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Clients&FriendsMemo

Marketplace Lending Update #4: Litigation Mounts to New Highs in Colorado – Securitizations under Attack

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On November 30, 2018, the Administrator of the Colorado Uniform Consumer Credit Code (the "Administrator") took Colorado's longstanding litigation against marketplace lenders Avant and Marlette to a new level, adding as defendants certain securitization trusts that had acquired Avant or Marlette loans. By threatening the buyers of marketplace loans, the Administrator is escalating the pressure on Avant and Marlette–and indirectly the pressure on other marketplace lenders that extend credit to Colorado consumers.

Background

As discussed in our prior Clients & Friends Memos (see *Marketplace Lending Update #1: Who's My Lender?* (Mar. 14, 2018) and *Marketplace Lending Update #2: Another Rocky Mountain Remand* (Mar. 29, 2018)), in 2017 the Administrator sued Avant and Marlette in separate actions, alleging that they made loans to Colorado consumers and charged interest rates above the maximum rate allowed by the Colorado Uniform Consumer Credit Code ("UCCC"). The Administrator asserts that although the loans were nominally by out-of-state FDIC-insured state-chartered banks (for Avant, Utah's WebBank, and for Marlette, New Jersey's Cross River Bank), the "true lenders" were Avant and Marlette. Although out-of-state banks are permitted to "export" interest rates and certain fees when making loans to Colorado consumers, exportation rights do not apply to entities such as Avant and Marlette, because neither is a bank. The Administrator therefore contends that the Avant- and Marlette-related loans made to Colorado residents must comply with the UCCC's restrictions on finance charges and fees.

Alternatively, the Administrator argues that, even assuming the banks were the "true lenders" of the Avant and Marlette loans, assignees of the loans are unable to collect the same interest rates and fees allowed to the originating banks, citing the Second Circuit's decision in *Madden v. Midland Funding, LLC*.[1] Under the Administrator's theory, even loans that may have been legal and enforceable when made may not necessarily be enforceable by their terms in the hands of a

[1] *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016) (refusing to apply the "valid-when-made" doctrine to loans originated by a national bank).

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subsequent non-bank holder. This is an attack on the so-called "valid-when-made" doctrine, a theory that is fundamental to the ability to transfer loans in the secondary market.[2]

Efforts earlier this year to derail the lawsuits through removal to federal court or to seek declaratory judgment relief in parallel actions in federal court failed.

In the newly amended complaints, the Administrator names as defendants thirty-six securitization trusts (collectively, the "Trusts") that the Administrator contends had purchased Avant or Marlette loans and for which either Wilmington Trust, N.A. or Wilmington Savings Fund Society, FSB (a national bank and a federal savings bank, respectively) serves as trustee (collectively, the "Wilmington Trustees"). The Administrator asserts that the Trusts violated the UCCC by receiving finance charges and late fees not authorized by the UCCC. The Administrator requests that the court order the Trusts to disgorge any finance charges or fees received beyond those permitted by the UCCC and:

> for every consumer credit transaction as may be determined at trial or otherwise in which a consumer was charged an excess charge, [to] order[] [Avant or Marlette and the respective] Trusts to pay to each such consumer a civil penalty determined by the Court not in excess of the greater of either the amount of the finance charge or ten times the amount of the excess charge.[3]

Analysis

The Administrator argues that the Trusts are "creditors" under the UCCC. The UCCC permits the Administrator to seek penalties from any "creditor."[4] In this regard, "creditor" is defined as:

> the seller, lessor, lender, or person who makes or arranges a consumer credit transaction and to whom the transaction is initially payable, ***or the assignee of a creditor's right to payment,*** but use of the term does not in itself impose on an assignee any obligation of his or her assignor….

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[2] For a detailed discussion of *Madden* and the valid-when-made doctrine, see our prior Clients & Friends Memo, *It's a Mad, Mad, Madden World* (June 29, 2016).

[3] The Administrator also argues that the Avant and Marlette loan agreements violate the UCCC because they contain a choice-of-law clause selecting a governing law other than Colorado. With respect to Marlette, the Administrator also alleges that Marlette charges a $25 extension fee not authorized by the UCCC.

[4] Colo. Rev. Stat. Ann. § 5-6-114.

As for the penalty of ten times the excess charges, the UCCC provides:

> If a creditor has made an excess charge in deliberate violation of or in reckless disregard for this code or if a creditor has refused to refund an excess charge within a reasonable time after demand by the consumer or the administrator, the court may also order the respondent to pay to the consumers a civil penalty in an amount determined by the court not in excess of the greater of either the amount of the finance charge or ten times the amount of the excess charge.[5]

The Administrator's claim for a tenfold penalty is aggressive. Even if the Trusts are "creditors," the Trusts are not plausibly alleged to have made an excess charge in "deliberate violation" or "reckless disregard" of the UCCC, since it has yet to be established who is the "true lender" or whether the UCCC's restrictions on rates and fees apply to the Avant and Marlette loans held by the Trusts. For the same reason, it seems doubtful that a "reasonable time" has yet passed. If the court were to conclude that the "true lenders" were in fact WebBank and Cross River Bank and uphold the valid-when-made doctrine, the loans are not subject to the UCCC's restrictions on finance charges and late fees under the doctrine of "exportation."[6] To demand that an entity disgorge loan fees and charges now or face the prospect of having to disgorge ten times those amounts later – even without a judicial determination whether the fees and charges were illegal–is a troubling tactic.

The Administrator's alternative assertion that the court should follow the Second Circuit's decision in *Madden* is even more troubling. The *Madden* decision has been widely criticized, including by the federal banking regulators. The notion that the same loan can be usurious or non-usurious depending on who owns the loan at any given time is a bit absurd. If the *Madden* concept were to prevail, it would not only disrupt the secondary market for loans, but also devalue such loans already on a bank's books; the bank would be unable to sell the loans at anything approaching their fair market value. The *Madden* concept also runs contrary to the public policy of protecting consumers by seemingly suggesting that a usurious and illegal loan can be made legal–effectively sanitized–merely by selling the loan to a bank with rate exportation authority.

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[5] Colo. Rev. Stat. Ann. § 5-6-114(b).

[6] *See* 12 U.S.C. § 1831d(a) (permitting FDIC-insured state-chartered banks to export the rate of interest allowed by the law of the State where the bank is located, notwithstanding any other state law to the contrary); *see also Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735 (1996) (concluding that late fees are considered part of the "interest rate" for exportation purposes).

In any event, the filing of the amended complaints underscores that the fight over the "bank origination model" used by marketplace lenders is far from over. Secondary market purchasers and warehouse lenders should continue to approach with caution marketplace loans involving consumers residing in states (such as Colorado) where the bank origination model is under attack, especially if the rates and fees being charged those consumers exceed local restrictions.

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