

# MODERN DAY LOAN SHARKING: DEFERRED PRESENTMENT TRANSACTIONS & THE NEED FOR REGULATION<sup>1</sup>

## I. INTRODUCTION

Throughout the nation, modern day "loan sharks" are making short-term loans at usurious interest rates to consumers under the guise of various "deferred presentment transactions."<sup>2</sup> The legal issue is whether these "deferred presentment transactions" are check cashing services or short-term loans.<sup>3</sup> This Note argues that under the "substance over form" rule, such transactions are in substance, and in fact, short-term loans disguised as "check cashing services" in an attempt to evade state usury laws and the federal Truth In Lending Act ("TILA").<sup>4</sup>

Part Two of this Note discusses three broad scenarios involved in deferred presentment transactions: (1) Same Fee, (2) Greater Fee and (3) Catalog Sales.<sup>5</sup> In each scenario, a customer writes a check that the check casher agrees to hold for a certain period of time (usually until the customer's next payday).<sup>6</sup> The customer immediately receives cash in an amount less than

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1. The idea for this Note came from Gene A. Marsh, B.S., M.S., J.D., Professor at the University of Alabama School of Law and his presentation to The Conference on Consumer Finance Law, Consumer Litigation and Debt Collection (October 1998); Gene A. Marsh, *One-Stop Shopping: Postdated Check Payday Loans, Catalog Sales and Auto Title Pawns* (unpublished manuscript, on file with the *Alabama Law Review*).

2. Jean Ann Fox, *Preliminary Report of Director of Consumer Protection: What Does It Take to be a Loan Shark in 1998? A Report on the Payday Loan Industry*, CONSUMER FED'N OF AM., Mar. 1998, at 989-93; *Special Issue: Check Cashers, Pay Day Loans and Pawns*, 16 NCLC REPORTS, CONSUMER CREDIT & USURY EDITION 13-15 (1998) [hereinafter *Special Issue*].

3. *Lender or Check Cashing Service? It Makes a Difference*, THE UNIFORM COMMERCIAL CODE LAW LETTER 8 (1998).

4. *Id.*; see 15 U.S.C. § 1601 (1994).

5. Defendants' Answer at 2-3, *Alabama Check Cashers Ass'n v. State Banking Dep't*, No. CV-98-1555 (Cir. Ct. Ala. filed July 1, 1998).

6. Defendants' Answer at 2-3, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

the face value of the check. At the end of the agreed upon period of time (typically fourteen or fifteen days), the customer has three options: (1) redeem his check by paying cash in the amount of the face value of the check; (2) "rollover" the loan and further defer payment for another (fourteen-day) period by paying an additional "fee;" or (3) do nothing and allow the check casher to cash the check.<sup>7</sup> In catalog sales transactions, the customer must purchase a "merchandise coupon" or "gift certificate" in order to cash his or her check.<sup>8</sup> To use the coupon, the customer must return to the check casher, who then assesses additional charges that the consumer would not have incurred had he or she purchased the goods directly from the merchant.<sup>9</sup>

Part Three discusses the background and causes of current deferred presentment schemes. Modern check cashing scams are variations of similar schemes struck down by courts in the early Twentieth Century.<sup>10</sup> These current schemes have arisen in response to lower income consumers' lack of access to traditional banking services and in response to short-term cash flow problems common to millions of low and modest income consumers nationwide.<sup>11</sup>

Part Four discusses the legal issue of whether deferred presentment transactions are short-term loans. Legal arguments focus on the definition of "loan" and "interest" and the technicalities of "negotiable instruments" under the Uniform Commercial Code ("U.C.C.").<sup>12</sup> State regulators and consumer-debtors argue that deferred presentment transactions are in actuality short-term loans for which check cashers receive "interest" at rates far in excess of usury laws, despite the "form" of the transaction.<sup>13</sup> On the contrary, check cashers argue that such transactions are merely check cashing services, in exchange for a "fee," governed

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7. *Id.*

8. *Id.*

9. *Id.*

10. Marsh, *supra* note 1, at 6; see Glover v. Buchman, 104 S.W.2d 66 (Tex. Civ. App. 1937).

11. *Special Issue, supra* note 2.

12. See Hamilton v. York, 987 F. Supp. 953, 956 (E.D. Ky. 1997); Decl. Rul., Mich. Dep't of Commerce Fin. Inst. Bureau (Apr. 25, 1995).

13. Defendants' Brief at 2-3, Alabama Check Cashers Ass'n v. State Banking Dep't, No. CV-98-1555 (Cir. Ct. Ala. filed July 1, 1998); Hamilton, 987 F. Supp. at 956.

and authorized by U.C.C. Article Three, which allows checks to be negotiated within a "reasonable time."<sup>14</sup>

This Note focuses on deferred presentment transactions in the state of Alabama and current cases involving regulation of the check cashing industry in Alabama. Part Five discusses the present status of Alabama law, *Alabama Check Cashers Ass'n v. State Banking Department*,<sup>15</sup> which involves the ability of the State to regulate check cashers under the Alabama Small Loan Act,<sup>16</sup> and recent cases on point from other jurisdictions.<sup>17</sup>

Part Six gives a nationwide overview of state regulation of deferred presentment transactions. At present, states have taken one of three approaches to the regulation of check cashing services: (1) payday loan laws that explicitly authorize and regulate payday loans, (2) prohibition of payday lending through small loans and check cashing laws, and (3) no regulation (allowing payday loans by omission).<sup>18</sup>

Part Seven discusses the legal and practical effects of deferred presentment transactions and offers recommendations for effective regulation of the check cashing industry. In short, the legal effect of allowing deferred presentment transactions to continue unregulated effectively nullifies usury laws, TILA, and Articles Three and Four of the U.C.C.<sup>19</sup> On a practical level, these short-term lenders prey upon less-sophisticated consumers, sending many into an unending cycle of indebtedness<sup>20</sup> and contributing to record-high levels of personal bankruptcy in the United States.<sup>21</sup> States should ban payday lending, or at least explicitly regulate this type of loan under state small loan laws

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14. Complaint at 5-6, *Alabama Check Cashers Ass'n v. State Banking Dep't*, No. CV-98-1555 (Cir. Ct. Ala. filed July 1, 1998); *Hamilton*, 987 F. Supp. at 956.

15. No. CV-98-1555 (Cir. Ct. Ala. filed July 1, 1998).

16. *Alabama Check Cashers Ass'n*, No. CV-98-1555.

17. *Hamilton*, 987 F. Supp. at 953; *In re Miller*, 215 B.R. 970 (Bankr. E.D. Ky. 1997); *In re Brigance*, 219 B.R. 486 (Bankr. W.D. Tenn. 1998), *aff'd* by Cash in a Flash v. Brown, 229 B.R. 739 (W.D. Tenn. 1999), and *aff'd* by *In re Brigance*, 234 B.R. 401 (W.D. Tenn. 1999); *Commonwealth v. Bar D Fin. Servs.*, 1994 WL 1031102 (Cir. Ct. Va. Mar. 21, 1994).

18. Fox, *supra* note 2, at 993.

19. Defendants' Brief at 11, *Alabama Check Cashers Ass'n* (No. CV-98-1555); *Hamilton*, 987 F. Supp. at 956.

20. *Special Issue*, *supra* note 2.

21. Rodney Ho, *Fees of Quick-Cash Chains Draw Scrutiny*, WALL ST. J., June 10, 1997, at B1.

and require disclosure compliant with TILA.<sup>22</sup> In addition, the public must be educated about the costs of these loans, and reasonably-priced credit alternatives must be made available to low-income households.<sup>23</sup>

## II. DEFERRED PRESENTMENT SCENARIOS

Deferred presentment check cashing transactions go by a variety of names: "payday loans," "cash advance loans," "check advance loans," "post-dated check loans" or "delayed deposit check loans."<sup>24</sup> Three broad types of deferred presentment scenarios exist in the check cashing industry: (1) Same Fee, (2) Greater Fee and (3) Catalog Sales.<sup>25</sup> In each scenario, the fee charged exceeds the interest rate limitation on small loans,<sup>26</sup> with effective annual percentage rates ranging from 261% to 1826%.<sup>27</sup> The deferral period is typically fourteen to fifteen days, corresponding with the customer's next payday.<sup>28</sup> Implicit in the agreement to defer negotiating the check is the understanding that the customer's check is "worthless" until then.<sup>29</sup> These scenarios are separate and distinct from "traditional" or "simple" check cashing services that are not at issue.<sup>30</sup>

Traditional check cashing services typically involve cashing third-party checks (usually the customer's paycheck or government benefits check) for a set fee, usually a percentage of the amount of the check.<sup>31</sup> Customers of these services typically have no bank account and, thus, no way to cash the check other than with the bank on which the check was written.<sup>32</sup> Simple check cashing does not involve delayed presentment.<sup>33</sup>

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22. Fox, *supra* note 2, at 994.

23. *Special Issue, supra* note 2, at 16.

24. Fox, *supra* note 2, at 989.

25. Defendants' Answer at 2-3, *Alabama Check Cashers Ass'n* (No. CV-98-1555); Marsh, *supra* note 1.

26. *Id.*; see also ALA. CODE § 5-18-15(a) (1975).

27. Fox, *supra* note 2, at 989.

28. Defendants' Answer at 2-3, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

29. Marsh, *supra* note 1, at 1. The check may or may not be post dated. *Id.*

30. *Id.*

31. Defendants' Answer at 1, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

32. Marsh, *supra* note 1, at 1.

33. *Id.*

First, under the Same Fee (or Flat Fee) scenario, the check casher cashes the consumer's check but agrees to delay deposit of the check until an agreed upon date.<sup>34</sup> The fee is typically a percentage of the face amount of the check (e.g., \$20 per \$100) and is the same whether the transaction is "simple" check cashing or "deferred."<sup>35</sup>

Second, under the Greater Fee (or Service Charge) scenario, the check casher cashes the consumer's check and agrees to delay deposit of the check until an agreed upon date.<sup>36</sup> The check casher charges a greater fee, either a flat fee or a percentage of the face amount of the check, in addition to the "flat fee" charged for "simple" check cashing transactions.<sup>37</sup> When a customer "rolls over" the transaction, this same fee is assessed for each subsequent deferral period.<sup>38</sup>

For example, consider the case of Janet Delaney, a \$16,000-a-year hospital food service worker who needed \$200 to pay her bills.<sup>39</sup> She wrote a check she couldn't cover to a check casher who gave her \$200 on the spot and agreed not to cash the check until her next payday for a \$38 fee.<sup>40</sup> On her next payday, Ms. Delaney did not have \$200 to pay the check casher, so she paid the payday lender another \$38 to defer payment another two weeks.<sup>41</sup> A year later, she had paid \$1220 in fees and still owed \$200.<sup>42</sup> Over a twelve month period, Ms. Delaney paid 610% interest, returning to the payday lender thirty-two times and borrowing from two other payday lenders just to make the fee payments.<sup>43</sup>

Third, under the Catalog Sales scenario, the check casher cashes the consumer's check and defers presentment of the consumer's check until an agreed upon date in consideration for

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34. Defendants' Answer at 2-3, *Alabama Check Cashers Ass'n* (No. CV-98-1555); Complaint at 5-6, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

35. Defendants' Answer at 2-3, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

36. *Id.*

37. *Id.*

38. *Id.*

39. John Hendren, *More states allow triple-digit loan rates*, TUSCALOOSA NEWS, Jan. 10, 1999, at 6B.

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

the customer "purchasing" a "gift certificate" (or merchandise coupon) to purchase items from a catalog.<sup>44</sup> The amount of the gift certificate is based on a percentage of the check amount (e.g., \$25 per \$100).<sup>45</sup> No other fee is charged at that time; however, the consumer must return to the check casher to redeem the gift certificate.<sup>46</sup> When the consumer's catalog order is placed, the check casher assesses additional fees (shipping and handling (as much as 10%), mark-up (as much as 33%),<sup>47</sup> and sales tax), which the check casher would not receive if the consumer purchased items directly from the catalog wholesaler.<sup>48</sup> "All customers of this type of check casher write checks over the amount of the gift certificate" (e.g., a consumer writes a check for \$125 and receives \$100 cash and a \$25 gift certificate).<sup>49</sup> Many of these "gift certificates" are never redeemed, in which case the check casher keeps their full value.<sup>50</sup> It is important to note that check cashers offering "catalog sales" do not advertise merchandise for sale, but they market their services by advertising "cash till payday."<sup>51</sup>

A related scenario involves automobile title pawns.<sup>52</sup> The pawn scenario is much like the Catalog Sales scenario, but instead of a "gift certificate," the consumer is required to purchase a "discount title voucher" that can be used for thirty days interest-free title pawn at the check casher's business.<sup>53</sup> Again, the discount voucher is based on the amount of the check cashed (\$25 per \$100 check), and presentment of the consumer's check is deferred for the agreed upon period.<sup>54</sup>

At the end of the deferral period, the consumer has three options: (1) redeem the check; (2) "roll over" the loan; or (3) al-

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44. Defendants' Answer at 2-3, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

45. *Id.*

46. *Id.*

47. Marsh, *supra* note 1, at 2.

48. Defendants' Answer at 3, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

49. *Id.*

50. Defendants' Brief at 11, *Alabama Check Cashers Ass'n v. State Banking Dept.*, No. CV-98-1555 (Cir. Ct. Ala. filed July 1, 1998).

51. Defendants' Answer at 3, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

52. *Special Issue, supra* note 2, at 15; Marsh, *supra* note 1, at 2.

53. Marsh, *supra* note 1, at 2.

54. Defendants' Answer at 3, *Alabama Check Cashers Ass'n* (No. CV-98-1555). Effective annual interest rates can exceed 900%. *Special Issue, supra* note 2, at 15.

low the check casher to cash the check.<sup>55</sup> Under the first option, the customer may redeem his or her check by paying the check casher cash in the amount of the check's face value.<sup>56</sup> Under the second option, the customer "rolls over" his or her loan, typically by writing a new check, and presentment is further deferred for an additional agreed upon period.<sup>57</sup> The check casher charges the customer an additional "fee" for each "rollover" transaction.<sup>58</sup> Under the third option, the customer simply does nothing and allows the check casher to present his or her check for payment.<sup>59</sup> If the customer's check bounces upon presentment by the check casher, the customer faces the threat of possible criminal penalties and treble damages under state bad check laws.<sup>60</sup> Check cashers often "place a 'hold' on the customer's checking account to enforce collection."<sup>61</sup> Payday lenders use the "threat of jail just as a loan shark might have used the threat of physical violence."<sup>62</sup>

### III. BACKGROUND AND CAUSES OF CURRENT DEFERRED PRESENTMENT TRANSACTIONS

"Payday lending" is one of our nation's fastest growing industries,<sup>63</sup> yet it is simply a modern day version of consumer abuses practiced at the beginning of the Twentieth Century.<sup>64</sup> "The typical 'loan shark' deal was a loan for \$5 on a Monday, repayable on Friday (pay day) for \$6. Ignoring compounding, this is an annual interest rate of 1040%. Those terms are typical of today's cash advance or pay day loan."<sup>65</sup> Payday lenders typi-

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55. Defendants' Answer at 2, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

56. *Id.*

57. *Id.* One Kentucky consumer who "rolled over" loans borrowed \$150 and paid over \$1000 in fees over a six month period, without paying down the principal, before declaring bankruptcy. Fox, *supra* note 2, at 990.

58. Defendants' Answer at 3, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

59. *Id.*

60. Hendren, *supra* note 39, at 6B.

61. Defendants' Brief at 2, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

62. Hendren, *supra* note 39.

63. *Id.*

64. Fox, *supra* note 2, at 990; Marsh, *supra* note 1, at 6.

65. Fox, *supra* note 2, at 990 (citing NATIONAL CONSUMER LAW CTR., THE COST OF CREDIT: REGULATION AND LEGAL CHALLENGES 38 (1995)).

cally lend smaller sums than loan sharks (\$100 to \$500), but charge interest rates that "would have made the Gambino family blush."<sup>66</sup> Similarly, the catalog sales scenario is "a 1990's version of a 1930's scam that was struck down by courts in Texas, Alabama, and elsewhere as a not-very-well disguised attempt to extract usurious interest."<sup>67</sup>

The explosive growth of payday loans can be attributed to deregulation of the banking industry, the absence of traditional small loan providers from the small-sum, short-term credit market, and the elimination of interest rate caps.<sup>68</sup> Deregulation of banking in the 1980s prompted banks to eliminate money-losing services, such as small balance bank accounts and free checking accounts, leaving millions of low-income households with no access to free financial services.<sup>69</sup> Payday lenders filled the void in the small loan market left by traditional small loan providers (mainstream institutions and national finance companies) who have moved out of this market due to higher returns on larger loans.<sup>70</sup> Even with the use of checking account overdraft loans and credit cards, a large number of consumers lack sufficient credit card limits or bank overdraft protection to meet their needs for small unsecured loans.<sup>71</sup> At the same time, "the elimination of interest rate caps" attracted payday lenders who "could

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66. Hendren, *supra* note 39. Lenders linked with the Gambino family Mafia charged three to five percent per week for illegal loans made through a check cashing office. *Id.* While payday lenders argue that their charges are "fees" rather than "interest," there was no question that amounts charged by the Gambino family check cashers were interest. *Id.*

67. Marsh, *supra* note 1, at 6; Glover v. Buchman, 104 S.W.2d 66 (Tex. Civ. App. 1937). In *Willis v. Buchman*, the Alabama Court of Appeals found the use of "merchandise coupons" to be a "technically elegant scheme" of subterfuge for evading laws against usury. 199 So. 886, 892 (Ala. App. 1940) *rev'd*, 199 So. 892 (Ala. 1940) (for mootness). The court addressed the subterfuge of requiring borrowers to purchase a "merchandise coupon":

Transactions cast in the form of sales of property to the borrower at more than its market value, imposed as conditions precedent to granting loans, have been held to be subterfuges to evade usury laws. A variation of this device is the practice of requiring the borrower to accept as part of the proceeds of the loan a merchandise coupon.

*Id.* at 891 (citing HUBACHEK'S ANNOTATION ON SMALL LOANS 164 (1938)).

68. *Special Issue, supra* note 2.

69. *Id.* at 13.

70. *Id.* at 14.

71. *Id.*

charge interest rates as high as they wished in several states."<sup>72</sup>

#### IV. THE LEGAL ISSUE: SHORT-TERM LOAN OR CHECK CASHING SERVICE

This issue is "a legal gray area of conflicting definitions of check cashing and small loans."<sup>73</sup> Under the "substance over form" rule, state regulators and consumer-debtors argue that charges received by check cashers are "interest," thus subjecting deferred presentment check cashing transactions to regulation under state small loan acts and TILA.<sup>74</sup> On the other hand, check cashers argue that amounts received are "fees" for services provided, not "interest," such that deferred presentment check cashing transactions are not subject to state regulation.<sup>75</sup>

Under the "substance over form" rule,<sup>76</sup> deferred presentment check cashing transactions constitute loans—advancements of money for a period of time—and charges associated with the use of money are in effect "interest." *Black's Law Dictionary* defines a loan as "delivery by one party to and receipt by another party of a sum of money upon agreement, express or implied, to repay it with or without interest."<sup>77</sup> Interest is defined as the "costs of using funds of another."<sup>78</sup> A check cashing

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72. *Id.*

73. Fox, *supra* note 2, at 989.

74. Defendants' Brief at 2-3, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

75. Complaint at 5-6, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

76. *Cochran v. State*, 119 So. 2d 339 (Ala. 1960) (affirming the collection of exorbitant insurance premiums as attempting to evade Alabama's laws against usury).

In determining whether a contract is usurious the substance of the transaction will be critically examined, for the name by which the transaction is called is wholly immaterial where it appears that its foundation was the loan of money; . . . the law intends that a search for usury shall penetrate to the substance.

*Cochran*, 119 So. 2d at 343. "Whatever thing of benefit comes to the lender as compensation for the use of money is interest, no matter what name it may be given or what expedients may be adopted to conceal the fact that the benefit received is, in essence, compensation for the use of the money." *Willis v. Buchman*, 199 So. 886, 890 (Ala. App.), *rev'd*, 199 So. 892 (Ala. 1940) (for mootness) (citing HUBACHER'S ANNOTATION ON SMALL LOANS, *supra* note 67, at 47).

77. BLACK'S LAW DICTIONARY 936 (6th ed. 1990).

78. *Id.* at 812.

transaction becomes a loan when both parties explicitly agree to defer presentment of the check for a period of time.<sup>79</sup> State regulators and consumer-debtors contend that any arguments made under the U.C.C. are irrelevant because "deferred presentment check cashing transactions are in substance and in fact loans."<sup>80</sup> Even if the form of the check is flawless, check cashers intend to exact charges for the use of money; thus the substance of the transaction is a loan.<sup>81</sup>

As loans, deferred presentment check cashing transactions are subject to licensing and other requirements of state small loan acts as well as to TILA disclosure requirements.<sup>82</sup> The fees associated with these transactions are usurious when they exceed small loan limits.<sup>83</sup>

Conversely, check cashers argue that a deferred presentment transaction is not a loan because the definition of a loan is not met: (1) No promissory note is signed, and no interest is charged (characterizing their charges as "service fees"),<sup>84</sup> and (2) a customer of a check cashing business has already tendered payment for the funds received by the giving of the check.<sup>85</sup>

Check cashers contend that a check meets all of the requirements of the definition of a negotiable instrument,<sup>86</sup> therefore, check cashing transactions are governed by Article Three of the U.C.C., not state small loan laws or TILA.<sup>87</sup> The U.C.C. does

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79. Defendants' Brief at 8, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

80. *Id.* at 6.

81. *Id.*

82. *Lender or Check Cashing Service? It Makes a Difference*, *supra* note 3.

83. Defendants' Brief at 8, *Alabama Check Cashers Ass'n* (No. CV-98-1555). Usury is defined as "charging an illegal rate of interest." BLACK'S LAW DICTIONARY, *supra* note 77, at 1545.

84. Decl. Rul., Mich. Dep't of Commerce Fin. Inst. Bureau (Apr. 25, 1995).

85. Letter from John E. Amari, State Senator, to Bill Pryor, Attorney General of the State of Alabama (Dec. 8, 1997) (on file with the author) [hereinafter Amari Letter]. Check cashers are trying to use the distinction between a check and a note to circumvent a finding that a loan exists:

The promissory note, . . . is . . . only a promise to pay, and does not represent the paying out or reduction of assets. A check, on the other hand, is a direction to the bank for immediate payment, is a medium of exchange, and has come to be treated . . . as a conditional payment of cash.

*Williams v. Commissioner*, 429 U.S. 569, 570 (1977) (distinguishing a check and a note).

86. See U.C.C. § 3-104 (1997).

87. Amari Letter, *supra* note 85. "The Payday Advance . . . is a carefully craft-

not require a check to be negotiated immediately, but within a "reasonable time," which is presumptively defined as thirty days after the date of issue.<sup>88</sup> Payday loans are typically held for two weeks, a presumptively reasonable amount of time.<sup>89</sup> Furthermore, the delayed presentment agreement does not transform an "unconditional promise or order to pay" into a conditional one.<sup>90</sup> In Alabama, post-dating checks is not illegal, and no law prohibits retailers from cashing a check over the amount of purchase.<sup>91</sup>

Check cashers assert that they provide a much-needed service that benefits consumers by enabling them to avoid service charges associated with "bouncing" checks, credit checks and having to pledge collateral to obtain funds.<sup>92</sup> Check cashers analogize payday advances to neighborhood pharmacists who agree to hold a check of a customer who needs medication for a sick baby today, but won't get paid until next week.<sup>93</sup> This analogy is countered by the fact that such a transaction would not include cash over the amount of the purchase and would be a rare exception in today's business environment.<sup>94</sup>

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ed transaction designed around the nuances of Article 3 of the Uniform Commercial Code. . . . [T]he intentional failure to enter into a written agreement [is a] maneuver[] to cloak a loan transaction in the technicalities of the law of negotiable instruments." Decl. Rul., Mich. Dep't of Commerce Fin. Inst. Bureau, at 5 (Apr. 25, 1995) (ruling that cash advances on checks held for future deposit is lending under Michigan's Regulatory Loan Act of 1963).

88. U.C.C. § 3-304(3)(c) (1989) (pre-revision Article Three provides that, with respect to the rights of a holder, a domestic check is presumed to be stale after 30 days); Decl. Rul., Mich. Dep't of Commerce Fin. Inst. Bureau (Apr. 25, 1995); Memorandum from State Banking Department on Anticipated Arguments of Check-Cashers to Gene A. Marsh, Counsel (1998) (on file with author) [hereinafter Memorandum from State Banking Dep't].

89. See *supra* note 85.

90. An order to pay is unconditional unless it states an express condition to payment. U.C.C. § 3-106(a) (1997). Whether or not the writing represents a conditional or unconditional promise is to be determined from the four corners of the document itself. *Holsonbäck v. First State Bank*, 394 So. 2d 381, 383 (Ala. Civ. App. 1980).

91. Memorandum from State Banking Dep't, *supra* note 88.

92. Complaint at 5, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

93. Memorandum from State Banking Dep't, *supra* note 88.

94. Defendants' Brief at 10, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

## V. ALABAMA LAW AND RECENT CASES

Check cashers are not licensed under the Alabama Small Loan Act ("SLA")<sup>95</sup> nor otherwise similarly regulated for deferred presentment check cashing transactions.<sup>96</sup> In a 1994 advisory opinion, the Attorney General of Alabama stated that "[c]heck cashing companies are making loans when they charge a fee and agree to hold the check or defer presentment of the check until sufficient funds are in the customer's account," and such transactions are "governed by the Alabama Small Loan Act (citations omitted) and the Mini-Code (citations omitted), and [are] subject to the Truth in Lending disclosure requirements."<sup>97</sup> The Alabama SLA authorizes licensing and regulation of lenders offering loans in the amount of \$749 or less.<sup>98</sup> Section 5-18-4(a) requires lenders to obtain a license,<sup>99</sup> and under section 5-18-4(d), criminal penalties attach to persons who willfully engage in making loans in the amount of \$749 or less without a license.<sup>100</sup> Section 5-18-15 limits charges on loans less than \$200 to 3% per month (or 36% APR),<sup>101</sup> and section 5-19-3 limits charges on any credit transaction less than \$2000 to \$15 per \$100 per year, with an equivalent annual percentage rate of 180% (or \$7.50 for a fifteen-day \$100 loan).<sup>102</sup>

The primary case pending in Alabama is *Alabama Check Cashers Ass'n v. State Banking Department*.<sup>103</sup> On July 1, 1998, the Supervisor of the Bureau of Loans issued Cease and Desist Orders against unlicensed check cashers for their "deferred pre-

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95. ALA. CODE §§ 5-18-1 to -23 (1975).

96. Marsh, *supra* note 1, at 1.

97. Op. Ala. Att'y Gen. No. 94-00210 (July 7, 1994).

98. ALA. CODE §§ 5-18-1 to -23.

99. *Id.* § 5-18-4(a).

100. *Id.* § 5-18-4(d).

101. *Id.* § 5-18-15.

102. *Id.* § 5-19-3.

103. No. CV-98-1555 (Cir. Ct. Ala. filed July 1, 1998). In December 1999, the State Banking Department argued a motion for summary judgment before the court; there has been no ruling as of the date this Note went to press. Telephone interview with V. Lynne Windham, Associate Counsel, State Banking Department (June 6, 2000); see *infra* note 135; see also *Victory Crossing, L.L.C. v. State Banking Dep't*, No. CV-98-409 (Cir. Ct. Ala. filed July 1, 1998); *Cash Express, Inc. v. State Banking Dep't*, No. CV-98-217 (Cir. Ct. Ala. filed July 1, 1998).

sentment transactions" involving less than \$749 and for which the fees charged exceeded the maximum interest rate allowed by the SLA.<sup>104</sup> The industry responded by filing suit against the State Banking Department, asking for a declaratory judgment and injunctive relief.<sup>105</sup> On October 9, 1998, Judge Reese of the Montgomery Circuit Court issued a Consent Order, pursuant to the parties' mediated agreement, that allows check cashers offering "payday loans" to continue operating during the pendency of the action, subject to certain terms of injunction.<sup>106</sup> The agreement allows lenders to charge up to \$16.67 for a fifteen-day \$100 loan, with an equivalent monthly rate of 33% and an APR of 400%—eleven times the legal limit.<sup>107</sup>

Under the arguments set forth above, the State Banking Department believes that the deferred presentment check cashing scenarios at issue are "mere subterfuge for evading the provisions of Alabama's Small Loan Act," and are in substance usurious, while the industry, relying on technicalities of form, contends that it is not subject to state regulation or TILA because it provides merely check cashing services (not loans) for which it charges "fees" (not interest).<sup>108</sup>

In addition, two private lawsuits have been filed: (1) *Austin v. Rapid Cash, Inc.*<sup>109</sup> and (2) a suit filed by Montgomery attorney Jere Beasley on behalf of a Prattville woman, Gloria Harris, who paid interest as high as 720% to three check cashing stores.<sup>110</sup> Beasley's lawsuit seeks compensatory and unspecified punitive damages, and Beasley has requested to make it a class action on behalf of other customers.<sup>111</sup>

Courts in other jurisdictions have recently addressed "de-

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104. Defendants' Brief at 4, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

105. *Alabama Check Cashers Ass'n* (No. CV-98-1555).

106. Consent Order, *Alabama Check Cashers Ass'n v. State Banking Dep't*, No. CV-98-1555 (Oct. 9, 1998).

107. *Id.*; *Outrageous Charges: Time to check payday lenders*, MONTGOMERY ADVERTISER, Dec. 29, 1998, at 10A; see ALA. CODE § 5-18-15.

108. Defendants' Brief at 2, *Alabama Check Cashers Ass'n* (No. CV-98-1555). In November 1998, a group of consumers asked to intervene in the case, seeking repayment of all fees paid by check cashing customers. Mike Cason, *Beasley files suit against check cashing stores*, MONTGOMERY ADVERTISER, Dec. 30, 1998, at 3C.

109. No. CV-98-465-JWB (Cir. Ct. Ala. filed 1998).

110. Cason, *supra* note 108.

111. *Id.*

ferred presentment" check cashing transactions and have found such transactions to be loans.<sup>112</sup> The transactions at issue in each of these cases are directly on point with all of the "deferred presentment" check cashing transactions presented in the Alabama cases.<sup>113</sup>

*Hamilton v. York*,<sup>114</sup> involved claims under the federal TILA, the federal Civil Racketeer Influenced Corrupt Organizations ("RICO") statute, Kentucky's usury statute, and common law fraud.<sup>115</sup> Defendant check casher agreed to hold the plaintiffs' checks for two weeks—for a charge of twenty percent of the cash advanced—before presenting the checks to a bank for payment or requiring plaintiffs to "pick up" their checks by paying the face amount or to renew the transaction by paying an additional fee.<sup>116</sup> Defendant argued that these were simple check cashing and that the amounts charged were only "service fees" for its check cashing services.<sup>117</sup> The Kentucky district court denied the defendant's Rule 12(b)(6) motion for all claims, applying the "substance over form" rule and using the definitions of "loan" and "interest" in *Black's Law Dictionary* to conclude that "it is clear that the charges incurred by the Hamiltons were interest from short-term loans, not service fees."<sup>118</sup>

*In re Miller*<sup>119</sup> involved bankruptcy proceedings wherein the debtor plaintiff challenged the *Hamilton v. York* defendant's "deferred presentment" check cashing practices.<sup>120</sup> In overruling the defendant's motion to dismiss, the Kentucky bankruptcy judge—presumably well familiar with debtor and creditor issues—stated:

[F]or the defendants to argue that they are not extending credit is

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112. *Hamilton v. York*, 987 F. Supp. 953 (E.D. Ky. 1997); *In re Miller*, 215 B.R. 970 (Bankr. E.D. Ky. 1997); *In re Brigance*, 219 B.R. 486 (Bankr. W.D. Tenn. 1998); *Commonwealth v. Bar D Fin. Servs.*, 1994 WL 1031102 (Cir. Ct. Va. Mar. 21, 1994).

113. *Hamilton*, 987 F. Supp. at 953; *In re Miller*, 215 B.R. at 970; *In re Brigance*, 219 B.R. 486; *Bar D Fin. Servs.*, 1994 WL 1031102, at \*1.

114. *Hamilton*, 987 F. Supp. at 953.

115. *Id.* at 955-58.

116. *Id.* at 955.

117. *Id.*

118. *Id.* at 956.

119. 215 B.R. 970, 974 (Bankr. E.D. Ky. 1997).

120. *In re Miller*, 215 B.R. at 974.

disingenuous. They are disbursing funds to people like the plaintiff on the promise of repayment of the sum plus the "service charge," at a later time. If this is not an extension of credit, this Court finds it hard to imagine any transaction that is.<sup>121</sup>

*In re Brigance*,<sup>122</sup> was another bankruptcy case in which the court found that the "deferred presentment" transaction at issue "clearly is a short-term extension of credit."<sup>123</sup> The plaintiff debtors wrote personal checks in exchange for cash advances, and the defendant check cashers held the checks for fourteen days before presenting them to a bank for payment.<sup>124</sup> Defendants claimed that they were secured creditors because their possession of negotiable instruments—the plaintiffs' checks—secured the plaintiffs' underlying obligation to pay.<sup>125</sup> The Tennessee bankruptcy judge held that the defendant creditors' claims were unsecured because "[w]hile it is clear that a negotiable instrument may be taken as security for an obligation, a negotiable instrument cannot serve as security for the very obligation it is intended to pay."<sup>126</sup>

One of the first known cases on "deferred presentment" check cashing is *Commonwealth v. Bar D Financial Services, Inc.*<sup>127</sup> In that case, the defendant check casher argued that it was buying checks at a discount rather than extending credit.<sup>128</sup> Declaring all of the defendant's transactions null and void, the judge found that the transactions were "loans" covered by the Virginia Consumer Finance Act and that the defendant's charges were usurious in violation of the Act.<sup>129</sup>

## VI. NATIONWIDE OVERVIEW OF STATE REGULATION

States generally take one of three approaches to payday

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121. *Id.*; see Defendants' Brief at 7, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

122. 219 B.R. 486, 493 (Bankr. W.D. Tenn. 1998).

123. *In re Brigance*, 219 B.R. at 493 (citing *In re Miller*, 215 B.R. at 974).

124. *Id.* at 488.

125. *Id.* at 492.

126. *Id.* at 493 (citation omitted).

127. 1994 WL 1031102, at \*1 (Va. Cir. Ct. Mar. 21, 1994).

128. *Bar D Fin. Servs.*, 1994 WL 1031102, at \*1.

129. *Id.*

lending: (1) payday loan laws that explicitly authorize and regulate payday lending, (2) prohibition of payday loans, or (3) no regulation.<sup>130</sup> Nineteen states and the District of Columbia have specific payday loan regulations that exempt payday lenders from state usury laws.<sup>131</sup>

Typically, payday loan laws set a maximum loan amount, a maximum term and fees. Lenders are required to obtain licenses or to register with state financial regulators. Written contracts, posted fees, and disclosure of the fee in dollars and as an Annual Percentage Rate are standard. Some states also limit paying one payday loan with the proceeds of another loan or rolling over the debt.<sup>132</sup>

Eighteen states, Puerto Rico, and the U.S. Virgin Islands prohibit payday loans.<sup>133</sup> These states prohibit payday loans through small loan laws—with maximum interest rates well below the typical range for payday loans—and through check cashing laws that expressly forbid cashing post-dated checks or making loans.<sup>134</sup> Alabama is included in this category because the Attorney General has declared payday loans to be subject to the Alabama SLA; however, payday lenders continue to operate outside the provisions of the SLA under a hairsplitting definition of “check cashing” versus “small loans.”<sup>135</sup>

Twelve states set no limits on small loan interest rates.<sup>136</sup>

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130. *Where the states stand on payday loans*, TUSCALOOSA NEWS, Jan. 10, 1999, at 6B; Fox, *supra* note 2, at 993.

131. California, Colorado, Florida, Iowa, Kansas, Kentucky, Louisiana, Minnesota, Mississippi, Missouri, Nebraska, Nevada, North Carolina, Ohio, Oklahoma, South Carolina, Tennessee, Washington and Wyoming. *Where the states stand on payday loans*, *supra* note 130, at 6B.

132. Fox, *supra* note 2, at 993.

133. Alabama, Alaska, Arizona, Arkansas, Connecticut, Georgia, Hawaii, Maine, Maryland, Massachusetts, Michigan, New Hampshire, Pennsylvania, Rhode Island, Texas, Vermont, Virginia and West Virginia. *Id.*

134. Fox, *supra* note 2, at 993.

135. Op. Ala. Att’y Gen. No. 94-00210 (July 7, 1994). The check cashing industry lobbied for a bill legalizing payday loans, but no such bill was passed in either the 1999 Special Session or 2000 Regular Session of the Alabama Legislature. In the 2000 Regular Session, Alabama Senate Bill 30 passed the Senate and received a favorable report by the House Banking Committee, but it was voted down by the House. Telephone Interview with V. Lynne Windham, Associate Counsel, State Banking Department (June 6, 2000); see S.B. 30, 1st Leg. Sess. (Ala. 2000).

136. Delaware, Idaho, Illinois, Montana, New Jersey, New Mexico, New York, North Dakota, Oregon, South Dakota, Utah and Wisconsin. *Where the states stand*

These states permit payday loans by omission.<sup>137</sup> One state, Indiana, sets a maximum annual APR of 36% but allows payday lending by setting a minimum finance charge of \$33 (or 1716% on a \$100 loan).<sup>138</sup>

States generally exempt banks from usury caps, small loan laws, and check casher laws, with the expectation that banks will not charge rates to trigger such limits.<sup>139</sup> This expectation may no longer be justifiable. Eagle National Bank, a federally chartered bank in Pennsylvania, makes "Cash Till Payday" loans of up to \$500 through a network of check cashers in several states.<sup>140</sup> By offering cash advance loans through a national bank, these check cashers slip through the gaps in state regulations.<sup>141</sup>

Where there are state statutes, the failure to obtain a license may void a transaction and require the return of all fees paid.<sup>142</sup> Likewise, failure to comply with interest rate limitations may void the entire transaction and disallow the check casher from collecting the principal of the check or retaining any fees paid.<sup>143</sup> In states without any regulation, fraud, unconscionability and statutory unfair and deceptive acts or practices ("UDAP") claims should be effective in attacking high fees and other overreaching practices.<sup>144</sup>

## VII. EFFECTS OF DEFERRED PRESENTMENT CHECK CASHING TRANSACTIONS AND RECOMMENDATIONS FOR EFFECTIVE REGULATION

Continued insufficient regulation of "deferred presentment" check transactions "will effectively undermine all consumer finance statutes, as well as undermine Articles Three and Four

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on payday loans, *supra* note 130, at 6B.

137. *Id.*

138. *Id.*

139. Fox, *supra* note 2, at 994.

140. *Id.*

141. *Id.*

142. *Special Issue, supra* note 2, at 13.

143. See *Commonwealth v. Allstate Express Check Cashing, Inc.*, No. HD-44-1 (Cir. Ct. Va. 1995) (unpublished opinion).

144. *Special Issue, supra* note 2, at 13.

of the U.C.C. Rather than executing promissory notes with all their attendant disclosures and limitations, lenders would merely use checks.<sup>145</sup> The Kentucky district court alluded to this in *Hamilton v. York*, stating that if the defendant's interpretation of Kentucky's check cashing statute was correct, "check cashing" companies would not have to stop with short-term loans[;] they could make long-term loans as long as it was under the guise of cashing a check.<sup>146</sup> Furthermore, banks would not be able to readily distinguish whether a check was payable on demand.<sup>147</sup> Current check processing is automated and automatic.<sup>148</sup> Routine use of checks as loans would require individual examinations of each check.<sup>149</sup>

On a practical level, the harm of usurious deferred presentment check cashing goes beyond the grossly exorbitant rates charged by payday lenders.<sup>150</sup> The high rates alone contribute to unmanageable levels of personal indebtedness among low and modest income households, sending many desperate consumers into a downward spiral of indebtedness<sup>151</sup> which ultimately forces them into bankruptcy.<sup>152</sup> Furthermore, the oppressive, fraudulent abuses of less-sophisticated consumers practiced by usurious check cashing lenders rises to the level of unconscionability.<sup>153</sup> Payday lenders often threaten debtors with criminal prosecution for the failure to "pick up" their checks at the end of the deferral period or for checks that are "bounced" upon presentment to banks.<sup>154</sup> For example, a nineteen-year-old nursing home worker had to bail herself out of jail to care for her six-month-old daughter when she called to warn a Hanceville, Alabama check casher that she would be late in repaying the \$200

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145. Defendants' Brief at 11, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

146. *Hamilton v. York*, 987 F. Supp. 953, 956 (E.D. Ky. 1997).

147. Defendants' Brief at 12, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

148. *Id.* See generally Ronald J. Mann, *Cases, Materials, and Problems on Payment Systems and other Financial Transactions* (Aug. 1998) (final draft, on file with The University of Michigan Law School).

149. Defendants' Brief at 12, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

150. Hendren, *supra* note 39.

151. Fox, *supra* note 2, at 990.

152. Ho, *supra* note 21.

153. Cason, *supra* note 108; see ALA. CODE § 5-18-2(b) (1975).

154. Hendren, *supra* note 39.

she borrowed at 520% APR.<sup>155</sup> Some lenders use the threat of bad check laws to pressure borrowers to roll over the loans<sup>156</sup> and to send collection agencies after customers who do not pay within thirty days.<sup>157</sup>

"[S]tate consumer protections are inadequate to prevent rate-gouging and to promote informed decisions."<sup>158</sup> States should ban deferred presentment check cashing transactions that violate usury laws.<sup>159</sup> According to the Consumer Federation of America, "[p]ayday loans are based on a fraudulent premise" because both the borrower and lender know that at the time the check is written, the borrower does not have sufficient funds on deposit to cover the check.<sup>160</sup> Additionally, states should close any loopholes that allow state licensed check cashers to offer cash advances through banks.<sup>161</sup>

Short of an outright ban on usurious deferred presentment check cashing transactions, these loans should be explicitly covered by state small loan laws—requiring licensing or registration with state banking officials—and should require disclosures complying with TILA.<sup>162</sup> Effective regulation should include: an absolute cap on effective annual interest rates, limits on the size of loans, prohibition of multiple loans and roll-over transactions, and the requirement of a written contract.<sup>163</sup> In addition, lenders should be prohibited from threatening borrowers with bad check laws or from bringing criminal prosecution for failure to pay these loans.<sup>164</sup> These loans should be treated as unsecured

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155. *Id.*

156. Fox, *supra* note 2, at 994.

157. Ho, *supra* note 21.

158. Fox, *supra* note 2, at 989.

159. *Id.* at 994. Without an effective ban on all usurious deferred presentment transactions, companies will continue to find other variations to perpetuate the same abusive practices. *Id.* at 991. For example, in Maryland, the Attorney General is currently challenging "sale-leaseback" deals whereby companies try to avoid Maryland's usury laws by having consumers "sell" a household item which the companies "lease" back using consumers' personal checks to evidence the "loan" transaction. *Id.* at 992.

160. *Id.* at 994.

161. Fox, *supra* note 2, at 994. The federal government by law or statute should also close any loopholes that permit national banks to make payday loans in states where such transactions are prohibited. *Id.*

162. *Id.*

163. *Id.*

164. *Id.* at 994.

for bankruptcy purposes.<sup>165</sup>

In addition to legislative action, states should take a "multi-faceted approach" to attack usurious deferred presentment loans.<sup>166</sup> The public at large must be educated about how much these loans really cost, how these costs impact their budgets, and how much these lenders make from poor and modest income communities.<sup>167</sup> If consumers knew and understood the true costs of these short-term loans, the use of such risky credit would drop dramatically.<sup>168</sup> Instead, consumers would use less risky alternatives (to the extent that they are available) to obtain short-term credit for their necessary living expenses (e.g., medical bills, car repairs, utility bills).<sup>169</sup> Such alternatives include low-cost checking and savings accounts and credit union loans, as well as state sponsored loans.<sup>170</sup> States must ensure that reasonably priced credit alternatives are readily available to low-income households.<sup>171</sup>

#### VIII. CONCLUSION

Deferred presentment transactions are clearly short-term loans that are fraudulently disguised as check cashing services. As loans, these transactions are subject to state small loan laws and the federal TILA. When the fees associated with these transactions exceed allowable interest rates under state small loan laws, such transactions are usurious and void in their entirety.

The "substance over form" rule, which has been applied in these types of cases since the beginning of the Twentieth Century, provides ample support for this conclusion, in addition to the long-standing public policy against usury.<sup>172</sup> Failure to recog-

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165. Fox, *supra* note 2, at 994.

166. *Special Issue, supra* note 2, at 16.

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.* Wisconsin's Welfare-to-Work Initiatives offer no-interest loans to help eligible applicants find or retain employment, and California offers low-interest car loans to address the need for transportation. *Special issue, supra* note 2, at 16.

171. *Id.*

172. Justice Brown's dissenting opinion in *Willis v. Buchman* cites Divine Authority, Shakespeare's Shylock from *The Merchant of Venice*, and the legal history of

nize "deferred presentment" check cashing transactions as loans would be inconsistent with public policy and precedent.

Finally, the solution to this growing problem lies in a multi-faceted approach including legislative action, public education and state assistance. States should ban usurious deferred presentment transactions or at least explicitly regulate such activities. The public must be educated as to the high costs of these types of transactions, and it must be provided low-cost short-term credit alternatives. State regulators, legislators, attorneys general and private attorneys must work together to eradicate this form of modern day loan sharking and protect vulnerable consumers in the small-sum, short-term credit market from these blatantly abusive practices.

*Lisa Blaylock Moss*

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usury as expounded in *Corpus Juris Secundum* as authority for the long-standing tradition of abhorrence against usury. *Willis v. Buchman*, 199 So. 892, 895 (Ala. 1940) (Brown, J., dissenting); Defendants' Brief at 12, *Alabama Check Cashers Ass'n* (No. CV-98-1555).

