Clients&FriendsMemo

Marketplace Lending #8: Colorado Scores in Madden 2020

June 24, 2020

On June 9, a Colorado trial court ruled that loans to Colorado consumers originated by Cross River Bank on behalf of Marlette Funding were subject to the Colorado usury rate -- despite federal law that allows an FDIC-insured bank such as Cross River Bank to "export" its rate of interest from the bank's home state. The decision in *Martha Fulford, Administrator, Uniform Consumer Credit Code v. Marlette Funding, LLC*[1] raises significant questions about the treatment of loans made by banks to Colorado residents and the ability of assignees of those loans—including securitizations—to collect the rate of interest originally agreed to by the borrower. The decision caps – at least for now – a three-year battle on this issue between the Colorado Consumer Credit Code Administrator (an officer in the Attorney General's Office) and Marlette Funding.

In January 2017, the Colorado Consumer Credit Code ("UCCC") Administrator sued Marlette to halt its reliance on the "bank origination model" to generate Marlette loans. According to the Administrator, Marlette loans to Colorado consumers violated the UCCC because the interest rate exceeded the rate allowed to non-licensed lenders. The Administrator asserted that although the loans were nominally by an out-of-state FDIC-insured state-chartered bank (New Jersey's Cross River Bank), the "true lender" was Marlette. And while the Administrator acknowledged that an out-of-state state-chartered bank (such as Cross River Bank) may "export" interest rates under Section 27 of the Federal Deposit Insurance Act ("FDIA"),[2] the Administrator asserted that exportation rights do not apply to Marlette loans due to the manner in which they are originated. According to the Administrator, because Marlette was the "true lender,; rate exportation under Section 27 did not apply, and the Marlette loans made to Colorado residents must comply with the UCCC's restrictions on finance charges and fees (including unlicensed lenders' cap of 12% and a cap of 21% for bank- or licensee-originated loans). The Administrator also relied on the Second Circuit's decision in *Madden v. Midland Funding, LLC*[3] to assert in the alternative that, even if the bank were the "true lender," assignees of the bank's loans cannot collect the same interest rates and fees that

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[1] Order Regarding Plaintiff's Motion for Determination of Law, Slip Op., Denver District Court, Denver County, Colo., No. 2017CV30376 (June 9, 2020).

[2] 12 U.S.C. § 1831d.

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

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banks may collect. Under that theory, even loans that may have been legal and enforceable when made by the bank may not be enforceable when in the hands of a subsequent non-bank holder.

The Defendants removed the case to federal court in 2017. At the same time, a separate declaratory judgment action was brought in federal court asking the court to declare the loans originated under the marketplace lending model to be valid on their terms. But the federal court abstained, citing the ongoing state litigation. Separately, the original *Marlette* matter was remanded.[4] The Commissioner then upped the ante by naming 36 securitization trusts that acquired Marlette's Colorado loans as co-defendants.[5] The securitization trusts' efforts to dismiss those claims failed.[6]

The Colorado litigation is one of many attempts to apply usury concepts to marketplace lenders, who use arrangements with unaffiliated banks to originate the loans—a practice often called "the bank origination model." Unlike a finance company, a bank is typically exempted from with state licensing requirements, and need not comply with borrower-state usury rates due to federal preemption. For marketplace lenders, the bank origination model facilitates streamlined and efficient origination of loans without the burden of having to comply with fifty different sets of state laws. The result, proponents of the model say, is greater access to consumer credit. But critics argue that the model allows unregulated out-of-state lenders to evade state supervision and charge interest rates exceeding state usury caps.

The key issue in most marketplace lending cases had long been the identity of the "true lender"—the bank or the marketplace lender. If the bank is the true lender, then the loans are deemed as originated by a bank, and borrower-state usury and licensing requirements are thus inapplicable. If the bank is not the true lender, then the loans are deemed not to have been originated by a bank and borrower-state usury and licensing requirements apply at origination. Since the Second Circuit's decision in *Madden v. Midland Funding*, however, a second issue has emerged: even if the bank is the true lender, can a non-bank assignee of the bank's loan collect the same rate of interest as imposed by the bank itself? That is, is the bank's loan enforceable in the hands of any

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[4] For further analysis of these issues, see our prior Clients & Friends Memo "Another Rocky Mountain Remand" (March 29, 2018).

[5] For further analysis of these issues, see our prior Clients and Friends memo "Litigation Mounts to New Highs in Colorado—Securitizations under Attack" (January 2, 2019).

[6] For further analysis of these issues, see our prior Clients and Friends memo "The Very Long Arm of Colorado Law" (April 24, 2019).

assignee so long as the loan was "valid when made"? [7] Those are the questions resolved by the *Marlette* court's June 9 ruling.[8]

The court answered those questions in the negative. The court reasoned that, by its plain text, "Section 27 [of the FDIA] applies [only] to state banks and does not extend the privilege of interest exportation to non-banks such as Marlette and other defendant trust banks."[9] If Congress "intended this privilege to extend beyond banks, their branches, or their subsidiaries," the court explained, "Congress could have easily included additional language."[10] But without that language, the court ruled, "[e]xtending [Section 27's] protections to third parties would create an end-run around usury laws for [non-bank] entities." And the court not only relied on *Madden* for that rationale, it adopted *Madden's* analysis expressly: "While Defendants and *amici* are adamant in their disagreement with *Madden*, this Court finds its analysis under the [National Bank Act] to be persuasive and applicable to this matter and analysis of Section 27 [of the FDIA]."

The court also questioned the bona fides of the valid-when-made doctrine:

> Defendants, of course, argue that [the valid when made doctrine] is long established and has been a guiding principle of banking for over a hundred years. *See Nichols v. Fearson*, 32 U.S. 103 (1833). Interestingly, however, the question presented [in *Nichols*] was whether a subsequent transfer of a promissory note rendered the original contract usurious. The [U.S. Supreme] Court found that it did not. *Id.* at 109. However, the argument here does not concern the validity of the original contract upon a transfer, but rather whether the assignee of a loan, regardless of its nature, may charge the interest rate of the assignor so long as the assignor's interest rate was valid. It is debatable, then, whether the version of "Valid When Made" is a cardinal rule greater than a century old.

The court ultimately disposed of defendants' valid-when-made argument by reasoning that because the text of Section 27 "limit[s] interest rate exportation rights to banks," the court need not resort to the valid-when-made doctrine for assistance in interpreting Section 27.[11] Under that reasoning, the enforceability of loans turns on whether the current holder of a loan is a bank – and not whether the

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[7] For further analysis of these issues, see our prior Clients and Friends memo "It's a Mad, Mad, Madden World" (June 29, 2016).

[8] The court suggested in dicta that Cross River Bank is not the true lender:

> Further, the Valid When Made doctrine implies that the first transaction was valid. This question is explored further in the Court's Order regarding summary judgment, but suffice it to say, if Marlette were the "true lender," then the interest rates associated with the loans in question were invalid in the first instance under Colorado usury law.

[9] Order, No. 2017CV30376, Denver District Court, at 7.

[10] *Id.* at 5 (citing *Forfar v. Wal-Mart Stores, Inc.*, 436 P.3d 580, 588 (Colo. App. 2018)).

[11] Order, No. 2017CV30376, Denver District Court, at 8.

loan was valid when made. The *Marlette* court's rationale would thus write the valid-when-made doctrine out of the law, at least with respect to bank-originated loans made on a cross-border basis..

Turning to the Defendants' argument that two federal banking regulators – the FDIC and Office of the Comptroller of the Currency, the regulator of national banks ("OCC") – "endorse [the Defendants'] position, reject *Madden*, and have proposed rule changes to Congress," the court recognized "that these federal agencies are entitled to some deference." But the court ruled that "the rule proposals are not yet law and the Court is not obligated to follow those proposals."[12] The court did not, however, reference the OCC's final regulation, announced only 11 days earlier, interpreting the interest rate exportation provisions of the National Bank Act to provide that an assignee of a national bank may collect the same rate of interest as the originating national bank[13]—and the court may well have been unaware of that final action. It is unclear, however, whether knowledge of the OCC's final rulemaking would have affected the court's ruling.

Thus, unpersuaded by the Defendants' arguments, the court relied on its reading of Section 27 and *Madden* to rule that "non-bank purchasers [of Marlette loans] are prohibited under C.R.S. § 5-2-201 from charging interest rates on the designated loans in excess of Colorado's interest caps" (*i.e.*, 12% or 21% for bank- or licensee-originated loans).

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[12] When interpreting the federal law it is charged to enforce, a banking agency is typically entitled to some deference, see *Smiley v. Citibank*, 517 U.S. 735 (1996)), although deference concepts can be less clear when the agency is interpreting federal law in a manner that overrides state law, especially when the agency's interpretation is somewhat inconsistent with a prior federal judicial decision, such as the Second Circuit's decision in *Madden v. Midland Funding*.

[13] Office of the Comptroller of the Currency, Final Regulation, Permissible Interest on Loans that are Sold, Assigned, or Otherwise Transferred, 85 Fed. Reg. 33530 (June 2, 2020). *See also* https://www.occ.gov/news-issuances/federal-register/2020/nr-occ-2020-71a.pdf. (May 29th news release from the OCC). Note that this final regulation should not affect the analysis over the identity of the true lender—an issue that we expect the Marlette court to deal with in a ruling on summary judgment. In the preamble accompanying its final regulation, the OCC was careful to draw a distinction between the "valid when made" doctrine and the question of whether marketplace loans made under the bank origination model are subject to challenge:

> Several commenters also requested that the OCC address who is the true lender in its regulatory text. One commenter requested that the OCC specifically include regulatory text providing that the rule does not affect the determination of which entity is the true lender. The OCC reiterates that this rule does not address which entity is the true lender but does not believe it is necessary to specifically include a statement to this effect in the regulatory text. Another commenter requested that the OCC include a proviso providing that the rule only applies when the bank is the true lender, as determined by the law of the state where the borrower resides. Because the rule only applies to bank loans that are permissible under section 85 or 1463(g), the OCC does not believe that adding this proviso is necessary. Other commenters requested that the OCC establish a test for determining when the bank is the true lender. This would raise issues distinct from, and outside the scope of, this narrowly tailored rulemaking.

Id. at p. 33535. A parallel regulation interpreting the interest rate exportation provisions of the FDIA has not yet been finalized by the FDIC. *Federal Deposit Insurance Corporation, Proposed Regulation, Federal Interest Rate Authority*, 84 Fed. Reg. 66845 (Dec. 6, 2019).

The court's ruling came as a surprise to some, who believed that the actions by the OCC and the FDIC would discourage courts from adopting the *Madden* decision. And it underscores the risks that persist in some states for marketplace lenders using the bank origination model and the care that should be exercised when using the model to originate consumer loans in excess of local usury rates and when purchasing or financing such loans.

While the trial court in *Marlette* has set out its view, we expect that whether Colorado follows *Madden* and rejects the "valid when made" theory will likely be addressed on appeal.[14]

We will continue to monitor these marketplace lending issues and provide further updates as appropriate.

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[14] A separate lawsuit was filed by the Administrator against another marketplace lender, Avant, based on an identical theory. This case is also pending before state court in Colorado before the same judge. *See Martha Fulford, Administrator, Uniform Consumer Credit Code v. Avant of Colo. LLC*, Denver District Court, Denver County, Colo., No. 2017CV30377 (filed Jan. 27, 2017).