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The Future of Tribal Lending Under the Consumer Financial Protection Bureau

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Some Indian tribes – particularly impecunious tribes located remotely from population centers, without sufficient traffic to engage profitably in casino gambling – have found much-needed revenue from consumer lending over the Internet.

In a typical model, the tribe forms a tribal lending entity (TLE) that is financed by a third party. The TLE then makes loans over the Internet to consumers nationwide, usually on terms that are unlawful under the internal laws of the states where the borrowers reside. Because the TLE is deemed an "arm" of the tribe, the TLE benefits from the tribe's sovereign immunity. As a result, the TLE may be sued only under very limited circumstances; and, perhaps even more importantly, the TLE is exempt from most state-court discovery intended to unearth the economic relationship between the TLE and its non-tribal financier.

Because this model has, at least to date, provided a relatively bulletproof means to circumvent disparate state consumer-protection laws, the model has attracted Internet-based payday and, to a lesser extent, installment lenders. Although data are spotty, it is likely the fastest-growing model for unsecured online lending. Tribal sovereign immunity renders this model the preferred legal structure for online lenders desirous of employing uniform product pricing and terms nationwide, including for loans to borrowers who reside in states that prohibit such lending entirely.

The tribal model is increasingly being adopted by online lenders who had formerly employed other models. Yet the legal risks of the model to those who would "partner" with TLEs are rarely emphasized.

Introduction to the Tribal Model

Payday loans are designed to assist financially constrained consumers in bridging small ($100 to $1,000) cash shortages between loan origination and the borrower's next payday. The permitted interest rates for such loans, where they are allowed, are high – generally in the APR range of 400 percent. Such permitted rates are, perhaps incredibly, less than the economic equilibrium price for such credit. A borrower who desires to extend a loan, or who is unable to repay a loan on the due date, may refinance, or "roll over," the loan. State laws and the "best practices" of the storefront payday lenders' trade association frequently limit such "rollovers" and permit a borrower with payment difficulties to demand an interest-free extended repayment plan.

TLEs are customarily tribally chartered. In the best embodiment, the TLEs have offices on tribal lands, operate payday-loan-decisioning computer servers there, and employ tribal personnel in various stages of the loan-origination process. But TLEs generally make extensive use of non-tribal subcontractors and typically receive substantially all of their financing from non-tribal financiers. As a result, the economic benefits of TLEs' lending operations frequently flow primarily to the financiers and not to the tribes.

The principal benefit of the tribal model to the TLE is the ability to charge – at least to date, with relative impunity – market rates for payday loans, typically in excess of $20 per $100 advanced for a two-week loan (equivalent to an APR of 520 percent). These rates generally exceed permissible charges in borrowers' states. Thirty-two states permit payday loans to their residents, but in most cases with maximum finance charges of $15 or less; the remaining states and the District of Columbia have applicable usury laws that either expressly or impliedly bar payday lending altogether.

Because TLEs deem themselves exempt from compliance with all borrower-state laws, a TLE engaged in payday lending usually charges a single rate nationwide and generally does not comply with state-law limitations on loan duration or rollovers. Online lenders generally seek to comply with federal laws applicable to consumer loans (e.g., TILA and ECOA).

Commercial payday lenders have entered into collaborations with Indian tribes in order to seek to benefit from the tribes' sovereign immunity. As noted above, in many cases the non-tribal participant may preponderate in the finances of the TLEs, causing regulators and some scholars to call into question the bona fides of the arrangements. The popular press often refers to these arrangements as "rent-a-tribe" ventures, similar to the "rent-a-bank" payday lending ventures formerly in use until the latter were effectively ended by federal bank regulators in 2005.

Following President Obama's putative recess appointment on January 4, 2012, of Richard Cordray as director of the Consumer Financial Protection Bureau (CFPB) – thereby enabling supervision of non-depository institutions – the CFPB is likely to subject the tribal model to increased scrutiny.

Tribal Sovereign Immunity

Indian tribes were sovereign nations prior to the founding of the United States. Thus, rather than grant sovereignty to tribes, subsequent treaties and legislative and juridical acts have served to recognize this inherent preexisting sovereignty. Because they are separate sovereigns, recognized Indian tribes are subject to suit only under limited circumstances: specifically, when the tribe has voluntarily waived its immunity, or when authorized by Congress. *Kiowa Tribe of Oklahoma v. Manufacturing Tech., Inc.*, 523 U.S. 751, 754 (1998).

The extent of immunity is governed largely by the Supreme Court's decision in *California v. Cabazon Band of Mission Indians*, 480 U.S. 202 (1987). Concepts of tribal immunity have been addressed extensively in prior articles and will not be belabored here. In brief summary, state and local laws may be applied to on-reservation activities of tribes and tribal members only under very limited circumstances generally inapplicable to tribal lending.

As recent examples of these principles, the appellate courts of California and Colorado were confronted with the assertion that tribal sovereign immunity prevents the use of state-court discovery methods to determine whether a tribe-affiliated Internet payday lender had a sufficient nexus with the tribe to qualify for sovereign immunity and, secondarily, to pursue discovery of the alleged sham relationship between the TLE and its financial backer. Relying in each case on the Supreme Court's determination that tribal sovereign immunity prevents compelled production of information to assist a state in investigating violations of and enforcing its laws, both of those courts denied meaningful discovery.

Sovereign immunity applies not only to tribes themselves but also to entities that are deemed "arms" of the tribe, such as tribally chartered TLEs.

Because the immunity of TLEs is substantially beyond cavil, the "action" in litigation over the tribal model has moved on from the tribes and their "arms" to non-tribal financiers, servicers, aiders, and abettors. Discovery of the details of the financial relationships between TLEs and their financiers has been a key aim of these state-court proceedings by regulators, since the non-tribal "money partners" of the TLEs almost certainly cannot assert tribal immunity. The principal risk to such financiers is recharacterization as the "true" lender in one of these arrangements.

Additional Resources

For other materials related to this topic, please refer to the following.

Business Law Section 2013 Spring Meeting

Online/Tribal Lending
9:00 PM – 10:30 PM,
Friday, April 05, 2013
International Ballroom East,
Concourse Level,
Washington Hilton Hotel
CFSC – Electronic Financial Services Subcommittee

Business Law Today

Native America: Culture, Business, and the Law (Mini-theme)
Volume 18, Number 2:
November/December 2008

Regulating the Subprime Market: Finding the Right Balance
By Michael C. Tomkies
Volume 17, Number 6
July/August 2008

Pre-CFPB Federal Regulation of Payday Lending

Prior to the enactment of the Dodd-Frank Act (the Act), federal enforcement of substantive consumer lending laws against non-depository payday lenders had generally been limited to civil prosecution by the Federal Trade Commission (FTC) of unfair and deceptive acts and practices (UDAP) proscribed by federal law. Although it could be argued that unfair practices were involved, the FTC did not pursue state-law usury or rollover violations. Because of the relative novelty of the tribal lending model, and perhaps more importantly because of the propensity of FTC defendants to settle, there are no reported decisions regarding the FTC's assertion of jurisdiction over TLEs.

The FTC's most public (and perhaps its first) enforcement action against a purported tribal-affiliated payday lender was not filed until September 2011, when the FTC sued Lakota Cash after Lakota had attempted to garnish consumers' wages without obtaining a court order, in order to collect on payday loans. The FTC alleged that Lakota had illegally revealed consumers' debts to their employers and violated their substantive rights under other federal laws, including those relating to electronic payments. The case, as with nearly all of the other FTC payday-lending-related cases, was promptly settled. Thus, it provides little guidance to inform future enforcement actions by the FTC or the CFPB.

The Looming Battle Over CFPB Authority

Article X of the Act created the Consumer Financial Protection Bureau with plenary supervisory, rulemaking and enforcement authority with respect to payday lenders. The Act does not distinguish between tribal and non-tribal lenders. TLEs, which make loans to consumers, fall squarely within the definition of "covered persons" under the Act. Tribes are not expressly exempted from the provisions of the Act when they perform consumer-lending functions.

The CFPB has asserted publicly that it has authority to regulate tribal payday lending. Nevertheless, TLEs will certainly argue that they should not fall within the ambit of the Act. Specifically, TLEs will argue, inter alia, that because Congress did not expressly include tribes within the definition of "covered person," tribes should be excluded (possibly because their sovereignty should permit the tribes alone to determine whether and on what terms tribes and their "arms" may lend to others). Alternatively, they may argue *a fortiori* that tribes are "states" within the meaning of Section 1002(27) of the Act and thus are co-sovereigns with whom supervision is to be coordinated, rather than against whom the Act is to be applied.

In order to resolve this inevitable dispute, courts will look to established principles of law, including those governing when federal laws of general application apply to tribes. Under the so-called *Tuscarora-Coeur d'Alene* cases, a general federal law "silent on the issue of applicability to Indian tribes will . . . apply to them" unless: "(1) the law touches 'exclusive rights of self-governance in purely intramural matters'; (2) the application of the law to the tribe would 'abrogate rights guaranteed by Indian treaties'; or (3) there is proof 'by legislative history or some other means that Congress intended [the law] not to apply to Indians on their reservation . . . .'"

Because general federal laws governing consumer financial services do not affect the internal governance of tribes or adversely affect treaty rights, courts seem likely determine that these laws apply to TLEs. This result seems consistent with the legislative objectives of the Act. Congress manifestly intended the CFPB to have comprehensive authority over providers of all kinds of financial services, with certain exceptions inapplicable to payday lending. Indeed, the "leveling of the playing field" across providers and distribution channels for financial services was a key accomplishment of the Act. Thus, the CFPB will argue, it resonates with the purpose of the Act to extend the CFPB's rulemaking and enforcement powers to tribal lenders.

This conclusion, however, is not the end of the inquiry. Since the principal enforcement powers of the CFPB are to take action against unfair, deceptive, and abusive practices (UDAAP), and assuming, arguendo, that TLEs are fair game, the CFPB may have its enforcement hands tied if the TLEs' only misconduct is usury. Although the CFPB has virtually unlimited authority to enforce federal consumer lending laws, it does not have express or even implied powers to enforce state usury laws. And payday lending itself, without more, cannot be a UDAAP, since such lending is expressly authorized by the laws of 32 states: there is simply no "deception" or "unfairness" in a somewhat more pricey financial service offered to consumers on a fully disclosed basis in accordance with a structure dictated by state law, nor is it likely that a state-authorized practice can be deemed "abusive" without some other misconduct. Congress expressly denied the CFPB authority to set interest rates, so lenders have a powerful argument that usury violations, without more, cannot be the subject of CFPB enforcement. TLEs will have a *reductio ad absurdum* argument: it simply defies logic that a state-authorized APR of 459 percent (permitted in California) is not "unfair" or "abusive," but that the higher rate of 520 percent (or somewhat more) would be "unfair" or "abusive."

Some Internet-based lenders, including TLEs, engage in specific lending practices that are authorized by no state payday-loan law and that the CFPB may ultimately assert violate pre-Act consumer laws or are "abusive" under the Act. These practices, which are by no means universal, have been alleged to include data-sharing issues, failure to give adverse action notices under Regulation B, automatic rollovers, failure to impose limits on total loan duration, and excessive use of ACH debits collections. It remains to be seen, after the CFPB has concluded its research with respect to these lenders, whether it will conclude that these practices are sufficiently harmful to consumers to be "unfair" or "abusive."

The CFPB will assert that it has the power to examine TLEs and, through the examination process, to ascertain the identity of the TLEs' financiers – whom state regulators have argued are the real parties in interest behind TLEs – and to engage in enforcement against such putative real parties. This information may be shared by the CFPB with state regulators, who may then seek to recharacterize these financiers as the "true" lenders because they have the "predominant economic interest" in the loans, and the state regulators will also be likely to engage in enforcement. As noted above, these non-tribal parties will generally not benefit from sovereign immunity.

The analysis summarized above suggests that the CFPB has examination authority even over lenders completely integrated with a tribe. Given the CFPB's announced intention to share information from examinations with state regulators, this scenario may present a chilling prospect for TLEs.

To complicate planning further for the TLEs' non-tribal collaborators, both CFPB and state regulators have alternative means of looking behind the tribal veil, including by conducting discovery of banks, lead generators and other service providers employed by TLEs. Thus, any presumption of anonymity of TLEs' financiers should be discarded. And state regulators have in the past proven entirely willing to assert civil claims against non-lender parties on conspiracy, aiding-and-abetting, facilitating, control-person or similar grounds, without suing the lender directly, and without asserting lender-recharacterization arguments.

The Future

Given the likelihood of protracted litigation regarding the CFPB's authority over TLEs, it is not unthinkable that the CFPB will assert that authority in the near future and litigate the issue to finality; the CFPB cannot be counted on to delay doing so until it has concluded its economic research with respect to payday lending (in which TLEs cannot be expected to rush to cooperate) or until litigation over the recess appointment of Director Cordray has been resolved.

TLEs, anticipating such action, will wish to consider two distinct strategic responses. On the one hand, hoping to insulate themselves from direct attacks by the CFPB under the "unfair" or "abusive" standards, TLEs might well amend their business practices to bring them into line with the requirements of federal consumer-protection laws. Many TLEs have already done so. It remains an open question whether and to what extent the CFPB may seek to employ state-law violations as a predicate for UDAAP claims.

On the other hand, hoping to buttress their immunity status against state attacks (possibly arising from shared CFPB-generated information about their relationships with tribes), TLEs might well amend their relationships with their financiers so that the tribes have real "skin in the game" rather than, where applicable, the mere right to what amounts to a small royalty on revenue.

There can be no assurance that such prophylactic steps by TLEs will serve to immunize their non-tribal business partners. As noted below with respect to the *Robinson* case, the "action" has moved on from litigation against the tribes to litigation against their financiers. Because the terms of tribal loans will remain illegal under borrower-state law, non-tribal parties who are deemed to be the "true" lenders-in-fact (or even to have conspired with, or to have aided and abetted, TLEs) may find themselves exposed to significant liability. In the past, direct civil proceedings against "true" lenders in "rent-a-bank" transactions have proven fruitful and have resulted in substantial settlements.

To be clear, state regulators do not need to join TLEs as defendants in order to make life unpleasant for TLEs' financiers in actions against such financiers. Instead, they may proceed directly against the non-tribal parties who finance, manage, aid, or abet tribal lending.

Nor does the private plaintiffs' class action bar need to include the tribal parties as defendants. In a recent example, a putative class plaintiff payday borrower commenced an action against Scott Tucker, alleging that Tucker was the alter ego of a Miami-nation affiliated tribal entity – omitting the tribal entity altogether as a party defendant. Plaintiff alleged usury under Missouri and Kansas law, state-law UDAP violations, and a RICO count. He neglected to allege that he had actually paid the usurious interest (which presumably he had not), thereby failing to assert an injury-in-fact. Accordingly, since Robinson lacked standing, the case was dismissed. *Robinson v. Tucker*, 2012 U.S. Dist. LEXIS 161887 (D. Kans. Nov. 13, 2012). Future plaintiffs are likely to be more careful about such jurisdictional niceties.

In the past, online lenders have been able to count on some degree of regulatory lassitude, as well as on regulators' (and the plaintiff bar's) inability to differentiate between lead generators and actual lenders. Under the CFPB, these factors are likely to fade.

Perhaps the prediction of the CFPB's early assertion of authority over TLEs is misplaced. Nevertheless, it is likely that the CFPB's influence over the long term will cause tribal lending and storefront lending to converge to similar business terms. Such terms may not be profitable for TLEs.

Finally, because the tribal lending model relies on continued Congressional tolerance, there remains the possibility that Congress could simply eliminate this model as an option; Congress has virtually unfettered power to vary principles of tribal sovereign immunity and has done so in the past. While such legislative action seems unlikely in the current fractious environment, a future Congress could find support from a coalition of the CFPB, businesses, and consumer groups for more limited tribal immunity.

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