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Choice-of-law clauses in online loans with consumers

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Courts and regulatory agencies have carefully scrutinized internet lending, beginning with the 10th U.S. Circuit Court of Appeals' 2008 decision in *Quik Payday Inc. v. Stork*. The court found that Quik Payday was required to obtain a license to offer payday loans to Kansas residents despite offering the transactions pursuant to the laws of Utah.[1]

In the wake of the *Quik Payday* decision, the Consumer Financial Protection Bureau and various state agencies have taken significant actions concerning internet lending, particularly with respect to loans that are relatively short in duration or have relatively high annual percentage rates, like payday loans. Frequently, those actions turn on whether the internet lender's choice of law was appropriate or whether the parties chose a certain state law that circumvents consumer financial protections.

Internet lenders in the small dollar space operate under one of the following models: single state choice of law, bank partnerships and tribal partnerships. Internet lenders as well as consumers should be aware of the risks that come with each of these models.

SINGLE STATE CHOICE-OF-LAW MODEL

As seen in the *Quik Payday* case, many internet lenders choose to operate under their home state laws and apply them to all loan contracts through a choice-of-law clause, regardless of whether the transaction involves in-state or out-of-state consumers. In this model, the lender generally does not partner with an entity such as a bank or a tribe.

Instead, the lender establishes a place of business in a certain state and offers loan contracts that provide for that state's law to govern the loan's terms, even though the consumers often reside in other states.

In several actions, private plaintiffs and regulatory agencies have challenged the enforceability of clauses selecting the lender's home state law as the law that governs the contract's terms.

In *Swanson v. Integrity Advance*, a case strikingly similar to the *Quik Payday* case, the Minnesota Supreme Court ruled that Minnesota's payday lending laws, rather than Delaware law, applied to payday loans made by a Delaware online lender.

The court based its decision on federal constitutional grounds. Even though the transactions were consummated in Delaware, the court found lender Integrity had injected itself into Minnesota's stream of commerce by initiating contact with Minnesota residents and delivering funds to bank accounts located there.[2]

The Integrity case is proof that lenders may be unsuccessful in arguing that online transactions do not reach into the consumer's home. Instead, courts will look at a variety of factors in determining whether to enforce a choice-of-law clause in a consumer loan contract, including whether the lender targeted out-of-state consumers with advertising and communications. Courts also often refuse to uphold choice-of-law clauses on the grounds that applying the foreign law would violate public policy.[3]

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As the cases above demonstrate, internet lenders may face compelling arguments that they injected themselves into other states' streams of commerce. They will have a difficult time overcoming those arguments.

BANK PARTNERSHIP MODEL

Bank partnerships are also the subject of continuing regulatory interest. In the bank partnership model, banks offer loans in conjunction with a non-lender acting as their marketing and servicing agent. The bank generally sets the underwriting criteria and funds the loans.

The partner entity performs marketing and servicing functions and, in some partnerships, purchases the right to collect revenue from the loans after origination.

Opponents of the bank partnership model argue that the non-bank entities are the true lender and are simply using the bank's charter to evade state interest rate limitations. These opponents have found some success in challenging the validity of the bank partnership model in a few cases.

In *Meade v. Avant of Colorado LLC*, the administrator of the Colorado Uniform Consumer Credit Code brought an enforcement action alleging that Avant, a non-bank affiliate assignee of loans from a federally insured bank, violated Colorado's finance charge limitations.[4]

The U.S. District Court for the District of Colorado found that Avant was the true lender, reasoning that Avant was the assignee of the loans and had "only a contractual relationship with WebBank," and that WebBank played "only an ephemeral role in making the loans" before "immediately sell[ing] them, and it [was] Avant which generally direct[ed] the fees and activities that allegedly violate[d] state law."[5]

Likewise, in *Pennsylvania v. Think Finance Inc.*, the U.S. District Court for the Eastern District of Pennsylvania held that Pennsylvania law, rather than federal banking law, applied to a transaction when the Pennsylvania attorney general sued Think Finance Inc., which had partnered with an out-of-state bank in a "rent a bank" scheme.[6]

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The *Avant* and *Think Finance* cases illustrate the importance of meaningful bank activity in a bank partnership transaction. It is important that the programs and their related materials make it very clear for consumers, regulators and courts to see extensive bank involvement in the transaction. It must be clear that the relationships are more than ephemeral.

Certainly, it must be made clear that the bank is doing more than merely providing the funding. Courts and regulators will not allow transactions if it appears that non-bank service providers direct the bank's actions and decisions. A critical question is whether the bank retains more than a nominal participatory interest in the transactions after origination.

TRIBAL MODEL

Another internet lending model is called the tribal model, in which an entity partners with a tribe to offer loans. The tribe is the lender, and the partner entity generally assists in marketing and servicing the transactions.

Those using this model claim that the law of the tribe applies to the transaction rather than the law of the consumer's state of residence. Federal and state regulators and attorneys general have been particularly skeptical of this model.

For example, in 2015, North Carolina sued an online consumer lender and its assignees that were offering transactions pursuant to the laws of the Cheyenne River Sioux Tribe. The state alleged the agreements violated North Carolina usury law.[7] The North Carolina Superior Court found that North Carolina law could apply because the state's usury law provides that loans with North Carolina residents are governed by North Carolina law, regardless of the location specified in the contract.[8]

In 2016 the Georgia Supreme Court similarly rejected Western Sky Financial LLC's argument that Georgia law did not apply to their small-dollar loans because the contracts were made on a reservation. The court ruled in favor of the Georgia attorney general, holding that Georgia law applied.[9]

In November 2017 the CFPB sued Think Finance LLC for its alleged participation in the origination, servicing and collection of online credit transactions. The CFPB claimed that the transactions violated state law and were void, even though they included a contractual choice-of-law clause purporting to establish tribal law as the governing law.[10] As of the date of publication, the lawsuit is pending.

Of the three models outlined, the tribal model appears to be the most susceptible to scrutiny. While state regulatory agencies and courts may not have the authority to regulate tribal sovereign governments in many cases, this does not mean that consumer loans made by tribes, often with the assistance of non-tribal partners, will be deemed enforceable (or even lawful) by state authorities.

Likewise, while tribal governments may benefit from immunities, those serving the tribe would have a much more difficult time winning the argument that they are similarly immune. Moreover, federal authority over tribes, particularly for the CFPB, is an ever-present reality.

CONCLUSION

Many people are closely watching to see how the CFPB under Mick Mulvaney (and possibly agency head nominee Kathy Kraninger) will approach internet lending and the various models outlined above, particularly tribal lending.

If the CFPB takes a less active approach to the regulation of internet lending, we may see more activity among state regulators and attorney generals seeking to protect their constituent consumers from out-of-state lenders. However, given the late 2017 action against Think Finance, it seems the CFPB is not backing down on its stance against the tribal model.

Given that both federal and state scrutiny is unlikely to decline, internet lenders should carefully consider the risks associated with the three models discussed above when structuring their business. The best way for them to avoid claims by consumers and regulators is to follow federal laws as well as state-specific lending, licensing and consumer protection requirements.

NOTES

[1] *Quik Payday Inc. v. Stork,* 549 F.3d 1302, 1310 (10th Cir. 2008).

[2] *Swanson v. Integrity Advance LLC,* 870 N.W. 2d 90 (Minn. 2015).

[3] For example, in a recent case that is not related to internet loans, a New York court applied New York law rather than Delaware law (as specified in a choice-of-law clause) to a criminal usury claim, finding that "to apply Delaware law would violate a fundamental public policy of New York," in large part because interest rates under Delaware law are not capped. *Madden v. Midland Funding LLC,* 237 F. Supp. 3d 130 (S.D.N.Y. 2017). The case had been remanded to the district court after the Second Circuit's ruling that national bank preemption did not apply to Midland as the purchaser of defaulted debt from a bank. *See Madden v. Midland Funding LLC,* 786 F. 3d 446 (2nd Cir. 2015).

[4] *Meade v. Avant of Colorado LLC,* 307 F. Supp. 3d 1134 (D. Colo. 2018).

[5] *Id.* at 1148.

[6] *Pennsylvania v. Think Finance Inc.,* 2016 WL 161597 (E.D. Pa. Jan. 14, 2016).

[7] *North Carolina v. Western Sky Financial LLC,* 2015 N.C.B.C. 84, 2015 WL 5091229 (N.C. Super. Aug. 27, 2015).

[8] *Id.*

[9] *W. Sky Fin. LLC v. State ex rel. Olens,* 300 Ga. 340, 793 S.E.2d 357 (2016).

[10] Complaint, *Consumer Financial Protection Bureau v. Think Finance LLC,* No. 4:17-cv-00127-BMM (D. Mont. Nov. 15, 2017), https://files.consumerfinance.gov/f/documents/cfpb_think-finance_complaint_112017.pdf.

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