STATE OF NEW MEXICO
COUNTY OF SANTA FE
FIRST JUDICIAL DISTRICT

ENDORSED 9ZN
First Judicial District Court

DEC 03 2010

Santa Fe, Rio Arriba &
Los Alamos Counties
PO Box 2268
Santa Fe, NM 87504-2268

No. D-01010CV-2009-01916

State of New Mexico, ex rel. Gary K. King, Attorney General,

Plaintiff,

v.

B&B Investment Group, Inc. d/b/a Cash Loans Now, and American Cash Loans, LLC d/b/a American Cash Loans,

Defendants.

DECISION

This case involves a challenge to the consumer small loan product known as a signature loan. These loans generally range from $50 to $300. No collateral or security is obtained. The signature loan carries an APR ranging from 1147% to more than 1500%, is amortized over a year-long repayment term, and requires borrowers to pay back several times in excess of the principal amount financed on their loan if the borrower takes the full year to pay back the loan. While Defendants offer only a 12-month signature installment loan, the interest on the loan is not precomputed, and the loan can be repaid at any time to avoid finance charges. See D's Exhibit 48. Thus, a person may borrow the money and avoid remaining interest charges by paying off the loan shortly after the money is borrowed.

The Attorney General has presented evidence regarding individual borrowers and the demographics of those who take out this type of loan. As to individual borrowers, the evidence shows that Oscar Wellito's borrowed $100. His loan carries an APR of 1147.14% and is amortized over a 12-month term. Over the term of the loan he makes repayment in 26 equal bi-weekly installments of $40.16 and one final payment of $55.24, and carries a total finance charge of $999.71. (Plaintiff's Exhibit 76) Mr. Wellito testified that he went to Cash Loans Now because he lived paycheck to paycheck and needed money for gas and to feed his children. (Tr. 9-23-2010, pp. 2 -3) When Mr. Wellito took out his first loan for $50 from Cash Loans Now, Mr. Wellito was making a little more than $9 per hour. (Tr. 9-23-2010, p. 3) Mr. Wellito chose Cash Loans Now not because they offered the best prices, but because the Cash Loans Now advertisements he had received made the process of obtaining a loan and paying it off look so easy. (Tr. 9-23-2010, pp. 3 -4)

Henrietta Charley's $200 loan amount carries an APR of 1147.14% and is amortized over a 12-month term, with repayment in 25 bi-weekly payments of $90.65 and a 26th final payment of $93.04 for a total of $2,160.04 finance charge, and total of payments of $2,360.04. (Plaintiff's Exhibit 31) Ms. Charley, a divorced mother of three, testified in her deposition that she earns only $10.71 per hour on a 32-hour per week work schedule. (Charley Deposition at 5:19 – 6:3; 7:20-24). Ms. Charley testified that while she is entitled to child support, her ex-husband pays it only "now and then." (Charley Deposition at 8:2-5). Ms. Charley falls behind on her bills whenever the child support is late. (Charley Deposition at 8:15-22). At the time she took out her loan from Cash Loans Now, Ms. Charley needed money for groceries and gas. (Charley Deposition at 10:10-21; 15:6-14). Ms. Charley chose Cash Loans Now not because they offered the best prices, but because they were an "easy" option and because her credit at the time "wasn't that great." (Charley Deposition at 18:16-21; 41:19-21). Cash Loans Now offered Ms. Charley an "easy" way out of her financial trouble. (Charley Deposition at 20:20-23).

Similarly, Ms. Atcitty, a fourth-grade Navajo bi-lingual educator, testified in her deposition that she takes home only $800-900 per month, or approximately $20,400 (net) per year during the school year. (Atcitty Deposition at 5:9 – 6:14; 9:19 – 10:5; 10:15-18; 11:5-11). Each summer, she is laid off for the month of July and draws no income during that time period. (Atcitty Deposition at 10:19 – 11:5). In addition to meeting her own expenses, she is called upon throughout the year to help meet the expenses of her two children and many grandchildren. (Atcitty Deposition at 12:5-18). Ms. Atcitty chose Cash Loans Now because she had a bad credit history, she was short on money, and because she (mistakenly) believed that borrowing from Cash Loans Now would allow her to improve her credit. (Atcitty Deposition at 24:7-8; 11:12-14; 13:16 – 14:5; 30:1-12).

The Attorney General presented demographic evidence that the borrowers of these loan products, as a group, have less education and less income than the population as a whole, and are more likely to be members of disadvantaged ethnic minority groups that the population as a whole. The Attorney General's expert, Christopher Peterson,[1] relied upon data generated by a 2009 FDIC survey of unbanked and underbanked households. (Plaintiff's Exhibit 81, at 10 & ns. 3 & 6) The FDIC survey reports the following data about unbanked and underbanked households in New Mexico, along with data about the racial/ethnic status of those households:

- 11.4% of New Mexico households are unbanked (Plaintiff's Exhibit 81, Table B-33);
- 13.4% of Hispanic households and 29.3% of "Other" households (probably, Native American households) in New Mexico are unbanked (Plaintiff's Exhibit 81, Table B-33);
- 21.7% of New Mexico households are underbanked (Plaintiff's Exhibit 81, Table B-33); and

[1] Professor Peterson is a law professor who has focused his research on consumer financial services. Tr. 09-23-2010, p. 68.

- 27.2% of Hispanic households and 29.0% of "Other" households in New Mexico are underbanked (Plaintiff's Exhibit 81, Table B-33).

The survey also reports the following data about the education level and income status of unbanked and underbanked households in New Mexico:

- 27.9% of unbanked households and 24.2% of underbanked households in New Mexico earn less than $15,000 per year (Plaintiff's Exhibit 81, Table B-33);
- 26.4% of unbanked households in New Mexico have no high school degree, while only a little more than 11% of those households have any college education at all (Plaintiff's Exhibit 81, Table B-33); and
- Over 50% of underbanked households in New Mexico have either no high school degree or only a high school degree, while just over 37% of those households have any college education at all (Plaintiff's Exhibit 81, Table B-33).

According to the testimony of James Bartlett, one of the owners of the defendant lenders, these are the households to whom Defendants market the signature loan product. (9/22/2010, TR-55, Lines 4-6; TR-55, Line 24 – TR-56, Line 4). These are the households with whom Defendants originate their signature loans. (9/22/2010, TR-60, Lines 16-21).

In addition to presenting evidence about the demographics of the people who take out signature loans, the Attorney General introduced evidence that the borrowers, who use signature loans to obtain credit, exhibit common behavioral heuristics and cognitive biases which, according to the Attorney General's witness, result in their making decisions that do not reliably promote their best interests. The Attorney General offered evidence that at least some signature loan borrowers exhibit certain behavioral heuristics and cognitive biases which result in their committing decision-making errors.[2]

[2] This testimony may have been offered to prove substantive unconscionability and to disprove Defendants' overly sanguine view of the ever-rational consumer borrower. In addition, the evidence is relevant to the issue of procedural unconscionability by linking the mechanisms used by Defendants to market its signature loans to the borrowers' lack of knowledge, ability, and capacity. .

According to the Attorney General's expert, Christopher Peterson, behavioral theories of consumer decision-making can be linked to specific borrower testimony the Attorney General offered, as well as to findings from a point-of-sale survey of subprime borrowers conducted by Professor Nathalie Martin at the University of New Mexico Law School. This testimony includes evidence of:

- Unrealistic Optimism: Professor Peterson testified that borrowers tend to overestimate their ability to control future circumstances and underestimate their exposure to risk. (Tr. 9-23-2010, pp. 131-132) This theory is consistent with borrower testimony from Mr. Wellito and Ms. Charley who both testified that they thought they would be able to pay off the loan early, before the long-term costs of the loan began to mount. (Tr. 9-23-2010, pp. 133-135; Charley Deposition at 16:5 – 17:14) This is also consistent with the findings of the Martin point-of-sale survey of subprime borrowers, namely, that surveyed borrowers were "hopelessly optimistic" about their ability to pay back the loans they had taken out. (Tr. 9-23-2010, pp. 136 -137)

- Intemporal Biases: Professor Peterson also testified that borrowers tend to discount the value of future wealth and future financial obligations while focusing on the benefits of quick cash in the present or near term. Thus, the promise of quick cash, or cash now, can override or circumvent a more considered judgment about the long-term costs and risks of the loan. (Tr. 9-23-2010, pp. 137-139) This theory is consistent with testimony from Mr. Wellito that he was drawn to Cash Loans Now because their advertisements made the whole process look so easy. (Tr. 9-23-2010, pp. 3 -4, 141-142) Similarly, Ms. Charley was drawn to Cash Loans Now because it was an "easy" way out of her financial distress. (Charley Deposition at 18:16-17; 41:19-21).

- Framing and Anchoring Effects: Professor Peterson also testified about "framing effects" - the way the price of a loan is framed for a prospective borrower may distort the borrower's perception of its cost. If the cost of a loan is framed as something nominal or very low, a borrower's expectations can be anchored in that perception, making it difficult for a borrower to reassess the true costs and risks of the loan once subsequent price information is divulged. (Tr. 9-23-2010, pp. 146 -151) This theory is also consistent with testimony from several borrowers who focused on the bi-weekly payment obligation rather than a consideration of the full, long-term costs and risks of the loan. (Atcitty Deposition at 15:5 – 20:24, 24:25 – 25:9, and 25:18 – 26:11; Charley Deposition at 40:2-5; Tr. 9-23-2010, p. 5)

- Information Overload: Professor Peterson also testified about the way borrowers process information - borrowers, when provided with a complex loan agreement containing legal and financial jargon, will opt out of gaining a comprehensive understanding of the agreement in favor of focusing on a term that they can understand, such as the bi-weekly payment amount. (Tr. 9-23-2010, pp. 153-154) This theory is consistent with borrower testimony to the effect that the loan origination process was a hurried "sign here, sign there" affair and testimony that borrowers focused on the bi-weekly payment obligation rather than the full, long-term costs. (Atcitty Deposition at 15:5 – 20:24, 24:25 – 25:9, and 25:18 – 26:11; Charley Deposition at 40:2-5; Tr. 9-23-2010, p. 5) This theory is also consistent with the findings of the Martin study, in which more than 70% of the surveyed borrowers could not identify the APR on their loan *at the point of sale*. (Tr. 9-23-2010, pp. 153 -154)

In counterpoint to the Attorney General's expert the Defendants presented Professor Tom Lehman.[3] Professor Lehman presented the neoclassical Benthemite arguments against limits on usury and the paternalism of intervention in the market. This theory is premised on the belief that individuals know what is best for themselves and they will act in their own best interest. Individuals, according to this theory, act rationally and balance the marginal costs and benefits of any action. (Tr. 9-30-2010, p. 7) Under the theories expressed by Professor Lehman, there is no such thing as a "fair" interest rate; there is only the rate that emerges in the market place. (Tr. 9-30-2010, p. 35)

This case cannot, in the Court's opinion, be decided without reference to the history of legislation on lending practices in New Mexico. New Mexico's legislative approach to lending regulation has varied, not surprisingly, based on the financial conditions being addressed at the time of the legislation. While territorial New Mexico may have had no usury laws and may have left the rate of interest to the contracting parties,[4] between the 1930's, the time of the Great

[3] Professor Lehman teaches economics at Indiana Wesleyan. One of his areas of concentration is the small loan, pay-day lending business.

[4] *Coler v. Board of County Com'rs of Santa Fe County*, 27 P. 619, 623 (N.M.Terr. 1891) (Laws 1872, Ch. 19 abolished usury, and left all persons free to contract concerning the rate of

Depression, and 1981, New Mexico had a statutory cap on interest. (See Tr. 09-23-2010, p. 224) In the 1970's the federal government did away with Regulation Q which then allowed states to set their own interest rates. (Tr. 9-30-2010, p. 111-12) In 1981, the New Mexico legislature abolished the usury rate and allowed the maximum rate of interest to be the "rate agreed to in writing by the parties." L. 1981, Ch. 263.

Prior to 1981 the legislature had also enacted the Small Loan Business Act of 1955 which recognized a widespread demand for small loans. NMSA 1978 § 58-15-1(A) (1955) The legislature recognized both the high cost of making these loans and the potential for borrower exploitation by exorbitant charges that exceeded the costs necessary to conduct a small loan business. NMSA 1978 § 58-15-1(B) and (C). In 1981, the usury provisions governing the Small Loan Business were also abolished. See Laws 1981, Ch. 263 repealing NMSA 1978 § 58-15-14 (effective 1983).

Subsequently, the state saw an increase in the number of payday lenders. Various parts of the state government, including the Attorney General and the Financial Institutions Division, tried to administratively regulate interest rates charged by payday lenders. However, litigation blocked these attempts. See Case Nos. CV-2006-01204 and CV-2006-01213 regarding the AG regulations. See Tr. 9-29-2010, pp. 98-99 regarding FID regulations. *Fastbucks of Alamorgordo, et.al. v. Verant, et. al.*, D-0202 CV 2006 06317, and *Check 'N Go, et al. v. Verant*, CV-2006 06370, were decided by Judge Knowles who issued a permanent injunction, enjoining the FID from enacting its proposed regulations. *Id.*

In 2007 the Legislature specifically addressed payday loans and effectively capped interest rates at an APR of about 400 percent. *See generally* NMSA 1978 § 58-15-31, *et seq.*

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interest.).

(2007). William Verant, Director of the FID, testified that the effective APR on a payday loan subject to the SLA's reform provisions would be around 400 percent. (Tr. 9-29-2010, p.126)[5] The regulations imposed on payday loans included other features that prevented unlimited rollovers, another perceived means of borrower exploitation.

Following this legislation, the number of payday lenders decreased sharply, and the number of small installment loans – such as the signature loans at issue here – increased. *See* Tr. 9-29-2010, pp. 61, 107, 109-114. These loans are offered under the Money, Interest, and Usury Act because such loans are not regulated under the Small Loan Act or Installment Banking Act. (Tr. 9-22-2010, p. 69) It is evident that once the legislature put curbs on the ability of the lenders to continue the most criticized aspects of the payday loan, lenders switched to the unregulated signature loan market and substituted the signature loan for the old payday loan.[6]

Two bills were introduced to address installment loan terms, including the rate of interest which could be charged. *See* Tr. 9-29-2010, p. 114-116. H.B. 558 and S.B. 331, introduced in 2009, of which the Court takes judicial notice, both address interest rates and loan duration. *See* Section 58-15-20.1(C) of each bill. Neither of these bills has been adopted, and the legislative debate is on-going. See Tr. 9-29-2010, p. 116-117.

In addition to raising competing economic world views, this case raises issues that implicate fundamental legal principles. On one level it raises issues of freedom of contract

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[5] Professor Peterson states that the interest rate in New Mexico on Payday Loans after the 2007 legislation is 404 percent. Christopher Peterson, *Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, 92 MINN. L. REV. 1110, 1142 (2008).

[6] In fact, Mr. Barlett testified that he had instituted this loan product in Illinois after that state enacted payday loan protections. (Tr. 9-22-2010, pp.53-54).

versus the unconscionability safety net.[7] On another level it raises systemic issues regarding role of courts versus the role of the legislature.

There is no doubt that freedom of contract and enforcing the parties' contract as written is deeply embedded in New Mexico law. *See, e.g., Watson Truck & Supply Co., Inc. v. Males*, 111 N.M. 57, 60, 801 P.2d 639, 642 (1990) ("This Court will not rewrite a contract to create an agreement for the benefit of one of the parties that, in hindsight, would have been wiser."). Not infrequently, however, even as the appellate courts state such principles, they recognize exceptions. Thus, *Eiferle v. Toppino*, 90 N.M. 469, 470, 565 P.2d 340, 341 (N.M. 1977), states: "Under the circumstances, we will not rewrite the contract into which the parties freely entered . . . , and, *absent unfairness which shocks the conscience of the court*, [a party is] entitled to enforce the contract as written." (Emphasis added.) The intertwining of these bedrock principles has been aptly stated by the Utah Supreme Court:

> With a few exceptions, it is still axiomatic in contract law that persons dealing at arm's length are entitled to contract on their own terms without the intervention of the courts for the purpose of relieving one side or the other from the effects of a bad bargain. . . . Parties should be permitted to enter into contracts that actually may be unreasonable or which may lead to hardship on one side. . . . Although courts will not be parties to enforcing flagrantly unjust agreements, it is not for the courts to assume the paternalistic role of declaring that one who has freely bound himself need not perform because the bargain is not favorable. Of course, this general principle has its limits. An established exception is that if a contract is unconscionable, in whole or in part, the court may, on equitable grounds, refuse to enforce the unconscionable provisions, or it may construe the contract to avoid an unconscionable result. . . .

Bekins Bar V Ranch v. Huth, 664 P.2d 455, 459 (Utah1983) (internal quotations and citations omitted).

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[7] Professor Amy Schmitz describes the role of unconscionability in the context of contracts as providing "a flexible safety net for catching contractual unfairness that slips by formulaic contract defenses." Amy Schmitz, *Embracing Unconscionability's Safety Net Function*, 58 ALA. L. REV. 73 (2006).

Unconscionability has a well-recognized role in the law of contracts with both common law and statutory origins. As recently stated by our Supreme Court:

> Unconscionability is an equitable doctrine, rooted in public policy, which allows courts to render unenforceable an agreement that is unreasonably favorable to one party while precluding a meaningful choice of the other party. *Guthmann v. La Vida Llena*, 103 N.M. 506, 510, 709 P.2d 675, 679 (1985); *see also Builders Contract Interiors, Inc. v. Hi-Lo Industries, Inc.*, 2006-NMCA-053, ¶ 8, 139 N.M. 508, 134 P.3d 795 ("We will allow equity to interfere ... only when 'well-defined equitable exceptions, such as unconscionability, mistake, fraud, or illegality' justify deviation from the parties' contract." (quoted authority omitted)). The doctrine of contractual unconscionability can be analyzed from both procedural and substantive perspectives. *See Fiser*, 2008-NMSC-046, ¶ 20, 144 N.M. 464, 188 P.3d 1215 (striking down a substantively unconscionable arbitration clause as violative of New Mexico public policy).

Cordova v. World Finance Corp. of NM, 2009-NMSC-21, ¶ 21, 146 N.M. 256, 208 P.3d 901. As *Cordova* recognized, "While there is a greater likelihood of a contract's being invalidated for unconscionability if there is a combination of both procedural and substantive unconscionability, there is no absolute requirement in our law that both must be present to the same degree or that they both be present at all." *Id.* at ¶ 24.

Substantive unconscionability "concerns the legality and fairness of the contract terms themselves. *Id.* at ¶ 22. As *Cordova* explained:

> Substantive unconscionability relates to the content of the contract terms and whether they are illegal, contrary to public policy, or grossly unfair. The substantive analysis focuses on such issues as whether the contract terms are commercially reasonable and fair, the purpose and effect of the terms, the one-sidedness of the terms, and other similar public policy concerns.

Id. (internal punctuation and citations omitted). The concept of substantive unconscionability has been codified in the Unfair Trade Practices Act ("UPA") as "an act or practice in connection with . . . the extension of credit . . . that to a person's detriment . . . results in a gross disparity between the value received by a person and the price paid." NMSA1978 § 57-12-2(E) (2009).

The UPA also codifies procedural unconscionability. Section 57-12-2(E)(1) UPA defines an unconscionable trade practice as any act or practice in connection with the extension of credit that, to a person's detriment, "takes advantage of the lack of knowledge, ability, experience, or capacity of a person to a grossly unfair degree."[8] Under common law, "[p]rocedural unconscionability goes beyond the mere facial analysis of the contract and examines the particular factual circumstances surrounding the formation of the contract, including the relative bargaining strength, sophistication of the parties, and the extent to which either party felt free to accept or decline terms demanded by the other." *Cordova, id.* at ¶ 23.

This decision will first address substantive unconscionability. In this case, the Attorney General attacks the interest rates – 1147 and 1500 percent – as being unconscionable. To quote from the Attorney General's closing argument brief:

> Defendants' signature loans contain terms that, on their face, result in a gross disparity between the value received by their borrowers and the price paid. They carry APRs ranging from 1147.14% to more than 1500% and are amortized over a 12-month term. So, for example, Oscar Wellito's $100 loan carries an APR of 1147.14%, is amortized over a 12-month term, requires repayment in 26 equal bi-weekly installments of $40.16 and one final payment of $55.24, and carries a total finance charge of $999.71. (Plaintiff's Exhibit 76). Henrietta Charley's $200 loan amount carries an APR of 1147.14% is amortized over a 12-month term, requiring repayment in 25 bi-weekly payments of $90.65 and a 26th final payment of $93.04 for a total of $2,160.04 finance charge, and total of payments of $2,360.04. (Plaintiff's Exhibit 31). These terms, by themselves, make out a prima facie case for gross disparity between value received and price paid.

Plaintiff's Closing Argument at p. 17. There is, indeed, something that is shocking about these APRs and about the amount of the charges. These facts, however, ignore the ability of the

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[8] The UPA states:

> "unconscionable trade practice" means an act or practice in connection with . . . the extension of credit . . . that to a person's detriment:
>
> (1) takes advantage of the lack of knowledge, ability, experience or capacity of a person to a grossly unfair degree; or
>
> (2) results in a gross disparity between the value received by a person and the price paid.

NMSA 1978 § 57-12-2(E) (2009).

borrower to pay early and to avoid much of the finance charge. More importantly, these facts ignore the fact that the borrow obtained a value beyond the face value, or even the time value, of the money borrowed – the ability to buy groceries for his children now, the ability to buy gas to get to a new job, the ability to pay off a cell phone.

This argument is a claim that the price of the loan is unconscionable. It is clear that price unconscionability cases are a subset of the unconscionability doctrine.[9] Some cases have recognized: "(g)iven the interest in commercial certainty, the exclusiveness of the creditors equitable remedy in bankruptcy, and the knowledgeability of the borrower where economic duress is the basis of the asserted unconscionability, to prove unconscionability there must be a showing, not only that the terms of the contract are onerous, oppressive or one-sided, but also that the terms bear no reasonable relation to the business risks. This is a showing that depends on the commercial environment and cannot be made from the face of the contract alone." *In re Metal-Built Products, Inc.*, 3 B.R. 176, 179 (Bkrtcy.Pa. 1980) (internal quotations and citation omitted). The theoretical underpinning for this result comes from the realization that "it is difficult to imagine that a party could not walk away from a transaction or that a party could be surprised by a price term so that the rules of unconscionability would come into play under traditional market assumptions."[10] This line of reasoning would reject the Attorney General's argument regarding substantive unconscionability.

There are, however, cases which reach an opposite result. For example, in *Carboni v. Arrospide*, 2 Cal. App.4th 76, 80, 2 Cal. Rptr.2d 845 (1991), the court had "little trouble" concluding that an interest rate of 200 percent was substantively unconscionable because "it imposes a cost on the borrower which is overly harsh and was not justified by the circumstances

[9] Frank P. Darr, *Unconscionability and Price Fairness*, 30 HOUS.L.REV. 1819 (1994).
[10] *Id.* at 1832.

in which the contract was made." *Id.* at 83. *See also O'Donovan v. Cashcall, Inc.*, 2009 WL 1833990, *8-9 (N.D. Cal. 2009) (holding the allegation of a 98 percent interest rate with repaying four to six times the original loan was sufficient to show substantive unconscionability).

The Attorney General and his expert do not credit the intangible value to the borrower of having a loan of the type at issue.[11] This Court believes that it is not appropriate for the Court to determine as a matter of law for all borrowers that the interest rate charged or the amount paid back always outweighs the value received by the borrower. The policy determination as to when it is better to deprive a class of consumers of a choice on the grounds that they are making a poor choice is better left to the legislature. Our legislature has taken the position that the market place is the best way to set interest rates for installment loans. Despite being asked to change that policy choice as it relates to signature loans, the legislature has refused to do so. The evidence from the Defendants' expert supports this policy decision. Whether it is the policy choice the Court would make is not the question. The question is who should make the choice.

To overcome this functional hurdle to the propriety of a court making this determination, the Attorney General cites the fact that the legislature adopted the UPA unconscionability provision, which assigns to the court the role of determining whether "results in a gross disparity between the value received by a person and the price paid." NMSA 1978, § 57-12-2(E)(2). To the Court, the statutorily mandated evaluation can be made with regard to an individual loan

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[11] It goes without saying that the Attorney General and his expert reject the Defendants' expert's concerns over possible adverse consequences if the signature loan market is abolished or driven out of New Mexico. In fact, the Attorney General's expert compared the ability of people to obtain a signature loan to the ability of people to obtain heroin both of which are so detrimental that they should, in Professor Peterson's opinion, be prohibited. The Court, however, believes that it is through the legislative process that the possible gains to be had from limiting interest rates and other lending practices can best be weighed against the possible detrimental effects of such limitations.

based on the evidence presented as it relates to each transaction.[12] In this case, the Attorney General eschewed such a showing for the vast bulk of the borrowers.[13] For these reasons the Court declines to declare either the interest rates or the repayment terms unconscionable.

This is not, however, the end of the inquiry. As recognized by the principles stated in *Cordova*, even if the price standing alone will not justify a finding of unconscionability, it is appropriate to look to the procedures surrounding the making of the loan. In this case, the terms of the loan are so onerous, that even if the Court is unwilling to declare them unconscionable out of deference to the legislative process, the procedural aspects of the transactions deserve particular scrutiny. *Cf. O'Donovan*, 2009 WL 1833990 at *7 (recognizing that a sliding scale is involved in evaluating the procedures surrounding contract formation and the harshness of the substantive terms); *Fiser v. Dell Computer Corporation*, 2008-NMSC-046, ¶ 20, 144 N.M. 464, 188 P.3d 1215 (stating: "The weight given to procedural and substantive considerations varies with the circumstances of each case.") (citation omitted).

As noted in *Perdue*, the "procedural aspects" of unconscionability include the absence of meaningful choice, the lack of sophistication of the borrower, and the presence of deceptive practices by the seller. *Perdue v. Crocker National Bank*, 38 Cal.3d 913, 702 P.2d 503, 513, 216 Cal.Rptr. 345, 355 (1985). Further, the UPA sets forth the following as an unconscionable lending trade practice under Section 57-12-2(E)(1): any detrimental act or practice that "takes advantage of the lack of knowledge, ability, experience, or capacity of a person to a grossly

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[12] Plaintiff's case will turn upon further allegations and proof setting forth the circumstances of the transaction, in addition to showing that the price charged outweighed the cost or fair market value. *Perdue v. Crocker National Bank*, 38 Cal.3d 913, 926, 216 Cal.Rptr. 345, 354, 702 P.2d 503, 512, (1985).

[13] Even as to the sample borrowers, the Court is unaware of a request that their loans be individually assessed for price unconscionability. If the Court is incorrect in its perception, this error should be called to the attention of the Court in the form of a motion requesting relief for the individual borrowers with supporting transcript and exhibit cites.

unfair degree." *See also* Restatement (Second) of Contracts § 208 (1979), cmt. c (identifying inequality of bargaining power and unfavorable terms as elements to consider in determining whether a contract is unconscionable).

In the Court's opinion these criteria look to the borrower, not to the lender, to determine procedural unconscionability. Under the heading of procedural unconscionability, the Attorney General discusses at length the poor underwriting practices of the Defendants – namely that they do not ascertain whether the borrowers can repay the loans. While the Court does not dispute the factual accuracy of the argument, the Court does question its legal applicability. The Attorney General cites no authority for the proposition that such practice would make a loan unconscionable.[14] The Court is not basing its decision on this argument.

The Court finds persuasive the evidence introduced by the Attorney General that the borrowers who obtain loans from Defendants are less educated and have less income.[15] These facts are indicative of the borrowers' lack of sophistication and lack of the statutory "knowledge, ability, experience, or capacity." This, without more, would probably not suffice to show unconscionability, but it does show that this market is not populated by two parties of equal bargaining ability and strength.

Analytically related to the demographic information about the borrowers as a group are the behavioral attributes of this group of borrowers. The Court finds persuasive the testimony from Professor Peterson that the borrowers as a group exhibit unrealistic optimism (p. 5, *supra*) and temporal biases (p. 5, *supra*).

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[14] The new provisions regarding payday loans address this issue, at least indirectly, by prohibiting loans where repayment of all loans would exceed 25 percent of the borrower's gross monthly income. The Court is unaware of any comparable provision that relates to installment loans, in general, or signature loans, in particular.
[15] According to the FDIC survey, significant numbers would fall below the federal poverty guideline.

These characteristics, however, are not determinative as to whether the loans are unconscionable. The Court must look to the Defendants' practices to determine if these practices have taken unfair advantage of the borrowers' characteristics. In this regard, the Court finds that the evidence supports a finding that Defendants' marketing practices are unconscionable given the lack of sophistication, knowledge, ability, experience, and capacity of the borrower targets.

Professor Peterson testified about the behavioral theory of "framing effects," which states that the way the price of a loan is framed for a prospective borrower can distort the borrower's perception of its cost. If the cost of a loan is framed as something nominal or very low, the borrower's expectations can be anchored in that perception, making it difficult for him or her to reassess the true costs and risks of the loan once subsequent price information is divulged. (Tr. 9-23-2010, pp. 146-151) This theory is also consistent with borrower testimony in this case. Several borrowers offered testimony that they focused on the bi-weekly payment obligation and did not consider the full, long-term costs and risks of the loan. (Atcitty Deposition at 15:5 – 20:24, 24:25 – 25:9, and 25:18 – 26:11; Charley Deposition at 40:2-5; Tr. 9-23-2010, p. 5).

- Information Overload: Professor Peterson also testified about information overload - borrowers, when confronted with a complex loan agreement, containing legal and financial terms, will opt out of gaining a comprehensive understanding of the agreement in favor of the same focus on a term that they can understand, such as the bi-weekly payment amount. (Tr. 9-23-2010, pp. 153 -154) This theory is also consistent with the borrowers' testimony that the loan origination process was a hurried "sign here, sign there" affair, conducted under the distress that naturally accompanies financial upheaval. And this theory is also consistent with the findings of the Martin study, in which more than 70% of the surveyed borrowers could not identify the APR on their loan *at the point of sale*. (Tr. 9-23-2010, pp. 153-154)

Defendants have a stated policy of quoting the price of their signature loans in terms of a small daily amount. (Plaintiff's Exhibit 56, at Bates No. B&B/CLN 00216, p. 25 of manual; Plaintiff's Exhibit 57, at Bates No. B&B/CLN 00107, p. 23 of manual; Plaintiff's Exhibit 58, at Bates No. B&B/CLN 02429, p. 17 of manual). In the 2009 store manual, employees are directed to quote the interest rate on Defendants' loans at "between $1 and $1.50 per day per $100 you borrow." (Tr. 9-22-2010, p.97-98) In the 2010 store manual, the rate is quoted as "less than $2 per day per $100 of the principal of the loan." (Tr. 9-22-2010, p.98) This practice frames the cost of the loan as something quite low, when the reality is that the cost is quite high; and it anchors borrowers' perception of the loan at this low number before a full disclosure of the long-term costs and risks of the loan are made in the TILA disclosure at the point of sale. (Tr. 9-23-2010, pp.146-147; 150-151).[16]

Defendants try to avoid the magnitude of this practice by claiming that the daily price quoting is limited to phone inquiries. But, as Bartlett also testified, the store manual provides a per day rate because, in his opinion, "people best understand the per day." (Tr. 9-22-2010, p. 101) The evidence also shows this practice extends to the loan origination process at the point of sale. Linda Ford testified in her deposition that the American Cash Loans employee who originated her loan told her that she would be paying $2.19 per day in interest on her loan. (Ford Deposition at 13:20-23). Moreover, and as James Bartlett admitted at trial, the nominal daily amounts the Defendants quote do not even accurately reflect the rates for the signature loans. (Tr. 9-22-2010, p. 98 -99)

[16] The Defendants also have advertisements and promotional material that promise "50% off," but the fine print shows that the 50% off applies only to the interest on the first of many installment payments. (Defendants' Exhibit 36, at B&B/ACL 00010; Defendants' Exhibit 36, at B&B/ACL 00012). This practice is comparable to the practice of quoting the cost of a loan in terms of a nominal daily amount, because it anchors prospective borrowers' perception of the promotion on a "half-price" feature, even though the actual promotion does not give the borrower a 50% discount on the full cost of the loan. (Tr. 9-23-2010, p. 152 -153).

The Court also finds that Defendants also have had a practice of withholding amortization schedules which show the total cost of the loan and which show that most of the first repayments go to interest only.[17] (Plaintiff's Exhibit 56, at Bates No. B&B/CLN 00249, p. 58 in manual; Plaintiff's Exhibit 57, at Bates No. B&B/CLN 00140, p. 56 in the manual; Plaintiff's Exhibit 58, at Bates No. B&B/CLN 02464, p. 52 in the manual)[18] Ms. Atcitty testified at her deposition that she did not get a copy of her amortization schedule. (Atcitty Deposition at 21-22; 32) She also testified that Cash Loans Now never explained that her signature loan was an installment loan requiring payments over a full year or that the majority of the bi-weekly payments called for over the first part of her repayment term would be applied to interest only. (Atcitty Deposition at 22 – 24; 32) Ms. Charley testified she was never given a copy of her amortization schedule. (Charley Deposition at 19; 20) Nor did anyone from Defendants' storefront tell her that the first 16 bi-weekly payments on her loan would be applied to interest only. (Charley Deposition at 20) Similarly, though he testified to not knowing what an amortization schedule is, Mr. Wellito confirmed that he never received a schedule outlining what his payment obligation would be. (Tr. 9/23/2010, p. 17) This practice exploits the borrower's unrealistic belief in his/her ability to repay the loan and hides a visual representation of the true cost of the loan.

Defendants have a stated policy encouraging their employees to "call active files to increase principal" and to let people know they can reborrow. (Plaintiff's Exhibit 57, at Bates No. B&B/CLN 00101, p. 17 of manual; Plaintiff's Exhibit 58, at Bates No. B&B/CLN 02485; Tr. 9-22-2010, pp. 92; 134; 95) Defendants' former employee testified that she frequently called

[17] This practice of having borrowers pay interest-only for a number of payments was noted as an aspect of unconscionability in *O'Donovan*, 2009 WL 1833990, *9.
[18] Mr. Barlett's denial that this is the policy is not credited in light of the inclusion of this direction in the various versions of the Policy Manual, including the July 2010 version. (Plaintiff's Exhibit 58, at Bates No. B&B/CLN 02464, p. 52 in the manual).

a customer who was one payment away from paying off the loan to offer them another loan. (Childers Deposition at 95:21-25). The evidence supports a finding that this practice exploits unrealistic optimism by encouraging them to max out their available credit at a time when their optimism is at its peak. (Tr. 9-23-2010, pp. 135 -136) Thus, Defendants contribute to the borrowers continuing in the cycle of never ending indebtedness.[19]

Further, the Defendants' signature loans have the indicia of a contract by adhesion. Employees and borrowers both testified to the non-negotiability of the terms. The loan terms were set by drop down menus in a computer program. (Kunz Deposition at 86:13-23; 87:20-23; Childers Deposition at 69:15-20; 76:9-12; Atcitty Deposition at 27:24 – 28:14; Kunz Deposition at 145:8 – 146:2; Tr. 9-22-2010, p. 85) The evidence supports a finding that the loans were non-negotiable.

It is also a fair inference that the parties had unequal bargaining power.[20] This consideration can take place "without specifics of the borrower's particular financial situation in the record" when it is clear "that the borrower needed money badly and would have been in a relatively weak bargaining position" as a result.[21]

The parties disagree over the role to be played by the availability of other loan alternatives in the marketplace. There is certainly case law supporting the Defendants' position that one element of the showing that needs to be made is that there was no alternative source the borrower could look to for credit. The Court, however, believes that New Mexico is moving

[19] Defendants also engage in some marketing practices such as targeting borrowers around the holidays and encouraging them to use loans for vacations. While there is evidence that this exploits the borrowers intemporal biases by focusing them on the short-term benefits rather than the long-term costs, the Court would be hard-pressed to say these tactics standing alone were unconscionable.

[20] *Cordova v. World Fin. Corp.*, 2009-NMSC-021, at ¶ 32.

[21] *Id.* (quoting *Wis. Auto Title Loans, Inc. v. Jones*, 714 N.W.2d 155, 169 (Wis. 2006)).

away from this as a required element of an unconscionability claim. *Cf. Cordova* 2009-NMSC-021, ¶ 31. This move away from a requirement that a plaintiff must show there were no alternative providers with better terms is consistent with the evolution of the law in other states. *See, e.g., O'Donovan*, 2009 WL 1833990, *7, citing *Shroyer v. New Cingular Wireless Servs., Inc.*, 498 F.3d 976, 985 (9th Cir. 2007) ("a contract may be procedurally unconscionable . . . when the party with substantially greater bargaining power presents a 'take-it-or-leave-it' contract to a customer – even if the customer has meaningful choice as to service providers.").

This Court agrees with the Attorney General's assessment that marketplace alternatives for the subprime borrower are not meaningful, more favorable alternatives. For this reason, the Court rejects the argument that the Attorney General must show that no such alternative products exist. The relevant inquiry under *Cordova* is whether Defendants' borrowers felt free to accept or decline the terms demanded by Defendants.[22] The evidence of the particular borrowers' circumstances and the demographics of the borrowers as a group lead the Court to conclude that in this context, freedom of choice was as illusory as the Benthemite rationale consumer. This loan product is specifically targeted at the unbanked which results in the borrowers having few alternative sources of credit. For these reasons, the Court finds that the loans are the product of procedural unconscionability.

The Court will briefly address the defense of estoppel asserted by the Defendants. Defendants assert that because the FID never prohibited them from charging the rates they charge, the Attorney General is now estopped from asserting that their loan products are unconscionable. The Court believes that this defense has not been proved either factually or

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[22] *Cordova v. World Fin. Corp.*, 2009-NMSC-021, ¶ 23, 146 N.M. at 262-63 ("Procedural unconscionability goes beyond the mere facial analysis of the contract and examines the particular factual circumstances surrounding the formation of the contract, including the relative bargaining strength, sophistication of the parties, *and the extent to which either party felt free to accept or decline terms demanded by the other*.") (emphasis added).

legally. The evidence shows that the FID has limited oversight of small lenders under the SLA, and it has no authority to regulate the interest rates charged on Defendants' signature loans. FID Director Verant testified that his division does not approve or disapprove of the interest rates charged by small loan licensees on installment loan products not within the SLA's regulatory ambit. (Tr. 9-29-2010, p. 24) Mr. Verant testified that payday loans are the only type of loan product FID approves. (Tr. 9-29-2010, p. 25) Mr. Verant further testified that he has limited authority under the Small Loan Act regarding other types of loans, so he does not have the authority to regulate interest rates or promulgate rules concerning permissible interest rates on any loan product other than the payday loan. (Tr. 9-29-2010, p. 64 -65, 130)

Defendants attempt to make out a case for regulation under the SLA licensure provisions that require the FID to determine that an applicant will promote the "convenience and advantage of the community" in which they operate. Mr. Verant testified that the APR and/or repayment term on a non-payday loan product could not provide a basis for denying licensure for failure to meet the "convenience and advantage" standard. (Tr. 9-29-10, p.131) The evidence shows that FID had no basis for regulating the signature loans; therefore, one cannot assume estoppel from the failure to regulate this product.

Further, the evidence also shows that the FID never told the Defendants that it "approved" of the interest rates being charged on the signature loans. Defendants argue that the annual examination process amounted to approval which then provides the basis for estoppel. That no one from FID ever explained FID's limited role in approving interest rates or loan agreements does not provide the basis for estoppel against the State. *Waters-Haskins v. N.M. Human Servs. Dep't*, 2009-NMSC-31, ¶ 16, 146 N.M. 391, 210 P.3d 817, states:

> We generally disfavor applying the doctrine of equitable estoppel against the State. The doctrine is rarely applied against the State and then only in exceptional

circumstances where there is a shocking degree of aggravated and overreaching conduct or where right and justice demand it.

(Internal quotation marks and citation omitted). The failure to inform a lender that an agency has no authority over its interest rates falls far short of the aggravated and overreaching conduct needed to estop the Attorney General from bring a claim that the loans in question are unconscionable.

The Court also rejects Defendants' claim that the Court is precluded from deciding this case under the political question doctrine. As the Court understands this claim it is directly to the Attorney General's request that the loans be declared substantively unconscionable because the interest rates are too high and the repayment terms result in repayment of many times the amount borrowed. In the Court's opinion this issue is moot because the Court declined to find substantive unconscionability.

Further, the Court rejects this defense because the legislature has empowered the Court to determine unconscionability of acts taken with regard to the extending of credit under the UPA. The courts have long played a role in assuring that contracts are fair. At least one commentator has noted: "Unconscionability merely promotes commercial good faith and enhances 'the underdog's potential to make free choices,' which supports contractual liberty at the core of market efficiency."[23] While some commentators have decried this role for the same reasons Defendants argue this is a political question, the courts at least in New Mexico have not hesitated to perform this salutary function. *See Fiser*, 2008-NMSC-046, ¶¶ 9, 21 (recognizing that New Mexico policy strongly supports the resolution of consumer claims and that it is not hyperbole or exaggeration to say that it is a fundamental principle of justice in New Mexico that corporations

[23] Schmitz, *supra* at n. 7, 58 ALA. L. REV. at 114.

may not tailor the laws that our legislature has enacted in order to shield themselves from the potential claims of consumers).

Even though there may not be cases in New Mexico which have specifically addressed the issue of signature loans, there are a number of cases, some of which have been cited above, that have provided the standards and contours for an unconscionability determination. In addition, cases from other jurisdictions have considered the issue of high interest and have applied the doctrine of unconscionability to those decisions. The common law, thus, provides a sufficient framework for a court to make the required determinations.

In sum, the Court does not believe the factors enumerated in *Baker v. Carr*, 369 U.S. 186, 217 (1962), militate in favor of dismissing the case. It has been recognized that "it is crucial to distinguish questions about whether judicial power exists, from questions about whether judicial power should be exercised. *Vander Jagt v. O'Neill*, 699 F.2d 1166, 1170, 226 (D.C. Cir. 1983). In the present case, the Court has determined that the political question doctrine did not deprive it of jurisdiction. Nevertheless, the Court has determined that as to the issues raised by the interest rates and the amount of the repayments, the Court will defer to the legislature.

For the reasons given above, the Court declines to find that the interest rates and the repayment amounts are unconscionable and rejects the claim of substantive unconscionability and rejects the claim that UPA Section 57-12-2(E)(2) has been violated. The Court does find that the practices used by Defendants to extend credit are procedurally unconscionable and that UPA Section 57-12-1(E)(1) has been violated. The Court reserved the remedy portion of the trial. When the parties wish to be heard on that aspect of the case, they should request a hearing.

Sarah M. Singleton

Sarah M. Singleton, District Judge

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