## ESSAY

# PREEMPTION, AGENCY COST THEORY, AND PREDATORY LENDING BY BANKING AGENTS: ARE FEDERAL REGULATORS BITING OFF MORE THAN THEY CAN CHEW?

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## I. INTRODUCTION

A pitched battle is currently being waged for control of the American banking industry. For over a hundred years, the federal and state governments have maintained a complex, but relatively stable truce in their contest for power. At the beginning of our republic, state governments were the primary charterers and regulators of banks. In the wake of the Civil War, the National Bank Act created parity between federal and state banks, cementing the notion of a "dual banking system" that endured through the twentieth century. But in the past five years, the federal government has become esurient, using its powers under the Supremacy Clause of the U.S. Constitution to cut a new, wider footprint of authority for federal banking regulators and for banks that rally to their banner. A series of controversial federal regulations have preempted the application of state consumer protection laws directed at prevention of "predatory lending" by national banks and thrifts. These regulations are controversial not merely because the recent rash of fraudulent, deceptive, and unconscionable lending has had a corrosive effect on minority communities, senior citizens, and the entire lower middle class. Rather, they are also controversial because democratically elected state representatives all across the country had responded to their constituents' demands by adopting such legislation, and no federal statute ever explicitly authorized the unelected beltway banking custodians to dismiss these state consumer protection laws.[1] In

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[1]In the case of home mortgage loans approximately forty states, counties, and municipalities have adopted predatory lending laws attempting to protect homeowners from predatory mortgage brokers and lenders. State laws include: Arkansas Home Loan Protection Act, ARK. CODE. ANN. §§ 25-53-101 et seq.; CAL. FIN. CODE §§ 4970-4979.7 (West 2003); Consumer Equity Protection Act, COL. STAT. § 5-3.5-201 et seq.; Connecticut Abusive Home Loan Lending Practices Act, CONN. GEN. STAT. ANN. §§ 36a-746-747, 754 ; Home Loan Protection Act, D.C. CODE § 26.1151.01 et seq.; Fair Lending Act, FLA. STAT. ANN. §§ 494.0079-.00797; Georgia Fair Lending Act, GA. CODE ANN. §§ 7-6A-1 et seq. (as amended); *Idaho House Bill 28*, ID. Stat. § 26-3103 *et seq.*; High Risk Home Loan Act Ill. Comp. Stat. §§ 137/1-137/175; Indiana Home Loan Practices Act, Ind. Code §§ 24-9-4-1 *et seq.*; Consumer Credit Code, Kan. Stat. Ann. §§ 16a-1-101 et seq.; High Cost Home Loan Act, KY. Rev. Stat. § 360.100; Truth

fairness, federal regulators have levied persuasive arguments justifying their decisions as necessary in an increasingly national financial services marketplace. In their view, as technology shrinks our world the notion of fifty different banking jurisdictions is quaint, inefficient, and perhaps even silly. Would it not save everyone a lot of time and trouble if we had only one set of laws to govern the banking industry?

In a recent article I observed that the political economy driving federal preemption of state banking regulation has a tendency to magnify the effect of preemptive action.[2] Because federal banks, state banks, thrifts, credit unions, and non-depository lenders all act in the same zero-sum competitive environment, political shelter for one type of institution is a direct threat to every other type. When the regulatory patrons of one type of institution act to relax the regulatory constraints of their members, rival patrons must respond, or risk losing their regulatory turf as the institutions they represent lose market share or shift their assets into better protected (read: less regulated) charters. This dynamic guarantees that even narrow federal efforts to preempt state law will *creep*.[3] In nearly thirty years since the Supreme Court's decision in *Marquette National Bank v. First of Omaha Corporation*[4] preemptive

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in Lending, Me. Rev. Stat. Titl 9-A, §§ 8-101 et seq.; X (Maryland); Massachusetts Predatory Home Loan Practices Act, Mass. Gen. Laws ch. 183C, §§ 1 et seq.; MICH. COMP. LAWS. ANN. Ch. 445, §§ 1631-1645 (Michigan); Nevada Assembly Bill No. 284, Nev. Rev. Stat. §§ 598D.010 et seq.; New Jersey Home Ownership Security Act of 2002, N.J. STAT. ANN. §§ 46:10B-22 *et seq.*; Home Loan Protection Act, N.M. REV. STAT. §§ 58-21A-1 et seq.; N.Y. BANKING LAW § 6-L (McKinney 2003) (New York); Restrictions and Limitations on High Cost Home Loans, N.C. Gen Stat. §§ 24-1.1E et seq.; Ohio H.B. 386, OHIO REV. CODE ANN. §§ 1349.25- 1349.39; Consumer Credit Code, 14A OKL. ST. § 79.0404.; Omnibus Mortgage Bankers and Brokers and Consumer Equity Protection Act, 63 PA. CONS. STAT. ANN. §§ 456.501- 456.524 (2003); Sough Carolina High Cost and Consumer Home Loans Act, S.C. Code Ann. §§ 37-23-10 et seq.; Tex. Fin. Code § 343.001 *et seq*.; X (Utah); West Virginia Residential Mortgage Lender, Broker, and Servicer Act, W.VA. CODE ANN. §§ 31-17-1 et seq.; WIS. STAT. §§ 428.101 - 428.211 (2004) (Wisconsin); X (Wyoming). Local ordinances include: s18 Chicago, Ill., Municipal Code of Chicago, Predatory Lending Ordinance §§ 2-32-4545, 2-92-325, 4-4-155, 8-4-325 So2000-2145 of 2000 (Aug. 8, 30, 2000); PROTECTION FROM PREDATORY LENDING AND MORTGAGE FORECLOSURE IMPROVEMENTS ACT OF 2002, 48 D.C. REG. 3505 (2001); PHILADELPHIA, PA., PROHIBITION AGAINST PREDATORY LENDING, PHILADELPHIA CODE §§ 9-2400 to 9-2408 *et seq* (April 9, 2001); DAYTON, OH., ORDINANCE 29990-01 (July 11, 2001) (codified at REV. CODE OF GEN. ORDINANCES §§ 112.40-.44); ATLANTA, GA., ORDINANCE 01-O-0843 (June 6, 2001) (codified at CODE OF ORDINANCES §§ 58-100 to -102); OAKLAND, CA., ORDINANCE 12361 C.M.S. (October 2, 2001); CLEVELAND, OH., ORDINANCE 737-02 (March 4, 2002), *amended at* Ordinance 45-03 (April 22, 2002); TOLEDO, OH., ANTI-PREDATORY LENDING ORDINANCE, 291-02 (Nov. 5, 2002).; LOS ANGELES, CAL., CAL. FIN. CODE DIVISION §§ 1.6 *et seq*. (December 18, 2002).

[2]Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 TEMPLE L. REV. 1, 72 (2005).

[3]*Id.* at 72-73.

[4]439 U.S. 229 (1978).

actions have almost without exception crept out to cover more and more commercial activity.[5] The result has been a steady, silent, deregulatory trend.

One the most recent manifestations of this preemption creep has been federal banking regulators' efforts to extend immunity from state law to the agents of federal depository institutions. These efforts have generated somewhat less commentary than one might expect. For, once federal regulators attempted to preempt most state law and oversight for operating subsidiaries, preemption for agents of depository institutions seemed less surprising. Of what little has been written on this subject, most scholars have analyzed the legality of the regulatory action. But, the preemption creep also produces the following questions: did Congress authorize the Office of Thrift Supervision and/or the Office of the Comptroller of the Currency to preempt state law with respect to bank agents?, may the Federal Deposit Insurance Corporation preempt state regulation of some state banking activities, including a state's regulation of an out-of-state bank's state licensed agent?, and would five justices on the recently reconstituted Supreme Court agree that a federal banking regulator can preempt state regulation of state licensed agents of a state chartered bank? While these are certainly questions that merit attention, this essay focuses instead on the advisability of federal preemption of state regulation of agents of depository institutions as a policy matter. In particular, this article explores whether economic theory on the relationship between a principle and an agent may hold some useful insights for those pondering the ideal scope of federal preemption of state regulation of depository institutions. Economists and legal scholars have long explored the costs and benefits of agency in a variety of different contexts.[6] For example, a significant body of research has developed using agency cost modeling to shed light on corporate law and the nature of the firm.[7] In

[5]My metaphor is by no means the only one. Others have called this process, or at least parts of it, as the perpetuation of a grand illusion, James J. White, *The Usury Trompe l'Oeil*, 51 S.C. L. REV. 445, (2000), and as an amazing ever expanding elastic rubber band, Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and its Effect on Predatory Lending Regulation*, 88 MINN. L. REV. 518 (2004).

[6]For influential introductions to the application of agency cost theory to law, *see* Kenneth J. Arrow, *The Economics of Agency*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 37 (John W. Pratt & Richard J. Zeckhauser eds., 1985); Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, 14 ACAD. MGMT. REV. 57 (1989); Stanford J. Grossman & Oliver D. Hart, *An Analysis of the Principal-Agent Problem*, 51 ECONOMETRICA 7 (1983); JEAN-JAQUES LAFFONT & DAVID MRTIMORT, THE THEORY OF INCENTIVES: THE PRINCIPAL-AGENT MODEL (2002); Eric Posner, *Agency Models in Law and Economics*, *in* CHICAGO LECTURES IN LAW AND ECONOMICS 225 (Eric A. Posner, ed., 2000); and Stephen A. Ross, *The Economic Theory of Agency: The Principals Problem*, 63 AM. ECON. REV. 134 (1973).

[7]*See, e.g.,* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure,* 3 J. FIN. ECON. 305, 308 (1976) (landmark paper discussing the "nexus of contracts" theory of the firm and highlighting the importance of agency relationships in analyzing it).

particular agency cost theory has been applied to issues such as regulation of middle management,[8] insider trading,[9] and the executive compensation.[10] Legal scholars have also found interesting applications for agency cost theory in jurisprudence,[11] criminal sentencing,[12] antitrust,[13] securities,[14]trusts and estates,[15] and tax law.[16] These theoretical questions are considered in the context of the ongoing predatory lending controversy which continues to rage in the nation's press, courts, and legislatures.

Part II of this article provides a brief introductory sketch of the predatory lending problem and recent legal developments concerning federal preemption of state authority to address that problem. Part III delivers an exposition of agency cost theory. Part IV applies those theories to the financial institution context. This section explores whether agents of depository institutions will have the same incentives to avoid predatory behavior as depository institutions themselves. And, it queries whether federal regulators are prepared to deal with any such disparities in those incentives without the assistance of state law enforcement. Part V offers brief concluding remarks.

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[8]Michael J. Meurer, *Law, Economics, and the Theory of the Firm*, 52 BUFF. L. REV. 727, 728-29 (2004).

[9]Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 896-72 (1982-83).

[10]Lucian Arye Bebchuck et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002); William J. Carney, *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, 1988 Wisc. L. Rev. 385; Kevin J. Murphy, *Executive Compensation*, *in* 3B HANDBOOK OF LABOR ECONOMICS 2485 (Orley Ashenfelter & David Cards eds., 1999); Tod Perry & Mark Zenner, *CEO Compensation in the 19990s: Shareholder Alignment or Shareholder Expropriation?*, 35 WAKE FOREST L. REV. 123 (2000).

[11]Linz Audain, *Judicial Selection, and an Agency Cost Model of the Judicial Function*, 42 AM. U.L. REV. 115 (1992).

[12]Kenneth Dau-Schmidt, *An Agency Cost Analysis of the Sentencing Reform Act: Recalling the Virtues of Delegating Complex Decisions*, 25 U.C. DAVIS L. REV. 659 (1992).

[13]Bruce H. Kobayashi, *Antitrust, Agency, and Amnesty: An Economic Analysis of the Criminal Enforcement of the Antitrust Laws Against Corporations*, 69 GEO. WASH. L. REV. 715 (2001).

[14]Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1094-1100 (1996).

[15]Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621 (2004).

[16]Joseph A. Snoe, *The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distributions Tax*, 48 U. MIAMI L. REV. 1 (1993).

## II. BACKGROUND: THE INTERSECTION OF TWO CONTROVERSIES

### *A. Predatory Lending In an Era of Financial Deregulation*

Policymakers in all civilizations must face difficult choices about the extent to which public institutions will intervene in credit markets on behalf of debtors. Throughout most of the twentieth century, American consumer credit law was generally rather skeptical of creditors who deployed harsh terms and practices in the origination and collection of consumer debts.[17] For example, most states had usury laws which provided some upper limit on pricing of small loans.[18] And, federal bankruptcy protections chastised overreaching creditors by giving consumers the possibility of a fresh start.[19] Moreover, particularly beginning in the mid-1960s, a series of consumer protection initiatives at both the federal and state level were enacted, facilitating a historically unprecedented public confidence in and acceptance of consumer borrowing. However, during the 1980s and largely continuing today, the trend against public intervention in credit markets took force.

A large number of commentators have complained that neglect and relaxation of consumer protection statutes has emboldened a portion of the personal finance industry to engage in a variety of abusive, misleading, and unfair practices loosely grouped under the term "predatory lending." In general, even the staunchest critics of consumer protection statutes have conceded that a predatory lending problem of some sort exists, although which loans and practices should qualify as such remains a matter of great debate.[20]

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[17] CHRISTOPHER L. PETERSON, TAMING THE SHARKS: TOWARDS A CURE FOR THE HIGH COST CREDIT MARKET 76-111 (2004); Christopher Peterson, *Truth, Understanding, and High Cost Consumer Credit: The Historical Context of the Truth-in-Lending Act*, 55 FLA. L. REV. 807 (2003).

[18] BARBARA A. CURRAN, TRENDS IN CONSUMER CREDIT LEGISLATION 15-16 (1965)

[19] Peterson, *Historical Context of Truth-in-Lending*, *supra* note , at 866.

[20] While the purpose of this short article is not to carefully define the parameters of what loans are predatory, there are widely accepted and historically grounded benchmarks upon which a discussion can proceed. For example, in the small loan market, most states continue to retain small loan interest rate caps on their books—although a variety of exceptions have rendered the caps frequently unenforceable. Also, the United States code treats loans at above 45% as a *per se* evidentiary factor of extortionate criminal loan sharking. 18 U.S.C. § 892(b)(2) (2006). Historically, many ancient governments have capped interest rates at between 20 and 36 percent. PETERSON, TAMING THE SHARKS, *supra* note , at 51-61. In the market for home mortgages many states have passed laws which come up with a recipe of terms which can combine to create a predatory loan. *See* Baher Azmy, *Squaring the Predatory Lending Circle*, 57 FLA. L. REV. 295 (2005) (summarizing state predatory mortgage lending statutes); Peterson, *Federalism and Predatory Lending*, *supra* note , 61-68 (same). To some extent, the Home Ownership and Equity Protection Act was the progenitor of this approach. In other credit markets such as those for home

Much of the predatory lending market has been served by non-depository creditors. Traditionally, pawnshops, payday lenders, "buy here-pay here" car dealerships, and rent-to-own financiers have had no relationship with depository institutions. Accordingly, federal and state banking regulators have understandably seen much of the troubling developments in predatory "fringe" markets as a problem outside their jurisdiction, and better addressed by attorneys general, law enforcement, and private litigation.[21] But in recent years several trends have called this assumption into question.

First, mainstream depository institutions have acquired some of the most notorious predatory lenders and currently operate those lenders as subsidiaries. For instance, The Associates, which is now owned by Citigroup, has been accused of pervasive predatory lending practices by the media, state attorneys general, and the Federal Trade Commission.[22] As a result, The Associates settled an action brought by the North Carolina state attorney general under both state and federal theories of law for $20 million.[23] After stonewalling a federal investigation,[24] The Associates reached a

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furnishings, cars, or credit cards, there is less consensus on which terms and practices merit the label predatory.

[21]*See, e.g.*, Comptroller of the Currency Administrator of National Banks, Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices, Advisory Letter No. 2003-2, at 1-2 (February 21, 2003) [hereinafter *OCC Advisory Letter*] ("[T]he OCC does not have reason to believe that national banks or their operating subsidiaries (collectively referred to herein as "national banks") generally are engaged in predatory lending practices . . . .").

[22]*See, e.g.,* Associates v. Troup, 778 A.2d 529, 537 (N.J. Super. 2001) ("Typically predatory lenders take advantage of borrowers due to their lack of sophistication in the lending market, due to their lack of perceived options for the loan based on discrimination or some other factor, or due to deceptive practices engaged in by the lender that mislead or fail to inform the borrower of the real terms and conditions of the loan. The record in this case indicates that this is consistent with what occurred in the Troup transaction."); Michael Hudson, *Signing Their Lives Away: Ford Profits from Vulnerable Consumers*, *in* MERCHANTS OF MISERY 42, 42-50 (Michael Hudson, ed., 1996) (detailing legacy of abusive lending by The Associates). *Associates Launches $200B Loan Program*, CHICAGO TRIBUNE, Sept. 28, 2003, at 11.

[23]*The Associates to Refund $20 Million to North Carolina Mortgagors*, 11(5) CONS. BANKR. NEWS 7 (Oct. 18, 2001).

[24]Paul Beckett, *FTC Files Motion Against Citigroup In Lending Case*, WALL ST. J., March 6, 2002, at B9 ("[T]he FTC said Citigroup has 'effectively stalled' in producing evidence for the discovery, . . . . [and] refused to provide any documents created prior to March 6, 1998, 'even though the FTC intends to prove that the Associates' substantial and widespread illegal lending practices date back to at least January 1, 1994.'")

predatory lending settlement for $215 million with the Federal Trade Commission.[25] Although Citigroup promised to clean up its new subsidiary's business practices, allegations of predation have continued to dog the division.[26] Civil and consumer rights organizations still accuse Citifinancial of predatory lending.[27] And, as recently as 2004 the Federal Reserve Board ordered Citigroup agreed to pay a 70 million dollar fine after a three year investigation turned up additional violations by Citifinancial of the Home Ownership and Equity Protection Act, the Equal Credit Opportunity Act and other predatory lending laws.[28]

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[25]Erick Bergquist, *FTC's Look At Subprime Industry Not Finished Yet*, AMERICAN BANKER, May 25, 2004, at 1. Absent possible preemption, these same deceptive practices would be actionable under most state Unfair and Deceptive Acts and Practices statutes.

[26]John Bamboa & David Glover, *Viewpoints: To Get Citi to Change Ways, Regulators Need to Do More*, AM. BANKER, Sept. 27, 2002, at 9.

[27]*Id.* ("[T]he largest settlement in . . . [the Federal Trade Commission's] history [of $215 million] was hardly a slap on the wrist to Citigroup. The company has assets of over $1 trillion, so the settlement represented a meaningless percentage of its assets – less than 0.1%. In fact, the settlement is likely to have less of a deterrent effect than a $20 parking fine for a bank official earning $100,000 a year.").

[28]Board of governors of the Federal Reserve System, *In re Citgroup, Inc.* and Citifiancial Credit Company, Order to Cease and Desist and Order of Assessment of a Civil Money Penalty Issued Upon Consent May 27 2004; Timothy L. O'Brien, *Fed Assesses Citigroup Unit $70 Million in Loan Abuse*, N.Y. TIMES, May 28, 2004, at C1; Erik Berguist, *Citi-Fed Pact on Subprime: Opening Act?* AM. BANKER, May 28, 2005, at 1.
Citigroup is by no means the only bank that has subsidiaries that have been accused of predatory lending. Indeed, Household Finance Company is now owned by HSBC Holdings, which is the second largest consumer finance organization in the U.S.—after Citigroup. Kathi Whitley, *Household International, Inc.*, HOOVERS ONLINE, available at <http://premium.hoovers.com/subscribe/co/factsheet.xhtml?ID=10750> (viewed September 22, 2004). Like The Associates, Household has a troubling legacy of predatory lending. A coalition of state attorneys general forced Household into the largest predatory lending settlement ever—nearly half-a-billion dollars. Jonathan Finer & Charles R. Babcock, *The Lure of High-Risk Loans; Huge Profits Drive Practice's Spread Despite Lawsuits*, WASH. POST, July 12, 2004, at E01 ("In the past few years, regulators and prosecutors have cracked down on some predatory lending practices. In 2002, Household International Inc. agreed to pay borrowers $484 million, a few weeks after a division of Citigroup Corp. settled a case with the Federal Trade Commission for $215 million."); Editorial, *Borrowed Trouble*, RALEIGH NEWS & OBSERVER, April 12, 2004, A10. Other examples allegations of predatory lending against bank subsidiaries include: Maudline Smith v. Ameriquest and NationsCredit, Case No. 32879-02 (N.Y. Sup. Ct., County of Queens 2002) (subsidiary of Bank of America accused of fraud in origination of home mortgage with balloon payment); Wells Fargo Home Mortgage v. Denise Brown et al. v. Peach & Pep Construction Co., Case No. 00-CH-481 (Cir. Ct. St. Clair County, Ill.) (subsidiary of Wells Fargo national bank accused of conspiracy to commit fraud and Truth in Lending violations).

Second, many commentators have pointed to increasingly onerous and deceptive pricing in mainstream banking products.[29] As the lines between the fringe and prime market have blurred, mainstream lenders have turned to terms and practices which are gradually approaching a point at which reasonable independent observers might describe as predatory. For example, there have been widespread complaints about credit card default interest rates of more than thirty percent.[30] Moreover, many are skeptical of universal default terms where a late payment on a some other obligation, such as the consumer's rent or a medical bill can trigger the default interest rate on a credit card which the consumer has always paid on time.[31] Consumer advocates complain of bait and switch advertising where credit card issuers unilaterally change contract terms shortly after origination.[32] Finally, increasing use of mandatory arbitration clauses and waivers of the right to pursue remedies in a class action may deprive consumers of a realistic opportunity to create case law inhibiting these sharp practices.[33] Collectively, these developments and others like them,[34] have made many mainstream banking products appear quite similar to financial agreements traditionally found in the fringe market.

Third, for several years fringe and predatory lenders have sought to obtain their own banking charters. And, in recent months, at least two appear to have succeeded in doing so. Consumer advocates' fears seem well grounded now that the Office of Thrift Supervision has extended a thrift charter to H&R Block, the largest tax return preparer

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[29]Elizabeth Warren, *Bankrupt Children*, 86 MINN. L. REV. 1003, 1025-26 (2002) (discussing impact of credit card debts on children of bankrupt consumers).

[30]Kathy Chu, *Sholdering Mega Credit Card Fees?*, USA TODAY, Nov. 18, 2005, at 03B; Kathleen Day & Caroline Mayer, *Credit Card, Fees Bury Debtors; Senate Nears Action on Bankruptcy Curbs*, WASH. POST, March 6, 2005, at A1.

[31]Patrick McGeehan, *Plastic Trap—Debt That Binds: Soaring Interest Compounds Credit Card Pain for Millions*, N.Y. TIMES, Nov. 21, 2004, at A1.

[32]Carolyn Carter, et al., *The Credit Card Market and Regulation: In Need of Repair*, 10 N.C. BANKING INST. 23, 42 (2006).

[33]*Id.* at 45-46.

[34]Another troubling example are bounce protection plans on checking accounts that in effect charge interest rates comparable to payday loans to consumers who over draw their checking account. Owen B. Asplundh, *Bounce Protection: Payday Lending in Sheep's Clothing*, 8 N.C. BANKING INST. 349, 350 (2004) . Consumer groups have complained that some banks charge bounce protection fees to consumers withdrawing money at ATM machine who do not realize they are overdrawing their account. Laura K. Thompson, *Bank Overdraft Programs Rankle Consumer Groups*, AM. BANKER, May 20, 2003 at 4.

in the country.[35] For years, consumer groups have been troubled by loan pricing and inflated fees charged by H&R Block.[36] They have accused H&R Block of deceptively marketing its loan products as quick tax returns, rather than as low risk triple-digit interest rate loans they are.[37] Similarly, the largest pawn shop chain in the state of Minnesota has successfully obtained an industrial loan charter.[38] While industrial loan corporations are something of an unusual breed of bank in most of the country, in the few states which authorize them, including Minnesota, and especially Utah, the favorable charters have facilitated non-depository institutions obtaining some of the same interest rate exporting capabilities as depository lenders.[39] Moreover, with the likes of Wal-Mart pushing for its own industrial loan corporation, fringe lenders with a history of predatory lending seeking the same thing may have an extremely powerful ally.[40]

Finally, many banking institutions in the United States have not been shy about using agents to originate and service predatory loans. Many of the most powerful fringe credit businesses in the country have used the imprimatur of federal banking regulators in making loans with interest rates over *ten times* the federal 45% *per se* evidentiary

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[35]Jody Shenn, *H&R Block: As OTS Oks Charter Bid, Spitzer Sues*, AM. BANKER, March 16, 2006, 1.

[36]Damian Paletta, *Tax Refund Loans Called Predatory*, AM. BANKER, Feb. 1, 2002, 5; CHI CHI WU, JEAN ANN FOX, AND ELIZABETH RENUART, TAX PREPARERS PEDDLE HIGH PRICED TAX REFUND LOANS: MILLIONS SKIMMED FROM THE WORKING POOR AND THE U.S. TREASURY (Washington, D.C., Boston: Consumer Federation of America & National Consumer Law Center, January 31, 2002)

[37]Much of the consumer group outrage over tax return loans stems from the fact that unlike many consumer loans, these products are low risk since the tax preparer is certain to receive a tax return check from the federal government. PETERSON, TAMING THE SHARKS, *supra* note , at 231-233. To the extent that there is repayment risk it stems from the tax preparer's own errors in preparing the consumer's return documents. Also, H&R Block has been criticized for skimming millions of dollars out of the government's earned income tax credit, the most important remaining poverty entitlement program designed to lift children out of poverty. Apparently, these concerns did not deter the OTS from granting H&R Block a federal banking charter and the preemption rights that go along with it.

[38]Sheryl Jean, *Pawnbroker to Banker? The Leading Provider of Payday Loans to Cash-strapped Minnesotans Expands its Financial Services -- But Consumer Advocates Aren't Happy*, ST. PAUL PIONEER PRESS, April 2, 2006, 1D.

[39]ILCs—A Review of Charter, Ownership, and Supervision Issues: Hearing Before the Subcom. On Financial Institutions and Consumer Credit of the H. Comm on Financial Services, 109th Cong. (July 12, 2006) (providing summary of Industrial Loan Company banking powers).

[40]See generally Kevin K. Nolan, *Wal-Mart's Industrial Loan Company: The Risk to Community Banks*, 10 N.C. Banking Inst. 187 (2006) (summarizing Wal Mart's efforts to enter the banking industry).

trigger for extortionate loan sharking.[41] For years bank regulators facilitated predatory payday lending by allowing both state and federal banks to make predatory payday loans out of fringe lending company store fronts.[42] It is true that the Officer of the Comptroller of the Currency and now more equivocally the Federal Deposit Insurance Corporation have used their regulatory discretion to curtail payday lending by banks with the cooperation of fringe agents.[43] Nevertheless, great damage was done to the fabric of American consumer protection law in the interim. By allowing out of state banks to make payday loans, local lenders could demand equal treatment from state legislators undermining usury laws one legislature at a time all across the country.[44] Meanwhile, at least for a time, fringe lenders with patron banks (with, in turn, a patron bank regulator) profited without concerning themselves with these ugly state political battles.

As a result of the foregoing trends, the assumption that the predatory lending market has been served by non-depository creditors may no longer be legitimate. In fact, the trends listed above demonstrate that as depository institutions begin to participate in the fringe market and utilize practices that many consider to be predatory, the lines between predatory fringe lending and traditional lending have become blurred.

### *B. Preemption in an Era of Consolidating Federal Power: The Case of Agents of Depository Institutions*

Collectively these trends, which all suggest that depository institutions may be growing closer to fringe market players and practices, have set a troubling stage for debates over federal preemption to play upon. Non-profit consumer advocacy organizations have been highly critical of federal preemption, as have state attorneys general. Consistent with these concerns, many commentators have worried that federal preemption of various aspects of the consumer finance system would undermine momentum needed for reform of consumer protection law. For example, Arthur Wilmarth has argued that the OCC's efforts to create field preemption are an illegal and

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[41] 18 U.S.C. § 892(b)(2) (2006).

[42] CONSUMER FEDERATION OF AMERICA & U.S. PUBLIC INTEREST RESEARCH GROUP, RENT-A-BANK PAYDAY LENDING: HOW BANKS HELP PAYDAY LENDERS EVADE STATE CONSUMER PROTECTIONS 2 (Nov. 2001).

[43] Annys Shin, *On Payday, Many GIs Pay Back*, WASH. POST, Sept. 11, 2006; Erick Bergquist, *FDIC Payday Stance May Narrow Field Further Still,* AM. BANKER, March 17, 2005, at 1.

[44] Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of "Payday" Loans in Military Towns*, 66 OH. ST. L.J.653, 830 (2005).

cynical power grab that will come at the expense of consumers.[45] Bahir Azmy recently argued that state level predatory mortgage lending reform is a positive example of the laboratories of democracy in action.[46] Robert Eager and C.F. Muckenfuss have described how state predatory mortgage lending statutes created a vehicle for federal banking regulators to issue orders preempting those statutes which gave an adumbrative competitive advantage to federal institutions over their state chartered counterparts.[47] Margot Saunders and Alys Cohen go so far as to suggest federal regulation is better seen as a cause of predatory lending than a hedge against it.[48] I have speculated that because federal regulators are aware of state parity laws and the incentive of states to protect their own institutions, perhaps efforts to preempt have more to do with a deregulatory agenda than an effort to change the balance of power in the dual banking system.[49]

Many in the banking industry, banking regulators in particular, have responded with formidable arguments on the necessity of federal preemption. For example, Julie Williams and Michael S. Bylsma from the OCC, have argued that federal preemption is necessary in a an increasingly national financial services marketplace.[50] They have also pointed out that federal banking regulators have replaced state law and enforcement with federal banking regulations that are sufficient to prevent consumer abuse.[51]

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[45]Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225 (2004).

[46]Azmy, *supra* note , at 391.

[47]Roger C. Eager & C.F. Muckenfuss, III., *Federal Preemption and the Challenge to Maintain Balance in the Dual Banking System*, 8 N.C. BANKING INST. 21, 27-31 (2004).

[48]Margot Saunders & Alys Cohen, *Federal Regulation of Consumer Credit: The Cause or the Cure for Predatory Lending?*, Harvard University Joint Center for Housing Studies Working Paper Series, BABC 04-21, at 17 (March 2004).

[49]Peterson, *Federalism and Predatory Lending, supra* note ?, at 96-97. Indeed rules currently under consideration by the FDIC appear to support this notion. The FDIC is considering moving to restore balance in the dual banking system by simply loosening regulation on state banks to mirror the immunity federally chartered institutions. If this approach works its way into the law, the result of preemption will not be a competitive advantage for one group of financial institutions, but less consumer protection overall without the nuisance of passing embarrassing congressional legislation.

[50]Julie L. Williams & Michael S. Bylsma, *Federal Preemption and Federal Banking Agency Responses to Predatory Lending*, 59 BUS. LAW. 1193, 1193 (2004) ("[T]oday's credit and financial markets are as national in scope as our highway system. Just as the value of a uniform interstate highway system to support our nation's commerce is well recognized, the value of a uniform national system for provision of financial services is coming to be so.").

[51]*Id.*

Moreover, federal regulators have expressed scepticism over whether federal banking institutions have actually been involved in predatory practices.[52] Credit rating companies, such as Standard and Poor's and Moody's, have buttressed these arguments by refusing to rate securities including loans from jurisdictions that adopt aggressive anti-predator liability rules.[53] Fringe lender trade associations have tried to polish their public image by hiring expensive public relations, some of which have a track record of creating phony grass roots organizations and smearing political opponents.[54]

A still emerging front in this national debate is whether banking regulators can and should preempt state law with respect to non-bank agents of banking institutions. By way of background, in recent years depository institutions have increasingly turned to outside contractors to complete a variety of tasks associated with banking activity.[55] For example, depository institutions have hired independent companies to conduct a variety of routine banking functions such as data processing, accounting, maintaining computer network security, and human resource administration.[56] But depository

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[52]Office of the Comptroller of the Currency, Economic Issues in Predatory Lending, Unpublished OCC Working Paper, July 30, 2003, at 4 (on file with author).

[53]*See* Natalie Abrams, et al., *Standard and Poor's Implements Credit Enhancement Criteria and Revises Representation and Warranty Criteria for Including Anti-Predatory Lending Law Loans in U.S. Rated Structured Finance Transactions*, May 13, 2004, www.standardandpoors.com; Erick Bergquist, *Georgia Amended Predatory Law After Preapproval by S&P*, AM. BANKER, March 11, 2003, at 1.

[54]*Compare* Steven Schlein & Jay Leveton, *For Immediate Release: Less Than 4 Percent of Military Have Taken a Payday Advance Loan Says New Survey*, Feb. 3, 2004 (on file with author) (press release issued on behalf of payday lender trade association), *with* Glen Martin, *Chemical Industry Told to Get Tough: Lobbyist's Memo Advises Hardball Tactics for Fighting Tighter California Regulations*, SAN FRANCISCO CHRONICLE, Nov. 21, 2003 ("'They're known for creating deceptive, phony front groups,' Walker said. 'They go through people's trash; they make a policy of hiring former FBI and CIA operatives. Their motto basically is that they're not a PR firm - you hire them when you want to win a war.' . . . Steven Schlein, a senior vice president with Nichols-Dezenhall, defended the firm's tactics. 'We may be aggressive in the service of our clients, but we never break the law,' he said."). *See also* Eamon Javers, *"The Pit Bull of Public Relations": Eric Dezenhall serves clients such as ExxonMiobil by Going After their Foes*, BUSINESS WEEK, April 17, 2006 ("Journalist Bill Moyers, who tangled with Dezenhall's firm over a 2001 documentary about the chemicals industry says: 'I consider them the Mafia of industry.'").

[55]Lavonne Kuykendall, *Market Changes, New Focus May Have Led NPC to Block*, AM. BANKER, June 2, 2004, 7 (discussing independent contractors in payment system banking); Jody Shenn, *A Strategy Fix for RBC Mortgage: New Compensation Structure Meant to Put Focus on Margins*, AM. BANKER, April 1, 2004, 1 (discussing industry practices with respect to loan origination).

[56]Karen Gullo, *Outsourcing Poses Dilema for Strategists*, AM. BANKER, June 27, 1990, at 1; James H. McKenzie & Jeb Britton, III, *Should You Heed the Siren Song of Third-Party Firms*, ABA BANKING J., October 1996, at 99; Office of Thrift Supervision, Department of Treasury, Third Party Arrangements, Thrift Bulletin TB 82a, at (Sept. 1, 2004).

institutions have also increasingly outsourced many tasks involving interaction with their customers, such as operating telephone call centers and bill paying services.[57] Some depository institutions have also hired independent contractors for loan brokering, loan servicing, real estate appraising, telemarketing, and direct mail solicitation on behalf of the depository institution. [58]

Depository institutions hire independent contractors to act as agents on behalf of the institution for a variety of reasons. One advantage of using independent contractors is avoiding sunk costs from excess labor capacity when business is slow. When business picks up, depository institutions can quickly and flexibly respond through independent contractors to whom the institution lacks a long-term commitment. Independent contractors are also responsible for their own benefits and health care—an increasingly important component of employee compensation in an era of skyrocketing health care costs.[59] Independent contractors that specialize in a particular banking activity may also develop special expertise allowing them to complete tasks more quickly and efficiently. Moreover, in an era of bank mergers and acquisitions, long-term commitments to employees can reduce the flexibility of the institutions as they posture for the most advantageous capital structure.

However, one potential drawback of independent contractors has been regulatory. As federal regulators have carved out protection for their constituent institutions from state oversight and law, federal depository institutions found a competitive advantage from avoiding the necessity of state licensing fees, state inspections, and also (more controversially) the application of many state consumer protection laws. This has created an issue of whether state law and regulatory authority apply to independent contractors of federal depository institutions. On the one hand, an independent contractor is just that: independent. Agents of depository institutions are not themselves depository institutions. On the other hand, banking regulators have been reluctant to force depositary institutions into less efficient capital structures for no good reason. What difference should it make whether a bank or thrift conducts its marketing or customer service through employees or through agents? Why should the latter be subject to state law and authority when the former is not? Finding no source of concern from these questions, federal banking regulators have taken a series of steps which

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[57]Office of Thrift Supervision, Department of Treasury, Third Party Arrangements, Thrift Bulletin TB 82a, at (Sept. 1, 2004).

[58]Orla O'Sullivan, *The Profitability Riddle: We Know What it is Not, But Not What it is,* ABA BANKING J., February 1998, at 78.

[59]Lee Conrad, *Loan Muscle Wears a Tie Now, Works Phones, Makes $$: Market Shakeout Leaves 20 Agencies as Major Players, and with little Bank Competition, They're Going After a Mountain of Late Debts. First Order of Business, Set Up Shop in India*, U.S. BANKER, May 13, 2004, at 46.

either explicitly or implicitly have allowed agents of depository institutions to attempt to avoid state legal and regulatory authority under the guise of federal preemption.

To date, the OTS has made the most explicit effort to preempt state law and oversight with respect to non-depository agents of a federal depository institution. In October of 2004 the OTS general counsel office issued an opinion letter responding to an inquiry from a federal savings association and its wholly owned subsidiary.[60] The thrift in question wanted to know whether independent agents it had hired to perform marketing, solicitation and customer service on loan products were "subject to state licensing or registration laws by reason of performing such activities on behalf of, and as agents for, the Association."[61] The thrift in question had entered into contracts with the independent businesses to market the thrift's loans through direct mail, telephone and personal contacts. The independent contractors also assisted loan applicants in completing application forms, answering questions, forwarding completed applications to the thrift, and other various customer service duties.[62] The independent contractors had exclusive representation arrangements where they did not provide similar services to any other lender. They received compensation based on the number of transactions actually consummated by the thrift.[63] The source of controversy behind the opinion letter was the fact that many states had required the independent contractors performing mortgage brokering services to register, obtain licenses, and otherwise comply with the state's mortgage brokerage licensing statute.[64]

In response to the inquiry, the OTS reasoned that thrifts were entitled to the freedom to make business decisions on how to conduct their operations.[65] It explained that thrifts should not be subject to state law simply because they chose to use an independent contractor rather than one of their own employees.[66] Still, the administrative action is at least partially explained by the massive financial interest at stake. According to an influential insurance industry trade publication, over fifty

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[60]Op. Chief Counsel, Office of Thrift Supervision, Authority of a Federal Thrift to Perform Banking Activities through Agents Without Regard to State Licensing Requirements, P-2004-7 (October 25, 2004), *available at* 2004 OTS LEXIS 6 (hereinafter OTS, P-2004-7].

[61]*Id.* at 1.

[62]*Id.* at 2.

[63]*Id.* at 3.

[64]*Id.* at 4.

[65]*Id.* at 11.

[66]*Id.*

insurance companies now own institutions with federal banking charters.[67] The largest of these insurance companies is State Farm, which owns State Farm Bank, a thrift regulated by the OTS.[68] Under the OTS opinion letter State Farm's approximately 17,000 insurance agents—all of whom are already subject to state insurance law—are purported to be free from state mortgage lending regulatory licensing and oversight in marketing home mortgages to their insurance clients.[69] In addition to significantly decreasing State Farm's regulatory oversight, the opinion also coincidentally increased the power base of the OTS.

For its part, the OCC issued a similar regulatory preemption determination in 2001.[70] While the OCC's provision is rather less explicit in its reasoning, it makes up for this in sheer chutzpah. The regulation purports to preempt the application of state consumer protection law and authority to (of all businesses) used car dealerships where they are acting as an agent of a national bank.[71] While there is no question that car dealerships provide an important, indispensable, and legitimate service to Americans, there is also no denying that automobile sales present one of the most notoriously treacherous personal finance situations faced by American consumers.[72] The state statute in question, the Michigan Motor Vehicle Sales Finance Act of 1950, a statute dating back to the Truman administration, was designed to attempt to rein in some of the abusive car dealership practices faced by Michigan residents. To this end, the statute required that "a person shall not engage in this state as a[n] . . . agent" in "the business of an installment seller of motor vehicles under installment sale contracts" without a license. Car dealers in Michigan are also required to put up a bond to cover liability to the state or consumers victimized by unlawful behavior,[73] and to make available their records to the state Financial Institutions Bureau.[74] Moreover, the statute

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[67]*State Farm Recieves Federal Bank Charter*, BEST'S INS. NEWS, Dec. 16, 2004, *available at* 2004 WL 101010275.

[68]*State Farm Digging in Its Heels Over Regulatory Ruling* BEST'S INS. NEWS, Dec. 17, 2004, *available at* 2004 WL 101010325.

[69]OTS, P-2004-7 at 14-15.

[70]Office of the Comptroller of the Currency, Preemption Determination, 66 FED. REG. 28593 (May 23, 2001) (*hereinafter*: OCC Car Dealership Preemption Letter).

[71]*Id.*

[72]*See, e.g.,* Michael Feyen, *Showroom Turncoat Comes Clean: Dirty Dealing Exposed, and how not to get Taken to the Cleaners when Buying a Car*, CAR & DRIVER, May 2006, at 94 (former salesman discusses remorse over past behavior).

[73]Mich. Comp. L. §492.105 (2005).

[74]*Id.* at § 492.110.

includes a variety of consumer protection provisions including price disclosures,[75] the prohibition of some potentially abusive contractual terms,[76] rules attempting to prevent unfair or coercive insurance sales in connection with car sales,[77] and limits on the type of junk fees dealers can charge.[78] Finally, the statute also limits the interest rate on car loans where a car dealer is itself offering the loan or is acting as a broker or agent for the lender.[79]

The OCC's ruling came about as a result of a dispute between National City Bank, a national bank located in Ohio, which had entered into an agreement with a car dealership in Michigan.[80] Under the agreement the dealer was to serve as a limited agent on behalf of the bank in soliciting car loans, taking applications, preparing loan documentation, and closing the loans by obtaining the consumer's signature on all the required documents.[81] National City Bank agreed to compensate the car dealer by paying a commission on each loan closed.[82] Under the contract, the bank had exclusive authority to approve loans, but the dealership was free to charge interest rates in excess of those required by the bank's underwriting guidelines.[83] Where customers agreed to interest rates inflated beyond the bank's risk-based underwriting standards, the bank agreed to a kick-back, sometimes called a yield spread premium, to the dealer in addition to the normal commission.[84] Consumer advocates and scholars have criticized this type of yield spread premium as one of the most important indicia of predatory

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[75] *Id.* at 492.113.

[76] These provisions include acceleration clauses, clauses waiving legal rights, clauses granting the dealership the power of attorney, and clauses waiving of assignee liability for the dealer's unlawful behavior. *Id.* at 492.114.

[77] *Id.* at 492.116.

[78] *Id.* at § 492.117, 492.131.

[79] *Id.* § 492.118.

[80] Michigan Financial Institutions Bureau, Department of Consumer and Industry Services, In the Matter of: Request By Rodney D. Martin on Behalf of National City Bank for a Declaratory Ruling on the Applicability of the Motor Vehicle Sales Finance Act to Certain Transactions, January 1, 2000 (*Hereinafter*: Michigan Financial Institutions Bureau Ruling); OCC Car Dealership Preemption Letter, *supra* note ?, at 28593-28594.

[81] OCC Car Dealership Preemption Letter, *supra* note ?, at 28593.

[82] Michigan Financial Institutions Bureau Ruling, *supra* note ?.

[83] *Id.*

[84] *Id.*

lending.[85] In such arrangements the car dealer or mortgage broker receives compensation in addition to a base commission in exchange for originating an "above par" loan—that is, a loan with a higher interest rate than the borrower qualifies for based on the lender's own guidelines.[86] Some empirical research suggests that minority and women borrowers end up paying higher interest rates where a lender and its agent sets up this type of relationship.[87] Moreover, even when disclosed this type of compensation is deceptive and confusing since the borrower rarely suspects that they would actually be charged an extra fee for the privilege of a higher interest rate.[88] Yield spread premiums give the broker or dealer the flexibility to target unsophisticated or trusting borrowers with sometimes ruinous prices, while still not losing borrowers who are more responsive to price competition.

Rather than simply complying with the statute—like other lenders and car dealers in Michigan—National City and its agent petitioned the Michigan State Financial Institutions Bureau for a declaratory ruling stating that the law did not apply to the bank, nor to the car dealership with whom it had contracted.[89] Understandably the Michigan agency refused to waive the application of the state motor vehicle installment sales law to the car dealership simply because the dealer signed a contracted with an out of state bank.[90] In its ruling, the Bureau did not contest that National City Bank was free to charge Ohio interest rates in direct loans to borrowers. Rather, the Bureau reasoned that when a national bank originated loans *through car dealerships*—business entities chartered, licensed, and regulated by the State and seemingly well beyond the scope of the Riegle-Neal Act—those dealerships were nevertheless obliged to comply with the commands of the Michigan legislature.[91] After all, the Supreme Court has, at least not yet, announced a "most favored used car dealer" doctrine.[92]

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[85]Predatory Mortgage Lending Practices: Abusive Use of Yield Spread Premiums: Hearing before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 107th Cong. Part I (Jan. 2002) (prepared statement of Ira Rheingold); Brian Collins, *Consumer Groups Still Pushing Hard on RESPA*, ORIGINATION NEWS, May 1, 2006, at 81.

[86]PETERSON, TAMING THE SHARKS, *supra* note ?, at 142; Brian A. Wahl, *Yield Spread Premium Class Actions Under RESPA: Confusion Predominates*, 19 REV. LITIG. 97, 98 n.1 (2000).

[87]Howell E. Jackson & Jeremy Berry, *Kickbacks or Compensation: The Case of Yield Spread Premiums* 3 (Jan. 8, 2002) (unpublished manuscript, on file with author).

[88]PETERSON, TAMING THE SHARKS, *supra* note ?, at 142.

[89]Michigan Financial Institutions Bureau Ruling, *supra* note .

[90]*Id.*

[91]*Id.* The Bureau explained:

> Where a bank licensed under the Act has engaged a licensed installment seller as an agent to facilitate the making of installment sale contracts, the agent must not only

Nevertheless, when National City Bank later asked the OCC for an opinion that would circumvent the Michigan regulator's decision, the OCC obliged. In making its case the OCC began with the truisms that national banks are authorized to make loans and to use agents in connection with their business.[93] Moreover, the OCC pointed out that under the *Marquette* Doctrine, national banks are free to charge interest rates in accordance with the laws of the bank's home state.[94] From these three premises the opinion letter concludes that

> in our opinion, Federal law preempts the [Michigan Motor Vehicle Sales Finance Act] . . . because the statute, as interpreted, conflicts with Federal law authorizing the Bank to engage in the activities in question and with the OCC's exclusive visitorial powers over national banks.[95]

Aside from being something of a grating *non-sequitur* of the nails on chalkboard variety, the letter never points to any specific statutory language from Congress authorizing the OCC to prevent Michigan from imposing consumer protection law on its car dealerships. Also noticeably absent from the OCC's determination was any mention of the arguably predatory yield spread premium based compensation National City Bank intended for its car dealer/agent.

Given the potentially far-reaching annulment of cumbersome state consumer protection law and regulatory oversight, it should come as no surprise that state depository institutions have become envious of the immunity from state law enjoyed by federal lenders. In 2005 the Financial Services Roundtable petitioned the FDIC to issue a rule grant sweeping preemption of state law to state chartered banks. After a public hearing on the subject, the FDIC issued a notice of rulemaking proposing to adopt

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> maintain licensure under the Act, but must endure that the installment sale transaction that it is facilititating is conducted in full compliance with the Act. Where such agent has facilitated the making of an installment sale contract and that transaction does not comply with the Act, that agent may be subject to an administrative enforcement action as well as any applicable criminal sanction.

*Id.*

[92]*Compare* Tiffany v. National Bank of Missouri, 85 U.S. 409 (1873) (announcing the "most favored lender doctrine" in interpreting Section 85 of the National Bank Act).

[93]OCC Car Dealership Preemption Letter, *supra* note , at 28595 ("First, section 24(seventh) specifically authorizes national banks to make loans. . . . Second, the authority of national banks under section 24 (seventh) permits a national bank to use the services of agents and other third parties in connection with a bank's lending business.").

[94]*Id.* ("Finally, under 12 U.S.C. § 85, national banks may charge interest in accordance with the laws of the state where the bank's main office is located without regard to where the borrower resides and despite contacts between the loan and another state.")

[95]*Id.*

much of the policy suggested by the roundtable. At the time of this writing, the FDIC has not yet acted on the proposed rules.[96] Like previous actions by the OTS and OCC, the FDIC's proposed rules will inevitably force the agency to take a position on preemption with respect to agents of state banks. For now at least, the FDIC's proposed rules do not specifically address whether preemption will also apply to independent contractors of state banks. Rather the proposed rules make preemption for out-of-state, state banks coextensive with the preemption given to national banks. The proposed rule states:

> [A]n out-of-State, State bank that has a branch in a host State may conduct any activity at such branch that is permissible under its home state law if it is either:
> (1) Permissible for a bank chartered by the host State, or
> (2) Permissible for a branch in the host State of an out-of-State, national bank.[97]

Because under the FDIC's proposed rules preemption for state banks are coextensive with preemption for national banks, as determined by the OCC, it would seem that given the OCC's ruling on agents, the proposed FDIC rules preempt the application of state law to state licensed agents of an out-of-state, state bank.

Even more puzzling, if the proposed FDIC rules are adopted, it would seem that the consumer protection laws of a state bank's *own* state will not apply to independent bank agents otherwise licensed by that state. After all, virtually all states have wild card parity laws for their own state chartered banks.[98] These rules purport to give every power to local banks that out-of-state banks have under federal law. Thus, assuming the FDIC goes through with its proposed rules, unless a court refuses to play the music as written, banking regulations when synthesized with state law will allow any depository institution to engage any independent contractor to make and service loans with

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[96]Perhaps it is waiting for vacancies on its commission before acting. One might wonder whether potential political fallout from the action in an election year beset by political problems for the administration might have something to do with the delay as well. The proposed FDIC rules have put state banking regulators in something of a quandary. Ethan Zindler, *State Agencies Divided on FDIC Preempt Plan*, AM. BANKER, Dec. 12, 2005, at 1. On the one hand they risk losing influence over financial institutions in their states if state banks shift into federal charters. *Id.* On the other hand, some regulators have opposed the rules for fear that they will weaken their regulatory authority by creating still more incentive for banks to relocated to states with weak regulation. *Id.*

[97]12 CFR § 362.19(d) (proposed) *reprinted at* 70 Fed. Reg. 60019, 60013 (Oct. 14, 1005).

[98]NATIONAL CONSUMER LAW CENTER, THE COST OF CREDIT: REGULATION AND LEGAL CHALLENGES § 3.11.1 (2d ed. 2000); Eager & Muckenfuss, *Federal Preemption*, *supra* note , at 66-67; John D. Hawke, Jr., Remarks Before Women in Housing and Finance Meeting 7-8 (September 9, 2003) transcript available at http://www.occ.treas.gov/ftp/release/2003-69a.pdf (last viewed September 11, 2004).

immunity from state oversight and consumer protection law.[99] Who could have foreseen the bickering and mischief made inevitable when the Supreme Court first picked its "most favorite" lender?[100]

As of yet, the judicial branch has not yet taken a clear position on whether federal preemption extends to independent agents of depository institutions. But eventually this issue must work its way into the courts. When it does there will be occasion for careful reflection on the advisability of the regulators' position. Obviously the text of the Riegle-Neal Act and Congressional intentions with respect to the agents of depository institutions will play the central role in this litigation. Nevertheless, courts (and banking regulators) must interpret Congressional statutes with a sanguine eye on the actual policy implications of their decisions. In the next section, I describe how agency cost theory which may hold some insight in analyzing this question.

## III. AGENCY COST THEORY

The complexity of agency relationships has created a fertile field for legal and economic analysis.[101] Both a principal and an agent form an agency relationship because they each expect to receive some net benefit. The parties expect that the relationship will lead to an efficient division of labor. Thus, a principal might benefit from the greater expertise of an agent, such as where shareholders of a corporation hire managers to skillfully oversee their ownership interest in the firm. Similarly, agency relationships allow investment in many different productive enterprises allowing those with wealth to diversify their holdings, insulating them from unforeseeable risks

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[99]Presumably state laws that have only an incidental relationship to a bank or thrifts authorized powers would not be preempted. But, we might translate this into "state laws are not preempted, unless they actually protect a consumer from something." This is small consolation indeed.

[100]In *Tiffany v. National Bank of Missouri*, 85 U.S. (18 Wall.) 409 (1873) the Supreme Court asserted that national banks are "national favorites." *Id.* at 413. This label subsequently evolved into a "most favored lender" doctrine. *Marquette*, 439 U.S. at 314.

[101]Economists have generally used a far more inclusive definition of agency relationships than does the law. For example, Stephen Ross defined agency relationships as arising "between two (or more) parties when one, designated as the agent, acts for, on behalf of, or as representative for the other, designated the principal in a particular domain of decision problems." Stephen A. Ross, *The Economic Theory of Agency: The Principal's Problem*, 63 AM. ECON. REV. 134, 134 (1973). For economists, even contractual arrangements between an employer and employee are sometimes viewed through the lense of agency cost theory. *Id.* This article does not intend to contribute to economic agency theory as such, nor does it hope to examine every conceivable agency relationship as broadly construed that might arise within the context of financial institutions. Rather, it hopes to mine agency cost theory for useful insights on the question of extending federal preemption of state law for independent contractors of depository institutions.

inherent in any one given venture. Sometimes principals seek agents where the principal recognizes, ex ante, the potential for some non-welfare maximizing behavior, such as when a parent creates a spendthrift trust for a child.[102] Even where a principal has greater capabilities with respect to a task than an agent, the principal may also have higher opportunity costs, and thus capture a Pareto gain from the agents's relatively inexpensive labor.

Despite these obvious advantages, agency relationships also come with significant costs. One of the central insights of economic agency cost theory over the past generation is that while an agency relationship may be relatively efficient in comparison to no relationship at all, the incentives of a principal and her agent nevertheless are frequently (if not always) misaligned.[103] Principals virtually never enjoy representation of an agent with the same cost-to-benefit ratio for expending resources on the completion of a given productive task. For example, in the classic corporate context, the manager of a company who has no wealth invested in the corporation she manages will have relatively little incentive to carefully manage corporate funds in comparison to the shareholders of that corporation.[104] Similarly, because a real estate agent receives only a percentage of the purchase price of a home, he has less incentive to invest time driving up the marginal sale price than the actual seller the agent represented.[105]

Social norms, business practices, contract terms, and the legal system often attempt to more closely align the incentives of agents and their principals. When a stranger at the beach asks another to watch his belongings, most people will invest some care and attention for those belongings even at a cost to themselves. Shareholders expect CEOs and other corporate managers to carefully and transparently document the expenditure of corporate resources to facilitate oversight. A real estate broker contract which provides a bonus for obtaining a large sale price might mitigate some of the agent's incentive to shirk his duties.[106] And, the law holds a trustee liable to his beneficiaries for losses sustained from reckless or unauthorized investments.[107] Indeed,

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[102]Sitkoff, *supra* note ?, at 674-77.

[103]Jensen & Meckling, *supra* note ?, at 308.

[104]Ross, *supra* note ?, at 138.

[105]Eric A. Posner, *Agency Models in Law and Economics*, *in* CHICAGO LECTURES IN LAW AND ECONOMICS 225, 230 (2000).

[106]*See* E. Posner, *supra* note ?, at 225-228 (exploring the agency incentives of contracts where compensation increases with performance).

[107]*Id.* at 226-28.

so entrenched is the notion of the need to keep the incentives of agents and principals aligned that the law frequently holds principals liable for the misdeeds of an agent.[108]

For a person or business to decide whether or not to contract with an agent, she must weigh the expected benefits of that relationship against its potential costs. Economic agency cost theory can assist in analyzing and quantifying those costs. Perhaps the most influential model of agency costs, first established by Jensen and Meckling, defines them as the sum of three variables.[109] Thus agency costs are equal to:

(1) the monitoring expenditures of the principle,
(2) the bonding expenditures by the agent, and
(3) the residual loss.[110]

The first type of agency cost is expenditures by the principal in monitoring the agent. By monitoring costs, economists usually imply not only observing the behavior of the agent, but also "efforts on the part of the principal to 'control' the behavior of the agent through budget restrictions, compensation policies, operating rules, etc."[111] Sometimes commentators divide this class of agency cost into external and internal monitoring.[112] With respect to the former, investors in a firm might hire accountants to periodically audit the books of a venture to deter inefficient allocation of resources by managers. Or with respect to the latter, a homeowner might purchase a newspaper and read the classified listings to discover whether her realtor is advertising the home as promised.

The second class of agency costs are usually labeled "bonding expenditures." By this, economists refer to situations where the principal will pay the agent to expend resources to guarantee that the agent will not take actions that harm the principal.[113] A bonding cost is incurred where the principal pays a premium to the agent to create some pool of resources or a legal obligation from which the principal can be compensated for detrimental actions of the agent. Thus, where a legal client hires an attorney for representation, a portion of the client's legal fees are diverted by the attorney into

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[108]Thus, the doctrine of *respondeat superior*. *See generally* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 69, at 500 (5th ed. 1984).

[109]Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. OF FIN. ECON. 305, 308 (1976).

[110]*Id.*

[111]Jensen & Meckling, *supra* note , at 308 n.9.

[112]*See, e.g.,*Meurer, *supra* note ?, at 735-36.

[113]Jensen & Meckling, *supra* note , at 308.

malpractice insurance premiums. If the attorney takes actions inconsistent with the interests of her principal that amount to malpractice, the principal will have a relatively certain pool of funds available for compensation.

Bonding can serve as a substitute for monitoring costs and vice versa. A certain bonding expenditure may decrease the marginal expected utility of monitoring expenditures. Moreover, inability to bond might signal a need to invest additional resources in monitoring. Thus, a testator might reject an estate planning attorney who is uninsurable since the bonding expenditure associated with the malpractice premium is a particularly worthwhile investment in protecting against potentially catastrophic losses associated with negligent estate planing. But, perhaps more importantly, the uninsurability of the attorney sends a troubling signal from insurance companies—parties that specialize in monitoring and spreading this type of risk. The goal of the law in this respect should be to create incentives that encourage an optimal mix of the two.[114]

The final class of agency costs is the principal's lost welfare caused by the divergence in her interests from the those of her agent. If because of circumstances such as technology, geography, or even personalities involved, an agent cannot be perfectly monitored or bonded, then we should expect that the interests of the principal and the agent will not be coextensive. This remaining pocket of diverging interests is generally called the "residual loss" associated with agency.[115] A client might monitor her attorney by calling regularly to ask about the status of a case. The parties might make bonding expenditures by taking a portion of her and other client's fees and allocating them for malpractice insurance. But, she can only call so often, before the attorney will no longer pay attention to her demands—creating a diminishing marginal return from time invested in this form of monitoring. And, malpractice insurance policies cannot be continually renegotiated to cover every possible outcome harmful to the client. The malpractice insurance might cover catastrophic negligence, but it will not compensate the client for an attorney whose mind wanders while preparing a brief, leading to less than hoped for actual legal work product per billed hour. Despite the client's best monitoring and bonding expenditures, the attorney who enjoys daydreaming whilst on the clock retains her incentive to work more slowly. The client cannot easily discover the less the than fully effective service allowing the attorney to capture a windfall when compared to the parties' contract. This windfall—the residual loss—is an agency cost the client must consider in comparing the benefit of an agent to its opportunity cost.

It is at least theoretically possible that a principal could create a fee structure to proportionally compensate the agent for the value of each action taken. But, to achieve this fee-to-act compensation structure, the value of each action taken by the agent

[114]*See* Kobayashi, *supra* note ?, at 715.

[115]Jensen & Meckling, *supra* note , at 308.

would need to be "completely known" to the principal.[116] In the real world, obtaining this information, and negotiating the contractual terms of this contract is highly unlikely—particularly given that at some point marginal investment in monitoring will be offset by decreases in the agent's productivity. Thus, the distraction from a client calling her attorney once an hour to make sure she is on task might take up more of the attorney's time than the daydreaming the client is concerned about. Rational principals will expend effort on monitoring and bonding until their marginal price of doing so is less than the expected benefit. High monitoring and bonding costs may explain why so many agency relationships lack fee-to-act payment structures. A six percent commission has been nearly universal for real estate agents. And, legal clients rarely give their counsel bonuses for highly productive billable hours. In the real world, residual loss often is often the dominant agency cost.

In policing agency relationships, the legal system is not only concerned about aligning the incentives of principals and agents. Perhaps even more prominent are the policies addressing third parties affected by a principal's agent. It is true that agency law affords damages to a principal from an agent who by illegally shirking his duties has harmed the principal. Yet, an old and oft-disputed stew-pot of litigation focuses on the extent to which principals can be held liable for the behavior of their agents that is harmful to others.[117] This harmful behavior may be unintentional—a result of accidental behavior just as likely to occur had the principal acted without an agent. But, the harmful behavior might also have a causal link to the agency relationship itself. Sometimes agency relationships *facilitate* harmful and inefficient behavior.

Returning to our example of a client and her lawyer, suppose that the client for nefarious purposes hopes to intentionally inflict some harm on a third party. She might physically assault her victim, but doing so would invite punishment from the state. She might say hateful things to the victim, but unlike sticks and stones, words may not achieve the desired result. An attorney, however, might be capable of using words in a special way to enlist the state in harming the victim. Thus, the client might turn to an agent—a seasoned and cynical litigator with experience in using the machinery of law to impost costs on others—to maliciously sue her victim for no good reason. Rational, self-interested parties to the agency relationship could both benefit: the client gets satisfaction and the attorney gets paid.[118] The law however, considers the interests of

[116] Ross, *supra* note ?, at 138.

[117] *See, e.g.,* Gleason v. Seaboard Air Line Ry. Co., 278 U.S. 349, 356-57 (1929) (a principal is liable for an agent's tortious acts committed within the course and scope of the agent's employment).

[118] It is not much of an objection to say that the client's preference to harm another is irrational. Economics has traditionally had little to say about the tastes of economic actors. Paul A. Samuelson & William D. Nordhaus, Economics 81 ($15^{th}$ ed. 1995). Economic theory in general, as does agency theory in particular, does not have insight into *why* individuals and firms prefer the things they do. Rather economic analysis helps us understand what individuals and firms will be willing to pay to realize their

the third party and will impose a penalty on both the lawyer and the client for misusing its process.[119] For us, the important point is that agency relationships—when left unchecked—can be used to capture an agent's comparative advantage in both socially beneficial *and* socially destructive behavior. With the behavior of agents, as with all human behavior, the law must create a regime of rules and procedure to sort out acceptable from unacceptable acts. Agency cost theory does not alter this imperative. We should expect Pareto dominated outcomes and great injustice, where agents specialize in illegitimate, yet profitable, acts that principals cannot themselves perform—or at least cannot perform without getting caught.

## IV. BANK AGENTS AND PREEMPTION IN AN ERA OF PREDATORY LENDING: AGENCY COSTS AND THE INCENTIVE TO FOREGO PREDATORY BEHAVIOR

Although an agent and its principal both expect that their respective expected utility will exceed their costs, they do not necessarily share the same incentive structure *vis-a-vis* the third parties and the government. Thus, in the case of consumer lending, it could be that a depository institution itself will have a greater incentive to avoid predatory behavior than will an agent of that institution. In this section, I argue that both consumer financial services law and the capital structure of that industry suggest at least three compelling reasons why bank agents are likely to be less averse to predatory lending then the banks they represent.

First, agents of depository institutions are likely to be relatively less concerned about damage to their reputation from allegations of predatory lending. Unlike its agents, banks have significant sunk costs invested in public perception of their business. Much of a bank's customer base is the result of its image and brand identity in its target market.[120] To this end, banks spend significant resources in advertising and community relations. Banks tend to have high profile roles in their communities. On this point, Landes and Posner persuasively explained consumers purchase something of significant

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preferences given the forces of supply and demand. In this view the client would not be irrational for wanting to inflict harm on another. Rather she would be irrational for paying more to inflict it than she had to.

[119]FED. R. CIV. P. Rule 11 (2006).

[120]It is generally well settled that the willingness of a firm to engage in a particular type of behavior can vary significantly with the extent that behavior is observable. *See, e.g.,* Steven C. Hackett, *Is Relational Exchange Possible in the Absence of Reputations and Repeated Contact?*, 10 J.L. ECON. & ORG. 360 (1994) (discussing the feasibility of sharing based relational contracts where behavior is unobservable).

value when contracting with brand name firms.[121] The argument is that consumers recognize higher profile firms have unrecoverable sunk costs, and are willing to pay a premium for the greater assurances associated with a brand name.[122] When purchasing complex financial services where the consumer does not understand the terms of an agreement, there is no substitute for trust. Even in an era of deposit insurance, it also takes significant trust to leave one's money with a bank. Indeed this is why banking regulators uniformly consider reputational threats to be an important component of safety and soundness, even where that reputational threat may not pose a short term threat to deposit insurance funds. After all, when a car dealership is accused of cheating consumers, people may or may not be surprised; but when a national bank is accused of cheating, it makes the evening news. This is not to say agents of depository institutions will be completely indifferent to reputational harm, but rather that they are unlikely to care as much as the depository institution itself. Accordingly, other things being equal, agents of depository institutions will be marginally more averse to the reputational risks associated with predatory lending.

Second, agents of depository institutions are likely to have less assets exposed to liability than depository institutions themselves. The primary deterrent to predatory lending in the American legal system is the risk of compensating victims for damages they have sustained. Indeed the threat of damages is the primary tool enforcing most law in our system. This is why the growing trend of judgment proof commercial enterprises, particularly higher risk enterprises, is such a troubling development. Lynn Lopucki has exposed a variety of strategies firms use to avoid compensating judgment creditors.[123] The shared theme of each of these strategies is separating the liability generating component of a business from the assets used to fund and obtained from the activity. Several commentators have pointed out that many predatory lenders depend on sheltering their assets from victims to remain viable.[124] This, at least in part, helps

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[121]W. Landes & Richard Posner, *Trademark Law: An Economic Perspective*, 30 J. L. & ECON. 265 (1987).

[122]*Id.*

[123]Lynn M. Lopucki, *The Death of Liability*, 106 YALE L. J. 1 (1996).

[124]Vern Countryman, *The Holder in Due Course and Other Anachronisms in Consumer Credit*, 52 TEX. L. REV. 1, 11 (1973); Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 640 (2002); Kathleen C. Engel & Patricia A. McCoy, *Predatory Lending: What Does Wall Street Have to Do With It?*, 15 HOUSING POL'Y DEBATE 715 (2004); Julia Patterson Forrester, *Constructing a New Theoretical Framework for Home Improvement Financing*, 75 OR. L. REV. 1095, 1138 (1996); Cassandra Jones Havard, *To Lend or Not to Lend: What the CRA Ought to Say About Sub-Prime and Predatory Lending*, 7 FLA. COSTAL L. REV. 1 (2005); Siddhartha Venkatesan, Note, *Abrogating the Holder in Due Course Doctrine in Subprime Mortgage Transactions to More Effectively Police Predatory Lending*, 7 N.Y.U. J. LEGIS. & PUB. POL'Y 177, 177 (2003).

explain the extraordinary number of bankruptcies amongst subprime home mortgage lending firms in the 1990s.[125]

However, at least one major participant in the economy has not yet been able to judgment proof its operations—at least when undertaken within its own firm structure: the depository institution. Unlike other firms and individuals, depository institutions face stiff public capital requirements associated with protecting deposit insurance funds. Banks must be cautious in engaging in predatory behavior because if a victim succeeds in obtaining damages, unlike an increasing number of businesses, the bank must actually pay. In contrast, agents of banks may be much more likely to declare bankruptcy in the face of significant predatory lending liability. And, if the profits of that predatory lending have already been distributed to shareholders, management, and secured creditors, predatory lending victims will have no remedy.[126] Moreover, unlike banks which face significant entry and exit costs, independent contractors such as mortgage brokerages, car dealerships, loan servicing companies and the like face virtually no entry or exit costs, since they require only minimal overhead, equipment, and financial reserves. It is far easier for these businesses to simply slip out of existence once the heat for predatory practices is turned up. Unlike depository institutions, independent contractor agents of depository institutions have a relatively greater incentive to evolve into predatory specialists with a low-asset, judgment proof, fly-by-night capital structure.

Finally, despite the best intentions of banking regulators, it is inevitable that independent contractor agents of depository institutions will receive less scrutiny than depository institutions themselves. This is because, unlike consumer agency administrators, attorneys general, and the plaintiffs' bar, the primary mission of banking regulators is to preserve the safety and soundness of the depository institutions they oversee. In a world of scarce resources, banking regulators will always be forced to make difficult choices about where and how they spend their supervisory efforts. Independent contractors of depository institutions will always rank low in priority with respect to threats posed to deposit insurance funds. Moreover, many independent contractors may be more difficult to supervise than depository institutions. For example, car dealerships are often located in out of the way places, may lack the technology and record keeping to facilitate quick auditing, and—at least in some parts of the country—may have business cultures resistant to oversight by the U.S. Treasury

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[125]Eggert, Predatory Lending, *supra* note ?, at 603; Eric Berquist, *Preparing for a Bad-Loan Boom*, AM. BANKER, Oct. 6, 2000, at 1.

[126]It should go without saying that bankruptcy code's the ninety day preference period is small consolation to consumers on this point. 11 U.S.C. § 547(b)(4)(a) (2006). This window which allows bankruptcy trustees to avoid payments and security interests granted on the eve of bankruptcy. But, ninety days is far too short a period of time to prevent judgment proofing when compared to the extremely long life cycles of a significant predatory lending class action or attorney general lawsuit.

Department. Moreover, because independent agents of depository institutions receive neither a their charter nor permission to expand from banking regulators, regulators may be surprised to find how little leverage they have over these non-bank actors. All together, we should expect that these factors will systematically impede the ability of banking regulators to keep a close eye on independent contractors. Other things being equal, federal regulators relative deterrence against predatory behavior will be marginally less for independent contractor agents than the depository institutions those agents serve.

The implications of agents' lower incentive to avoid predation are further illuminated when one considers the possibility of vicarious liability. If we assume that a bank or thrift cannot be held liable for the illegal predatory behavior of its agent, then a rational, profit-maximizing bank would simply outsource predatory behavior whenever that behavior is profitable. For consumers this is clearly the worse alternative of the two possible rules.[127]

But even if the depository institution will be held liable for its agent's predation, the residual loss cost of agency suggest that the agent will still retain a predatory incentive. Take as an example an agency relationship between a car dealership and a national bank similar to that involved in the OCC's determination to preempt state law with respect to agents of national banks. Since the bank will be liable for its agent's practices, we can expect it to use monitoring and bonding expenditures to reduce the risk that the agent will seek to maximize its profit through illegal behavior. Liability should be a robust deterrent for the bank since it values its reputation, it has high exit and entry costs into the marketplace, and public asset requirements guarantee that the bank has significant resources to loose if exposed to the wrath of an indignant jury. Still, the profits to be had from using a car dealer as a marketing and delivery vehicle for its loans could be too tempting to pass up. We would expect that the bank would attempt to monitor the car dealership by regularly auditing the dealership's books, by conducting due diligence on the dealership's reputation and financial stability, and by retaining the right to make key decisions with respect to loan approval. A risk averse bank might even require that the dealership maintain a modest cash collateral account in escrow to compensate the bank for any liability it incurs from the agent.

Still, the car dealership gets paid only by closing loans, giving it an incentive to close as many loans as possible—even ones where the borrower may not actually qualify for a loan, or where the borrower may not actually agree to the loan being offered. The dealer has an incentive to overestimate the credit worthiness of the borrower by padding the borrower's reported income. Similarly, the dealer has an incentive to obtain the borrower's signature by hiding or misrepresenting the true cost

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[127]In a related forthcoming piece, I argue that this is precisely what has happened in the market for private label subprime home mortgage backed securities market. *See* Christopher Peterson, *Predatory Structured Finance: Securitization, Liability, and Home Mortgage Lending* (forthcoming 2006).

of the loan. Such risks are far from theoretical. Rather they make up the core of the thousands of consumer protection cases involving car dealerships, mortgage brokers, and consumers.

The incentive structure of the dealer is even further misaligned where the dealer is compensated with a yield spread premium, as it was in the National City Bank petition acted upon by the OCC. In such contracts the bank obtains a monitoring advantage of knowing that the dealer will try to get the greatest return possible on the bank's assets. But, this return may or may not be a legal return. In a democratic society, banks and car dealers must not discriminate in the prices they charge based on impermissible protected classes. Doing otherwise is a violation of the Equal Credit Opportunity Act (as well as the Fair Housing Act in the case of home mortgages).[128] But even absent discrimination, yield spread premiums are an invitation to loan brokers to commit fraud, to commit deceptive practices, and violate the Truth-in-Lending Act since consumers must somehow be enticed into agreeing to a contract with a value *lower* than the consumer's opportunity cost. By definition, no rational consumer will agree to pay a higher interest rate than he or she qualifies for from the very lender with whom they contracted. Yield spread premium compensation is contingent upon an irrational contract. Where a broker or dealer specializes in obtaining consumer signatures on contracts that are against the consumers own best interests, we should expect fraud, deception, and obscured disclosure.

This analysis exposes a troubling paradox in the recent public policy advocacy of depository institutions and federal banking regulators. With one hand banks and their regulators are attempting to distance themselves from their proxies. Frequently in predatory lending cases involving a lender and an independent contractor of that institution, consumers will propose joint liability theories seeking to hold the depository institution liable for the behavior of its agent. Without variation, in these cases the lenders characterize their agents as autonomous and independent so that the wrongful actions of the one cannot be attributed to the other.[129] Thus when a bank takes a home mortgage on assignment from a table-funded mortgage broker, it is likely to claim that it lacked notice of any fraud by the broker. Thus, the bank preserves its status as a holder in due course.[130] Or, when a bank makes an automobile loan to a consumer

[128]Equal Credit Opportunity Act, 15 U.S.C. §§ 1691 et seq. (2006); Fair Housing Act, 42 U.S.C. §§ 3601-3619 (2006).

[129]*See, e.g.,* Pennsylvania v. Parisi, 873 A.2d 3, 10-11 (Pa. Cmwlth, 2005) (aider-abetter liability); Mason v. Fieldstone Mortgage Co., No. 00 C 0228, 2000 WL 1643589, at *1 (N.D.Ill., 2000) (aider-abetter liability); Williams, 700 N.E.2d at 868. Williams v. Aetna Fin. Co., 700 N.E.2d 859, 868 (1998) (civil co-conspirator liability); Mathews v. New Century Mortg. Corp., 185 F.Supp.2d 874, 890 (S.D.Ohio, 2002) (civil co-conspirator liability); George v. Capital South Mortgage Investments, Inc., 961 P.2d 32, 32-39, 44-45 (Kan. 1998) (joint venturer liability).

[130]Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: the Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1301 (2001).

through a car dealer agent, the bank will refuse to accept responsibility for the fraud, deception, and obscured disclosure of the dealership.[131]

Yet with the other hand depository institutions and federal banking regulators are attempting to characterize their proxies as virtually indistinguishable from themselves. In the debate over preemption of state law with respect to agents, banking regulators have characterized the legal boundaries between a depository institution and its non-bank agent as merely a choice about capital structure with little or no bearing on the commercial reality of the transactions in which the agent will engage. Thus in its opinion on preemption of state law with respect to independent contractors of thrifts the OTS explained:

> [F]ederal savings associations have the freedom to make business decisions about the manner in which they will conduct their operations. This includes decisions as to how to market and offer the association's products and services, and how to best facilitate customer access to, and applications for, such products and services. An association's decision as to how to conduct its operations and market its products and services should not result in the association being subject to a hodgepodge of state requirements. An association should not be hamstrung in the exercise of its authorized power *merely because it chooses to market its products and services using agents whose activities the association closely monitors and controls*.[132]

The use of the word "merely" seems rather befuddling given that the agency had just used the federal thrift statutes to preempt state law for people who are *not* thrifts. But what may be more, the profoundly different predatory incentives of a thrift in comparison to its independent contractor suggest a concrete and fundamental economic reason why preemption should not extend beyond the federally chartered depository institution itself.

Certainly the extent to which a depository institution will have notice of and control over the predatory behavior of an independent agent will depend on the facts of each circumstance. But then, is this not an argument against preempting state law with respect to independent agents? State governments have the ability to experiment with different approaches in designing rules to ferret out which types of contracts and which types of agents are more likely to engage predatory behavior than their depository masters.[133] State governments have the geographic flexibility to more accurately

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[131]*See, e.g.,* Jackson v. South Holland Dodge, Inc., 312 Ill.App.3d 158, 244 Ill.Dec. 835 (Ill.App. 1 Dist., 2000) (assignee arguing against liability to consumer for car dealership's misrepresentations to consumer).

[132]OTS, P-2004-7, *supra* note ?, at 11 (emphasis added).

[133]Azmy, *supra* note ?, at 391.

respond to the wide variations in the severity of credit fraud in different states. State governments are more likely to have a vested local political interest in responding to the needs of consumers affected by predatory lending. State governments are more likely to have an infrastructure in place that is capable of dealing with car dealers, mortgage brokers, loan services and other agents than federal banking regulators with limited legislative missions, limited funding, and limited personnel. Returning to the OCCs agent preemption determination, are the two small OCC offices in Detroit and Iron Mountain really prepared to police the consumer credit practices of the Michigan's 1,930 licensed motor vehicle installment sellers[134]—including those with confidence inducing names like "The Used Car Factory,"[135] "ACE Used Cars of Muskegon,"[136] and "Ultimate Value Auto Sales"?[137]

## V. CONCLUSION

By attempting to extend preemption to the agents of depository institutions, banking regulators have removed from state regulation complex, unpredictable, and potentially harmful relationships. The shifting incentives of agents have confounded scholars, regulators, and judges—not to mention economists—in a tremendous cross section of legal relationships. Even with the most carefully devised monitoring and bonding expenditures, independent agents cannot be expected to always act in the interests of the depository institutions they represent. It is less likely that independent agent's interests, even when constrained by monitoring and bonding, will happen to coincide with the welfare of the American people.

At a minimum, the agency costs associated with depository institution agents suggests that if we as a country go forward with preemption for these actors, it is absolutely essential that the fabric of state legal and administrative protections be replicated on a federal level. Currently, there is no credible federal legal or regulatory strategy which can deter the agents of federal depository institutions at least with

[134]The Michigan Financial Institutions Bureau license data base lists 1,930 licensed motor vehicle installment sellers in Michigan. OFIS Search Criteria for Consumer Finance Licensees, http://www.dleg.state.mi.us/fis/ind_srch/cons_fin/ofis_consumer_finance_criteria.asp?industry=InS, April 18, 2006. The OCC is divided into four districts. Michigan is in the central region which is headquartered in Chicago, that is supposed to regulate Indiana, eastern and northwestern Iowa, northern Kentucky, Michigan, Minnesota, eastern Missouri, North Dakota, Ohio, South Dakota, southwestern Virginia, southwestern West Virginia, and Wisconsin. Office of the Comptroller of the Currency, About the OCC, http://www.occ.treas.gov/district.htm, April 18, 2006.

[135]Michigan license no. IS-19592.

[136]Michigan license no. IS-0010722.

[137]Michigan license no. IS-20644.

respect to the problems posed by predatory lending. There is no federal usury law to check the outrageous prices of payday loan banking agents. There is no serious federal predatory mortgage lending law. There is no private cause of action for the Federal Trade Commission Act to enforce the FTC's regulations on unfair and deceptive trade practices. For their part, federal banking regulators have not flinched even as credit card interest rates have crept closer and closer to the federal *per se* extortionate loan sharking trigger of the Consumer Credit Protection Act.[138] Even well-settled and long established federal consumer protection statutes, such as the Truth in Lending Act, are in a state of shameful disrepair.[139] And finally, there are simply far too few federal regulators to monitor the agents of depository institutions.

Furthermore, policy makers must accept the reality that if the legal system grants agents of federal depository institutions immunity from state law, it will create a potentially irresistible incentive for states to follow suit. If federal depository institutions can outsource their special legal status along with their operations, state depository institutions and the regulators that derive their revenue and power from them, will inevitably clamor for the same treatment. The floor must not be lowered for agents of federal depository institutions, lest the floor be lowered for agents of all depository institutions.

The regulatory apparatus of the United States has not yet demonstrated the capability of successfully regulating the abusive and predatory practices of depository institutions themselves. To suggest with hardly a quiet breath of authorization from the Congress, that federal banking regulators can be trusted to also police actors lending through a tenuous, shifting, volatile agency relationship borders on the absurd. Indeed, it leads one to suspect that these regulators have no intention of policing that relationship at all. And therein lies a final ironic twist: perhaps the more fundamental principal-agent monitoring failure lies in the inability of the American people to successfully monitor their agents charged with overseeing the nation's banking industry.

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[138] *Compare* Kathleen Day & Caroline Mayer, *Credit Card, Fees Bury Debtors; Senate Nears Action on Bankruptcy Curbs*, WASH. POST, March 6, 2005, at A1 (discussing forty percent interest rates credit cards) *with* 18 U.S.C. § 892(b) (establishing presumption of extortion for loans with interest rates in excess of forty-five percent).

[139] The Truth in Lending Act's $25,000 scope limitation is now lower than the purchase price of a middle class family sedan. Inflation since the Congress adopted the Truth in Lending Act has rendered the statutory damage awards for violations of the Act comically irrelevant. The maximum statutory damage award for an ordinary Truth in Lending violation is $1,000, which is now the equivalent of approximately $193.00 in 1968 dollars. Robert C. Sahr, Consumer Price Index (CPI) Conversion Factors to Convert to 2005 Dollars, http://oregonstate.edu/Dept/pol_sci/fac/sahr/cv2005x.pdf, September 19, 2006. Moreover, by federal reserve board's own admission, only 78% of national banks actually complied with the Truth in Lending Act in 2003. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, 91ST ANNUAL REPORT 71(2004).