

# Client Alert

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## Where Are We Now: A Look at the EFTA's Prohibition of Compulsory Payments of Loans by Electronic Fund Transfers

Although the Electronic Funds Transfer Act (the EFTA) has been on the books for almost 40 years, seemingly without significant controversy, it is now garnering increased attention due to the proposed examination guidance recently issued by the Federal Deposit Insurance Corporation (FDIC).<sup>1</sup> The examination guidance proposed increase scrutiny on financial institutions that conduct lending operations using third-party lenders to originate or secure funding for loans. FDIC-regulated financial institutions will soon be held responsible for ensuring third-party lender compliance with federal regulations, as well as monitoring and controlling the risks associated with the transaction. According to the proposed guidance, a financial institution's "board of directors and senior management are ultimately responsible for managing third-party lending arrangements as if the activity were handled within the institution." Thus, the financial institution should conduct due diligence reviews on the policies and procedures of each third-party lender and monitor ongoing compliance with consumer protection laws. Failure to do so may result in the financial institution's being held accountable as if it were individually responsible for any violations. In light of the proposed examination guidance, the EFTA deserves special consideration during the loan origination process.

### Brief Background of the EFTA Prohibition on Compulsory Use of Electronic Fund Transfers

The EFTA was enacted by Congress in 1978 and implemented by Regulation E to provide a "basic framework establishing the rights, liabilities, and responsibilities of participants in electronic banking." Section 1693k of the EFTA states, "[n]o person may condition the extension of credit to a consumer on such consumer's repayment by means of preauthorized electronic fund transfers ...."<sup>2</sup> The EFTA defines a preauthorized transfer as "an electronic fund transfer authorized in advance to recur at substantially regular intervals."<sup>3</sup> This prohibition of compulsory electronic fund transfers was imposed to "protect consumers who arrange for regular payments [...] to be deducted automatically from their bank accounts."<sup>4</sup>

### Remedies

Lenders who are found to violate the EFTA by conditioning an extension of credit on borrowers' use of electronic fund transfers are subject to both actual and statutory damages under the EFTA.<sup>5</sup> Actual

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<sup>1</sup> FDIC, FIL-50-2016, Proposed Examination Guidance for Third-Party Lending, (July 29, 2016) (available at: <https://www.fdic.gov/news/news/financial/2016/fil16050a.pdf>).

<sup>2</sup> 15 U.S.C.A. § 1693k(1); see also 12 C.F.R. § 1005.10.

<sup>3</sup> 15 U.S.C. § 1693a(9).

<sup>4</sup> *Okocha v. HSBC Bank USA, N.A.*, 2010 WL 5122614, at \*2 (S.D.N.Y. Dec. 14, 2010).

<sup>5</sup> As a result of the Supreme Court's decision in *Spokeo, Inc. v. Robins*, \_\_\_ U.S. \_\_\_, 136 S.Ct. 1540 (2016), courts have been required to address certain jurisdictional issues relating to whether a plaintiff is required to incur an injury in fact before having standing and bringing a claim under the EFTA. See *De la Torre v. CashCall, Inc.*, No. 08-CV-03174-MEJ, 2016 WL 6892693, at \*2 (N.D. Cal. Nov. 23, 2016) (holding that in light of the recent *Spokeo*

damages under the EFTA require proof that the damages were incurred as a result of the violation.<sup>6</sup> Additionally, individual actions may result in statutory damages between \$100 and \$1,000, while class actions may result in statutory damages in the amount of the lesser of \$500,000 or 1 per centum of the net worth of the defendant.<sup>7</sup> In the case of a successful EFTA action, the lender may also be liable for attorney's fees and court costs.<sup>8</sup> Lenders may avoid liability by showing that any violation was unintentional and resulted from a bona fide error, or that any act was done in good faith compliance with a rule, regulation or official interpretation.

### Cases Interpreting the EFTA

Although not visited in depth often, a few cases have interpreted the EFTA's prohibition on compulsory electronic fund transfers. Facially, the EFTA's prohibition on compulsory use of electronic fund transfers seems clear, however, since the use of electronic fund transfers decreases the risk of loan default, certain lenders have tested the limits of the prohibition.

After considering the totality of the circumstances, multiple lenders have been found to violate the EFTA by incorporating into their loan agreements various "check the box" provisions or the ability to discontinue electronic fund transfers. For example, in *De La Torre v. CashCall*, potential borrowers were required during the loan application process to check a box authorizing the lender to initiate payment by electronic fund transfer.<sup>9</sup> The application presented repayment by electronic fund transfers as the only option available, and potential borrowers who did not check the box could not obtain a loan from the lender. The loan agreement further included a clause that authorized the lender to schedule payment withdrawals on or about the first day of each month but gave borrowers the right to cancel the electronic fund transfers at any time, including prior to the first payment.

The court held that the process described in *De La Torre v. CashCall* was a clear example of a lender's conditioning the extension of credit on the borrowers' consent to having payments withdrawn from their bank accounts by electronic fund transfer. Even though the terms of the agreements allowed the borrowers to cancel the electronic fund transfers prior to making the first payment in order to pay by other means, the court concluded that the electronic fund transfers authorization was still a condition to obtaining the funds. The court reasoned that violation of Section 1693k "occurs at the moment of conditioning — that is, the moment the creditor requires a consumer to authorize electronic fund transfers as a condition of extending credit to the consumer."<sup>10</sup> Accordingly, the court found that these agreements violated the EFTA.<sup>11</sup>

Another example is *F.T.C. v. PayDay Financial*, in which the lender implemented a similar program that allowed borrowers to revoke consent for the electronic fund transfers "at any time (including prior to [the] first payment due date) by sending written notification."<sup>12</sup> The lender argued that borrowers could "infer from the language that, if the electronic fund transfers can be revoked prior to the first payment due date, then the loan was not conditioned on agreement to the electronic fund transfers clause."<sup>13</sup> The court

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decision, a congressionally defined intangible injury is concrete and sufficient to establish Article III standing). While the issue of standing is of critical importance, the impact of *Spokeo* on the EFTA is beyond the scope of this article.

<sup>6</sup> 15 U.S.C. § 1693m(a)(a).

<sup>7</sup> 15 U.S.C. § 1693m(a)(2)(B).

<sup>8</sup> 15 U.S.C.A. § 1693m(3).

<sup>9</sup> *De La Torre v. CashCall, Inc.*, 56 F. Supp. 3d 1073 (N.D. Cal. 2014), on reconsideration, 56 F. Supp. 3d 1105 (N.D. Cal. 2014), judgment entered, 2014 WL 7277377 (N.D. Cal. 2014).

<sup>10</sup> *Id.* at 1089.

<sup>11</sup> *De La Torre v. CashCall* is further significant as it is the first instance of a court's applying the civil damages provisions for a Section 1693k violation in the EFTA's 37-year history. The court ordered the defendant to pay \$500,000 in statutory penalties. The award could have been even higher, but the borrowers failed to prove they suffered any actual damages as a result of the violation.

<sup>12</sup> *F.T.C. v. PayDay Fin. LLC*, 989 F. Supp. 2d 799, 812 (D.S.D. 2013).

<sup>13</sup> *Id.*

quickly rejected this argument, and relied instead on evidence that the lender never issued a loan without the consumer's agreement to repayment by electronic fund transfers. This evidence, coupled with the lack of language "expressly stating that the extension of credit was not conditioned" on repayment by electronic fund transfer, supported the finding that the lender violated Section 1693k of the EFTA.<sup>14</sup>

Another example is *Mitchum v. GFG*, in which the court declined to dismiss EFTA claims brought by plaintiffs who had obtained loans secured by postdated checks.<sup>15</sup> In *Mitchum*, the loan agreement had a paragraph authorizing the lender of two-week, closed-end loans to effect payments from the borrower's bank account as such amount became due. The agreement also contained blank spaces for borrowers to identify their bank and a check number to secure payment of the loan. The court held that because the lender could obtain the bank account number from the borrower's postdated checks, the extension of credit could still be interpreted as conditioned on the preauthorized electronic funds transfer.<sup>16</sup> Moreover, the court held that loans repaid by electronic fund transfers are subject to the EFTA, even if the loans themselves were originated and secured by checks. Finally, the court held that because the two-week loans could be rolled over three times, the debits would qualify as "recurring" under the EFTA.

The question arises, however, as to what guidance has been provided to assist lenders who wish to be paid by electronic fund transfers to comply with the EFTA. The supplement to Regulation E notes that the regulatory agencies consider programs to comply with the EFTA if the lender offers to consumers a "reduced annual percentage rate or other cost-related incentive for an automatic repayment feature, provided the program with the automatic payment feature is not the only loan program offered by the creditor for the type of credit involved."<sup>17</sup> Based on this guidance, a lender who provides multiple loan programs alongside a program that includes a pre-authorized electronic funds agreement with a cost-related incentive would be in compliance with the EFTA. Finally, in perhaps the only case in which a court has declined to find a violation of Section 1693k, a Pennsylvania court held that incentivizing payment by promising to provide loan funds by direct deposit sooner than those provided by mail is not a violation of the EFTA's prohibition against compulsory electronic fund transfers.<sup>18</sup>

## Conclusion

Litigation surrounding Section 1693k of the EFTA has historically been infrequent. However, as a result of the recent FDIC examination guidance, regulatory scrutiny of FDIC-regulated financial institutions and their third-party lender partners will be enhanced. Thus, financial institutions and their third-party lending partners should consider their compliance with the EFTA. Due to the lack of substantive judicial interpretation surrounding the EFTA, there is uncertainty concerning what is permissible. The cases that do survive the early stages of litigation make it clear that courts will go to great lengths to support the congressional intent behind the enactment of the EFTA, which is to protect consumers' rights when entering into a loan agreement. Now that financial institutions may be held responsible for violations caused by third-party lenders during the origination process, both the financial institution and the third-party lenders should be particularly diligent with regard to electronic fund transfers' use, to avoid regulatory inquiries, costly litigation, damages and statutory penalties.

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<sup>14</sup> *Id.* at 813.

<sup>15</sup> *Mitchum v. GFG Loan Co.*, No. 99 C 1866, 2000 WL 294119, at \*8 (N.D. Ill. Mar. 17, 2000).

<sup>16</sup> *Id.*

<sup>17</sup> 12 CFR Pt. 1005, Supp. I, 10(e)(1).

<sup>18</sup> *Commonwealth of Pennsylvania v. Think Fin., Inc.*, No. 14-CV-7139, 2016 WL 183289, at \*25 (E.D. Pa. Jan. 14, 2016).

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