***RICO Report*: S02 Ep02, Unlawful Debt Collection Claims**
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Callan Stein:

Hello, and thank you for joining me on this installment of the RICO Report where we're going to talk about a somewhat unique and a little bit discreet topic in the world of RICO jurisprudence, that of unlawful debt collection and how that can serve as a basis for a RICO violation. My name is Cal Stein, and I'm a partner in the White Collar and Litigation Practice groups at Troutman Pepper. I represent clients in white collar criminal and government investigation matters, as well as in complex civil lawsuits and in RICO litigation. I am very pleased to have another of my colleagues here with me today, Tim Bado. Tim, why don't you go ahead and introduce yourself.

Timothy Bado:

Thanks for having me on the show today, Cal. I am an associate in our Atlanta office in our RISE Practice Group, which is our Regulatory Investigations, Strategy + Enforcement group. I represent our corporate clients facing government investigations and enforcement actions. Relevant to this podcast, I also have experience with civil RICO claims and debt collection actions, so I've also represented banks and loan servicers through the collection of various debts.

Callan Stein:

Well, that's great. Thanks so much for joining us, Tim. I think we're going to have a really interesting discussion here today. So, as I said, we're here today to talk about unlawful debt collection, which is not something that many people will really typically think of when they think about the RICO statute and RICO litigation. It's also something that we have really not yet focused on here at the RICO Report, as all of our other episodes have really focused on what I'll refer to as more traditional RICO cases involving a pattern of racketeering activity, and then, as a predicate for that, the types of offenses one more closely aligns with RICO: mail and wire fraud, drug trafficking, money laundering, that type of thing. I think it would actually take a while for most people to get to unlawful debt collection activity when thinking about RICO, but that's really one of the reasons this episode, I think, is going to be so interesting.

So, with that, let's get started. I want to start with a somewhat basic discussion of just how the RICO statute is implicated through acts of unlawful debt collection. Tim, I'm going to turn to you to get us started here in a moment. I want to start where we always start on the RICO Report, which is the RICO statute itself. In this case, what we're talking about is 18 U.S.C. 1962, which we have discussed at great length on the RICO Report as it sets forth the prohibited activities under the RICO statute. We've discussed those prohibited activities in the context of traditional racketeering activity. So why don't you start us off by talking a bit about the activity of unlawful debt collection and how that conduct fits into each of the four subsections of Section 1962 representing the four categories of conduct that the RICO statute prohibits.

Timothy Bado:

I think we need to start then exactly, and I don't want to skip ahead too far here, but what is the unlawful debt and how we get into usury rates? What typically we'll see here is a company, or an individual it could be, is going to be offering loans at very high interest rates, and that's what's going to be considered the unlawful debt. But as we get into Section 1962 and we look at specifically Subsection A here, "... for a person who has received income." That would be these companies or individuals who are receiving income from the collection of this unlawful debt. For example, if someone loans a customer money for any type of activity at a usurious interest rate, any income they receive from the collection of that debt is going to be implicated here under Section A. So, any kind of income received there, and if they're looking to, I guess, acquire an interest in an established operation, using that fund to do so will implicate Subsection A.

Then when we move here to Subsection B, if you look at just the Unlawful Debt Collection Act itself, so if in the sense that you are collecting a debt unlawfully but in doing so are acquiring a controlling interest in an enterprise through the unlawful debt collection, that would implicate Subsection B here. Moving on to C, I think that's probably where you're going to see the most common claims when you just look at the language of itself. This is just an employee associated with an enterprise who engages in conduct or participates in the enterprise's affairs of collection of unlawful debt. We're not even talking here about receiving income or acquiring an interest. We are solely talking about the conduct itself. So simply engaging in the conduct of unlawful debt will implicate 1962-C.

Then when we look at D here, the conspiracy to violate any of these above provisions, that's somewhat speaks for itself with a difference being you need obviously more than one person to conspire, so that's the caveat there, but just conspiring, thinking about it, taking a meaningful step to violate any of those other subsections is going to implicate Subsection D. All of this is, of course, goes back to the intent of RICO to begin with, which is to combat organized crime. So that is, as you mentioned, not quite as popular in the debt collection context, but we are seeing it more today.

Callan Stein:

Thanks, Tim. I think it's not unexpected to hear you say that Subsection C is the one that's going to be most implicated. We've talked a lot about Subsection C here on this podcast. Typically, that is the one you see way more than the other three. But we're not yet done with the statutory text here. Tim just very helpfully walked us through the ways that unlawful debt collection can arise in Section 1962's prohibited activities. But what we did not see in that section is just what constitutes an unlawful debt for RICO purposes. For that answer, we have to flip one section back in the RICO statute. We have to flip to Section 1961, which is the definition section, Subsection 6, which defines unlawful debt. When we look at 1961 Subsection 6, we see that Congress has actually helped us out a little bit by helpfully dividing the definition of unlawful debt into two separate requirements, both of which must be met, and they are denoted by Subsection A and Subsection B in that definition.

Let me start with the first requirement, which is found in Subsection A. The first requirement for an unlawful debt is that the debt was incurred in one of two ways, either in connection with illegal gambling activity, and, of course, I emphasize the word "illegal" because, as many people know, gambling is actually becoming more and more legal across the United States these days, so either in connection with illegal gambling activity, or the second way is that the incurred debt is unenforceable pursuant to federal or state usury laws. That's the one that you mentioned a moment ago, Tim, and that we'll talk about a little bit more. Usury laws, of course, addressing the amount of interest that can legally be charged.

What I think is really interesting about this first requirement of the definition, is what do we immediately see here? We see two things, gambling and usurious loans, another word for which is loan sharking. So, between gambling and loan sharking, it's pretty clear that this definition of unlawful debt is a genuine vestige of the original purpose of the RICO statute that Tim mentioned, which was to combat organized crime, gambling and loan sharking being two of the types of activities one will typically and easily associate with the more traditional ideas of organized crime. I want to turn to the second requirement of an unlawful debt in a moment. But before I do, I want to turn to you, Tim, for a quick primer on usury laws, specifically how those laws intersect with the RICO statute in defining unlawful debt.

Timothy Bado:

Sure, Cal. When you're looking at and thinking about state usury laws, what you're going to be looking at is the interest a lender can collect on the debt that's incurred. What we'll see looking across various states, the interest rate caps that states allow are going to vary. As we'll talk about in a little bit, New York, for example, has a 16% interest rate cap, whereas many other states, including Colorado, for example, have up to a 36% interest rate cap. So, loans that are offered. i.e., the debt being incurred, to customers cannot exceed these amounts. If they do, so for example, if we see a loan at 50% or 75% interest rate, that will be considered a usurious loan under that state's laws. That's what's considered an unlawful debt here as we get into 1961 Subsection 6.

Callan Stein:

Let's go back now to the definition section of RICO and the definition of unlawful debt. A moment ago, I summarized the first requirement, which was essentially that it be an unlawful debt that was incurred either through illegal gambling activity or loan sharking. Now let's turn to the second requirement, which is found in Subsection B of the definition. There are a couple components to this requirement, but let me talk about the first one, which is that the debt be incurred either in connection with the business of illegal gambling or the business of making usurious loans, i.e., the business of loan sharking. One of the things I want to talk about is, what does that really mean? What is the business of illegal gambling or the business of loan sharking? We'll get to that, but there's more to this definition as well. Tim, why don't you talk to us about that.

Timothy Bado:

Sure, Cal. In the context of usurious laws, I think what's important here is to look at this last sentence where the usurious rate is at least twice the enforceable rate. So, as I mentioned a moment ago, for example, where New York is at 16% interest cap, a plaintiff will not have a RICO claim if a loan is offered at, say, 20%, for example. It might be unenforceable under New York's laws, but it has to be at least 32% to trigger a possible RICO violation.

I think there are a couple interesting cases that talk about this, and we'll get into those in a second. But I think another interesting point to this is if a RICO plaintiff or the government can prove a loan was usurious, they don't need to establish any criminal activity whatsoever to make out a RICO case. As we'll see, many states, they have civil usury laws, but they also have criminal penalties. We'll get into that here more in a second.

I want to talk about the Durante Bros. case from the Second Circuit. It looks a lot at the language itself as we talked about these. Unlike the definition of racketeering activity, the definition of unlawful debt does not refer to offenses or acts that are chargeable or punishable. It just doesn't have that criminal language in the unlawful debt. So we really only need to look at the language of unlawful debt itself to see that it says a debt must be merely unenforceable. In the civil context, what's important to remember there as well is that, while no criminal activity needs to be proven, the character of the debt only needs to be proven by a plaintiff or by the government by a preponderance of the evidence. So that's obviously a much lower standard than we would see in a criminal context, always something to be keeping in mind there. But also there's no need for proof of a prior conviction based on usurious laws for success on a civil RICO claim.

We'll see this as an example in the Durante Bros. case where, in 1970 in New York, the state interest rate cap at that time was 7.5%. So collecting 15% was considered usurious but was not a violation of New York's criminal usury law unless the rate exceeded 25%. So here is the perfect example where we can see there's a RICO violation, at least under this particular subset, but there's not a criminal violation. That's just one element that you'll always need to be watching out for.

Additionally, the plaintiff or the government does not need to prove a defendant knew the exact rate was being charged. For example, let's say a company's in the business of offering loans that they know are at 50%, which is going to be above every state's state usury laws, but they don't have to know that the plaintiff's loan specifically, for example, was offered with a 62% or a 49% interest rate. The government or a plaintiff doesn't need to prove that. It's just sufficient to show that the defendant knew the debt was unlawfully usurious, again, at twice the legal rate.

We've also got another case that talks about administrative fees or late fees, which I think is really interesting because right now we've talked about really only the context of interest rates. We can look at the Nolan case out of the Fifth Circuit that affirmed the district court's dismissal of a RICO claim based on an identical action as well where the plaintiff alleged the defendants collect unlawful debts in the form of administrative fees in violation of Section 1962, A and C as we talked about a few minutes ago. But the Fifth Circuit held the late fees were not an unlawful debt under 1961 Subsection 6 because the fees were not usurious. Without a violation, there can be no conspiracy, so that claim was dismissed as well.

It's really interesting to see what is considered usurious and what is not. That's why, I think, as you noted at the top of the podcast, that this is a narrow, not frequently discussed area because this topic is so narrow. This holding in the Fifth Circuit is part of a string of cases that hold that administrative or late fees are not sufficient to establish a usury crime because they're not classified as unlawful debt.

Callan Stein:

Thanks for that, Tim. That all makes good sense to me. I want to pick up where I left off and also on something you said. You gave an example where you talked about a company in the business of offering loans. I do want to spend some time talking about that component of the definition. What does that really mean? What is being in the business of illegal gambling or in the business of loan sharking?

Well, loyal listeners of the RICO Report may hear that phrase and immediately connect it to another concept that we've discussed far more frequently, that of the pattern of racketeering activity. We know that the RICO statute is not aimed at reaching isolated conduct. Rather, it is aimed at reaching repeated conduct or conduct that threatens to be repeated. This concept of unlawful debt arising only in the context of the business of illegal gambling or the business of usurious loans seems to be getting at that same point. But this is a really important point to make because, unlike RICO claims based on racketeering activity, there is no pattern requirement for unlawful debt collection RICO claims. The prevailing view, in fact, among federal courts is that a single act of unlawful debt collection can support a RICO claim. That is, of course, not the case with other racketeering activity.

Returning now to this concept of the business of, even though a single collection of an unlawful debt can suffice to support a RICO claim, more is required. RICO does remain focused on actual or threatened repetition of criminal activity, and this is where the business of requirement that I just described comes in. So, Tim, talk to us a little bit about the business of requirement. What does it mean? How does it interact with the somewhat surprising revelation that a single act of unlawful debt collection can support a RICO claim?

Timothy Bado:

As you said, a single act can support a RICO claim. However, there has to be evidence of a larger debt collection operation or, as you've said, business of illegally lending money. For example, if a gambling debt, the proof of a single instance of collection is sufficient only if there's also evidence that the collection activity was part of a larger gambling operation. The same goes for usury. It's the same concept. A proof of a single instance of making usurious loan is sufficient only if there's also evidence that it was part of the business of lending money at a usurious rate.

Callan Stein:

Thanks for that clarification, Tim. Actually, this discussion kind of raises another nuanced issue that I think is worth discussing. Tim, when I hear you talk about the business of requirement and the business of illegal gambling and the business of usurious rate lending, the thing that comes to my mind is how some of that at least could probably be pleaded or at least alleged in the context of a more traditional fraud case as opposed to an unlawful debt collection case, at least under RICO. So, Tim, can you talk to us a little bit about the difference in pleading an unlawful debt collection RICO case and pleading a RICO case based on fraud that we may have seen before?

Timothy Bado:

I think you're exactly right that a lot of people, I think, at first glance are going to think unlawful debt collection and fraud have a lot of similarities, which they of course do. But I think there are some key distinctions, as you've pointed out, particularly in the pleading standard. There's a really good, recent case out of the Eastern District of Virginia that discusses the pleading standard. That court held actually an unlawful debt is substantially different than common law fraud.

As we know, fraud has to be pled with particularity under Rule 9B of the Federal Rules of Civil Procedure. This requires a much higher pleading standard than Rule 8, which just requires a short and plain statement. When looking at this case, the context of RICO claims, when you're talking about mail fraud or wire fraud, mortgage fraud, any of the traditional fraud predicate acts have to be pled under Rule 9B. However, when you're talking about debt collection, because this is considered substantially different than fraud, you only need to look to Rule 8 and satisfy those requirements. So the pleading standard's actually lower when you're talking about usurious loans compared to fraud. Again, several courts across the country have held this same standard to the point now where that is the prevailing opinion.

For example, we look at a case out of the District of New Jersey here, another very recent case, that says the exact same thing. I'll just quote from there real quick. "A plaintiff must plea all [inaudible 00:19:35] of fraud and each example must be pled with particularity," which we know, but this applies to mail fraud, wire fraud, or bank fraud that constitutes racketeering activity. Whereas we know debt collection is very narrow, and all they need to allege is a single instance of collection of a usurious loan. What you'll also see, too, is when alleging fraud, because these examples are going to come from the traditional predicate, actually you'll need at least two of those, which, again as we have mentioned, you only need one in the context of debt collection.

Callan Stein:

Okay, great. Tim, we've focused so far on the legal element of unlawful debt collection RICO cases. I want to pivot now, as we often do on the RICO Report, and talk about some of the practical implications of this piece of the RICO statute. I want to talk about how this plays out in the real world. Tim, we're going to start with you. As we were preparing for this podcast, one of the things you raised was something of a hot topic involving the CFPB and state attorney generals. For you listeners out there, as Tim mentioned, he's part of our excellent RISE group, which is dedicated to following each and every trend that is currently out there and being pursued by state AGs across the entire country. So when Tim mentioned to me that this was something that could be on the radar, I paid close attention and made sure we want to have him cover it here today. So, Tim, why don't you tell us a little bit about that?

Timothy Bado:

Again, Cal, you are exactly right in that in our state AG practice, we focus on trends from not only state AGs but also federal regulators because those regulators are often, as we're seeing now, communicating with state attorney generals and prodding them in the right direction and to certain things that these offices might want to look into.

The lending of usurious loans is one of the hottest topics out there right now in what the government is calling rent-a-bank schemes. What that means is a bank and a non-bank will partner to offer loans to consumers. The purpose of these loans is to offer them at high interest rates, and they're often offered to consumers in a situation that they don't have any other option than to accept these loans. For example, if you need your tires repaired and that costs $500, well, many consumers don't have the $500, so they'll take out loan.

How and why regulators are looking at this is through the context of the banks are, under the FDIC Act, able to impute interest rates from a state where that bank is chartered. For example, Utah is a popular destination because there is no max interest rate. If a non-bank will partner with a bank that can impute those rates, they can legally offer those rates in that state. So it's a regulator's position that this practice allows non-banks to circumvent state usury laws. They claim that the non-banks are actually the true lender of the loans because what you'll see, for example, when a consumer signs the loan documents, the heading and the communications and the servicing and the collection of these loans will all be through the non-bank company. So the regulators are saying that the non-banks are actually the lenders of these loans. So we're seeing concerted efforts from state and federal regulators to challenge this practice.

I think this is highly relevant to RICO because these loans, they're sometimes what we'll see as high as 10 times the interest rate caps. We're seeing loans at 100%, 200%, 300%, and there's no state where those interest rates are remotely legal, again, from a state's perspective. So I think what we'll see in the future are significantly more enforcement actions brought by state attorney generals' offices and federal regulators challenging this practice. If it's found that the non-banks are actually the true lenders of this, then you're going to have lenders offering loans well in advance of twice the enforceable rate, and these are going to be ripe for RICO actions. Again, if this continues at this pace that we're seeing with the regulators here, I would not at all be surprised to see a wave of RICO actions as a new angle to take in this context.

The second part that I want to talk about here is the Fair Debt Collection Practices Act and how that's not a predicate offense under the RICO statute. It really addresses two separate areas. They're both debt collection. However, one focuses on the unfair and deceptive or misleading practices, which is the FDCPA, while RICO is narrow and it only focuses on these usurious loans. While we'll often see RICO and FDCPA claims brought by plaintiffs, they're actually very different. Not only do they have different elements, but also it's completely different in the burdens of proof that must be shown and the predicate acts that must be shown. So the FDCPA or the state iterations are not going to be an area where regulators are going to be able to go after these companies. It's going to be under RICO.

Callan Stein:

Fascinating, fascinating stuff from you. Before we end, there's one more trend that I want to address. That is the recent uptick in RICO cases that we've seen being brought against companies operating in the merchant cash advance space, or MCAs. First, what is a merchant cash advance? Well, the way it typically goes is something like this. A merchant, i.e., a business, needs cash. It has product. It has customer. It's sold that product to its customers, but it needs more cash than it has on-hand often because the customers have not yet paid for the products. So the merchant has outstanding accounts receivables but not enough cash on hand.

This is where the MCA comes in. The merchant will often go to a company that gives out merchant cash advances, which is basically a transaction whereby the business gives the merchant cash upfront in exchange for the merchant assigning to the MCA company a certain percentage of the merchant's outstanding accounts receivable. That percentage is often high. If the MCA company actually collects the full percentage of accounts receivable, the payment to the MCA can exceed usury rates that would apply if the transaction was structured as a loan versus a merchant cash advance.

Now, here's the rub in these cases. If the arrangement is structured properly, they are not loans. They're merchant cash advances. But if they are structured improperly, a plaintiff can bring a claim, often a RICO claim, arguing that even though they're calling these things cash advances, they are, in reality, a loan and thus subject to usury laws. If they are loans subject to usury laws and the MCA company ends up collecting more money than usury laws permit, the plaintiff can claim unlawful debt collection and bring a RICO claim. I've seen a number of these cases.

The underlying law of what characteristics there are in an MCA agreement that actually lead to these transactions being cash advances as opposed to loans, it's a complicated set of law. It changes all the time and can vary state by state and circuit by circuit. So there are openings that we have seen for plaintiffs to bring unfair and illegal debt collection RICO cases against even legitimate MCA businesses, and I suspect we are going to see more and more of these cases. They're difficult to win at the motion-to-dismiss stage, though not impossible, but it does take some specialized knowledge, both of the RICO statute and of the laws pertaining to usury and in the context of merchant cash advances to win them.

With that, we are out of time here today, so I want to bring this discussion to a conclusion. Tim, I really want to thank you for joining me on this podcast. I want to thank everyone for listening. If you have any thoughts or comments about this series, I invite you to contact me directly at callan.stein@troutman.com. If you have any thoughts or comments about this episode, you can contact me or you can contact Tim at tim.bado@troutman.com. You can subscribe and listen to other Troutman Pepper podcasts wherever you listen to podcasts, including on Apple, Google, and Spotify. Thank you for listening and stay safe.