

# Client Alert

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## Department of Defense Adopts Significant Changes to Its Military Lending Act Regulations

By Leonard Chanin and Obrea Poindexter

On July 22, 2015, the Department of Defense (DOD) published sweeping changes to its rules that implement the Military Lending Act (MLA). The amended rules significantly expand the scope of the MLA provisions by covering both new types of creditors and new credit products, including installment loans and other closed-end credit products and credit cards and other open-end credit accounts. The rules become effective on October 1, 2015, with compliance required by October 3, 2016. However, compliance with the rules for credit cards is delayed until October 3, 2017, unless extended for an additional year until October 3, 2018.

### BACKGROUND

In general, the MLA and DOD implementing rules apply to active duty service members and their spouses or dependents. Under the prior DOD rules, the provisions applied to only a narrow range of consumer credit products—"payday" loans, vehicle title loans and refund anticipation loans.

In September 2014, the DOD proposed extensive changes to its rules, including greatly expanding the scope of the rule. The DOD received more than 500 comment letters, including comments from industry, consumer groups, government agencies and other interested parties. Commenters expressed divergent views on the proposed rule—with many opposing large parts of the proposal, but others supporting it. While few, if any, would question the need to ensure that active duty service members (and their spouses and dependents) are protected from predatory lending practices, the final rule goes far beyond addressing such practices and may ultimately restrict service member access to traditional credit products due to the lack of clarity of the rules and the significant risks and liability creditors will face if they fail to comply with the rules.

### FINAL DOD RULE

#### Coverage

The final rule applies to "creditors" that extend "consumer credit" to "covered borrowers." Each of these terms is defined in the rule. Creditors include banks, credit unions, savings associations, finance companies and other lenders, as well as any assignee of a creditor. Consumer credit is defined very broadly and covers any credit extended to a "covered borrower" for personal, family or household purposes that is subject to a finance charge or is payable by written agreement in more than four installments (subject to exceptions noted below). The final rule applies to both closed-end and open-end credit, including installment loans, boat loans, single payment loans, lines of credit and credit cards, as well as other consumer credit transactions.

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There are several important exceptions to the credit transactions covered by the final rule. First, a loan or line of credit secured by a dwelling is exempt from coverage. For example, a loan to purchase or refinance a consumer's dwelling is exempt, as are a second mortgage loan or home equity line of credit. Second, a loan to finance the purchase of a motor vehicle, when the loan is secured by the vehicle, is exempt. However, a loan in which a consumer is refinancing a car loan is not exempt. Third, a loan to finance the purchase of personal property, when the loan is secured by that property, is exempt. Similar to the exemption for motor vehicle loans, a loan secured by personal property, that is not to purchase that property, is not exempt.

The final rule applies to "covered borrowers," which is defined as a consumer who, at the time he or she is first obligated on a credit transaction, is a service member who is on "active duty" or a spouse or dependent of such a person (which includes a child under the age of 21). The rule ceases to apply to a credit transaction (otherwise covered) if/when the consumer ceases to be on active duty. In addition, the final rule does not apply to credit transactions entered into before a service member is on active duty. Creditors may use the DOD's online database or another method to determine whether a consumer is a "covered borrower." In general, the rule creates a "safe harbor" for determining whether a consumer is a covered borrower if the creditor uses information from the DOD database or information from a nationwide consumer reporting agency (CRA) and complies with certain record retention and other provisions. It is not clear whether these databases will identify spouses and dependents.

## Requirements of the Rule

There are significant, substantive limitations that apply to credit transactions covered by the final rule. We describe some of the most important ones here. First, a creditor may not charge a consumer a military annual percentage rate (MAPR) that is greater than 36%. As discussed in more detail below, the MAPR is not the interest rate on the loan, nor is it the APR disclosed under the Consumer Financial Protection Bureau's (CFPB) Regulation Z. It potentially includes far more fees and charges. Second, a loan (or line of credit) may not have a prepayment penalty. The final rule does not define prepayment penalty, but creditors may be able to use the "definition" in Regulation Z. Third, aside from federally or state-chartered or -licensed banks, savings associations or credit unions, a creditor may not make a loan in which the title of a vehicle is taken as security.

There are several other significant provisions in the rule, such as those that prohibit lenders from "requiring" consumers to submit to arbitration or from imposing "other onerous legal notice provisions" in the case of a dispute. Another provision prohibits creditors from demanding "unreasonable notice" from the consumer as a condition of legal action. It will be essential for creditors that extend credit to active duty service members (or their spouses or dependents) to carefully review all of the substantive limitations imposed by the rule; failure to do so not only poses a risk of violating the rule but also of the credit agreement being "void from inception," as discussed later.

One additional prohibition is potentially quite broad, but unclear in its scope. This provision states that a creditor may not "use a check or other method of access to a consumer's deposit, savings, or other financial account." While this provision is presumably intended to prohibit certain "payday" loan practices, the language of the rule is much broader than simply banning such practices. Importantly, there are three exceptions to this provision. A creditor may: (1) require an electronic fund transfer to pay the transaction; (2) require direct deposit of the

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consumer's "salary" as a condition of eligibility for the credit; or (3) take a security interest in funds deposited after the extension of credit (in an account established in connection with the credit transaction)—provided that applicable law does not prohibit any of the actions.

## Calculation of the MAPR

The calculation of the MAPR will likely be one of the most challenging provisions for creditors. While creditors may be able to work through the complexity of the rule, the lack of clarity on what fees must be included in the MAPR will undoubtedly pose risks and operational issues.

Similar to the proposed rule, the final rule only permits a creditor to impose a MAPR of 36% or less for closed-end loans and for any billing cycle for open-end credit. For closed-end credit, the MAPR will be a one-time calculation made prior to/at the time the loan is made. However, for open-end credit transactions, the MAPR must be calculated for each billing cycle to determine whether a creditor is within the 36% MAPR. There are detailed and highly complex rules for determining what fees must be included in the MAPR, with distinct rules for credit cards.

First, for all credit transactions (open-end and closed-end) the MAPR must include any fee/premium for credit insurance, including single premium credit insurance, and for debt cancellation or debt suspension agreements. These amounts must be included regardless of whether such fees/premiums are voluntary and could be excluded from the finance charge under Regulation Z. In addition, for open-end credit, these fees/premiums must be included in the MAPR even if the products are obtained after the account is opened. Second, the MAPR must include any fee for a "credit-related ancillary product sold in connection with" the credit (whether for closed-end or open-end credit), and even if sold after the account is opened, for open-end credit. There is virtually no guidance on what products are deemed "credit-related ancillary products sold in connection with" a transaction.

Third, finance charges, as defined under Regulation Z, must be included in the MAPR. Fourth, except for special rules that apply to credit cards (and certain narrowly defined short-term loans subject to other federal agency rules), any application fee must be included in the MAPR, even if such a fee would not be a finance charge under Regulation Z. Fifth, except for credit cards, any "participation fee" must be included in the MAPR, even if the fee would not be a finance charge under Regulation Z. Other provisions limit the amount of participation fees for non-credit card open-end plans under certain circumstances.

There are highly complex rules that apply to credit card accounts, which permit creditors to exclude finance charges (aside from interest), application fees and participation fees from the MAPR, if such fees are "bona fide" and "reasonable." In general, to determine whether a fee is bona fide and reasonable and need not be included in the MAPR, a creditor must compare the amount of the fee with the amount typically imposed by other creditors for the same or a substantially similar product or service. The rule provides a "safe harbor" for making such a determination by comparing fees to the average amount charged by five or more large issuers of credit cards.

## Disclosures

Like the proposed rule, the final rule requires creditors to provide extensive disclosures to consumers in written and oral form. Disclosures may be provided orally in person or via a toll-free telephone number (provided the consumer is provided with the telephone number). Written disclosures also must be provided to the consumer.

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Three types of disclosures must be given. First, the creditor must give a “statement” of the MAPR. This does not require disclosure of a rate or dollar amount of charges for the transaction. Instead, creditors must provide a statement that describes the fees that are included in the MAPR and other information, substantially similar to the lengthy model text set out in the final rule. Second, the final rule requires creditors to provide Regulation Z disclosures, as applicable. Creditors are not required to give consumers a second set of those disclosures. Third, creditors must describe the payment obligation of the consumer; provision of the Regulation Z payment disclosures for closed-end loans and the account-opening disclosures for open-end accounts will satisfy this disclosure provision.

## Compliance

There are significant risks related to noncompliance, including potential civil liability. In addition, the final rule provides that any credit agreement that fails to comply with the rules or which contains a provision prohibited under the MLA is “void from inception” of the contract. Given the numerous substantive prohibitions under the rule and the lack of clarity on some aspects of the rule, it is not clear how creditors will address the risk of liability for noncompliance and the possibility that credit contracts may be voided.

## WHAT'S A LENDER TO DO?

While there are many things that may keep lenders awake at night as they try to ensure compliance with the rule, we mention three matters deserving attention.

### Which Consumers are “Covered Borrowers”?

While a creditor can use any method to determine whether a consumer is on active duty or otherwise covered by the final rule, a creditor only gets a “safe harbor” for such determination if it uses information from the DOD database or from a nationwide CRA. If a creditor cannot access the DOD database at the time needed, or if third parties are unable to obtain the information from the DOD database to replicate the database, a creditor may not be able to rely on the safe harbor. It remains to be seen whether nationwide CRAs will be able to offer information to creditors about the status of consumers (whether a service member is on active duty and whether a person is a dependent/spouse of such a person). Creditors may want to devote attention to the creation of other methods to seek to “conclusively determine” whether a consumer is a covered borrower.

### What Fees must be Included in the MAPR?

With Joycean clarity, the DOD final rule provides that the MAPR must include any fee for a “credit-related ancillary product sold in connection with the credit transaction.” For well over 40 years, the Federal Reserve Board (and more recently the CFPB) has provided rules, commentary and guidance in implementing the Truth in Lending Act to determine what fees are finance charges and when a fee is imposed directly or indirectly by a creditor as an incident to an extension of credit. Even after 40-plus years, such matters are not always clear. There is virtually no guidance in the supplemental information accompanying the DOD final rule on what a credit-related ancillary product is or when it is sold “in connection with” a credit transaction. Absent guidance or clarity, creditors will have to decide whether they will need to cease offering products to consumers in connection with a transaction to effectively manage compliance and legal risks.

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## What are “Onerous” and “Unreasonable” Notice Provisions?

The DOD final rule contains several requirements that prohibit certain actions or provisions. For example, the final rule provides that a creditor may not require the consumer to submit to arbitration “or impose other onerous legal notice provisions” in disputes. Similarly, the rule states that a creditor may not demand “unreasonable notice” from a consumer as a condition for legal action. These and other provisions will surely present challenges to creditors as they seek to ensure compliance with such broad and unclear requirements.

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