor if the creditor "recognizes the applicant is a covered borrower as a result of the documents presented as part of the credit transaction."[26] The commentary does not indicate that creditors can ignore sources of information other than those in paragraph (b), and states that this caveat to the safe harbor "prevents creditors from using the declaration to allow covered borrowers to waive their right to the protections provided by the regulation."[27] But it may be difficult to pierce this safe harbor if the borrower falsifies his or her status unless it is clear from the documents that the creditor knew or should have known the borrower's status.

Primary Requirements for Covered Loans

Once a credit transaction is covered by the MLA, the following rules apply:

- The military APR ("MAPR") may not exceed 36%;[28]
- The credit may not be secured with a check, access to a financial account, or military allotment, though credit at or under 36% may require electronic payment, direct deposit, or a security interest in funds deposit after and in connection with the credit;[29]
- The MAPR must be disclosed orally and in writing (though not in advertisements); [30]

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[15] 15 U.S.C. § 1602(i); Reg. Z § 226.2.(a)(20); TILA Official Staff Commentary § 226.2(a)(20); NCLC, Truth in Lending § 5.2.2 (5th ed. 2003 & 2006 Supp.).

[16] TILA Official Staff Commentary § 226.2(a)(20)-6.

[17] NCLC, Truth in Lending § 5.2.3 (5th ed. 2003 and 2006 Supp.)..

[18] *Id.* § 5.2.2

[19] TILA Official Staff Commentary § 226.2(a)(20).

[20] *See* NCLC. Truth in Lending **§ 5.2.2.4 (5th ed. 2003 and Supp.)**.

[21] 10 U.S.C. § 987(i)(1); 32 C.F.R. § 232.3(c).

[22] 32 C.F.R. § 232.5(a)(1).

[23] 32 C.F.R. § 232.5(b)(2).

[24] 32 C.F.R. § 232.5(d).

[25] 32 C.F.R. § 232.5(b).

[26] 72 Fed. Reg. at 50588.

[27] *Id.*

[28] 10 U.S.C. § 987(b); 32 C.F.R. § 232.4(b).

[29] 10 U.S.C. § 987(e)(5), (6); 32 C.F.R. § 232.8(a)(5), (6).

[30] 10 U.S.C. § 987(c); 32 C.F.R. § 232.6. A toll-free telephone number may be provided for internet and mail transactions. *Id.* § 232.6(b)(2). The disclosures must also include a statement about assistance available to service members. *Id.* § 232.6(a)(4).

- Mandatory arbitration clauses are banned;[31]
- The credit may not be rolled over or renewed except on terms more favorable to the borrower;[32]
- Prepayment penalties are banned;[33]
- Waivers of legal rights and onerous notice requirements in case of disputes are banned.[34]

The definition of payday and auto title loans incorporates the requirement that the loan be secured in a method that is banned by the MLA. Thus, the list of protections is essentially moot, since loans that are secured in that manner are unlawful, and all others, except for refund anticipation loans, are exempt from the Act.

Calculating the 36% Cap

The following are all included in the MAPR and subject to the 36% cap:

- Interest, fees, credit service charges, credit renewal services;[35]
- Credit insurance premiums and debt cancellation or suspension fees;[36]
- Fees for credit-related ancillary products sold in connection with and either at or before consummation of the credit transaction.[37]

This definition is broader than TILA's APR. The DOD commentary makes clear that the MAPR includes "high fees associated with origination, membership, administration, or other cost that may not be captured in the TILA definition of APR."[38] Thus, a $150/month participation fee should be included in the MAPR regardless how it is treated under TILA. The MAPR may also be broader than state definitions of interest. For example, the large broker fees charged by Texas payday lenders who exploit that state's credit services loophole[39] should be included in the MAPR both as "credit service charges." and as a finance charge under TILA.

The commentary also states that voluntary credit insurance and the cost of ancillary products such as internet access or catalog sales – regardless whether they are always included in the TILA APR – are included in the MAPR definition.[40]

The MAPR excludes only the following fees:

- Fees or charges for actual unanticipated late payments or other defaults;[41]
- Legally required taxes or fees paid to public officials related to security interests;[42]
- Tax return preparation fees.[43]

Predatory lenders may attempt to structure their products to encourage late payments or other defaults, and thus shift the interest costs to late or default fees outside of the 36% cap. Advocates should examine whether such fees are not "unanticipated" and instead should be included in the MAPR.

Enforcement

DOD expresses a desire for state regulators to assist in enforcing the MLA,[44] and nothing in the MLA preempts them from doing so. Any credit agreement that violates the statute or the regulations is void from the inception.[45] The DOD commentary makes clear that the Department expects this provision to be enforced in private litigation,[46] and both the statute and regulations explicitly preserve other remedies, such as those under contract law governing a void contract.[47]

Application of State Protections to Military

The MLA and its regulations preempt only inconsistent state laws, and expressly permit state laws that provide greater protection to service members.[48] Thus, states are free to adopt laws that target predatory credit excluded from the MLA, to the extent that other laws do not preempt them.

The MLA prohibits states from discriminating against nonresident military stationed in the state or from permitting credit to nonresident military to avoid state interest caps or consumer lending protections.[49] This provision's impact is unclear because the military installment loans that were the primary target of this provision do not meet the regulation's definition of "consumer credit."

Nonetheless, two potential avenues exist to stop discrimination by military installment lenders. First, neither the nondiscrimination provision in the statute nor the one in the regulations uses the term "consumer credit."[50] It may be possible to argue that this provision extends to all creditors and all covered military borrowers, regardless whether the credit at issue is otherwise outside the MLA. The problem is that lenders will undoubtedly argue that the regulations' limitations on "consumer credit" are incorporated into the definitions of "creditor" and "covered borrower."

Second, a court might find that, to the extent that military installment loans are excluded, the regulations' narrow definition of "consumer credit" is inconsistent with the statute and outside of DOD's regulatory authority. The statute permits DOD to define "consumer credit" and to impose "criteria or limitations" that DOD determines appropriate. [51] However, the definition and the limitations must be "consistent with the provisions" of the statute.[52]

Setting aside concerns about other types of credit, the exclusion of military installment loans is arguably inconsistent with the statute. The statute contains two provisions directly aimed at military installment loans, indicating Congress's expectation that such loans would be covered: the nondiscrimination provision, and the inclusion of credit insurance premiums in the MAPR. Congress adopted these provisions in response to the DOD's report discussing how military installment lenders avoid state laws and avoid state interest

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[31] 10 U.S.C. § 987(e)(3), (f)(4); 32 C.F.R. §§ 232.8(a)(3), 232.9(d).
[32] 10 U.S.C. § 987(e)(1); 32 C.F.R. §232.8(a)(1).
[33] 10 U.S.C. § 987(e)(7); 32 C.F.R. § 232.8(a)(7).
[34] 10 U.S.C. § 987(e)(2), (3) (4); 32 C.F.R. § 232.8(a)(2)(3)(4).
[35] 32 C.F.R. § 232.3(h)(1)(i).
[36] 32 C.F.R. § 232.2(h)(1)(ii).
[37] 32 C.F.R. § 232.2(h)(1)(iii).
[38] 72 Fed. Reg. at 50587.
[39] *See* Lovick v. Ritemoney Ltd., 378 F.3d 433 (5th Cir. 2004) (finding that broker fees were not interest under state law).
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[40] 72 Fed. Reg. at 50587.
[41] 32 C.F.R. § 232.3(h)(2)(i).
[42] 32 C.F.R. § 232.3(h)(2)(ii), (iii).
[43] 32 C.F.R. § 232.3(h)(2)(iv).
[44] 72 Fed. Reg. at 50589, 50590.
[45] 10 U.S.C. § 987(f)(3); 32 C.F.R. § 232.9(c).
[46] 72 Fed. Reg. at 50590.
[47] 10 U.S.C. § 987(f)(2); 32 C.F.R. §232.9(b).
[48] 10 U.S.C. § 987(d)(1); 32 C.F.R. § 232.7(a).
[49] 10 U.S.C. § 987(d)(2); 32 C.F.R. § 232.7(b).
[50] 10 U.S.C. § 987(d)(2); 32 C.F.R. § 232.7(b).
[51] 10 U.S.C. § 987 (h)(2)(D), (E); *id.* § 987(i)(6).
[52] 10 U.S.C. § 987 (h)(2)(D), (E).

caps by adding useless credit insurance.[53] The exclusion of these loans is inconsistent with the statutory provisions aimed directly at them.

Possible Expansion of the Law

DOD declined consumer requests to enact the narrow regulations as interim regulations, to be followed by more encompassing final rules. However, DOD promised to monitor market developments to assess the level of protection provided, and noted that it maintains authority to issue additional rules. Consequently, advocates who encounter payday, auto title or refund anticipation loans that escape coverage should bring these loans to DOD's and NCLC's attention. Similarly, advocates should continue to alert policymakers to evidence of other destructive credit products that harm the men and women who protect us.

November 5 Deadline to Comment on OTS' Aggressive Unfairness Rule

The Office of Thrift Supervision recently set out a notice requesting comment on an aggressive series of potential practices it is considering declaring unfair for savings banks.[54] The OTS has the authority under the FTC Act and other federal laws to prescribe regulations to prevent unfair or deceptive acts by the federal savings associations it regulates.[55] In the past, the OTS has rarely exercised this authority.[56]

Among the questions the OTS is requesting comment are whether the action should apply only to the banks or also to related entities, whether to define prohibited practices or simply enunciate criteria to determine whether a practice is unfair, and whether to turn portions of recent Guidances governing the banking industry into specific prohibitions. [57]

The OTS is considering defining as unfair various credit card practices, such as "universal default,"[58] imposing over-the-limit-fees triggered by late fees, charging penalty fees in consecutive months based on previous late or over the limit transactions, requiring binding mandatory arbitration, and applying payments first to balances subject to a lower rate of interest (instead of those subject to higher rates) or applying payments first to fees instead of principal and interest.

Other proposals relate to such mortgage lending practices as repetitive refinancing of the same mortgage loan without benefit to the homeowner, making default a prerequisite to refinancing, changing loan terms upon default, layering discretionary pricing on top of pricing that has already taken risk into account, force-placing hazard insurance without giving reasonable notice to borrowers to cure a deficiency, and failing to employ reasonable loss mitigation measures prior to initiating foreclosure.

Other proposals would prohibit imposing high gift card fees or setting an expiration date less than one year from the date of issuance, freezing deposit accounts containing federal benefit payments upon receipt of attachment or garnishment orders, and setting off of debts owed to the financial institution from federal benefit payments deposited in accounts.

Comments are due November 5, 2007 and must be identified as OTS-2007-0015. They can be submitted to the Federal e-Rulemaking Portal. Go to www.regulations.gov, select ``Office of Thrift Supervision'' from the agency drop-down menu, then click submit. Select Docket ID ``OTS- 2007-0015." This web address allows you to view public comments and supporting materials.[59]

[53] Department of Defense, *Report on Predatory Lending Practices Directed at Members of the Armed Forces and Their Dependents* at 18-19, 51-52 (Aug. 9, 2006).
[5454] 72 FR 43570 (August 6, 2007) proposing to amend 12 CFR 535.
[55] 15 U.S.C. § 57a(f)(1), also referred to as section 18(f) of the FTC Act.
[56] 50 FR 19325 (May 8, 1985); 12 CFR 535.
[57] See 72 FR 43572 (Aug. 6, 2007).
[58] An interest rate increase being triggered by adverse information unrelated to the credit card account or card issuer, also called adverse action pricing.

[59] Comments can also be mailed to Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention OTS-2007-0015 or hand-delivered to Guard's Desk, East Lobby Entrance, 1700 G Street, NW., from 9 a.m. to 4 p.m. on business days, Attn: Regulation Comments, Chief Counsel's Office, Attn: OTS-2007-0015.