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Are These Game Changers? Developments in the Law Affecting Virtual Currencies, Prepaid Payroll Cards, Online Tribal Lending, and Payday Lenders

By Sarah Jane Hughes* and Stephen T. Middlebrook**

I. INTRODUCTION

In the year since our last survey, there have been significant legal developments in the areas of virtual currencies, prepaid payroll cards, online tribal lending, and payday lending. What connects some of these topics is an increasingly common strategy by federal banking regulators to influence and control the actions of entities that are not directly subject to their supervision through the relationships such entities have with regulated financial institutions. These developments also demonstrate robust state legislative and regulatory action relating to the provision of electronic payments and financial services, and document class actions alleging violations of federal and state laws.

This survey addresses developments taking place roughly between June 1, 2013 and June 5, 2014. Part II of this survey discusses the travails of Bitcoin and other alternative currencies. Part III addresses actions related to payroll cards. Part IV looks at the U.S. Supreme Court decision in Michigan v. Bay Mills Indian Community and various state efforts to rein in online interstate lending marketed by tribal communities and other lenders. Part V examines the U.S. Department of Justice’s “Operation Choke Point,” the prosecution of Four Oaks Bank, and a lawsuit brought by payday lenders against federal banking regulators. Part VI sets forth conclusions about the manner in which federal and state regulation of electronic

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payments and financial services is developing and suggests issues to watch closely in 2015.

II. BITCOIN AND OTHER VIRTUAL CURRENCIES

Our 2013 survey reported on the March 2013 guidance issued by the Financial Crimes Enforcement Network (“FinCEN”) for virtual currencies. Since then, both FinCEN and the Internal Revenue Service (“IRS”) have provided additional guidance, a number of state regulators have spoken up about virtual currencies, and the troubled Bitcoin exchange Mt. Gox is being liquidated and sued by former customers.

FinCEN issued two additional pieces of guidance related to virtual currencies in January 2014. In the first, FinCEN clarified that merely mining Bitcoin, using it to pay for goods and services, or converting it into real currency does not create an obligation to register as a “money services business” under FinCEN regulations. Other activities, however, such as transferring Bitcoin to a third party at the behest of others might constitute “money transmission” and thus require registration. In the second, FinCEN informed an entity that was buying and selling convertible virtual currency as an investment for its own account that it was not engaged in money transmission. FinCEN noted that the creation of specialized software used to manage the purchase and sale of its virtual currency holdings for oneself also does not trigger a “money service business” registration obligation.

The IRS released guidance on the tax treatment of Bitcoin, stating that transactions based in virtual currencies should be treated as exchanges of “property” for federal tax purposes. If the fair market value of property received in exchange for virtual currency exceeds the user’s adjusted basis in the virtual currency, the user’s gain may be taxable. One commentator expressed concern that the IRS’s guidance destroys the fungibility of the virtual currency, rendering it less useful for online commerce. In response to the IRS guidance, legislation

2. See id. at 264–70.
5. See id. at 2.
7. See id. at 2.
9. See id. at 2.
has been introduced that would prohibit the federal government from taxing virtual currencies for five years.\(^\text{11}\)

At the state level, regulators in California,\(^\text{12}\) Connecticut,\(^\text{13}\) Indiana,\(^\text{14}\) Nevada,\(^\text{15}\) New Mexico,\(^\text{16}\) and Texas\(^\text{17}\) all issued statements or guidance related to virtual currency activities in their respective states. In addition, New York announced that it would consider formal applications from entities wishing to establish and operate regulated virtual currency exchanges within the state.\(^\text{18}\)

In February 2014, Mt. Gox, at one time the largest Bitcoin exchange in the world, halted operations amid rumors of internal theft.\(^\text{19}\) It ultimately filed for reorganization under Japan’s bankruptcy laws\(^\text{20}\) and initiated a related proceeding under Chapter 15 of the U.S. Bankruptcy Code (Ancillary and Other Cross-Border Cases).\(^\text{21}\) The Japanese court has determined that Mt. Gox should be liquidated, not reorganized.\(^\text{22}\) In February 2014, a consumer class action lawsuit was filed against Mt. Gox, alleging the company failed to secure and protect its customers’ virtual currency and that insiders conspired to steal Bitcoin belonging to Mt. Gox users.\(^\text{23}\)

### III. Recent Legal Developments Affecting Payroll Cards

The last twelve months have proven to be quite tumultuous for payroll cards, the banks and processors that provide them, and the employers who use them to pay their workers. The tone for the past year was set in June 2013 by a negative article in the New York Times that asserted that some employees were being required to use payroll cards by their employers and that the cards often were

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20. See Alex Hern, MtGox Files for Bankruptcy in Japan After Collapse of Bitcoin Exchange, GUARDIAN (Feb. 28, 2014, 8:30 AM), http://goo.gl/ruSF2b.  
accompanied by high fees. Other commentators, however, argued that payroll cards provide an economical alternative for many workers, are sufficiently regulated to protect consumers, and generally suffer from a great deal of misinformation. Amidst this media scrutiny, significant legislative, regulatory, and litigation activity took place—leaving the payroll card industry and users scrambling to keep up with changes. Underscoring the difficulty of these challenges, JPMorgan Chase decided to exit the prepaid card business.

A. REGULATORS CLARIFY THAT FEDERAL LAW REQUIRES EMPLOYERS TO OFFER CHOICE

In response to the New York Times article, a group of sixteen U.S. senators asked the Consumer Financial Protection Bureau (“CFPB”) and the Department of Labor (“DOL”) to “take a closer look” at whether payroll card fees may violate the Electronic Fund Transfer Act (“EFTA”) or the Fair Labor Standards Act (“FLSA”). In particular, the senators asked the CFPB to clarify what options for receiving wages employers are required to offer their workers when implementing a payroll card program. They also asked the DOL to clarify to what degree the FLSA applies to such products.

On September 12, 2013, CFPB Director Cordray answered, confirming that Regulation E, which implements the EFTA, already contains specific provisions that govern payroll cards. He explained that although CFPB rules “do not regulate the type or size of fees that can be charged,” they do require consumers receive written disclosures of terms and conditions, including fees, and also provide cardholders with additional consumer protections. Cordray noted that Regulation E requires employers utilizing a payroll card to offer employees the choice of at least one other method of receiving their wages. On the same day, the CFPB issued a bulletin that summarized Regulation E’s requirements that payroll card programs provide disclosures, access to account history, limited liability for unauthorized transfers, and error resolution rights. The bulletin also addressed the issue of choice:

28. See id. at 2.
29. See id.
31. See id.
32. See id. at 2.
An employer may . . . offer employees the choice of receiving their wages on a payroll card or receiving it by some other means. Permissible alternative wage payment method(s) are governed by state law, but may include direct deposit to an account of the employee's choosing, a paper check, cash, or other evidence of indebtedness.\footnote{Id. at 3.}

In light of the CFPB's guidance, it is clear that federal law requires employers making payroll cards available to their employees to offer at least one other method of wage payment, but leaves it up to state law to determine what are the permissible alternatives.

In January 2014, the DOL responded to the senators stating that direct deposit of wages, including to a payroll card, is permissible under the FLSA as long as the employee has the option of receiving payment by some other method.\footnote{See Letter from Laura A. Fortman, Principal Deputy Adm'r, Wage & Hour Div., Dep't of Labor to Sen. Richard Blumenthal (Jan. 8, 2014), available at http://goo.gl/0NieS.} The agency noted that, if an employee is not given this option, a violation of the FLSA might occur if account maintenance charges reduce the employee's wages below the statutorily required minimum wage.\footnote{See id.}

B. STATE LEGISLATORS AND REGULATORS TAKE ACTION REGARDING PAYROLL CARDS

This survey year saw a marked increase in legislation addressing payroll cards introduced in state legislatures.\footnote{See Kirsten N. Washington, Rise in Payroll Card Legislation Adds to Compliance Pressures, BLOOMBERG BNA (May 23, 2014), http://goo.gl/ddyPbaK.} Nebraska enacted a fairly standard payroll card law authorizing the product as a means of wage payment so long as the card meets requirements of Regulation E and provides at least one means of accessing the full amount of wages without a fee per pay period.\footnote{See L.B. 765, 103d Leg. (Neb. 2014).} Illinois passed a more restrictive bill that authorizes payroll cards only if the employee is offered another method of wage payment, receives certain disclosures in advance, may withdraw his or her full wages at least once a pay period without cost, has unlimited free access to balance information by telephone, and is not charged an inactivity fee until after a full year of abandonment by the cardholder.\footnote{See H.B. 5622, 98th Gen. Assemb. (Ill. 2014).} The Illinois legislation also requires the card program to provide two free declined transactions per month and takes the unprecedented step of capping subsequent charges to "commercially reasonable fees, limited to cover the costs to process declined transactions."

Hawaii went even further, authorizing employers to utilize payroll cards only if the employee is offered the choice of direct deposit or a check; is given a detailed set of disclosures in a prescribed format; is allowed to make at least three free withdrawals per period, one of which must permit withdrawal of the full amount of wages; is permitted unlimited free access to balance and account information

\footnote{See id. § 14.5(4).}
twenty-four hours a day, seven days a week; is provided one free replacement card per year; and is never assessed an overdraft fee. Because the highly prescriptive Illinois and Hawaii laws depart significantly from the regulatory schemes in place in other states, payroll card issuers will likely have to modify their enrollment forms, disclosure packets, and processing systems in order to continue operating in Illinois and Hawaii. It will be interesting to see if providers can find an economically viable way to meet these unique, nonstandard requirements or whether they stop serving cardholders in those states.

Legislators are not the only state officials interested in payroll cards. In July 2013, the New York State Attorney General sent letters to a number of large employers in his state demanding documents about their payroll card programs, including detailed information about fees. In the year since those requests, however, the Attorney General has not publicly taken action against any employers utilizing payroll cards.

C. EMPLOYERS SUED OVER THEIR PAYROLL CARD PROGRAMS

Much of the early media scrutiny on payroll cards was prompted in part by a class action lawsuit filed in Pennsylvania state court by a former employee of a fast food restaurant alleging that she had been required to receive her wages on a JPMorgan Chase payroll card in violation of the state wage-and-hour law.

In California, clothing giant PVH Corp. was sued twice over its use of payroll cards to pay wages to some of its employees. In Chavez v. PVH Corp., plaintiffs alleged violations of California state law for failure to obtain employees’ consent before paying to a payroll card, failure to provide an itemized wage statement, and for other causes. The parties have agreed to a settlement of $1,850,000 from which California employees will be reimbursed for fees and charges they incurred using their Money Network payroll cards. In Lapan v. PVH Corp., the class purports to encompass employees in California and the rest of the United States. In addition to state law claims, the Lapan plaintiffs assert that the Money Network payroll card program violates the FLSA because employees are charged fees for some card transactions that “cause[] Plaintiffs and the Class to be paid less than the statutory minimum wage and statutory overtime compensation for all hours worked.”

41. See H.B. 1814, 27th Leg. (Haw. 2014).
47. Id. ¶ 22.
In a fourth class action, *Branson v. Destiny Foods, Inc.*, plaintiffs assert that their employer, owner of twenty-nine Subway sandwich shops in and around Austin, Texas, forced employees to accept their wages on a Global Cash payroll card.\(^{48}\) Plaintiffs also claim the employer failed to provide timely information on fees associated with use of the card\(^ {49}\) and required employees to establish accounts at a particular financial institution in violation of the EFTA.\(^ {50}\)

**IV. ONLINE INTERSTATE LENDING AND TRIBAL IMMUNITY**

Lenders owned by Indian tribes or affiliated entities and operating online suffered setbacks in the past year—two of which we mention in this Part. In August 2013, the New York State Attorney General sued Western Sky Financial, a tribally affiliated lender based in South Dakota, for operating within New York without a license and for usury violations.\(^ {51}\) The lender ultimately settled with the state and made $20 million available to consumers for refunds.\(^ {52}\)

On May 27, 2014, the U.S. Supreme Court decided *Michigan v. Bay Mills Indian Community*,\(^ {53}\) involving claims by the State of Michigan against the Bay Mills Indian tribe relating to the tribe’s off-reservation casino. In a five–four split, the Court held that the Indian Gaming Regulatory Act only authorized suits to enjoin gaming activity located “on Indian lands.”\(^ {54}\) Justice Kagan, writing for the majority, explained that the 1993 Compact between the Tribe and the State of Michigan “empowered Bay Mills to conduct class III gaming on “Indian lands”; conversely, it prohibits the Tribe from doing so outside that territory.”\(^ {55}\) One commentator reads the decision as the end of online tribal payday lending that does not comply with state law interest-rate caps and licensing requirements and concludes that “courts can enter an injunction stopping illegal lending—even by tribal entities.”\(^ {56}\)

Whether the lower courts will read *Bay Mills* this way remains to be seen.

**V. OPERATION CHOKE POINT TARGETS CUSTOMERS OF BANKS CAUSING PAYDAY LENDERS TO SUET REGULATORS**

This survey year saw a major U.S. Department of Justice (“DOJ”) campaign, known as “Operation Choke Point,” produce its first settlement and become

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49. See id. ¶ 18.
50. See id. ¶ 19 (citing 15 U.S.C. § 1693k(2)).
54. Id. at 1084 (citing to 25 U.S.C. § 2710(d)).
55. Id. at 2029.
more contentious. In a March 20, 2013 speech, Michael J. Bresnick, executive
director of the Financial Fraud Enforcement Task Force, mentioned that failure
to maintain robust Bank Secrecy Act ("BSA") and Anti-Money Laundering
("AML") procedures can result "in significant civil, or even criminal, penalties
under the Bank Secrecy Act, [the Financial Institutions Reform, Recovery, and
Enforcement Act of 1989], and other statutes" and urged banks "not only to
know their customers, but also to know their customers' customers."57 As a
part of Operation Choke Point, the DOJ sent subpoenas to fifty banks and pay-
ment processors.58

Subsequently, on September 27, 2013, the Federal Deposit Insurance Corp.
("FDIC") issued Financial Institution Letter 43-2013, titled FDIC Supervisory
Approach to Payment Processing Relationships with Merchant Customers that
Engage in Higher-Risk Activities.59 These events appear to have set the stage
for other developments in this survey year.

A. THE FIRST DOJ PROSECUTION YIELDS A SETTLEMENT

On January 8, 2014, the DOJ announced a settlement in its first action arising
out of Operation Choke Point, United States v. Four Oaks Fincorp, Inc.60 The con-
sent order provided for a civil money penalty of $1.2 million. Its permanent in-
junction provisions prohibit defendants from (a) processing ACH debit or check
transactions against customer accounts on behalf of third-party payment proces-
sors, (b) providing bank accounts or banking services to third-party payment
processors, and (c) except with advance notification to the United States and
considerable advance and ongoing diligence, providing ACH or credit card pro-
cessing services to numerous categories of enterprises in the credit repair or
mortgage relief services industry, to telemarketers without limitation, internet
short-term lenders, or other internet-based businesses.61

B. ACTIONS IN THE U.S. HOUSE OF REPRESENTATIVES SIGNAL TROUBLE
AHEAD FOR OPERATION CHOKE POINT

On May 24, 2014, the House Committee on Oversight and Government Reform
issued a staff report on Operation Choke Point with sternly worded findings that
charge the DOJ with depriving lawful businesses of needed banking services and
targeting businesses disfavored by the Obama administration, along with their

bankers, for special investigation. The report also charges that the DOJ lacks adequate legal authority to pursue these investigations. In a related note, on May 29, 2014, the House of Representatives approved a rider to the DOJ’s 2015 appropriations that prohibits federal spending on Operation Choke Point.

C. PAYDAY LENDERS FILE SUIT AGAINST THE BANKING REGULATORS

On June 5, 2014, the Community Financial Services Association of America (“CFSA”), a trade association for community lenders including providers of payday loans, and Advance America filed suit against the Federal Deposit Insurance Corp., the Board of Governors of the Federal Reserve System, and the Office of the Comptroller of the Currency alleging the regulators’ use of informal guidance to target payday lenders through their banking relationships exceeds the agencies’ statutory authority and is unlawful. Plaintiffs seek an order “to prevent Defendant agencies from abusing their regulatory authority over financial institutions to enforce a de facto boycott by financial institutions of the CFSA’s member businesses.” The complaint alleges that regulators employ “back-room pressure tactics” on financial institutions, warning that continued relationships with payday lenders will result in “harsh and prolonged examinations,” with the result that over eighty banking institutions have terminated relationships with CFSA members. The CFSA asserts that regulators accomplish this by issuing vague formal “safety and soundness” regulations through the notice and comment process which are supplemented with “a raft of informal guidance documents establishing a novel and even more subjective and pliable regulatory standard—‘reputational risk’—issued without any notice, without any input from interested parties, and without the support of an administrative record.”

Plaintiffs assert that the regulatory agencies have failed to follow the Administrative Procedures Act and seek to have the illegally promulgated regulations declared void.

VI. CONCLUSION

Each year when we put together this annual survey, we include what we consider to be the “game changing” developments in electronic payments and financial

63. See id.
64. See 160 CONG. REC. H5001-02 (daily ed. May 29, 2014) (approving the Luetkemeyer Amendment).
66. Id. at 1.
67. Id. ¶ 7.
68. Id. ¶ 9.
69. Id. ¶ 72 (citing 5 U.S.C. § 553(b), (c)).
70. Id. ¶ 71 (citing 5 U.S.C. § 706(2)(D)).
services that reveal the direction of the evolution in electronic payments and financial services, their acceptance by users, and the trends in their regulation at the federal and state levels. This year, choosing what to present was as difficult as ever. The year’s most salient developments have settled few of the really big issues we face, but they point to future battles over the scope and style of electronic financial products and services and their regulation. These include how the United States or the states will regulate emerging virtual- or crypto-currencies, how employers use payroll cards and what protections the states or Congress will require for their use, whether Native American tribes can provide online, off-reservation and interstate credit or other financial products, and whether and how Congress may restrict federal prosecutions aimed at curbing payments processing by banks on behalf of certain merchants.