True Lender Developments: Litigation and State Regulatory Actions

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Introduction

For many years, banks have partnered with non-bank companies to offer loan programs to consumers. Some of these bank partnerships have been challenged by consumer advocates through so-called "true lender" litigation in state and federal court, by state regulators, and through criminal prosecutions.

The crux of the true lender challenge is that, at the time a loan is originated, the lender on the face of the loan paper, the bank, is not the true lender. Rather, the true lender is another non-bank financial company that marketed and sold the financial product or service to the consumer. If a true lender challenge is successful, the non-bank financial company may face significant civil and criminal penalties for failing to be licensed as a lender, and the loans may be usurious and void in some jurisdictions. Tribal lending programs have also been challenged in true lender litigation. Participants in the bank partnership space should be familiar with the tribal lending cases, as favorable outcomes for true-lender-test proponents in tribal lending cases make it more likely that a true lender challenge will be successful with respect to a bank partnership. This survey reviews key developments in true lender challenges in the past year.

Litigation

Two cases from the Central District of California are instructive. In *Beechum v. Navient Solutions, Inc.*,[1] the court granted a motion to dismiss in favor of the lender and its non-bank loan servicers, based on a finding that the loans at issue were exempt from California's usury cap. The plaintiffs sued Navient Solutions, the Student Loan Marketing Association, and SLM Corporation on behalf of a California class. The plaintiffs obtained private student loans from Stillwater National Bank and Trust Company ("Stillwater"), a national bank.[2] The bank subsequently sold the loans to a securitization trust established to hold the

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1. No. EDCV 15-8239-JGB-KKx, 2016 WL, 5340454 (C.D. Cal. Sept. 20, 2016).
2. *Id.* at *1.

loans, while the non-bank defendants serviced the loans.[3] The plaintiffs claimed that the non-bank entities were the true lenders, and that the interest rates charged on the loans exceeded the annual cap of 10 percent imposed by California, absent some other authority, like a license under the California Finance Lenders Law.[4] The defendants argued that California law does not limit the interest rate that a national bank, like Stillwater, may impose.[5] In arguing that the non-banks were the true lenders, the plaintiffs urged the court to review the substance of the transactions, rather than their form.[6]

The *Beechum* court, however, declined to do so, noting that the cases cited by the plaintiffs provided that a court may consider "substance" over "form" and the parties' intent only to assess whether a transaction satisfies the elements of usury or falls under a common law exemption to the usury prohibition, not to assess whether the transaction or a party to it falls under a constitutional or statutory exemption from the usury prohibition.[7] It found that no case holds that the "applicability of a statutory or constitutional exemption to the usury provision is a question of fact and is based on the 'substance' of a transaction."[8] Furthermore, the *Beechum* court cited two California cases that directed courts to look only to the face of the transaction to assess whether it falls under a statutory exemption from the usury prohibition and not to look to the intent of the parties.[9] Consequently, the court found that it would look only at the face of the transactions at issue, not the substance, to assess whether the loans were exempted from the usury prohibition.[10] Because a national bank, rather than the non-bank servicer defendants, originated the loans, they were exempt from California's usury cap.[11]

The opposite conclusion was reached in *CFPB v. CashCall, Inc.*,[12] in which another judge on the same court evaluated the substance of a tribal lending model to determine the identity of the true lender.[13] The Consumer Financial Protection Bureau ("CFPB") argued that CashCall was the true lender, not CashCall's tribal lending partner, Western Sky Financial ("Western Sky"), a South Dakota company

3. *Id.*

4. *Id.* at *2, *4 (citing CAL. CONST. art. XV, § 1); *see* California Finance Lenders Law, CAL. FIN. CODE §§ 22000–227800 (Deering 2007 & Supp. 2017).

5. *Beechum*, 2016 WL 5340454, at *5.

6. *Id.*

7. *Id.* at *6.

8. *Id.*

9. *Id.* at *7. The court cited *Jones v. Wells Fargo Bank*, 5 Cal. Rptr. 3d 835, 843 (Ct. App. 2003), noting that "cases where intent to evade the usury law is an issue typically involve[d in] situations where the lender claims a transaction is not a loan at all" and that "Defendants' intent was irrelevant" where the "agreement fit within a legally authorized exception to the general usury law," and *WRI Opportunity Loans II LLC v. Cooper*, 65 Cal. Rptr. 3d 205, 214 (Ct. App. 2007), noting that, "when a loan meets the requirements for a statutory exemption to the usury law, courts will not look beyond those requirements."

10. *Beechum*, 2016 WL 5340454, at *8.

11. *Id.*

12. No. CV 15-7522-JFW, 2016 WL 4820635 (C.D. Cal. Aug. 31, 2016).

13. *Id.* at *5–6.

licensed to do business by the Cheyenne River Sioux Tribe ("CRST").[14] Under the CashCall tribal lending model, CashCall agreed to purchase all loans made by Western Sky.[15] Western Sky agreed to sell the loans to CashCall before any payments were made by the borrowers, so that borrowers never made payments to Western Sky.[16] Western Sky funded the loans with money deposited in a reserve account by CashCall, such that there was "enough money to fund two days of loans, calculated on the previous month's daily average."[17] To buy the loans, CashCall paid Western Sky the amount financed by Western Sky and a premium of more than 5 percent.[18] CashCall also guaranteed Western Sky a minimum monthly payment of $100,000 and a $10,000 monthly administrative fee.[19] The court noted that CashCall "never declined to purchase a loan made by Western Sky."[20]

Although it found no binding precedent on the issue, the *CashCall* court agreed that, to identify the true lender, it must consider "the substance, not the form, of the transaction."[21] The court explained that it must consider the totality of the circumstances to determine which party or entity had the "predominant economic interest" in the transaction, and it concluded that CashCall, not Western Sky, was the true lender.[22] The court stated that the most determinative factor was "whether Western Sky placed its own money at risk at any time during the transactions, or whether the entire monetary burden and risk of the loan program was borne by CashCall."[23] It found that, as between CashCall and Western Sky, CashCall assumed "all economic risks and benefits of the loans immediately upon assignment," it bore the risk of default, and it bore the regulatory risk.[24] Because CashCall was the true lender, with the "predominant economic interest" in the transaction, the choice-of-law clause in the loan notes for CRST law was not applicable and, accordingly, state usury and licensing law applied to the loans.[25]

Predominant Economic Interest

The "predominant economic interest" test articulated in *CashCall* derives from a Georgia statute limiting payday lending.[26] The statute "restricts in-state payday

14. *Id.* at *2, *5–6. When CashCall initially expanded its consumer and small business lending program from California into other states, it used the bank partnership model. *Id.* at *1. When the banks withdrew from the partnership under pressure from the Federal Deposit Insurance Corporation, CashCall turned to the tribal lending model to structure its loans. *Id.* at *1–2.

15. *Id.* at *2, *6.

16. *Id.* at *2.

17. *Id.* at *6.

18. *Id.* at *2, *6.

19. *Id.* at *6.

20. *Id.* at *2.

21. *Id.* at *5.

22. *Id.* at *6 (quoting CashCall, Inc. v. Morrisey, No. 12-1274, 2014 WL 2404300, at *14 (W. Va. May 30, 2014)).

23. *Id.*

24. *Id.*

25. *Id.* at *6–9.

26. *Id.* at *6 (citing Ga. Code Ann. § 16-17-2(b)(4) (West 2015) ("A purported agent shall be considered a de facto lender if the entire circumstances of the transaction show that the purported agent holds, acquires, or maintains a predominant economic interest in the revenues generated by the

stores from acting as agents for out-of-state banks . . . where the agency agreement grants *the in-state agent* 'the predominant economic interest' in the bank's payday loan."[27] In *BankWest, Inc. v. Baker*, a case that interpreted the Georgia statute, the parties agreed that payday stores that hold more than 50 percent of the revenues from a loan have the predominant economic interest in the loan.[28] Georgia outlawed this type of agency agreement to prevent in-state payday stores from circumventing its usury laws.[29]

The predominant economic interest test, which is also found in similar statutes in Nevada and New Hampshire,[30] was cited in a New York case without tying that test to a New York statute. In *People v. County Bank of Rehoboth Beach*,[31] the court noted that:

> While we have no quarrel with the federal regulatory guidelines that define a lender, we disagree with respondents' contention that simply because written documentation provides that County Bank is responsible for such functions that such is dispositive of the question here. It strikes us that we must look to the reality of the arrangement and not the written characterization that the parties seek to give it, much like Frank Lloyd Wright's aphorism that "form follows function." Thus, an examination of the totality of the circumstances surrounding this type of business association must be used to determine who is the "true lender," with the key factor being "who had the predominant economic interest" in the transactions.[32]

The *County Bank* court found no legal basis to determine who had the predominant economic interest because New York statutes did not, and do not, have this concept imbedded into a potentially applicable statute.[33] Nevertheless,

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loan.")); *see* BankWest, Inc. v. Baker, 411 F.3d 1289, 1292–93 (11th Cir. 2005) (interpreting the Georgia statute), *vacated*, 433 F.3d 1344 (11th Cir. 2005) (en banc) (per curiam) (vacating panel's decision to rehear en banc), *vacated*, No. 04-12420, 2006 WL 1329700 (11th Cir. Apr. 27, 2006) (en banc) (vacating and remanding to panel to address mootness).

27. *BankWest*, 411 F.3d at 1293. The statute provides that certain loan transactions are not exempt from its requirements if they involve "any arrangement by which a de facto lender purports to act as the agent for an exempt entity. A purported agent shall be considered a de facto lender if the entire circumstances of the transaction show that the purported agent holds, acquires, or maintains a predominant economic interest in the revenues generated by the loan." GA. CODE ANN. § 16-17-2(b)(4) (West 2015).

28. *See BankWest*, 411 F.3d at 1299.

29. *Id.* at 1293.

30. *See* NEV. REV. STAT. ANN. § 675.035(3) (Supp. 2017) (providing that the Nevada Installment Loan and Finance Act applies to any person who "seeks to evade its application by any device, subterfuge or pretense, including, without limitation: (a) Calling a loan by any other name; (b) Using any agents, affiliates or subsidiaries in an attempt to avoid the application of the provisions of this chapter; or (c) Having any affiliation or other business arrangement with an entity exempt from the provisions of this chapter [as a bank or other exempt entity], the effect of which is to evade the provisions of this chapter, including, without limitation, making a loan while purporting to be the agent of such an exempt entity where the purported agent holds, acquires or maintains a material economic interest in the revenues generated by the loan"); *see also* N.H. REV. STAT. ANN. § 399-A:2(III) (2017) (providing that the New Hampshire statute regulating small loans, title loans, and payday loans applies to any persons that seek to evade its application, using virtually the same language as Nevada).

31. 846 N.Y.S.2d 436 (App. Div. 2007).

32. *Id.* at 438–39.

33. *See id.*

other courts have picked up this concept,[34] including the *CashCall* court in California, and regulators have begun to assert the true lender concept, as discussed below.

State Enforcement Actions and Related Litigation

During the past year, regulators in Maryland and Colorado used the true lender challenge to attack bank partnerships. In June 2016, the Maryland Court of Appeals affirmed a finding in favor of the state financial regulator's contention that a non-bank partner that promotes loans originated by a bank must be licensed as a credit services business in Maryland and may only broker loans at interest rates permitted under Maryland law.[35]

In January 2017, the Colorado Uniform Consumer Credit Code ("U3C") Administrator filed lawsuits against Marlette Funding LLC ("Marlette") and Avant of Colorado LLC ("Avant") to shut down the bank partnership model they employed within the state, taking the position that consumer loans offered by those online lenders in Colorado cannot exceed the rates permitted for a state-supervised lender, i.e., 21 percent APR.[36] Marlette and Avant partnered with New Jersey-based Cross River Bank and Utah-based WebBank, respectively, to offer consumer loans through an online lending platform.[37] The banks originated consumer loans nationwide on a uniform basis, relying on their authority under section 27 of the Federal Deposit Insurance Act ("FDIA")[38] to charge the same interest rate in all states.[39]

Citing *Madden v. Midland Funding, LLC*[40] and *CashCall, Inc. v. Morrisey*,[41] the Colorado U3C Administrator alleged that, once the loans were purchased by Marlette and Avant, they became subject to Colorado rate limitations and were usurious.[42] The Administrator also alleged that state banks cannot assign their FDIA interest rate preemption authority to non-bank partners when they pur-

34. *See*, *e.g.*, State *ex rel.* McGraw v. CashCall, Inc., No. 2008C1964, 2012 WL 11875220, at *11–15 (W. Va. Cir. Ct. Sept. 10, 2012).

35. CashCall, Inc. v. Md. Comm'r of Fin. Regulation, 139 A.3d 990, 994 (Md. 2016); *see* Robert Savoie & Phillip (PJ) Hoffman, *Marketplace Lending Developments: A Survey of Federal and State Issues Confronting the Industry*, 72 Bus. Law. 529, 534–35 (2017) (in the 2017 *Annual Survey*) (discussing the Maryland decision).

36. Amended Complaint at paras. 29, 40–41, Meade v. Marlette Funding LLC, No. 1:17-cv-00575-PAB (D. Colo. Mar. 3, 2017) [hereinafter Marlette Complaint]; Amended Complaint at paras. 31, 42–43, Meade v. Avant of Colo. LLC, No. 1:17-cv-00620-WJM (D. Colo. Mar. 9, 2017) [hereinafter Avant Complaint]; *see* Colo. Rev. Stat. § 5-2-201(2) (2017).

37. Marlette Complaint, *supra* note 36, at paras. 3–33; Avant Complaint, *supra* note 36, at paras. 4–35.

38. 12 U.S.C. § 1831d(a) (2012).

39. *See* Complaint for Declaratory Judgment and Injunctive Relief at paras. 1–10, Cross River Bank v. Meade, No. 1:17-cv-00832 (D. Colo. Apr. 3, 2017) [hereinafter Cross River Complaint]; Complaint for Declaratory Judgment and Injunctive Relief at paras. 1–13, WebBank v. Meade, No. 1:17-cv-00786-PAB (D. Colo. Mar. 28, 2017) [hereinafter WebBank Complaint].

40. 786 F.3d 246 (2d Cir. 2015), *cert. denied,* 136 S. Ct. 2505 (2016).

41. No. 12-1274, 2014 WL 2404300 (W. Va. May 30, 2014).

42. Marlette Complaint, *supra* note 36, at paras. 29–30, 41; Avant Complaint, *supra* note 36, at paras. 31–32, 43.

chase the loans.[43] The Administrator contended that the non-bank partners were the true lenders of the loans based on the predominant economic interest test established by the West Virginia Supreme Court in *Morrisey*.[44] Specifically, the U3C Administrator identified the following factors to argue that the non-bank partners had the predominant economic interest in the transactions: 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, applying lending criteria established by Marlette and Avant and their respective bank partners; and the banks bore little or no risk of financial loss in the event the borrower defaulted on the loan.[45]

In response to the enforcement actions against Marlette and Avant, Cross River Bank and WebBank filed separate lawsuits for declaratory judgment and injunctive relief, alleging that those enforcement actions against the non-banks unlawfully restricted the banks' lending business and caused irreparable financial loss.[46] The banks argued that the enforcement actions interfered with their authority under the FDIA to operate a nationwide lending program with uniform interest rates, and that the application of *Madden* unlawfully restricted their ability to sell loans to third parties.[47]

The banks further contended that they were the true lenders based on the following factors, among other things:

- The banks retain many of the loans they originate, and sometimes they choose to sell loans to various partners.
- The banks use non-bank partners as technology service providers to help market and originate loans to geographically diverse consumers.
- The banks bear continuing regulatory accountability over the loans under FDIA and state banking regulations.
- The banks have continuing oversight and monitoring of legal compliance, even after a loan is sold.[48]

Although the litigation is ongoing, there is one claim that raises concern for bank partnership platforms that operate in any U3C state that has a statutory provision that an agreement by a consumer is invalid with respect to consumer credit transactions, or modifications of such transactions, when that agreement

43. Marlette Complaint, *supra* note 36, at para. 29; Avant Complaint, *supra* note 36, at para. 31.
44. Marlette Complaint, *supra* note 36, at paras. 32–35; Avant Complaint, *supra* note 36, at paras. 30–33.
45. Marlette Complaint, *supra* note 36, at para. 32; Avant Complaint, *supra* note 36, at para. 34.
46. *See* Cross River Complaint, *supra* note 39, at paras. 1–10; WebBank Complaint, *supra* note 39, at paras. 1–13.
47. Cross River Complaint, *supra* note 39, at paras. 1–10; WebBank Complaint *supra* note 39, at paras. 1–13.
48. Cross River Complaint, *supra* note 39, at paras. 15–75; WebBank Complaint *supra* note 39, at paras. 20–31.

provides that the law of another state shall apply.[49] Any such U3C provision could provide grounds for a U3C state regulator to challenge a loan agreement that has a governing law clause that specifies a state other than the state where the consumer lives. It is unclear how a court would resolve the tension between a bank partnership program—which relies on rate exportation consistent with federal law—and this state law provision limiting choice-of-law clauses.

49. *See* Colo. Rev. Stat. § 5-1-201(8) (2017); Idaho Code § 28-41-201(8) (Supp. 2017); Ind. Code Ann. § 24-4.5-1-201(6) (LexisNexis 2013); Iowa Code § 537.1201(6) (2017); Kan. Stat. Ann. § 16a-1-201(8) (2007); Me. Rev. Stat. Ann. tit. 9-A, § 1-201(8) (2016); Okla. Stat. Ann. tit. 14A, § 1-201(9) (West 2016); S.C. Code Ann. § 37-1-201(10) (2015); Wis. Stat. § 421.201(10) (2015); Wyo. Stat. Ann. § 40-14-120(j) (2017).

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