Memorandum*

TO: Chief Legal Officer, American Bankers Association
FROM: Director, American Bankers Association
DATE: November, 2016

Setting

You are the legal director of the American Bankers Association (ABA), a trade association representing banks of all sizes and charters, from the largest national commercial banks to small state-chartered community banks. Your role within the organization is to determine legal strategies for the ABA to best represent the interests the banking industry. This includes a wide range of responsibilities ranging from advising member banks on legal strategy, initiating strategic lawsuits, filing amicus briefs for cases that have important implications on the banking industry, writing comment letters for proposed legislation and regulations, as well as lobbying members of Congress and administrative agencies to advance the interests of the banking industry. In this capacity, you have been tracking some legal developments over the past couple years that have many in the banking industry concerned about the implications on their business. Primary among these issues are recent cases where courts have cast doubt upon the legality of certain parts of the loan securitization industry and marketplace lending models. The director of the ABA has tasked you with developing an effective strategy to handle some of these adverse legal developments.

Loan Securitization – History and Background

Securitization is the practice of taking a financial asset (such as a bank’s right to receive payments from a customer on a loan) and selling the related cash flow (the customer’s payments) to an investor as a security (called an asset-backed security). The practice of asset securitization in the financial sector dates back to the 1970s with the structured financing of mortgage pools. Before this practice, banks were essentially portfolio lenders — holding loans until they were paid off or hit maturity. Since its inception, very few (if any) banks continue to function as exclusively portfolio lending companies for a number of reasons which include spreading the risk of default and freeing up funds to lend to new borrowers. Thus, the U.S. banking industry transformed from an “originate-to-hold” model to an “originate-to-distribute” model. Since its inception in the 1970s, the lending and securitization markets in the U.S. have grown to enormous levels. As of June 30, 2016, FDIC-insured institutions held nearly $9 trillion in outstanding loans — all of which are assets which could be

* This case study was prepared by Dylan M. Aluise, Harvard Law School Class of 2017, under the supervision of Professor Howell E. Jackson. This case study is intended for educational purposes only and is not intended to offer legal advice.

1 See About the American Bankers Association, AM. BANKERS ASS’N (last visited Nov. 26, 2016), http://www.aba.com/About/Pages/default.aspx.
3 See id.
securitized. In 2015 alone, $1.7 trillion in new loan securitizations were issued, adding to the over $9 trillion in outstanding securitizations that have been originated by various lenders.\(^6\)

In essence, the process of securitization is distilled into two steps: First, the bank or company with an asset (known as the “originator”) takes an asset it wants to remove from its balance sheets and puts it into a pool with other assets it wants to sell and then sells this asset pool to an issuer (such as a Special Purpose Vehicle or “SPV” set up by a financial institution).\(^7\) Second, the issuer finances this purchase of pooled assets by selling interest-bearing securities, typically in the form of a bond or collateralized debt obligation (“CDO”) to investors in the capital markets.\(^8\) These investors may then trade these securities or otherwise receive payments from a trust account that is funded by the cash flows (borrowers’ principal and interest payments) from the pooled assets.\(^9\) This can also be demonstrated in the following diagram:\(^10\)

Banks and other originators seek to take advantage of securitization for a few distinct reasons. First, the securitization market allows originators to transfer some of the risks of ownership of the loan, such as default risk, to a more diffuse population—including some parties more willing or better able to manage these risks.\(^11\) Second, banks are better able to manage their portfolio by moving loans off of their balance sheet to better handle potential asset-liability mismatches and credit concentrations.\(^12\) Furthermore, securitization improves banks’ returns on capital because it converts an on-balance-sheet asset into an off-balance-sheet income stream that is less capital intensive.\(^13\) Finally, securitization allows banks to increase their liquidity in order to support their lending operations.\(^14\) Each dollar made by selling the securitized asset is another dollar that can be lent out by the bank to new borrowers. Because the business of banking is lending, this extra liquidity and flexibility is crucial to increasing bank revenue.\(^15\) The capital gained by securitizing loans frees up capital for the bank to

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\(^8\) See id.

\(^9\) See id.

\(^10\) Id.


\(^12\) Id.

\(^13\) Id. at 4.


help meet the credit needs of their communities. According to the ABA, “[i]n today’s banking environment, efficient lending requires not only a functioning primary market in which banks make loans to borrowers, but also an efficient secondary market in which banks sell loans to other parties.” Similarly, investors also stand to benefit from the asset securitization market. In many instances, securitized assets offer better returns than other instruments of similar quality. Additionally, a properly diversified pool of securitized assets obviates the need for investors to obtain a detailed understanding of each underlying asset or loan.

Marketplace Lending – Structure and Brief Background

The modern marketplace lending industry in the U.S. began in 2006 with the launch of Prosper which was quickly followed by Lending Club. While the purpose of the marketplace lending industry’s peer-to-peer model of connecting the customer/borrowers directly to investor/lenders is meant to disrupt the traditional consumer banking model, some banks have a vested interest in the industry. The FDIC sums up the marketplace lending bank-partnership model as follows: the structure behind marketplace lending begins with a customer using an online platform to submit an application for a loan. The platform then collects information about the borrower’s creditworthiness and uses proprietary models to determine credit risk and set an interest rate. The platform then posts the loan request for potential lenders and investors to choose to fund. Once investors have put forth enough capital to fund the loan, the platform then notifies the bank which the platform has partnered with and then that bank originates the loan for the customer. The bank then issues a note tied to the specific loan it just made to the platform which in turn sells portions of that note to the investors who expressed interest in funding the borrower’s loan. These notes are guaranteed by the underlying loan and the investors only receive money when payment has been made by the borrower to the platform to pay off the loan. This can be illustrated as follows:

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16 Cf. id.
17 Id.
19 Id.
20 See Peter Renton, Peer To Peer Lending Crosses $1 Billion In Loans Issued, TECHCRUNCH (May 29, 2012), https://techcrunch.com/2012/05/29/peer-to-peer-lending-crosses-1-billion-in-loans-issued/.
23 Morrison & Foerster LLP, supra note 21, at 1.
The relationship between the bank and the marketplace lending platform is critical for the functioning of the marketplace lending industry for platforms not utilizing a “direct lending” model whereby the platform becomes a licensed lender in its own right. This relationship has been called the bank-partnership model, or the more pejorative “rent-a-charter” model. Platforms use this model to take advantage of the bank’s license to lend as well as its power to export interest rates rates under 12 U.S.C. § 85 (for national banks) or 12 U.S.C. § 1831d(a) (for state-chartered banks) derived from the Supreme Court’s Marquette decision.25 In this sense, some state-chartered banks such as Web Bank in Utah have profited greatly from partnering with marketplace lending platforms to increase their volume of loan origination.26

To put this into perspective, Web Bank (which partners with both Prosper and Lending Club) has become one of the most profitable banks in the country, using its chartered status to originate nearly $6 billion in loans annually to just Prosper and Lending Club alone.27 This amount of lending compares drastically to the $226 million in assets on Web Bank’s balance sheet, which allows it to amass a 44% return on equity which is about five times the average for U.S. banks and 11% better than Goldman Sachs’ best year since becoming a public company.28 However, Web Bank is extremely dependent upon the marketplace lending industry in order to function — its growth has precisely tracked the growth of the industry. To illustrate this, as of Q1 2016, Web Bank reported loans held for sale as equal to 62.07% of its total assets (compared to the national average of 0.47%).29 In short, the viability of banks like Web Bank and fellow banks reliant upon the bank-partnership model have their fortunes tied to the ability to originate and sell loans to their platform partners. It is a vested interest that they will likely go to great lengths to protect.

The Controversy Surrounding Madden v. Midland Funding LLC

The Second Circuit’s 2015 decision in Madden v. Midland Funding LLC,30 coupled with the Supreme Court’s denial of the petition for certiorari has put both the securitization market and marketplace lending industry bank-partnership model into a state of uncertainty. In the Madden case, a Bank of America credit card customer, Salih Madden, challenged the attempts of Midland Funding—a debt collector—to collect on her credit card debt. The challenge was based on the legal premise that the collection attempt violated New York’s state usury law. Madden, who was a resident of New York, had previously signed a credit card contract with Bank of America, agreeing to an interest rate of 27% per annum. To charge this interest rate, Bank of America used its power under the National Banking Act31 to export the usury laws of its home state, Delaware, which allowed any interest rate agreed to by contract.32 Madden eventually fell behind on her credit card payments and Bank of America ultimately charged off her existing debt of over $5,000 as uncollectible. Bank of America’s affiliated entity, FIA, then sold and assigned the debt to Midland Funding, which regularly engages in the practice of purchasing debt at a fraction of the value and then seeking to collect on that debt. When Midland attempted to collect on Madden’s outstanding Bank of America credit card debt at the contract’s original 27% interest rate, Madden then sued Midland on the basis that Midland was attempting to collect interest above New York’s 25% criminal usury rate.33

27 Noah Buhayar, Where Peer-to-Peer Lenders are Born, BloombergBusinessweek (Apr. 16, 2015, 6:00 AM), http://www.bloomberg.com/news/articles/2015-04-16/webbank-where-peer-to-peer-loans-are-born (noting that in 2014, Web Bank’s “38 employees generated more than $400,000 in profit apiece, about four times the amount at JPMorgan Chase”).
28 Id. (as of 2014).
29 Fox, supra note 26.
30 Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015), cert. denied, 136 S. Ct. 2505 (2016).
33 See N.Y. Penal Law § 190.40 (2015) (making it criminally usurious for an entity to charge or collect interest at a rate above 25% per year).
Midland’s practice here was not unusual. Banks have regularly engaged in the practice of making loans and then subsequently selling those loans to debt collectors either when they have been charged off as uncollectible or when the bank otherwise wants to increase its liquidity to make new loans. This practice runs parallel to the securitization model, yet the underpinnings of debt assignment are analytically similar. The practice of selling charged-off debt to a third-party non-bank debt collector had been litigated in other circuit courts and was found to be unobjectionable, most notably in the Eighth Circuit’s Phipps and Krispin cases. 

And, at the Madden trial, the District Court for the Southern District of New York followed the reasoning of these cases to find that Midland was within its legal right to collect on the debt at the original interest rate of 27% because the debt contract was valid and non-usurious when it was made and did not become usurious simply because of its subsequent assignment.

However, the Second Circuit reversed on the premise that because Midland is not “a national bank nor a subsidiary or agent of a national bank, or is otherwise acting on behalf of a national bank, and because application of the state law on which Madden's claims rely would not significantly interfere with any national bank's ability to exercise its powers under the [National Bank Act],” federal preemption of state usury laws would not be appropriate in this context. Thus, because Bank of America retained no interest in the loan after it was assigned to Midland, the loan therefore became subject to the state usury laws of the borrowers’ home state. In departing with the reasoning behind the Eighth Circuit cases, the Second Circuit’s opinion required two logical steps that were controversial — first, that the long-standing “valid-when-made” principle of contract law was inapplicable here; and second, that this decision would not significantly interfere with national banks’ powers under the National Bank Act. The Second Circuit ultimately remanded the case in order to determine the applicability of the credit card contract’s choice-of-law clause. The Second Circuit’s Madden decision created a sense of uncertainty in the financial services community because it upset long-held assumptions about the validity of assigned contracts. Despite the remand, the logic of the Madden opinion appeared to have broad implications. Loans that a bank assigns to non-bank entities — including asset-backed securities and the marketplace lending loans — would appear to become subject to state usury law in the hands of the assignee. Furthermore, it meant that these contracts in states like New York could become valueless in the hands of the assignee as usurious contracts are void and unenforceable, thus relieving the debtor of the obligation to pay.

Midland Funding promptly petitioned the Supreme Court for a writ of certiorari to review the case. The ABA, along with several other organizations, filed amicus briefs strenuously urging the Supreme Court to grant certiorari and reverse the ruling. These briefs argued that the Madden decision upset a centuries-old understanding, grounded in Supreme Court precedent, that a validly formed contract could not be rendered...

34 Phipps v. FDIC, 417 F.3d 1006 (8th Cir. 2005); Krispin v. May Department Stores Co., 218 F.3d 919 (8th Cir. 2000).
36 Madden, 786 F.3d at 249.
37 See id. at 250-51; see also 12 U.S.C. § 25b(b)(1)(B) (2012) (codifying the Watters v. Wachovia standard of “prevents or significantly interferes with the exercise by the national bank of its powers” for National Bank Act preemption into statute); Watters v. Wachovia Bank, N.A., 550 U.S. 1, 12, 18 (2007) (holding that state laws which would prevent or significantly interfere with “enumerated” or “incidental” powers granted by the National Bank Act would be preempted and extending these powers to bank subsidiaries); Pac. Capital Bank, N.A. v. Connecticut, 542 F.3d 341, 353-54 (2d Cir. 2008) (holding that state laws that would prohibit national banks from exercising their incidental powers through agents would be preempted by the National Bank Act).
38 It should be noted that the Second Circuit remanded the case to the Southern District of New York for a determination on Madden’s choice of law clause, which has the potential to negate the Second Circuit’s decision outside of its National Bank Act holdings. See Madden, 786 F.3d at 253, n.4.
39 See Barkley Clark & Mike Lochmann, A Momentous Court Decision May Hurt Bank Lending Powers, BankDirector.com (July 22, 2015), http://www.bankdirector.com/issues/regulation/a-momentous-court-decision-may-hurt-bank-lending-powers/ (describing the Madden decision as “shockwaves through the banking industry”).
41 In 1833, the Supreme Court acknowledged that one of the “cardinal rules” of usury is that “a contract, which, in its inception, is unaffected by usury, can never be invalidated by any subsequent usurious transaction.” See Nichols v. Pearson, 32 U.S. 109 (1833) (emphasis added); see also Gaither v. Farmers & Mech. Bank of Georgetown, 26 U.S. 37, 43 (1828) (“[F]or the rule cannot be doubted, that if the note free from usury, in its origin, no subsequent usurious transactions respecting it, can affect it with the taint of usury.”).
invalid or have its terms changed simply due to assignment.43 Midland further argued that three other circuits44 had recognized this valid-when-made principle in the context of evaluating the usurious nature of debt contracts, with Judge Posner of the Seventh Circuit colorfully concluding "once assignors were authorized to charge interest, the common law kicked in and gave the assignees the same right, because the common law puts the assignee in the assignor's shoes, whatever the shoe size."45 Furthermore, the briefs posited that the decision was already having a negative effect on the financial services industry.46 While debt collection is a small, but important part of the financial services industry, securitization of assets plays a giant role. The briefs note that banks have relied on the same exportation and assignment methods as used in Madden to securitize loan assets and have them be fully enforceable even when the bank retains no further interest in the loan. If there is liability for trying to enforce the interest rate the securitized assets after assignment, it presents a large hurdle for banks to be able to sell their loans in the securitization market. According to the amicus brief of the Clearing House Association, a trade group representing large commercial banks, Madden “casts doubt on whether any loan that is sold or transferred by its original lender remains free of usury” which could destabilize the assumptions that the loan securitization market has relied on for decades.47

Midland Funding, as well as the amici curiae supporting the petition for certiorari, also asserted that the Madden decision significantly interfered with banks’ powers under the National Bank Act arguing that the power to sells loans is linked to the power to originate loans under the National Bank Act.48 Under Barnett Bank of Marion County, North America v. Nelson, the Supreme Court held that state laws which “significantly impair the exercise of authority, enumerated or incidental under the [National Bank Act] . . . must give way” and be preempted by federal law.49 Using this framework, Midland argued that the Madden decision allowed New York state usury law to significantly interfere with banks’ powers to export interest rates in the wake of the Supreme Court’s Marquette decision and subsequent statutory provisions allowing national banks to export their home state usury rate unimpaired by any lower usury limit in a customer’s state.50 Thus, Midland argued that Madden would prevent banks from effectively being able to assign or securitize their loans without being impaired by the usury rate of the customer’s state. This, in turn, would mean that banks could not effectively export interest rates because they would need to have a lower interest rate if they ever wanted to sell the loans. According to Midland’s argument in its petition for certiorari this amounted to significant interference under the Barnett standard and thus preemption of New York’s usury laws would be proper.51

The Supreme Court issued an order calling for the views of the Solicitor General to weigh in on the case.52 The Solicitor General filed an amicus brief that was critical on the merits of the Madden ruling.53 First, the Solicitor General’s brief argued that the Second Circuit failed to recognize that the National Bank Act incorporated the common-law “valid-when-made” principle, which would allow a contract to remain valid after assignment.54 Second, the Solicitor General claimed that the Second Circuit took an interpretation federal preemption that was too narrow when deciding that preemption was inappropriate simply because the national bank did not retain any further interest in the loan it originated after assignment, and that in effect the bank did have an interest in the loan because if the bank is unable to sell the loan, it would have to keep it on its own

44 See, e.g., Olvera v. Blitt & Gaines, P.C., 431 F.3d 285 (7th Cir. 2005); Phipps v. FDIC, 417 F.3d 1006 (8th Cir. 2005); Krispin v. May Department Stores Co., 218 F.3d 919 (8th Cir. 2000); FDIC v. Lattimore Land Corp., 656 F.2d 139 (5th Cir. 1981).
45 Olvera, 431 F.3d at 289.
51 See Petition for Writ of Certiorari, supra note 35, at 17-20.
52 Midland Funding, LLC v. Madden, 136 S. Ct. 1484 (2016).
54 See id. at *9-10.
balance sheet.\(^{55}\) Finally, the Solicitor General argued that the *Madden* decision was at odds with the *Barnett* decision because banks engage in the practice of selling loans and the decision would fundamentally impair a national banks’ ability under federal law to originate and sell loans based on the usury rate of a bank’s home state.\(^{56}\) According to the Solicitor General, the proper interpretation of the National Bank Act is to defer to the maximum interest rate allowed in the bank’s home state and to completely preclude any other state from imposing a lower maximum rate either directly or indirectly.\(^{57}\) However, the Solicitor General ultimately urged the Supreme Court not to grant certiorari for three reasons: 1) there was no direct circuit split between the Second and Eighth Circuits; 2) issues of preemption were not properly presented at the court below; and 3) Midland may still win on remand on the choice-of-law issue despite the Second Circuit’s errors.\(^{58}\) Following the Solicitor General’s advice, the Supreme Court denied Midland’s petition for certiorari on June 27, 2016.\(^{59}\)

The Aftermath of the *Madden* Case

The *Madden* decision has already had an impact on both the loan securitization market as well as marketplace lending industry. After the Supreme Court’s decision not to hear *Madden*, lenders and purchasers of securitized debt assets became concerned about the status of their consumer loans that had any jurisdictional nexus to the Second Circuit and which were originated using banks’ exportation power to originate loans in excess of state usury limits.\(^{60}\) While the *Madden* ruling applies only to New York, Connecticut, and Vermont, a crop of lawsuits across the country have begun to challenge the exportation of interest rates based on contractual assignment to a non-bank assignee in the wake of the Second Circuit’s decision.\(^{61}\) Furthermore, beyond these challenges in other jurisdictions, *Madden* has had a “chilling effect” because customers outside of New York, Vermont and Connecticut seeking to file suit “could find a way to link their cases to Vermont, Connecticut or, more likely, New York.”\(^{62}\)

*Madden*’s impact looms large for banks because it has the power to “significantly disrupt the secondary market for bank loans[,]”\(^{63}\) On a more immediate level, *Madden* means that banks will no longer be able to effectively securitize or sell their consumer loans made to customers in New York, Vermont, or Connecticut where the exported interest rate is in excess of the respective state’s usury rate as any potential assignees will avoid purchasing such loans or security in such loans.\(^{64}\) Because of this, firms have already begun removing loans from borrowers in the New York, Vermont, and Connecticut from asset-back securitization markets due to usury concerns.\(^{65}\) *Madden* also means that banks may have to sell other debt assets at a discount due to the uncertainty surrounding an assignee’s ability to collect on the contract should other circuits opt to follow the Second Circuit’s precedent.\(^{66}\) This, in short, “rais[es] doubt about the enforceability of [a national bank’s] loan contracts and decreas[es] the marketability and value of every loan in its portfolio.”\(^{67}\) Furthermore, banks must

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55 See id.
56 See id. at 10-13.
57 See id. at 6-13.
58 See id. at 6.
64 See Kom & Gottlieb, supra note 48.
be wary of assignees exercising put-back rights or indemnity claims against the bank for any potential breaches of representations and warranties regarding the enforceability of the debt contract, creating a huge potential shift of liability to the banks.68 Finally, Madden has caused many third-party debt buyers to restructure their approach to buying debt, by pressuring banks to retain an on-going economic interest in the loans so that there is a colorable argument that the third-party is “acting on behalf of” a bank to try to circumvent the logic behind Madden’s holding.69 This restructuring would impair banks’ ability to maximize their capital to extend new loans and would also work to expose banks to an increased risk of default. For example, in the Madden case, Bank of America effectively sold a debt they did not believe their customer would pay back. By selling the debt, the bank recouped at least some value for the loan it extended and this capital (which would otherwise not be at the bank’s disposal) would then be available to extend credit to borrowers in the future.

The Madden decision has also had ramifications for other stakeholders in the financial system. For borrowers, Madden could potentially increase the cost of credit, as banks will likely shift at least some of the extra risk and uncertainty of not being able to properly securitize and sell the customer’s debt to the customer in the form of higher interest rates to even lower-risk borrowers.70 Additionally, Madden has caused the volume of loans to high-risk borrowers located under the Second Circuit’s jurisdiction to sharply decline in contrast to the rest of the country. Using data from marketplace lending resources, researchers from Stanford Law School, Columbia Law School, and Fordham Law School tracked the impact of the Madden decision. This study revealed that as of May, 2016, marketplace lending to high-risk borrowers has increased by 124% since the Madden decision in jurisdictions outside the Second Circuit, while lending to high-risk borrowers in Connecticut, New York and Vermont has declined by 48% over the same time frame.71 This includes a total of zero loans issued to borrowers with a FICO score below 625.72

Finally, for entities that have purchased debt either as an asset-backed security or as a debt servicer with a jurisdictional nexus to the Second Circuit, the Madden ruling means that they may need to approach each borrower on the other side of the loan to renegotiate terms in order to comply with state usury law, because the contracts would otherwise be unenforceable.73 Debt purchasers like Midland have particular cause for concern because they may be subject to criminal liability under state law and sanctions under the federal Fair Debt Collection Practices Act for attempting to collect on their assigned contracts that are now considered in excess of state usury limits.74 For instance, Midland attempted to collect on Madden’s debt at a 27% interest rate in New York where it is a Class C felony to attempt to collect on a debt above a 25% interest rate.75

In addition to the traditional banking industry, experts have also expressed concerns over the “acute risk” of the Madden decision’s impact on the growing marketplace lending industry.76 The specific risk to marketplace lending is the “potential to severely disrupt the partner bank origination model.”77 This impact

69 See id.
70 See Wheeler, supra note 60.
71 See Honigsberg et al., supra note 63, at 20.
72 See id. at 20, n. 45.
73 See N.Y. Gen. Oblig. Law § 5-511(1); Seidel, 598 N.E.2d at 9; Kaye Scholer LLP, supra note 68.
75 See N.Y. Penal Law § 190.42 (2015); Korn & Gottlieb, supra note 48.
necessarily extends to the banks who serve as partners to marketplace lending platforms which, like Web Bank, have business models substantially relying on marketplace lending to run a profitable business. While the marketplace lending industry does not typically rely on bank partnerships with national banks subject to the National Bank Act, they do rely on partnership with state banks, like Web Bank, who benefit from an identical power under federal law to export interest rates. Thus, following Madden’s logic, even a state bank in a partnership with a marketplace lending platform will likely no longer be able to originate loans with its marketplace lending platform in excess of the borrower’s home state usury limit in New York, Connecticut, or Vermont, with the risk that the Second Circuit’s holding could be adopted in other circuits as well. Furthermore, the trend of marketplace lending platforms not extending credit to high-risk borrowers is concerning in light of the fact that the U.S. Department of the Treasury has pointed to the potential of the marketplace lending industry to expand access to credit for under-banked populations. One additional fear that some state-chartered banks fear is that these marketplace lenders might avoid using the bank-partnership model and instead opt to directly compete with banks by becoming a licensed lender in their own right and begin utilizing a direct lending model.

**True Lender Cases – A Related Doctrine Spells Trouble for Marketplace Lenders**

A separate, but somewhat related line of cases have also tested the bank-partnership model of the marketplace lending industry through a “true lender” theory. The true lender theory posits that the loans arranged by marketplace lending platforms and originated by banks such as Web Bank should not be considered bank loans because the true lender-in-interest is the lending platform and not the bank. Most prominently, the Consumer Financial Protection Bureau argued this theory in a case it brought in U.S. District Court for Central District of California against CashCall, Inc., a payday lender which uses partner banks to finance its payday loan products. In the *CashCall* case, the district court judge ruled that CashCall, and not its bank partner (in this case it was a “tribal lending model” using a Native American tribe as the exempt lending entity, but it is analytically the same for national and a state-chartered banks) was the true lender in interest. This meant that the court considered CashCall, and not the bank-partner, to be the lending party based on the following factors: CashCall assumed all of the economic risks and benefits, took assignment of the loan before the customer’s first payment was due, funded a collateral account at the bank-partner, guaranteed a monthly fee, took on all of the default and regulatory risk, and had indemnified its bank-partner. In this case, the court looked beyond the form of the transaction and evaluated the totality of the circumstances to determine the substance of the arrangement. Because CashCall was the true lender-in-interest, the loans that the company arranged were deemed to be void and unenforceable on two grounds: 1) the loans were not exempt from usury limits and thus usurious; and 2) the loans were originated by CashCall — an entity that was not licensed to lend under the state laws where many CashCall borrowers were domiciled.

While the Central District of California federal case is the most prominent of the “true lender” cases, state courts have also recently applied similar logic in applying the true lender doctrine to the detriment of entities attempting to take advantage of the bank partnership model to export bank’s preemption powers to get around usury and licensing laws. While these cases have primarily been aimed at payday lenders, the rationale would seem to apply in equal effect to marketplace lenders utilizing a bank-partnership model to the same ends.

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83 See id. at 5-6.
84 See id. at 6.
85 See id. at 9.
86 See, e.g., *CashCall, Inc. v. Maryland Com’r of Fin. Regulation*, 139 A.3d 990 (Md. 2016).
as well. Like *Madden*, this line of true lender cases is a threat to state-chartered banks that rely on the bank-partnership model for its business. Due to the emergence of true lender problems, marketplace lenders may decide to forgo the bank-partnership model and decide to adopt a direct lending model instead, which would spell disaster for banks that rely on the bank-partnership model to generate business.88

However, it should be noted that the true lender doctrine is not being universally followed in all courts. In fact, the Central District of California—the same court that decided the *CFPB v. CashCall* case—opted not to apply the true lender analysis in *Beechum v. Navient Solutions, Inc.*89 *Beechum* was a student loan case where loans were originated by a national bank in excess of California’s usury rate and then assigned Navient, a student loan servicing company. When Navient sought to dismiss the case, the plaintiffs responded that following the logic of *CashCall*, Navient was the true lender-in-interest because Navient “originated, underwrote, funded and bore the risk of loss as to the loans.”90 The court, however, rejected the plaintiffs’ argument and opted to not look beyond the form of the transaction as had been done in *CashCall*. The court concluded that because the California Constitution provided an explicit exemption from its usury laws for banks’ that the court would decline to look beyond the form of the transaction to apply California’s usury laws.91 The logic applied in *Beechum* also appears to be at odds with the Second Circuit’s *Madden* opinion, so it is a case worth keeping an eye on through its appeal to the Ninth Circuit.

**Congressional Response**

In the wake of the Supreme Court’s decision to deny certiorari in the *Madden* case, Representative Patrick McHenry introduced H.R. 5724 “Protecting Consumer’s Access to Credit Act” in the United States House of Representatives.92 The purpose of the bill is to “reaffirm[] the longstanding legal precedent under the National Bank Act and the Federal Deposit Insurance Act that federal law preempts a loan’s interest as valid when made.”93 The bill is aimed as a specific rebuke of the Second Circuit’s *Madden* decision and is meant to undo the uncertainty for banks and credit markets created by the “unprecedented” reading by the Second Circuit.94 However, the bill has had no action in the five months since its introduction and referral to the House Financial Services Committee in July, 2016.95

**Consumer Issues — Concerns Regarding Payday Lenders and Predatory Debt Collection Practices**

Some actors in the financial system have taken advantage of the bank-partnership model and usury preemption to prey upon consumers who are in desperate need for credit. These predatory lending and debt collection practices are a widespread problem in the United States, affecting millions of consumers.96 Payday loans are short-term credit which are generally required to be repaid in a lump-sum single-payment upon receipt

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88 See Misberg & Baker, supra note 81.
91 See id.
93 Id.
94 Id.
Abusive debt collection practices regarding loans assigned by banks to third party debt collectors is also a concerning consumer protection issue. In 2014, the CFPB handled over 88,300 debt collection complaints, making debt collection the leading source of consumer complaints registered with the CFPB. 102 Debt collectors across the country have engaged in various abusive practices such as “phantom debt collection” whereby collectors attempt to collect debts that either do not exist or are not owed to the phantom debt collector, 103 calling individual debtors thousands of times, 104 and filing suits with faulty or unsubstantiated evidence to support a debt collection claim. 105 To illustrate the point, in CashCall v. Morrissey, the West Virginia Attorney General successfully sought action under West Virginia’s usury laws against CashCall, a third party debt collector that purchased and attempted to collect loans at interest rates as high as 89% and 96% and also engaged in the unscrupulous practice of calling some customers over 1,000 times. 106 While these abusive practices were not present in the Madden case, the ABA should be cognizant moving forward that these practices do exist and that consumer protection is an important issue that ought to be recognized as part of legal challenges moving forward.

What to Do?

Based on the above information, the director of the ABA wishes for you to develop a comprehensive legal strategy in the face of Madden and the true lender litigation. The director wishes to hear your proposals regarding the following:

98 See id. at 47869 (noting that most payday lenders charge $15 for each $100 loaned and basing the estimate on the fact that the median payday loan amount is $350 which, when accompanied by average fees and finance charges on payday loans, amounts to a total cost of a median short-term loan at $402.50).
100 See id. at 47877.
101 See id. at 47883-85.
103 See Consumer Fin. Prot. Bureau, supra note 97, at 34-35.
105 See Consumer Fin. Prot. Bureau, supra note 97, at 23 (noting that a single firm in Georgia filed over 350,000 debt collection suits in Georgia alone from 2009 to 2013, with a single attorney responsible for over 130,000 of them in a two-year period).
• **Litigation:**
  - Is further litigation the correct route? What would this litigation strategy look like and where would you bring the case(s)?
  - Is this the right time to try to “seek” a circuit split and attempt to have the Supreme Court finally weigh in on the merits of the *Madden* case? What are the risks of seeking further litigation? Is the possibility of “nationalizing” the *Madden* decision and spreading its deleterious effects to other jurisdictions worth the potential benefits?
  - What other groups or organizations might make for good litigation partners moving forward, and how might you convince them join your litigation strategy? For example, a consortium of marketplace lenders may wish to seek similar results in litigation, but beyond the few state-chartered bank-partners in the industry, many banks view marketplace lenders as direct competitors. Or, would the surprising step of engaging with consumer groups make sense? Consumer groups have applauded the *Madden* decision because it strengthens state usury laws, but consumers have also been hurt by the decision in the form of higher costs of borrowing to even being completely shut out of some lending markets (as demonstrated above).
  - How do you handle the competing interests within the ABA’s constituency? Large commercial banks are concerned primarily with the securitization markets and would not necessarily want ABA resources being diverted to dealing with the effects of the true lender cases, while smaller state banks that are bank-partners may wish to have true lender cases actively dealt with because their entire business model relies upon that model.

• **Lobbying Efforts**
  - What steps would you take, if any, to lobby policymakers or regulators to best represent the interest of the financial services industry? Are there any outside-the-box solutions beyond Representative McHenry’s bill — perhaps one that could appease both consumer groups and banks in order to gain enough consensus to pass a bill into law? How would you aim to build a coalition to achieve this type of consensus?

• **Advice to Banks**
  - Finally, in your capacity as a lawyer, what advice would you give both in-house and outside counsel to the ABA’s member banks? What steps should they be taking in order to minimize the impact of these recent litigation developments?
  - What type of structure might avoid the impact of the *Madden* ruling moving forward? If the *Madden* ruling is premised on banks not having any “skin in the game” because the third-party was not “acting on behalf of” a bank, is there any way to get around this technicality? But, if your advice is for banks to retain some ongoing economic interest in each of their loans, how do you respond to concerns that this might limit future extensions of credit (because of less capital to lend) and also increase bank’s risk of default? Is there any argument to be made to prudential regulators about the increased risk present in the financial system when banks are retaining too much risk of default on their balance sheet when this risk was previously non-existent because the loans were able to be effectively sold?
  - How do you advise banks that have loans to customers in New York, Connecticut, or Vermont that they wish to sell or securitize? What should these banks tell their potential assignees?
  - How should banks handle the representations and warranties clauses in their previously-sold loans that have a jurisdictional nexus to the Second Circuit?
  - How should banks that have bank-partnership arrangements with marketplace lenders structure the transaction in order to avoid the uncertainty surrounding the true lender doctrine?

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57 See Korn & Gottlieb, *supra* note 48.
APPENDIX
Appendix Item 1
THE SUBPRIME mortgage crisis that began in 2007 has given the decades-old concept of securitization a bad name. Securitization is the process in which certain types of assets are pooled so that they can be repackaged into interest-bearing securities. The interest and principal payments from the assets are passed through to the purchasers of the securities.

Securitization got its start in the 1970s, when home mortgages were pooled by U.S. government-backed agencies. Starting in the 1980s, other income-producing assets began to be securitized, and in recent years the market has grown dramatically. In some markets, such as those for securities backed by risky subprime mortgages in the United States, the unexpected deterioration in the quality of some of the underlying assets undermined investor confidence. Both the scale and persistence of the attendant credit crisis seem to suggest that securitization—together with poor credit origination, inadequate valuation methods, and insufficient regulatory oversight—could severely hurt financial stability.

Increasing numbers of financial institutions employ securitization to transfer the credit risk of the assets they originate from their balance sheets to those of other financial institutions, such as banks, insurance companies, and hedge funds. They do it for a variety reasons. It is often cheaper to raise money through securitization, and securitized assets were then less costly for banks to hold because financial regulators had different standards for them than for the assets that underpinned them. In principle, this “originate and distribute” approach brought broad economic benefits too—spreading out credit exposures, thereby diffusing risk concentrations and reducing systemic vulnerabilities.

Until the subprime crisis unfolded, the impact of securitization appeared largely to be positive and benign. But securitization also has been indicted by some for compromising the incentives for originators to ensure minimum standards of prudent lending, risk management, and investment, at a time when low returns on conventional debt products, default rates below the historical experience, and the wide availability of hedging tools were encouraging investors to take more risk to achieve a higher yield. Many of the loans were not kept on the balance sheets of those who securitized them, perhaps encouraging originators to cut back on screening and monitoring borrowers, resulting possibly in a systematic deterioration of lending and collateral standards.

The securitization process
In its most basic form, the process involves two steps (see chart). In step one, a company with loans or other income-producing assets—the originator—identifies the assets it wants to remove from its balance sheet and pools them into what is called the reference portfolio. It then sells this asset pool to an issuer, such as a special purpose vehicle (SPV)—an entity set up, usually by a financial institution, specifically to purchase the assets and realize their off-balance-sheet treatment for legal and accounting purposes. In step two, the issuer finances the acquisition of the pooled assets by issuing tradable, interest-bearing securities that are sold to capital market investors. The investors receive fixed or floating rate payments from a trustee account funded by the cash flows generated by the reference portfolio. In most cases, the originator services the loans in the portfolio, collects payments from the original borrowers, and passes them on—less a servicing fee—directly to the SPV or the trustee. In essence,
Securitization represents an alternative and diversified source of finance based on the transfer of credit risk (and possibly also interest rate and currency risk) from issuers to investors.

In a more recent refinement, the reference portfolio is divided into several slices, called tranches, each of which has a different level of risk associated with it and is sold separately. Both investment return (principal and interest repayment) and losses are allocated among the various tranches according to their seniority. The least risky tranche, for example, has first call on the income generated by the underlying assets, while the riskiest has last claim on that income. The conventional securitization structure assumes a three-tier security design—junior, mezzanine, and senior tranches. This structure concentrates expected portfolio losses in the junior, or first loss position, which is usually the smallest of the tranches but the one that bears most of the credit exposure and receives the highest return. There is little expectation of portfolio losses in senior tranches, which, because investors often finance their purchase by borrowing, are very sensitive to changes in underlying asset quality. It was this sensitivity that was the initial source of the problems in the subprime mortgage market last year. When repayment issues surfaced in the riskiest tranches, lack of confidence spread to holders of more senior tranches—causing panic among investors and a flight into safer assets, resulting in a fire sale of securitized debt.

Securitization was initially used to finance simple, self-liquidating assets such as mortgages. But any type of asset with a stable cash flow can in principle be structured into a reference portfolio that supports securitized debt. Securities can be backed not only by mortgages but by corporate and sovereign loans, consumer credit, project finance, lease/trade receivables, and individualized lending agreements. The generic name for such instruments is asset-backed securities (ABS), although securitization transactions backed by mortgage loans (residential or commercial) are called mortgage-backed securities. A variant is the collateralized debt obligation, which uses the same structuring technology as an ABS but includes a wider and more diverse range of assets.

The allure of securitizing

Securitization started as a way for financial institutions and corporations to find new sources of funding—either by moving assets off their balance sheets or by borrowing against them to refinance their origination at a fair market rate. It reduced their borrowing costs and, in the case of banks, lowered regulatory minimum capital requirements.

For example, suppose a leasing company needed to raise cash. Under standard procedures, the company would take out a loan or sell bonds. Its ability to do so, and the cost, would depend on its overall financial health and credit rating. If it could find buyers, it could sell some of the leases directly, effectively converting a future income stream to cash. The problem is that there is virtually no secondary market for individual leases. But by pooling those leases, the company can raise cash by selling the package to an issuer, which in turn converts the pool of leases into a tradable security.

Moreover, the assets are detached from the originator’s balance sheet (and its credit rating), allowing issuers to raise funds to finance the purchase of assets more cheaply than would be possible on the strength of the originator’s balance sheet alone. For instance, a company with an overall “B” rating with “AAA”-rated assets on its books might be able to raise funds at an “AAA” rather than “B” rating by securitizing those assets. Unlike conventional debt, securitization does not inflate a company’s liabilities. Instead it produces funds for future investment without balance sheet growth.

Investors benefit from more than just a greater range of investible assets made available through securitization. The flexibility of securitization transactions also helps issuers tailor the risk-return properties of tranches to the risk tolerance of investors. For instance, pension funds and other collective investment schemes require a diverse range of highly rated long-term fixed-income investments beyond what the public debt issuance by governments can provide. If securitized debt is traded, investors can quickly adjust their individual exposure to credit-sensitive assets in response to changes in personal risk sensitivity, market sentiment, and consumption preferences at low transaction cost.

Sometimes the originators do not sell the securities outright to the issuer (called “true sale securitization”) but instead sell only the credit risk associated with the assets without the transfer of legal title (“synthetic securitization”). Synthetic securitization helps issuers exploit price differences between the acquired (and often illiquid) assets and the price investors are willing to pay for them (if diversified in a greater pool of assets).

Growth of securitization

The landscape of securitization has changed dramatically in the last decade. No longer is it wed to traditional assets with specific terms such as mortgages, bank loans, or consumer loans (called self-liquidating assets). Improved modeling and risk quantification as well as greater data availability have encouraged issuers to consider a wider variety of asset types, including home equity loans, lease receivables, and small business loans, to name a few. Although most issuance is concentrated in mature markets, securitization has also registered significant growth in emerging markets, where large and highly rated corporate entities and banks have used securitization to turn future cash flow from hard-currency export receivables or remittances into current cash.

In the future, securitized products are likely to become simpler. After years of posting virtually no capital reserves against highly rated securitized debt, issuers will soon be faced with regulatory changes that will require higher capital charges and more comprehensive valuation. Reviving securitization transactions and restoring investor confidence might also require issuers to retain interest in the performance of securitized assets at each level of seniority, not just the junior tranche.

Andreas Jobst is an Economist in the IMF’s Monetary and Capital Markets Department.

Finance & Development September 2008 49
Appendix Item 2
Asset Securitization

Comptroller’s Handbook

November 1997
Asset Securitization

Introduction

Background

Asset securitization is helping to shape the future of traditional commercial banking. By using the securities markets to fund portions of the loan portfolio, banks can allocate capital more efficiently, access diverse and cost-effective funding sources, and better manage business risks.

But securitization markets offer challenges as well as opportunity. Indeed, the successes of nonbank securitizers are forcing banks to adopt some of their practices. Competition from commercial paper underwriters and captive finance companies has taken a toll on banks’ market share and profitability in the prime credit and consumer loan businesses. And the growing competition within the banking industry from specialized firms that rely on securitization puts pressure on more traditional banks to use securitization to streamline as much of their credit and originations business as possible. Because securitization may have such a fundamental impact on banks and the financial services industry, bankers and examiners should have a clear understanding of its benefits and inherent risks.

This booklet begins with an overview of the securitization markets, followed by a discussion of the mechanics of securitization. The discussion evolves to the risks of securitization and how, at each stage of the process, banks are able to manage those risks.

A central theme of this booklet is the bank’s use of asset securitization as a means of funding, managing the balance sheet, and generating fee income. The discussion of risk focuses on banks’ roles as financial intermediaries, that is, as loan originators and servicers rather than as investors in asset-backed securities. Although purchasing asset-backed securities as investments clearly helps to diversify assets and manage credit quality, these benefits are discussed in other OCC publications, such as the “Investment Securities” section of the Comptroller’s Handbook.
Definition

Asset securitization is the structured process whereby interests in loans and other receivables are packaged, underwritten, and sold in the form of “asset-backed” securities. From the perspective of credit originators, this market enables them to transfer some of the risks of ownership to parties more willing or able to manage them. By doing so, originators can access the funding markets at debt ratings higher than their overall corporate ratings, which generally gives them access to broader funding sources at more favorable rates. By removing the assets and supporting debt from their balance sheets, they are able to save some of the costs of on-balance-sheet financing and manage potential asset-liability mismatches and credit concentrations.

Brief History

Asset securitization began with the structured financing of mortgage pools in the 1970s. For decades before that, banks were essentially portfolio lenders; they held loans until they matured or were paid off. These loans were funded principally by deposits, and sometimes by debt, which was a direct obligation of the bank (rather than a claim on specific assets).

But after World War II, depository institutions simply could not keep pace with the rising demand for housing credit. Banks, as well as other financial intermediaries sensing a market opportunity, sought ways of increasing the sources of mortgage funding. To attract investors, investment bankers eventually developed an investment vehicle that isolated defined mortgage pools, segmented the credit risk, and structured the cash flows from the underlying loans. Although it took several years to develop efficient mortgage securitization structures, loan originators quickly realized the process was readily transferable to other types of loans as well.

Since the mid 1980s, better technology and more sophisticated investors have combined to make asset securitization one of the fastest growing activities in the capital markets. The growth rate of nearly every type of securitized asset has been remarkable, as have been the increase in the types of companies using securitization and the expansion of the investor base. The business of a credit intermediary has so changed that few banks, thrifts,
Market Evolution

The market for mortgage-backed securities was boosted by the government agencies that stood behind these securities. To facilitate the securitization of nonmortgage assets, businesses substituted private credit enhancements. First, they overcollateralized pools of assets; shortly thereafter, they improved third-party and structural enhancements. In 1985, securitization techniques that had been developed in the mortgage market were applied for the first time to a class of nonmortgage assets — automobile loans. A pool of assets second only to mortgages, auto loans were a good match for structured finance; their maturities, considerably shorter than those of mortgages, made the timing of cash flows more predictable, and their long statistical histories of performance gave investors confidence.

The first significant bank credit card sale came to market in 1986 with a private placement of $50 million of bank card outstandings. This transaction demonstrated to investors that, if the yields were high enough, loan pools could support asset sales with higher expected losses and administrative costs than was true within the mortgage market. Sales of this type — with no contractual obligation by the seller to provide recourse — allowed banks to receive sales treatment for accounting and regulatory purposes (easing balance sheet and capital constraints), while at the same time allowing them to retain origination and servicing fees. After the success of this initial transaction, investors grew to accept credit card receivables as collateral, and banks developed structures to normalize the cash flows.

The next growth phase of securitization will likely involve nonconsumer assets. Most retail lending is readily “securitizable” because cash flows are predictable. Today, formula-driven credit scoring and credit monitoring techniques are widely used for such loans, and most retail programs produce fairly homogeneous loan portfolios. Commercial financing presents a greater challenge. Because a portfolio of commercial loans is typically less homogeneous than a retail portfolio, someone seeking to invest in them must often know much more about each individual credit, and the simpler tools for
measuring and managing portfolio risk are less effective. Nonetheless, investment bankers and asset originators have proven extremely innovative at structuring cash flows and credit enhancements. Evidence of this can be seen in the market for securitized commercial real estate mortgages. Commercial real estate is one of the fastest-growing types of nonconsumer assets in the securitization markets, which fund approximately 10 percent of commercial mortgage debt.

**Benefits of Asset Securitization**

The evolution of securitization is not surprising given the benefits that it offers to each of the major parties in the transaction.

**For Originators**

Securitization improves returns on capital by converting an on-balance-sheet lending business into an off-balance-sheet fee income stream that is less capital intensive. Depending on the type of structure used, securitization may also lower borrowing costs, release additional capital for expansion or reinvestment purposes, and improve asset/liability and credit risk management.

**For Investors**

Securitized assets offer a combination of attractive yields (compared with other instruments of similar quality), increasing secondary market liquidity, and generally more protection by way of collateral overages and/or guarantees by entities with high and stable credit ratings. They also offer a measure of flexibility because their payment streams can be structured to meet investors’ particular requirements. Most important, structural credit enhancements and diversified asset pools free investors of the need to obtain a detailed understanding of the underlying loans. This has been the single largest factor in the growth of the structured finance market.

**For Borrowers**

Borrowers benefit from the increasing availability of credit on terms that lenders may not have provided had they kept the loans on their balance
sheets. For example, because a market exists for mortgage-backed securities, lenders can now extend fixed rate debt, which many consumers prefer over variable rate debt, without overexposing themselves to interest rate risk. Credit card lenders can originate very large loan pools for a diverse customer base at lower rates than if they had to fund the loans on their balance sheet. Nationwide competition among credit originators, coupled with strong investor appetite for the securities, has significantly expanded both the availability of credit and the pool of cardholders over the past decade.
Appendix Item 3
Inside

A Framework for Cybersecurity

Marketplace Lending

Lending Viewpoint: Results from the FDIC’s Credit and Consumer Products/Services Survey

Regulatory and Supervisory Roundup
Marketplace Lending

Marketplace lending is a small but growing alternative to traditional financial services for consumers and small businesses. Attracted by opportunities for earnings growth, some banks have entered the marketplace lending business either as investors or through third-party arrangements. As with any new and emerging line of business, marketplace lending can present risks. Financial institutions can manage these risks through proper risk identification, appropriate risk-management practices, and effective oversight. Conversely, failure to understand and manage these risks may expose a financial institution to financial loss, regulatory action, and litigation, and may even compromise an institution’s ability to service new or existing customer relationships. Before participating in marketplace lending, financial institution management should identify potential vulnerabilities and implement an effective risk-management strategy that protects the bank from undue risk.

This article is intended to heighten bankers’ and examiners’ understanding of marketplace lending and potential associated risks, including those arising in third-party arrangements. The article also highlights the importance of a pragmatic business strategy that considers the degree of risk together with the potential revenue stream, and emphasizes the importance of banks exercising the same due diligence they practice whenever they extend credit to a borrower.

Marketplace Lending Defined

For purposes of this article, marketplace lending is broadly defined to include any practice of pairing borrowers and lenders through the use of an online platform without a traditional bank intermediary. Although the model, originally started as a “peer-to-peer” concept for individuals to lend to one another, the market has evolved as more institutional investors have become interested in funding the activity. As such, the term “peer-to-peer lending” has become less descriptive of the business model and current references to the activity generally use the term “marketplace lending.”

Marketplace lending typically involves a prospective borrower submitting a loan application online where it is assessed, graded, and assigned an interest rate using the marketplace lending company’s proprietary credit scoring tool. Credit grades are assigned based on the marketplace lending company’s unique scoring algorithm, which often gives consideration to a borrower’s credit score, debt-to-income ratio, income, and other factors set by the marketplace lender. Once the application process is complete, the loan request is advertised for retail investors to review and pledge funds based on their investment criteria. A loan will fund from the monies collected if investors pledge sufficient capital before the deadline stated in the loan request (e.g., 14 days after the request is posted). As an alternative to funding loans through such retail investments, institutional investors can provide funding through whole loan purchases or direct securitizations.

When a borrower’s requested loan amount is fully pledged, the market-
place lending company originates and funds the loan through one of two frameworks: 1) the company lends the funds directly (subsequently referred to as a “direct marketplace lender”) or 2) the company partners with a traditional bank to facilitate the loan transaction (subsequently referred to as a “bank-affiliated marketplace company”).

A direct marketplace lender typically is required to be registered and licensed to lend in the respective state(s) in which it conducts business. Direct marketplace lenders facilitate all elements of the transaction, including collecting borrower applications, assigning credit ratings, advertising the loan request, pairing borrowers with interested investors, originating the loan, and servicing any collected loan payments. As part of the transaction, direct marketplace lenders issue investors either registered or unregistered security notes (subsequently referred to as “security notes”) in exchange for the investments used to fund the
loan. Consequently, the borrower’s repayment obligation remains with the direct marketplace lender, the security notes issued to investors become the obligation of the direct marketplace lender, and the investors are unsecured creditors of the direct marketplace lender. (See Figure 1 on the previous page for an illustration of this process.)

Some marketplace lending companies operate under the second framework by working through a cooperative arrangement with a partner bank. In these cases, the bank-affiliated marketplace company collects borrower applications, assigns the credit grade, and solicits investor interest. However, from that point the bank-affiliated marketplace company refers the completed loan application packages to the partner bank that makes the loan to the borrower. The partner bank typically holds the loan on its books for 2-3 days before selling it to the bank-affiliated marketplace company. Once the bank-affiliated marketplace company purchases the loan from the partner bank, it issues security notes up to the purchase amount to its retail investors who pledged to fund the loan. By the end of the sequence of transactions, the borrower’s repayment obligation transfers to the bank-affiliated marketplace company, and the security noteholder maintains an unsecured creditor status to the bank-affiliated marketplace company, which mirrors the outcomes described under the direct funding framework (see Figure 2 on the previous page). In certain circumstances, some institutional investors may invest in whole loan transactions, which are often arranged directly between the interested parties and outside any cooperative arrangement with a partner bank.

Once the process is complete, borrowers begin making fixed monthly payments to the bank-affiliated marketplace company which issues a pro rata payment to the investor, less loan servicing fees.

Common barriers to entry for banks and other traditional financial services entities include state licensure laws, capital requirements, access to financing, regulatory compliance, and security concerns. Some of these barriers may not exist for marketplace lending companies. New start-up marketplace lenders may be established quickly and often with a unique niche to capture a particular share of the market. In 2009, industry analysts with IBISWorld identified at least three marketplace lending companies; by 2014, the number had grown to 63 marketplace lending companies. As of September 2015, the number of established marketplace lending companies totaled 163 with new entrants continuing to join the competitive market.

Concomitant with the increasing number of market participants, new or expanded product lines are introduced as companies attempt to establish a niche position in the market. Some examples of marketplace loan products include unsecured

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consumer loans, debt consolidation loans, auto loans, purchase financing, education financing, real estate lending, merchant cash advance, medical patient financing, and small business loans.

**The Importance of Effective Risk Identification**

The marketplace lending business model depends largely on the willingness of investors to take on the credit risk of an unsecured consumer, small business owner, or other borrower. Given the market’s infancy and that it has primarily existed in an environment of low and steady interest rates, current credit loss reports or loss-adjusted rates of return may not provide an accurate picture of the risks associated with each marketplace lending product.

Further, each marketplace lending company’s risk level and composition varies depending on the business model or credit offering, with potentially significant variations across credit products. Given the credit model variations that exist, using a nonspecific approach to risk identification could lead to an incomplete risk analysis in the bank’s marketplace investments or critical gaps in bank management’s planning and oversight of third-party arrangements. As such, banks should perform a thorough pre-analysis and risk assessment on each marketplace lending company with which it transacts business, whether acting as an institutional investor or as a strategic partner.³

A comprehensive list of risks associated with marketplace lending is not possible without an understanding of the arranged lending activity and the products offered. Although not a complete list, some risks include third-party, credit, compliance, liquidity, transaction, servicing, and bankruptcy risks. Before engaging in marketplace activity, banks should complete appropriate due diligence and ensure effective risk identification practices are in place as part of the risk assessment process.

**Third-party risk** can vary greatly depending on each third-party arrangement, elevating the importance for banks to conduct effective due diligence. Banks are encouraged to review the FDIC’s Financial Institution Letter 44-2008 titled *Guidance for Managing Third-Party Risk*,⁴ which discusses the critical elements to an effective third-party risk management process: (1) risk assessment, (2) due diligence in selecting a third party, (3) contract structuring and review, and (4) oversight.

Before engaging in any third-party arrangement, a financial institution should consider whether the proposed activities are consistent with the institution’s overall business strategy and risk tolerances. Bank management is encouraged to develop a strong understanding of the marketplace lending company’s business model, establish contractual agreements that protect the bank from risk, regularly monitor the marketplace service provider, and require the marketplace lending company to take corrective action.

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Appendix Item 4
Thus, the FSA had no effect on the supervised release portion of Johnson’s pre-FSA sentence.

CONCLUSION

For the foregoing reasons, we AFFIRM the judgment of the district court.

Saliha MADDEN, on behalf of herself and all others similarly situated, Plaintiff–Appellant,

v.

MIDLAND FUNDING, LLC, Midland Credit Management, Inc., Defendants–Appellees.

No. 14–2131–cv.

United States Court of Appeals, Second Circuit.

Argued: March 19, 2015.
Decided: May 22, 2015.

Background: Credit card customer of national bank brought putative class action against debt collector, who had purchased customer’s debt from the bank, claiming that collector violated the Fair Debt Collection Practices Act (FDCPA) and New York usury law by charging and attempting to collect interest at a rate higher than that permitted under New York law. The United States District Court for the Southern District of New York, Cathy Seibel, J., denied class action certification and entered judgment for debt collector. Customer appealed.

Holding: The Court of Appeals, Straub, Circuit Judge, held that the National Bank Act (NBA) did not preempt customer’s claims that debt collector violated New York usury laws by charging and attempting to collect interest at an impermissibly high rate.

Reversed in part, vacated in part, and remanded.

1. Banks and Banking ⇝232

“National banks” are corporate entities chartered not by any State, but by the Comptroller of the Currency of the United States Department of the Treasury.

See publication Words and Phrases for other judicial constructions and definitions.

2. Banks and Banking ⇝270(5)
States ⇝18.19

National Bank Act (NBA) did not preempt credit card customer’s putative class action claims that debt collector violated New York usury laws by charging and attempting to collect interest at a rate higher than that permitted under New York law, even though debt collector was assignee of national bank that had issued the credit card, where debt collector, who had purchased the debt from the issuer, acted on its own behalf, and not on behalf of the issuer, in attempting to collect on the debt. 12 U.S.C.A. § 85; N.Y.McKinney’s General Business Law § 349; N.Y.McKinney’s Penal Law § 190.40.

3. States ⇝18.3

Preemption can generally occur in three ways: where Congress has expressly preempted state law, where Congress has legislated so comprehensively that federal law occupies an entire field of regulation and leaves no room for state law, or where federal law conflicts with state law.

4. Banks and Banking ⇝270(1)
States ⇝18.19

National Bank Act (NBA) provides the exclusive cause of action for usury
127–28, both of which were disputed with respect to Madden. Similarly, the court held that the requirements of Rule 23(b)(2) (relief sought appropriate to class as a whole) and (b)(3) (common questions of law or fact predominate) were not satisfied “because there is no showing that the circumstances of each proposed class member are like those of Plaintiff, and because the resolution will turn on individual determinations as to cardholder agreements and assignments of debt.” Id. at 128.

On May 30, 2014, the parties entered into a “Stipulation for Entry of Judgment for Defendants for Purpose of Appeal.” Id. at 135. The parties stipulated that FIA had assigned Madden’s account to the defendants and that Madden had received the Cardholder Agreement and Change In Terms. This stipulation disposed of the two genuine disputes of material fact identified by the District Court, and provided that “a final, appealable judgment in favor of Defendants is appropriate.” Id. at 138. The District Court “so ordered” the Stipulation for Entry of Judgment.

This timely appeal followed.

DISCUSSION

Madden argues on appeal that the District Court erred in holding that NBA preemption bars her state-law usury claims. We agree. Because neither defendant is a national bank nor a subsidiary or agent of a national bank, or is otherwise acting on behalf of a national bank, and because application of the state law on which Madden’s claims rely would not significantly interfere with any national bank’s ability to exercise its powers under the NBA, we reverse the District Court’s holding that the NBA preempts Madden’s claims and accordingly vacate the judgment of the District Court. We also vacate the District Court’s judgment as to Madden’s FDCPA claim and the denial of class certification because those rulings were predicated on the same flawed preemption analysis.

The defendants contend that even if we find that Madden’s claims are not preempted by the NBA, we must affirm because Delaware law—rather than New York law—applies and the interest charged by the defendants is permissible under Delaware law. Because the District Court did not reach this issue, we leave it to the District Court to address in the first instance on remand.

I. National Bank Act Preemption

[2] The federal preemption doctrine derives from the Supremacy Clause of the United States Constitution, which provides that “the Laws of the United States which shall be made in Pursuance” of the Constitution “shall be the supreme Law of the Land.” U.S. Const. art. VI, cl. 2. According to the Supreme Court, “[t]he phrase ‘Laws of the United States’ encompasses both federal statutes themselves and federal regulations that are properly adopted in accordance with statutory authorization.”


[3] “Preemption can generally occur in three ways: where Congress has expressly preempted state law, where Congress has legislated so comprehensively that federal law occupies an entire field of regulation and leaves no room for state law, or where federal law conflicts with state law.” Wachovia Bank, N.A. v. Burke, 414 F.3d 305, 313 (2d Cir.2005), cert. denied, 550 U.S. 913, 127 S.Ct. 2093, 167 L.Ed.2d 830 (2007). The defendants appear to suggest that this case involves “conflict preemption,” which “occurs when compliance with both state and federal law is impossible, or when the state law stands as an obstacle to the accomplishment and execution of the

[4] The National Bank Act expressly permits national banks to “charge on any loan ... interest at the rate allowed by the laws of the State, Territory, or District where the bank is located.” 12 U.S.C. § 85. It also “provide[s] the exclusive cause of action” for usury claims against national banks, Beneficial Nat’l Bank v. Anderson, 539 U.S. 1, 11, 123 S.Ct. 2058, 156 L.Ed.2d 1 (2003), and “therefore completely preempt[s] analogous state-law usury claims,” Sullivan v. Am. Airlines, Inc., 424 F.3d 267, 275 (2d Cir.2005). Thus, there is “no such thing as a state-law claim of usury against a national bank.” Beneficial Nat’l Bank, 539 U.S. at 11, 123 S.Ct. 2058; see also Pac. Capital Bank, N.A. v. Connecticut, 542 F.3d 341, 352 (2d Cir.2008) (“[A] state in which a national bank makes a loan may not permissibly require the bank to charge an interest rate lower than that allowed by its home state.”). Accordingly, because FIA is incorporated in Delaware, which permits banks to charge interest rates that would be usurious under New York law, FIA’s collection at those rates in New York does not violate the NBA and is not subject to New York’s stricter usury laws, which the NBA preempts.

[5] The defendants argue that, as assignees of a national bank, they too are allowed under the NBA to charge interest at the rate permitted by the state where the assignor national bank is located—here, Delaware. We disagree. In certain circumstances, NBA preemption can be extended to non-national bank entities. To apply NBA preemption to an action taken by a non-national bank entity, application of state law to that action must significantly interfere with a national bank’s ability to exercise its power under the NBA. See Barnett Bank of Marion Cnty., N.A. v. Nelson, 517 U.S. 25, 33, 116 S.Ct. 1103, 134 L.Ed.2d 237 (1996); Pac. Capital Bank, 542 F.3d at 353.

The Supreme Court has suggested that NBA preemption may extend to entities beyond a national bank itself, such as non-national banks acting as the “equivalent to national banks with respect to powers exercised under federal law.” Watters v. Wachovia Bank, N.A., 550 U.S. 1, 18, 127 S.Ct. 1559, 167 L.Ed.2d 389 (2007). For example, the Supreme Court has held that operating subsidiaries of national banks may benefit from NBA preemption. Id.; see also Burke, 414 F.3d at 309 (deferring to reasonable regulation that operating subsidiaries of national banks receive the same preemptive benefit as the parent bank). This Court has also held that agents of national banks can benefit from NBA preemption. Pac. Capital Bank, 542 F.3d at 353–54 (holding that a third-party tax preparer who facilitated the processing of refund anticipation loans for a national bank was not subject to Connecticut law regulating such loans); see also SPGCC, LLC v. Ayotte, 488 F.3d 525, 532 (1st Cir.2007) (“The National Bank Act explicitly states that a national bank may use ‘duly authorized officers or agents’ to exercise its incidental powers.” (internal citation omitted)), cert. denied, 552 U.S. 1185, 128 S.Ct. 1258, 170 L.Ed.2d 68 (2008).

Banks may pursue collection of delinquent accounts by (1) handling the collections internally, (2) using third parties as agents in collecting the debt, or (3) selling the debt to debt buyers for a fee.

In most cases in which NBA preemption has been applied to a non-national bank entity, the entity has exercised the powers of a national bank—i.e., has acted on behalf of a national bank in carrying out the national bank's business. This is not the case here. The defendants did not act on behalf of BoA or FIA in attempting to collect on Madden's debt. The defendants acted solely on their own behalves, as the owners of the debt.

No other mechanism appears on these facts by which applying state usury laws to the third-party debt buyers would significantly interfere with either national bank's ability to exercise its powers under the NBA. See Barnett Bank, 517 U.S. at 33, 116 S.Ct. 1103. Rather, such application would “limit[ ] only activities of the third party which are otherwise subject to state control,” SPGGC, LLC v. Blumenthal, 505 F.3d 183, 191 (2d Cir.2007), and which are not protected by federal banking law or subject to OCC oversight.

We reached a similar conclusion in Blumenthal. There, a shopping mall operator, SPGGC, sold prepaid gift cards at its malls, including its malls in Connecticut. Id. at 186. Bank of America issued the cards, which looked like credit or debit cards and operated on the Visa debit card system. Id. at 186–87. The gift cards included a monthly service fee and carried a one-year expiration date. Id. at 187.

The Connecticut Attorney General sued SPGGC alleging violations of Connecticut's gift card law, which prohibits the sale of gift cards subject to inactivity or dormancy fees or expiration dates. Id. at 187–88. SPGGC argued that NBA preemption precluded suit. Id. at 189.

We held that SPGGC failed to state a valid claim for preemption of Connecticut law insofar as the law prohibited SPGGC from imposing inactivity fees on consumers of its gift cards. Id. at 191. We reasoned that enforcement of the state law “does not interfere with BoA's ability to exercise its powers under the NBA and OCC regulations.” Id. “Rather, it affects only the conduct of SPGGC, which is neither protected under federal law nor subject to the OCC's exclusive oversight.” Id.

We did find, in Blumenthal, that Connecticut's prohibition on expiration dates could interfere with national bank powers because Visa requires such cards to have expiration dates and “an outright prohibition on expiration dates could have prevented a Visa member bank (such as BoA) from acting as the issuer of the Simon Giftcard.” Id. at 191. We remanded for further consideration of the issue. Here, however, state usury laws would not prevent consumer debt sales by national banks to third parties. Although it is possible that usury laws might decrease the amount a national bank could charge for its consumer debt in certain states (i.e., those with firm usury limits, like New York), such an effect would not “significantly interfere” with the exercise of a national bank power.

Furthermore, extension of NBA preemption to third-party debt collectors such as the defendants would be an overly broad application of the NBA. Although national banks' agents and subsidiaries exercise national banks' powers and receive protection under the NBA when doing so,
extending those protections to third parties would create an end-run around usury laws for non-national bank entities that are not acting on behalf of a national bank.

The defendants and the District Court rely principally on two Eighth Circuit cases in which the court held that NBA preemption precluded state-law usury claims against non-national bank entities. In *Krispin v. May Department Stores*, 218 F.3d 919 (8th Cir.2000), May Department Stores Company (“May Stores”), a non-national bank entity, issued credit cards to the plaintiffs. *Id.* at 921. By agreement, those credit card accounts were governed by Missouri law, which limits delinquency fees to $10. *Id.* Subsequently, May Stores notified the plaintiffs that the accounts had been assigned and transferred to May National Bank of Arizona (“May Bank”), a national bank and wholly-owned subsidiary of May Stores, and that May Bank would charge delinquency fees of up to “$15, or as allowed by law.” *Id.* Although May Stores had transferred all authority over the terms and operations of the accounts to May Bank, it subsequently purchased May Bank’s receivables and maintained a role in account collection. *Id.* at 923.

The plaintiffs brought suit under Missouri law against May Stores after being charged $15 delinquency fees. *Id.* at 922. May Stores argued that the plaintiffs’ state-law claims were preempted by the NBA because the assignment and transfer of the accounts to May Bank “was fully effective to cause the bank, and not the store, to be the originator of [the plaintiffs’] accounts subsequent to that time.” *Id.* at 923. The court agreed:

> [T]he store’s purchase of the bank’s receivables does not diminish the fact that it is now the bank, and not the store, that issues credit, processes and services customer accounts, and sets such terms as interest and late fees. Thus, although we recognize that the NBA governs only national banks, in these circumstances we agree with the district court that it makes sense to look to the originating entity (the bank), and not the ongoing assignee (the store), in determining whether the NBA applies.

*Id.* at 924 (internal citation omitted). 2

*Krispin* does not support finding preemption here. In *Krispin*, when the national bank’s receivables were purchased by May Stores, the national bank retained ownership of the accounts, leading the court to conclude that “the real party in interest is the bank.” *Id.* Unlike *Krispin*, neither BoA nor FIA has retained an interest in Madden’s account, which further supports the conclusion that subjecting the defendants to state regulations the sentence were “in these circumstances,” which referred to the fact stated in the previous sentence of the bank’s retention of substantial interests in the credit card accounts. As we understand the *Krispin* opinion, the fact that the bank was described as the “originating entity” had no significance for the court’s decision, which would have come out the opposite way if the bank, notwithstanding that it originated the credits in question, had sold them outright to a new, unrelated owner, divesting itself completely of any continuing interest in them, so that its operations would no longer be affected by the application of state law to the new owner’s further administration of the credits.
does not prevent or significantly interfere with the exercise of BoA’s or FIA’s powers.

The defendants and the District Court also rely upon *Phipps v. FDIC*, 417 F.3d 1006 (8th Cir.2005). In that case, the plaintiffs brought an action under Missouri law to recover allegedly unlawful fees charged by a national bank on mortgage loans. The plaintiffs alleged that after charging these fees, which included a purported “finder’s fee” to third-party Equity Guaranty LLC (a non-bank entity), the bank sold the loans to other defendants. The court held that the fees at issue were properly considered “interest” under the NBA and concluded that, under those circumstances, it “must look at the originating entity (the bank), and not the ongoing assignee . . . . in determining whether the NBA applies.” *Id.* at 1013 (quoting *Krispin*, 218 F.3d at 924 (alteration in original)).

*Phipps* is distinguishable from this case. There, the national bank was the entity that charged the interest to which the plaintiffs objected. Here, on the other hand, Madden objects only to the interest charged after her account was sold by FIA to the defendants. Furthermore, if Equity Guaranty was paid a “finder’s fee,” it would benefit from NBA preemption as an agent of the national bank. Indeed, *Phipps* recognized that “[a] national bank may use the services of, and compensate persons not employed by, the bank for originating loans.” *Id.* (quoting 12 C.F.R. § 7.1004(a)). Here, the defendants do not suggest that they have such a relationship with BoA or FIA.

II. Choice of Law: Delaware vs. New York

The defendants contend that the Delaware choice-of-law provision contained in the Change In Terms precludes Madden’s New York usury claims. Although raised below, the District Court did not reach this issue in ruling on the defendants’ motion for summary judgment. Subsequently, in the Stipulation for Entry of Judgment, the parties resolved in the defendants’ favor the dispute as to whether Madden was bound by the Change In Terms. The parties appear to agree that if Delaware law applies, the rate the defendants charged Madden was permissible.

3. We are not persuaded by *Munoz v. Pipestone Financial, LLC*, 513 F.Supp.2d 1076 (D.Minn. 2007), upon which the defendants and the District Court also rely. Although the court found preemption applicable to an assignee of a national bank in a case analogous to Madden’s suit, it misapplied Eighth Circuit precedent by applying unwarranted significance to *Krispin*’s use of the word “originating entity” and straying from the essential inquiry—whether applying state law would “significantly interfere with the national bank’s exercise of its powers,” *Barnett Bank*, 517 U.S. at 33, 116 S.Ct. 1103, because of a subsidiary or agency relationship or for other reasons.

4. The Change In Terms, which amended the original Cardholder Agreement, includes the following provision: “This Agreement is governed by the laws of the State of Delaware (without regard to its conflict of laws principles) and by any applicable federal laws.” App’x at 58, 91.

5. We reject Madden’s contention that this argument was waived. First, although the defendants’ motion for summary judgment urged the District Court to rule on other grounds, it did raise the Delaware choice-of-law clause. *Defs.’ Summ. J. Mem. 4 & n. 3, No. 7:11–cv–08149 (S.D.N.Y. Jan. 25, 2013), ECF No. 32*. Second, this argument was not viable prior to the Stipulation for Entry of Judgment due to unresolved factual issues—principally, whether Madden had received the Change In Terms.

6. We express no opinion as to whether Delaware law, which permits a “bank” to charge any interest rate allowable by contract, see Del. Code Ann. tit. 5, § 943, would apply to the defendants, both of which are non-bank entities.
Madden moved for class certification before the District Court. The District Court denied the motion, holding that because “assignees are entitled to the protection of the NBA if the originating bank was entitled to the protection of the NBA . . . the class action device in my view is not appropriate here.” App’x at 120. Because the District Court’s denial of class certification was entwined with its erroneous holding that the defendants receive the same protections under the NBA as do national banks, we vacate the denial of class certification.

CONCLUSION

We REVERSE the District Court’s holding as to National Bank Act preemption, VACATE the District Court’s judgment and denial of class certification, and REMAND for further proceedings consistent with this opinion.

In re: In the Matter of the GRAND JURY EMPANELED ON MAY 9, 2014
John Doe; ABC Entity, Appellants.

No. 15–1264.

United States Court of Appeals,
Third Circuit.

Argued April 21, 2015.

Filed: May 15, 2015.

Background: Grand jury issued subpoena directing custodian of records for professional corporation to produce certain documents. The United States District Court for the District of New Jersey, Stanley R. Chesler, J., held corporation in contempt for noncompliance. Corporation and its principal appealed.

Holdings: The Court of Appeals, Cowen, Circuit Judge, held that:

(1) Fifth Amendment privilege against self-incrimination was not available to corporate custodian, and

(2) district court did not abuse its discretion in concluding that subpoena was not overbroad and it did not lack particularity.

Affirmed.

1. Criminal Law ⊃1147

A district court’s decision to quash a grand jury subpoena is reviewed for abuse of discretion.

2. Witnesses ⊃298, 306

Fifth Amendment privilege against self-incrimination was not available to corporate custodian to avoid compliance with grand jury subpoena for corporate records merely because he was that corporation’s sole owner and employee. U.S.C.A. Const. Amend. 5.

3. Witnesses ⊃298, 306

Unlike the collective entity doctrine, which states that the contents of the subpoenaed business records are not privileged, the so-called act-of-production doctrine is less concerned with the nature of the entity that owns the documents, and more concerned with the communicative or non-communicative nature of the disclosures sought to be compelled.

4. Witnesses ⊃298

The government is prohibited under the so-called act-of-production doctrine from making any evidentiary use of the “individual act” of the custodian producing evidence in response to a subpoena issued to the corporation because when the custodian produces documents pursuant to a
Appendix Item 5
No.

In the Supreme Court of the United States

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MIDLAND FUNDING, LLC, AND MIDLAND CREDIT MANAGEMENT, INC., petitioners

v.

SALIHA MADDEN

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ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI

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PETITION FOR A WRIT OF CERTIORARI

Midland Funding, LLC, and Midland Credit Management, Inc., respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., infra, 1a-18a) is reported at 786 F.3d 246. The oral ruling of the district court on petitioners’ motion for summary judgment (App., infra, 21a-48a) is unreported.
principle that, in the context of the facts presented by this case, compels preemption.\(^5\)

3. Under the reasoning of the preceding decisions, a loan validly originated by a national bank in accordance with the law of the State where the bank is located cannot become subject to regulation by other States simply because it is held by another entity. The Second Circuit’s decision stands alone in allowing a State to regulate the interest on a loan originated by a national bank in the exercise of its National Bank Act powers as soon as the loan passes into the hands of another entity. The ensuing conflict, on an issue critical to the functioning of national banks, warrants resolution by this Court.

**B. The Decision Below Is Erroneous**

Further review is also merited because the Second Circuit’s decision regarding the preemptive scope of the National Bank Act is deeply flawed. It is undisputed that the national bank that originated respondent’s loan was permitted to charge interest at the rate at issue. It is also undisputed that, if the bank had not assigned the loan to petitioners, any state-law claims against the bank would be preempted. The question presented is whether respondent may pursue the same state-law claims against petitioners simply by virtue of the assignment by the originating national bank.

In refusing to recognize preemption in these circumstances, the Second Circuit went astray in two funda-

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\(^5\) The Second Circuit’s decision in this case also cannot be reconciled with a decision of the First Circuit, which recognized that the National Bank Act preempts state laws that, although they purport to regulate non-national-bank entities, actually “seek[] to prohibit the sale of [a] bank product itself.” *SPGGC, LLC v. Ayotte*, 488 F.3d 525, 534 (2007), cert. denied, 552 U.S. 1185 (2008).
mental ways. First, the Second Circuit failed to acknowledge the preemptive force of Section 85 of the National Bank Act, with the result that it hollowed out a national bank’s fundamental power to set interest rates. Second, the Second Circuit eviscerated the Barnett Bank “significant interference” test, now codified in Section 25b(b)(1), by incorrectly concluding that state regulation of banks’ assignees will not significantly interfere with the banks’ exercise of their powers. Because the Second Circuit’s decision cannot be reconciled with this Court’s decisions regarding the preemptive scope of the National Bank Act, further review is warranted.

1. To begin with, the Second Circuit’s decision allows state law to infringe the core enumerated power of national banks to set interest rates at the level allowed by their home States. As this Court has recognized, Section 85 preempts state laws that interfere with that power. See Marquette National Bank, 439 U.S. at 318-319.

It is a fundamental principle of usury law that “a contract, which, in its inception, is unaffected by usury, can never be invalidated by any subsequent usurious transaction.” Nichols, 32 U.S. (7 Pet.) at 109. That principle—known as the “valid-when-made” principle—was firmly established at common law well before 1864, when Congress enacted the National Bank Act (including the provision that is now Section 85). See, e.g., ibid.; Gaither v. Farmers’ & Mechanics’ Bank of Georgetown, 26 U.S. (1 Pet.) 37, 43 (1828); Tuttle v. Clark, 4 Conn. 153, 157 (1822); Tate v. Wellings, 100 Eng. Rep. 716, 721 (K.B. 1790); 1 William Blackstone, Commentaries on the Laws of England 379 n.32 (18th London ed., W.E. Dean 1838) (reciting the principle that “[t]he usury must be part of the contract in its inception”). Because Congress legislated against that common-law backdrop, Section 85 incorporates the principle that an interest rate set by an

The “valid-when-made” principle is essential to a national bank’s ability to set interest rates. Courts, including this Court, have consistently recognized the dangers of a rule that would allow a non-usurious loan to become usurious after an assignment. See Nichols, 32 U.S. (7 Pet.) at 110 (noting that, under such a rule, a “contract, wholly innocent in its origin, and binding and valid, upon every legal principle, [would be] rendered, at least, valueless, in the hands of the otherwise legal holder”); Olvera v. Blitt & Gaines, P.C., 431 F.3d 285, 287-288 (7th Cir. 2005) (rejecting such a rule on the ground that it would “produce[] a senseless result” that “would push the debt buyers out of the debt collection market and force the original creditors to do their own debt collection”); LFG National Capital, LLC v. Gary, Williams, Finney, Lewis, Watson & Sperando P.L., 874 F. Supp. 2d 108, 125 (N.D.N.Y. 2012) (explaining that such a rule “would in effect prohibit—make uneconomic—the assignment or sale by banks of their commercial property to a secondary market,” which “would be disastrous in terms of bank operations and not conformable to the public policy exempting banks in the first instance” (internal quotation marks and citation omitted)). By ignoring the “valid-when-made” principle, the Second Circuit’s decision substantially vitiates the authority granted to national banks by Section 85.

The practical effect of the Second Circuit’s decision is to authorize state interference in what had previously been understood to be an exclusively federal regime. Under that unprecedented decision, States are permitted to regulate a national bank’s loans when they come
into the hands of its counterparties, thereby effectively restricting the bank’s power to set interest rates on loans it might sell or otherwise assign. But as this Court has previously noted, “the various provisions of [Sections] 85 and 86 form a system of regulations all the parts of which are in harmony with each other and cover the entire subject, so that the State law would have no bearing whatever upon the case.” *Beneficial National Bank*, 539 U.S. at 10 (alterations and internal quotation marks omitted). The Second Circuit’s decision is patently incompatible with the National Bank Act’s complete displacement of state law regulating interest rates.

2. The Second Circuit further erred when it rejected an additional (and distinct) source of preemption. The National Bank Act more generally preempts any consumer financial state law—whether or not it concerns interest—that “prevents or significantly interferes with the exercise by [a] national bank of its powers.” 12 U.S.C. 25b(b)(1); accord *Barnett Bank*, 517 U.S. at 33. That broader form of preemption applies to all of a national bank’s enumerated and incidental powers, including its powers to originate and sell loans. See 12 U.S.C. 24 (Seventh); 12 C.F.R. 7.4008(a), 34.3(a); pp. 5-6, *supra*.

The Second Circuit’s decision is inconsistent with the *Barnett Bank* test, as codified in Section 25b(b)(1). Specifically, the Second Circuit’s decision fails to account for the substantial impact the state regulation of assignees would have on a national bank’s ability to sell on the secondary markets loans with rates greater than permitted by some States’ usury laws (or otherwise to rely on counterparties for functions such as debt collection and secu-
ritization). The Second Circuit’s decision interferes both with the power of a national bank to originate loans in the first place and with the specific powers of a national bank to participate in the secondary markets for loans and to pursue the collection of delinquent accounts.

In rejecting preemption under the *Barnett Bank* test, the Second Circuit narrowly focused on the identity of the regulated entities, noting that assignees lack a structural connection with the banks: they are not subsidiaries, nor are they acting as banks’ agents when they attempt to collect interest. See App., *infra*, 8a-9a. But the crux of the preemption analysis is the “exercise of [a national bank’s] powers.” *Barnett Bank*, 517 U.S. at 33; see *id.* at 32-34. The proper focus under the *Barnett Bank* test is thus on the effect of a state regulation on the national bank—not on any formal feature of the state law, such as the identity of the party that is the direct object of the regulation.

In other contexts, this Court has rejected the proposition that a State can avoid preemption simply by regulating the counterparties of entities as to which preemption would otherwise apply. In *Rowe v. New Hampshire Motor Transport Association*, 552 U.S. 364 (2008), the Court held that a federal law preempting the regulation of motor carriers also preempted the regulation of retailers in their use of motor carriers’ services. The Court

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Appendix Item 6
In the Supreme Court of the United States

MIDLAND FUNDING, LLC, MIDLAND CREDIT MANAGEMENT, INC., PETITIONERS,
v.
SALIHA MADDEN

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

BRIEF OF THE CLEARING HOUSE ASSOCIATION L.L.C., FINANCIAL SERVICES ROUNDTABLE, CONSUMER BANKERS ASSOCIATION, LOAN SYNDICATIONS AND TRADING ASSOCIATION, AND THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS AMICI CURIAE SUPPORTING PETITIONERS

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An essential role of Amici’s members is to provide credit on efficient terms to the consumers and small- and medium-size businesses which form the backbone of the American economy. Amici submit that a court should not, irrespective of the specific circumstances of the case before it, repudiate basic legal principles, and thereby disrupt established market expectations at substantial cost to the public well-being.

**SUMMARY OF ARGUMENT**

I. A. Since the first half of the nineteenth century, this Court has recognized the “cardinal rule” that a loan that is not usurious in its inception cannot be rendered usurious subsequently, including by being sold or transferred to a third party. The cardinal rule is critically important to the functioning of the multi-trillion dollar U.S. credit markets, as it enables banks and financial institutions to buy and sell loans without fear that the loans will become subject to usury challenges because the assignee or purchaser of the loans may be subjected to different state usury laws.

\[2 \text{ Amici agree with petitioners that, under the Second Circuit’s decision, the application of state usury laws will make it far more difficult (or conceivably impossible) for institutions to sell or securitize loans they have originated, and thus will “substantially interfere” with the purpose of the NBA. Pet. at 14-21. Amici submit this brief to further explain to this Court (i) the bases for reversing the Second Circuit’s decision, and (ii) the national importance of this issue.}\]
The cardinal rule was well entrenched in American common law when Congress enacted Section 85 of the NBA in 1864—under which a loan originated by a national bank is subject only to the usury law of the bank’s home state—and thus was presumptively incorporated into that provision. Moreover, since the enactment of the NBA, lower courts and regulatory agencies have consistently applied this “cardinal rule,” and it remains a cornerstone of the credit markets. Accordingly, for over a hundred and fifty years, the multi-trillion dollar U.S. credit markets have functioned on the understanding that a loan originated by a national bank under the NBA is subject only to the usury law applicable at origination, regardless of whether and to whom it is subsequently sold or assigned.

By ignoring this rule, the decision below injects significant uncertainty into an area of the law that the credit markets have long viewed as settled and upon which they have relied.

B. Although the Second Circuit’s decision on its face addresses only Section 85, the court’s refusal to apply the cardinal rule casts doubt on the propriety of any validly originated loan that is sold or transferred. For example, the logic of the decision below applies directly to Section 27 of the FDIA, which provides state-insured banks the same certainty as to the application of their home state usury laws that is provided to national banks by Section 85.

C. The Second Circuit’s decision also conflicts with decisions from the Fifth, Seventh, and Eighth Circuits. This conflict adds to the uncertainty generated by the decision below, because the same exact loan could be deemed usurious by a court in the
Second Circuit due to a post-origination sale of the loan, while courts in these other circuits would conclude that the loan is valid so long as it was lawful at origination. The decision also creates uncertainty as to how the other nine courts of appeals might rule, with grave effect in the interim, whereas previously there were no contrary decisions.

II. A. The consistent and certain application of this Court’s “cardinal rule” under the NBA and the FDIA is essential to the proper functioning of the credit markets. By departing from that rule, the decision below has injected significant uncertainty into the purchase and sale (directly or through securitization) of all types of loans (not just charged-off credit card debt), whether by national banks, state-chartered banks, or non-bank entities and whether through a single transaction between counterparties, the secondary credit markets, securitizations, or participations. In the event of a sale, the validity of such loans can no longer be determined based solely on the circumstances at origination; it now may depend on the state in which the borrower resides, the state in which the loan purchaser resides, the law chosen to govern the agreement, and/or the circuit in which the borrower files suit.

B. The availability and accessibility of credit is a “crucial ingredient” for the growth of the nation’s economy. Banks provide trillions of dollars in credit and are the primary source of loans for consumers and small businesses. Because of this central role in the financial markets, commentators have recognized that decreases in banks' ability to extend credit can negatively affect the entire economy.
C. The uncertainty caused by the decision below already threatens to decrease the availability and increase the cost of credit. If the decision below were allowed to stand, potential purchasers of loans and interests in loan securitizations will face the significant risk that a loan that was valid at origination may have been rendered usurious through assignment. This increased risk is likely to make purchasers less willing, if not entirely unwilling, to buy loans or interests in certain securitizations of loans that may turn out to be subject to additional state usury limits (including criminal penalties), or even a change in the usury law of the state in which the loan was originated. Credit market participants may respond by reducing the origination of loans (especially those to individuals or businesses within certain circuits), increasing the original rate of interest, or simply refusing to purchase or securitize certain loans. This potential decrease in the liquidity and value of loans threatens to increase the cost and decrease the availability of credit, particularly for small businesses and lower-income families. Because loans to such borrowers carry greater credit risk, such loans require higher interest rates, thus creating greater exposure to usury limits. The cost of credit, particularly to those closer to usury limits, will likely increase, because banks are likely to be less able to resell or securitize such loans on their balance sheet to finance additional lending. Moreover, the disruption of the credit markets and reduction of liquidity and value of loan portfolios held by banks could have ramifications for the safety and soundness of the banking system.
Appendix Item 7
No. 15-610

In the Supreme Court of the United States

MIDLAND FUNDING, LLC, ET AL., PETITIONERS

v.

SALIHA MADDEN

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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In the Supreme Court of the United States

No. 15-610

MIDLAND FUNDING, LLC, ET AL., PETITIONERS

v.

SALIHA MADDEN

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
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BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

INTEREST OF THE UNITED STATES

This brief is submitted in response to the Court’s order inviting the Solicitor General to express the views of the United States. In the view of the United States, the petition for a writ of certiorari should be denied.

STATEMENT

amount a national bank could charge for its consumer
debt in certain states,” such an effect “would not ‘sig-
nificantly interfere’ with the exercise of a national
bank power.” *Id.* at 10a-11a. The court further held
that it would be an “overly broad application of the
NBA” to “extend[] [its] protections” to “non-national
bank entities that are not acting on behalf of a nation-
al bank.” *Id.* at 11a.

Finally, the court distinguished *Krispin, supra,*
and *Phipps, supra.* Pet. App. 11a-14a. The court ex-
plained that the national bank in each of those cases
had an ongoing interest in the loan or an ongoing rela-
tionship with the assignee. *Ibid.* The court dis-
tinguished *Phipps* on the additional ground that the
national bank in that case “was the entity that char-
ger the interest to which the plaintiffs objected,”
whereas in this case respondent “objects only to the
interest charged after her account was sold by FIA to
[petitioners].” *Id.* at 14a.

The court of appeals remanded for consideration of
whether, pursuant to the choice-of-law provision con-
tained in respondent’s amended credit-card agree-
ment, Delaware law governs the maximum interest
that petitioners may charge. Pet. App. 14a-15a. The
court noted that “[t]he parties appear to agree that if
Delaware law applies, the rate [petitioners] charged
[respondent] was permissible.” *Id.* at 15a.

5. The court of appeals denied petitioners’ petition

**DISCUSSION**

Petitioners contend (Pet. 11-25) that review is war-
ranted to address whether the NBA preempts re-
spondent’s state-law usury claim. The court of ap-
peals erred in holding that state usury laws may valid-
ly prohibit a national bank’s assignee from enforcing the interest-rate term of a debt agreement that was valid under the law of the State in which the national bank is located. But there is no circuit split on the question presented; the parties did not present key aspects of the preemption analysis to the courts below; and petitioners may still prevail on remand despite the error in the court of appeals’ interlocutory decision. For all of those reasons, further review is not warranted.

1. The court of appeals’ decision is incorrect. Properly understood, a national bank’s Section 85 authority to charge interest up to the maximum permitted by its home State encompasses the power to convey to an assignee the right to enforce the interest-rate term of the agreement. That understanding is reinforced by 12 U.S.C. 24(Seventh), which identifies the power to sell loans as an additional power of national banks. The court of appeals appeared to conclude that, so long as application of New York usury law to petitioners’ collection activities would not entirely prevent national banks from selling consumer debt, state law is not preempted. See Pet. App. 10a-11a. That analysis reflects a misunderstanding of Section 85 and of this Court’s precedents.

a. The NBA prescribes the interest rate that a national bank may charge its loan customers and establishes an exclusive federal cause of action for usury. In particular, Section 85 permits an “association,” i.e., a national bank, to “charge on any loan * * * interest at the rate allowed by the laws of the State, Territory, or District where the bank is located,” or a rate one percent above the Federal Reserve discount rate, whichever is higher, “and no more.” 12 U.S.C.
Section 86 establishes an exclusive federal cause of action, and specifies the applicable penalties, for the collection of interest greater than that allowed by Section 85. See 12 U.S.C. 86 (knowingly charging interest above the rate permitted by Section 85 “shall be deemed a forfeiture of the entire interest which the note, bill, or other evidence of debt carries with it,” and the debtor may recover from the national bank “twice the amount of the interest thus paid”).

The effect of these provisions is to set a maximum interest rate that a national bank may charge (the rate allowed by its home State) and to preclude any State other than the one where the national bank is located from imposing a lower maximum interest rate. See Marquette Nat’l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299, 314-315, 318 (1978) (holding that a national bank located in Nebraska may charge its customer in Minnesota the maximum rate of interest permitted by Nebraska law). “To the extent the enumerated federal rates of interest are greater than permissible state rates, state usury laws must, of course, give way to the federal statute.” Id. at 318 n.31; see 12 C.F.R. 7.4001(b) (stating the same understanding).

A national bank’s power to charge the interest rate authorized by Section 85 includes the power to transfer a loan, including the agreed-upon interest-rate term, to an entity other than a national bank. When Congress enacted Section 85’s earliest statutory antecedent, it was already established that a bank’s power to

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2 The Office of the Comptroller of the Currency has defined the term “interest” by regulation, 12 C.F.R. 7.4001(a), and this Court has deferred to that definition, see Smiley v. Citibank (S.D.), N.A., 517 U.S. 735, 741-742, 744-745 (1996).
sell loans was a “necessarily implied” corollary of the power to originate loans. *Planters’ Bank of Miss. v. Sharp*, 47 U.S. (6 How.) 301, 322 (1848) (holding that state law that barred state bank from transferring a loan violates the constitutional prohibition on state impairment of contracts, U.S. Const. Art. I, § 10, Cl. 1). As this Court has recognized, “in discounting notes and managing its property in legitimate banking business, [a bank] must be able to assign or sell those notes.” *Id.* at 323; see *id.* at 321-325.

A national bank’s federal right to charge interest up to the rate allowed by Section 85 would be significantly impaired if the national bank’s assignee could not continue to charge that rate. Under the long-established “valid-when-made” rule, if the interest-rate term in a bank’s original loan agreement was non-usurious, the loan does not become usurious upon assignment, and so the assignee may lawfully charge interest at the original rate. See *Nichols v. Fearson*, 32 U.S. (7 Pet.) 103, 109 (1833) (a “cardinal rule[] in the doctrine of usury” is that “a contract, which, in its inception, is unaffected by usury, can never be invalidated by any subsequent usurious transaction”); *Gai-ther v. Farmers & Mechs. Bank of Georgetown*, 26 U.S. (1 Pet.) 37, 43 (1828) (“[T]he rule cannot be doubted, that if the note be free from usury, in its origin, no subsequent usurious transactions respecting it, can affect it with the taint of usury.”). The power explicitly conferred on national banks by Section 85—i.e., the power to originate loans at the maximum interest rate allowed by the national bank’s home State—therefore carries with it the power to use the loans once originated for their usual commercial purposes, which include assignment of such loans to others.
b. **Respondent’s state-law usury claim is preempted by Section 85 because it directly interferes with a national bank’s authority to make and transfer loans at the permitted rate of interest.** The credit-card debt at issue in this case was originated by FIA, a national bank that is located in Delaware. FIA’s contract with respondent specified a 27% rate of interest, which the parties agree was permissible under Delaware law. Pet. App. 15a. Accordingly, once respondent defaulted on the debt, FIA was entitled to charge 27% interest going forward on the accumulated balance.

Instead of continuing to attempt to collect on the debt, FIA sold the debt to petitioners. As FIA’s assignees, petitioners were entitled to charge the same interest rate that FIA could have charged under the credit-card agreement and Delaware law. To the extent that New York law establishes a lower maximum interest rate, application of that limit to FIA’s assignees would impair the national bank’s federally recognized authority to originate and transfer loans at the rate permitted by the NBA. And, in the aggregate, the marketability (and therefore the value) of a national bank’s loan portfolio could be significantly diminished if the national bank could not transfer to assignees the right to charge the same rate of interest that the national bank itself could charge.

Section 85 authorizes each national bank to charge interest up to the maximum rate allowed by the bank’s home State. **Congress’s conferral of that federal right**

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3 Although respondent first obtained her credit-card account from Bank of America, the parties and the courts below assumed that Bank of America’s consolidation of its credit-card accounts in FIA created a new account, making FIA the national bank that originated the loan at issue. See Pet. App. 3a, 5a, 36a-37a.
should be understood to incorporate the understandings that (a) sale of loans is an integral aspect of usual banking practice, and (b) a loan that was valid when made will not be rendered usurious by the transfer. To the extent that application of New York usury law would prevent FIA from fully exercising the powers conferred by Section 85, state law is preempted. See *Barnett Bank of Marion Cnty., N.A. v. Nelson*, 517 U.S. 25, 28-29, 37-38 (1996) (holding that, because the NBA authorizes national banks to sell insurance in small towns, a state law preventing national banks from selling most kinds of insurance is preempted). Put another way, there is an “irreconcilable conflict” (id. at 31) between the NBA (specifically, 12 U.S.C. 85) and any state law that would preclude FIA’s assignees from charging the full amount of interest that is permitted by the laws of FIA’s home State.

c. Congress could have empowered national banks to charge certain rates of interest (as it did in Section 85), while expressly authorizing States to regulate the terms on which loans originated by national banks could be assigned to other entities. See *Barnett Bank*, 517 U.S. at 34 (citing NBA provisions that “accompany a grant of an explicit power with an explicit statement that the exercise of that power is subject to state law”). If Congress had enacted such a provision, it would rebut the inference that a national bank’s federal right to originate loans at the maximum interest rate allowed by its home State includes the power to assign that right to others. But nothing in the NBA suggests that Congress intended to limit the national bank’s power in that way.

To the contrary, in addition to specifying the rate of interest that a national bank may charge, the
NBA expressly authorizes national banks to carry on the business of banking by “discounting and negotiat-
ing promissory notes, drafts, bills of exchange, and other evidences of debt.” 12 U.S.C. 24(Seventh). That power includes the power to sell loan contracts. See 12 C.F.R. 7.4008 (“A national bank may make, sell, purchase, participate in, or otherwise deal in loans * * * subject to such terms, conditions, and limita-
tions prescribed by the Comptroller of the Curren-
cy and any other applicable Federal law.”). Section 24(Seventh), by identifying the power to sell loans as an additional enumerated power of national banks, reinforces the longstanding understanding that a national bank’s Section 85 powers include the power to transfer loans to other entities, which may continue to charge interest at the original rate.4 Application of state usury law here would “prevent or significantly interfere with the national bank’s exercise of [those] powers,” Barnett Bank, 517 U.S. at 33, and it there-
fore is preempted.

d. In holding that application of New York usury law to petitioners’ collection activities is not preempt-
ed here, the court of appeals erred in three principal respects. First, the court failed to recognize that a national bank’s Section 85 power to charge certain interest rates carries with it the power to assign to others the right to charge the same rates. The court noted that the district court and other courts of ap-
peals have relied on the valid-when-made principle, Pet. App. 12a n.2, 13a, but it failed to appreciate the

4 Congress has continued to recognize and reaffirm the preemptive effect of Section 85. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1044(f), 124 Stat. 2017 (codified at 12 U.S.C. 25b(f)).
significance of that principle in this case. Because the court of appeals considered only part of a national bank’s Section 85 powers, it failed to understand how application of state usury law to petitioners would impair the bank’s exercise of those powers.

Second, the court of appeals believed that, because FIA had assigned respondent’s debt outright and retained no control over (or financial stake in) petitioners’ efforts to collect that debt, application of state usury law would “limit [] only activities of” petitioners, and not of the national bank itself. Pet. App. 9a-10a (citation omitted; brackets in original); see id. at 2a, 11a. That analysis is misconceived. To the extent that New York law prohibits petitioners from charging the full amount of interest that FIA itself could have charged, that law prevents FIA from fully exercising its federal right to originate loans at the interest rate allowed by Delaware law, which includes the right to sell those loans to others. For preemption purposes, such state-law interest-rate restrictions on petitioners acting as FIA’s assignees are no different from explicit state-law restrictions on the national bank’s exercise of its assignment power.

Third, the court of appeals relied on an unduly narrow conception of conflict preemption. The court acknowledged that application of state usury law to a national bank’s assignees “might decrease the amount a national bank could charge for its consumer debt in certain states.” Pet. App. 11a. The court stated, however, that because “state usury laws would not prevent consumer debt sales by national banks to third parties,” that sort of price effect “would not ‘significantly interfere’ with the exercise of a national bank power.” Id. at 10-11a (emphasis added). The italicized word
suggests that, so long as the application of New York
usury law would not render national-bank loans un-
saleable, state law is not preempted.

That analysis reflects an unduly crabbed concep-
tion of NBA preemption, and of implied-conflict pre-
emption generally. When federal law “explicitly grants
a national bank an authorization, permission, or pow-
er,” and does not “explicit[ly] state[] that the exercise
of that power is subject to state law,” state law is
preempted to the extent that it restricts that power.
*Barnett Bank*, 517 U.S. at 34. If New York had at-
temded to regulate the interest that FIA itself could
charge New York residents, state law would clearly
have been preempted by Section 85, without regard to
the degree of practical harm to the national bank that
New York usury law would entail. See *Marquette
Nat’l Bank*, 439 U.S. at 314-315. Because the federal
power conferred by Section 85 (reinforced by Section
24(Seventh)) includes the power to convey to an as-
signee the right to charge the maximum interest al-
lowed by the national bank’s home State, a state law
that precludes the national bank from fully exercising
that power is similarly preempted. Preemption in
these circumstances does not require a showing that
state usury law would reduce the price FIA could
obtain for any particular loan or category of loans, let
alone a showing that state law would “prevent con-
sumer debt sales by national banks to third parties.”

2. Although the decision below is incorrect, there is
no conflict among the circuits on the question pre-
sented here. Petitioners contend (Pet. 11-14) that the
decision below conflicts with the decisions in *Phipps v.
FDIC*, 417 F.3d 1006 (8th Cir. 2005), *Krispin v. May*
Department Stores Co., 218 F.3d 919 (8th Cir. 2000), and FDIC v. Lattimore Land Corp., 656 F.2d 139 (5th Cir. 1981) (Lattimore). Because the questions presented in those cases were significantly different from the question presented here, those decisions do not conflict with the ruling below.

a. The disputed question in Phipps was whether the mortgage-loan fees charged by a national bank were “interest” within the meaning of Section 85. 417 F.3d at 1011. The plaintiffs were borrowers who had obtained second mortgage loans from Guaranty National Bank of Tallahassee (GNBT), a national bank. Id. at 1009. They argued that the fees charged by GNBT at origination were prohibited by Missouri law. Ibid. The defendants (GNBT and two entities to which GNBT had sold the loans) argued that, because the lawsuit concerned “interest” charged by a national bank, the plaintiffs’ claims were preempted. Id. at 1010. The court of appeals agreed that most, if not all, of the fees charged by the national bank were “interest” within the meaning of Section 85, and it affirmed the district court’s dismissal of the complaint. Id. at 1011-1014.

In this case, respondent concedes that petitioners may collect the principal and all of the interest that accumulated during the period that FIA held the debt, even though that pre-assignment interest accrued at a rate higher than petitioners themselves could have charged. See Br. in Opp. 6. She argues only that, once FIA sold the debt to petitioners, the rate at which additional interest could accrue was governed by state rather than federal law. Ibid. By contrast, Phipps did not present any issue concerning the rate at which post-assignment interest accrues, because
the charges at issue were imposed by the national bank itself at the time it made the loans. Although the plaintiffs in *Phipps* sued GNBT’s assignees as well as GNBT itself, 417 F.3d at 1009, their claim was based on the fees charged by the national bank at origination, not on any additional interest accruing after the loans were sold, see *ibid.* (“[T]he plaintiffs strenuously argue their claims are based on unlawful fees charged, not unlawful interest.”). Thus, as the court below correctly explained, “*Phipps* is distinguishable from this case” because in *Phipps* “the national bank was the entity that charged the interest to which the plaintiffs objected,” whereas respondent “objects only to the interest charged after her account was sold by FIA to [petitioners].” Pet. App. 14a.

b. *Krisspin* involved a challenge to late fees charged to a holder of a department store credit-card account. 218 F.3d at 921-922. The store issued the credit card, then “assigned all its credit accounts, and transferred all authority over the terms and operation of those accounts,” to the May National Bank of Arizona, a wholly-owned subsidiary of the store. *Ibid.* The store “purchased the bank’s receivables on a daily basis.” *Ibid.* at 923. The plaintiffs sued the store, arguing that the late fees violated state law, *id.* at 921-922, and the court of appeals held that the NBA completely preempted their claims, *id.* at 924. The court concluded that, “for purposes of deciding the legality of the late fees charged to [plaintiffs’] credit accounts, * * * the real party in interest is the bank, not the store,” because the bank “issues credit, processes and services customer accounts, and sets such terms as interest and late fees.” *Ibid.*
The Eighth Circuit’s complete-preemption holding in *Krispin* rested on the court’s determination that the national bank in that case was the “real party in interest” with respect to the plaintiffs’ credit-card account. That determination rested on the fact that, despite the bank’s daily sale of its receivables to the store, the bank maintained an ongoing credit relationship with each account holder. In this case, by contrast, FIA’s sale of respondent’s debt to petitioners entirely terminated the credit relationship between respondent and the national bank. FIA sold respondent’s debt outright; it retained no continuing role in administering her account and no continuing right to any interest that petitioners might be able to collect. See Pet. App. 13a (distinguishing *Krispin* on that basis).

c. *Lattimore* involved a loan that was originated by Hamilton Mortgage Corporation (which was not a national bank) and then assigned to Hamilton National Bank, which continued to charge interest at the rate specified in the original agreement between the mortgage corporation and the borrowers. 656 F.2d at 140-141, 146. The borrowers argued that, although the mortgage corporation was allowed to charge that rate, the national bank was not because the rate exceeded the maximum permitted by the national bank’s home State. See id. at 146 (noting that the original interest rate would be usurious in the national bank’s home State of Tennessee but not in the mortgage corporation’s home State of Georgia). The court of appeals concluded that the national bank could continue to charge the original rate because “[t]he non-usurious character of a note should not change when the note changes hands.” *Id.* at 148-149. Because the loan had
originally been made by an entity that was not a national bank, the court viewed state usury law, rather than Section 85, as controlling the determination whether the interest charged was lawful. See id. at 147-150.

The court in *Lattimore* did not address the question presented here. *Lattimore* involved a loan transferred *from* a state-regulated entity *to* a national bank, not a loan originated and subsequently assigned *by* a national bank. Although the court in *Lattimore* applied the valid-when-made rule, and the Second Circuit in this case overlooked that principle, the courts were considering different issues. To be sure, there is an appealing symmetry to the idea that, if the law that governs the originating entity continues to apply after one sort of transfer, it should likewise apply when the assignment runs in the opposite direction. See Pet. 13-14. There is, however, no legal or logical reason to conclude that the Fifth Circuit’s analysis in *Lattimore* (even assuming it is correct) must control in the situation presented here.

3. For two additional reasons, this case would be a poor vehicle for resolution of the question presented.

   a. The deficiencies in the court of appeals’ preemption analysis may be attributable in part to the parties’ failure to present the full range of preemption arguments below.

   In the district court, petitioners argued that respondent’s claims “are expressly pre-empted by federal law” because “§§ 85 and 86 [of Title 12] provide the exclusive cause of action for such claims.” Pets. Mem. of Law in Support of Mot. for Summ. J. 3 (Jan. 25, 2013) (D. Ct. Doc. 32) (citation omitted). The parties’ dispute centered on whether a national bank
must retain an interest in a loan it transfers in order for the transferee to validly invoke NBA preemption. Compare *id.* at 3, 7-8 (petitioners arguing that preemption applies to “both national banks and assignees of their receivables”) (emphasis omitted), with Resp. Mem. of Law in Opp. to Mot. for Summ. J. 3, 16-24 (Mar. 4, 2013) (D. Ct. Doc. 42) (respondent arguing that “a non-national bank assignee [may] enjoy the benefit of the National Bank Act exemption [only] where the national bank assignor retains a cognizable, substantive interest in the debt going forward”). The parties’ briefs did not distinguish between different types of preemption or address whether application of state usury law would interfere with the national bank’s exercise of its powers.

In the court of appeals, the parties’ arguments shifted. Respondent argued, *inter alia*, that petitioners must establish that application of state law would “significantly interfere with the national bank’s exercise of its powers.” Resp. C.A. Br. 14 (citations omitted); see *id.* at 12-14. Petitioners’ brief argued for NBA preemption but did not specify how the preemption analysis should work and did not cite Section 85 even once. The brief stated that petitioners had “no burden whatsoever to show an interference with a national bank’s exercise of powers,” Pets. C.A. Br. 23, which suggests that petitioners were attempting to disavow a conflict-preemption argument. But the brief also stated that the district court’s invocation of the valid-when-made rule “was not central to the [district court’s] decision and does not change the analysis at all.” *Id.* at 16.

As a result, the court of appeals expressed uncertainty about the precise nature of petitioners’ preemp-
tation theory, see Pet. App. 7a (stating that petitioners “appear to suggest that this case involves ‘conflict preemption’”), and attempted to limit its holding to the arguments presented by the parties, id. at 9a (stating that “no other mechanism appears on these facts” to establish that application of state usury law would significantly interfere with a national bank’s exercise of its powers). The court of appeals’ failure to recognize the full scope of powers granted to national banks under Sections 85 and 24(Seventh), and the court’s failure to appreciate the potential significance of the valid-when-made rule, may be attributable at least in part to the lack of clarity in the briefing. Because the briefing in the court of appeals failed to address key components of the preemption analysis, this is an unattractive case for further review.

b. The decision below is interlocutory, and resolution of the question presented might not affect the outcome of this case. Petitioners argued in the court of appeals that, even if respondent’s claims are not preempted by the NBA, respondent’s credit-card agreement with FIA contains a choice-of-law provision that mandates the application of Delaware law. Pet. App. 1a-2a. The court of appeals did not decide that issue, but instead remanded for the district court to consider the effect of the choice-of-law clause. Id. at 14a-15a. Because the parties “appear to agree that if Delaware law applies, the rate [petitioners] charged [respondent] was permissible,” id. at 15a, petitioners will likely prevail on remand if the district court accepts their reading of the credit-card agreement.

Even if the district court determines that New York law (rather than Delaware law) applies, petitioners could prevail on remand if New York usury law
itself incorporates the valid-when-made principle (assuming that petitioners have preserved such an argument). The argument that New York law incorporates this principle would be a natural corollary to petitioners’ description of the valid-when-made rule as a “fundamental principle of usury law.” Pet. 15; see Clearing House Ass’n L.L.C. et al. Cert. Amicus Br. 9-12 & n.3 (noting longstanding and pervasive acceptance of valid-when-made principle). And, to the extent that New York usury law treats FIA’s lawful origination of the loan as a ground for allowing petitioners to charge the same interest rate that FIA could have charged, state law does not conflict with the federal scheme. More generally, the practical importance of the pre-emption issue presented in this case depends significantly on the extent to which individual States decline to incorporate the valid-when-made rule into their own usury laws. Petitioners have made no effort to demonstrate that state-law departures from the valid-when-made rule have been widespread. For this reason as well, the Court’s review is not warranted at the present time.
Appendix Item 8
ORDER DENYING DEFENDANTS' MOTION FOR SUMMARY JUDGMENT
[filed 6/30/2016; Docket No. 139]

HONORABLE JOHN F. WALTER, UNITED STATES DISTRICT JUDGE

*1 On June 30, 2016, Plaintiff Consumer Financial Protection Bureau ("Plaintiff" or "CFPB") filed a Motion for Partial Summary Judgment. On July 11, 2016, Defendants CashCall, Inc. ("CashCall"), WS Funding, LLC ("WS Funding"), Delbert Services Corporation ("Delbert Services"), and J. Paul Reddam ("Reddam") (collectively, "Defendants") filed their Opposition. On July 18, 2016, Plaintiff filed a Reply.


Pursuant to Rule 78 of the Federal Rules of Civil Procedure and Local Rule 7-15, the Court found these matters appropriate for submission on the papers without oral argument. The matters were, therefore, removed from the Court's August 15, 2016 hearing calendar and the parties were given advance notice. After considering the moving, opposing, and reply papers, and the arguments therein, the Court rules as follows:

I. FACTUAL AND PROCEDURAL BACKGROUND 1

A. The Defendants

Defendant CashCall, a California corporation, is a lender to consumers and small businesses. Defendant Reddam is the founder, CEO, sole owner, and President of CashCall. Defendant WS Funding is a wholly-owned subsidiary of CashCall, which was formed to purchase loans made by non-party Western Sky Financial. 2 Defendant Delbert Services is a Nevada corporation which was formed to service loans that CashCall deemed in default, or "charged-off", and to provide collection services for other, unrelated clients.

B. CashCall's Consumer Loan Business
CashCall entered the unsecured consumer lending market in 2003 to provide a lower cost alternative to payday loans for credit-impaired borrowers and small businesses. Before 2006, CashCall primarily (if not exclusively) made loans to customers in California. In 2006, CashCall decided to expand its business beyond California. However, it opted not to obtain licenses to lend in other states because “in many of those states, the usury laws would not permit [CashCall] to make or service loans at the rates [CashCall] deemed necessary to make a profit.” Instead, CashCall expanded its business by paying two state-chartered federally-regulated banks to make loans that CashCall then purchased and serviced. The Maryland Court of Appeals recently referred to CashCall's arrangement with the state-chartered banks as a “rent-a-bank” scheme designed to take advantage of a federally-insured bank’s exemption from state usury limits. *CashCall, Inc. v. Maryland Comm'r of Fin. Regulation*, 139 A.3d 990, 995 n.12 (Md. 2016). This lending model was successful for CashCall until the two state-chartered banks withdrew from the arrangement under pressure from the FDIC.

*2 After the two state-chartered banks withdrew from the arrangement, counsel Claudia Callaway of Katten Muchin Rosenman LLP (“Katten”) advised CashCall’s general counsel, Dan Baren, that she was recommending that her clients move to a “tribal model,” and “that under federal Indian law the tribal lender could make these loans, and they could sell the loans to a non-tribal entity, and the loans could be collected upon at the contract rate, and the loans would not be subject to state regulation.” Baren described the “tribal model” as “almost identical to the [state-chartered] bank model.”

Callaway introduced Baren to Martin Webb, who was a member of the Cheyenne River Sioux Tribe (“CRST”) in South Dakota and who had founded two or three previous payday lending companies that used the tribal lending model. Webb and Baren discussed forming a tribal lending entity through which Webb would sell loans to CashCall.

As a result of those discussions, in 2009, Webb formed Western Sky Financial (“Western Sky”) with CashCall in mind. Western Sky was a South Dakota limited liability company and was licensed to do business by the CRST. Webb was Western Sky’s sole owner. Western Sky’s offices were located in Timber Lake and Eagle Butte, on the CRST Reservation in South Dakota. Western Sky constructed new facilities on the Reservation, including a call center and office, and communication infrastructure with CashCall’s assistance. Between January 2010 and August 2013, Western Sky was one of the largest private employers on the Reservation, employing more than 100 employees.

### C. CashCall and Western Sky's Agreements and Business Relationship

CashCall and Western Sky entered into two agreements signed by Reddam and Webb on behalf of their respective companies: (1) an Agreement for the Assignment and Purchase of Promissory Notes (the “Assignment Agreement”), and (2) an Agreement for Service (the “Service Agreement”). These agreements remained in effect from the time they were signed until Western Sky ceased doing business in September 2013.

Pursuant to the Assignment Agreement, signed in February 2010, CashCall, through its wholly-owned subsidiary WS Funding, agreed to “purchase from Western Sky Financial all loans made through www.westernsky.com as evidenced by the Notes.” CashCall's purchase obligation was “subject to the accuracy and correctness of Western Sky's representations and warranties contained in the Agreement,” including that borrowers satisfy “the criteria as set by Western Sky Financial from time to time, as shown more fully in the Criteria Appendix provided by Western Sky Financial.” To fund the Western Sky loans, a reserve account was established for Western Sky, into which CashCall deposited enough money to fund two days of loans, calculated on the previous month's daily average. Western Sky used this money to fund consumer loans. CashCall purchased all of Western Sky's loans after waiting a minimum of three days after the funding of each loan. CashCall never declined to purchase a loan made by Western Sky.

CashCall paid Western Sky the full amount disbursed to the borrower under the loan agreement plus a premium of 5.145% (either of the principal loan amount or the amount disbursed to the borrower). CashCall guaranteed Western Sky a minimum payment of $100,000 per month, as well as
a $10,000 monthly administrative fee. **Western Sky agreed to sell the loans to CashCall before any payments had been made by the borrowers. Accordingly, borrowers made all of their loan payments to CashCall, and did not make a single payment to Western Sky. Once Western Sky sold a loan to CashCall, all economic risks and benefits of the transaction passed to CashCall.**

*3 CashCall agreed to reimburse Western Sky for any repair, maintenance and update costs associated with Western Sky's server. CashCall also reimbursed Western Sky for all of its marketing expenses and bank fees, and some, but not all, of its office and personnel costs. In addition, CashCall agreed to “fully indemnify Western Sky Financial for all costs arising or resulting from any and all civil, criminal or administrative claims or actions, including but not limited to fines, costs, assessments and/or penalties ... [and] all reasonable attorneys fees and legal costs associated with a defense of such claim or action.”

Pursuant to the Service Agreement between CashCall and Western Sky, Western Sky granted CashCall a “non-exclusive license, to reproduce the name, trade name, trademarks, and logos of Western Sky Financial.” CashCall agreed to provide Western Sky with customer support, marketing, website hosting and support, assignment of a toll-free phone number, and to handle electronic communications with customers (although not all of these services were ultimately provided). In exchange for these services, Western Sky paid CashCall 2.02% of the face value of each loan that it sold to CashCall.

**D. The Lending Process for Western Sky Loans**

Consumers applied for Western Sky loans by telephone or online. When Western Sky commenced operations, all telephone calls from prospective borrowers were routed to CashCall agents in California. As the business developed, a growing number of Western Sky loan agents on the Reservation handled calls from prospective borrowers. Over time, “[l]oan agents for CashCall only handled the overflow for Western Sky applicants or borrowers calling in, should the staff at Western Sky not be able to handle the amount of calls.” CashCall loan agents were instructed to tell loan applicants that CashCall was hired to handle overflow calls for Western Sky.

Western Sky developed the underwriting criteria for its loans with input from CashCall. Although Western Sky employees reviewed, audited, and approved loans from the Western Sky offices on the Reservation, CashCall employees also independently reviewed the documentation submitted by borrowers to determine if it met program criteria and performed other loan origination and underwriting functions.

A borrower approved for a Western Sky loan would electronically sign the loan agreement on Western Sky's website, which was hosted by CashCall's servers in California. The loan proceeds would be transferred from Western Sky's account to the borrower's account. After a minimum of three days had passed, the borrower would receive a notice that the loan had been assigned to WS Funding, and that all payments on the loan should be made to CashCall as servicer. Charged-off loans were transferred to Delbert Services for collection.

The loan agreement for a Western Sky loan identified Western Sky Funding, LLC as the lender, and informed the borrower, in bold type, that it was “**subject solely to the exclusive laws and jurisdiction of the Cheyenne River Sioux Tribe, Cheyenne River Indian Reservation.”** In the “Governing Law” section of the agreement, the borrower was informed that:

This Agreement is governed by the Indian Commerce Provision of the Constitution of the United States of America and the laws of the Cheyenne River Sioux Tribe. We do not have a presence in South Dakota or any other states of the United States. Neither this Agreement nor Lender is subject to the laws of any state of the United States of America.

In a separate section of the loan agreement, the borrower was informed that Western Sky “may assign or transfer this Loan Agreement or any of our rights under it at any time to any party.” The interest rate on the Western Sky loans was clearly and prominently disclosed on the first page of the loan agreement.
III. DISCUSSION

A. The Court will apply the law of the 16 subject states.

The CFPB's theory as to Defendants' liability rests entirely on its argument that the Court should disregard the tribal choice-of-law provision in the loan agreements, and apply the law of the borrowers' home states. Accordingly, the Court must first determine whether the loan agreements are governed by CRST law, as provided by the choice-of-law provision, or the law of the borrowers' home states.

Because the Court's jurisdiction is premised on federal question jurisdiction, federal common law supplies the choice-of-law rules. See Huynh v. Chase Manhattan Bank, 465 F.3d 992, 997 (9th Cir. 2006) (holding that, where jurisdiction is not premised on diversity of citizenship, federal common law governs). “Federal common law follows the approach outlined in the Restatement (Second) of Conflict of Laws.” Huynh, 465 F.3d at 997. Pursuant to section 187(2) of the Restatement (Second) of Conflict of Laws (“Restatement”), “[t]he law of the state chosen by the parties to govern their contractual rights and duties will be applied, ..., unless either (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties’ choice, or (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.” Restatement § 187(2). The Court concludes that the CRST choice-of-law provision fails both of these tests, and that the law of the borrowers' home states applies to the loan agreements.

1. CashCall, not Western Sky, is the “true” or “de facto” lender.

In order to properly apply the choice-of-law principles set forth in Restatement § 187(2), the Court must determine the identity of the parties to the loan agreements. Although Western Sky is identified as the lender in the loan agreements, the CFPB argues that the Court should consider the substance, not the form, of the transaction and determine that CashCall is the “true” or “de facto” lender. Neither the Court nor the parties have discovered any binding precedent on this issue. However, after reviewing all of the relevant case law and authorities cited by the parties, the Court agrees with the CFPB and concludes that it should look to the substance, not the form, of the transaction to identify the true lender. See Ubaldi v. SLM Corp., 852 F. Supp. 2d 1190, 1196 (N.D. Cal. 2012) (after conducting an extensive review of the relevant case law, noting that, “where a plaintiff has alleged that a national bank is the lender in name only, courts have generally looked to the real nature of the loan to determine whether a non-bank entity is the de facto lender”); Eastern v. American West Financial, 381 F.3d 948, 957 (9th Cir. 2004) (applying the de facto lender doctrine under Washington state law, recognizing that “Washington courts consistently look to the substance, not the form, of an allegedly usurious action”); CashCall, Inc. v. Morrisey, 2014 WL 2404300, at *14 (W. Va. May 30, 2014) (unpublished) (looking at the substance, not form, of the transaction to determine if the loan was usurious under West Virginia law); People ex rel. Spitzer v. Cty. Bank of Rehoboth Beach, Del., 846 N.Y.S.2d 436, 439 (N.Y. App. Div. 2007) (“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.”). “In short, [the Court] must determine whether an animal which looks like a duck, walks like a duck, and quacks like a duck, is in fact a duck.” In re Safeguard Self-Storage Trust, 2 F.3d 967, 970 (9th Cir. 1993).

*6 In identifying the true or de facto lender, courts generally consider the totality of the circumstances and apply a “predominant economic interest,” which examines which party or entity has the predominant economic interest in the transaction. See CashCall, Inc. v. Morrisey, 2014 WL 2404300, at *14 (W.D. Va. May 30, 2014) (affirming the lower court's application of the “predominant economic interest” test to determine the true lender, which examines which party has the predominant economic interest in the loans); People
ex rel. Spitzer v. Cty. Bank of Rehoboth Beach, Del., 846 N.Y.S.2d 436, 439 (N.Y. App. Div. 2007) (“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.’”); cf. Ga. Code Ann. § 16-17-2(b) (4) (“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.”). The key and most determinative factor is 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. See, e.g., Eastern, 381 F.3d at 957 (“[T]he touchstone for decision here is whether licensed or unlicensed parties were placing their own money at risk at any time during the transactions.”); Morrissey, 2014 WL 2404300 at *7 (in reaching its conclusion that CashCall was the true or de facto lender, the lower court found that “numerous provisions of CashCall's agreements with FB & T placed the entire monetary burden and risk of the loan program on CashCall, and not on FB & T.”). Indeed, as the Ninth Circuit stated in Eastern, “a lender is one who puts money at risk.” Eastern, 381 F.3d at 957.

Based on the totality of the circumstances, the Court concludes that CashCall, not Western Sky, was the true lender. CashCall, and not Western Sky, placed its money at risk. It is undisputed that CashCall deposited enough money into a reserve account to fund two days of loans, calculated on the previous month’s daily average and that Western Sky used this money to fund consumer loans. It is also undisputed CashCall purchased all of Western Sky’s loans, and in fact paid Western Sky more for each loan than the amount actually financed by Western Sky. Moreover, CashCall guaranteed Western Sky a minimum payment of $100,000 per month, as well as a $10,000 monthly administrative fee. Although CashCall waited a minimum of three days after the funding of each loan before purchasing it, it is undisputed that CashCall purchased each and every loan before any payments on the loan had been made. CashCall assumed all economic risks and benefits of the loans immediately upon assignment. CashCall bore the risk of default as well as the regulatory risk. Indeed, CashCall agreed to “fully indemnify Western Sky Financial for all costs arising or resulting from any and all civil, criminal or administrative claims or actions, including but not limited to fines, costs, assessments and/or penalties ... [and] all reasonable attorneys fees and legal costs associated with a defense of such claim or action.”

Accordingly, the Court concludes that the entire monetary burden and risk of the loan program was placed on CashCall, such that CashCall, and not Western Sky, had the predominant economic interest in the loans and was the “true lender” and real party in interest. The Court will now apply the principles set forth in Restatement § 187(2), in light of the Court's determination of the real parties in interest to the loan agreement, i.e., CashCall and the borrower.

2. The Cheyenne River Sioux Tribe has no substantial relationship to the parties or the transactions and there is no other reasonable basis for the parties' choice of CRST law.

The Court concludes that the CRST has no substantial relationship to the parties or the transactions and that there is no other reasonable basis for the parties' choice of CRST law. See Restatement § 187(2)(a).

As indicated in the comments to Restatement § 187(2), a state has a substantial relationship to the parties or the transaction when, for example, “this state is that where performance by one of the parties is to take place or where one of the parties is domiciled or has his principal place of business. The same will also be the case when this state is the place of contracting except, perhaps, in the unusual situation where this place is wholly fortuitous and bears no real relation either to the contract or to the parties.” Restatement § 187(2), comment f.

*7 In light of CashCall's status as the true lender, the Court concludes that the CRST does not have a substantial relationship to the parties or the transactions. Indeed, CashCall, the true lender, is a California corporation domiciled in Orange County that the CRST neither owns or manages. The borrowers do not reside on the Reservation and, in fact, never entered CRST lands to apply for loans. They applied for their loans...
and licensing. Indeed, the lack of such laws may instead merely “reflect a choice to favor individual contract decisions and the free flow of capital.” See Shannon-Vail Five Inc. v. Bunch, 270 F.3d 1207, 1213 (9th Cir. 2001). However, as the CFPB points out, the CRST has enacted laws that criminalize usury, suggesting that the CRST does not have any interest in protecting these types of transactions.

Accordingly, the Court concludes that application of CRST law would be contrary to a fundamental policy of the Subject States, and that the Subject States have a materially greater interest than the CRST in the enforcement of its usury and licensing laws.

(b) Absent an effective choice-of-law provision, the Subject States' laws apply.

Pursuant to Restatement § 188, absent an effective choice of law provision by the parties, courts apply the local law of the state which “has the most significant relationship to the transaction and the parties.” Restatement § 188(1). In making this determination, courts consider the following factors: “(a) the place of contracting, (b) the place of negotiation of the contract, (c) the place of performance, (d) the location of the subject matter of the contract, and (e) the domicile, residence, nationality, place of incorporation and place of business of the parties.” Id. at § 188(2). “These contacts are to be evaluated according to their relative importance with respect to the particular issue.” Id. In light of the CashCall's status as true lender, these factors weigh in favor of the application of the law of the borrowers' home states. The borrowers were citizens or residents of the addresses listed on their loan applications (i.e., their home states), the borrowers applied for the loans from their home states, the funds were received by the borrowers in their home states, and the borrowers made payments on their loans from their home states. In addition to the home states of the borrowers, California also has significant contacts to the loan transactions. CashCall is a California corporation domiciled in Orange County. In order to apply for the loan, the borrowers visited Western Sky's website, which was hosted by CashCall's servers in California. In addition, the funds for the loans were provided by CashCall in California (albeit initially funneled through Western Sky's bank accounts). Moreover, although some loan origination functions took place on the Reservation, some also took place in California. Although California, the CRST, and the borrowers' home states each have some interest in the loan transactions, the Court is required to determine which state has the most significant relationship to the transaction and the parties. After weighing all of the factors, the Court concludes that the borrowers' home states have the most significant relationship to the transactions.

*9 The Court's conclusion is consistent with Restatement § 195, which specifically governs the “Contracts for the Repayment of Money Lent.” Section 195 provides in relevant part: “The validity of a contract for the repayment of money lent and the rights created thereby are determined, in the absence of an effective choice of law by the parties, by the local law of the state where the contract requires that repayment be made....” However, Restatement § 195 only applies “when the contract requires that the loan be repaid in a particular state. It is necessary either that the place of repayment be explicitly stated in the contract, or that it can be determined by necessary inference from the contract's terms, or lastly, that repayment in a particular place is required by business usage. The rule does not apply when the loan can be repaid in any one of two or more states.” Restatement § 195, comment a. In this case, nine of the ten sample loan agreements provided to the Court authorized Western Sky (and in reality, CashCall) to withdraw the borrower's loan payments by electronic funds transfer from the borrower's bank account, unless the borrower opted out. Thus, repayment was generally required to be made by EFT from or in the borrowers' home states.

Accordingly, the Court concludes that, absent an effective choice-of-law provision, the law of the borrowers' home states applies to the loan agreements.

For the foregoing reasons, where Western Sky loans were made to borrowers in the Subject States, the Court concludes that the tribal choice of law provision is
unenforceable and the Court will apply the laws of the Subject States.

B. Western Sky loans are void or uncollectible under the laws of most of the Subject States.

Because the CFPB has established that CashCall is the true lender and that the laws of the Subject States apply to the loan agreements, the Court must now determine whether the CFPB has demonstrated that the loans are void or uncollectible under the laws of the Subject States. In absence of any meaningful briefing by the Defendants on this issue, the Court concludes that Defendants do not seriously dispute the CFPB’s argument.

The Court concludes that the CFPB has established that the Western Sky loans are void or uncollectible under the laws of most of the Subject States. See CFPB’s Combined Statement of Facts [Docket No. 190] (“CFPB’s CSF”) at ¶ 147-235. Indeed, CashCall has admitted that the interest rates that it charged on Western Sky loans exceeded 80%, which substantially exceeds the maximum usury limits in Arkansas, Colorado, Minnesota, New Hampshire, New York, and North Carolina. (Arkansas's usury limit is 17%; Colorado's usury limit is 12%; Minnesota's usury limit is 8%; New Hampshire's usury limit is 36%; New York's usury limit is 16%; and North Carolina's usury limit is 8%). A violation of these usury laws either renders the loan agreement void or relieves the borrower of the obligation to pay the usurious charges. In addition, all but one of the sixteen Subject States (Arkansas) require consumer lenders to obtain a license before making loans to consumers who reside there. Lending without a license in these states renders the loan contract void and/or relieves the borrower of the obligation to pay certain charges. CashCall admits that, with the exception of New Mexico and Colorado, it did not hold a license to make loans in the Subject States during at least some of the relevant time periods.

C. CashCall and Delbert Services violated the CFPA by servicing and collecting on loans where payments were not due and owing.

*10 After resolving these preliminary issues, the Court is finally able to address the gravamen of the CFPB's claims – whether Defendants' conduct violates the CFPA. Under section 5536(a)(1)(B) of the CFPA, it is unlawful for any covered person “to engage in any unfair, deceptive, or abusive act or practice.” 12 U.S.C. § 5536(a)(1)(B). “An act or practice is deceptive if: (1) there is a representation, omission, or practice that, (2) is likely to mislead consumers acting reasonably under the circumstances, and (3) the representation, omission, or practice is material.” Consumer Fin. Prot. Bureau v. Gordon, 819 F.3d 1179, 1192-93 (9th Cir. 2016) (quotations and citations omitted). “Deception may be found based on the ‘net impression’ created by a representation.” Id. (quotations and citations omitted).

Based on the undisputed facts, the Court concludes that CashCall and Delbert Services engaged in a deceptive practice prohibited by the CFPA. By servicing and collecting on Western Sky loans, CashCall and Delbert Services created the “net impression” that the loans were enforceable and that borrowers were obligated to repay the loans in accordance with the terms of their loan agreements. As discussed supra, that impression was patently false — the loan agreements were void and/or the borrowers were not obligated to pay.

The Court concludes that the false impression created by CashCall's and Delbert Services' conduct was likely to mislead consumers acting reasonably under the circumstances. Indeed, the intentionally complicated and sham structure of the Western Sky loan program would have made it impossible for reasonable consumers to know that CRST law did not govern the loan agreements, and thus that their loans were void and/or not payable under the laws of their home states. Not surprisingly, the CFPB has presented evidence that borrowers were, in fact, misled. See CFPB's Exh. 524 (Affidavit of Karen Barboza) at ¶ 12 (“I was under the impression that I was obligated to pay back the full amount of my loan. I do not recall ever being told by anyone at CashCall that I was not obligated to pay back all or some of my loan.”); Exh. 526 (Affidavit of John A. Melo) at ¶ 12 (“From the beginning I was led to believe that I was obligated to repay my loan in full. Aside from the May 2013 phone call wherein they said that they are not presently collecting from Massachusetts' residents, I do not recall being told by anyone at CashCall or Western Sky that my loan was void or that I was not obligated to repay all or some of the loan.”); Exh. 527