Westlaw Journal
BANK & LENDER LIABILITY
Litigation News and Analysis • Legislation • Regulation • Expert Commentary
VOLUME 21, ISSUE 15 / DECEMBER 14, 2015

EXPERT ANALYSIS

Citizen, Soldier, Small-Business Owner? Commercial Lending and The Servicemembers Civil Relief Act

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The Servicemembers Civil Relief Act, 50 U.S.C.A. § 3901, provides certain protections to military service members regarding their financial obligations. The act applies to virtually every type of debt that a service member may obtain. It provides benefits such as an interest rate cap and procedural limitations on foreclosure, repossession and eviction.

Over the past several years, the Department of Justice and federal banking regulators have systematically enforced SCRA compliance with creditors related to residential mortgages, student loans and motor vehicle loans held by service members. The resulting settlements have led to hundreds of millions of dollars in consumer remediation and stringent compliance management obligations for banks and non-bank financial institutions.

The world has changed dramatically in the century since Congress enacted the SCRA's predecessor, the Soldiers' and Sailors' Civil Relief Act, which was the first comprehensive service member protection statute. Today, service members leave behind more than just their families when they answer the call of duty. Some leave behind businesses complete with property, employees and independent financial obligations.

Taking this into account, federal regulators are now expanding their traditional focus beyond consumer lending to include small business loans. For example, the Consumer Financial Protection Bureau recently posted an "expression of interest" in hiring an assistant director for small business lending, and members of Congress have placed renewed pressure on that agency to promulgate rules to implement the small business loan data collection provisions of the Dodd-Frank Act.[1]

As regulators continue to review all types of financial transactions for SCRA compliance, one area of increasing interest has been service member-affiliated commercial loans. While the SCRA is relatively limited in its express treatment of commercial loans, a detailed reading of the statutory text and relevant case law provides some guidance to financial institutions that service these loans.

BACKGROUND

When Congress enacted the Soldiers' and Sailors' Civil Relief Act during World War I, it was focused primarily on protecting service members' *personal* obligations during their period of service. Because Congress was focused on the service members themselves — and because commercial lending did not exist in its modern form at the time — it never explicitly addressed service members' commercial obligations. Indeed, when the SSCRA was passed and then reenacted during World War II, members of Congress never suggested in either the statutory text or legislative history that its protections could apply to business obligations. Rather, Congress was squarely focused on providing the SSCRA's protections to service members, which were (and remain) defined as members of the uniformed services.[2]

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Congress modernized and recodified the SSCRA as the SCRA in 2003. Part of the motivation for this recodification was Congress' recognition that "the world of 1940 could not have foreseen all the changes in American life that more than 60 years of technological advance and business practices would bring."[3]

Among many other updates, Congress added a new section to address the modern practice of extending commercial loans to both business organizations and service members. In Section 596, Congress stated that when a service member's "trade or business" has an obligation or liability for which the service member is personally obligated, that individual's personal assets may not be used to satisfy the trade or business obligation during the period of military service.

SERVICE MEMBER PRIMARILY OBLIGATED ON DEBT

The text of the SCRA does not distinguish among protections based upon the purpose of a loan. Therefore if a service member is personally liable for repayment of a business or commercial loan, regulators and courts are taking the position that the act covers these loans just as it would any other obligation or debt. This scenario typically arises either when a service member personally takes out a corporate loan from a financial institution or when a service member co-signs with a small business so both the individual and the business are jointly and severally liable on the debt.

For example, in *Cathey et al. v. First Republic Bank*,[4] Stewart and Donna Cathey obtained financing to construct a gas station and convenience store. In issuing the loan, the bank required the Catheys to sign all of the promissory notes for these corporate loans "in their individual capacities."

Stewart Cathey then entered military service and provided his bank with a copy of his military orders so he could receive the SCRA's interest rate benefit. The bank nevertheless charged him an interest rate that exceeded the SCRA's 6 percent cap.

The Catheys sued the bank, and the court held that the institution did not comply with the statute. However, the court made it clear that the loans were eligible for SCRA benefits only because the service member was a signatory:

> Every single promissory note at issue was signed individually by each plaintiff [including the servicemember] and by the corporation. The notes expressly provide that all three 'promise to pay.' All three are referred to collectively as borrower in the note and in the business loan agreement. Both plaintiffs and the corporation are referred to as borrower in all of the commercial guarantee agreements. This is not a case where loans were executed by a corporation which happened to be owned in part by a serviceman. Rather, this case involves loans incurred by a serviceman. The fact that the loans were also incurred by others (his wife and his family's corporation) is irrelevant to my consideration.[5]

Thus, the court held the business purpose of the loan was irrelevant so long as the service member was personally obligated on it, the SCRA applied.

SERVICE MEMBER NOT PRIMARILY OBLIGATED ON DEBT

Conversely, where a business organization is solely responsible for the debt, a loan is ineligible for SCRA protection. By definition, a business organization cannot be a service member under the SCRA because a business cannot be a member of the uniformed services. Where there is no service member obligated on the debt, the SCRA does not apply.

At least one court interpreting the earlier version of the statute concluded that the protections for service members extend only to natural persons and specifically exclude business organizations.[6] Further, Congress' explicit purpose in enacting the SCRA was to provide protections for "servicemembers of the United States to enable such *persons* to devote their entire energy to the defense needs of the Nation."[7]

Congress' use of the word "persons," together with the definition of service member, clearly show that the statute's protections do not apply where only a business organization is liable for the debt.

This analysis holds where a service member is an owner of a business organization. The distinction in law between individuals and business organizations owned by individuals is longstanding, and it has repeatedly been affirmed by the Supreme Court.[8] For example, a publicly traded corporation does not become eligible for SCRA benefits simply because a service member owns stock in it. This rationale applies equally to ownership in closely held corporations and publicly traded corporations. The SCRA provides benefits and protections only on the debts owed by the service member, not debts owed solely by the business organization.

In this regard, the statute is designed to ensure that service members cannot use the protection of the statute as both a sword and a shield. Rather, the SCRA provides service members with the opportunity to have their obligations "modified as justice and equity require."

At least one court has misread the *Cathey* case and incorrectly held that the SCRA can apply to a commercial loan held solely by a business. In that case, *Linscott et al. v. Vector Aerospace et al.*,[9] Jeffrey Linscott owned and operated JL Aviation Inc., a corporation that helicopter flight services. JLA alone entered into a contract to retain Vector Aerospace to repair a helicopter turbine. Due to a dispute over the quality of the company's work, JLA elected not to make the required contractual payments. In response, Vector kept the turbine, demanded full payment plus 18 percent interest and listed the turbine for sale. Linscott and JLA filed suit jointly under the SCRA, arguing that the 18 percent interest rate violated the statutory cap.

Although only JLA — and not Linscott himself — had entered into the repair contract, the magistrate judge held that the SCRA applied. The only support that the magistrate judge provided for applying the SCRA was a single citation to *Cathey*. As discussed above, the decision in *Cathey* turned entirely on the fact that the service member was obligated as a primary borrower on the loan. *Linscott* instead states that *Cathey* provided SCRA protection because the obligor was a "family corporation" owned by a service member.

Not only did *Linscott* fundamentally misread *Cathey*; it is also inconsistent with the text of the SCRA itself, which provides protections only to service members.

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CONCLUSION

The SCRA, a statute that grew out of the World War I era, is being applied to the modern economy. Although the 2003 recodification emphasized that there is a difference between a service member's personal and business debts, financial institutions must look to case law to understand how the SCRA affects commercial lending. Even then, the complicated nature of personal liability for commercial loans can lead courts to misapply the protections of the act. With SCRA compliance as a key part of any loan servicing plan — and with the CFPB potentially expanding its regulatory purview to include small business commercial lending — financial institutions should confirm that their policies and procedures appropriately ensure that SCRA benefits apply to service members' commercial loans.

NOTES

[1] Consumer Financial Protection Bureau, *Assistant Director, Small Business Lending (Expression of Interest),* LinkedIn, https://www.linkedin.com/jobs2/view/78946898 (last visited Nov. 13, 2015). Although the Dodd-Frank Act was passed in 2010 and the CFPB was created in 2011, the statutorily mandated small business loan data collection rules for banks and other financial institutions have not yet been put in place. While the CFPB does not have enforcement authority under the SCRA, it does examine institutions for SCRA compliance in its supervisory capacity and can refer potential SCRA violations to the Department of Justice for enforcement action. *Memorandum of Understanding Between the Consumer Financial Protection Board and the United States Department of Justice Regarding Fair Lending Coordination* (Dec. 6, 2012), http://files.consumerfinance.gov/f/201212_cfpb_doj-fair-lending-mou.pdf; Letter from Rep. Donald M. Payne Jr. et al. to Dir. Richard Cordray (Aug. 21, 2015); Dodd Frank Act § 1071, 15 U.S.C.A. § 1691c-2.

[2] 50 U.S.C.A. § 3911.

[3] *The Servicemembers Civil Relief Act and The Soldiers' and Sailors Civil Relief Equity Act: Hearing on H.R 5111 and H.R. 4010 Before the H. Subcomm. on Benefits of the Comm. of Veterans Affairs,* 107th Cong. 8 (2002) (statement of Craig W. Duehring, Acting Secretary of Defense, Reserve Affairs, Department of Defense).

[4] *Cathey et al. v. First Republic Bank,* No. 00-CV-2001, 2001 WL 36260354 (W.D. La. July 6, 2001).

[5] *Id.*

[6] *See Bolz Cooperage Corp. v. Beardslee,* 245 S.W. 611, 612-13 (Mo. Ct. App. 1922) ("We are jealous to liberally construe the Soldiers' and Sailors' Civil Relief Act so as to effectuate its purpose, but we cannot read into the Act something which is not therein contained and which is clearly excluded."). The closest approximation to calling a business organization into military service occurred during the Korean War when President Harry S. Truman nationalized the steel industry. *See Youngstown Sheet & Tube Co. v. Sawyer,* 343 U.S. 579 (1952). However, nationalizing the steel industry during wartime was distinct from actually calling the industry — a collection of organizations — into military service.

[7] 50 U.S.C.A. § 3902. Although one recent Supreme Court case in the area of campaign finance law has extended the First Amendment's protections to include corporate entities, *Citizens United v. Federal Election Commission,* 558 U.S. 310 (2010), this case, decided after 2003, provides no suggestion that in 2003 Congress intended to expand the SCRA to cover corporations. Further, the purpose of the SCRA — to prevent service members from being disadvantaged by performing their military duty — is not furthered by protecting corporate entities.

[8] *See, e.g., Dole Food Co. v. Patrickson,* 538 U.S. 468, 474 (2003) ("A basic tenet of American corporate law is that the corporation and its shareholders are distinct entities.") (collecting cases)); *Cedric Kushner Promotions Ltd. v. King,* 533 U.S. 158, 163 (2001) ("The corporate owner/employee, a natural person, is distinct from the corporation itself, a legally different entity with different rights and responsibilities due to its different legal status.").

[9] *Linscott v. Vector Aerospace,* No. 05-cv-682, 2006 WL 1310511 (D. Or. May 12, 2006).

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