UNITED STATES OF AMERICA
Before the
CONSUMER FINANCIAL PROTECTION BUREAU

ADMINISTRATIVE PROCEEDING
File No. 2015-CFPB-0029

In the Matter of:	
INTEGRITY ADVANCE, LLC and JAMES R. CARNES,	**RESPONDENTS' MEMORANDUM OF LAW IN SUPPORT OF MOTION TO OPEN RECORD FOR A NEW HEARING**
Respondents.	

RESPONDENTS' MEMORANDUM OF LAW IN SUPPORT OF MOTION TO OPEN RECORD FOR A NEW HEARING

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Respondents Integrity Advance, LLC and James R. Carnes submit this memorandum in advance of the August 16, 2019 Scheduling Conference to explain why a new trial and evidentiary hearing is required to allow Integrity Advance, LLC and James R. Carnes to, among other things, establish a statute of limitations defense (which was improperly denied without a hearing in earlier proceedings), the credibility of its witnesses which is especially crucial to defend against individual liability, and to potentially introduce an advice of counsel/good faith defense based on the recent decision in *CFPB v. CashCall, Inc. et al*, CV 15-07522-JFW (RAOx), 2018 U.S. Dist. LEXIS 9057 (C.D. Cal. Jan. 19, 2018). As explained below, due process requires that when the CFPB seeks significant civil penalties and other relief, as it intends to do in this matter, Respondents be given a full opportunity to present all of its factual and legal defenses, especially when the law has changed and continued to develop on issues that are highly relevant to the CFPB's allegations. Respondents' Motion to Open Record for a New Hearing should be granted.

I. Procedural Background

The original Administrative Law Judge who heard this matter was improperly appointed. *See* Dkt. 212 at 1. Therefore, on May 29, 2019, Consumer Financial Protection Bureau ("CFPB") Director Kathleen L. Kraninger ordered that this matter be remanded for a "new hearing and recommended decision in accordance with the Bureau's Rules of Practice for Adjudication Proceedings" before Administrative Law Judge Christine J. Kirby ("the ALJ"). *See* Dkt. 216 at 2, 9. On July 24, 2019, the ALJ ordered the parties to submit a Joint Proposed Pre-Hearing Schedule by August 14, 2019 in advance of a telephonic Scheduling Conference on August 16, 2019. *See* Dkt. 227 at 3. The ALJ stated that she intends to "conduct a de novo record review." *Id.* (relying on *Intercollegiate Broad Sys., Inc. v. Copyright Royalty Bd.*, 796 F.3d 111, 116 (D.C. Cir. 2015)). However, the ALJ will "at the appropriate time, give the parties

the opportunity to present arguments as to whether the record needs to be supplemented with further evidence." *Id.*

Respondents offer this memorandum of law in support of their Motion to Open Record for a New Hearing and to explain why the de novo record review that occurred in *Intercollegiate* is inappropriate in this case and would deny Respondents their due process rights.[1]

II. Legal Standard

The appropriate remedy for an adjudication tainted by an Appointments Clause violation is a "new hearing before a properly appointed official." *Lucia v. SEC*, 138 S. Ct. 2044, 2055 (2018) (internal citations omitted). The rules that govern CFPB hearings are found in the Rules of Practice for Adjudication Proceedings at 12 CFR §1081 ("the CFPB Rules"). The CFPB Rules provide for, among other things, dispositive motions, pre-hearing discovery, witness testimony at a live hearing before a hearing officer, and appeals. *See* 12 CFR §1081.100, *et al.*

In some circumstances in which a matter has been remanded after an Appointments Clause violation, a de novo record review is appropriate where the parties have not identified (1) any determination that "turned on witness credibility" nor (2) any relevant evidence that is not on the record. *Intercollegiate*, 796 F.3d at 116 (the parties "fail[ed] . . . to point to any instance of an exclusion of relevant evidence that affected the outcome . . . or to any portion of the Final Determination that turned on witness credibility.")

In this matter, consistent with the Supreme Court's holding in *Lucia* and the CFPB Director's order, a new hearing is required that comports with the procedures contained in

[1] Respondents (and presumably Enforcement Counsel) will be filing dispositive motions in this matter that may cut short or curtail the need for an evidentiary hearing. However, in the absence of the ALJ's ruling on such motions, a new hearing is required as set forth in this memorandum of law.

the CFPB Rules. Additionally, under the analysis of *Intercollegiate,* a new hearing is required so that the ALJ can effectively make witness credibility determinations and the factual record can be developed to allow Respondents to present defenses to the charges, including statute of limitations defenses which the prior ALJ improperly denied, and defenses explained in recent cases, including in *CashCall*. In particular, it is clear from the existing record that the ALJ would have to make witness credibility determinations regarding whether Mr. Carnes should be held individually liable.

III. Argument

A. Respondents are Entitled to a New Hearing in Accordance with CFPB Rules

As held by the Supreme Court, the proper remedy for an Appointments Clause violation is a "new hearing before a properly appointed official." *Lucia*, 138 S. Ct. at 2055 (internal citations omitted). The parties in this matter have agreed that the *Lucia* decision applies to this case as the prior ALJ was not properly appointed. *See* Dkt. 212 at 1. Accordingly, the CFPB Director ordered a new hearing. *See* Dkt. 216 at 2. On the face of her order, the CFPB Director has directed that Respondents be granted a new hearing "in accordance with the Bureau's Rules of Practice for Adjudication Proceedings." *Id.* The CFPB Rules clearly outline the process for CFPB hearings, which includes pre-hearing discovery and a live hearing with the opportunity for both sides to present evidence and examine witnesses. *See, e.g.,* 12 CFR §1081.206-210, 300-306.

Similarly, the Chief ALJ for the Securities and Exchange Commission ("SEC") has ordered that post-*Lucia* matters before the SEC are entitled to new hearings; it is only appropriate to conduct a mere review of the existing record where both parties agree to that review. *See In re: Pending Administrative Proceedings*, File Nos. 3-15006, et al., Chief Administrative Law Judge's Order Assigning Proceedings Post *Lucia v. SEC* (assigning new

ALJs to preside over new hearings except "where the parties waived their right to a new hearing and requested that the Commission decide their petitions for review on the present record.") In the absence of an agreement by the parties, a full "new hearing" is required.[2]

The posture of this case is separate and distinct from the *Intercollegiate* matter, where the prior court simply directed that that matter be "vacated and remanded" but did not expressly order a "new hearing." *Intercollegiate*, 796 F.3d at 116. Here, the CFPB Director has ordered a new hearing to accord with the CFPB Rules. Additionally, the *Intercollegiate* court was evaluating the amount of process that was appropriate to ensure fairness in a matter in which a $500 minimum annual fee was at issue. *Id*. at 130. Here, the CFPB is seeking tens of millions of dollars in restitution and civil money penalties. Therefore, the amount of due process that is appropriate to fairly adjudicate the claims is necessarily much greater. *See Mathews v. Eldridge*, 424 U.S. 319, 335 (1976) (the nature and degree of procedural due process that is required depends upon the "private interest that will be affected by official action," among other factors.)

B. **The Court's Analysis in *Intercollegiate* Requires a New Hearing**

Even assuming that the ALJ's reliance on *Intercollegiate* is correct, the analysis in that case makes clear that a full new hearing is appropriate here because (1) the ALJ must make determinations based on witness credibility and (2) there is relevant evidence that is not on the current record. *See Intercollegiate*, 796 F.3d at 116.

1. A New Hearing is Required to Assess Witness Credibility

To hold Mr. Carnes individually liable, the CFPB has to prove that: (1) Mr. Carnes participated directly in the allegedly deceptive acts or had the authority to control those

[2] Of course, nothing in this memorandum precludes the parties in this matter from agreeing to rely on certain aspects of the existing factual record in the interest of efficiency. Respondents will confer with Enforcement Counsel on any aspects of the record where that might occur.

acts, and (2) Mr. Carnes had knowledge of the alleged misrepresentations, was recklessly indifferent to the truth or falsity of the alleged misrepresentations, or was aware of a high probability of the alleged fraud along with an intentional avoidance of the truth. *See CFPB v. Gordon*, 819 F.3d 1179, 1193 (9th Cir. 2016). However, the testimony in the existing record shows just the opposite. Mr. Carnes testified that he did not draft or revise Integrity Advance's loan agreement, and the company retained outside counsel to create the document and ensure that it complied with Delaware and federal law. Hr'g Tr. I-95:10-13; II-75:11-25; II-76:1-13. Similarly, the former general counsel testified that neither Mr. Carnes nor anyone else internal at the company was an expert in consumer law and that all agreements were written by outside counsel. *Id*. at II-26:20-25; II-27:1-6.

In fact, Enforcement Counsel already has conceded that the testimony on the record does not establish Mr. Carnes' liability in itself and repeatedly asked the first ALJ to find that Mr. Carnes was not credible in his testimony in order to hold him individually liable. For example, Enforcement Counsel stated:

> At trial, Carnes and Foster would not clearly state who decided to implement Integrity Advance's deceptive loan agreement . . . Based on all of the evidence and the credibility of the witness' testimony, the ALJ can find that Carnes approved the use of the deceptive loan agreement.

Enforcement Counsel's Post-Hearing Brief, Dkt. 162 at 11. Enforcement Counsel further urged the original ALJ to reject testimony of Mr. Carnes:

> While Carnes tried to distance himself from this decision (testifying that he "possibly" saw a loan agreement template at some point in 2008) the Administrative Law Judge should find Carnes's testimony on this topic not credible and reject it.

Id. at 17.

The original ALJ in the underlying matter did in fact rely on credibility determinations in making the factual findings underpinning his conclusions as to Mr. Carnes' individual liability. *See* Recommended Decision, Dkt. 176 at 51-54; xvi, ¶92; xxiv, ¶12; xxv, ¶24; xxxi, ¶33; xxxi-xxxii, ¶35; xxxv, ¶58 and 62; xxxix, ¶98. The ALJ also relied on credibility determinations to find that Integrity Advance's use of remotely created checks ("RCCs") was unfair. *Id.* at 35; xxv, ¶20. The ALJ explained that such witness credibility determinations are made based on "the totality of circumstances" after considering a number of "traditional factors" including "the demeanor of the witness." *See* Recommended Decision, Dkt. 176 at 12-13 (*citing St. Claire Marine Salvage, Inc. v. Bulgarelli,* No. 13-10316, 2014 WL 3827213, at *6 (E.D. Mich. Aug. 4, 2014), *aff'd* (July 22, 2015)).

Given the state of the existing record, a new, appropriately appointed fact-finder must make witness credibility determinations to determine whether the CFPB has met its burden as to Mr. Carnes' individual liability, as well as other issues such as whether Integrity Advance's use of RCCs was unfair. This can only be done effectively at an evidentiary hearing in which the ALJ can hear live witness testimony and judge the credibility of the witnesses for herself. *See Lucia*, 138 S. Ct. at 2050 (citing to the SEC's petition that "an ALJ's 'personal experience with the witnesses' place him 'in the best position to make findings of fact' and 'resolve any conflicts in the evidence.'") Therefore, Respondents seek a new evidentiary hearing in this matter.

2. Recent Developments in the Law Necessitate Development of the Factual Record

Additionally, intervening case law has reinforced and, in some instances, expanded the need to further develop the factual record through additional discovery.[3]

[3] Respondents are not asking the ALJ to make dispositive rulings on these substantive issues at this point and, therefore, this memorandum of law does not contain Respondents' full arguments on the merits. Respondents are merely identifying areas that require additional discovery and/or a live evidentiary hearing in order for the ALJ

a. *Statutes of Limitations*

One such area is the statute of limitations for claims brought under the Consumer Financial Protection Act ("CFPA"). By statute, CFPA claims must be brought within three years of the "date of discovery of the violation." *See* 12 U.S.C. § 5564(g)(1). However, at the time of the underlying proceedings, then CFPB Director Richard Cordray maintained that no statutes of limitations applied to the CFPB's administrative proceedings. *PHH Corp. et al.,*2014-CFPB-0002, Decision of the Director at 10 (June 4, 2015). Expressly relying on that decision, the improperly-seated ALJ rejected Respondents' arguments that the CFPB's claims were time-barred. *See* Dkt. 75 at 20; Dkt. 176 at 29. Those rulings rendered any request for additional discovery and/or an evidentiary hearing related to the date that the CFPB "discovered" the potential violations moot at that point.

Since that time, the former Director's ruling has been overturned by the D.C. Circuit Court of Appeals. *See PHH Corp. v. CFPB*, 839 F.3d 1, 41 (D.C. Cir. October 11, 2016), upheld on statute of limitation grounds and reversed on other grounds by 881 F.3d 75 (D.C. Cir. January 31, 2018) (statutes of limitations apply to CFPB actions in both administrative proceedings and civil actions).[4] In fact, the court in *PHH* expressly referenced the present matter

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to fully and properly consider and adjudicate the matter. As the record is developed, either party may identify additional areas that require further development

[4] This ruling also applies to the statutes of limitations for claims brought by the CFPB under the Truth in Lending Act ("TILA"), the Electronic Funds Transfer Act ("EFTA"), and the derivative CFPA claims. *PHH,* 839 F.3d at 41. However, the statutes of limitations for those claims run from the date of "violation" rather than the date of "discovery," so Respondents are not requesting additional discovery related to the statutes of limitations for those claims at this point. *See* 15 U.S.C. § 1640(e) ("Except as provided in the subsequent sentence, any action under this section [TILA] may be brought in any United **Error! Hyperlink reference not valid.** district court, or in any other court of competent jurisdiction, within one year from the date of the occurrence of the violation"); 15 U.S.C. § 1693m(g) ("Without regard to the amount in controversy, any action under this section [EFTA] may be brought in any United States district court, or in any other court of competent jurisdiction, within one year from the date of the occurrence of the violation."); 12 U.S.C. § 5564(g)(2) ("in any action arising solely under an enumerated consumer law [e.g., TILA and EFTA], the [CFPB] may commence, defend, or intervene in the action in accordance with the requirements of that provision of law, as applicable.").

in finding that the CFPB "misreads the enforcement provisions of the Dodd-Frank Act" in its contention that statutes of limitations do not apply. *Id.* at 51. Therefore, the CFPA's statute of limitations is applicable to this action, and the date on which the CFPB "discovered" the potential violations is extremely relevant and potentially dispositive.

Given that development in the law, Respondents renewed their discovery requests on this issue. *See* Dkt. 192 at 12, FN 11; Dkt. 203 at 11-12, ¶¶4-5. Respondents are now again seeking additional discovery and have submitted documents requests and a proposed subpoena to Enforcement Counsel, who has stated that the CFPB objects to such requests.[5] Additional discovery should be allowed on this potentially dispositive defense.

b. *Advice of Counsel/Good Faith*

Another area of law that has developed since the initial hearing is the impact of the advice of counsel and good faith on the appropriateness of ordering restitution in CFPA actions. *See CFPB v. CashCall, Inc. et al*, CV 15-07522-JFW (RAOx), 2018 U.S. Dist. LEXIS 9057, at *40-41 (C.D. Cal. Jan. 19, 2018) (holding that the advice of counsel and good faith is "relevant to the determination of whether restitution is an appropriate remedy" in a CFPA matter). As such, Respondents may assert the defense of good faith reliance on the advice of transactional counsel either as a defense to liability or as relevant to restitution. In the Proposed Pre-Hearing Schedule, Respondents have proposed making this determination and notifying Enforcement Counsel within 30 days of the Scheduling Conference, and filing any motion to amend their answer shortly thereafter. If Respondents do raise advice of counsel, Respondents would not object to Enforcement Counsel seeking reasonable discovery on the issue.

[5] Respondents have narrowly-tailored the requests to seek documents related to CFPB activity from July 21, 2011 to November 18, 2012, three years before the CFPB filed the Notice of Charges. Additionally, Respondents acknowledged that some responsive documents may be protected by privilege. In such instances, Respondents requested a log identifying the date, parties, and subject matter of any documents withheld or redacted for privilege.

c. *Imposing and Calculating Restitution in CFPA Matters*

A third area of developing law is the appropriateness of restitution in CFPA matters – both the circumstances in which it should be ordered and how it should be calculated. As analyzed by the court in Cashcall, restitution is not appropriate in CFPA cases where the CFPB does not show fraudulent intent. Restitution also is not appropriate when the CFPB fails to prove that consumers did not received the benefit of their bargain. *Id.* at *36-37 (finding CFPB failed to show defendants "intended to defraud consumers or that consumers did not receive the benefit of their bargain…" and thus that CFPB failed to meet its burden to show restitution was appropriate.); *see also CFPB v. Nationwide Biweekly Admin., Inc.*, Case No. 15-cv-02106-RS, 2017 U.S. Dist. LEXIS 145923, at *31 (N.D. Cal. Sept. 8, 2017) (finding that CFPB did not meet its burden to show restitution was warranted, including an analysis of the lack of evidence of fraudulent intent). The existing record does not show that Mr. Carnes or Integrity Advance intended to defraud customers or that customers did not receive the benefit of their loans.

Even if the CFPB could show that Respondents acted with fraudulent intent, which it has not and cannot, restitution should then be calculated based on the "unjust gains" to the Respondents, which may be calculated as "net revenue." *See Cashcall*, 2018 U.S. Dist. LEXIS 9057 at *43. In *Cashcall*, the court rejected the CFPB's proposed restitution amount because, among other things, it was not "netted to account for expenses." *Id.* at *44. The court also noted that defendants must have the opportunity to show that the "net revenue" overstates any "unjust gains." *Id.* at *43.

Consistent with these developments, respondents intend to supplement the record with expert analysis of the purported damages and restitution figures. Enforcement counsel may also seek the opportunity to supplement the record with expert testimony.

IV. Conclusion

Consistent with the CFPB Director's order, Respondents have been granted a new hearing to be conducted in accordance with the CFPB Rules. The CFPB Rules include the opportunity to obtain discovery and present evidence at a live evidentiary hearing. Such procedures are necessary as the ALJ will be required to make witness credibility determinations in her rulings on liability and any penalties/restitution and intervening case law has established the need to further develop the factual record on these significant defenses and issues.

For the foregoing reasons, the ALJ should grant Respondents' Motion and permit the factual record to be opened and the new hearing to proceed.

Respectfully submitted,

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