Chapman and Cutler LLP

Chapman Client Alert

August 18, 2020 Current Issues Relevant to Our Clients

Colorado True Lender Litigation Settled

The parties to the closely watched litigation by the Attorney General of Colorado as Administrator of the Colorado Uniform Consumer Credit Code (“Administrator”) against two marketplace lending (“MPL”) platforms have agreed to settle the litigation.[1] The settlement, as more fully described below, allows the MPL platforms to continue to work with sponsor banks without being subject to state allegations that federal preemption does not apply to assignees or that the platforms are the true lenders on the loans, provided that the loans have an APR of under 36% and are subject to certain requirements and restrictions imposed by the settlement. While the settlement applies to all similar loan programs of the two lending banks involved in the litigation—WebBank and Cross River Bank—presumably, if the provisions of the settlement agreement are followed by other programs, the state would not pursue actions as to those programs either, although that is not clear under the terms of the settlement. Higher APR programs remain at risk for possible regulatory scrutiny.

Background of the Litigation

- In January, 2017 the Administrator filed two actions in Colorado state court—one against each platform—alleging that the platforms were the true lenders on loans to Colorado residents and certain loans exceeded the usury rates and late fees allowable under Colorado law and the loan agreements did not contain a Colorado governing law provision.[2]
- The platforms in March 2017 removed the actions to federal court.
- The federal court remanded the actions to the state court in March 2018.
- Contemporaneously, the lending banks filed actions in federal court for a declaratory judgment that federal preemption applies to the programs. In March 2018, these actions were dismissed based on the doctrine of abstention that the issue could be decided in the state court proceeding.
- The platforms filed motions to dismiss which were denied in the summer of 2018, but the lending banks were allowed to intervene in the actions.
- In November 2018, the Administrator filed an Amended Complaint naming the trustees of various securitization trusts and special purpose entities as additional defendants making similar allegations against them for violations of Colorado law.
- The trusts and entities filed motions to dismiss which were denied.
- Motions for summary judgment by both sides were filed and in June 2020, the Court ruled that even if the banks were the true lenders on the program loans, that the platforms as assignees of the loans could not take advantage of the federal preemption and stand in the shoes of the bank with respect to loan terms.
- At the same time, federal banking regulators finalized regulations codifying that the terms of the loan at the time of origination, if valid when made, do not change when the loan is sold, transferred, or assigned.

Terms of the Settlement

General Terms and Licensing

The settlement focuses on “Specified Loans” which are those loans that would have interest rates in excess of those allowed by Colorado law, or 21%. Many provisions of the settlement deal with this group of loans.

The settlement covers not only the parties to the litigation, but all similar programs of the lending banks.

It appears that the Administrator wants to be sure that the lending banks share in economic risks of the loans.

No loans may exceed 36% APR. Any platform that takes assignment of the loans and engages in direct collection or

enforcement of those loans must be licensed as a supervised lender under the Colorado Uniform Consumer Credit Code and be subject to additional reporting for the Specified Loans.

Oversight and Compliance

The programs must adhere to certain requirements including that the programs are subject to federal or state oversight. The bank must control the program and review, approve and oversee (with audit rights) origination, marketing, website content, credit terms, credit models, and approval or denial of all applicants. The bank must be the named lender, fund loans from its own funds, and approve third-party subcontractors. The platforms must have a compliance management system, including for complaints, and the parties must comply with regulatory guidance for third party arrangements, be subject to audit and corrective action.

Options for Specified Loans

For the loans that exceed Colorado usury limits of 21%, called Specified Loans, there are three options to ensure that the lending banks have "skin in the game" as to those loans. There are no limitations generally placed on loans with an APR less than 21%.

Option 1: Uncommitted Forward Flow Arrangements

Under this option, there is no commitment by the platform to purchase loans from the bank. The bank will provide a notice of loans it wants the platform to purchase, but the platform is under no obligation to purchase and only need to purchase those loans it specifies. The bank may retain, sell, or securitize loans that the platform does not choose to purchase. Under this option, indemnification by the platform can only be made for services not performed, but not for either the performance of the loans or any failure to purchase loans offered. The program can be collateralized, but not for Specified Loans, unless there has been a commitment to purchase those loans and up to certain limits.

Option 2: Maximum Transfer of Specified Loans in Forward Flow Commitment

Under this option, the bank can transfer up to 49% of the economic interest in the Specified Loans in a committed forward flow arrangement or 25% of the Specified Loans on a committed basis, with the rest being on an uncommitted basis. This includes whole loans, participations or sale of receivables. There would be no restrictions on collateral or indemnification on committed loans. The banks may sell loans to others including to securitizations.

Option 3: Program Loans

Under this option, the banks can sell 85% of all program loans to the platform, but no more than 35% can be Specified Loans.

The state will also consider other alternative structures.

Other Provisions

The settlement provides for the payment of certain monetary amounts to the Administrator and to a fund for economic literacy education. There is no admission of liability on behalf of the defendants.

The settlement also provides for a "safe harbor" for the litigants. The state will not pursue claims, past of future, for violations of Colorado law based on matters of preemption, true lender or assignment. In addition, all other programs of the lending banks that comply with the terms of the settlement will be subject to the safe harbor.

The court will dismiss the litigation with prejudice and any administrative actions pending will be withdrawn and any expired licenses will be renewed.

The terms of the settlement apply for 5 years, but a conflicting change of law could reduce it to 2 years.

Actions in other states could reduce the 36% APR in certain circumstances.

In addition, certain loan modifications and forbearances will be made to Colorado borrowers in respect of the pandemic.

Observations

The settlement provides a sigh of relief for the MPL industry which has been watching this litigation with interest. Protracted litigation and imminent appeals—which would have resulted in prolonged uncertainty in the industry—have now been avoided.

The terms of the settlement are consistent with most mainstream MPL programs, although some re-structuring may be necessary in terms of the purchase of Specified Loans. But MPL will again be alive and well in Colorado, at least for loans up to 36%, ending a drought created when many platforms avoided Colorado due to this litigation. This will increase the access to credit for Colorado residents.

The fate of other programs remains in some doubt. However, it would seem that programs that adhere to the parameters of the settlement should not come into the Administrator's sights, particularly when these might be addressed as part of the

licensing process that would be required, but high rate programs would still remain on the radar screen of the Administrator and subject to the types of claims brought in this litigation.

This settlement may serve to chill efforts of other state regulators on similar MPL issues or serve as a basis for similar settlements in other jurisdictions. Or it may serve as impetus for renewed discussion of the imposition of a national usury rate.

States may face a more difficult time pursuing claims against MPL platforms due to the recent actions of federal banking regulators codifying as federal regulations that the interest rates made on a loan at inception do not change when the loan is sold or assigned. Arguably, courts must give deference to these regulations.

The settlement should provide a level of certainty and comfort for investors in MPL loans and for the securitization of Colorado loans.

In any event, this settlement in Colorado is a significant development in the MPL arena.

For More Information

If you would like further information concerning the matters discussed in this article, please contact Marc Franson or the Chapman attorney with whom you regularly work.

Marc P. Franson
Chicago
312.845.2988
franson@chapman.com

1 The cases are *Martha Fulford, Administrator of the Uniform Consumer Credit Code v. Marlette Funding LLC dba Best Egg et al*. Case no. 2017 CV 30376 and *Martha Fulford, Administrator of the Uniform Consumer Credit Code v. Avant of Colorado LLC dba Avant et al.*, Case No. 2017 CV 30377. The information in this Client Alert is based upon a terms sheet agreed to by the parties in the litigation and the actual settlement agreement may contain some differences from the prior agreed upon terms.

2 In the original Complaint, the Administrator did not make allegations against, nor even mentioned the roles of the lending banks in the programs.

Chapman and Cutler LLP

Attorneys at Law · Focused on Finance®

This document has been prepared by Chapman and Cutler LLP attorneys for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material.

To the extent that any part of this summary is interpreted to provide tax advice, (i) no taxpayer may rely upon this summary for the purposes of avoiding penalties, (ii) this summary may be interpreted for tax purposes as being prepared in connection with the promotion of the transactions described, and (iii) taxpayers should consult independent tax advisors.

© 2020 Chapman and Cutler LLP. All rights reserved. Attorney Advertising Material.