



Testimony of Creola Johnson

President's Club Professor of Law,
The Ohio State University Moritz College of Law

Before the House Financial Services Committee
on
Rent-A-Bank Schemes and New Debt Traps:
Assessing Efforts to Evade
State Consumer Protections and Interest Rate Caps

February 5, 2020

Chairwoman Waters, Ranking Member McHenry, and members of the committee, it is an honor for me to appear today. Thank you for the opportunity to share some thoughts on the partnerships between payday lenders and national banks and how they result in high-cost financial debt traps for many Americans.

My name is Creola Johnson, and I am the President's Club Professor of Law, at the Michael E. Moritz College of Law located at The Ohio State University. I teach advertising law, bankruptcy law, commercial law, and consumer law courses. I also research and write extensively about consumer finance issues, including subprime mortgages, credit card indebtedness, student loans, and debt relief scams.

I was the first academic to publish a law review article about the payday lending industry, and it was entitled: *Payday Loans: Shrewd Business or Predatory Lending?*.¹ My conclusion was that payday loans are predatory, and, as I will explain further momentarily, they continue to be predatory products that are harmful to the majority of borrowers. Even more borrowers will be harmed if rent-a-bank partnerships are legitimized on a national level.

In order to complete my first article on payday loans, I obtained funding from the Office of Research at The Ohio State University.² I was able to conduct research by having several consumers participate in a survey where they actually obtained payday loans.³ My survey findings uncovered businesses whose ultimate goal was to get consumers to quickly sign contracts agreeing to pay back money in a single balloon payment and to pay a finance charge amounting to a triple-digit interest rate. Instead of providing requested loan details, the lenders surveyed wanted to essentially keep borrowers in the dark about the consequences of signing those loan contracts.⁴ For example, in violation of federal law, 77 percent of the payday lenders surveyed would not even allow the participants to read the printed loan contract before signing it.

I've been asked to describe briefly the various forms of arrangements/partnerships which reveal the payday lender as the "true lender," according to enforcement authorities and class-action litigants.

1. Simple rent-a-bank partnership—In a simple agreement between the bank and the payday lender, the bank is identified as the lender on the borrower's

¹ See Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 MINN. L. REV. 1, *26-98 (2002) [hereafter "Johnson, *Payday Loans*"],

available at <https://scholarship.law.umn.edu/cgi/viewcontent.cgi?article=1743&context=mlr>

² See *Id.* at 1 (funding was provided by the University Seed Grant Program).

³ The payday loan survey was conducted at payday loan businesses located in Franklin County, Ohio. *Id.*

⁴ *Id.* at 45 (survey finding that payday lenders violated the Truth in Lending Act by their "failure to provide the APR in response to oral inquiries about the cost of the loan, failure to provide the APR in payday loan advertisements, and failure to provide the consumer with written disclosures prior to contract consummation"). Payday lenders in the survey not only violated state and federal laws, but the industry's standards of best practices.

loan document. However, the payday lender immediately buys the loan from the bank and does every function related to the loan. In these partnerships, the payday lender bears at least 90% of the risk of borrowers' defaulting on their loans.⁵ The payday lender then claims the right to charge consumer borrowers triple-digit interest rates because the lender is in partnership with a state- or nationally-chartered bank that is exempt from usury laws by the National Bank Act.⁶

2. Broker partnership—Under this arrangement, payday lenders claim to be exempt organizations that are allowed to charge consumer borrowers broker fees in order to secure loans for them. These payday lenders, however, are simply using the banks to fund their operations in order to skirt state usury laws.⁷
3. Rent-a-tribe partnership—This is an agreement between a payday lender and a Native American tribe and, as a result of the partnership, the payday lender relies on the tribe's tribal immunity to charge usurious interest rates. For instance, Cashcall, Inc., a non-bank payday lender started partnering with different tribes after the FDIC issue guidance for banks to cease rent-a-bank partnerships.⁸ These rent-a-tribe partnerships were simple in the beginning, but have gotten relatively complex. Although the tribal entities claim to be the lenders, litigation has revealed that the payday lenders retain almost all of the revenue and perform all loan-related functions.⁹ After years of

⁵ See *Goleta National Bank v. O'Donnell*, 239 F.Supp.2d 745 (S.D. Ohio 2002); See, e.g. *West Virginia v. CashCall, Inc.*, 605 F.Supp.2d 781, 787 (S.D. W.Va. 2009) (holding that a payday lender did not have to issue usurious loans if it was “found to be a de facto lender”); *Flowers v. EZPawn*, 307 F.Supp.2d 1191, 1205 (N.D. Okla. 2004) (allowing a class-action lawsuit against payday lender to proceed in state court where plaintiffs allegations demonstrate that the payday lender was the true lender and not County Bank where the payday lender “exerts[ed] ownership and control over [the payday] loans[,] . . . carri[ed] out all interactions with the borrowers, accept[ed] the ultimate credit risk, collect[ed] and pocket[ed] virtually all of the finance charges and fees, and own[ed] and control[ed] the branding of the loans”)

⁶ For further discussion, see Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855, 868 (2007) (describing how that “from about 2000 to 2005, banks facilitated the growth of the national payday lending providers by partnering with them, so that the providers could avoid local usury restrictions through the shelter of federal rules preempting the application of those restrictions to banks”).

⁷ West Virginia sued payday lender CashCall for violating state law by, among other things, issuing loans at usurious interest rates. Under the agreement between CashCall and First Bank and Trust of Millbank (located in South Dakota), CashCall had to purchase all loans originated by the bank with three days of a borrower obtaining a loan. See, e.g., *West Virginia v. CashCall, Inc.*, 605 F.Supp.2d 781, 787 (S.D. W.Va. 2009) (agreeing with lower court's finding that the payday lender was not an exempted credit repair organization). For further discussion, see Diane Standaert & Sara Weed, Center for Responsible Lending, *Payday Lenders Pose as Brokers to Evade Interest Rate Caps* (July 2010) <https://bit.ly/2Mqj6zJ>.

⁸ See *CFPB v. CashCall, Inc.*, No. CV 15-7522-JFW (RAOx), 2016 WL 4820635, at *1-2 (C.D. Cal. Aug. 31, 2016) (stating that CashCall's rent-a-bank scheme as a “lending model was successful for CashCall until . . . two state-chartered banks withdrew from the arrangement under pressure from the FDIC”); *Pennsylvania by Shapiro v. Think Fin., Inc.*, No. 14-CV-7139, 2018 WL 637656, at *2 (E.D. Pa. Jan. 31, 2018) (describing how Think Finance, Inc., a payday lender, initially partnered with First Bank of Delaware to offer exorbitantly-priced payday loans to consumers and then partnered with Native American tribes to do the same).

⁹ See, e.g., *Solomon v. Am. Web Loan*, No. 4:17CV145, 2019 WL 1320790, at *21 (E.D. Va. Mar. 22, 2019) (holding that plaintiffs had sufficiently alleged that the payday lender was the true lender based plaintiffs' allegation that the tribe “serve as a nominal creditor as it receives only 1% of the revenues from the loans,” and that they payday lenders are the

litigation, courts now agree that payday lenders cannot rely on these partnerships to charge borrowers interest rates that are violation of usury laws that are applicable in the states where the borrowers reside.¹⁰

4. Complex rent-a-bank partnership—This partnership is referred to as bank-sponsored lending program. It is structured as a participation-based relationship, where the bank keeps all the loans on its books and sells to the payday lender a participation interest of up to 95 percent of the loan receivables.¹¹ As was the case in the simple rent-a-bank partnerships, in these bank-sponsored participation-interest partnerships, the payday lender performs all of the loan servicing functions and receives the majority of the revenue.¹² In a lawsuit filed by the Pennsylvania attorney general, Think Finance, Inc., an online non-bank lender had attempted to circumvent usury laws by using two different partnerships, rent-a-bank and rent-a-tribe, with several different entities involved.¹³ In the rent-a-bank program, one of the related entities was an investor which provided over \$90 million of the loan funding in exchange for a fixed 20% return, and then that investor formed an entity called a “special purpose vehicle” to purchase participation interests in the loans. Pennsylvania argued that this complicated structure was just a means of charging usurious interest rates. The court, however, held this bank-involved partnerships did not violate state law and dismiss the claims against the investor because, according to the court, Pennsylvania alleged nothing more than “passive” involvement by the investor and its affiliate.

With this overview in mind, I want to focus on what I describe as the overarching themes of the business model of payday lending: (1) “keeping borrowers in the dark” and (2) “keeping them on the hook paying as long as possible.”

Through my research, I found that payday lenders want to keep borrowers in the dark. That is what rent-a-bank partnerships do. The consumer’s interactions are *only* with the payday lender, but the contract identifies some other entity as the

actual lenders because they buy the loans from the tribe and “they perform all substantive lending functions and bear the economic risk”). Nathalie Martin & Joshua Schwartz, Regulation in the Fringe Economy Symposium: The Alliance Between Payday Lenders and Tribes: Are Both Tribal Sovereignty and Consumer Protection at Risk?, 69 WASH & LEE L. REV. 751, 755 (2012)

¹⁰ See, e.g., *Solomon v. Am. Web Loan*, No. 4:17CV145, 2019 WL 1320790, at *21 (E.D. Va. Mar. 22, 2019).

¹¹ See Pepper Hamilton, LLP, Participation-Based ‘Bank Sponsor’ Lending Programs: Exploring the Advantages and Risks, JD Supra (Blog), May 4, 2019, available at 2019 WLNR 13837781 (attorneys stating that under this structure, “the bank has no choice but to be actively involved, [and] there is less risk that the participation-based lending program will be characterized as an unlawful ‘rent a charter’ scheme”).

¹² See *id.*

¹³ See *Commonwealth of Pennsylvania by Shapiro v. Think Finance, Inc.*, No. 14-cv-7139, 2018 WL 637656, at *1 (E.D. Pa. Jan. 31, 2018) (allowing the attorney general to pursue its claim against defendants that partnered with Native American tribes in “rent-a-tribe” schemes, where the “tribal entity would act as the nominal lender and the Defendants, the defacto lender, would avoid state regulation under the cloak of the tribe’s sovereign immunity”).

lender. In my first published article, I discussed pending litigation involving Ace Cash Express, Inc., a Texas-based payday lender offering loans at stores physically located in the State of Ohio.¹⁴ Consumers, however, signed loan contracts that stated Goleta National Bank was the lender even though this California-based bank had no officers or employees in Ohio.¹⁵ Goleta's \$17 fee charged on each \$100 loan resulted in an Annual Percentage Rate ("APR") of 440%.

In 2001, Goleta filed a lawsuit against the superintendent of financial institutions of the Ohio Department of Commerce to get a court order restraining the superintendent from enforcing the Ohio Small Loan Act against ACE for lending at usurious rates in violation of state law. Goleta contended that the National Bank Act preempted the superintendent's authority to enforce Ohio law against ACE because the company was Goleta's agent. Under the agreement between ACE and Goleta, ACE actually bore 90% of the loan risk. The court held that meant that ACE was not acting as Goleta's agent, and, therefore, Goleta had no standing as it could not prove any injury to itself.¹⁶ The court noted that a ruling against ACE would not prevent Goleta from actually lending in Ohio. However, "Goleta simply would be prevented from covering ACE, for a fee, with the umbrella of a national bank in order to enable ACE to circumvent Ohio's usury laws."¹⁷

I like the court's use of "umbrella" as a metaphor. Except, this is no ordinary umbrella that payday lenders want to use. Much like the umbrella in the James Bond movie "For Your Eyes Only,"¹⁸ the rent-a-bank "umbrellas" have sharp spikes protruding in order to pin down consumers and then trap them in cycles of long-term indebtedness.

After numerous lawsuits against ACE and others, federal regulators began cracking down on rent-a-bank partnerships in 2005, and we thought such partnerships had been nearly eliminated in 2010.

By that time, I had decided to do additional research about payday lending and discovered a host of practices, that amounted to subterfuge to hide unlawful lending practices in violation of state usury laws. I have documented those practices in my article entitled "*America's First Consumer Financial Watchdog Is on A Leash: Can the CFPB Use Its Authority to Declare Payday-Loan Practices Unfair, Abusive, and Deceptive?*"¹⁹ In that article, I explained that how payday

¹⁴ *Id.* at 45. See *Goleta National Bank v. O'Donnell*, 239 F.Supp.2d 745 (S.D. Ohio 2002).

¹⁵ See 239 F. Supp.2d at 747.

¹⁶ *Id.* at 757.

¹⁷ *Id.* at 756.

¹⁸ See Gadgets from James Bond Movies, <https://www.gq.com/story/best-james-bond-007-gadgets>.

¹⁹ See Creola Johnson, *America's First Consumer Financial Watchdog Is on A Leash: Can the CFPB Use Its Authority to Declare Payday-Loan Practices Unfair, Abusive, and Deceptive?*, 61 CATH. U. L. REV. 381 (2012), [hereafter, "Johnson, *America's First Consumer Financial Watchdog*"] available at <https://scholarship.law.edu/cgi/viewcontent.cgi?article=1011&context=lawreview>.

lenders had reincarnated the lending model nationwide by entering into partnerships with Native American tribes and claiming –hiding under the umbrella of– “tribal immunity” to avoid state laws.²⁰

For a time, payday lenders were successful in using rent-a-tribe partnerships to claim tribal immunity to charge consumers triple and quadruple-digit interest rates and trap them in long periods of indebtedness. However, several recent court rulings demonstrate that the tide has turned. In 2019, the U.S. Court of Appeals for the Second Circuit made it clear that an online lending operation could not use a rent-a-tribe partnership to claim that a tribe was authorized to issue loans ostensibly from a reservation in Montana to circumvent a Vermont law capping loans at 24% in order to charge residents of Vermont interest rates as high as 376%.²¹ The Second Circuit stated:

Plain Green is a payday lending entity [claiming tribal affiliation but is] cleverly designed to enabled Defendants to skirt federal and state consumer protection laws under the cloak of tribal sovereign immunity. That immunity is a shield, however, *not a sword*. . . .

Tribes and their officers are not free to operate outside of Indian lands without conforming their conduct in these areas to federal and state law.²²

As a result of this ruling, the tribe and the lenders funding its operations must comply with Vermont law.²³

Because class-action litigants and enforcement authorities have been successful in securing numerous settlements against payday lenders using rent-a-tribe partnerships, payday lenders have resurrected their partnerships with banks as a way to escape usury laws.²⁴

The Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corp. (FDIC) proposed rules would enable payday lenders to partner with banks to circumvent consumer protection laws in about half the states. Consider that while the above-mentioned tribal lender would be restricted by the 24% APR in Vermont, a payday lender in partnership with a bank will be able rely on the exemption doctrine to charge triple-digit interest rates to people who can

²⁰ See Johnson, *America's First Consumer Financial Watchdog*, (“Using this doctrine, lenders argue that because their businesses are located on or headquartered within the borders of a Native American reservation, they are bound by the laws of that reservation only, not the laws [capping interest rates in] . . . the state in which the borrower resides.”). See also Nathalie Martin & Joshua Schwartz, *The Alliance Between Payday Lenders and Tribes: Are Both Tribal Sovereignty and Consumer Protection at Risk?*, 69 WASH. & LEE L. REV. 751, 762-63 (2012).

²¹ See *Gingras v. Think Fin., Inc.*, 922 F.3d 112 (2d Cir. 2019) (describing the rent-a-tribe scheme’s operation and its funding by Think Finance, Inc.).

²² *Id.* (emphasis supplied).

²³ See *id.* at 128.

²⁴ See Pepper Hamilton, LLP, Participation-Based ‘Bank Sponsor’ Lending Programs: Exploring the Advantages and Risks, JD Supra (Blog), May 4, 2019, available at 2019 WLNR 13837781.

least afford them. Not only would the OCC and the FDIC empower payday lenders and banks to circumvent state laws but would in effect overturn the Second Circuit’s decision in *Madden v. Midland Funding*, where the court ruled that a usury law would apply to a non-bank purchasing loans from a bank.²⁵

Pending cases against non-bank lenders show how they are using rent-a-bank partnerships to issue high-cost loans in violation of state law. For illustrative purposes, consider Kabbage, Inc., which is a non-bank online lender that gives cash advance loans to small businesses.²⁶ Kabbage funds its lending operation, in part, from its partnership with Celtic Bank, a state-chartered bank in Utah, a state with no maximum interest rate for small business and commercial loans.²⁷ According to several lawsuits, the borrowers only interact with Kabbage but Celtic Bank is named as the lender in each loan transaction charging APRs as high as 95%.²⁸ Kabbage then buys all loans within two days of origination and thereafter performs all lending-related functions, including servicing the loans. Kabbage bears 100% of the risks, and, as result, litigants assert that Kabbage has violated usury laws in California, Colorado, Massachusetts, and New York.²⁹ In fact, in a joint webinar presentation with the National Federation of Independent Business, Kabbage’s co-founder and chief operating officer acknowledged that Kabbage is the direct lender.³⁰

Borrowers argue that Kabbage’s loan terms amount to contracts of adhesion because, in addition to the borrowers agreeing to pay usurious interest rates, borrowers waive the right to a jury trial, waive the right to participate in a class action, waive the right to seek legal redress in their home state, and waive the right to assert claims for compensatory, consequential and punitive damages.³¹ Borrowers also grant Kabbage a security interest on all the borrowers’ assets and

²⁵ The Second Circuit is the only U.S. Court of Appeals to hold that non-bank assignees are not entitled to preemption protection simply by virtue of holding loans that were originated with a national bank. *Madden v. Midland Funding, LLC*, 786 F.3d 246, 249-53 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016).

²⁶ See *Barnabas Clothing, Inc. v. Kabbage, Inc.*, No. CV 18-3414 PSG (SSX), 2018 WL 9669565, at *1 (C.D. Cal. June 8, 2018) (alleging that, in addition to violating state usury laws, perpetuated an illegal scheme, when “Kabbage entered into a criminal enterprise known as a ‘rent-a-bank’ scheme with Celtic Bank, a foreign bank chartered in Utah (a state, unlike California, with no maximum interest rate for commercial loans)”).

²⁷ See, e.g., Complaint, *Barnabas Clothing, Inc., et al. v. Kabbage, Inc.*, No. CV 18-3414 PSG (SSX), available at 2018 WL 1608431 (Cal.Super. Mar. 22, 2018) [hereafter *Barnabas Complaint*];

²⁸ See, e.g., *id.*; Complaint, *Bright Kids NYC, Inc., et al vs. Kabbage, Inc., et al*, No. 1:19-cv-09221-JMF, (S.D.N.Y. Oct. 4, 2019), available at https://www.consumerfinancemonitor.com/wp-content/uploads/sites/14/2019/10/Bright_Kids_NYC_v._Kabbage.pdf) [hereafter *Bright Kids Complaint*].

²⁹ See, e.g., *Barnabas Complaint*, (alleging that small business and its owner “at all times dealt exclusively with Kabbage” and “had absolutely no dealings of any kind with Celtic Bank on any of these loan transactions.”); *Bright Kids Complaint*.

³⁰ See, e.g., *Bright Kids Complaint, supra*.

³¹ See, e.g., *Barnabas Complaint, supra*; Complaint, *supra*, Complaint, *NRO Boston, LLC, et al, vs. Kabbage, Inc., et al*, No. 17-11976, 2017 WL 4569540 (D. Mass. Oct. 12, 2017) (alleging that the Kabbage included “unconscionable and unfair provisions in connection with the loan agreements, which were contracts of adhesion” in violation of Massachusetts law).

the individuals that own the borrowers must personally guarantee all debts owed to Kabbage.³² In all these cases, Kabbage moves to compel arbitration and essentially prevents small-business entrepreneurs from obtaining judicial relief.³³ In one of the arbitration cases, the arbitrator found that Celtic Bank was the lender despite the fact that Kabbage is contractually obligated to purchase 100% of the receivables arising from the loan transactions.³⁴ As a result of the forgoing, Kabbage is not only perfectly positioned to get away with charging usurious interest rates, but to perpetrate the worst lending and collection practices.³⁵

Today, I must once again argue that rent-a-bank partnerships are no better than when they appeared 20 years ago. Rent-a-bank partnerships will enable payday lenders to have far more funding to trap far more consumers and small-business owners than was possible years ago. The rent-a-bank partnerships will allow payday lenders to use funding from banks to perpetrate nationwide the following practices (discussed extensively in my law review articles):

1. Debt entrapment practices - These are practices that ensure a borrower will not be able to repay the loan by the initial due date and will eventually default or have to do something to extend the life of the loan. Debt entrapment practices include approving borrowers for credit with only minimal or non-existent credit checks, issuing to borrowers loans with large principal amounts and triple-digit interest rates, and establishing short maturity dates for loan repayment.³⁶
2. Debt treadmill practices - These are practices designed to make sure that the lender will receive, at a minimum, continuing stream of fee payments from the borrower. Debt treadmill practices include: multiple rollovers fees to extend the loan's due date, multiple back-to-back loans, rapacious electronic debits to borrowers' bank accounts, and illegal garnishments of consumer borrowers' wages.³⁷

³² See, e.g., Bright Kids Complaint, *supra*.

³³ See *Barnabas Clothing, Inc. v. Kabbage, Inc.*, No. CV 18-3414 PSG (SSX), 2018 WL 9669565, at *1 (C.D. Cal. June 8, 2018) (granting Kabbage's motion to compel arbitration).

³⁴ See e.g., Plaintiffs' Brief in Opposition to Defendants' Motion to Compel Arbitration and Stay Proceeding, *Bright Kids vs. Kabbage*, No. 1:19-cv-09221-JMF (S.D.N.Y. Jan. 3, 2020) (discussing Kabbage's use of arbitration clauses to have lawsuits filed against it tossed out of federal court).

³⁵ See, e.g., NRO Complaint, *supra* (alleging that Kabbage violated state law in a number of ways, including racking up finance charges by requiring borrowers "to enter into a new loan agreement every time money is drawn from the line of credit").

³⁶ See Creola Johnson, *Congress Protected the Troops: Can the New CFPB Protect Civilians from Payday Lending*, 69 WASH. & LEE L. REV. 649, 650 (2012), available at <https://scholarlycommons.law.wlu.edu/cgi/viewcontent.cgi?article=4274&context=wlulr> (describing in detail debt entrapment practices and arguing that Congress should pass a federal law capping interest rates on payday loans to protect the civilian population from predatory lending).

³⁷ See *id.*

3. Debt criminalization practices - These are practices perpetrated by payday lenders to make borrowers fear imminent arrest for crimes if they do not comply with the payday lenders' demands for payments. Such criminalization practices include (1) threatening to pursue prosecution of consumers for committing a crime; (2) filing police reports to initiate criminal charges against consumers; and (3) misusing civil contempt proceedings to obtain arrest warrants against consumers.³⁸

As I close my remarks today, I ask that Congress pass H.R. 5050, the “Veterans and Consumers Fair Credit Act,” which would establish a 36% nationwide rate cap for consumer loans.³⁹

³⁸ See Creola Johnson, *Creditors' Use of Consumer Debt Criminalization Practices and Their Financial Abuse of Women*, 34 COLUM. J. GENDER & L. 5 (2016), available at <https://academiccommons.columbia.edu/doi/10.7916/D88W3RVX>.

³⁹ See The Veterans and Consumers Fair Credit Act, H.R. 5050 and S. 2833, 116th Congress (2019).