

# Continuing Challenges to Interstate Lending by Depository Institutions

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## INTRODUCTION

In 1978, the Supreme Court in the landmark decision of *Marquette National Bank v. First of Omaha Service Corp.*<sup>1</sup> resolved the longstanding debate as to whether a national bank could charge interest in interstate transactions based upon the rates authorized by the laws of the state in which the bank's home office was located.<sup>2</sup> The Supreme Court unequivocally held that under the National Bank Act,<sup>3</sup> a national bank could charge an interest rate authorized in the bank's home state in interstate lending transactions with residents of other states.<sup>4</sup> This power has not been directly challenged since that decision, and today it is an accepted legal premise that a national bank can "export" the interest rates of its home state in interstate lending transactions. In 1980, Congress passed the Depository Institutions Deregulation and Monetary Control Act (DIDMCA),<sup>5</sup> in which it extended this right to other depository institutions, including federal savings and loans, savings banks, and credit unions, as well as state-chartered banks, savings and loans, credit unions and industrial loan companies holding federal deposit insurance.<sup>6</sup> The purpose of DIDMCA was clearly stated in the legislative enactment: to give these depository institutions the same right to "export" interest rates as was available to national banks.<sup>7</sup> The power to export interest rates by all types of federally insured depository institutions also has not been challenged and remains an accepted tenet in interstate lending.

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1. 439 U.S. 299 (1978).
2. *Id.* at 301.
3. 12 U.S.C. § 85 (2000).
4. *Marquette Nat'l Bank*, 439 U.S. at 307-19.
5. Pub. L. No. 96-221, 94 Stat. 142 (1980).
6. *Id.*; 12 U.S.C. §§ 1463(g), 1785, 1813, 1831d(a).
7. 12 U.S.C. § 1831d(a) (containing "rate allowed by the laws of the State . . . where the bank is located" language and "[i]n order to prevent discrimination against state-chartered insured banks" language); see also *id.* §§ 1730g, 1785, 1813 (2001).

## SCOPE OF "INTEREST"

In the late 1980s and the early 1990s, numerous challenges were raised in plaintiffs' class action cases regarding the scope of the meaning of the word "interest" in the National Bank Act and DIDMCA.<sup>8</sup> Some depository institutions had taken the position that the term "interest" included not just the simple numerical rate but rather included other monetary returns to the lender in the form of various fees such as late fees and returned check fees. This continuing litigation began badly for the depository institutions in 1991 when the U.S. District Court for the District of Massachusetts decided a case against Greenwood Trust Company, holding that other credit terms apart from interest rates, such as late fees, were not included in the term "interest" and thus were not controlled by DIDMCA.<sup>9</sup> The U.S. Court of Appeals for the First Circuit thereafter reversed the district court, defining the term "interest" to include late fees.<sup>10</sup> Nevertheless, the *Greenwood Trust* case spawned numerous additional lawsuits alleging that various types of fees had been overcharged by depository institutions that had been relying upon the fee authority of their home state. This litigation was ultimately resolved in 1996 when the Supreme Court decided in *Smiley v. Citibank (South Dakota), N.A.*<sup>11</sup> that late fees and other types of fees that constitute additional return to the lender also constitute "interest."<sup>12</sup> The *Smiley* Court relied heavily upon a then recently promulgated regulation of the Office of the Comptroller of the Currency (OCC) defining the term "interest" to include "any payment compensating a creditor or prospective creditor for an extension of credit, making available of a line of credit, or any default or breach by a borrower of a condition upon which credit was extended."<sup>13</sup> The Federal Deposit Insurance Corporation (FDIC) and the Office of Thrift Supervision (OTS) followed with similar interpretations defining many types of fees as interest for purposes of interest rate exportation.<sup>14</sup>

8. See Jeffrey I. Langer, *The Scope of Exportation: Some Unresolved Issues After Smiley v. Citibank*, 52 BUS. LAW. 1065 (1997); Darrell L. Dreher, Hugh M. Hayden, & Michael C. Tomkies, *Developments in the Interstate Delivery of Consumer Financial Services*, 50 BUS. LAW. 1093 (1995); Darrell L. Dreher, Hugh M. Hayden, & Michael C. Tomkies, *Developments in the Interstate Delivery of Consumer Financial Services: Location, Fees and Common Law*, 49 BUS. LAW. 1325 (1994); Darrell L. Dreher & Michael C. Tomkies, *Interstate Delivery of Consumer Financial Services: Credit Card Issuers Win Decisions in Greenwood Trust and Related Cases*, 48 BUS. LAW. 1097 (1993); Darrell L. Dreher & Michael C. Tomkies, *Interstate Delivery of Consumer Financial Services: Greenwood Trust Decision Rendered*, 47 BUS. LAW. 1251 (1992); Harvey N. Bock, Darrell L. Dreher, & Michael C. Tomkies, *Developments in the Interstate Delivery of Consumer Financial Services*, 46 BUS. LAW. 1223 (1991); Jeffrey I. Langer & Jeffrey B. Wood, *A Comparison of the Most Favored Lender and Exportation Rights of National Banks, FSLIC-Insured Savings Institutions, and FDIC-Insured State Banks*, 42 CONSUMER FIN. L.Q. REP. 4 (1988).

9. *Greenwood Trust Co. v. Massachusetts*, 776 F. Supp. 21, 25-39 (D. Mass. 1991), *rev'd*, 971 F.2d 818 (1st Cir. 1992).

10. *Greenwood Trust Co. v. Massachusetts*, 971 F.2d 818, 830-831 (1st Cir. 1992).

11. 517 U.S. 735 (1996).

12. *Id.* at 745-47.

13. 12 C.F.R. § 7.4001(a) (2000).

14. See 12 C.F.R. § 560.110(a); FDIC General Counsel's Op. No. 10; Interest Charges Under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. 19,258, 19,259 (Apr. 17, 1998).

## CURRENT ISSUES

If counsel for depository institutions had assumed that the *Marquette* and *Smiley* cases resolved the right of depository institutions to engage in interstate lending without further challenges to the right to charge their home state rates and fees, they were wrong. Today the challenges continue in the form of plaintiffs' class actions and state regulators' attempts to enforce state interest and fee limitations without regard to federal preemption. Plaintiffs' class actions are currently attacking exportation rights in interstate lending transactions by alleging: (i) that someone other than the depository institution is the actual lender in the transaction; (ii) that the depository institution is not a bank under the federal statutes; (iii) that methods of applying payments result in overcharges; and (iv) that agents of the depository institution violated a state requirement thus impacting upon the loan transaction of the depository institution. State regulators are also attacking interstate lending by depository institutions by: (i) adopting regulatory positions that prohibit agents of depository institutions from assisting in transactions that do not fully comply with the state statutes; (ii) recharacterizing transactions to find that other entities are in fact the actual lenders in the transaction; and (iii) adopting interpretations that are inconsistent with federal preemption.

Thus, depository institutions today face attacks on their interstate lending practices from two directions: litigation and state regulators. Federal regulatory agencies have responded with expanded regulations and interpretations further clarifying the scope of federal preemption in interstate lending, but this does not seem to have alleviated the flurry of lawsuits or the continuing regulatory pronouncements from state regulators, seeking to narrow the federal preemption rights of depository institutions. The basic goal in many of the class actions is to side-step the bank's right to export the interest rates and fees of its home state, thereby creating numerous rate and fee overcharges under various state laws with resulting penalties, damages, and attorneys' fees recoveries. The purpose of state regulators apparently is to retain maximum local control over consumer protection issues, but the result is often just the opposite as increasingly stringent enforcement positions often result in further preemptive pronouncements by federal regulators and litigation that, to date, has generally upheld federal preemption rights.

The following cases illustrate the scope of this battle, though they are by no means an exhaustive list of the lawsuits and regulatory pronouncements affecting interstate lending by depository institutions.

## CLASS ACTION LITIGATION

### TRUE CREDITOR ISSUE

In *Matheis v. The May Department Stores Co.*,<sup>15</sup> the plaintiffs brought consolidated Missouri state law usury class action claims against The May Department

15. Nos. 4:98CV01722 RWS, 4:98CV1739 RWS, 1999 U.S. Dist. LEXIS 21917 (E.D. Mo. May 21, 1999), *rev'd sub nom.* *Krispin v. May Dep't Stores Co.*, 218 F3d 919, 921 (8th Cir. 2000).

Stores Company ("May"). May originally issued credit cards to the plaintiffs and was the creditor in the original cardholder agreements with the plaintiffs. The cardholder agreements allowed unilateral modification by May with at least fifteen days' notice to cardholders. Shortly after the establishment of May National Bank ("Bank"), a wholly-owned subsidiary of May created to handle May's credit card operations, May sent an "IMPORTANT NOTICE" to its cardholders, providing that "[e]ffective immediately, credit is being extended by the May National Bank of Arizona" and stating that late fees would now be "up to \$12.00, or as allowed by law."<sup>16</sup> Subsequent notices provided that late fees would be "\$15, or as allowed by law. This varies from state to state."<sup>17</sup> There was little additional information and the notices did not purport to change any other terms of the agreement. The Bank thereafter sold its credit card receivables on a daily basis to May. The plaintiffs claimed that under state usury laws, applicable to the original issuer May, they were charged usurious late fees after the substitution of the Bank as the issuer, and that the National Bank Act did not apply because the party collecting the late fees was really May, not the Bank. The district court held that because credit was originated by the Bank, the National Bank Act controlled; thus, the plaintiffs' state law usury claims were preempted.<sup>18</sup> The district court also looked to the law of the Bank's home state, Arizona, to determine the late fees the Bank could assess.<sup>19</sup> On appeal, the U.S. Court of Appeals for the Eighth Circuit agreed with the district court, holding that the state law usury claim implicated the National Bank Act and that the Bank was the real party in interest.<sup>20</sup> The Eighth Circuit noted that the Bank, not May, issued the credit on a continuing basis, processed and serviced the accounts and set the terms of credit.<sup>21</sup> The Eighth Circuit remanded the case so that the plaintiffs could argue violations of the National Bank Act and for consideration of state law contract issues, including the issue of inadequate notice of a change in terms, an issue the court raised in a footnote.<sup>22</sup> This decision is important to the credit industry because it establishes that the sale of receivables by a creditor does not change the debtor-creditor relationship, nor the law applicable to that relationship. The Eighth Circuit noted, however, the existence of state contract law issues.<sup>23</sup> If the defendants failed to contractually effect a change of applicable law in the cardholder agreements, then the law applicable to the original creditor, May, rather than the Bank, would remain applicable, i.e., not the Bank's home state law.

Several separate but nearly identical suits have been filed around the country against ACE Cash Express, Inc., the owner, operator and franchiser of stores that

16. *Krispin*, 218 F3d at 921.

17. *Id.*

18. *Matheis*, 1999 U.S. Dist. LEXIS 21917, at \*11.

19. *Id.* at \*11-\*12.

20. *Krispin*, 218 F3d at 924.

21. *Id.*

22. *Id.* at 924 n.2, 925.

23. *Id.* at 925.

offer “payday” or deferred presentment loans on behalf of a national bank.<sup>24</sup> In a representative suit, *Long v. ACE Cash Express, Inc.*,<sup>25</sup> the plaintiff filed a putative class action suit alleging that ACE entered into usurious and misleading lending contracts under Florida state law by feigning the use of Goleta National Bank as the creditor when ACE was the actual owner of the loans in order to avoid the Florida usury statutes. The plaintiff alleged that ACE and Goleta entered into a master loan agreement whereby ACE would offer bank loans designating Goleta as the lender through ACE’s retail sites in Florida. Under the agreement, ACE purchased from Goleta all of the loans made on the previous day, and ACE then received “substantially” all of the interest and the risk. The loans are accessed in this case through debit cards that could be used at various ATM machines. The plaintiff claimed that the real purpose of the agreement was to allow ACE to evade state usury laws by allowing ACE to utilize Goleta’s name and national bank standing, but because the loans were actually made by ACE, state laws and not the National Bank Act were applicable. ACE removed the case to the U.S. District Court for the Middle District of Florida on the theory that the plaintiff failed to name an indispensable party, Goleta, whose loans are governed by the National Bank Act, which preempts all state usury claims. The federal district court held, however, that whether ACE was the proper party named in the suit was not the question at issue.<sup>26</sup> The district court remanded the case, holding simply that the National Bank Act did not apply to ACE because ACE is not a national bank, and thus the National Bank Act cannot preempt the plaintiff’s state law claims and there is no federal jurisdiction.<sup>27</sup> The allegations in this case raise the issue of whether the lender named in the loan contracts is the true creditor or whether another entity, such as a servicer or a purchaser of a participation interest (in this case ACE is both), can be found to be the creditor. In order to so find, the court would have to ignore the clear contractual relationships and recharacterize the transactions to fit the plaintiff’s theory. Such a recharacterization would result in complete contract reformation and changes of parties, accounting and audit anomalies and serious bank regulatory issues. The court would be entering a legal quagmire.

In a similar case, *Phanco v. Dollar Financial Group, Inc.*,<sup>28</sup> the plaintiff brought a putative class action suit alleging that Eagle National Bank (“Bank”), designated

24. See Complaint, *Hudson v. ACE Cash Express, Inc.*, No. IP01-C-1336-H/G (S.D. Ind. filed Sept. 11, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law); Complaint, *Purdie v. ACE Cash Express, Inc.*, No. 301-CV1754-X (N.D. Tex. filed Sept. 6, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law); Complaint, *Johnson v. ACE Cash Express, Inc.*, No. 01-CV-2299 (D. Md. filed Aug. 2, 2001) (voluntarily dismissed by plaintiffs) (on file with *The Business Lawyer*, University of Maryland School of Law); Complaint, *Long v. ACE Cash Express, Inc.*, No. 3:00-CV-1306-J-25TJC (M.D. Fla. filed Nov. 1, 2000) (removed from state court) (on file with *The Business Lawyer*, University of Maryland School of Law); Complaint, *Brown v. ACE Cash Express, Inc.*, No. 24-C-01-004036 (Cir. Ct. Md. filed Aug. 20, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law).

25. Complaint, *Long*, No. 3:00-CV-1306-J-25TJC.

26. Order, *Long v. ACE Cash Express, Inc.*, No. 3:00-CV-1306-J-25TJC, at 2 (M.D. Fla. June 18, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law).

27. *Id.* slip op. at 2-3.

28. No. CV 99-1281 GHK (RZx) (C.D. Cal. Nov. 22, 2000) (on file with *The Business Lawyer*, University of Maryland School of Law).

as the lender in his "payday loan" transaction documents, was not the actual lender, but merely lent its name to Dollar Financial Group, Inc. and its affiliates, the corporations that allegedly made the "payday loans." The plaintiff claimed that this fiction allowed the corporations to avoid various state laws that either expressly prohibited short-term loans made by "deferred deposit" check cashing or imposed limitations with which the corporation would have had to comply if it was the lender. The plaintiff based his claim on allegations that: (i) the Bank did not meet prospective borrowers; (ii) the Bank did not review or approve borrowers' credentials; (iii) the Bank did not make credit decisions; (iv) the Bank did not advance funds; (v) the Bank did not bear risk of non-payment; (vi) the Bank did not own any of the accounts into which borrowers' checks were deposited; and (vii) the Bank had no knowledge of the loans made. Your authors understand that the defendant in this case disputes the facts as alleged by the plaintiff. Nevertheless, a settlement was reached in this suit, although the details of the settlement were not reported in the final order.<sup>29</sup>

### BUSINESS OF RECEIVING DEPOSITS

In *Heaton v. Monogram Credit Card Bank of Georgia*,<sup>30</sup> a credit card customer brought a state court class action suit against Monogram Credit Card Bank of Georgia ("Bank"), the card issuer, for allegedly charging late fees in excess of the limit allowed under the Louisiana Consumer Credit Law. After the Bank removed the case to federal court, however, the district court remanded the case back to state court because it found that the Bank, a Georgia credit card bank, was not a "state bank" under the Federal Deposit Insurance Act because it was not engaged in the business of receiving deposits from its customers.<sup>31</sup> Accordingly, the district court found no federal question jurisdiction and no federal preemption.<sup>32</sup> While *Heaton* was on appeal to the Fifth Circuit, the FDIC published General Counsel's Opinion No. 12,<sup>33</sup> which interpreted the requirement in section 5 of the Federal Deposit Insurance Act that an applicant for deposit insurance must be "engaged in the business of receiving deposits other than trust funds."<sup>34</sup> The General Counsel's opinion states that the statutory requirement of being "engaged in the business of receiving deposits other than trust funds" is satisfied by the continuous maintenance of one or more non-trust deposits in the aggregate amount of \$500,000.<sup>35</sup> The opinion states that the FDIC will determine on a case-by-case basis whether the holding of non-trust deposits in amounts less than \$500,000

29. *Id.*

30. 231 F.3d 994 (5th Cir. 2000), *cert. denied*, 533 U.S. 915 (2001).

31. *Heaton v. Monogram Credit Card Bank of Ga.*, No. Civ. A. 98-1823, 1999 WL 1789422, at \*1 (E.D. La. Nov. 22, 1999), *appeal dismissed*, 231 F.3d 994 (5th Cir. 2000), *cert. denied*, 533 U.S. 915 (2001).

32. *Id.*

33. FDIC General Counsel's Op. No. 12, *Engaged in the Business of Receiving Deposits Other Than Trust Funds*, 65 Fed. Reg. 14,568 (Mar. 17, 2000).

34. *Id.*; 12 U.S.C. § 1815(a)(1) (2000).

35. FDIC General Counsel's Op. No. 12, 65 Fed. Reg. at 14,572.

meets the definition.<sup>36</sup> The source of the deposit funds is not considered relevant.<sup>37</sup> The FDIC has now converted the General Counsel's opinion into a regulation.<sup>38</sup> Although the General Counsel's opinion specifically disapproved of the district court's analysis in the *Heaton* case, the U.S. Court of Appeals for the Fifth Circuit did not reach the substance of this case on appeal, holding that the district court order finding that the court lacked subject matter jurisdiction and remanding to state court was "not reviewable on appeal or otherwise."<sup>39</sup> The U.S. Supreme Court denied the Bank's petition for writ of certiorari to review the Fifth Circuit's procedural ruling.<sup>40</sup> The Fifth Circuit did reinstate the Truth in Lending Act (TILA)<sup>41</sup> claim that the district court had allowed the plaintiffs to dismiss on remand, noting that the Bank would have immediate grounds to once again remove the case to federal court.<sup>42</sup> Shortly after the Fifth Circuit's remand, the plaintiffs amended their petition to delete the Truth in Lending claim and the Bank removed the case again to federal court. In district court again, the FDIC moved to intervene in the suit and the plaintiffs moved to remand the case to state court. The district court remanded the case again, holding that the Bank was not "engaged in the business of receiving deposits" and even if the Bank were a state bank, complete preemption did not apply, and that therefore the district court lacked subject matter jurisdiction over the case and that the FDIC's motion to intervene was moot.<sup>43</sup> The FDIC has appealed from the decision to the Fifth Circuit. The allegations in *Heaton* represent another attempt to attack a bank's ability to export rates and fees by questioning the bank's status as an insured state bank under the federal law authorizing exportation. In order to adopt the plaintiffs' theory, however, a court will have to overcome the FDIC's longstanding position and interpretations of the act it is charged with interpreting and, specifically, overturn the FDIC's determination to grant deposit insurance to the Bank thirteen plus years ago. The court also would have to overcome strong Supreme Court precedent granting the federal banking agencies substantial deference in their interpretations of such statutes.<sup>44</sup>

*Herren v. Monogram Credit Card Bank of Georgia*<sup>45</sup> is a case similar to *Heaton*. In *Herren*, the original plaintiff brought a putative class action suit against Monogram ("Bank") in Arkansas state court, alleging that the Bank charged usurious interest

36. *Id.*

37. *Id.*

38. FDIC Final Rule, Engaged in the Business of Receiving Deposits Other Than Trust Funds, 66 Fed. Reg. 54,645 (Oct. 30, 2001).

39. *Heaton v. Monogram Credit Card Bank of Ga.*, 231 F3d 994, 997, 998, 1000 (5th Cir. 2000) (citing 28 U.S.C. § 1447(d)).

40. *Monogram Credit Card Bank of Ga. v. Heaton*, 533 U.S. 915 (2001).

41. 15 U.S.C. §§ 1601-1666j (2000).

42. *Heaton v. Monogram Credit Card Bank of Ga.*, 231 F3d at 1000.

43. *Heaton v. Monogram Credit Card Bank of Ga.*, No. Civ. A. 98-1823, 2001 WL 15635, at \*2-\*4 (E.D. La. Jan. 5, 2001); *Heaton v. Monogram Credit Card Bank of Ga.*, No. Civ. A. 98-1823, 2001 WL 125346, at \*1 (E.D. La. Feb. 14, 2001).

44. See *Smiley v. Citibank*, 517 U.S. 735, 739-44 (1996).

45. Motion to Dismiss for Lack of Subject Matter Jurisdiction, *Monogram Credit Card Bank of Ga. v. Herren*, No. 5:01 CV00264WRW (E.D. Ark. filed Sept. 18, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law).

