



# LEGAL ISSUES AFFECTING FINANCIAL SERVICE CENTERS

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# 5 Important Legal Issues

1. “Red Flag” Rules
2. Arbitration
3. Zoning
4. Military Lending Act
5. Employee Shortages



# Red Flag Rules



# Background

- Fair and Accurate Credit Transactions Act of 2003
- The regulations require that the program to identify, detect, and respond to patterns, practices, or specific activities that could indicate identity theft

# Important Definitions

- A “**creditor**” is defined as: “any entity that regularly extends, renews, or continues credit; any entity that regularly arranges for the extension, renewal, or continuation of credit; or any assignee of an original creditor who is involved in the decision to extend, renew, or continue credit.”
- A “**covered account**” is defined as: “an account used mostly for personal, family, or household purposes, and that involves multiple payments or transactions.”
- “**Red Flag**” is defined as: “means a pattern, practice, or specific activity that indicates the possible existence of identity theft”.

# Establishment of a Written Identity Theft Program

- Applies if covered entity offering one or more covered accounts.
- Must be designed to detect, prevent, and mitigate identity theft in connection with the opening of a covered account or any existing covered account.
- Program must be appropriate to the size and complexity of the financial institution or creditor and the nature and scope of its activities

# Elements of the Program

- Program must include reasonable policies and procedures to
  - Identifying relevant red flags for covered accounts and incorporate those Red Flags into the program.
  - Detecting Red Flags that have been incorporated into the program.
  - Responding appropriately to any Red Flags that are detected to prevent and mitigate identity theft.
  - Ensuring that the program is updated periodically to reflect changes in risks to customers or the safety and soundness of the creditor from identity theft.

# Identifying Relevant Red Flags

- (1) Risk Factors
  - Types of covered accounts it offers or maintains.
  - Methods it provides to open or access its covered accounts.
  - Previous experiences with identity theft.
- (2) Sources of Red Flags
  - Incidents of identity theft that the financial institution or creditor has experienced.
  - Methods of identity theft that have been identified that reflect changes in identity theft risks.
  - Applicable supervisory guidance.

# Identifying Relevant Red Flags

- (3) Categories of Red Flags
  - Alerts, notifications, or other warnings received from consumer reporting agencies or service providers.
  - Presentation of suspicious documents.
  - Presentation of suspicious personal identifying information, such as a suspicious address change.
  - Unusual use of, or other suspicious activity related to, a covered account.
  - Notice from customers, victims of identity theft, law enforcement authorities, or other persons regarding possible identity theft in connection with covered accounts.

# What Type of Red Flags Can a FSC Expect?

- *Suspicious Documents*
  - Documents provided for identification appear to have been altered or forged
  - The photograph or physical description on the identification is not consistent with the appearance of the applicant or customer presenting the identification

# What Type of Red Flags Can a FSC Expect?

- *Suspicious Personal Identifying Information*
  - The Social Security Number has not been issued, or is listed on the Social Security Administration's Death Master File
  - Personal identifying information provided by the customer is not consistent with other personal identifying information provided by the customer. For example, there is a lack of correlation between the SSN range and date of birth
  - Personal identifying information provided is associated with known fraudulent activity as indicated by internal or third-party sources used by the financial institution or creditor
  - The SSN provided is the same as that submitted by other persons opening an account or other customers

# Detecting Relevant Red Flags

- Obtaining identifying information about, and verifying the identity of a person opening an account
- Authenticating customers, monitoring transactions, and verifying the validity of change of address requests, in the case of existing covered accounts.

# Updating the Program

- Periodic update to reflect changes in risks to customers or to the safety and soundness of the business from identity theft
- Factors to consider:
  - Experiences with identity theft
  - Changes in methods of identity theft
  - Changes in methods to detect, prevent, and mitigate identity theft
  - Changes in the types of accounts that are offered or maintained
  - Changes in the business arrangements of the financial institution or creditor, including mergers, acquisitions, alliances, joint ventures, and service provider arrangements.

# Administration of the Program

- Board approval of the initial written Program (or an appropriate committee of the board of directors)
- Board of directors, an appropriate committee, or a designated employee at the level of senior management should be involved in the oversight, development, implementation and administration of the Program.
- Staff should be trained, as necessary, to effectively implement the program.
- Review staff reports re: compliance issues
- Exercise appropriate and effective oversight of service provider arrangements



# Enforcement

A large green graphic on the left side of the slide, consisting of a vertical bar and a horizontal bar that meet at a rounded corner, forming an L-shape.

# What Do the Red Flag Rules Mean to You?

# Arbitration



# Why Arbitration?

- Advantages of arbitration: Over time, arbitration is considered:
  - Cheaper & faster than litigation
  - Prevents bad (disadvantageous) law from being made
  - Avoid reputation injury from major litigation

# Disadvantages of Arbitration

- Arbitrator's lack of expertise
- Arbitrators' reputations for splitting the baby
- Bad individual results & limited right to appeal
- May need to litigate enforceability of arbitration provision

## Two Key Questions

- Did the consumer assent to the arbitration provision?
- Is the arbitration provision unconscionable?



**Assent**

# The Unconscionability Defense

- Most common method of defeating arbitration agreements.
- Two types of unconscionability:
  1. Procedural – i.e., the process of contract formation (e.g., small print, convoluted language, inconspicuous print, lack of understanding, inequality of bargaining power etc.)
  2. Substantive – i.e., unfavorably one-sided (e.g., non-neutral arbitrators, distant forum for arbitration, restriction on arbitable claims etc.)

# Class Action Waivers

- No one knows whether any court will uphold a class action waiver provision in a payday loan agreement.
- No one knows where a class action may strike.
- A lender with a fair arbitration agreement with a class action waiver provision is a less attractive defendant than one without that contractual defensive

## Dealing with class actions in your arbitration agreement?

- Decide whether you want to exclude or include class actions – CONSULT WITH YOUR ATTORNEY!
- If you decide to exclude, you must specify prohibition against class actions in arbitration provision (otherwise, could leave in the hands of arbitrator to decide)
- Modify “Severability Clause” to nullify entire arbitration agreement if waiver found unenforceable.

## Alternatives to Class Action Waivers

- Require customer to give notice of potential claim and allow lender to cure
- Add provision that if class action waiver is challenged, validity should be determined by court
- Add provision that if court finds arbitration clause unenforceable, class action will proceed in court
- Offer customer the right to opt-out of arbitration
  - Price discount for customers who agree to arbitrate disputes

# The Small Claims Exemption

- Exclude Small Claims Court actions from the arbitration agreement
- This permits the consumer to proceed in a forum as convenient as arbitration if the consumer is truly just interested in resolving the merits of the dispute
- It also permits use of Small Claims Court for collection actions where there is no anticipated counterclaim

# Industry Experience

- Not much experience with arbitration: most collection matters in Small Claims Court.
- Response of lenders who have been in arbitration is lukewarm.
- The most important experience has been the one the industry has not had: there has been no spate of consumer class action litigation directed against payday lenders.
- There has also been no appellate case specifically holding a class action waiver provision in a payday loan agreement unenforceable

# Implementation Strategies

- made in Florida between a Florida licensee and a Florida resident.)
- Be extremely fair to the customer:
  - 1. Substantive fairness in the underlying contract
  - 2. Procedural fairness in the arbitration provision
    - a. Bilateral implementation
    - b. Uniform application
      - Give the customer the choice of arbitration provider
      - Make the arbitration forum customer-friendly
      - Be willing to pay for the consumer's initiation of arbitration

# Strategies Continued

- Making the arbitration provision conspicuous
  - a. Put it in the title of the transaction Agreement
  - b. Put it in bold type or capital letters
  - c. Make the jury trial waiver/judicial reference provision conspicuous
  - d. Have the consumer sign it separately for each transaction
    - Excluding Small Claims Court actions
    - Avoiding excessive broadness in arbitration actions (personal injury)
    - Apply state judicial ethical rules to the arbitrator (California rule)
    - Require the arbitrator to apply applicable law
    - Providing an appeal procedure
    - Offer the customer his/her choice of language
    - Discount the loan for an arbitration agreement

# Implementation Strategies

- Use FAA coverage language approved by U.S. Supreme Court in *Buckeye v. Cardegna* (546 U.S. 440 (2006)):
  - “This Arbitration Agreement is made pursuant to a transaction involving interstate commerce, and shall be governed by the Federal Arbitration Act (the “FAA”), 9 U.S.C. Sections 1-6.”
- Be extremely fair to the customer:
  - Substantive fairness in the underlying contract
  - Procedural fairness in the arbitration provision
    - Bilateral implementation
    - Uniform application
  - Give the customer the choice of arbitration provider
  - Make the arbitration forum customer-friendly
  - Be willing to pay for the consumer’s initiation of arbitration

## Implementation Strategies (cont.)

- Exclude small claims court actions
- Give consumer unfettered right to reject arbitration provision by sending a notice to the company.
- Require the arbitrator to apply applicable law
- Provide for an appeal procedure
- Offer the customer his/her choice of language
- Discount the loan for an arbitration agreement
- Making the arbitration provision conspicuous
  - Put it in the title of the transaction Agreement
  - Put it in bold type or capital letters
  - Make the jury trial waiver/judicial reference provision conspicuous
  - Have the consumer sign it separately for each transaction

# REMEMBER

- Extremely Volatile Area of the Law
- Seek advice of counsel at least annually to check on status of law
  - A court ruling can impact the enforceability of your arbitration agreement
  - Modifications to the arbitration clause may be necessary
- The costs and risks associated with operating your business are great so protect yourself.

## Zoning Issues Affecting FSCs



# Zoning Out FSCs

- Local jurisdictions across the country rely on comprehensive plans and zoning ordinances to achieve orderly community development
  - As long as zoning regulation: (1) furthers a legitimate public purpose, (2) is not unduly oppressive to private interests, and (3) is not applied in a discriminatory fashion, it will typically withstand judicial scrutiny
- The problem: Municipalities throughout the country are attempting to restrict or prohibit financial service centers from opening locations in their communities
  - Conflicting regulatory requirements
  - Reduces competition

## Myths about FSCs

- Negative impact upon property values
- Negative impact upon citizens
- Banks and credit unions servicing financial needs
- Removing money from the local economy
- Usurious fees
- Aesthetically unappealing

# Driving Forces

- Growth of the industry
- Grass roots effort by consumer groups
  - E.g., “Controlling the Growth of Payday Lending Through Local Ordinances and Resolutions: A Guide for Advocacy Groups and Government Officials” (November 2007)
- Political agenda
- Appearance of some stores
- Public misperception about the industry

# Types of Restrictions

- Temporary moratorium during study period
  - Preserve status quo while amendments are considered
  - If deemed to be protecting public health safety and general welfare, will typically be deemed to be reasonable
- Permanent moratorium
  - If terms are rationally related to danger or problem, moratorium may be used as proper exercise of municipal power
  - grandfather or phase out existing operators
- Limit on density or distance
- Special zoning districts
- Special/conditional use permits
- Substantive restrictions on loan terms
  - caps on fees, minimum terms, APR caps, distance restrictions, store appearance, public safety, signage, etc.

# Industry Response

- Preemption of substantive regulation of loan terms
  - A local municipality may not regulate the terms or conditions of any lawful financial transaction between a consumer and regulated business
- Need to find out about it early and get active early in the process
- Identify driving force:
  - What exactly is the municipality trying to accomplish?
  - Who is the target? Payday lenders vs. check cashers vs. liquor stores?
  - Store visits and local contacts

# What Can Industry Live With?

- Reasonable aesthetic standards
- Reasonable safety standards
- Distance requirement coupled with variance or special use permit process for exceptions
- Can't live with:
  - Local regulation of terms of the transaction
  - Permanent moratoriums on new businesses
  - Permanent caps on the number or ratio of businesses to population

# Military Lending Act- 1 Year later



# Military Lending Act – 1 Year Later

- Restriction of credit options to military
- Baseline for Federal and State legislation
- FDIC Small Dollar Loan Pilot Program
- State regulators misinterpreting requirements

## General Overview

- 36% cap on payday loans, vehicle title loans and refund anticipation loans
- Prohibits extension of consumer credit to a covered borrower, including spouse and dependents



# Covered Borrower Identification Statement – Safe Harbor Provision

- Most important aspect of Military Lending Act
- Safe harbor process for identifying service member and their dependents.
- Must obtain a signed statement from credit applicants declaring whether or not they are covered borrowers.
- Protects against inadvertent violation.
- For creditors providing consumer credit via the Internet, they can obtain an electronic signature that complies with the E-SIGN Act.

# Caveat to Safe Harbor Provision

- Inconsistency between signed declaration and documentation provided by borrower as part of the credit transaction
  - e.g., a current military leave and earning statement as proof of employment or military ID Lenders should seek to resolve the inconsistency
- Lenders should seek to resolve the inconsistency
- If unable to resolve:
  - treat the applicant as a covered borrower, or
  - decline to extend credit due to the inability to verify.

# Verification of Applicant Status Via Military Database

- If an applicant claims to be a covered borrower without presenting proof of status, further validation is not required
- Creditors have the option of verifying an applicant's status as a covered borrower by either requesting the applicant to provide a current military leave and earning statement or a military identification card.
- [www.dmdc.osd.mil/mla/owa/home](http://www.dmdc.osd.mil/mla/owa/home)
  - Use to verify the status of covered borrowers
  - use to resolve questions or inconsistencies

## Limitation on Marital Status Inquiry

- Equal Credit Opportunity Act (Regulation B) prohibits marital status inquiry as part of consideration of a credit application.
- Employees cannot ask, either orally or in writing, an applicant if they are married.
- Must rely on the borrower's representation in the Covered Borrower Identification Statement.

# Adverse Action Notices

- The ECOA and Regulation B require creditors to notify applicants of adverse actions taken in connection with an application for credit.
- If a an application submitted by a covered borrower is denied, a notice of adverse action taken must be provided within specified time frames and in specified forms mandated by Regulation B.

# Handling Employee Shortages



# The Problem of Cash Shortages

- Cash shortages have direct effect on a FSCs profitability
- Can an operator recover amount of shortages from the employee?
  - Assumption is that you can, but depending on the state an employer may be severely restricted or even prohibited from withholding wages to set-off against cash shortages.

# Rights to Recovery

- Federal Law: Fair Labor Standards Act
  - Permits employee deductions unless otherwise prohibited or limited under state law
  - cannot reduce the employee's wages below minimum wage.
- State Laws
  - Varies by State

# Examples of State Laws

- California
  - Labor Code Sections 221 and 224 define the only instances in which an employer may withhold wages.
  - The courts have held that the ability of an employer to deduct wages from an employee's wages due to cash shortage is regulated by Industrial Welfare Commission Orders.
  - Industrial Welfare Commission Order No. 14-2001(8) provides:
    - “Cash Shortage and Breakage. No employer shall make any deduction from the wage or require any reimbursement from an employee for any cash shortage . . . unless it can be shown that the shortage . . . is caused by a dishonest or willful act, or by the gross negligence of the employee.”
  - Experience has shown that the Labor Commission interprets gross negligence at a “willful” standard.

# Examples of State Laws

- New York
  - NY Labor Code Section 193 prohibits deductions for cash shortages.
  - NY Labor Administrative Rules, 12 NYCRR 142-2.10, also prohibits deductions for cash shortages.

# Examples of State Laws

- Arizona

- Employer cannot withhold unless there is a reasonable good faith dispute as to the amount of wages due, including the amount of any counterclaim or any claim of debt, reimbursement, recoupment or set-off asserted by the employer against the employee.
- Reasonable deductions permitted (not in excess of 25% of net wages) from single paycheck if agreed to by prior written agreement
- If worker quits because of deduction he is deemed to have done so without good cause
- Without prior agreement, good cause depends on reasonableness of employer's actions

# Examples of State Laws

- Indiana

- A wage deduction constitutes an assignment of wages. IC 22-2-6-1
- Any wage assignment must be (i) in writing, (ii) signed by the employee, (iii) revocable, and (iv) agreed in writing by the employer. IC 22-2-6-2.
- Only items listed in statute may be subject to wage assignment. Shortages are not included.
- Some have used IC 22-2-6-2(b)(7), which provides for payment of a loan made to the employee, to recover from employee.