

# City of Debtors: Law, Loan Sharks, and the Shadow Economy of Urban Poverty, 1900–1970

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Peter Laudani, a truck driver in Brooklyn, had been struggling for over a year to pay his bills when he saw a commercial for small loans in 2010. The television ad promoted what the lender, Western Sky, called “The Problem Solver Loan.” Laudani had no shortage of problems. In 2009, in the midst of the Great Recession, he had been laid off from his job. Things went downhill from there. Although Laudani was not unemployed for long, the pay at his next job was not as good—\$4 to \$5 less per hour—and the bills soon began to pile up. Western Sky offered a solution: a \$1,000 loan repayable over two years, with monthly payments of \$166.95 to be deducted directly from the borrower’s bank account. Laudani’s total payments over the course of the loan would amount to \$4,156.79, plus any late charges he incurred. He paid a little over \$2,500 on the debt before defaulting.<sup>1</sup>

Some might call this loan sharking. Expressed as an annual percentage rate, or APR, the cost of Laudani’s loan was over 190 percent per year—well above the legal limit in New York State. The State Attorney General subsequently filed suit, alleging that Western Sky had violated New York’s licensed lender law and civil and criminal usury laws. New York regulators also put pressure on the banks that processed Western Sky’s payment requests, seeking for them to cut ties with the lender. The office of the Attorney General had a problem, however. Western Sky was not located in New York. The company lent money over the Internet, from an office located on the Cheyenne

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1. Affirmation of Jordan S. Adler, Exhibit A-8, *People by Schneiderman v. Western Sky Financial, LLC et al.*, Index No. 451370/2013 (N.Y. County Supreme Court, Aug. 12, 2013) (Affidavit of P.L.). The borrower’s name has been changed to protect his privacy.

River Sioux Reservation in South Dakota where, it claimed, the law of the Sioux Tribe governed. The lender argued that New York had no power to stop tribal lenders from doing business with borrowers like Laudani, while New York insisted that it must be allowed to shield its own residents through the enforcement of its consumer protection laws.<sup>2</sup> In short, the lawsuit raised hard questions about the scope of the state's authority to regulate small-sum lending.

Such questions have arisen repeatedly over the past century in different forums and have continued to challenge policymakers. Although the case against Western Sky eventually settled and the company shuttered its operations, the conflict between Western Sky and New York State illustrates some of the enduring challenges that states have confronted in policing the market for small loans.<sup>3</sup> For decades, small-dollar loans have puzzled policymakers and ordinary Americans because they raise tricky questions about the role of the state in the marketplace. These loans are troubling because they implicate a fundamental policy question: What is the meaning of justice within capitalism? For more than a century, Americans have asked: Is there a way to grant low-income workers small amounts of credit at lower cost? Can law make small loans safer and, if so, where should we draw the line between necessary protection and overreaching paternalism?

Although these same questions have come up again and again, the answers have changed over time, as the business of lending small sums to working-class borrowers has grown and developed from a handful of smaller, marginal enterprises into a big, modern business. The problem of how to regulate small loans first arose in the late nineteenth century with the invention of the "salary loan" business, which offered quick cash to working-class borrowers who pledged their future wages as collateral. More than a hundred years later, the same problem remains in a different guise, as the Consumer Financial Protection Bureau works on new regulations to govern modern forms of small-dollar credit such as payday loans. My dissertation, *City of Debtors*, explores the decades in between, chronicling the development of the small-sum lending business, from the Progressive Era through the War on Poverty in the 1960s. It also examines how

2. Respondents' Memorandum of Law in Support of their Motion to Dismiss, *People by Schneiderman v. Western Sky Financial, LLC et al.*, Index No. 451370/2013 (N.Y. County Supreme Court, Sept. 17, 2013); Respondents' Memorandum of Law in Opposition to Respondents' Motion to Dismiss and in Further Support of the Verified Petition, *People by Schneiderman v. Western Sky Financial, LLC et al.*, Index No. 451370/2013 (N.Y. County Supreme Court, Oct. 25, 2013).

3. Andrew R. Johnson, "Payday Lender Agrees to Fine, Refunds," *Wall Street Journal*, January 23, 2014.

Americans have attempted to make these forms of credit safer by shaping and reshaping the legal terrain on which American households and lenders bargain with one another.

As *City of Debtors* describes, the business of small-sum lending to wage workers first drew widespread attention at the turn of the twentieth century, when urban, working-class households sought out quick cash or credit to purchase goods.<sup>4</sup> Although pawnshops, or “hock shops,” had existed for centuries, other forms of small-sum lending grew rapidly after the Civil War.<sup>5</sup> By 1900, “chattel loans,” cash advances secured by a lien on the borrower’s personal property, and “salary loans,” secured by an assignment of the borrower’s future wages, had become a common source of credit for urban working-class laborers. Buying goods “on time” or “on installment” was also increasingly part of everyday life. Merchants sold clothing, furniture, and sewing machines on credit to working-class buyers, who agreed to pay back the sales price plus credit charges or risk repossession of their purchases if they failed to pay the debt.

At that time, the business was essentially outlawed in most places because the legal rates of interest were too low for small-sum lenders to operate profitably. However, lenders found ways around state usury laws and also often required borrowers to sign “wage assignments” to allow the lenders to collect any unpaid balance directly from the worker’s salary without first going before a judge. In response, New York and other states adopted laws to limit the use of wage assignments, which lenders then challenged in court. New York ultimately prevailed after extended litigation in the 1910s, after courts found that the state had the power to regulate small-sum loans to prevent the borrowers from becoming “public charges,” dependent on the state for support.<sup>6</sup> The business did not fade away, however. It continued operating in the shadows and retaining its unsavory reputation, but it had limited access to new capital to grow.

It was against this backdrop that the newly formed Russell Sage Foundation began a decades-long campaign to devise and enact new legal rules to govern small loans. On the eve of World War I, businessmen including Clarence Hodson and Frank R. Hubachek founded a lenders’

4. On small-sum lending between the Progressive Era and Great Depression, see Lendol Glen Calder, *Financing the American Dream: A Cultural History of Consumer Credit* (Princeton, NJ: Princeton University Press, 1999); Mark H. Haller and John V. Alviti, “Loansharking in American Cities: Historical Analysis of a Marginal Enterprise,” *American Journal of Legal History* 21 (1977): 125–156.

5. On the history of pawnshops, see Wendy A. Woloson, *In Hock: Pawning in America from Independence through the Great Depression* (Chicago: University of Chicago Press, 2010).

6. See Anne Fleming, “The Borrower’s Tale: A History of Poor Debtors in Lochner Era New York City,” *Law and History Review* 30, no. 4 (2012): 1053–1098.

trade association, The American Association of Small Loan Brokers, which joined the Russell Sage Foundation's quest to police small-sum lending and legitimize the industry through law. This campaign was founded on the belief that workers sometimes needed small loans, but that outdated laws had driven lending underground and prevented "honest capital" from entering the business. Together these men devised a model lending law, the Uniform Small Loan Law, to be enacted on a state-by-state basis.

This stable legal foundation helped the business to grow and thrive over the 1920s—that is, until new threats emerged in the 1930s and 1940s. These threats came from litigious borrowers and their attorneys, from new competitors such as commercial banks, and from populist politicians. So, in the midst of the Depression, policymakers once again puzzled over whether to suppress or encourage the business, and lenders likewise questioned what form of regulation would best protect their interests. Policymakers also began to worry about another problem in the 1930s: poor families who bought household goods on credit, also known as buying "on time."

By the 1930s, the volume of goods sold on credit had grown considerably since the beginning of the century, and social service organizations started sounding an alarm about problems that poor households experienced in buying goods "on the installment plan." Part of the difficulty was that sales finance was hardly regulated at all, largely because of a judge-made legal principal known as the "time-price doctrine." Under this doctrine, state usury laws did not apply to credit sales; neither did the Uniform Small Loan Law, which governed only small-sum cash lending. So, state policymakers had to start from scratch, figuring out how to regulate small extensions of sales credit and the debt collection process for borrowers who failed to pay.

*City of Debtors* traces the early state-level attempts to regulate credit sales, beginning in the 1930s when states like New York began putting limits on the debt collection process. Just as state officials had done for cash loans in the early 1900s, they began by limiting creditors' use of wage assignments to collect unpaid sales debts. Reformers attacked what they called the "wage shark racket," which threatened to turn poor borrowers into public charges. State-level legislative efforts continued to develop over the 1940s and 1950s, even after the Russell Sage Foundation closed down its consumer credit program in 1946. The struggle to place the business under regulation culminated in the 1950s with the state-level adoption, in New York and elsewhere, of retail installment sales acts that limited how much merchants could charge for credit and mandated that buyers receive certain disclosures.

The push for greater protections for working-class installment buyers then moved to the courts in the 1960s, where judges used their equitable and constitutional authority to broaden the scope of state oversight in cases involving small loans. An educational cartoon from a legal aid provider on Long Island, New York, depicts a typical case: a low-income mother buys a freezer and a “food plan” on credit from a door-to-door salesman, only to find out later that the fast-talking salesman signed her up for a bad deal.<sup>7</sup> The food is terrible and very expensive. Luckily, she is able to retain a legal aid lawyer to challenge the credit sales contract in court. The judge in the fictional case, as in the many cases brought by real-life poor borrowers, must then decide what constraints—if any—the law imposes on the relationship between borrower and lender. In the 1960s, courts again needed to define the bounds of state authority over small-sum lending, just as they did in the 1910s when lenders challenged state restrictions on wage assignments. In the fictional case depicted in the cartoon, the judge finds in favor of the borrower, refusing to enforce the sales agreement. Real-life borrowers likewise sometimes prevailed in food-freezer lawsuits on the grounds that their sales contracts were “unconscionable” and, therefore, unenforceable. In other cases in the late 1960s and early 1970s, courts further expanded public oversight of small-sum lending by recognizing that poor borrowers had constitutional rights to some due process in debt collection cases. Thus, at the same time that America “rediscovered” poverty in the 1960s, courts also rediscovered the public interest in policing poor people’s private loans.

Throughout, *City of Debtors* presents this history from the vantage point of the people who helped to make the law governing small-sum loans and who lived with its consequences: politicians and judges, reformers and scofflaws, creditors and debtors. To show the interplay between household economy and political economy, this story integrates the “bottom-up” approach of social historians with the “top-down” perspective of traditional legal and political history. This approach reveals the state at work, puzzling over how to protect the least powerful without interfering too deeply in private bargains. It also shows how ordinary people made and experienced law in their daily lives as consumers and producers, borrowers and lenders, and litigants. To capture a more fine-grained picture of the economic and legal landscape, the dissertation focuses on the City and State of New York, which served as incubators for numerous lending reforms that later spread throughout the country and were home to a number of

7. Nassau County Department of Social Services, *Legal Services for Welfare Clients: Three-Year Report as of April 30, 1970* (Mineola, NY, 1970), 12.

key reform organizations. It also draws on a large array of sources, including records from courts and executive branch officials, social service agencies, philanthropic organizations, and trade associations, to reconstruct the stories of ordinary working-class families and small-sum lenders who left few records behind.

*City of Debtors* makes two major contributions to business history. First, it adds a new chapter to the growing literature on the history of twentieth-century American capitalism. Compared to recent work on the history of consumer lending, it breaks new ground by focusing on small-sum loans and state-level regulations while combining a long chronological span with a ground-level viewpoint.<sup>8</sup> More broadly, much of the scholarship about twentieth-century American capitalism has focused on national state-building and federal regulation. It emphasizes how federal policy privileged particular groups and forms of economic growth and shaped middle-class markets for housing, labor, education, and consumer goods.<sup>9</sup> As *City of Debtors* shows, the states retained primary control over many key aspects of commercial life over the course of the century, even as the federal regulatory state expanded.<sup>10</sup> Looking at the state and local levels, this study tells a new story of political economy in which the federal government is scarcely to be found. Instead, we find a nation governed by dozens of separate (and sometimes competing) sovereigns, operating with little oversight or interference from the central authorities. Federalism remained alive and well in modern America, including in governance of the marketplace.

Second, *City of Debtors* also contributes to our understanding of the relationship between business, poverty, and the welfare state. A small group of historically minded social scientists has recently begun to look for a quantitative link between welfare and credit, asking whether credit has served as a form of private income support that

8. See, for example, Louis Hyman, *Debtor Nation: The History of America in Red Ink* (Princeton, NJ: Princeton University Press, 2011); Calder, *Financing the American Dream*.

9. See, for example, Greta R. Krippner, *Capitalizing on Crisis: The Political Origins of the Rise of Finance* (Cambridge, MA: Harvard University Press, 2011); Meg Jacobs, *Pocketbook Politics: Economic Citizenship in Twentieth-Century America* (Princeton, NJ: Princeton University Press, 2005); Ira Katznelson, *When Affirmative Action Was White: An Untold History of Racial Inequality in Twentieth-Century America* (New York: W. W. Norton, 2005); Alice Kessler-Harris, *In Pursuit of Equity: Women, Men, and the Quest for Economic Citizenship in 20th-Century America* (Oxford: Oxford University Press, 2001).

10. On the significance of state and local law in the governance of real estate and land use in the twentieth century, see, for example, N.D.B. Connolly, *A World More Concrete: Real Estate and the Remaking of Jim Crow South Florida* (Chicago: University of Chicago Press, 2014); Lizabeth Cohen, *A Consumer's Republic: The Politics of Mass Consumption in Postwar America* (New York: Knopf, 2003).

compensates for a less-generous public welfare state.<sup>11</sup> *City of Debtors* explores a different but related question: How has the need to provide relief to the poor influenced the ways that states regulate the business of small-dollar loans? It argues that we cannot understand the regulation of small-sum lending without incorporating poverty and the welfare state into the analysis. Concerns about poverty and poor relief offered powerful justifications for improving state regulation of the small-sum lending business and also raised the stakes of law reform.

This story has particular significance today. Since the Great Recession, “subprime” has become part of our everyday vocabulary. It is used not only to categorize high-cost home mortgage loans, but also credit cards and auto loans for less-creditworthy borrowers.<sup>12</sup> Moreover, thanks to heightened media coverage and recent publicity by the Consumer Financial Protection Bureau, debates over regulation of modern forms of high-cost, small-dollar credit, such as payday loans, also regularly draw headlines.<sup>13</sup> *City of Debtors* contributes to these discussions by showing that the business of small-sum lending has a long history and that these loans have always provoked controversy among policymakers and everyday Americans. Furthermore, law has always bound the small-loan market, although the rules of the game have changed from decade to decade through the work of judges and legislators, borrowers and lenders, and litigators and law reformers. Although history cannot predict what lies ahead, understanding small-sum lending’s past is the first step in charting a new course forward.

11. See, for example, Jan L. Logemann, “From Cradle to Bankruptcy: Credit Access and the American Welfare State,” in *The Development of Consumer Credit in Global Perspective: Business, Regulation, and Culture*, edited by Jan L. Logemann, 201–219 (New York: Palgrave Macmillan, 2012); Krippner, *Capitalizing on Crisis*; Monica Prasad, *The Land of Too Much: American Abundance and the Paradox of Poverty* (Cambridge, MA: Harvard University Press, 2012); Gunnar Trumbull, *Consumer Lending in France and America* (Cambridge: Cambridge University Press, 2014), 10–12.

12. See, for example, Ann Carrns, “Subprime Borrowers Often Lured by High-Fee Credit Cards,” *New York Times*, February 5, 2015; Michael Corkery and Jessica Silver-Greenberg, “Many Buyers for Subprime Auto Loan Bundle,” *New York Times*, March 15, 2015.

13. See, for example, Editorial, “Progress on Payday Lending,” *New York Times*, March 28, 2015.