Clients&FriendsMemo

Marketplace Lending Update: Who's My Lender?

March 14, 2018

Over the last several weeks, two notable cases in federal court challenging certain aspects of the business model of marketplace lending companies headed down separate paths. First, in an action brought against Kabbage, Inc. and Celtic Bank Corporation in the United States District Court for the District of Massachusetts,[1] the parties agreed to, and the Court approved, a stipulation staying the proceedings pending an arbitrator's review of whether the claims in that action are covered by the arbitration provisions in the governing loan agreements. Second, in an action against marketplace lender Avant in the United States District Court for the District of Colorado,[2] the Court accepted a magistrate judge's recommendation to remand the case to state court over Avant's objection.

The Kabbage Action (Massachusetts)

In October 2017, Plaintiffs NRO Boston, LLC and Alice Indelicato sued Kabbage, a non-bank finance company, and Celtic Bank, Kabbage's lending partner, alleging violations of Massachusetts' criminal usury and consumer protection laws. In short, Plaintiffs alleged that Kabbage's arrangement with Utah-based Celtic Bank enabled it to make loans with interest rates exceeding twenty percent, the maximum rate allowed under the Massachusetts criminal usury statute. Specifically, Plaintiffs alleged that Kabbage entered into a "criminal enterprise with Celtic Bank for the express purpose of evading the criminal usury laws." Plaintiffs claimed that even though Celtic Bank is listed as the lender on Kabbage's loan documents, Celtic is not the "true lender" because those loans are immediately assigned to Kabbage following their issuance. Plaintiffs contended that Kabbage is the lender because Kabbage originates, underwrites, funds, and assumes full responsibility for all risk of loss on the loans. According to Plaintiffs, by making loans with rates above twenty percent, Kabbage violated Massachusetts' criminal usury laws, the penalty for which is to render void the allegedly usurious loans, not merely to reduce their interest rates to a non-usurious level as in most jurisdictions.

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1 *NRO Boston, LLC & Indelicato v. Kabbage, Inc. & Celtic Bank Corp.*, No. 1:17-cv-11976 (D. Mass. Oct. 12, 2017).

2 *Meade v. Avant of CO, LLC*, No. 1:17-cv-00620 (D. Col. Mar. 9, 2017).

In response to Plaintiffs' claims, Defendants countered that Plaintiffs' federal action was inappropriate given the arbitration provisions in the loan agreements. When Plaintiffs refused to consent to arbitration, Kabbage and Celtic Bank moved to compel arbitration. After the parties had fully briefed the motion, they entered into a stipulation staying the federal court proceedings until an arbitrator determines whether Plaintiffs' claims must be arbitrated. On February 23, 2018, the Court approved this stipulation and denied Defendants' motion to compel arbitration as moot. Plaintiffs must file a demand for arbitration by March 25, 2018, and the parties must update the Court within thirty days of the arbitrator's decision.

The Avant Action (Colorado)

Meanwhile, in Colorado, marketplace lender Avant is facing litigation in Colorado state court after the federal District Court's March 1, 2018, decision to adopt a magistrate judge's report and recommendation to remand the action to state court. Colorado's Administrator of the Uniform Consumer Credit Code sued Avant in state court in early 2017, alleging that Avant, also a non-bank finance company, charged interest rates above the maximum allowed by Colorado law and that Avant's loan agreements contained unlawful choice-of-law provisions through its affiliation with Utah-based WebBank. Avant's relationship with WebBank is similar to Kabbage's relationship to Celtic Bank. Unlike in Massachusetts, however, a violation of the Colorado usury statute does not result in voiding the loan; instead, the statute calls on the Court to reduce and enforce the finance charge to comply with the statutory limit.

Avant removed the action to federal court but, on March 1, 2018, the Court adopted the magistrate judge's recommendation to remand the action to state court. The Court agreed with the magistrate that Plaintiff's state law claims were not completely preempted by the Federal Deposit Insurance Act because the claims at issue were not asserted against a state bank, as state-chartered WebBank was not a named Defendant in the action. In adopting the magistrate judge's recommendation, the Court rejected arguments advanced by several industry associations appearing as *amici curiae*, including the American Bankers Association and Loan Syndications and Trading Association,[3] that the true lender doctrine warranted federal jurisdiction because the loans were made by WebBank. Rather, the Court concluded that although Avant may have a federal preemption defense to Plaintiffs' state law claims if WebBank is determined to be the true lender, this does not does not provide the Court with federal question jurisdiction based on complete preemption and, therefore, does not justify removal. As a result, Avant will be forced to assert its argument that Plaintiffs' claims are preempted by federal law, and any other defenses, in state court. That being said, the analysis in the magistrate's recommendation adopted by the Court suggests that the magistrate believed that the true lender in this instance was Avant, not the bank.

[3] The Clearing House Association, the Marketplace Lending Association, and non-party WebBank also filed briefs as *amici curiae*.

Takeaways and Analysis

Both the Kabbage and Avant actions are part of a series of challenges to the marketplace lending model in courts across the country that have reached different results due to the variations of state laws, the unpredictability of courts, and the competing policies of consumer protection and federal preemption. These actions join a growing number of cases attempting to apply usury concepts to loans originated by marketplace lenders that use arrangements with unaffiliated banks to originate their loans, a practice commonly referred to as "the bank origination model." Unlike a finance company, a bank is not required to comply with state law licensing requirements and loans made by a bank do not need to comply with home 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. Conversely, critics of the bank origination model view it as enabling unregulated out-of-state lenders to evade state supervision and to charge interest rates exceeding state usury caps. Thus, the key question in these cases has become, who is the "true lender" of these loans – the marketplace lender or the bank?

In determining the "true lender," courts have developed two different approaches, with the choice of approach invariably dictating the result. Certain courts focus on the fact that the bank is the party to the loan agreement and is the entity that actually disbursed the proceeds. These courts conclude that the bank is the true lender and that federal preemption applies. Other courts, however, conduct a broader analysis, focusing on the origination and underwriting of a loan, as well as any material interest in the extension of credit, if any, the bank retains after origination. These courts conclude that the finance company is the true lender and, therefore, federal preemption does not apply.

In February 2018, the U.S. House of Representatives passed a bill that would seem to resolve the "true lender" dispute in favor of the bank origination model;[4] however, the U.S. Senate has yet to consider the bill. Thus, it seems that true lender challenges to the bank origination model are likely to continue for the foreseeable future, as litigants wrestle with the patchwork of state usury and consumer protection laws implicated by these actions in courtrooms across the United States.

Conclusion

The *Kabbage* and *Avant* true lender cases are notable for different reasons. The *Kabbage* action in Massachusetts raises concerns for marketplace lenders because the state law penalty for usury is to void the loan, which would not only negatively impact Kabbage but also increase the risk for parties that purchase and securitize Kabbage loans. On the other hand, the *Avant* litigation in Colorado is one of the first challenges brought by a state regulator against a finance company that is not thought of as a payday lender. While the resolutions of these actions may not provide much

[4] Protecting Consumers' Access to Credit Act of 2017 (H.R. 3299).

certainty for marketplace lenders given the myriad of regulatory regimes that presently govern the online lending industry, these cases likely will establish guideposts for how courts and tribunals are viewing these issues. We will continue to monitor these developments closely.

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