Courts Allow States to Regulate Out-of-State Internet Financial Services Providers*

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Mr. Himes handles matters throughout all phases of litigation, including trials and appeals, as well as counseling clients in various dispute situations. Much of his experience is in complex cases for major business entities, but he has also handled cases for individuals and smaller-scale businesses involved in complicated disputes. While frequently on the defense side, he also represents clients as plaintiffs or claimants. Many of his matters involve multiple parties and multiple jurisdictions. In addition to litigating in federal and state courts, Mr. Himes represents clients in regulatory proceedings and investigatory matters. He is frequently called upon by out-of-state lawyers to take on complex cases in the New York courts.

I. Second Circuit Issues Decision in Payday-Loan Regulatory Case

In a clash of competing sovereigns' interests, the United States Court of Appeals for the Second Circuit upheld the authority of the New York Department of Financial Services (DFS) to regulate online payday loans made by Indian tribal lenders (the tribal lenders) to New York borrowers.[1] The Second Circuit's decision in the *Otoe-Missouria* case affirmed the lower court's denial of a preliminary injunction sought by the tribal lenders to prevent the DFS from interfering with the tribes' consumer lending business by barring these loans and pressuring banks and the National Association of Clearing House Associations (NACHA) to cease doing business with the tribal lenders.[2]

II. Background

The *Otoe-Missouria* case arose from DFS actions in the summer of 2013 to regulate out-of-state payday lenders. The DFS sent cease-and-desist letters to a number of online payday lenders identified as having made loans to New York residents, accusing them of using the Internet to make high-interest loans in violation of the state's usury laws.[3] The tribal lenders in the *Otoe-Missouria* case received the letter. The DFS also wrote to financial services industry participants who were involved in the lenders' financing and transaction processing, including banks and NACHA, the operator of the Automated Clearing House (ACH) payment system.[4] The DFS's letters urged these participants to take actions to assure that they do not provide a pipeline for the supposedly illegal loans.

III. Competing Arguments

The tribal lenders contended that the DFS's actions "had immediate and devastating effects" on them, causing the banks and NACHA to end their relationships with the tribal lenders. This, in turn, shut down the tribal lenders' transactions "not just with New York borrowers, but with consumers in every other state in the union."[5] The Second Circuit noted the competing views of the DFS's actions: the tribal lenders described the actions "as a 'market-based campaign explicitly designed to destroy Tribal enterprises,' and New York…defend[ed] [its actions] as a 'comprehensive effort to determine how best to protect New Yorkers from the harmful effects of usurious online payday loans.'"[6]

In seeking a preliminary injunction, the tribal lenders invoked the Indian Commerce Clause of the U.S. Constitution, which generally protects Native Americans' tribal sovereignty. Their contention was that New York had improperly "projected its regulations over the [I]nternet and onto reservations." Consequently, "both the tribes and New York believed that the high-interest loans fell within their domain, both geographic and regulatory…."[7] As the Second Circuit put it, their interests "collided." The main issue was "where they collided -- in New York or on a Native American reservation."[8]

The tribal lenders asserted that the transactions occurred on tribal land for the following reasons:

- The loan application process took place via a website owned and controlled by the tribes;
- the loans were reviewed and assessed by the tribal loan underwriting process;
- the loans complied with rules of the tribal authorities;
- the loans were funded out of tribal bank accounts; and
- the loan applications informed the borrowers that tribal law principally governed.[9]

In essence, the tribal lenders argued that "through technological aids and underwriting software, loans are approved through processes that occur on the Reservation in various forms."[10]

On the other hand, the loans had substantial New York connections.[11] While approved on tribal reservations, the loans flowed across borders to consumers in New York. New York borrowers never went to tribal lands but instead signed loan contracts electronically. Borrowers listed New York addresses on applications and provided information on their bank accounts in New York. The tribal lenders reached into New York to collect payments from the borrowers' New York accounts. And the alleged "harm inflicted by these high-interest loans fell upon customers in New York," resulting in complaints to the DFS.[12]

IV. The Second Circuit's Decision

The district court held that the tribal lenders were not entitled to a preliminary injunction because they had not shown likelihood of success on the merits.[13] The tribes claimed that their sovereignty was infringed on the grounds that New York "had no authority to order tribes to stop issuing loans originated on Native American reservations" and that the state "regulated activity far outside its borders when it launched a 'market-based campaign' to shut down tribal lending in every

1. Otoe-Missouria Tribe of Indians v. New York State Dep't of Financial Services, 769 F.3d 105 (2nd Cir. 2014).
2. *Id*. at 107 & 118.
3. *Id*. at 109.
4. *Id*.
5. *Id*.
6. *Id*. at 109.
7. *Id*. at 108.
8. *Id*.
9. *Id*. at 115.
10. *Id*. at 108.
11. *Id*.
12. *Id*.
13. *Id*. at 109.

state in the Union."[14] The district court explained that, to make this merits showing, the tribes needed to prove that the transactions occurred "somewhere other than New York, and, if they occurred on reservations, that the tribes had a substantial interest in the lending businesses."[15]

The Second Circuit held that the district court reasonably concluded that the plaintiffs failed to make their case. At bottom, the court found that the factual record was too uncertain – producing ambiguity about the place of Internet lending and the nature of the DFS's regulatory campaign – to support preliminary injunctive relief.[16]

V. Broader Implications of the Second Circuit Decision

Of possibly broader significance for regulatory actions generally, the Second Circuit highlighted the ambiguous – and unresolved – nature of loans made over the Internet: "Neither our court nor the Supreme Court has confronted a hybrid transaction like the loans at issue here, e-commerce that straddles borders and connects parties separated by hundreds of miles."[17] The court also observed, by way of a footnote that should not be overlooked, that tribal lenders "are not the only entities who have sought to enter this [lending] market and take advantage of [I]nternet-based technology to make loans to New York residents from remote locations. Companies located abroad or in non-reservation locations…have adopted similar business models."[18] Ultimately, this lawsuit may provide additional guidance on the permitted scope of state regulation of interstate loans (and other transactions) over the Internet.

VI. Minnesota Supreme Court Rules that the Commerce Clause Does Not Prevent Minnesota from Regulating Internet Loans to State Residents

The Minnesota Supreme Court ruled that the Commerce Clause of the United States Constitution does not preclude Minnesota from applying its payday lending law to loans consummated in Delaware that are made to Minnesota residents over the Internet.[19] The Minnesota Supreme Court joined the Tenth Circuit which, under similar facts in *Quik Payday Inc. v. Stork*,[20] also rejected a Commerce Clause challenge to the application of the borrower's home state law to Internet payday loans.

In *Integrity Advance,* the Minnesota Attorney General (AG) filed a lawsuit against the lender in which she alleged that loans made by the lender to Minnesota residents over the Internet violated several provisions of Minnesota's payday lending law, including interest rate and term limits. The lender argued that the application of Minnesota law to its loans violated the extraterritoriality principle of the Commerce Clause because Minnesota was seeking to regulate commerce that occurred wholly outside the state.[21]

According to the lender, the "commerce" in question occurred outside of Minnesota because the loan contracts were signed by the lender in Delaware at its principal place of business. While not expressly stated in the opinion, the loan contracts presumably included a choice-of-law provision designating Delaware law.

VII. Minnesota Court's Decision

In *Integrity Advance*, the trial court granted summary judgment to the AG and its decision was affirmed by the court of appeals and the Minnesota Supreme Court. In rejecting the lender's Commerce Clause argument and affirming the court of appeals, the Supreme Court characterized as "unjustifiably narrow" the lender's view that where the loan contracts were signed by the lender was the sole determinant of where the challenged "commerce" occurred.[22]

Instead, the Court found that the "commerce" regulated by the Minnesota law included "[t]he payment of funds to and from Minnesota borrowers, which for most of these loan transactions included electronic transfers into and out of Minnesota banks" and "the approximately 28,000 calls and emails between [the lender] and prospective borrowers in Minnesota by prescribing the terms and conditions of the loans [the lender] could offer."[23]

As a result, the Court concluded that the Minnesota law had only a "negligible" effect on commerce in other states and did not "control the terms on which companies lend money in other states." Because the lender did not argue that the Minnesota law was discriminatory or excessively burdened interstate commerce, those issues were not considered by the Court.

In its *Integrity Advance* opinion, the Supreme Court distinguished the Minnesota law from the Indiana Uniform Consumer Credit Code (U3C) provision at issue in the Seventh Circuit's decision in *Midwest Title Loans v. Mills*.[24] Under that provision, a loan was deemed to be made "in" Indiana, and hence subject to regulation by Indiana, if the loan involved an Indiana resident solicited in the state by any means. The lender, which advertised in Indiana, made loans to Indiana residents, in person, in Illinois.

After the Indiana Department of Financial Institutions (DFI), based on the U3C provision, demanded that the lender cease this activity, the lender sued the DFI in federal district court, arguing

14. *Id.* at 112.

15. *Id.*

16. *Id.* at 114 - 115.

17. *Id.* at 114.

18. *Id.* at 108, n. 1.

19. State of Minnesota by its Attorney General, Lori Swanson, Respondent v. Integrity Advance, LLC, Appellant, 870 N.W.2d 90 (Minn. S.Ct. 2015).

20. 549 F.3d 1302 (10th Cir. 2008).

21. *Integrity Advance*, 870 N.W.2d at 94 - 95.

22. *Id.* at 95.

23. *Id.*

24. 593 F.3d 660 (7th Cir. 2009).

that the Commerce Clause prevented the extra-territorial regulation contemplated by the U3C. The district court's decision agreeing with the lender's position was unanimously affirmed by the United States Court of Appeals for the Seventh Circuit. The lender also obtained attorneys' fees from the State of Indiana as a "prevailing party" in a federal Civil Rights Act lawsuit brought by the lender.[25]

In *Integrity Advance*, the Minnesota Supreme Court observed that, in contrast to the U3C, the Minnesota law's jurisdictional provision limited the law's application to loans that were completed while a Minnesota resident was physically located in that state.[26]

25. *Id.* at 662 & 669, cited in *Integrity Advance*, 870 N.W.2d at 95.

26. *Integrity Advance*, 870 N.W. 2d at 96.