Fourth Circuit Takes Expansive View of MLA Auto-Loan Exemption

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In a decision highly anticipated by the auto finance industry, a federal appeals court recently held that auto loans remain exempt from the Military Lending Act even when they finance related costs or services beyond the purchase price of the vehicle. Under the MLA, secured loans such as mortgages and auto loans enjoy an exemption from the law's 36% interest rate cap, its prohibition on arbitration, and other consumer protections designed to benefit servicemembers and their dependents. The Fourth Circuit in *Davidson v. United Auto Credit Corp.*[1] concluded that lenders can bundle related products or services — such as GAP insurance, pre-paid interest, and processing fees — into an auto loan without disqualifying the loan from the MLA's exemption. For now, the decision maintains the status quo in the auto finance market as lenders largely interpreted a 2020 Department of Defense rule consistent with the *Davidson* court's holding. But it may portend yet another round of rulemaking as the Biden Administration has signaled its intention to use its regulatory authority to address GAP coverage under the MLA.

CASE BACKGROUND

The lawsuit flowed from an auto loan the plaintiff, Jerry Davidson, obtained from United Auto Credit to finance the purchase of a used car. Davidson at the time was a sergeant in the U.S. Army and thus generally covered by the MLA's consumer protections. Davidson's loan financed not just the purchase price of the vehicle but also charges for GAP insurance, a processing fee, and some prepaid interest. (In the event of a total loss of the vehicle, "GAP" insurance, or guaranteed asset protection, protects consumers from having to pay back the portion of an auto loan not covered by regular car insurance, which only covers the fair market value of the vehicle.)

The parties did not dispute that Davidson's loan included an arbitration provision or that Davidson did not receive the extra disclosures required of MLA-covered loans. The case centered on a legal question — whether a loan financing both the purchase of a vehicle and additional related costs (a "hybrid" loan as the DOD and CFPB dubbed it in an amicus brief, or a "dual-purpose loan" as the *Davidson* court described it) is exempt from the MLA. Davidson alleged that by financing GAP insurance and other costs, UAC could not take advantage of the MLA exception for loans that finance the purchase of a vehicle. The district court granted UAC's motion to dismiss, concluding that the ancillary costs rolled into his loan were "directly related" to the purchase of the vehicle, and that Davidson's loan therefore fit within the MLA's auto loan exception. The lower court found persuasive the fact that the DOD in 2020 retracted a 2017 regulation that supported Davidson's position. Siding with Davidson now, the court reasoned, would render the 2020

guidance meaningless.[2]

THE MILITARY LENDING ACT

Both the district and appeals courts wrestled with the MLA's history and purpose, its precise wording, and how to make sense of a series of DOD regulations interpreting the act. In 2006, at Congress's request, the Department of Defense issued a report detailing the challenges servicemembers face in connection with consumer debt (the Report). It concluded, among other things, that "[p]redatory lending undermines military readiness, harms the morale of troops and their families, and adds to the cost of fielding an all-volunteer fighting force."[3] The Report stressed that the Department's "primary concern" was the prevalence of payday lending and "the overt marketing of some installment and Internet lenders" around military bases.[4] Short-term loans with triple-digit interest rates were the focus.

The Report was a precursor to the enactment of the MLA later in 2006. While the MLA itself contains no express statement of purpose, its enactment closely followed publication of the Report and occurred at a time when over 160,000 U.S. troops were actively deployed in Iraq and Afghanistan.[5] (Indeed, in the Davidson litigation both sides treated the Report as akin to legislative history.)

MLA protections apply to active duty military personnel and their dependents.[6] The law's main feature is a 36% interest rate cap for consumer loans. It also bars creditors from including mandatory arbitration provisions in consumer credit contracts and requires creditors to provide certain additional disclosures to MLA-covered consumers. Under the MLA, creditors may not impose prepayment penalties nor require servicemembers to effectuate payments on a loan through the military allotment system. Mortgages and vehicle loans — secured by valuable collateral and carrying lower interest rates — were specifically exempted from MLA coverage, consistent with the Report's emphasis on unsecured, high-interest loans.

> The MLA regulates only "consumer credit" as follows:
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> The term "consumer credit" has the meaning provided for such term in regulations prescribed under this section, except that such term does not include (A) a residential mortgage, or (B) a loan procured in the course of purchasing a car or other personal property, when that loan is offered for the express purpose of financing the purchase and is secured by the car or personal property procured.[7]

Thus, under the statute, secured auto loans are not subject to MLA restrictions where made "for the express purpose of financing the purchase" of the vehicle. If a loan fits within the exemption, then the MLA's protections do not apply — for example, the creditor would not be limited to the 36% MLA rate cap; the loan may carry a mandatory arbitration agreement; and the additional MLA disclosures need not be provided.

THE FOURTH CIRCUIT'S DECISION

The MLA's auto exemption was front and center in the *Davidson* case. If Mr. Davidson's "dual-purpose loan" — financing GAP insurance and other costs beyond the cost of the vehicle — was subject to the MLA, then UAC would face civil liability for its failure to provide MLA disclosures and its use of a mandatory arbitration clause. Davidson filed his complaint as a putative class

action, alleging that "easily thousands of consumers" were affected.[8] The MLA provides for $500 in statutory damages per violation, the possibility of punitive damages, plus costs and reasonable attorney fees for successful plaintiffs[9] — making Davidson's class claim worth millions of dollars.

The case drew three significant amicus briefs. A collation of industry trade associations argued, among other things, that the MLA should not be read to discourage the financing of GAP insurance, which must be arranged at the loan's inception because it affects the underlying loan's terms. The goal of the MLA — to maintain military readiness by preventing servicemembers from falling into debt traps — indeed would be hampered if, after a total vehicle loss, a servicemember could not wash her hands of the old debt. A group of former and current members of Congress argued that all auto loans are excluded from MLA's coverage, regardless whether they also finance GAP insurance. In support of Davidson, the United States, in a brief filed by DOD, the CFPB, and the Justice Department, argued that the auto-loan exception does not apply to loans financing "bundles of disparate products."

By a 2-1 vote, the court sided with UAC. Writing for the court (and joined by Judge Stephanie Thacker), Judge Julius Richardson concluded that the statutory wording "for the express purpose," as used in the auto-loan exemption, means "for the specific purpose."[10] Further, the court concluded (in the context of the MLA at least) that for a loan to have the "express" or specific purpose of financing a vehicle does not demand that the loan solely or exclusively finance the vehicle cost. Accordingly, because Davidson's loan was made for the specific purpose of financing the purchase of the vehicle (no matter that it additionally financed other related costs), the loan fell within the MLA exemption. The court affirmed the lower court's dismissal of Davidson's complaint. Judge J. Harvie Wilkinson III dissented, stressing the law's overall purpose to protect servicemembers and dependents in connection with consumer financial products, and worrying that "unscrupulous lenders" will test the limits of the court's decision by financing more costs and services tenuously related to the vehicle purchase.[11] Davidson has until July 11 to seek review by the Supreme Court.

FUTURE MLA RULEMAKING

In its amicus brief, the United States went out of its way to highlight DOD's authority to issue MLA regulations. It asked the court, should it side with UAC, to affirm that such a decision "leaves undisturbed [DOD's] authority to promulgate appropriate regulations through notice-and-comment rulemaking that address GAP coverage."[12] While the Fourth Circuit's opinion did not provide the formal reaffirmation of DOD's authority sought by the United States, its general MLA rulemaking authority is not reasonably subject to dispute (and indeed the court referenced the agency's rulemaking authority in a footnote).

The Department of Defense has issued several MLA interpretive rules over the years. Notably, a 2017 DOD rule declared that loans secured by a vehicle and financing anything beyond the vehicle purchase price (such as GAP insurance) do not qualify for the MLA exemption.[13] That 2017 guidance, which mirrored Davidson's position, was withdrawn however in 2020.[14] As mentioned, the withdrawal of the 2017 guidance featured prominently in the district court's dismissal of Davidson's claim.

For now, the Fourth Circuit's decision affirms the view that inclusion of GAP coverage and other costs will not banish a secured auto loan to the realm of non-exempt financial products under the

MLA. Whether DOD attempts to undo the *Davidson* holding through further rulemaking is an open question. On the one hand, DOD made its position clear in its amicus brief that "hybrid loans" financing GAP coverage do not qualify for the auto-loan exemption, and its assertion of rulemaking authority appears to contemplate forthcoming guidance. On the other hand, it would be unusual for any federal agency, much less the normally staid DOD, to promulgate a rule that directly contradicts a reported decision of a federal appeals court. Unlike the district court's dismissal, which leaned heavily on an interpretation of the rulemaking history, the Fourth Circuit's analysis rested on an interpretation of the statute itself. DOD is now left to grapple with whether and how to impose its policy view in light of the *Davidson* decision.

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[1] 65 F.4th 124 (4th Cir. 2023).
[2] *Davidson v. United Auto Credit Corp.*, No. 20-cv-1263-LMB-JFA, 2021 WL 2003547, at *5 (E.D. Va. May 19, 2021).
[3] *See* U.S. Dep't of Def., Rep. on Predatory Lending Pracs. Directed at Members of the Armed Forces and their Dependents 46 (Aug. 2006), https://apps.dtic.mil/sti/pdfs/ADA521462.pdf.
[4] Report at 53.
[5] *See* Amy Belasco, Congressional Research Service, Troop Levels in the Afghan and Iraq Wars, FY2001-FY2012: Cost and Other Potential Issues (July 2, 2009), https://sgp.fas.org/crs/natsec/R40682.pdf.
[6] *See* 32 C.F.R. § 232.3(g)(1).
[7] 10 U.S.C. § 987(i)(6).
[8] Compl. ¶ 43, *Davidson v. United Car Sales Co., LLC*, No. 1:20-cv-1263 (E.D. Va. Apr. 1, 2020), ECF No. 1.
[9] *See* 10 U.S.C. § 987(f)(5).
[10] 65 F.4th at 127.
[11] *Id*. at 134.
[12] Br. of United States 34, *Davidson v. United Auto Credit Corp.*, No. 21-1697 (4th Cir. Jan. 6, 2022), ECF No. 24-1.
[13] *See* 82 Fed. Reg. 58739-01, 58740 (Dec. 14, 2017).
[14] *See* 85 Fed. Reg. 11842-02 (Feb. 28, 2020).