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Federal Preemption Developments: "True Lender" Standards and *Madden v. Midland Funding*

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Consumer Finance
MONTHLY BREAKFAST BRIEFING

"TRUE LENDER" STANDARDS

Bank Partner Programs

- Retailers, marketplace platforms, and others may rely on partnerships with banks to originate loans.
- Programs are structured to take advantage of authority provided to banks under federal law to "export" the interest rate permitted in the state in which the bank is located.
- Programs sometimes are structured to limit the extent to which online marketplace lending platforms are required to obtain licenses to make loans.

Challenges to Bank Partner Programs – Recharacterization Risks

- Federal and state courts evaluating "true lender" claims have adopted multiple standards for determining when relationships should be recharacterized.
  - Some courts have determined the "true lender" solely through reliance on the party named in loan agreements as the creditor
  - Some courts have determined the "true lender" through a narrow evaluation of facts regarding which party engages in the three non-ministerial acts that federal banking regulators have identified:
    - Determination to extend credit;
    - The extension of credit itself; and
    - The disbursement of funds resulting from the extension of credit.
  - Some courts have taken a more fact-intensive approach, evaluating the totality of the circumstances to determine which party retains the "predominant economic interest" in loans originated under the relationship.

Bethune v. Lending Club

- Plaintiffs allege that Lending Club is the true Lender
  - "Use of Web Bank was a pretext and a sham."
- The complaint provides a list of traditional banking functions that the plaintiff alleges that Web Bank did not perform, which include:
  - Setting the parameters of the loans, such as type, risk, amount, and use;
  - Deciding what information to obtain from borrowers;
  - Determining credit score or otherwise evaluating the borrower;
  - Setting the interest rate, fees, payment terms, or length of the loan;
  - Assuming any risk in lending the money;
  - Having any right or intent to keep the note (as it was contractually required to transfer the note to Lending Club within 48 hours of funding);
  - Having any servicing obligations on the note; and
  - Having any recourse obligations on the note.

Other Factual Assertions

- Excerpting Lending Club marketing materials and descriptions of its program that do not indicate any substantial involvement by Web Bank;
- Relying on Web Bank statements regarding its function as a "pass-through"
  - Arguably out of context, as the statement appears to refer to Web Bank as a capital pass-through, which would be true of any lender that routinely sold loans on the secondary market;
- Relying on statements in Lending Club's securities disclosures to support the proposition that Lending Club knew and intended its loans to be usurious.

Complaint Addresses Old Program

- The complaint cuts off its class period on February 26, 2016, after which Lending Club made changes to its relationship with Web Bank to provide Web Bank a continuing interest in loans originated under the platform. The complaint does not expressly challenge Lending Club's current practices.
- The complaint identifies the program changes described above as driven by *Madden*, but does not directly rely on *Madden* as part of the claim.

RICO Claim

- Plaintiffs use RICO to seek treble damages.
  - Use of state RICO or "corrupt organization" statutes is not new to true lender litigation—*see Georgia Cash America, Inc. v. Greene*, involving claims under the Georgia RICO Act for unlawful debt collection activity, or *Pennsylvania v. Think Finance*, No. 14-cv-7139 (E.D.Pa. Jan. 14, 2016), involving claims under the Pennsylvania Corrupt Organizations Act for criminal usury.
- Plaintiffs do not assert claims under New York's criminal usury law.

What's Next

- Lending Club and WebBank have informed the court that they will file a Motion to Compel Arbitration.
- Briefing schedule:
  - June 17, 2016: Lending Club and WebBank will file joint motion.
  - July 18, 2016: Plaintiffs will file opposition to motion.
  - August 1, 2016: Lending Club and WebBank will file joint reply.
- Outcome of motion may depend on whether: (i) class representative opted-out of arbitration; and (ii) Lending Club's arbitration provisions are enforceable.
- Unclear whether there would be any other potential class representatives who have opted-out of arbitration.

What's Next (continued)

- New decisions
- Increased focus by regulators (Department of Treasury, Consumer Financial Protection Bureau, Federal Trade Commission, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Federal Reserve Board, State banking/consumer credit regulators, State Attorneys General)
- Increased enforcement:
  - CFPB
  - NY DFS
  - Others?

National Bank "Interest Exportation" Authority

- 12 U.S.C. § 85 permits a national bank to charge "interest" at the rate permitted by the laws of the state where the bank is located. Laws of other states (such as the borrower's state) are preempted.
  - 12 U.S.C. §1831d and 12 U.S.C. §1463(g) provide the same authority to FDIC-insured state banks and federal savings associations, respectively.
- "Interest" encompasses all charges that compensate the creditor for the extension of credit or the borrower's default.
  - Periodic finance charges
  - Late fees
  - Membership fees or annual fees
  - Overlimit fees
  - NSF fees
  - Prepayment fees

Assignee Authority to Charge Interest at Rate Contracted for by the Originating Bank

- 12 U.S.C. §85 and its analogues do not expressly provide that an assignee of a bank may charge interest at the rate contracted for by the bank.
  - Contrasts with Section 501(a) of DIDMCA (first-lien mortgage usury preemption) and the Alternative Mortgage Transaction Parity Act.
- Five basic arguments as to why an assignee is entitled to do so:
  - Common law valid-when-made principle embedded in 12 U.S.C. §85 and its analogues.
  - Applying state usury laws to a national bank would "significantly interfere" with the bank's authority to charge interest in accordance with the laws of the states where it is located.
    - In *Barnett Bank of Marion County v. Nelson*, 517 U.S. 25 (1996), the Supreme Court held that a state law was preempted if it "prevents or significantly interferes with" a national bank's exercise of its powers.
  - As a matter of state usury law, a contract is not usurious if it was not usurious when made.
  - Assuming that the contract provides that the laws of the national bank's location state governs, those state laws should apply via choice-of-law principles.
  - UCC shelter principle gives the assignee the same rights as the assignor.

Before *Madden*, Courts Had Uniformly Held that Preemption Turns on the Identity of the Originator

- *Krispin v. May Department Stores Co.*, 218 F.3d 919 (8th Cir. 2000)
  - "[A]lthough . . . the NBA governs only national banks . . . in these circumstances . . . it makes sense to look to the originating entity (the bank), and not the ongoing assignee (the store), in determining whether the NBA applies."
- *Phipps v. FDIC*, 417 F.3d 1006, 1013 (8th Cir. 2005)
  - "Courts must look at 'the originating entity (the bank), and not the ongoing assignee . . . , in determining whether the [National Bank Act] applies.'"
- *FDIC v. Lattimore Land Corp.*, 656 F.2d 139 (Unit B Sept. 1981)
  - Involved reverse facts: Non-national bank originated the loan and assigned the loan to a national bank.
  - "The non-usurious character of a note should not change when the note changes hands."

Background of *Madden*

- Saliha Madden, a New York resident, obtained a credit card from a national bank that carried an interest rate of 27%.
- New York usury law caps the interest on loans at 16% or 25%, depending on the circumstances.
  - Prohibits any person from *charging or receiving* interest in excess of the cap.
- After Madden defaulted and the issuer charged off her debt, the receivables were assigned to Midland Funding, LLC (together with Midland Credit Management, Inc., the other defendant, "Midland").
- Midland attempted to collect the receivables, including interest at the contractual rate.
- Madden sues, alleging violations of the New York usury law and asserting derivative claims under the Fair Debt Collection Practices Act ("FDCPA").

District Court Proceedings

- Madden sued Midland, claiming that Midland violated NY usury law by charging interest in excess of the cap, and the Fair Debt Collection Practices Act ("FDCPA")
- District court held that the usury claim was preempted by the NBA, and dismissed the FDCPA claim because it was predicated on the usury claim.

Second Circuit Decision

- Reverses district court.
- Said that NBA preempted state law for a non-national bank only when the non-national bank was acting on behalf of a national bank.
- Distinguished decisions in other circuits on the grounds that in those cases the national bank had retained an interest in the loan at issue.

Midland's Response to the Second Circuit Decision

- Seeks *en banc* review.
- When that is denied, petitions the Supreme Court for a *writ of certiorari*.
- Midland's arguments:
  - Decision creates a circuit split.
  - Madden was incorrectly decided:
    - Valid-when-made doctrine is embedded in 12 U.S.C. §85.
    - Allowing a state to prohibit an assignee from collecting interest lawfully contracted for by a national bank would "significantly interfere" (within the meaning of *Barnett*) with a national bank's authority to contract for interest at the rate permitted by Section 85.
  - Second Circuit decision is important.

Madden's Reply to Midland's *Cert Petition*

- No circuit split.
- Impact of the decision is limited to charged off debts.
  - Court didn't address performing debts.
- Case is not the right vehicle to address the issue.
  - Midland did not articulate its primary arguments until the *en banc* petition, so it might have waived them.
- Case involves superseded law.
  - Facts of the case arose before the preemption-related amended to the NBA in the Dodd-Frank Act took effect.
  - Those amendments addressed whether and to what extent NBA preempts state laws for a non-national bank.
- Second Circuit decided the case correctly.

OCC and Solicitor General Brief

- March 21, 2016: Supreme Court invites Solicitor General to submit a brief recommending whether the Court should review the decision.
- SG submits a brief jointly with the OCC.
- Brief argues that decision was "incorrect" and "reflects an unduly crabbed conception of [National Bank Act] preemption."
- Still, recommends that the Court not grant *cert*.
  - No clear split among the circuits.
  - Midland did not effectively argue the preemption issue until its en banc petition.
  - Appeal is interlocutory, and Midland might still win on state grounds.
- Both Madden and Midland submitted supplemental briefs.

What Happens if the Court Grants *Cert*?

- Prediction: Midland wins. It simply has the better arguments.
- The Court's reasoning will be important, though.
  - Valid-When-Made Embedded in 12 U.S.C. §85: If the Court decides the case this way, then it will be less clear whether the decision compels the conclusion that non-interest laws are preempted for assignees.
    - However, lower courts will probably extend the holding to state-chartered banks and federal savings associations.
  - "Significantly interferes" with National Bank's Authority: If the Court decides the case this way, then lower courts will probably conclude that many non-interest laws are preempted for assignees of national banks also.
    - Lower courts will probably extend holdings to federal savings associations. See 12 U.S.C. §1465(a) (preemption standards for national banks apply to federal savings associations).
    - Less clear whether lower courts will extend the holding to state-chartered banks.

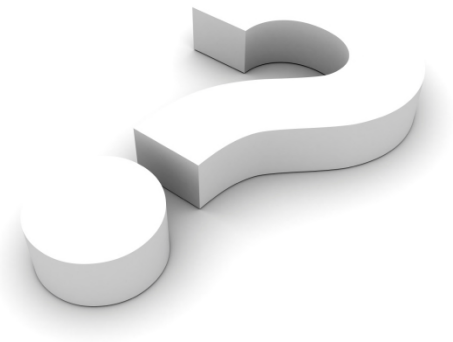
What Happens if the Court Denies *Cert*?

- Short-term:
  - Continued uncertainty for the secondary market in the short term.
  - Midland might still win on state law grounds, but this won't provide a clear national rule.
- Long-term:
  - Court might still take up the issue eventually.
  - Other circuits might follow *Madden*—or the Second Circuit might try to limit *Madden*.

Steps to Mitigate Risk

- Structural: Ensure the bank has continuing involvement with the loan.
- Geographic: Not purchase loans originated in the Second Circuit.
  - Doesn't automatically mean that there will not be venue in the Second Circuit.
- Practice: Abide by usury caps.

QUESTIONS?



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