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What Laws Apply? *Madden*, True Lender and Product Recharacterization Challenges

Consumer Finance Monthly Breakfast Briefing

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Roadmap

- Issues for Bank-Originated Loans
 - True Lender
 - *Madden*
- Product Recharacterization for Innovative Products and Non-Credit Advances
 - Point-of-Sale Financing
 - Payroll Advance Products
 - Factoring and Merchant Cash Advances



What Laws Apply to Bank-Originated Loans?
Madden and True Lender

The *Madden* and True Lender Issues

- Certain state laws are preempted in application to banks, and other state laws expressly exempt some or all banks or other depositories.
- Programs may rely on inapplicability of such state laws when designing program terms, including interest rates for program loans.
- When programs involve origination relationships between banks and non-banks and/or the transfer of loans from a bank to a non-bank, challenges have arisen as to whether the program may benefit from the bank's preemption or exemption from state laws.

The *Madden* and True Lender Issues

- True Lender = Whether the bank (or a non-bank lending platform or origination services provider) will be treated as the lender for regulatory purposes, including licensing and usury, at origination
- *Madden* = Whether, once lawfully originated by a bank, a loan may be enforced pursuant to its contractual terms after transfer to a non-bank purchaser/assignee



Madden

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Madden Background

- Class of claims arising from Second Circuit decision in *Madden v. Midland Funding, LLC* (786 F.3d 246) in 2015.
 - Facts: A non-bank debt buyer charged interest on a defaulted credit card account at rates permissible at origination only because the original creditor was a bank.
 - Holding: The non-bank could not rely on preemption arguments available to the bank that permitted charging interest in excess of state law limitations.
- Serious questions as to the breadth of the ruling and whether the defendant raised the right arguments at trial to avoid waiving defenses.
- While cited by other courts, not adopted outside of Second Circuit.

Recent *Madden* Developments: Litigation

- Recent cases against JPMC (WDNY) / Capital One (EDNY)
- In June 2019, plaintiffs filed class action lawsuits against various Capital One and Chase affiliated entities (but not the banks) involved in the banks' credit card securitization programs.
- The lawsuits allege that the bank affiliates purchasing the receivables from the national banks cannot collect interest at the rate permitted by the Cardholder Agreement based upon *Madden*.
- Plaintiffs emphasize "true sale" nature of the securitizations.
- Neither Chase nor Capital One had arbitration clauses in their cardholder agreements.

Recent *Madden* Developments: Litigation (cont.)

- Motions to dismiss, supported by SFA/BPI amicus brief
 - These claims seek to over-extend *Madden*.
 - *Madden* involved sale of the entire account, emphasized that the bank had no ongoing role.
 - Credit card securitization involves the ongoing sale of receivables only, bank continues to:
 - Be the party to cardholder agreement
 - Set interest rates
 - Collect interest
 - Fund new advances

Recent *Madden* Developments: Litigation (cont.)

- JPMC Magistrate Report & Recommendation (January 22, 2020)
 - Recommends dismissal of complaint (including usury and unjust enrichment claims)
 - Finds application of *Madden* to fact pattern to be mixed, requiring a de novo preemption review
 - Concludes that JPMC's authority under federal banking law to sell/transfer loans would be impaired by application of usury limits to purchasers
 - Recommendation subject to review/adoption by District Court judge, and potential appeal and subsequent challenge

Recent *Madden* Developments: Regulation

- FDIC and OCC proposed rules to clarify Federal interest rate authority to address marketplace uncertainty regarding the enforceability of the interest rate terms of loan agreements following a bank's assignment of a loan to a non-bank, including confusion resulting from *Madden*.
- The FDIC notes that the proposed rule does not address which entity is the "true lender" when a State bank makes a loan and assigns it to a third party. The proposal states that the FDIC views unfavorably entities that partner with a State bank with the sole goal of evading a lower interest rate established under the law of the entity's licensing rate.



True Lender

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True Lender Background

- The “true lender” issue is not unique to marketplace lending and case law has developed in connection with credit cards and payday lending.
- Courts have applied a number of legal standards to analyze “true creditor,” including named lender, totality of the circumstances and predominant economic interest.

True Lender Background

- *Krispin v. May Dep't Stores Co.*, 218 F.3d 919 (8th Cir. 2000) – “It makes sense to look to the originating entity (the bank), and not the ongoing assignee (the store), in determining whether the NBA applies.”
- *Sawyer v. Bill Me Later, Inc.*, 23 F.Supp.3d 1359 (D.Utah2014) – Bank true lender on facts, but “court would still be required to dismiss ... claims as preempted by Section 27 “even if it were not the true lender.”
- *CashCall, Inc. v. Morrissey*, 2014 WL 2404300 (W.Va. Sup. Ct. 2014) – “the ‘predominant economic interest test’ [is] the proper standard to determine the true lender.”

Recent True Lender Developments

- States regulators have been more active in scrutinizing relationships.
- One state, Colorado, has sued licensees, Avant and Marlette, and contacted others licensed as supervised lenders.
 - Brought in state court and attempted removal to federal court failed
 - Initial defendants' motions to dismiss were denied, after which the complaint was expanded with parallel claims against certain of the programs' securitization trusts/trustees
- As more entities obtain state licenses to perform marketing and servicing activities, state oversight will continue to increase.



What Laws Apply to Innovative Products? Recharacterization

Point-of-Sale Finance

- Rapidly developing market for point-of-sale financing, including products designed to be outside of many core financial regulatory requirements
- Hot products
 - Buy Now Pay Later – No interest and typically few installments (4 or fewer); single-use and reusable account structure
 - Loan or retail installment contract approaches
- Risk = Will a purported retail installment contract be treated as a loan
 - California guidance and *Sezzle* licensing opinion/consent order

Payroll Advance Products

- Variety of products offered by payroll processors and others
- Products offer employees the ability to receive earned wages earlier than normal payroll processing, frequently on a no-recourse basis
- Typically no periodic interest, but party providing advance may be compensated through a per-advance fee, a subscription fee, or a voluntary contribution
- Recharacterization risks = Loan or Wage Assignment
 - New York Earnin inquiry

Factoring and Merchant Cash Advance (MCA)



- Small business and commercial financing product involving:
 - True sale of existing receivables (factoring)
 - Sale of future receivables on an as-generated basis (MCA)
- Multi-factor analysis, but key issue tends to be whether the acquiring party bears the risk of non-payment or non-generation of the underlying receivables
- Risk = Will agreement be considered a business-purpose loan secured by receivables, rather than a true sale



Questions?



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