TRUE LENDER: *AN OLD LEGAL CONCEPT GETTING NEW ATTENTION*

Elizabeth L. Anstaett, Emily C. Cellier

Elizabeth L. Anstaett is a partner with Dreher Tomkies LLP. Her practice focuses on banking and financial services law with a concentration in consumer financial services and small business lending on a 50-state basis. Ms. Anstaett is engaged in the representation of banks, finance companies, and other financial institutions in Ohio and nationally. She regularly advises clients on state and federal regulatory matters, multistate compliance, and the development of lending programs. Ms. Anstaett teaches Banking Law at The Ohio State University, Moritz College of Law, as an adjunct professor. She received a J.D. degree from The Ohio State University College of Law (summa cum laude; Order of the Coif; Ohio State Law Journal) and a B.A. from The Ohio State University.

Emily C. Cellier is an associate with Dreher Tomkies LLP. Emily works on assignments in all areas of the Firm's practice, specifically addressing federal and state regulatory compliance issues with respect to consumer and commercial lending. She received a J.D. from The Ohio State University College of Law (summa cum laude; Order of the Coif; Ohio State Law Journal) and a B.A. from Asbury University in Wilmore, Kentucky.

I. INTRODUCTION

Elizabeth L. Anstaett

Emily C. Cellier

Bank partnerships, private label credit cards, retail installment sales contracts, payday lending, marketplace lending: What do all these programs have in common? All have been subject to "true creditor" or "true lender" challenges. True creditor/lender challenges arise in the context of loan programs involving a lender with authority to charge interest and fees that other lenders cannot charge. For example, a bank can rely on its home state interest rate authority based on federal law in loans made to residents of other states. Legal challenges are usually based on usury claims attacking reliance on the bank's preemption authority, particularly if some other party to the loan transaction engages in activities usually associated with the lender. The argument is that the bank is **not** the "true lender" and that the non-bank is the "true lender" improperly relying on the bank's rate authority. There also can be licensing requirements that apply to non-bank lenders. Some of these "true lender" challenges resulted from poor structuring of the programs, but many resulted from a lack of understanding of the law by those bringing the challenge. A review of the case law that developed from true lender challenges in

the 1970s and continuing to the present gives a road map to structuring loan programs that appropriately rely on third party expertise and may involve the selling of receivables. Structuring loan programs properly in order to avoid potential "true lender" issues can help lenders prevent costly litigation and regulatory actions relating to rate and fee authority and licensing requirements.

II. True Lender Litigation

A. Dragging the Body Cases.

The true lender issue developed in the 1970s and 1980s in the "dragging the body" case law first seen in Pennsylvania.[1] The phrase "dragging the body" is derived from the practice of motor vehicle dealers "dragging their customers' bodies" to specific lenders chosen by the dealers.

In *Anderson v. Automobile Fund*, the Pennsylvania Superior Court affirmed the lower court's decision that a "dragging the body" type loan was a loan and declined to re-characterize the loan as a retail installment sale.[2] Factors the Superior Court considered included: (i) the loan contract between the lender and the purchasers was not a contract for the retail sale of a motor vehicle and (ii) the lender did not take a security interest in the car.[3] However, in *King v. Central Bank*, a California court re-characterized a loan of money for the purchase of car insurance as an installment sale.[4] In reaching its decision, the court examined the substance of the "loan" transaction and found that the bank's furnishing of financing services in close connection with the plaintiff's purchase of the car insurance fell within the definition of "services" under the Unruh Act (which governs retail installment sales in California).[5] A Georgia court looked closely at the facts surrounding a consumer's credit purchase of a mobile home in order to determine whether the Motor Vehicle Sales Finance Act ("MVSFA") applied to the transaction.[6] The court found that the sale of the mobile home was not a retail installment transaction and that the MVSFA was not applicable.[7] In reaching its conclusion, the court considered the facts that the seller did not furnish the financing or retain a purchase money security interest in the mobile home.[8]

Many other courts have reviewed transactions to determine whether a retail installment sales ("RISA") contract or a loan is involved, with differ-

1. Re-characterization of contracts by courts has been a concern for contracting parties for many years. *See* Greenhow's Adm'x and Heirs v. Harris, 20 Va. (6 Munf.) 472, 472 (1820).
2. 391 A.2d 642, 644–49 (1978).
3. *Id.* at 645.
4. 558 P.2d 857 (1977).
5. *Id.* at 858–61.
6. Massey v. Stephens, 270 S.E.2d 796 (1980).
7. *Id.*
8. *Id.* at 799.

ent laws applicable to RISA contracts versus loans.[9] From these cases and statutes, examined below, it is clear that the intent of the parties as expressed in the written agreement is a key consideration.

B. Private Label Credit Card Cases.

As private label credit cards issued by banks with a retailer's name prominently featured on the card became common, more true creditor challenges emerged. In *Krispin v. May Department Stores*, the cardholders originally filed suit against the department store in state court raising various claims related to their allegations of impermissible late fees.[10] Defendant removed the case to federal court pursuant to the National Bank Act (federal law), and the district court entered judgment for the department store on most of the claims.[11] In their appeal of the district court's exercise of jurisdiction and its decision, the cardholders stressed that their original complaint had focused on the department store and not the bank because, among other things, after the transfer of its accounts to the bank, the store had purchased the bank's receivables on a daily basis.[12] The department store argued, however, that its purchase of the bank's receivables did not alter the fact that the cardholder's accounts were controlled by the bank.[13] Based on its findings that the store effected a valid assignment of the accounts, and that the store's purchase of the bank's receivables did not diminish the fact that the bank (and not the store) issued credit, processed and serviced the accounts, and set rates and fees, the Eighth Circuit recognized that "it makes sense to look to the originating entity (the bank), and not the ongoing assignee (the department store), in determining whether the NBA [National Bank Act] applies . . . and that for purposes of deciding the legality of the late fees . . . the real party in interest is the bank, and not the store."[14] Similarly, in a case involving a mall credit card issued by a bank, the First Circuit cited the following factors to support its finding that the bank was the "true creditor" in the program: (i) the card issuing bank had a direct contractual relationship with consumers, (ii) the bank had a role in setting fees and terms, and (iii) the bank received direct

9. *See* General Motors Acceptance Corp. v. Kettelson, 580 N.E.2d 187 (Ill. App. Ct. 1991) (declining to re-characterize a retail installment sale as a loan); Micro Switch Employees' Credit Union v. Collier, 530 N.E.2d 595 (Ill. App. Ct. 1988) (declining to re-characterize a car loan as a retail installment sale); Commercial Nat'l Bank v. Scott, 398 So. 2d 1127 (La. 1981) (recharacterizing the credit purchase of a mobile home as a "retail installment transaction"); Barnes v. Michigan Nat'l Bank Corp., 407 N.W.2d 23 (Mich. Ct. App. 1987) (declining to re-characterize a direct loan as an installment).

10. 218 F.3d 919, 922 (8th Cir. 2000).

11. *Id.*

12. *Id.* at 923.

13. *Id.*

14. *Id.* at 924.

payments from consumers.[15] The court indicated that where a party's role is limited to acting as the bank's agent in marketing and selling the bank product, the facts of the case support a finding that the bank is the creditor of the program.[16]

These cases correctly focused on the facts, including the bank's level of control over the program and the contractual arrangement between the parties.

C. Retail Installment Sales Contract and Private Label Program Issues.

The courts deciding the RISA and private label credit card cases acknowledged the business reality that lenders, sellers, and banks hire third parties to perform services. Additionally, these courts recognized that selling RISA contracts or receivables is a common business practice that provides the lender/seller with funds for other business activities. The practice of retail installment sellers selling RISA contracts to sales finance companies is well established, and many states have separate statutory schemes for retail installment sales contracts and sales finance companies.[17] Today, many retailers work with banks to offer private label credit cards. Despite the fact that private label cardholders may not know the name of the bank issuing the card, there have been few challenges to these private label credit card programs. In these programs, the credit agreement is between the bank and the cardholder, and the bank establishes the terms of credit. Applications for private label cards may be submitted through a store clerk, the bank may hire servicers to perform various functions including mailing statement and answering cardholder calls, and the bank may sell receivables. However, these private label programs have not been the focus of recent challenges by regulators or plaintiffs.

D. Payday Lending and High Cost Mortgage Cases.

In the early 2000s, there were some successful challenges to high cost loan programs based on true creditor challenges. In *Flowers v. EzPawn Oklahoma*, the district court granted a motion to remand a class action alleging usury and fraud against a nonbank partner acting as a servicer in a Delaware bank's payday loan program.[18] The court concluded that the nonbank partner would be the "true creditor" of the program if the following allegations in the complaint were true: the nonbank partner (i) exerted ownership and control over the loans; (ii) carried out all interactions

15. SPGGC v. Ayotte, 488 F.3d 525, 529 (1st Cir. 2007).

16. *Id.* at 534.

17. *See* Illinois Sales Finance Agency Act, 205 ILCS 660/1; Illinois Retail Installment Sales Act, 815 ILCS 405/1.; Maryland Retail Credit Accounts, MD. COM. LAW CODE ANN. §§ 12-50; Maryland Sales Finance Companies, MD. FIN. INST. CODE ANN. §§ 11-401; New York Retail Installment Sales Act, N.Y. PERS. PROP. LAW §§ 401; New York Sales Finance Companies, N.Y. BANKING LAW §§ 491.

18. 307 F. Supp. 2d 1191 (N.D. Okla. 2004).

with the borrowers; (iii) accepted the ultimate credit risk; (iv) collected and kept all of the finance charges and fees; and (v) owned and controlled the branding of the loans.[19] The court discounted that the bank entered into the loan agreement with borrowers and that the loan proceeds were paid to borrowers by checks drawn from the Delaware bank.[20] In a case involving high-cost mortgages, the Third Circuit concluded without discussion that the nonbank partner made and serviced mortgage loans originated by two distressed banks.[21] The court determined that the banks were paid a fee for nothing more than "disguis[ing] the origin of their loans" and that all fees and other charges for the loans flowed through the banks to the nonbank partner.[22] In *Georgia v. Cash America*, the Georgia court found that the nonbank partner was the "true creditor" of the loans when the nonbank partner (i) provided funds for the loans; (ii) assumed the risk of loss of the loans; (iii) indemnified the bank for claims of illegality in the transactions; (iv) acted as a direct payday lender in other states; (v) received a 95% interest in the loans; (vi) was required to purchase all unpaid loans; and (vii) received between 75-95% of the revenues as compensation for its services.[23]

Other courts reviewed the facts of bank partnership loan programs and found the bank to be the "true creditor." In *Hudson v. Ace Cash Express*, the district court cited the following facts to support its finding that the national bank was the "true creditor": (i) the note named the bank as the lender; (ii) the bank sold a 95% participation interest in the loans to the non-bank partner; (iii) loan applications were sent to the bank in California; and (iv) the bank made the loans from California.[24] The court noted that though the bank sold participation interests, the bank retained a 5% stake in its loans.[25] The court found that the bank's sale of a participation interest to the nonbank "neither destroyed the debtor creditor relationship between the bank and borrower nor created privity between the [nonbank] and the borrower."[26] These cases illustrate the importance of proper structure and documentation.

19. *Id.* at 1205.
20. *Id.*
21. *In re* Cmty. Bank of N. Va., 418 F.3d 277 (3rd Cir. 2005).
22. *Id.* at 284.
23. 734 S.E.2d 67 (2012).
24. No. IP 01-1336-CH/S, 2002 WL 1205060, *3–5 (S.D. Ind. May 30, 2002).
25. *Id.* at *5.
26. *Id.* at *5 (citing Cottage Savings Ass'n v. Commissioner of Internal Revenue, 499 U.S. 554, 557 n.3 (1991) ("By exchanging merely participation interests rather than the loans themselves, each party retained its relationship with the individual obligors.")).

E. Bank Partnership Cases.

Recently, marketplace lending and bank partnership programs have given rise to increased scrutiny by regulators based on the "true lender" issue. It is good business for banks to seek out those with technological expertise for these programs in order to maximize efficiencies and reach more customers. However, some regulators have challenged these programs in part because national banks and FDIC-insured banks are permitted to "export" interest pursuant to Section 85 of the National Bank Act (NBA) and Section 27 of the Federal Deposit Insurance Act (FDIA).[27] The Federal Deposit Insurance Corporation ("FDIC") has opined that Section 27 of the FDIA, which contains substantially similar language to Section 85 of the NBA, should be construed the same as Section 85, as they embody similar terms and concepts.[28] Thus, in regard to federal usury preemption, national banks and FDIC-insured banks have the same rate and interest-like fee authority, as explained below.[29]

In *Marquette National Bank v. First Omaha Services*, the Supreme Court interpreted the "interest" rate authority granted national banks under Section 85 of the NBA as being applicable to any borrower of the bank without regard to the location of the borrower; this provides the foundation for national banks to "export" interest on a nationwide basis.[30] "Exportation" authority is also commonly referred to as the federal preemption of state usury laws (or federal usury preemption). "Interest" for purposes of Section 85 of the NBA (and, consequently, Section 27 of the FDIA) is a matter of federal law, not state law.[31] The Office of the Comptroller of the Currency ("OCC") has ruled that the term "interest" as used in Section 85 includes any payment compensating a creditor or prospective creditor for an extension of credit, making available a line of credit, or any default or breach by a borrower of a condition upon which credit was extended.[32] It includes, among other things, the following fees connected with credit extension or availability: numerical periodic rates, late fees, not sufficient funds fees, overlimit fees, annual fees, cash advance fees, and membership fees.[33] It does not ordinarily include appraisal fees, premiums, and commissions attributable to insurance guaranteeing repayment of any

27. 12 U.S.C. §§ 85, 1831d (referring to Section 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA)).

28. *See, e.g.*, FDIC, Opinion Letter No. 10 from James D. La Pierre, Dep. Exec. Sec. (Apr. 17, 1998).

29. *See id.*

30. 439 U.S. 299 (1978).

31. *See e.g.*, Discover Bank v. Vaden, 489 F.3d 594 (4th Cir. 2007); In re Cmty. Bank of N. Va., 418 F.3d 277 (3rd Cir. 2005); Greenwood Trust v. Massachusetts, 971 F.2d 818 (1st Cir. 1992); Hunter v. Greenwood Trust, 679 A. 2d. 653 (N.J. 1996), *reinstating* 640 A. 2d 855 (N.J. 1995).

32. 12 C.F.R. § 7.4001(a).

33. *Id.*

extension of credit, finders' fees, fees for document preparation or notarization, or fees incurred to obtain credit reports.[34] The OCC interpretation defining "interest" to include late fees (thus making late fees exportable) was upheld by the Supreme Court in *Smiley v. Citibank (South Dakota), N.A.*[35] National banks also have additional preemption authority based on the NBA and *Barnett Bank of Marion County, N.A. v. Nelson.*[36] Thus, national banks and FDIC-insured banks can rely on their home state interest rate and interest-like fee authority in making loans to residents of all states. For this reason, many banks are chartered in states with no limitations on interest rates and interest-like fees for banks. Additionally, national banks have visitorial powers based on the NBA.[37] These federal authorities permit national banks to avoid certain state laws and state licensing and examination requirements.

Based on federal banking law as outlined above, operating a nationwide bank lending program has definite advantages. In addition, these well-established principles of federal banking law put bank loan programs beyond the reach of state regulators. However, by bringing "true lender" challenges, state regulators and the Consumer Financial Services Bureau ("CFPB") are able to challenge these loan programs. The state regulators and the CFPB see the non-bank partners as taking advantage of bank preemption in these programs. However, if the bank is the true lender in the loan program, then it is appropriate for the loan program to rely on bank preemption and true lender challenges will not be successful.

III. Recent Cases

In a recent case brought by the CFPB, the United States District Court for the Central District of California held that CashCall, Inc. was the "true lender" in a tribal lending program, and that, as the true lender, CashCall and other related defendants violated the federal Consumer Financial Protection Act.[38] The district court stated that it was obligated to look at the substance, and not the form of the transactions.[39] According to the district court, the totality of the circumstances showed that CashCall was the true lender because CashCall had a "predominant economic interest" in the loans because CashCall put its own money at risk as evidenced by the facts that (i) CashCall funded the loans; (ii) CashCall purchased the loans before any payments were due and at a premium; (iii) CashCall guaranteed Western Sky certain rates of return in connection with the program; and (iv) CashCall agreed to fully indemnify Western Sky for losses in connection with

34. *Id.*
35. 517 U.S. 735 (1996).
36. 517 U.S. 25 (1996).
37. 12 U.S.C. § 484(a).
38. CFPB v. CashCall, No. CV 15-7522-jf2 (RAOx), 2016 WL 4820635 (C.D. Cal. Aug. 31, 2016).
39. *Id.* at *5.

the program.[40] In another true creditor case, the West Virginia Attorney General alleged that CashCall had entered into a "sham" relationship with the First Bank & Trust of Milbank, South Dakota, for the purpose of using the bank's charter to evade the state's usury laws.[41] The suit alleged that although the loans obtained by West Virginia consumers were made to appear as if they were issued by the South Dakota Bank, CashCall was the "true lender" because it bore the entire economic risk of the loans.[42] The court agreed, finding that CashCall bore the "predominant economic risk" of the lending program and that, therefore, CashCall was the de facto lender of such loans.[43]

Following the reasoning in these cases, the Colorado Attorney General recently filed substantially similar complaints against Marlette Funding LLC ("Marlette") and Avant of Colorado LLC ("Avant") alleging violations of Colorado's Uniform Consumer Credit Code based on "true lender" challenges and utilizing the "predominant economic interest" test.[44] Many of the facts cited by the Colorado Attorney General to support the conclusion that the non-bank entities held the "predominant economic interest" are normal business practices. Although the cases brought by the Colorado Attorney General are only in the complaint stage and the facts have not been developed, it will be important in defending the case that the non-bank entities make clear the existing law on true creditor issues and the appropriate roles of the parties. In response to the Colorado Attorney General's complaints, Web Bank and Cross River Bank, the bank partners in the Marlette and Avant programs, filed complaints discussing the cardinal rule of lending law that a loan that is "valid when made" remains valid for its entire term.[45] Additionally, the Web Bank and Cross River complaints discuss traditional true lender case law factors such as who is disclosed as the lender in the program, who provides underwriting criteria, who retains control over the program, who retains an ongoing interest in the loans, and who assumes ongoing risks in the program. It is encouraging to see the established legal precedents presented to the courts.

40. *Id.* at *6. *See also* State ex rel Swanson v. CashCall, No. A13-2086, A14–0028, 2014 WL 4056028 (Minn. App. Ct., Aug. 18, 2014); McGraw v. CashCall, No. 08-C-1964 (Cir. Ct. Kanawha County, W. Va., Sept. 10, 2012), *aff'd*, CashCall v. Morrisey, 2014 WL 2404300 at *5 (May 30, 2014).

41. *See* McGraw v. CashCall, No.: 08-C-1964 (Cir. Ct. Kanawha County, W.Va. Sept. 10, 2012).

42. *Id.*

43. *Id.*

44. *See* Complaint, Meade v. Marlette Funding, No. 1:17-CV-00575-PAB (D. Colo. March 3, 2017); Complaint, Meade v. Avant of Colorado, No. 1:17-CV-00620-WJM-STV (D. Colo. March 9, 2017).

45. *See* Complaint, Cross River Bank v. Meade, No. 1:17-cv-00832-PAB (D. Colo. Apr. 3, 2017); Complaint, WebBank v. Meade, No. 1:17-cv-00786-PAB-CBS (D. Colo. March 28, 2017).

IV. Proper Structuring

Although some of the recent case law fails to discuss established legal principles, well-structured programs will survive. In developing lending programs with an intention of relying upon a bank's authority to export interest rates, it is important that the bank function as the true lender and not merely as a service provider who receives a fee for services. Key to surviving a true lender challenge, the bank should:

1. Assume those risks in the program normally associated with the lender, such as the risk of loss in the event of nonpayment; and
2. Receive the benefits of a lender from the credit transactions, such as the profit resulting from the income yield after expenses.

Additionally, the bank should advance its own funds to borrowers. Other program features that banks should consider to protect against a claim that the bank is not the "true lender" include:

- The bank establishes the credit criteria for the program;
- The credit criteria can only be changed by the bank;
- The bank establishes rates and fees for the program;
- The bank controls credit decisions and underwriting;
- The bank contracts for certain services and pays market rate fees for such services;
- The bank assumes risk of losses in credit program;
- If the bank securitizes or participates receivables, the bank retains a percentage on its books;
- If the bank securitizes or participates receivables, the bank defers transfer for a certain period of time after receivable is created;
- The bank's communications with its customers are clearly written to indicate the bank is the creditor
- The bank exercises oversight over all aspects of the program, extending to any vendor or sub-servicer involved in the program.

These are the same factors and considerations used by banks in establishing successful private label credit card programs in the 1990s. The evaluation of the above factors, the development of program structure, and the establishment of program parameters require a combination of legal and business judgments. The responsibilities that each party assumes and the practices that support the true creditor analysis should be reflected in contracts with third party service providers. In addition, the bank's policies and procedures should be developed with true lender issues in mind. Equally important is ensuring that the written documents accurately reflect how the loan program actually operates.

V. Conclusion

While many have spoken of the end of the bank partnership model, banks will continue to lend money and rely on third-party expertise in delivering their products to customers. Banks will continue to sell participation interests and receivables in order to fund future loans and other bank services. The key is understanding the legal landscape when structuring these arrangements and being able to explain to regulators and others the established law on true lender and related issues and how the structure of the loan program complies with these principles. As the case law develops in the area of true lender, program structure and operations must be monitored and revised as necessary. "True lender" concerns should not doom a program, but the issues must be considered and addressed when structuring a loan program and entering into relationships with third parties.