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February 1, 2016 Current Issues Relevant to Our Clients

New Federal Court Decision Applies the "True Lender" Doctrine to Internet-Based Payday Lender

A recent decision of the U.S. District Court for the Eastern District of Pennsylvania has highlighted once again the regulatory risks that the so-called "true lender" doctrine can create for internet-based lenders who partner with banks to establish exemptions from applicable state consumer protection laws (including usury laws). Although the Court did not reach a final decision on the merits, it declined to accept federal preemption as grounds to dismiss an enforcement action brought by the Commonwealth of Pennsylvania against an internet-based payday lender who arranged for a state-chartered bank to fund loans at interest rates exceeding the Pennsylvania usury cap.

The case is *Commonwealth of Pennsylvania v. Think Finance, Inc.* (January 14, 2016).[1] The defendants Think Finance and affiliated companies (the *"Defendants"*) had for a number of years operated internet-based payday lenders that made loans to Pennsylvania residents. The interest rates on these loans far exceeded those permitted under Pennsylvania usury laws.[2] The Defendants initially made these loans directly to Pennsylvania residents and did so lawfully as the Pennsylvania Department of Banking (the *"Department"*) took the position that the usury laws applied only to lenders who maintained a physical presence in Pennsylvania. In 2008, the Department reversed its position and published a notice stating that internet-based lenders would also be required, going forward, to comply with the usury laws. The Defendants nevertheless continued to arrange payday loans for Pennsylvania residents under a marketing agreement with First Bank of Delaware, an FDIC-insured state chartered bank (the *"Bank"*), pursuant to which the Bank would originate loans to borrowers solicited through the Defendants' websites. The exact nature of the financial arrangements made between the Defendants and the Bank is not made clear in the Court's opinion, but it appears that the Bank did not retain any substantial interest in the loans and that the Defendants received most of the related economic benefits.[3]

The Attorney General of Pennsylvania brought suit against the Defendants, claiming that the Defendants had violated not only Pennsylvania's usury laws, but by engaging in certain deceptive and/or unlawful marketing and collection practices, had also violated a number of other federal and state statutes, including the Pennsylvania Corrupt Organizations Act, the Fair Debt Collection Practices Act and the Dodd-Frank Act. The Attorney General argued in her complaint that the Defendants could not lawfully collect any interest owed on the loans in excess of the 6% usury cap and asked the Court to impose various sanctions on the Defendants, including the payment of restitution to injured borrowers, the payment of a civil penalty of $1,000 per loan ($3,000 per loan in the case of borrowers 60 years or older) and the forfeiture of all associated profits.

In a motion to dismiss the claims, the Defendants argued that federal preemption of state consumer protection laws permitted the Bank to offer the loans at interest rates exceeding the Pennsylvania usury cap. Specifically, the Depository Institutions Deregulation and Monetary Control Act of 1980 permits federally-insured state-chartered banks (such as the Bank) to charge loan interest in any state at rates not exceeding the higher of (i) the maximum rate allowed by the state in which the loan is made, and (ii) the maximum rate allowed by the Bank's home state. As the Bank was based in Delaware, and Delaware permits its banks to charge loan interest at any rate agreed by contract, the Defendants argued the Bank was not bound by the Pennsylvania usury cap and lawfully made the loans to Pennsylvania residents. The Defendants therefore asked the Court to dismiss the Attorney General's claims.

The Attorney General responded that the Bank was only a "nominal" lender and that the Defendants should be treated as the "true" lenders for regulatory purposes as they marketed, "funded" and serviced the loans, performed other lender functions and received most of the economic benefit of the lending program. The Attorney General contended in this regard that the Defendants had operated a "rent-a-bank" program under which they improperly relied upon the Bank's banking charter to evade state regulatory requirements (including the usury laws) that would otherwise apply to them as non-bank consumer lenders. The opposing arguments of the Attorney General and the Defendants therefore required the Court to consider whether the Defendants were entitled to dismissal of the usury law claims because the Bank had originated the loans (thereby making preemption applicable)

or whether the Attorney General's allegations could support a finding that the Defendants were the "true lenders" and as such remained subject to the state lending laws.[4]

Similar "true lender" claims have been asserted by both regulators and private plaintiffs against other internet-based lenders who market loans for origination by bank partners. In certain cases, the courts have held that as the "true lender" the website operator was not entitled to exemption from state usury or licensing laws.[5] In others, the courts have placed greater emphasis on the bank's role as the named loan originator and held that preemption applied even though the website operator marketed and serviced the loans and had the predominant economic interest.[6] No clear rule has emerged although regulatory challenges almost certainly are more likely to be made when excessive interest rates and/or abusive sales or collection practices are involved. In this case, the loans imposed interest rates of 200% to 300%.

In the present case, the Court held that the facts alleged by the Attorney General were sufficient to support an "inference that the [Defendants] are the true lenders" and it denied the motion to dismiss. The Court in particular found support for that inference in the "high rate of payment" received by the Defendants on the loans and the "level of control" which the Defendants exerted. The Court further stated that controlling precedent in the Third Circuit (the federal judicial circuit which includes Pennsylvania, Delaware and New Jersey) distinguishes between banks and non-banks in applying federal preemption (with only claims against banks being preempted).[7] Since the Attorney General's lawsuit made no claims against the Bank, said the Court, the claims against the Defendants could proceed and were not subject to dismissal on federal preemption grounds.[8]

- It is important to note that the Court's ruling was made on a motion to dismiss — where the facts alleged by the plaintiff must be accepted by the court as true — and thus was at the earliest stage of the proceedings. As a result, this is not a final disposition of the case — nor a determination on the merits of the case — or that the Defendants were, in fact, the "true lenders" of the loans or that they violated any Pennsylvania or federal laws. The case will now continue for further proceedings and so it could be months or perhaps even years before a decision is rendered and the Court ultimately could decide that the Defendants were not the "true lenders" (and the Bank was the true lender) and that no violations occurred. Thus, the immediate impact of this case is not truly significant and should not impact internet-based programs at this time.

- It is also important to note that the loans at issue in this case were in the 200% to 300% APR range. Challenges to programs occur where in factual scenarios like this the interest rates are extraordinarily high and where there are allegations of abusive collection practices or other violations of consumer protection laws. In addition, this case was also directed at loans made through Native American tribes, a fact that would not be present in other alternative lending programs.

- The case is nonetheless of interest to marketplace lenders, payday lenders and other internet-based loan marketers because it demonstrates that plaintiffs will continue to raise the "true lender" theory and courts will not necessarily dismiss at an early stage (for failure to state a claim upon relief can be granted) "true lender" claims solely because a bank is the named lender on the loans, at least where there are allegations that the originating bank does not have substantive duties or an economic interest in the program.

- In order to mitigate the risk of claims based on the "true lender" doctrine, companies that engage in internet-based lending programs through an arrangement with one or more banks should consider how the programs are structured. For example, consideration should be given to operations where the bank has substantive duties and/or an economic interest in the program or loans. We are aware that some internet-based lending programs are considering structural changes of this nature.

- Banks should also take care to fulfill their obligations under the federal banking guidance to monitor and supervise the internet marketer's performance of its duties as a bank service provider.[9]

As the landscape continues to evolve, careful consideration of these issues may help reduce the likelihood that true lender claims will be brought against a program, or if brought, that they will succeed.

For More Information

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1 Civil Action No. 14-cv-7139.

2 Pennsylvania law limits the interest rate on consumer loans of less than $50,000 made by unlicensed lenders to six percent per annum. The Defendants did not hold any Pennsylvania lending licenses.

3 In addition to the marketing arrangement with the Bank, the Defendants also managed websites which marketed payday loans on behalf of originators affiliated with Native American tribes (the "*Tribal Entities*"). The interest rates charged by the Tribal Entities also far exceeded the Pennsylvania usury cap. In its complaint, the Commonwealth of Pennsylvania contended that the Tribal Entity loans violated the usury laws. The Defendants argued in response that the Tribal Entities have sovereign immunity under federal law and are therefore exempt from state usury restrictions.

4 The Court's decision and the Attorney General's complaint make it clear that the Bank was the named lender on each of the loans marketed on behalf of the Bank. At the same time, the Attorney General alleged that the Defendants "funded" the loans. The meaning of that statement is not certain. The Attorney General alleged that the Defendants arranged for third-party investors to provide the Tribal Entities with the cash which they used to fund their loans. She did not expressly make the same allegation in relation to the Bank and the Bank loans.

5 See, e.g., *CashCall v. Morrissey*, No. 12-1274, 2013 W. Va. LEXIS 587 (W. Va. May 30, 2014). The website operator was also found to be engaged in unlawful collection practices.

6 See, e.g., *Hudson v. ACE Cash Express, Inc.,* No. IP 01-1336-C H/S, 2002 WL 1205060 (S.D. Ind. May 30, 2002) and *Sawyer v. Bill Me Later, Inc.*, 23 F.Supp 3d 1359 (D. Utah 2014).

7 The Court cited *In re Community Bank of Northern Virginia*, 418 F3d 277 (3d Cir. 2005). However, this case involved removal from federal to state court, a jurisdictional issue, and not the substantive issue of preemption, a different legal question.

8 The Court also declined to dismiss the Attorney General's claims against the Defendants in relation to the Tribal Entity loans.

9 The Winter 2015 edition of *Supervisory Insights* published by the FDIC recognizes that banks participate in marketplace lending programs and can do so by identifying and managing risk associated with those programs and monitor third party relationships by following regulatory guidance. FIL-9-2016 (2/1/16). *See also* FIL 49-2015 and FIL 44-2008.

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