True Lender Developments: Litigation and State Regulatory Actions

*By Catherine M. Brennan and Latif Zaman**

Introduction

Bank partnership lending programs have existed for years and have played a significant role in the growth of the online lending industry and the fintech sector. In a bank partnership lending program, a non-bank partner markets loans and processes applications on behalf of a bank. The bank will then originate the loans pursuant to its rate exportation authority. Typically, the bank holds the loan for a limited time and then sells the loan, or the majority of the receivables from it, to the partner while retaining a participation interest. Opponents of bank partnerships argue that the non-bank entity should be considered the "true lender" in these transactions. A true lender claim is based on allegations that the bank is not actively engaged in the lending program and does not receive the benefits or take the risks of a true lender. If a true lender challenge is successful, the partner could face significant penalties for usury and unlicensed lending.

This survey reviews key developments in true lender challenges in the past year.

Private Litigation

Actions filed in October 2017 in Massachusetts and in March 2018 in California involved true lender challenges to a bank partnership program used to originate commercial-purpose loans. In *NRO Boston, LLC & Indelicato v. Kabbage, Inc.*[1] and *Barnabas Clothing v. Kabbage, Inc.*,[2] commercial borrowers sued Kabbage, a non-bank financial company, and its bank partner, Celtic Bank, a Utah state-chartered industrial bank insured by the Federal Deposit Insurance Corporation ("FDIC"), for violations of state usury and consumer protection laws, in addition to causes of action under the federal Racketeer Influenced and Corrupt Organizations Act[3] ("RICO").[4] Kabbage and Celtic Bank partnered

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1. *See* Complaint, NRO Boston, LLC & Indelicato v. Kabbage, Inc., No. 17-11976, 2017 WL 4569540 (D. Mass. Oct. 12, 2017) [hereinafter NRO Complaint].

2. *See* Complaint, Barnabas Clothing v. Kabbage, Inc., No. BC699166, 2018 WL 1608431 (Cal. Super. Ct. Mar. 22, 2018) [hereinafter Barnabas Complaint].

3. 18 U.S.C. § 1962 (2018).

4. NRO Complaint, *supra* note 1, at 25–28; Barnabas Complaint, *supra* note 2, at 12–15.

to offer lines of credit to small businesses.[5] Loan documents identified Celtic Bank as the lender.[6] Celtic Bank relied on its authority under section 27 of the Federal Deposit Insurance Act ("FDIA")[7] to charge the same interest rate in all states.[8] However, the complaints alleged that Kabbage, rather than Celtic Bank, remained the true lender in these transactions because it assumed the risk of loss from the loans and handled all communications with borrowers.[9] The complaints alleged that Kabbage underwrote, originated, and funded the loans, while paying Celtic Bank a fee to use its name and charter.[10] The complaints alleged that Kabbage took assignments of the loans and receivables from Celtic Bank after issuance by Celtic Bank.[11]

Both plaintiffs asserted that Kabbage violated state usury limitations and also engaged in unfair and deceptive practices and false advertising by claiming that Celtic Bank originated the loans and that the loans imposed permissible interest rates.[12] Both plaintiffs also asserted federal RICO claims.[13] RICO creates liability for "any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt."[14] RICO also creates liability for conspiring to violate the statute.[15] The complaints alleged that the partnership between Kabbage and Celtic Bank constituted an enterprise[16] for the common purpose of, among other things, originating and funding usurious loans.[17] The complaints alleged that the partnership engaged in interstate commerce because Kabbage and Celtic Bank originated online loans to borrowers located in various states.[18] Further, both plaintiffs asserted that, through its business communications, the partnership engaged in mail and wire fraud, as well as racketeering activities under RICO.[19] Under RICO, "unlawful debt" includes debt incurred in connection with the business of lending money at a

5. NRO Complaint, *supra* note 1, at 11; Barnabas Complaint, *supra* note 2, at 7.
6. NRO Complaint, *supra* note 1, at 2, 14; Barnabas Complaint, *supra* note 2, at 2–3.
7. 12 U.S.C. § 1831d (2018).
8. NRO Complaint, *supra* note 1, at 8; Barnabas Complaint, *supra* note 2, at 3.
9. NRO Complaint, *supra* note 1, at 14; Barnabas Complaint, *supra* note 2, at 2–4.
10. NRO Complaint, *supra* note 1, at 2; Barnabas Complaint, *supra* note 2, at 2.
11. NRO Complaint, *supra* note 1, at 2; Barnabas Complaint, *supra* note 2, at 2–3.
12. NRO Complaint, *supra* note 1, at 18–22, 29; Barnabas Complaint, *supra* note 2, at 15–19; *see* MASS. GEN. LAWS ch. 271, § 49 (2017); CAL. CONST. art. XV, § 1.
13. Barnabas Complaint, *supra* note 2, at 12–15; NRO Complaint, *supra* note 1, at 25–28.
14. 18 U.S.C. § 1962(c) (2018).
15. *Id.* § 1962(d).
16. "Enterprise" is broadly defined to include "any individual, partnership, corporation, association, or other legal entity, and any union or group of individuals associated in fact although not a legal entity." *Id.* § 1961(4).
17. Barnabas Complaint, *supra* note 2, at 13; NRO Complaint, *supra* note 1, at 25.
18. Barnabas Complaint, *supra* note 2, at 13; NRO Complaint, *supra* note 1, at 25.
19. Barnabas Complaint, *supra* note 2, at 14; NRO Complaint, *supra* note 1, at 26 ("Defendants' use of wires to defraud [the borrowers] and other small businesses is essential to the success of the Kabbage Enterprise, and includes, but is not limited to, exchanging documents necessary for the loans by and between Kabbage, the borrowers and Celtic Bank; the disbursement of funds and the payment of monies by and between Kabbage and the borrowers; and the payment of Celtic Bank's fee for each transaction.").

rate that would be usurious under federal or state law, where the usurious rate is at least twice the enforceable rate.[20] The complaints alleged that the defendants knew that the loans imposed interest rates that were at least twice the legally enforceable rates and, therefore, knew that the debt was unlawful.[21] The plaintiffs asked the court to declare the loans void and also sought direct and consequential damages, punitive and treble damages, attorney's fees and costs, and refund of amounts paid.[22]

In February 2018, the *NRO* court entered an order staying the proceedings pending the outcome of arbitration.[23] As for *Barnabas*, the case was removed to federal court in April 2018[24] and, in June, the court entered an order similarly staying the case pending the outcome of arbitration.[25] Although it is unlikely that either case will proceed to trial, both are important in that they involve true lender challenges to commercial-purpose transactions and raise RICO claims. Civil remedies for violations under RICO can include treble damages and attorney's fees and costs,[26] while criminal penalties could include up to twenty years imprisonment.[27]

State Enforcement Actions and Related Litigation

State regulators have also pursued true lender challenges against bank partnerships, even if not expressly articulated as such. In West Virginia, the state's highest court has stated that the state's credit services organization statute[28] applies to loan brokers regardless of whether the broker is compensated directly by the consumer or indirectly by the lender.[29] Additionally, the state attorney general has pursued enforcement actions against non-bank partners that promote loans originated by banks when such firms have not registered as credit services organizations.[30] In November 2017, the attorney general entered into a consent agreement with LendingClub, which was allegedly operating without registering as a credit services organization, whereby the firm agreed to comply with relevant state consumer protection laws.[31]

20. 18 U.S.C. § 1961(6) (2018).

21. Barnabas Complaint, *supra* note 2, at 14; NRO Complaint, *supra* note 1, at 26.

22. NRO Complaint, *supra* note 1, at 22–30; Barnabas Complaint, *supra* note 2, at 19.

23. Stipulation and Order to Stay all Proceeding Pending Arbitration, NRO Boston, LLC & Indelicato v. Kabbage, Inc., No. 1:17-cv-11976-GAO (D. Mass. Feb. 23, 2018), ECF #32.

24. Notice of Removal, Barnabas Clothing, Inc. v. Kabbage, Inc., No. 2:18-cv-03414-PSG (C.D. Cal. Apr. 24, 2018).

25. Order Granting Defendants' Motion to Stay Proceedings in Favor of Arbitration, Barnabas Clothing, Inc. v. Kabbage, Inc., No. 2:18-cv-03414-PSG (C.D. Cal. June 8, 2018).

26. 18 U.S.C. § 1964(c) (2018).

27. *Id.* § 1963(a).

28. W. Va. Code §§ 46A-1-101–8-102 (2017); *id.* § 46A-6C-5.

29. Arnold v. United Cos. Lending Corp., 511 S.E.2d 854, 862 (W. Va. 1998), *overruled on other grounds by* Dan Ryan Builders, Inc. v. Nelson, 737 S.E.2d 550 (W. Va. 2012); *see also* Harper v. Jackson Hewitt, Inc., 706 S.E.2d 63, 71 (W. Va. 2010).

30. Assurance of Discontinuance, *In re* LendingClub Corp. (W. Va. Att'y Gen. Nov. 13, 2017); Assurance of Discontinuance, *In re* Avant, Inc. (W. Va. Att'y Gen. May 26, 2016).

31. *See supra* note 30.

As discussed in last year's *Annual Survey*,[32] the Colorado Uniform Consumer Credit Code Administrator filed lawsuits in January 2017 to shut down bank partnership programs between Marlette Funding, LLC and New Jersey-based Cross River Bank[33] and between Avant of Colorado, LLC and Utah-based WebBank,[34] both of which offered loans in Colorado through online lending platforms. The Administrator contended that the non-bank partners were the true lenders of the loans because they retained the "predominant economic interest" in the transactions based on the following factors: the non-bank partners paid the bank's costs associated with the initiation of the lending program, as well as the marketing costs; the non-bank partners decided which applicants would receive loans by applying their own lending criteria; and the banks bore little or no risk of financial loss in the event of default.[35]

Marlette and Avant argued that the cases involved a federal issue because the banks' rate authority under the FDIA completely preempted state law claims against the banks' assignees; accordingly, the defendants removed the cases to federal court.[36] However, in March 2018, the federal judge in *Avant* remanded the case to state court, holding that state law claims against non-banks were not subject to complete preemption, even if the state law claims would have been subject to complete preemption if they had been brought against a national or state-chartered bank.[37] The federal judge in *Marlette* came to the same conclusion and also remanded that case to state court.[38] Both judges further affirmed that complete preemption would not be warranted even if the non-bank defendants had a close relationship with a bank.[39] Marlette and Avant argued that federal law also preempted the state law claims because they related to state usury limitations on loans made by banks that had rate authority under the FDIA.[40] However, both judges held that Avant and Marlette were the true lenders or parties of interest in the transactions and therefore preemption did not apply.[41] As explained in the *Avant* ruling: "the non-bank, Avant, is the assignee of the loans; Avant has only a contractual relationship with WebBank, which plays only an ephemeral role in making the loans, then immediately sells them; and it is Avant which generally directs the fees and activities that

32. *See* Catherine M. Brennan, Kavitha J. Subramanian & Nora R. Udell, *True Lender Developments: Litigation and State Regulatory Actions*, 73 BUS. LAW. 535, 539 (2018).

33. Amended Complaint at 4, Meade v. Marlette Funding, LLC, No. 1:17-cv-00575-MJW (D. Colo. Mar. 3, 2017) [hereinafter Marlette Complaint].

34. Amended Complaint at 5, Meade v. Avant of Colo., LLC, No. 1:17-cv-00620-WJM-STV (D. Colo. Mar. 9, 2017) [hereinafter Avant Complaint].

35. Marlette Complaint, *supra* note 33, at 5–6; Avant Complaint, *supra* note 34, at 5–7.

36. Notice of Removal, Meade v. Avant of Colo., LLC, No. 17-cv-30377 (Colo. Dist. Ct. Mar. 9, 2017); Notice of Removal, Meade v. Marlette Funding, LLC, No. 17-cv-30376 (Colo. Dist. Ct. Mar. 3, 2017).

37. Meade v. Avant of Colo., LLC, 307 F. Supp. 3d 1134, 1146 (D. Colo. 2018).

38. Meade v. Marlette Funding, LLC, No. 17-cv-00575-PAB-MJW, 2018 WL 1417706, at *3 (D. Colo. Mar. 21, 2018).

39. *Marlette*, 2018 WL 1417706, at *3; *Avant*, 307 F. Supp. 3d at 1146.

40. *Marlette*, 2018 WL 1417706, at *3; *Avant*, 307 F. Supp. 3d at 1147.

41. *Marlette*, 2018 WL 1417706, at *3; *Avant*, 307 F. Supp. 3d at 1148.

allegedly violate state law."[42] In the *Marlette* ruling, the court stated that, where a plaintiff sufficiently alleges that a non-bank entity is the true lender, complete preemption does not apply, "even if the non-bank entity worked closely with the bank to administer loans."[43]

Both judges conceded that the preemption claims could still be raised in the state court proceedings.[44] Thus, the March 2018 proceedings only resulted in rulings on jurisdiction. Avant and Marlette have since filed motions to dismiss the state court actions based on federal preemption.[45] Importantly, the state court will not be bound by the district court's March 2018 true lender or preemption analysis. The state court proceedings are still pending as of this writing.

In response to the Colorado actions against Marlette and Avant, Cross River Bank and WebBank filed suit alleging that Colorado's enforcement actions against their non-bank partners unlawfully restricted the banks' lending businesses and caused irreparable financial loss.[46] However, in March 2018, these claims were dismissed based on the *Younger* abstention doctrine because the banks' claims could be adequately resolved in the state court proceedings against Marlette and Avant and the state had an important interest in enforcing its usury laws.[47]

In 2016, the Pennsylvania attorney general sued the internet lender Think Finance, which had partnered with Native American tribes and the First Bank of Delaware ("FBD") to offer allegedly usurious loans.[48] The attorney general also sued Victory Park Capital Advisors ("VCPA") and other investors in Think Finance for conspiring with the online lender to violate the Pennsylvania Corrupt Organizations Act ("COA"), a statute similar to RICO, based on their roles in the allegedly usurious "rent-a-bank"[49] and "rent-a tribe"[50] programs.[51]

The *Think Finance* court dismissed the COA claims related to the bank lending program,[52] noting that a successful COA claim requires either a showing that the

42. *Avant*, 307 F. Supp. 3d at 1148.

43. *Marlette*, 2018 WL 1417706, at *3.

44. *Id.* at *4; *Avant*, 307 F. Supp. 3d at 1152.

45. Motion to Dismiss, Meade v. Avant of Colo., LLC, No. 17-cv-30377 (Colo. Dist. Ct. Apr. 5, 2018); Motion to Dismiss, Meade v. Marlette Funding, LLC, No. 17-cv-30376 (Colo. Dist. Ct. Apr. 17, 2018).

46. Complaint at 3–4, Cross River Bank v. Meade, No. 1:7-cv-00832 (D. Colo. Apr. 3, 2017); Complaint at 2–5, WebBank v. Meade, No. 1:17-cv-00786-PAB (D. Colo. Mar. 28, 2017).

47. WebBank v. Meade, No. 17-cv-00786-PAB-MLC, 2018 WL 1399914, at *2–4 (D. Colo. Mar. 19, 2018) (citing Younger v. Harris, 401 U.S. 37, 41 (1971)); Cross River Bank v. Meade, No. 17-cv-00832-PAB-KMT, 2018 WL 1427204, at *2–3 (D. Colo. Mar. 22, 2018) (same).

48. Pennsylvania v. Think Fin., Inc., No. 14-cv-7139, 2016 WL 183289, at *1 (E.D. Pa. Jan. 14, 2016).

49. "Rent-a-bank" is a term with negative connotations that refers to a bank partnership arrangement where the bank ostensibly originates the loan but otherwise has little involvement in the transaction. Essentially, the non-bank partner "rents" the bank's rate authority for a nominal sum.

50. "Rent-a-tribe" is a negative term for an arrangement similar to a "rent-a-bank," but where a non-bank entity partners with a tribal sovereign, instead of a bank, to originate loans.

51. Second Amended Complaint, Pennsylvania v. Think Fin., Inc., No. 14-cv-7139 (E.D. Pa. Dec. 21, 2017).

52. Pennsylvania v. Think Fin., Inc., No. 14-cv-7139, 2018 WL 637656, at *9 (E.D. Pa. Jan. 31, 2018).

defendant participated in racketeering activities as a principal or participated in the operation or management of the criminal enterprise. The court found that the attorney general only alleged "that [the investor] joined the scheme by being a primary investor and created [a related entity] to purchase participation interests from the 'rented' bank. . . . But a defendant does not incur liability under the COA for merely funding an alleged unlawful enterprise."[53] Accordingly, the court held that the attorney general failed to plead sufficient allegations to support the COA claim against the investors in connection with the bank lending program.[54]

The *Think Fina*nce court did, however, find that the attorney general pleaded sufficient allegations to support a COA claim against the investors based on their involvement in the tribal lending program. Although VCPA initially invested in the bank lending program a few years after its inception, the court noted that VCPA's involvement with the proposed tribal lending program began even before Think Finance reached an agreement with a tribal partner.[55] The court noted that VCPA actively participated in the design of the tribal lending program, including the development of the financing and contract structures and continued to purchase interests in the tribal lending program after the similar bank lending program ended in the face of regulatory pressure.[56] Accordingly, the court allowed claims related to the tribal lending program to proceed.[57]

Regulators in other states have imposed substantive and licensing requirements on bank partners pursuant to broadly worded lending statutes. For instance, the Massachusetts Small Loan Act[58] applies to an expansive list of activities, including "directly or indirectly engaging, for a fee, commission, bonus or other consideration, in the business of negotiating, arranging, aiding or assisting the borrower or lender in procuring or making . . . [small loans] whether such loans are actually made by such person or by another party."[59] The Massachusetts Division of Banks has opined that a party marketing for or assisting a lender in arranging a loan subject to the Small Loan Act is required to obtain a license.[60]

In March 2018, the Massachusetts Division of Banks entered into a consent order with LendingClub and its subsidiary, Springstone Financial, LLC, for allegedly arranging loans subject to the Act without a license.[61] LendingClub agreed to pay a $2 million administrative fee and to reimburse consumers for interest

53. *Id.*
54. *Id.*
55. *Id.* at *1–2.
56. *Id.* at *6.
57. *Id.* at *9.
58. Mass. Gen. Laws ch. 140, §§ 96–114A (2017).
59. *Id.* § 96.
60. Mass. Div. of Banks Opinion Letter 00-013 (Jan. 2, 2000), https://www.mass.gov/opinion/summary-of-selected-opinion-00-013; Mass. Div. of Banks Opinion Letter 00-054 (June 6, 2000), https://www.mass.gov/opinion/summary-of-selected-opinion-00-054.
61. Consent Order, *In re* LendingClub Corp., No. 2018-0001 (Mass. Div. Banks Mar. 12, 2018), https://www.mass.gov/consent-order/lendingclub-corporation-and-springstone-financial-llc.

and any fees it collected in excess of those permitted under the Small Loans Act.[62]

The New Hampshire Banking Department has also reached similar settlements with companies allegedly partnering with banks to offer loans without obtaining the required license.[63]

62. *Id.*

63. *See* Consent Order, *In re* Klarna Inc., No. 17-052 (N.H. Banking Dep't Nov. 8, 2017), https://www.nh.gov/banking/orders/enforcement/documents/17-052-co-20171108.pdf; *see also* Consent Order, *In re* RockLoans Marketplace LLC, No. 17-071 (N.H. Banking Dep't Oct. 24, 2017), https://www.nh.gov/banking/orders/enforcement/documents/17-071-co-20171024.pdf.