MAYDAY PAYDAY: CAN CORPORATE SOCIAL RESPONSIBILITY SAVE PAYDAY LENDERS?

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Introduction

When Enron and WorldCom went bankrupt in 2001 and 2002, scholars, legislators, and corporate leaders scurried to find ways to prevent another major collapse in the U.S. equity markets. They scrutinized accounting practices, financial disclosure requirements, and the various components of corporations to develop new or stronger laws that would prevent future corruption and market failure. In a word, these reforms analyzed and restructured standards for corporate accountability.[3]

A second debate rages, but with less reform to date, regarding corporate social responsibility. In this article, we define corporate social responsibility as an interdisciplinary theory supporting the notion that corporations have a responsibility to contribute more to society than they take from it. In the context of Enron and WorldCom, this debate examines the negative impacts of these two corporations' practices on the communities in which they operated. The debate also raises the question, can corporations and legislators establish, together with corporate accountability, a heightened mandate for corporate social responsibility?

This article will analyze corporate social responsibility with respect to one aggressive lending industry: the industry of payday loans. Payday loans, also known as "cash advances" or "deferred deposit" loans, are loans that have a fast turn-around rate and provide quick access to cash. The industry debuted just over a decade ago and has since experienced tremendous market growth.[4] Because we believe that the intense recent growth of the payday loan industry will lead to an increasing number of payday corporations going public, we have performed a case study on one of the top public payday lenders, Advance America Cash Advance Centers, Inc ("Advance America").[5]

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[3] Cynthia Williams defines corporate accountability as corporations' obligation to account to society for the implications of their actions. This accountability entails a duty to inform society about social, political, economic, and environmental consequences of managers' and directors' exercise of their fiduciary responsibilities. Cynthia A. Williams, *Corporate Social Responsibility in an Era of Economic Globalization*, 35 U.C. DAVIS L. REV. 705 (2002).

[4] The first payday lender, Check Into Cash, Inc. of Tennessee, opened business in 1993. Pearl Chin, *Payday Loans: The Case for Federal Legislation*, 2004 U. ILL. L. REV. 723, 726.

[5] Payday lending practices are also the source of some angst in Canada. Some critics place the responsibility on Canadian banks and credit unions to "re-learn the art of serving the working poor so as

There are several problems with the payday lending industry, including problems permitted under current laws that regulate the industry and problems that raise questions of corporate social responsibility. Consumer rights advocates argue that payday lenders target clients who are vulnerable because of their low income or lack of financial knowledge. They further claim that payday lending agreements frequently include aggressive loan terms, encourage vicious debt cycles, and are followed by coercive collection practices. Advocates have also noted that payday lenders' failure to disclose loan terms to consumers until the terms come due harms consumers.[6]

In this article we ask what the best ways are to maximize the wealth of the payday lending industry while limiting the industry's harmful impact on consumer communities? We assert that payday lenders will likely demonstrate greater corporate social responsibility only after there is a change in the laws that govern the industry coupled with industry-wide reform in corporate governance. In Part I of this article we elaborate the problems associated with payday lending practices and examine one public payday company, Advance America. In Part II, we explore three potential solutions to minimize consumer harm in the payday loan industry: (1) changing the laws that govern payday lending as a financial industry; (2) supporting a status quo approach that allows the market to correct itself over time; and (3) encouraging internal change in payday lending corporate governance. We conclude that legislators and corporate leaders will best engage corporate social responsibility by balancing payday lending internal reform with Congress's imposed reform of harmful practices.[7]

I. THE PAYDAY LENDING DILEMMA

Payday lending is a lucrative industry that currently benefits from under-regulation. Lenders offer consumers small, unsecured, high interest, short-term cash loans.[8] In most cases, consumers write a personal check in the amount of the short-term loan plus a fee, post-dating the check so that the lender can hold the check as collateral until the end of the payday term, usually one to four weeks.[9] When the loan period has expired, the consumer can allow the lender to cash the check, pay the value of the loan in cash, or get a rollover loan for another period.[10]

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to start low-income families on the path toward greater financial stability." Critics also argue that Canada should promulgate civil and criminal laws that curb the growth of the payday loan industry. However, if the government were to heavily regulate the payday lending industry or shut it down, it is likely that unsophisticated customers with a source of income and a liquidity shortfall will continue these transactions through an underground market. So far, Canada has not solved the payday lending problem. *Wither the Payday Loan*, WINNIPEG FREE PRESS, Jan. 29, 2005, at A14.

[6] Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?,* 87 MINN. L. REV. 1, 32 (2002); Pennsylvania ACORN, *License to Steal? How Philadelphia's Largest Check-Cashier Chain Is Using Its State-Issued License to Siphon Millions of Dollars from Low-Income Households*, March 20, 2003, at 9. *See also* Chin, *supra* note 4, at 742.

[7] We respond to Dean Kellye Testy's challenge to find meaningful linkages between progressive corporate law and progressive social movements in order to foster better relations between corporations and society. In this article, we link corporate law regarding payday lenders to consumer rights. Kellye Y. Testy, *Linking Progressive Corporate Law with Progressive Social Movements*, 76 TUL. L. REV. 1227 (2002).

[8] Joseph M. Vincent, *The Pay Day End of Predatory Lending*, Statewide Civil Legal Services Conference (Leavenworth, Washington), Sept. 28, 2004, at 2.

[9] Chin, *supra* note 4, at 724.

[10] *Id*.

Since its inception a decade ago, the payday lending industry has benefited from a vast consumer base and rapid growth. From 2000 to 2003, consumers in the state of Washington took out over $1 billion in payday loans, which represented a growth in the lending market of 84%.[11] During the same period, the number of payday lending companies operating in Washington State increased from 90 to 124, with a total of 378 branch offices.[12] In 2003, consumers in Washington State took out a total of 2,983,477 small loans, an amount that equals one and a half loans for every Washington State resident who is 16 years or older.[13] In addition to repaying the premium on their loans, these consumers paid a total of $76,436,106.50 in fees.[14] Over 70% of consumers were repeat consumers, taking from two to nineteen loans during a one-year period.[15] These statistics, including lending fees and the rate of repeat consumers, help illustrate how consumers can easily become trapped in a web of accumulated loans and finance charges that can ultimately lead to grave debt or bankruptcy.

While the payday lending industry boomed over the last decade, state and federal governments' responses have varied from no response, to supporting the industry, to issuing some industry regulations. Meanwhile, the problems that consumer rights advocates have documented persist. They point to surveys and empiric studies that demonstrate five specific dangers of a completely unregulated payday industry:

- Payday lenders use aggressive loan terms that are not permitted in other banking or credit card contexts;
- Payday lenders frequently fail or refuse to disclose loan terms to consumers before they take out a loan;
- Payday lenders are permitted to trap consumers in perpetual cycles of debt;
- Payday lenders use coercive collection practices; and
- Payday lenders target a low-income clientele with unsophisticated financial knowledge.

First, payday lenders use aggressive loan terms that are prohibited in other credit industries. While credit card companies charge an annual percentage rate (APR) in the lower two-digit range, payday lenders charge APRs that range from 390% to 7,300%, with an average APR of 500%.[16] In addition to sky-high interest rates, payday lenders charge borrowing fees that vary, placing an additional burden on consumers when lenders fail to disclose material terms.

A related problem is the process lenders use to secure short-term loans with post-dated checks. Instead of using a check as a promise to pay a fee, payday lenders encourage consumers to write the lender a check to securitize a loan when the lender knows the consumer cannot pay. This practice raises the question of the proper use of a check. Payday lenders frequently use this post-date check system to their advantage,

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[11] WA State Department of Financial Institutions, *Payday Lending Report, Statistics & Trends for 2003, available at* http://www.dfi.wa.gov/news/DFI_PaydayReport.pdf.

[12] *Id.* at 1.

[13] *Id.* at 2.

[14] *Id.*

[15] *Id.* at 3.

[16] Chin, *supra* note 4, at 724.

sometimes in ways that break the law. At least one study documented payday lenders that took federal welfare checks for repayment, a clear violation of federal law.[17]

Second, payday lenders too frequently fail or refuse to disclose loan terms to consumers before they take out a loan. This practice violates the federal Truth in Lending Act, which requires creditors to disclose the interest rate in dollar amounts and percentages, to disclose any finance charges, and to conspicuously display the interest rate and finance charges.[18] Nonetheless, studies show that as many as 68 percent of payday lenders failed to disclose accurate interest rates on charts or brochures.[19] In one survey that revealed payday lenders' failure to disclose interest rates, only 21 percent of lenders responded to consumer requests with accurate interest rate disclosures.[20]

Third, the unlimited rollover feature of most payday loans causes some consumers to accumulate an unmanageable cycle of debt.[21] For this reason, the rollover feature has been called the payday loan's "most dangerous feature." One consumer who borrowed $150 paid $1,000 in fees for six months without ever paying down the original $100 in debt.[22] Another consumer was able to reduce her principal balance of $400 to $238, but only after paying $1,364 in fees over fifteen months.[23] These problems are not unique, and as targeting practices and statistics suggest, they may not be coincidental. A study of payday lending practices throughout several states found that over a twelve-month period, consumers renewed their loans an average of ten to twelve times.[24] Because multiple loans make up the bulk of payday lending profits, lenders have an incentive to keep consumers in perpetual debt.[25]

Fourth, some payday lenders use scare tactics to force consumers to repay debt. Even when a lender knows the consumer does not have sufficient funds, the lender attempts to cash the consumer's check in order to later prosecute the consumer for issuing a bad check.[26] Payday lenders use these tactics competitively to ensure that their consumers will repay them before repaying other obligations, including debts to other payday lenders.[27]

Finally, payday lenders tend to target consumers who have low incomes and little or no collateral for borrowing from a bank. Payday loan consumers are frequently "unbanked," and include a high number of military personnel and minorities.[28]

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[17] According to Philadelphia ACORN, a consumer advocacy group, Currency One payday lenders cashed Earned Income Tax Credit (EITC) checks in violation of the Check Cashier Licensing Act, 63 P.S. § 2323 (e). Pennsylvania ACORN, *supra* note 6, at 10.

[18] 15 U.S.C. §§1601-1693 (2000).

[19] Chin, *supra* note 4, at 731.

[20] *Id.*

[21] *Id.* at 729.

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] Chin, *supra* note 4, at 732.

[27] *Id.*

[28] Chin reports that "[t]he business plan for one [payday lender] describes its customers as 'disproportionately [belonging to] minority [groups] with a household income of less than $25,000, a high school or GED education or less…and female heads of household with dependents.' This same document shows that lenders target welfare recipients, regarding this population as 'a fertile market for payday lenders.'" Chin, *supra* note 4, at 727.

Consequently, many consumer rights advocates view payday loans as an abusive part of banking and lending systems that are based on financial apartheid.[29]

In response to consumer advocates' arguments for regulation of the industry, industry advocates insist that they are providing a needed service. When their service is no longer needed, they say, the market will correct itself. The problem with this argument is not its main assertion, but its assumptions. Industry advocates assume that the payday lending market can correct itself because it is a free and open market. A free market is a market where consumers have free access to information and they are able to make rational choices based on that information. In the case of payday lenders, when lenders refuse to disclose material terms regarding the short-term loans they offer before the consumer signs a contract with the lender, [30] the assumption that consumers have free access to information is doomed to fail. As a consequence of the large scale failure to share contract terms with consumers before they enter into payday loan contracts, consumers are unable to compare prices. Without information and without the ability to compare prices, consumers cannot make rational choices. Because consumers do not have free access to information regarding payday lenders and because they cannot make rational decisions regarding their access to credit, the market will not correct itself as it would if there were a truly free and open market.

Even if the real problem is not the lack of a free and open market, there is another problem. In a democratic society where regulations keep most lending practices in check, the payday lender represents a kind of "free rider." While payday lenders' techniques result in large gains to the payday lending industry, these same payday lenders' techniques frequently also cause damage in other parts of society. In free market terms, these payday lenders are a kind of "free rider" because they take advantage of the public good of the marketplace at the public's ultimate expense.[31]

Whatever our take on payday lenders and their place in the market, it is clear that their current operations have negatively impacted consumer communities. As the frequency of payday loans increase, consumers spend more of their available funds paying interest fees rather than using their limited funds to purchase goods. When payday lenders exploit customers by surprising them with arguably unconscionable contract terms, the exploitation also invites governmental intervention, which leads to litigation and high litigation costs. Additionally, public trust in these companies diminishes while other costs to society increase. These social costs include bad credit ratings, lower savings rates, less home ownership, bankruptcies, an increase in the number of people depending on welfare, and the costs of preventing and deterring criminal behavior. Ultimately, aggressive payday lending practices will produce diminishing, and ultimately negative, marginal rates of return for the lending industry, while continuing to cause notable social damage. One way or another, the costs to society alone should raise a red flag.

How, then, do we resolve the dilemma of maintaining the useful services provided by payday lenders while prohibiting overly aggressive lending practices? We

[29] Chin, *supra* note 4, at 727.

[30] Pennsylvania ACORN, *supra* note 6, at 9; *See also* Chin, *supra* note 4, at 742.

[31] In his testimony to the Indian Affairs Committee of the New Mexico Legislature, Ray Prushnok reported that most payday lenders have a return in the range from 25 to 35 percent, a significant number considering that most Fortune 500 companies have a return on equity of less than 12 percent. Ray Prushnok, *NMPIRG Testimony on Payday Loans*, Indian Affairs Committee presentation, Sept. 15, 2004, at 2.

believe that the answer lies in externally initiated legislation and internally initiated corporate governance reform.

a. CASE STUDY: ADVANCE AMERICA

While most payday lending companies are privately held, three are publicly traded corporations in the United States today: Ace Cash Express, Inc.; Cash America International, Inc.; and Advance America Cash Advance Centers, Inc ("Advance America").[32] This article will focus on Advance America, one of many payday lending companies operating in Washington State, to illustrate the numerous problems that pervade the payday lending industry, to examine possible solutions, and to propose additional reform.

Advance America operates on two business models. First, in most states, it lends payday cash advances directly to its customers, a practice called the "standard business model."[33] Second, in other states, it acts as a processing, marketing, and servicing agent through its payday cash advance centers for state-chartered banks that make payday cash advances to their customers. These state-charted banks are insured and guided by the Federal Deposit Insurance Corporation (FDIC). This agency relationship is called the "agency business model."[34] This model is also known as the "rent-a-charter" or "rent-a-bank" model, a model where payday lenders use nationally chartered banks to circumvent state usury and consumer protection laws forbidding payday lending practices.[35] Through this model, federal interstate banking laws, regulations and guidelines enable an FDIC-insured, state-chartered bank located in one state to make loans to a consumer in another state and to charge fees and/or interest allowed by the lending bank's home state, even if the fees and/or interest exceed what may be charged in the consumer's state.[36]

Advance America is one of the largest operators in the business of making small, short-term, high-interest loans to customers who pledge postdated checks as collateral.[37] It charges $15 for a $100 loan and uses less coercive collection methods than most payday lenders.[38] However, when customers cannot repay their loans on time, the repayment schedule can prove oppressive. For example, Rachel Morgan, a 37-year-old child-care worker who makes $12,996 a year, paid more than $1,000 over less than one year in fees to Advance America and Check Into Cash without ever paying down the principal.[39] In exchange for $150 in cash, she wrote her first check for $176 to Check Into Cash. Two weeks later when the loan came due Rachel faced payments on the mortgage on her family's trailer home, rent for the lot, food, clothing, utilities, and medical care for her children. When she did not have $176 to repay her loan, she borrowed more money from Check Into Cash and Advance America to renew her loans.

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[32] The Advance America stock symbol is AEA, *available at* http://www.advanceamerica.net/index.php.

[33] Advance America Inc. Investor Relation, Annual Report 10-K SEC filing, at 5, *available at* http://aea.client.shareholder.com/edgar.cfm.

[34] *Id.*

[35] *Id.*

[36] *Id.*

[37] *Available at* http://www.advanceamerica.net/index.php.

[38] Advance America, Cash Advance Centers, Inc., Hoover's Company In-dept Records, Sept. 15, 2004.

[39] John Cheves, *Fletcher Supports Lenders' Hopes*, LEXINGTON HERALD LEADER, Feb. 14, 2005.

At one point, she paid $60 every two weeks just in fees alone. When she could not repay the principal of the loans, she finally filed bankruptcy. [40]

In recent years the company's cash advance business has grown rapidly. First, net income is on the rise. From 2002 to 2003, Advance America's net income grew by 79.6%.[41] During that year, the company announced dividends of $1.48 per share, and made a net income of $96.2 million.[42] Transactions have also increased. From 2003 to 2004, interest and loan fees, the main source of revenue for the company, increased by 17%.[43] In 2004 alone, the company processed 11,586,000 cash advance transactions generating interest and fees amounting to $570,200,000.[44] In addition to increasing its net income and transactions, Advance America has expanded its operations. In 2003, the company opened 330 new stores and closed 32 stores.[45] As of December 31, 2004, it operated 2,408 payday cash advance centers in 34 states[46] with 5,900 employees.[47]

Why would anyone invest in Advance America or in another payday lender if its practices are harmful to society? The first most obvious reason is that payday lending companies provide substantial income and a favorable rate of return on investment. Although Advance America and similar companies face regulatory uncertainty, lawsuits, and even vilification by consumer groups, analysts and investors look beyond those issues to focus instead on the robust cash flow.[48] For example, in 2004, most shareholders probably were not asking questions when Advance America provided $1.20 earnings per share.[49] Second, the payday lending business is growing rapidly. From 1997 to September 2004, the number of states allowing payday advances or small loans has grown from 16 to 37 including the District of Columbia. In 2004, Advance America processed 1,407,000 more transactions than in 2003, which translates to a growth of 13% annually.[50] As more states allow these services, payday lenders will be ready to meet the demand.

While investors may enjoy a high rate of return on their investments in the payday lending industry, uncertainties abound. Some uncertainties include changes in state lending laws, changes in federal lending laws, and competition from new companies entering the market. One recent example of a change in federal lending laws is the new FDIC guidance. On March 2, 2005, the FDIC issued a revised Payday Lending Guidance[51] to FDIC-supervised institutions ("rent-a-banks"), including the

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[40] *Id.*

[41] Advance America, *supra* note 33, at 51.

[42] *Id.* at 34-35.

[43] *Id.*

[44] *Id.* at 38.

[45]Advance America, *supra* note 33, at 48; *see also* Susan Orr, *Payday lender Advance America Inc. Sees Revenues, Expenses Rise*, HERALD-JOURNAL (Spartanburg, South Carolina), Feb. 16, 2005.

[46] *Id.* at 14.

[47] *Id.* at 20.

[48] Karen Richardson, *Tracking the Numbers/Street Sleuth: Investors Rethink 'Payday Lending.' Practice of Making Loans With Paycheck as Collateral Comes Under Scrutiny*, WALL STREET JOURNAL, Feb. 17, 2005.

[49] *Id.* at 35.

[50] Advance America, *supra* note 33, at 38.

[51] Federal Deposit Insurance Corporation, *FDIC Revises Payday Lending Guidance,* Press Release 19-2005, March 2, 2005, *available at* http://www.fdic.gov/news/news/press/2005/pr1905.html.

national lending banks that charter their services to Advance America:[52] BankWest, Inc., First Fidelity Bank, Republic Bank & Trust Company, and Venture Bank.[53] The FDIC Guidance conveys three messages. First, it reiterates that federal law authorizes federal and state-chartered insured depository institutions ("rent-a-banks") to export their home states' interest rates to other states in which they do business. Second, it acknowledges that these institutions may administer their own lending programs or do so through arrangements with third parties.[54] Third, it targets the frequency of borrower usage of payday loans offered by FDIC supervised institutions and will limit the period a customer may have payday loans outstanding from any lender to three months during the previous twelve-month period.[55]

Although the long-term financial impact of the FDIC Guidance on payday lenders is unclear, the short-term impact is already evident. On March 2, 2005, within minutes of the FDIC's new Guidance announcement, Advance America's stock price plummeted from a high of $24 per share to $15.67 per share. Despite a stock value decrease of almost 35%, most analysts recommend that investors hold the Advance America's shares because the restrictions imposed by the FDIC apply only to those lenders who operate under the "rent-a-bank" model.[56]

II. CHANGING THE PAYDAY LENDING BUSINESS MODEL

So long as payday lending corporations profit, shareholders will continue to invest in corporations such as Advance America, even when the business of payday lending ultimately hurts consumer communities. In this portion of the article, we will analyze three other approaches to reforming aggressive payday lending practices. First, we will balance the advantages and disadvantages of allowing the payday lending market to self correct. Second, we will examine proposed state and federal legislative reforms to weigh whether those options are best for addressing aggressive payday lending practices. Third, we will survey corporate governance theories and ask whether each theory may effectively change payday lending for the better.

b. ALLOWING THE MARKET TO SELF-CORRECT

One option to change the payday lending industry is to take no action, but allow the market to correct itself. Market self-correction could stem from different sources such as a shift in supply and demand, the long-term effects of payday loans on the community, or a change in shareholder awareness and action.

Recent industry growth suggests that a shift in demand is unlikely to influence a change in payday lending practices. While other kinds of lenders may have to reduce their interest rates to stay competitive, the payday lending industry has boomed over the

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[52] Advance America, *SEC Filing, 8-K*, March 3, 2005, *available at* http://aea.client.shareholder.com/edgar.cfm?PageNum=2&DocType=&SortOrder=Date%20Descending&Year=.

[53] Advance America, *supra* note 33, at 5.

[54] *Supra* note 51.

[55] *Id.*

[56] Lawrence Meyers, Pay Cut for Payday Lenders?, MOTLEY FOOL, March, 17, 2005, available at http://www.fool.com/news/commentary/2005/commentary05031704.htm.

last decade with no indication of reduced rates. Because the need and the market demand for short-term lenders are so great, it is unlikely that the market will correct itself.

It is equally unlikely that the long-term community effects of payday lending practices will influence the industry to change. As we have argued above, the market is not truly competitive because consumers do not have access to information to compare payday lenders when payday lenders conceal material terms of their loans. Further, it may take many years or even decades for the effects of the industry on its consumers and community to become so visible that payday consumers would not use such a service.

Finally, shareholder awareness will probably not lead to self-correction of payday lending practices. Even if shareholders are so disturbed by payday lending practices that they seek to influence corporate governance, they have limited tools for challenging the corporation's business strategy. Shareholders can vote in new directors who possess the same vision that they possess, or they can submit a shareholder proposal to the board. Elections, however, are a difficult way for shareholders to change the corporate course of business because most shareholders will not have enough shares to make their collective vote count. Even if shareholders do manage to collect enough votes, they cannot be certain their elected directors will make the choices that the shareholders prefer. Shareholder proposals will be equally ineffective and probably less popular because the proposal of reducing interest rates may not be as likely to maximize shareholder value. Consequently, other shareholders and directors will quickly rebuff the proposal. Therefore, shareholder proposals seeking to reduce interest rates will be politically difficult, if not impossible, to implement.

c. EXTERNAL CHANGE: REFORMING THE INDUSTRY FROM THE OUTSIDE

In response to coercive payday lending practices at the state level, and the lack of an overarching regulation at the federal level, consumer advocates have proposed legislative reform of the industry. They appear to agree that the goal of reform is not to shut down the industry because the industry has the potential to provide mutually beneficial services to communities in need of short-term credit. [57] Rather, advocates seek to reform payday lending practices to limit the detrimental impact on consumers.[58]

At the state level, legislative proposals aim at mitigating future harm in payday lending practices. These proposals generally include limiting the number of rollover loans a consumer can take at any given time, establishing a 24-hour waiting period once a loan is paid before the lender may grant another loan to the same consumer, and requiring payday lenders to limit interest rates.[59]

Even if consumer advocates successfully limit payday lending practices in a majority of states, payday lenders still have a loophole through the use of "rent-a-bank" arrangements. According to payday lenders, Section 85 of the National Bank Act (NBA) allows a nationally chartered bank to "take, receive, reserve, and charge on any loan or

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[57] Warren Bolton, *Payday Lending Tantamount to Bondage for Unwitting Borrowers*, THE STATE (South Carolina), Jan. 21, 2005.

[58] *Id.*

[59] Chin, *supra* note 4, at 724-25. *See also* Joseph M. Vincent, *The Pay Day End of Predatory Lending*, Statewide Civil Legal Services Conference (Leavenworth, Washington), Sept. 28, 2004, at 10.

discount made, or upon any notes, bills of exchange, or other evidences of debit, interest at the rate allowed by the law of the State…where the bank is located."[60] The United States Supreme Court has held that under the NBA, nationally chartered banks may conduct interstate lending transactions using the interest rate of their home states.[61] However, the Court has not yet considered whether nationally chartered banks may use the NBA in partnerships with payday lenders.

Payday lenders use this loophole in the law to forum shop for nationally chartered banks who are willing to partner with payday lenders and whose home states allow triple-digit annual percentage rates on loans. Even though this practice has been condemned by the FDIC and the Office of the Comptroller of Currency (OCC),[62] payday lenders persist in violating those guidelines. Consumer rights advocates argue that because of this "rent-a-bank" national loophole, federal legislative reform is the only possibility for impacting harmful industry practice.

One scholar proposes that federal legislative reform should include at least three basic standards.[63] First, federal statutory reform should limit practices that exploit vulnerable consumer communities and that perpetuate indebtedness.[64] Second, federal statutory reform should close the rent-a-bank loophole to prevent payday lenders from skirting state law by resorting to underregulative federal law.[65] Third, federal statutes should impose a ceiling on payday lending interest rates.[66]

But what if federal legislative reform is not the panacea? What if it overreaches and damages the consumer community and the industry? The Sarbanes-Oxley Act of 2002 has faced similar criticism for unnecessarily regulating corporations.[67] In light of that lesson, perhaps self-initiated and industry-designed reform would help develop more sustainable contact with consumer communities and their advocates and would lessen the risk of facing any forthcoming federal regulations.

d. INTERNAL CHANGE: REFORMING THE INDUSTRY FROM THE INSIDE

If the law of corporations is normative law shaped by business theory and practice, then the most meaningful change in corporate law comes from corporations themselves. Corporate governance theory examines corporate practices in light of what is best for society and business. General corporate governance theory can be divided into two conflicting camps: the contractarian camp[68] and the communitarian camp.[69] The contractarian camp focuses on the shareholder primacy model, a model that

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[60] Chin, *supra* note 4, at 732, *citing* 12 U.S.C. §85 (2000).

[61] *Marquette National Bank v. First of Omaha Service Corp.*, 439 U.S. 299 (1978).

[62] *FDIC Urges Payday-Loan Limits*, WALL STREET JOURNAL, January 30, 2003, at C13; *U.S. Tells Bank to End Support of Payday Loan*, WALL STREET JOURNAL, Jan. 4, 2002, at C1.

[63] Chin, *supra* note 4, at 726.

[64] *Id.*

[65] *Id.*

[66] *Id.* For a more detailed discussion of what a responsible federal payday lending statute would entail, *see id. at* 749.

[67] *See e.g.,* Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L 1 (2002).

[68] Henry N. Butler & Fred S. McChesney, *Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation*, 84 CORNELL L. REV. 1195, 1199 (1999).

[69] Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 873 (1997).

perceives the corporation as a discrete entity operating to make a profit for its shareholders.[70] In the contractarian camp, the boundaries of the corporate entity are set by the contracts that help it achieve this goal, and the corporation is not responsible to other individuals or entities outside its own series of contracts.[71]

In contrast to contractarians, communitarians argue that any theory that focuses blindly on shareholder profit fails to capture the full extent of the corporation's relationship to the community in which it operates, and this failure leads to short-sighted corporate planning and governance.[72] Communitarians instead perceive the corporation as an entity that exists as part of the larger landscape of society.[73] This camp has inspired the development of the team production model, stakeholder theory, and corporate social responsibility.[74] Communitarian theorists assert that the corporation is integrally connected to society in a number of ways, and that it is within society's and the corporation's best interest to foster broader notions of corporate citizenship.[75]

1. CONTRACTARIAN MODELS

Corporate law today is based on the notion of shareholder primacy. Under the classical theory of shareholder primacy, shareholders of a publicly traded corporation are deemed the owners of the corporation because they collectively own the corporation. Under this same theory, officers and directors owe a duty to shareholders to maximize profits for them.[76] This theory is also called the "grand design principal-agent model" based on the principal-agent relationship between the "principal" shareholders and the "agent" directors and officers.[77] When courts conceptualize the corporation as a reflection of this principal-agent relationship, they fashion laws that favor the principal shareholders and shareholder profits.[78] Under this model, whenever there is a conflict of interest between the interests of the officer or director and the interests of the shareholder, the shareholder interest prevails.[79] Many proponents of the shareholder primacy theory defend their vision of the corporation because they believe it gives shareholders the power to change corporate behavior.

However, there are three reasons why the shareholder primacy theory misguides corporate law and corporate courts. First, shareholders are a mere legal fiction. They represent money rather than people. Second, shareholders do not have any real control over directors. Third, most shareholders cannot realistically threaten to "vote with their feet" as a means of influencing corporate behavior. For these three reasons, elaborated below, shareholder primacy is illusory.

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[70] Testy, *supra* note 7, at 1231.
[71] *Id.*
[72] Bainbridge, *Supra* note 72, at 886.
[73] *Id* at 902.
[74] Testy, *supra* note 7, at 1232-40.
[75] *Id.* at 1238.
[76] Butler & McChesney, *supra* note 68, at 1199.
[77] Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 257 (1999).
[78] *Id.*
[79] *Id.*

First, according to Greenwood, shareholder primacy is illusory because shareholders are a mere legal fiction.[80] When directors and officers refer to shareholders, they refer not to the diverse group of people who hold stock in the company, but rather to the shares that make up the corporation's worth in the stock market. Thus, shareholders cannot truly effectuate any personal power over the corporation as its owners or "principals." Even if shareholders try to exercise their power, the law that is driven by the shareholder primacy model gives directors and officers a shield: the business judgment rule. Under the business judgment rule, directors and officers can justify their business decisions as being necessary to support the faceless group of people who expect a profit.[81] While it may be true that most shareholders own shares simply to make a profit, the point here is that directors and officers never ask for shareholder input, and when shareholders give their input, law provides directors and officers an easy way to avoid it. Shareholders have nominal power only. Their contrary views or motivations do not really matter.

Fictional shareholder problems exist in the payday lending industry. If directors and officers of a payday lender such as Advance America only perceive shareholders as profiteers, they will never truly work for, much less grasp, shareholder-owners' diverse interests. Shareholders, in turn, may go along with a payday lender who charges high interest rates because they believe it is futile to voice an opposing opinion. Instead of expressing an opinion, they assume that all corporate decisions are ultimately made by the board of directors. In their complacency, they learn to separate their financial investments from any consequences that payday lenders have on the community. Finally, because actual people are not consulted, directors and officers of a payday lending company may run the company aggressively without any internal checks.

Second, shareholder primacy is illusory because, as Blair and Stout argue, shareholders in public corporations do not in any realistic sense elect board members.[82] Instead, they tend to elect the directors that management recommends.[83] Assuming that the shareholders of payday lending corporations are no different than those in other publicly held corporations, payday lending shareholders have no real power to select a Board that will improve industry practices.[84]

Third, shareholder primacy is illusory because even if payday lending shareholders want to change corporate behavior, they cannot do so by threatening to sell their shares. According to Berle and Means, shareholders as owners of the corporation become powerless because of the separation of ownership and control in public corporations.[85] This separation of ownership and control leads to shareholders holding the corporation as a passive investment while managers control the corporation.[86]

In the payday lending industry, as in other industries, unless large groups of shareholders sell their shares around the same time, individual shareholders usually do

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[80] Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are corporate Managers Trustees, Revisited,* 69 S. CAL. L. REV. 1021 (1996).

[81] Blair & Stout, *supra* note 77, at 306.

[82] Blair & Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

[83] *Id.*

[84] *Id.* at 288.

[85] ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY, (3d ed. 1991) (1932).

[86] Mark J. Roe, *A Political Theory of American Corporate Finance,* 91 COLUM. L. REV. 10 (1991).

not hold enough shares to manifest disapproval of directors' or officers' decisions.[87] Even if there are enough shareholders to make a difference when they sell their stock, directors and management may be unaware of the reasons why shareholders have abandoned the corporation. Without communication with management, the sell-off threat is not powerful enough to influence corporate behavior.[88]

In sum, shareholder primacy is a fictional creation of law, and it is a creation that gives corporate executives power to engage in business that may cause problems outside the corporation, causing ripple effects that damage society. This assertion leaves us with a dilemma: if shareholders do not have "primacy" in a corporation, who or what does?

2. COMMUNITARIAN MODELS

Communitarian models expand the focus of corporate governance to include shareholders and other constituencies. Other constituencies might include employees, bondholders, consumers, the environment, and society. According to communitarians, the corporation is an entity shaped by and responsible to the community in which it operates.

This more expansive paradigm of corporate governance has positive potential for directors and officers in the payday lending industry, an industry that faces serious consumer rights concerns in addition to the dilemma of deciding how to conduct business given market and law-based incentives. Under a communitarian model, directors and officers face less pressure to increase profits and more encouragement to respond to diverse concerns in the community. The most successful corporations are corporations that comply with the law and turn a profit in a way that is responsive to concerns from its consumer communities.[89]

The most important difference between contractarians and communitarians lies in the way each model views the interplay between law and society. The contractarian model is necessarily law-based because it focuses on the legally binding contracts of the corporation and the legal fiction of shareholders. In contrast, the communitarian model focuses on a broader web of relationships that are both legal and societal. In this sense, the communitarian model measures the success of a corporation quantitatively and qualitatively. Communitarians agree that the bottom line counts, but they also count litigation costs that corporations avoid by creating a safer work place, a healthier environment, and more positive community relations.

This observation leads to a second difference. While law may be drafted to respond to contractarian theory, law alone will not be sufficient to respond to communitarian theory. To properly implement communitarian theory, corporations must comply with laws designed to help the corporation make contributions to society. This incentivization can only go so far. Corporations must also take it upon themselves to engineer their leadership to be responsive to the society in which they work.

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[87] *Id.*

[88] *Id.*

[89] There are a number of examples of well-known retail and financial corporations whose corporate governance is based on communitarian theory: The Body Shop; Ben & Jerry's; Whole Foods; Nike; Levi Strauss; and Vanguard. Note, *Finding Strategic Corporate Citizenship: A New Game Theoretic View*, 117 HARV. L. REV. 1957, 1969 (2004).

Corporate governance reform that embraces communitarian values will depend on laws, corporations, and the society.

Three of the best known extractions of the communitarian model are the team production model, the stakeholder and multiple constituency theory, and the theory of corporate social responsibility. The best-suited theory for payday lending is the theory that allows the industry to keep business healthy while responding to concerns from its consumer community.

TEAM PRODUCTION MODEL

Blair and Stout challenged contractarian theory with a new model for corporate governance emphasizing that directors have a duty to more than just their shareholders.[90] Instead, directors have a duty to balance the interests of all constituencies in order to maximize the joint product of the corporation.[91] Directors, acting as trustees who mediate with other team members on the shareholders' behalf, work with the entire corporate "team" to maximize profits and other corporate goods.[92] The team in this model includes managers, shareholders, employees, creditors, and the community. The goods that this team can create include more than just profits—it also encompasses the corporation's positive public image. And the corporation is more than just a vehicle for shareholder profit, it is a nexus of firm-specific investments.

There are several ways that Advance America and other payday lending corporations could benefit from structuring their corporate governance around this model. For instance, if payday lending corporations were to hire directors who view the corporation as a nexus of firm specific investments—a series of investments that include the consumer community—then the corporation as a whole would be more willing to mediate less harmful business practices with community leaders. The team production model also offers payday lending corporations a way to address harmful practices and improve relations with consumer communities without their resorting to federal legislative reform of the industry as a whole. Consumer advocacy groups could talk with directors directly to seek alternate approaches to aggressive lending practices.

However, as critics of this model have argued, the impact of this model is limited to the extent that the "team" responds first to teammates who wield the most power.[93] Economic power in the payday lending industries resides in investment sources and profitable consumer communities. But political power seems to persist in the notion that the industry must drive a profit for its shareholders. What the team production theory model lacks, and what the industry needs, is a change in this paradigm to recognize payday lenders' impact on and connections to consumer communities.[94]

STAKEHOLDER AND MULTIPLE CONSTITUENT THEORIES

Stakeholder theory takes as its starting point the Berle-Means concept that corporations are a nexus of contracts where shareholders are only one of a number of

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[90] Blair, *supra* note 77.
[91] *Id.*
[92] *Id.*
[93] Testy, *supra* note 7, at 1234.
[94] *Id.* at 1244.

contracts that comprise the corporation.[95] Contracts, in turn, cut, shape, and guide directors' fiduciary duties. This theory regards fiduciary duties as residual shareholder rights, rather than primary rights that surpass all others.

Payday lending corporations that structure their board of directors according to the stakeholder theory may count among their constituencies consumers and consumer advocates. In particular, directors who are encouraged to view contracts with consumers as key to the success of the corporation might treat those contracts with more care. More care in the case of payday lenders could include improved disclosure practices, limited annual percentage rates, a cap on lenders who have not repaid their first loan or loans, and a limit on how many loans an individual consumer can have at one time. If corporate directors view the corporation as part of the fabric of the consumer community in which it operates, they will prioritize healthy contracts with consumers because they know that ongoing business depends on it.[96]

This theory, however, features some of the same pitfalls as the team production model. Consumer communities lack political power to demand more favorable contracts with payday lenders. Payday lenders, in turn, will not be inspired to initiate better contract deals with consumer groups if they do not view the transaction as being beneficial to the business. In other words, the stakeholder theory paradigm shift changes the focus from one constituent to multiple constituents, but that shift will not necessarily change industry practices without some additional outside influence.

CORPORATE SOCIAL RESPONSIBILITY

Corporate social responsibility presents a new paradigm of the corporation, looking beyond maximizing short-term shareholder profits to see potential mutual benefits to society and to the corporation.[97] Some scholars argue that firms can achieve corporate social responsibility by "strategic corporate citizenship."[98] These scholars define strategic corporate citizenship as intrinsically motivated corporate behavior that serves both a company's self-interest and the public interest while advancing the corporation's strategy and profits.[99] Corporations can achieve strategic corporate citizenship by tying socially responsible behavior directly to profit maximization or by broadening the scope of how corporations define their self interest, such as avoiding public disgrace or enhancing public reputation.

We believe that the corporate social responsibility theory offers the most meaningful vehicle for reforming harmful payday lending practices because it provides a new paradigm for corporations, a paradigm that challenges lenders to foster greater corporate social responsibility and demonstrates how they might reap greater benefits from it.

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[95] Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Non-shareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266 (1999).

[96] Testy, *supra* note 7, at 1239.

[97] Note, *Supra* note 89, at 1957.

[98] *Id.* at 1969.

[99] Roger L. Martin, *The Virtue Matrix: Calculating the Return of Corporate Responsibility*, HARV. BUS. REV., March. 2002, at 68, 73.

i. When Individual Corporations are Socially Responsible

It is no simple task to motivate individual corporations to act in a socially responsible manner. One corporation might decide to contribute to society by dedicating funds to acting in a socially responsible manner while its main competitor decides to defect by forgoing compliance with laws in order to pursue its self-interest.[100] A dilemma is created when a corporation must choose between pursuing pure self-interest and pursuing a common good that would help all parties, including the corporation.

But what if social activism is not in the corporation's or the shareholders' best interest? Does the corporation face a truly binary choice: to either forego or engage in socially responsible behavior? Game theory suggests that corporations face a more complex choice than "to be or not to be" socially responsible. Because corporations are interdependent on other corporations, they must consider a number of factors other than self interest. The sum of corporations' decisions in light of their interdependence is called "game theory."[101] Game theory posits that even if socially responsible behavior is not in the corporation's immediate self interest, the corporation may be induced to act in a socially responsible manner because its competitors do so.[102]

The game theory model has already been applied to corporate social responsibility in the payday lending industry. According to its web site, Advance America has contributed to society through implementing five best practices.[103] First, it complies with laws and regulations, such as SEC requirements and the Federal Truth in Lending Act.[104] Second, it encourages its lenders to fully disclose to consumers the costs of a loan, including the dollar amount and the annual percentage rate (APR).[105] Third, it requires lenders to advertise in a truthful manner.[106] Fourth, it gives consumers a right to rescind the loan contract at no cost by the end of the following business day.[107] Finally, it will not permit lenders to threaten criminal action if a consumer cannot pay off her account.[108] These consumer-oriented best practices help the industry build a more sustainable market for borrowing communities. As we have outlined above, they also help the industry profit.

However, Advance America shows room for improvement. We would recommend that Advance America and other payday lenders take further steps toward reforming aggressive lending practices to encourage a healthy finance relationship with return consumers. First, it should lower interest rates to a level that keeps lenders in business while protecting more consumers from bankruptcy. Such a change would help Advance America, and later the industry, to offer lending rates that can be posted

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[100] Note, *supra* note 89, at 1961.

[101] *Id.*

[102] "This game implies that by tying socially responsible behavior directly to profit maximization (through reputational enhancement or employee motivation), by broadening the scope of how corporations define their self interest (avoiding public opprobrium or conferring legitimacy), or by providing perks to individual decisionmakers, social responsibility can be converted into strategic corporate citizenship." Note, *supra* note 89, at 1972.

[103] See http://www.advanceamerica.net/values_cfsa.php

[104] *Id.*

[105] *Id.*

[106] *Id.*

[107] *Id.*

[108] *Id.*

without fear of driving away consumers or stirring up more consumer litigation.[109] Second, regardless of what various states will allow, Advance America should set a uniform limit on the amount of late fees. Third, it should limit how many rollovers a consumer can use on one loan in order to prevent consumers from falling into a cycle of debt. Fourth, Advance America should contribute to community programs, making lenders' names synonymous with good will.

What if Advance America chooses to ignore the common benefit to the community by continuing to charge high interest rates for its short-term loans? Payday lenders argue that they already benefit the community by providing a necessary service to those who are in need of quick cash between paychecks. Without their services, consumers would not be able to meet financial obligations, including rent, credit card payments, and others. When consumers fail to make payments on other obligations, their failure creates a domino effect that taints the whole economy. This argument, however, is limited to what the market—what constituent consumers and society as a whole—can bear.

Payday lenders' pursuits of profits at the expense of the social good may result in short-term net gain to the payday lending industry, but it does so by harming consumers. As a result of repeated harm, the public trust in payday lenders will diminish, and diminishing public trust will lead to negative marginal returns for the lending industry. This erosion of trust and consequential loss of profits ultimately spoils a common public good because such behavior invites governmental intervention, which leads to litigation and high litigation costs.[110]

Aggressive payday lending also increases social costs. As the frequency of payday loans increases, payday lending consumers spend more of their available funds paying interest fees instead of purchasing goods. Eventual costs to society as a whole include a range of consequences from lower savings rates and bad credit ratings to increasing numbers of people who depend on welfare and higher costs of deterring and preventing criminal behavior. Reduced consumer spending over a long period, coupled with an increase in other social costs, ultimately reduces the nation's gross national product that harms the national economy.

In light of these concerns that threaten the long-term sustainability of the payday loan market, we suggest that Advance America expand its self-reform efforts to set the pace for the industry as a whole. Even if Advance America incurs upfront costs by providing lower interest rates and other limitations, it will enjoy long-term benefits in the form of competitive advantage and market share advantage in those communities where it is a known contributor.

ii. When Groups of Corporations are Socially Responsible

Externally imposed, or "exogenous," change through the legislature is one vehicle for developing corporate social responsibility. Another vehicle for developing corporate social responsibility is internal or "endogenous" change one scholar calls

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[109] We suggest that Advance America or another leader in the payday lending industry meet with consumer advocates to set a mutually reasonable rate for loans, one that will keep business healthy without allowing severe damage to parts of the consumer base.

[110] Note, *supra* note 89, at 1966.

"endogenizing."[111] Endogenizing is a process of industry-wide reform in response to changing social norms. Inherent in this process is the corporation's recognition that it operates in an interdependent market and society. It starts with a first mover who reaches out to consumer communities, jumps hurdles, and swallows initial costs. Once the first mover paves the road and demonstrates how to overcome hurdles, other companies fall in line to benefit from the contributions of the first mover while they develop more efficient responses to social change.[112] State and federal governments can help by encouraging communication among corporations, advancing conversations between corporations and consumers, monitoring competitive behavior that drives aggressive practices, enabling private actors to help monitor problematic corporate practices, and recognizing individual corporate contributions.[113]

One example of endogenizing comes from JP Morgan Chase & Co. In 2004, JP Morgan distributed $225,000 to six credit unions in five states for pilot projects that offer alternatives to payday loans.[114] Banks and credit unions are in the best position to test the new business model for short-term payday lending because they are closed tied to the community, they deal with working families, and they know low-income families' financial needs. If JP Morgan successfully implements profitable alternatives to the current business model of payday lending, other companies will emerge which can provide a short-term lending service without charging high interest rates. This could set off a snowball effect to endogenize a sense of corporate citizenship throughout the entire payday lending industry. But it is up to individual payday lenders to initiate positive reform. To the extent that they fail to do this, restrictive regulation is key.

The level of industry endogenization can help legislators and society in general decide how much to regulate the industry. The more responsive an industry is in its interactions with public figures, the media, government, and peer groups, the more individual corporations in an industry are able to endogenize a sense of corporate citizenship.[115] When an entire industry endogenizes, focusing its efforts on contributing to the public good and corporate social responsibility, less government intervention is required.[116] Conversely, when an industry continues to defect by failing to comply with laws and failing to resolve the societal problems it creates, more government intervention is required. In the context of payday lenders, this sliding scale approach to legislation and corporate governance suggests that legislators, working together with the media, consumer rights groups, and payday lender businesses, can decide how much government intervention is necessary depending on how much payday lenders have contributed to the public good.

Given current aggressive lending practices, payday lenders are bound to pay for increased litigation costs while society pays for increased social welfare costs. Of all the possible approaches to this problem, we believe that the best reform will be shaped in part by internal reform. Advance America has an excellent opportunity to endogenize corporate social responsibility through its interactions with consumer rights groups,

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[111] *Id.* at 1977.

[112] *Id.* at 1978. Specific examples of contributions include funding public education campaigns and researching alternatives to harsh lending practices. *Id.*

[113] *Id.* at 1965.

[114] *Wither the Payday Loan*, WINNIPEG FREE PRESS, Jan. 29, 2005, at A14.

[115] Note, *supra* note 89, at 1977.

[116] *Id.* at 1976.

who have carefully documented damages to consumer communities and whose subsequent recommendations may serve as helpful guidelines for reform. Advance America might consider hosting a consumer rights conference aimed at discussing industry reform. The board of Advance America might choose to work directly with consumer rights groups through an executive committee that examines legislative reform, and precludes reform, to the extent possible, by developing responsive best practices. These are just a few ideas of how one leading payday lender could raise the standard for a more sustainable payday lending industry, where what the industry takes from society is equal to what it gives.

Conclusion

Current payday lending industry practices invite consumer criticism at best and consumer bankruptcy at worst. But commonly proposed solutions to the problem range from one side of the spectrum to the other. At one extreme, a solution entails a governmental mandate that all payday lenders engage in a set of defined acts and abstain from others. But government regulation is bound to be less responsive to the market and to society than an industry that finds a way to endogenize corporate social responsibility. Moreover, governmental regulatory agencies frequently lack resources necessary to sufficiently monitor and sanction misbehavior. At the other extreme, the government can adopt an entirely hands-off approach that allows payday lenders to self-enforce positive social behavior. But this approach does not prevent payday lenders from returning to acting in their own self-interest.

The solution we propose lies somewhere in the middle. We propose that the payday lending industry will benefit the most if the federal government works with the industry to initiate its own change, and then reforms laws to set standards that will ensure both healthy profit margins and a more financially stable consumer base. By endogenizing its own practices and by helping to shape and comply with new federal standards, payday lenders have the potential to evolve from defectors of the public good to models of corporate social responsibility.