Summer 2018: Federal and state developments in bank partnerships

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For many years partnerships have allowed banks to offer loans to consumers and businesses by leveraging the resources of nonbank entities. In the internet age, many financial technology, or fintech, companies have become partners, offering technology solutions for banks seeking to extend credit and other products to customers. As the pace of innovation increases, federal and state regulators, legislatures and courts have responded where they see the need to regulate what is essentially a business relationship between a bank and a service provider. In this commentary, we discuss the following developments, with an eye toward what's to come:

UNCONSCIONABLE LOANS IN CALIFORNIA

De La Torre v. CashCall[1] is a ruling that will impact bank partnerships. In *CashCall,* the California Supreme Court held that the interest rate on a consumer loan of $2,500 or more may render the loan unconscionable under the California Financing Law — even though the statute does not set an interest cap for those loans. The court issued the opinion in response to a certified question from the 9th U.S. Circuit Court of Appeals, because the issue — whether a loan originated under a statute that allows the parties to contract for any rate of interest could be unconscionable based on the interest rate — had not yet been addressed.

The case opens the door for consumer claims that loans are unconscionable based on the interest rates, but the door is heavy. The court reiterated that an unconscionability claim requires fact-intensive inquiry based on the circumstances of the individual loan transaction and that a loan must be both procedurally and substantively unconscionable to meet the standard.

The court also acknowledged that unsecured loans made to high-risk borrowers often justify high rates. Moreover, the remedies available are limited to restitution and injunctive relief and do not include attorney fees or damages. The court observed that the "relative paucity of remedies . . . should serve to limit pure attorney-driven lawsuits (since no attorney fees may be recovered) as well as blackmail settlements (since no money recovery beyond restitution is possible)."

Even though it did not specifically address bank partnerships, the *CashCall* case echoes in the bank partnership space because of how the decision will affect rate exportation. In short, rate exportation is the authority under which a national or state-chartered bank located in one state may charge the interest rate permitted by its home state to a resident of another state, even though the bank's home state rate exceeds the rate permitted in the consumer's state.

The *CashCall* case interacts with rate exportation because interest rates imposed by a bank exporting California's interest rate authority do appear to be limited by unconscionability concerns. The *CashCall* decision relies on the unconscionability standard codified in California's Civil Code, which is incorporated into the CFL. Although the CFL does not apply to banks, the California Civil Code does.

In July, the OCC announced that it will consider applications for national bank charters from fintech companies that conduct the "business of banking."

And under the OCC's regulations, banks' exportation authority is limited by state law relating to "that class of loans that are material to the determination of the permitted interest."[2] Accordingly, even when banks export interest from outside of the CFL, they still will be limited by the Civil Code's unconscionability standard.

The *CashCall* case is exciting because it decided a new question of California law. Although the decision's implications for rate exportation are important, the case is unlikely to drastically alter banks' lending operations, whether they are lending to California consumers or under California law.

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THE OCC AND FINTECH CHARTERS

In July, the OCC announced that it will consider applications for national bank charters from fintech companies that conduct the "business of banking."[3] The business of banking includes the core banking functions

of receiving deposits, paying checks and lending money. Fintech companies must perform at least one of these functions to be eligible for a national bank charter as a special purpose national bank.

With its announcement, the OCC released a policy statement and a supplement to its comptroller's licensing manual, which sets out the considerations that apply to fintech companies. The supplement notes that newly chartered SPNBs will face more frequent and intensive supervision from the OCC in their early years of operation.

Additionally, because the OCC expects applications from fintech companies that do not receive deposits, the agency will impose certain conditions on approved applicants. The conditions will be specific to SPNBs because such entities are uninsured by the FDIC, which insures depository institutions. The conditions will provide extra protections for consumers, who will not be able to seek recourse against FDIC insurance in the event of loss. The agency will require that a fintech company has a contingency plan with options to sell itself, wind down or merge with a nonbank affiliate. SPNBs must also maintain a minimum capital level account for sufficient liquidity in stressed conditions.

It remains to be seen which fintech companies will shoulder the burden of being among the first OCC charter applicants. It is likely that when a charter is issued, the Conference of State Bank Supervisors and the New York Department of Financial Institutions, both of which have already sued the OCC over its authority to issue fintech charters, will reinstitute their lawsuits since the cases were previously dismissed.

FEDERAL AND NEW YORK REPORTS ON FINTECH AND BANK PARTNERSHIPS

The Treasury Department and the NYDFS released reports this summer on fintech and online lending, respectively. Both reports squarely address bank partnerships in the context of fintech and online lending but contain opposing recommendations.

The NYDFS report, which was released in July, recommended: (1) equal application of consumer protection laws to online lenders; (2) application of the state's usury limits to all lending in New York; and (3) licensing and supervision for all online lenders.[4]

The NYDFS sees bank partnerships as a regulatory concern. It disagrees with the position that the bank is the true lender and that the nonbank entity is thus not subject to New York's licensing requirements. Instead, it believes that in many cases the online lender is the true lender. Although this appears to be a criticism of specific bank partnerships and not the bank partnership model in general, the department's report nonetheless generally casts the partnerships as problematic.

> The holding in *Madden* suggests that a nonbank entity that purchases loans originated by a bank cannot continue to impose the rates for which the bank contracted with the consumer unless it holds its own independent rate authority.

The NYDFS is particularly concerned with the interest rates on financial products offered to New York consumers — and the authority of nonbank entities to charge those rates. On that issue, the department cited with approval the *Madden v. Midland* decision,[5] in which the 2nd U.S. Circuit Court of Appeals held that non-national bank entities that purchase loans originated by national banks cannot rely on the National Bank Act to protect them from state-law usury claims.

The decision effectively disposes of the valid-when-made theory, which loan assignees have relied on for years. The holding in *Madden* suggests that a nonbank entity that purchases loans originated by a bank cannot continue to impose the rates for which the bank contracted with the consumer unless it holds its own independent rate authority. For example, in some states the nonbank holder must hold a license to impose the rate for which the bank contracted.

In contrast, the valid-when-made theory had established that when an interest rate was valid when the loan was made, the rate could not be later deemed usurious based only on the subsequent holder's lack of independent rate authority.

The NYDFS report also expresses its opposition to the Modernizing Credit Opportunities Act (H.R. 44391), which is a pending federal bill that seeks to overrule *Madden*. The department stated that if enacted, the bill "could result in 'rent-a-bank charter' arrangements between banks and online lenders that are designed to circumvent state licensing and usury laws."

After the NYDFS issued its report, the Treasury Department released its extensive report on the regulatory framework for nonbank financial institutions, financial technology and financial innovation. The report detailed more than 80 recommendations, including three addressing bank partnerships.[6] It noted generally that bank partnership arrangements have "enhanced the provision of credit to consumers and small businesses."

To address constraints that "unnecessarily limit the prudent operation of partnerships between banks and marketplace lenders," the Treasury recommends that Congress:

- Codify the "valid-when-made" doctrine (that the NYDFS rejects) to preserve the ability of banks and marketplace lenders to buy and sell validly made loans without the risk of conflicting with state interest rate limitations.
- Codify that the existence of a service or economic relationship between a bank and a third party (including a fintech company) does not affect the role of the bank as the true lender of the loans it makes.

The Treasury also says bank regulators should reaffirm (through additional clarification of applicable compliance and risk-management requirements, for example) that the bank remains the true lender under such a partnership agreement. It further recommends that states revise credit services laws, which apply to traditional loan broker businesses, to exclude companies that solicit, market or originate loans on behalf of a federal depository institution under a partnership agreement.

FEDERAL LEGISLATION STALLS

Notwithstanding the Treasury's recommendation to codify the long-established bank partnership model, two bills that would do just that have not advanced since early this year. The House of Representatives passed the Protecting Consumers' Access to Credit Act of 2017,[7] also known as the *Madden* bill, in February 2018.

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That bill would codify the valid-when-made doctrine and overrule the *Madden* decision.

Similarly, there has been no movement on the Modernizing Credit Opportunities Act,[8] also called the True Lender bill, which was referred to the House Financial Services Committee in November 2017. The True Lender bill provides that an economic relationship between an insured depository institution and a nonbank third party that performs lending-related functions does not affect the determination of the institution's location or its role as a lender.

Regulators, legislatures and courts are not in agreement — but that's no surprise. They are all responding in the bank partnership and fintech space, and the important thing now is to keep up with them. WJ

NOTES

[1] 422 P.3d 1004, 18 Cal. Daily Op. Serv. 7990 (2018).

[2] 12 C.F.R. § 7.4001(b).

[3] "OCC Begins Accepting National Bank Charter Applications From Financial Technology Companies," OCC NR 18-74 (O.C.C.), 2018 WL 3629320 (July 31, 2018); 12 C.F.R. § 5.2.

[4] New York Department of Financial Services, Online Lending Report (July 11, 2018), *available at* https://www.dfs.ny.gov/about/press/pr1807111.htm.

[5] 786 F.3d 246 (2d Cir. 2015).

[6] "Treasury Releases Report on Nonbank Financials, Fintech, and Innovation," Treas. SM-447 (Dept. Treas.), 2018 WL 3629322 (July 31, 2018). Full Report, *available at* https://home.treasury.gov/news/press-releases/sm447.

[7] H.R. 3299, 115th Congress, 2nd Session, 2017 CONG US HR 3299.

[8] H.R. 4439, 115th Congress, 1st Session, 2017 CONG US HR 4439.

CRIMINAL LAW

Judge sends loan modification scammer to prison for 57 months

A federal judge has ordered a New York man to serve 57 months in prison for operating a loan modification scam that defrauded at least 26 struggling mortgage borrowers out of more than $400,000 in total.

United States v. Halpern, No. 17-cr-306, defendant sentenced (D.N.J. Aug. 27, 2018).

Jeffrey Halpern, 63, owner of JCK Marketing, must also pay $411,000 in restitution to his victims and serve three years of supervised release after completing the prison term, U.S. Attorney Craig Carpenito of the District of New Jersey said in a statement.

U.S. District Judge Peter G. Sheridan imposed the sentence on Halpern, who admitted that he accepted payments from mortgage borrowers in the state but provided no loan modification services to them.

Halpern, of Hewlett, New York, pleaded guilty in August 2017 to one count of wire fraud, prosecutors said.

FALSE PROMISES

Halpern ran the fraud scheme between 2009 and 2016, targeting homeowners in New Jersey and other states, prosecutors said.

Halpern told his victims that he and his East Rockaway, New York-based company could obtain mortgage modifications on residential properties in exchange for upfront fees, according to a criminal information filed in tandem with the plea agreement.

At least 26 people paid fees ranging between $1,500 and $85,000 for the purported services, prosecutors said.

Halpern used text messages to communicate with one New Jersey homeowner, including one message that demanded a $2,500 payment to Halpern's bank account. This individual paid Halpern $65,720 during the life of the scam, the charges said.

The defendant ran the fraud scheme between 2009 and 2016, targeting homeowners in New Jersey and other states, prosecutors said.

Halpern also falsely represented that the mortgage borrowers had to pay "bank fees" for the loan modifications, according to the charges.

Prosecutors say he demanded these payments repeatedly, even though the homeowners' financial institutions would not have imposed these costs for legitimate modifications. WJ

Related Filings:
Criminal information: 2017 WL 3587972

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