The Risk Retention Rule as a Framework for Marketplace Lending Funding Arrangements

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ABSTRACT

The legal landscape of marketplace lending remains uncertain, with no consensus on what level of bank involvement in a bank partner model is sufficient for courts to consider the arrangement substantive. If this continues, the fraught legal environment will hamper businesses, lead to unpredictable results in litigation, and threaten the survival of a rapidly growing, innovative segment of finance. By implementing a "5% economic interest" test, we can utilize a tried and tested approach seen in the risk retention rule to analyze bank involvement levels and provide clarity to market participants and related litigation. While various other solutions have been proposed, including a special charter for marketplace lenders, they have been criticized as regulatory overreach and do not strike at the core issue: moral hazard by banks that currently bear no risk of loss stemming from portfolio performance under the bank partner model.

A 5% economic interest test solves this issue in the same way the risk retention rule has targeted the Asset Backed Securities market, aligning incentives between banks and marketplace lenders. This paper provides a survey of how the bank partner model and marketplace lending industry developed, litigation brought against marketplace lenders and its unpredictable results, the rationale behind the passage of the risk retention rule, and argues for adoption of a risk retention rule analogue to fix moral hazard within the marketplace lending industry.

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INTRODUCTION

The financial crisis of 2007 ("Great Recession") caused an upheaval in the markets, a sharp gross domestic product decline, and significant economic loss.[1] With a retrenchment of traditional financial institutions from credit markets due to increased regulation, financial technology ("Fintech") companies filled the vacuum, deploying innovative methods to gauge creditworthiness and streamline the borrowing process.[2] With an exponentially increasing volume of loans extended and numerous complaints about business practices, regulators have begun examining marketplace lenders more closely, with a particular focus on partnerships established by these lenders with third-party bank partners.[3]

These partnerships are not a novel business model, but one historically employed by the payday loan industry, which then, as now, was subject to similar criticisms and complaints.[4] Since many marketplace lenders do not possess lending licenses, they instead rely on a partner-bank to originate loans, before marketing these loans nationwide.[5] Complications involving allegations of usurious loans and a business model designed to circumvent

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[1] *See generally* Robert Rich, *The Great Recession*, FED. RES. HIST. (Nov. 22, 2013), https://www.federalreservehistory.org/essays/great_recession_of_200709.

[2] Ruhi Dang, *The Ebb and Flow of Marketplace Lending*, MEDIUM: WHARTON FINTECH (Apr. 28, 2017), https://medium.com/wharton-fintech/the-ebb-and-flow-of-marketplace-lending-9963ef7a49b5.

[3] Telis Demos & Peter Rudegeair, *Greater Scrutiny Looms for 'Rent-a-Charter' Deals*, WALL ST. J. (Aug. 21, 2016, 8:56 PM), https://www.wsj.com/articles/greater-scrutiny-looms-for-bank-online-lender-rent-a-charter-deals-1471824803.

[4] *See generally* Michael A. Stegman & Robert Faris, *Payday Lending: A Business Model that Encourages Chronic Borrowing* 17 ECON. DEV. Q. 8 (2008).

[5] Zane Gilmer, *"True Lender" Litigation on the Rise: Recent Litigation and Enforcement Actions Challenge Traditional Bank Partnership Model*, STINSON LEONARD STREET: DODD-FRANK.COM (Apr. 2, 2018), http://dodd-frank.com/true-lender-litigation-on-the-rise-recent-litigation-and-enforcement-actions-challenge-traditional-bank-partnership-model/.

regulatory oversight have plagued marketplace lenders, leading to litigation in multiple states to determine whether the bank or the marketplace lender should be considered the true lender when extending loans.[6]

True lender challenges to the bank partner model have produced different judicial analytical models and results, yielding an unpredictable and destabilizing legal environment for marketplace lenders.[7] However, the true lender debate can be resolved by looking to other sectors of regulated finance for guidance, specifically the asset backed securities ("ABS") market and its risk retention rule.[8]

I. *BACKGROUND*

Marketplace lending involves linking up borrowers with non-originating loan investors by leveraging Fintech.[9] Since the Great Recession, there has been an increase in activity within the marketplace lending sector and as of 2015, Fintech companies have made $28.5 billion in outstanding loans, representing 12.5% of total consumer lending.[10] Meanwhile, Fintech lending in the business sector reached $5.6 billion in 2015, representing 1.3% of total business lending in the country.[11] With its growing stature, marketplace lending is gaining increased influence in the financial system.[12] However, there has also been increased litigation and scrutiny over the business model of some marketplace lenders, and adopting a clear framework can resolve much of the uncertainty within the marketplace lending space.[13] To better understand the bank partner model, this paper will first provide a brief survey of lending models.

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[6] David D. Christensen & Jennifer J. Nagle, *"True Lender" litigation heats up: small business sues marketplace lender and partner bank, alleging conspiracy to evade usury laws*, LEXOLOGY: FINTECH LAW WATCH (Oct. 30, 2017), https://www.lexology.com/library/detail.aspx?g=7fa6d1e4-e2c0-4742-8573-0ff0d09fd106.
[7] *See id*.
[8] Andrew M. Faulkner, *Regulators Adopt Final Risk Retention Rules for Asset-Backed Securities*, SKADDEN: 2015 INSIGHTS (Jan. 2015), https://www.skadden.com/insights/publications/2015/01/regulators-adopt-final-risk-retention-rules-for-as.
[9] *See* DAVID W. PERKINS, CONG. RESEARCH SERV., R44614, MARKETPLACE LENDING: FINTECH IN CONSUMER AND SMALL-BUSINESS SUMMARY (2016).
[10] Julapa Jagtiani & Cathy Lemieux, Fed. Res. Bank of Philadelphia, FDIC Conference, Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information (Sept. 8, 2017).
[11] *Id.*
[12] *Id.*
[13] Catherine Brennan & Latif Zaman, *New Fintech Legislation: The Madden and True Lender Bills*, ABA BUSINESS LAW TODAY (Feb. 15, 2018), https://businesslawtoday.org/2018/02/new-fintech-legislation-the-madden-and-true-lender-bills/.

A. Bank Loan Origination Models

Historically, loans were made on an "originate-to-hold" model, where a bank would fund loans based solely on the deposits it held, and would keep the loan on its balance sheet until the loan's maturity date.[14] However, as banks were able to expand their financing sources to bonds, commercial paper and repurchase agreements, a new model known as "originate-to-distribute" was born, where rather than holding onto loans until maturity, banks would syndicate the loans or sell them on a secondary market.[15] This development was key to the growth in credit markets in the United States.[16] By selling the originated loan to third parties as an ABS, banks enjoyed better risk sharing.[17] Banks could then originate more loans without running afoul of capital requirement rules, since distributed loans were no longer on their books.[18]

However, the originate-to-distribute model had its disadvantages. Allowing banks to move risk away from their books introduced issues of moral hazard and adverse selection.[19] Loan originators longer had to be overly concerned about the creditworthiness of borrowers because losses from defaults would not be borne by the originator.[20] Also, information asymmetry between the originator and buyer of the loan means that originators who possess unobservable private information can sell lower quality loans without buyers' knowledge.[21]

B. The Bank Partner Model

The bank partner model is an extension of the "originate-to-distribute" model. Under the bank partner model, a marketplace lender enters into an agreement with a bank (the "partner-bank") to originate loans, thus removing the need for the marketplace lender to obtain a banking license.[22] As mentioned, this is not a new phenomenon and has been used in other parts of finance.[23] The overall securitization market for loans commonly employs this model.[24] Also, payday lenders, like marketplace lenders, typically focus

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[14] Vitaly M. Bord & João A. C. Santos, *The Rise of the Originate-to-Distribute Model and the Role of Banks in Financial Intermediation* 18 ECON. POL'Y REV. 1 (2012).
[15] *Id.*
[16] *Id.*
[17] *Id.* at 2.
[18] *Id.* at 1–2.
[19] *See* ANTJE BERNDT & ANURAG GUPTA, MORAL HAZARD AND ADVERSE SELECTION IN THE ORIGINATE-TO-DISTRIBUTE MODEL OF BANK CREDIT 1-2 (2009).
[20] *Id*. at 2.
[21] *Id*.
[22] Anthony R.G. Nolan et al., *Bridging The Divide Between Banks And Marketplace Lenders*, LAW360 (July 28, 2016, 12:49 PM), https://www.law360.com/articles/822253/bridging-the-divide-between-banks-and-marketplace-lenders.
[23] *Id.*
[24] Bord & Santos, *supra* note 14, at 1.

on extending "small dollar, short term loan[s]" to consumers.[25] The National Bank Act authorized banks to export their home state's interest rates nationwide through preemption of state law, providing banks with a means to circumvent state usury laws.[26] Due to this, a non-bank entity operating with a partner-bank can gain the advantages and conveniences of doing business essentially as a bank, without being required to set up the compliance regimes necessary to operate as an actual bank.[27] Thus, by partnering with a bank located in a state permitting high interest rates, the non-bank entity can charge said interest rate nationwide without complying with local usury laws.

While marketplace lender business models vary, a common model involves deploying a website with an algorithm to process loan applications based on the completed online forms of consumers seeking a loan.[28] These forms request personal and financial information of the consumer to assess their creditworthiness.[29] The algorithm then quotes a rate, and upon acceptance by the consumer, the loan is disbursed within days.[30] The loan is funded by a partner-bank, which then sells the loan to the marketplace lender.[31] The marketplace lender will either hold, or securitize and sell the loans using a payment dependent note by matching investors with loan portfolio risk profiles, earning servicing and interest fees."[32] Key advantages of this model are that the marketplace lender does not have to apply for lender licenses, and that a uniform interest rate can be charged nationally regardless of state law.[33] Both the bank and the marketplace lender benefit from this arrangement, since a lending license can cost the marketplace lender more than $500,000, while a bank can increase profits and lower costs through the partnership.[34]

C. *Federal Preemption of State Banking Laws*

The United States has adopted a "dual banking system" and banks can choose to apply for a charter with either a state banking authority or federally

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[25] BRANDI B. REYNOLDS, PAYDAY LENDERS- GREAT BANKING PARTNERS OR BANKING LIABILITY? 3 (2016).
[26] *See* JAY B. SYKES, CONG. RESEARCH SERV., R45081, BANKING LAW: AN OVERVIEW OF FEDERAL PREEMPTION IN THE DUAL BANKING SYSTEM 2–3, 9 (2018).
[27] *See* PERKINS, *supra* note 9, at 2–3.
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *See* PERKINS, *supra* note 9, at 2–3.
[32] *Id.*
[33] *See* Mike Whalen, *Bank Partnership or Go it Alone?*, GOODWIN (2016), https://www.goodwinlaw.com/-/media/files/viewpoints/alerts/2016/082316-bank-partnership-article.pdf?la=en.
[34] *Id.* (estimating costs incurred for a lending license); FDIC, PROPOSED GUIDANCE: EXAMINATION GUIDANCE FOR THIRD-PARTY LENDING (2016).

through the Office of the Comptroller of the Currency ("OCC").[35] This decision impacts whether the state or federal government has regulatory authority over the bank.[36] However, state-chartered banks are still subject to federal "tax, consumer protection and antidiscrimination laws," while federal-chartered banks are subject to state laws on "contracts, torts, property rights, and debt collection" if these do not conflict with federal law.[37]

Under the Supremacy Clause of Article VI of the Constitution, and subsequent explanations by the Supreme Court, ". . . any state law, however clearly within a State's acknowledged power, which interferes with or is contrary to federal law, must yield [to federal law]."[38] With the passage of the National Bank Act ("NBA") in 1864, the Supreme Court's ruling in *Marquette*, and subsequent legislation allowing state-chartered banks to "export" their home state's interest rate, the right of banks to charge the maximum allowed interest rate under their home state nationwide is well-established.[39]

D. Marketplace Lending Today

With an increase both in number of marketplace lenders as well as volume of loans generated, the industry has become more competitive and companies increasingly focus on achieving rapid growth.[40] In this competitive environment, obtaining fifty different licenses and complying with each state's regulations including disclosures and usury limits would be a costly alternative to reaching a nationwide consumer base without a partner-bank.[41] As such, the bank partner model is commonly employed by marketplace lenders to circumvent such problems due to the partner-bank's federal

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[35] *See generally* SYKES, *supra* note 26.
[36] *Id.*
[37] *Id.*
[38] *See* U.S. Const. art. VI, cl. 2.; Gade v. Nat'l Solid Wastes Mgmt. Assn., 505 U.S. 88, 108 (1992).
[39] 12 U.S.C. § 1831d(a) ("In order to prevent discrimination against State-chartered insured depository institutions . . . with respect to interest rates . . . such State bank[s] . . . may, notwithstanding any State constitution or statute which is hereby preempted for the purposes of this section, take, receive, reserve, and charge on any loan or discount made, or upon any note, bill of exchange, or other evidence of debt, interest . . . at the rate allowed by the laws of the State . . . where the bank is located . . . ."); Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299, 299 (1978).
[40] David Gogel, *Marketplace Lending: A Roadmap for Growth or the Next Subprime?*, MEDIUM: WHARTON FINTECH (Dec. 6, 2016), https://medium.com/wharton-fintech/marketplace-lending-a-roadmap-for-growth-or-the-next-subprime-5089d8c1506f.
[41] Zach Fox, *How are marketplace lenders' lenders doing?*, BANKING EXCHANGE (June 7, 2016, 4:35 PM), http://www.bankingexchange.com/news-feed/item/6288-how-are-marketplace-lenders-lenders-doing?Itemid=259.

preemption right.[42]

A key driver behind the success of marketplace lending is Fintech's innovative and cost-effective approach when compared to banks.[43] One such innovation is improved underwriting models that can capture the risk profile of consumers otherwise overlooked in traditional FICO score models, allowing them to enter the credit market.[44] By increasing the clarity of risk, lenders can reduce the cost of credit through an improved understanding of the market.[45] Another innovation is the automation of processing loan applications, allowing consumers to seamlessly apply for and obtain a quick decision on a loan. This results in increased efficiency for the marketplace lender and an improved customer experience for borrowers.[46]

An additional factor in the rise of marketplace lending is the state of the credit markets after the Great Recession, with large banks retreating from many credit markets they previously served.[47] This was compounded by the increased regulations imposed on banks after the Great Recession that mandated reductions in loan exposure.[48] Marketplace lenders filled the post-recession vacuum at the lower end of the credit spectrum when many banks closed branches around the country.[49] The lower end of the credit spectrum brings about unique business challenges, particularly the difficulty in assessing complex risk profiles.[50]

Furthermore, demand has been increasing for marketplace lending, particularly in areas where larger banks are not present.[51] With interest rates close to zero, investors are seeking higher yield securities and marketplace lending is seen as an attractive asset class.[52] In 2016, consumers borrowed over $10 billion in personal loans from Lending Club and Prosper, two major marketplace lenders.[53] While only 25% of consumers recognized or have

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[42] PERKINS, *supra* note 9, at 7–8.
[43] *Id.*
[44] Dang, *supra* note 2.
[45] *Id.*
[46] *Id.*
[47] Jagtiani & Lemieux, *supra* note 10.
[48] Dang, *supra* note 2.
[49] Jagtiani & Lemieux, *supra* note 10.
[50] Liran Einav et al., *The impact of credit scoring on consumer lending,* 44 RAND J. OF ECONOMICS 249, 255 (2013).
[51] Jagtiani & Lemieux, *supra* note 10.
[52] According to Greenwich Associates, a market research company, sixty-seven percent of institutional investors cite the higher yield of marketplace loans as the primary reason to invest in 2017, *see* Allen Taylor, *News Comments*, LENDING TIMES (Mar. 7, 2018), https://lending-times.com/2018/03/07/wednesday-march-7-2018-daily-news-digest/#heading-3.
[53] Robert Adams et al. *U.S. Consumers' Awareness and Use of Marketplace Lending*, FED. RES. BANK OF BOSTON 2 (2017),

heard about the four largest marketplace lenders (Lending Club, Prosper, SoFi, and Avant), the volume of loans generated through marketplace lending registered over nine times growth from 2013 to 2015.[54] The three factors of Fintech's rise, retreat of traditional banks from certain credit markets, and increasing demand for marketplace lending loans created a perfect storm for the marketplace lending industry to grow. Many marketplace lenders have since adopted the bank partner model in their operations.[55]

Despite this rapid rise, the industry faces headwinds. The increase in litigation and resulting uncertain legal landscape, combined with an uptick in loan losses from poor portfolio performance, have led to companies in the industry becoming increasingly nervous about the industry's future direction.[56] In particular, marketplace lenders that use the bank partner model may be subject to litigation, as a direct result of adopting the bank partner model as a mechanism to circumvent state usury laws.

Recently, there have been varying efforts to regulate marketplace lenders. The OCC has introduced a special purpose national bank charter aimed at Fintech companies, which began accepting applications on July 31, 2018.[57] However, there is opposition to this new form of bank charter from various states including New York, which sued the OCC through the New York State Department of Financial Services, claiming the OCC exceeded its mandate—the Conference of State Bank Supervisors filed a similar lawsuit.[58] Additionally, industry publications have criticized the new OCC Fintech charter for being too unwieldy and imposing too much regulatory burden without a corresponding increase in benefits.[59] Aside from the new OCC Fintech charter, several marketplace lenders are also exploring

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https://www.bostonfed.org/publications/current-policy-perspectives/2017/us-consumers-awareness-and-use-of-marketplace-lending.aspx.

[54] *Id.*

[55] Christensen & Nagle, *supra* note 6.

[56] Patrick Jenkins, *US Peer-to-peer Lending Model Has Parallels with Subprime Crisis*, FIN. TIMES (May 30, 2016), https://www.ft.com/content/84f696ec-2436-11e6-9d4d-c11776a5124d.

[57] News Release, Office of the Comptroller of the Currency, OCC Begins Accepting National Bank Charter Applications From Financial Technology Companies, (July 31, 2018).

[58] Lydia Beyoud, *State Regulators File Suit to Block Federal 'Fintech Charter' (2)*, BLOOMBERG LAW (Oct. 25, 2018), https://www.bloomberglaw.com/document/X3O816MK000000?bna_news_filter=banking-law&jcsearch=BNA%252000000166ab25d35daf7faf3ffd720002#jcite.

[59] Todd Baker, *BankThink: Why There's No Need for the OCC's Fintech Charter*, AM. BANKER (Oct. 1, 2018), https://www.americanbanker.com/opinion/why-theres-no-need-for-the-occs-fintech-charter.

Industrial Loan Company charters.[60] In October 2018, New York actively discussed imposing new licensing requirements and regulations on Fintech companies.[61] In the face of these disparate challenges from multiple sources, the proposal in this note has the potential to clarify the status of marketplace lending in a simpler, tried-and-tested manner.

E. Past and Present Criticism of the Bank Partner Model

The bank partner model has been subject to past criticism.[62] Apart from the criticism of the payday lending industry for its "high fees, poor disclosure" standards and "aggressive" collections on loans, the nature of the bank partner model in facilitating circumvention of state usury laws also drew concern.[63] For example, South Dakota does not have codified usury laws (and has limited usury legislation), thus banks chartered in South Dakota can charge an uncapped interest rate (subject to certain limitations).[64] When a marketplace lender partners with a South Dakota bank for loans made outside of South Dakota, it can circumvent local usury laws by utilizing South Dakota's higher interest rates, thereby increasing returns through higher interest income. This practice attracted the ire of consumer protection groups and the scrutiny of regulators, with some branding the practice "rent-a-charter."[65]

When ACE Cash Express, then the largest cash-checking chain in the nation, adopted the bank partner model, the move was noted as "potentially the most important event of the past couple of years for the company."[66] In fact, Donna Tanoue, former chairperson of the FDIC, specifically mentioned the bank partner model during a June 2010 speech, stating that "[i]t is legal,

[60] Julie Stackhouse, *Fintech Interest in Industrial Loan Company Charters: Spurring the Growth of a New Shadow Banking System?*, FED. RES. BANK OF ST. LOUIS: ON THE ECONOMY (Oct. 24, 2017), https://www.stlouisfed.org/on-the-economy/2017/october/fintech-interest-industrial-loan-company-charters-spurring-new-shadow-banking-system.
[61] Evan Weinberger, *N.Y. Considering Online Lender Licensing Rules, Top Regulator Says*, BLOOMBERG LAW (Oct. 17, 2018), https://www.bloomberglaw.com/document/X450Q5F0000000?bna_news_filter=true&jcsearch=BNA%2520000001667eb4d1afa5e7fffeb4040002#jcite.
[62] *See* Stegman & Faris, *supra* note 4 (noting that payday lending has led to high incidences of chronic consumer indebtedness); Joe Mahon, *Banking on the fringe*, FED. RES. BANK OF MINN.: FEDGAZZETTE (July 1, 2004), https://www.minneapolisfed.org/publications/fedgazette/banking-on-the-fringe.
[63] Ronald A. Wirtz, *A Helping Hand, or New Age Loan Sharking?*, FED. RESERVE BANK OF MINN.: FEDGAZZETTE (Oct. 1, 2000), https://minneapolisfed.org/publications/fedgazette/a-helping-hand-or-new-age-loan-sharking.
[64] S.D. CODIFIED LAWS § 54-3-1.1 (2016).
[65] Demos & Rudegeair, *supra* note 3.
[66] Wirtz, *supra* note 63.

but I don't like it."[67] Many payday lenders adopted a bank partner model, or a tribal partner model, where they sign agreements with either a bank chartered in a state with lax usury laws, or with a financial company affiliated with a Native American tribe (who are immune to certain lawsuits due to sovereignty).[68] In doing so, the partner-bank's role is limited to issuing loans while the payday lenders act as the 'marketer' of loans, finding opportunities for banks to extend credit.[69] The lender would take assignment of loans originated by the partner-bank almost immediately after origination.[70] Thus, the bank's role is effectively only to underwrite the loans with their preemption right, with the bulk of operations done by the lender.

Because federal regulators declared the bank partner model as deceptive and sought action against the worst offenders, the payday lending industry evolved away from the bank partner model.[71] On the other hand, some states have also enacted legislation allowing either payday lending itself, or alternatively, deferred presentment transactions on a fee-based system approximating the returns these lenders originally obtained through a high annual percentage rate ("APR").[72]

As increasing numbers of marketplace lenders use the bank partner model, some state regulators, particularly in West Virginia, California and Colorado, have again taken an interest in this practice and have sought regulatory action.[73] Thus, marketplace lenders and their partner-banks face a recharacterization risk where the nature of the partnership is considered a sham and the strict economic form of the partnership is disregarded. This recharacterization of transactions is not a novel concept. Recharacterization is a regular occurrence in finance—for example, in credit markets, recharacterization of debt to equity is commonplace, particularly when courts factor

[67] *Id.*
[68] *See generally* Jared Bennett, *Is Congress Expanding Credit for the Poor or Enabling High-Interest Lenders?*, CTR. FOR PUB. INTEGRITY (Dec. 22, 2017), https://www.publicintegrity.org/2017/12/22/21441/congress-expanding-credit-poor-or-enabling-high-interest-lenders.
[69] Gilmer, *supra* note 5.
[70] *Id.*
[71] Bennett, *supra* note 68.
[72] *See generally* Heather Morton, *Payday Lending 2016 Legislation*, NAT'L CONF. OF ST. LEGISLATURES (Nov. 18, 2016) http://www.ncsl.org/research/financial-services-and-commerce/payday-lending-2016-legislation.aspx (surveying different state laws regarding deferred presentment for the payday industry).
[73] CFPB v. Cashcall, Inc., No. CV 15-7522-JFW, 2016 WL 4820635, at *1 (C.D. Cal. Aug. 31, 2016); Meade v. Marlette Funding LLC, No. 1:17–cv–0575–PAB–MJW, 2018 WL 1417706, at *1 (D. Colo. Mar. 21, 2018); CashCall, Inc. v. Morrisey, No. 12-1274, 2014 WL 2404300, at *1 (W. Va. May 30, 2014).

in the substance of a transaction.[74] The Fourth Circuit has affirmed that the substance, not economic form of a transaction, should be evaluated when deciding if a transaction should be recharacterized.[75]

F. The Bank Partner Model

Despite the challenges and criticisms of the bank partner model, it has its advantages and supporters.[76] First, consumers benefit from sounder, cheaper, more transparent, and more readily available financial services when banks can partner with marketplace lenders in offering their financial services to customers.[77] Second, there is already a "robust regime" of supervision developed by federal banking agencies, particularly around third parties, to ensure that activities occurring externally from a bank are supervised to the same level as that of internal activities, providing protection to consumers and the greater financial system.[78] With banks commonly utilizing third parties for services and loan purchases, this regulatory regime has been tested.[79] Additionally, the Federal Deposit Insurance Corporation ("FDIC") has published detailed guidance on how the bank partner model should be supervised.[80] Third, smaller banks can diversify their portfolio risk by partnering with marketplace lenders, without having to invest the high capital costs of developing expertise in Fintech.[81] Finally, these banks can find customers through new avenues such as the internet, and increase their geographical footprint along with offering loans based on a more precise understanding of customers with lower creditworthiness.[82]

The broader securitization market also employs the "originate-to-distribute" practice seen in bank partnerships.[83] The "originate-to-distribute" model provides many tangible benefits in the financial system. First, the risk in a loan portfolio can be shifted from being the sole burden of the originating

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[74] Mark A. Salzberg, *Recharacterization: It's The Substance Of The Transaction That Matters*, LEXOLOGY: ESQUIRE GLOBAL CROSSINGS (Sept. 6, 2016), https://www.lexology.com/library/detail.aspx?g=3faedc07-1e15-404d-b846-c15289dcb3cc.
[75] *Id.*
[76] *See generally Examining Opportunities and Challenges in the Financial Technology ('Fintech') Marketplace, Hearing Before the Subcomm. on Fin. Institutions and Consumer Credit of the H. Comm. on Fin. Services*, 115th Cong. (2018) (statement of Andrew M. Smith, Partner, Covington & Burling LLP).
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.*
[83] Bord & Santos, *supra* note 14, at 21.

bank to a wider set of investors more willing or able to manage such risks. This allows for better management of a bank's portfolio, lowering borrowing costs and releasing capital for banks to deploy elsewhere.[84] Second, investors can provide more liquidity in the markets while benefiting from increased flexibility in their own portfolios as a result of securitization.[85] Third, consumers ultimately benefit from this arrangement through increased ability of lenders to offer lower interest rates on credit cards and fixed-rate mortgages.[86] This non-exhaustive list shows that on the whole, securitization and the "originate-to-distribute" model provides many parties with benefits otherwise unavailable to them.

The Center for Financial Services Innovation, partly echoed by the FDIC, has stated that the bank partner model provides all parties involved with benefits, allowing banks to serve a broader base of clients with varied products, marketplace lenders to offer financial products to customers nationwide, and consumers to access higher quality credit.[87]

II. ANALYSIS

Despite some institutional and government support of the bank partner model, its increased use resulted in heightened attention, prompting several states to bring "true lender" cases.[88] Much of this litigation is centered around which entity should be considered the "true lender" in a bank partner model.[89] Regulators have argued that, in bank partnerships where the funding process is largely controlled by the marketplace lender or where the bank does not participate in the financial downside, the marketplace lender is the "true lender."[90] However, different courts have applied different analyses to the bank partner model, resulting in discrepant outcomes and a lack of clarity for market participants and observers.[91]

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[84] OFFICE OF THE COMPTROLLER OF THE CURRENCY, ASSET SECURITIZATION: COMPTROLLER'S HANDBOOK (1997).
[85] *Id.*
[86] *Id.* at 4–5.
[87] FDIC, PROPOSED GUIDANCE: EXAMINATION GUIDANCE FOR THIRD-PARTY LENDING (2016); Center for Financial Services Innovation, Comment Letter on Proposed Guidance for Third-Party Lending (Oct. 27, 2016), https://cfsinnovation.org/research/cfsi-comment-letter-on-proposed-guidance-for-third-party-lending/.
[88] Christensen & Nagle, *supra* note 6.
[89] *Id.*
[90] Christensen & Nagle, *supra* note 6.
[91] Henry G. Morriello et al., *Who's the Lender? Two "True Lender" Cases with Implications for Marketplace Platforms*, ARNOLD AND PORTER LLP (Nov. 10, 2016), https://www.arnoldporter.com/en/perspectives/publications/2016/11/2016_11_10_who_s_the_lender_comparing_tw_13318.

While courts have yet been unable to formulate an objective standard in evaluating these cases, they have in some instances implemented a subjective analysis in order to determine the "true lender" status within these loan structures.[92] A "true lender" analysis is employed to determine which party involved in a loan transaction is the de facto lender in a loan, based on the circumstances within a case.[93] In some instances, this has resulted in marketplace lenders, rather than the bank issuing the loan, being regarded as the de facto lender; thus recharacterizing their arrangement as a sham.[94] This nullifies the federal preemption of interest rates, since preemption rights are not extended to marketplace lenders, and can render the debt uncollectable.[95] However, an inconsistent application of the doctrine has resulted in a fractured regulatory landscape, in part due to the unique facts and circumstances of each case and the test's subjectivity.[96]

A. Predominant Interest Test—Differing Outcomes

When analyzing "true lender" status, courts may assess which party within the transaction has a predominant economic interest in the loan.[97] In gauging the predominant economic interest of a party, a "totality of the circumstances" standard is used, where instead of a single deciding factor or specific guidelines, the court will account for the specific facts and context within a case.[98] While all factors may be considered, courts have highlighted a crucial factor: which party bears the monetary burden and risk.

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[92] Morrisey, 2014 WL 2404300, at *24 n.19 (citing Spitzer v. County Bank of Rehoboth Beach, 45 A.D.3d 1136, 846 N.Y.S.2d 436 (N.Y. App. Div. 2007) and noting that "[t]he Spitzer court then found that a totality of the circumstances must be used to determine the identity of the 'true lender,' with the key factor being who had the predominant economic interest in the transactions.").

[93] *Id.*

[94] *Id.* (citing Ghirardo v. Antonioli, 8 Cal.4th 791, 35 Cal.Rptr.2d 418, 883 P.2d 960, 965 (Cal.1994) (citations omitted) ("stating that the trier of fact must look to the substance of the transaction, rather than its form, and must determine whether such form was mere sham and subterfuge to cover up usurious transactions.")).

[95] CFPB, 2016 WL 4820635, at *9 (declaring that "loans are void or uncollectible" in states where usury laws were violated after determining that the marketplace lender was the true lender, not the bank).

[96] Richard P. Eckman et al., *New True Lender Case Provides Support for the Bank Partnership Model*, PEPPER HAMILTON (Sept. 22, 2016), http://www.pepperlaw.com/publications/new-true-lender-case-provides-support-for-the-bank-partnership-model-2016-09-22/.

[97] Morrisey, 2014 WL 2404300, at *24 n.19 (highlighting that "State courts have also applied the 'predominant economic interest' test in deciding cases on the merits" and providing a few examples of courts applying this standard").

[98] *Id.* (citing Spitzer v. County Bank of Rehoboth Beach, 45 A.D.3d 1136, 846 N.Y.S. 2d 436 (N.Y. App. Div. 2007) and noting that "[t]he Spitzer court then found that a totality of the circumstances must be used to determine the identity of the 'true lender,' with the key factor being who had the predominant economic interest in the transactions.").

In *CashCall, Inc. v. Morrissey*, the Attorney General of West Virginia brought suit against CashCall, a consumer finance company, for unlawful lending, unlawful debt collection, and usury practices in violation of the Consumer Credit Protection Act.[99] CashCall had marketing agreements with the First Bank and Trust of Millbank, South Dakota ("FB&T"), an FDIC-insured bank chartered in South Dakota.[100] Under the agreement, FB&T made small unsecured loans at high interest rates to consumers in various states, which CashCall would purchase within three days of the loans' origination date.[101] From August 2006 to February 2007, CashCall purchased loans made by FB&T to 292 West Virginia residents, with ten loans for $1,075.00 at an eighty-nine percent annual interest rate; 214 loans for $2,600.00 at a ninety-six percent annual interest rate; and sixty-three loans for $5,000.00 at a fifty-nine percent annual interest rate. 212 of these loans would eventually default.[102] The case was brought due to complaints of debt collection abuse, with the State alleging that the agreement between CashCall and FB&T was "a sham" designed to use federal preemption to evade local licensing and usury laws.[103]

The court found that provisions within the agreement between CashCall and FB&T resulted in the entire monetary burden and loan risk being placed on CashCall, rather than FB&T.[104] Also, CashCall paid above the loan's principal value.[105] Additionally, CashCall had to indemnify FB&T against all losses, including claims from borrowers, and they were obligated to purchase all loans originated by FB&T as long as CashCall's underwriting guidelines were followed by the bank.[106] Finally, CashCall treated these loans as if they were funded by CashCall themselves when reporting financial statements.[107] These factors led the court to conclude that CashCall was the "true lender" rather than FB&T—CashCall agreed to these terms in order to evade West Virginia's state usury laws by sheltering under FB&T's South Dakota charter and federal preemption right in exporting South Dakota's interest rates, thus circumventing West Virginia's usury cap of eighteen percent.[108]

In *Consumer Financial Protection Bureau v. CashCall, Inc.*, CashCall partnered with Western Sky Financial, a South Dakota limited liability company licensed to do business by the Cheyenne River Sioux Tribe.[109] CashCall

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[99] Morrisey, 2014 WL 2404300, at *1.
[100] *Id.*
[101] *Id.*
[102] *Id.*
[103] Morrisey, 2014 WL 2404300, at *1.
[104] *Id.* at *6.
[105] *Id.*
[106] *Id.* at *7.
[107] *Id.*
[108] *Id.*
[109] CFPB, 2016 WL 4820635, at *2.

entered into agreements with Western Sky to purchase loans made by Western Sky via a subsidiary, WS Funding, subject to the following terms: Western Sky would set the loan criteria, and CashCall would deposit enough money for two days' worth of loans into a reserve account based on the prior month's daily average loans issued.[110] This money was to be used by Western Sky to fund consumer loans, which were then sold to CashCall after a minimum three day waiting period.[111] All of Western Sky's loans under this program were sold to CashCall, and CashCall paid Western Sky the principal of the loan at the time of origination, plus a 5.145% premium.[112] CashCall guaranteed a minimum payment of $100,000 per month, and a $10,000 monthly administrative fee.[113] With the short window between disbursing funds to borrowers and selling to CashCall, borrowers made all of their loan payments to CashCall and Western Sky did not receive any payments from borrowers—therefore, CashCall, rather than Western Sky, bore all the economic risks and benefits relating to the transaction.[114] Additionally, under the agreement, CashCall would reimburse Western Sky for their costs of business including servers, marketing expenses and part of the office and personnel costs, as well as fully indemnifying Western Sky from costs arising from lawsuits.[115] CashCall was also given a non-exclusive license to use the trademarks of Western Sky, and would provide Western Sky with business support such as handling customer service calls and electronic communications, for which Western Sky would pay 2.02% of the face value of each loan.[116]

When borrowers contacted Western Sky for a loan, the loan documents stated that borrower was "subject solely to the exclusive laws and jurisdiction of the Cheyenne River Sioux Tribe, Cheyenne River Indian Reservation."[117] As the servicing partner, borrowers would make payments out to CashCall. Loans made by Western Sky included ones with interest rates ranging from 134.34% to 318.52%.[118] The Consumer Financial Protection Bureau ("CFPB") brought action against CashCall for unfair, deceptive, and abusive acts and practices ("UDAAP") in violation of the Consumer Financial Protection Act of 2010 ("CFPA"),[119] alleging that CashCall was "servicing and collecting full payment on loans that state-licensing and usury laws had rendered wholly or partially void or uncollectible."[120]

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[110] CFPB, 2016 WL 4820635, at *2.
[111] *Id.*
[112] *Id.*
[113] *Id.*
[114] *Id.*
[115] *Id.* at *3.
[116] *Id.*
[117] *Id.*
[118] CFPB, 2016 WL 4820635, at *4.
[119] 12 U.S.C. § 5536(a)(1)(B) (2012).
[120] CFPB, 2016 WL 4820635, at *4.

The court determined that the loan agreements were governed by the law of the borrowers' home state rather than CRST law.[121] Section 187(2) of the Restatement (Second) of Conflict of Laws states that "[t]he law of the state chosen by the parties to govern their contractual rights and duties will be applied . . . unless either (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties."[122]

Noting that there is no binding precedent that a court should consider the substance of a transaction rather than the form, the court nonetheless found that CashCall was the "true lender."[123] Similar to the court in West Virginia, the key factor here was which party bore the monetary burden and risk.[124] Since CashCall placed its money at risk, and bore the default as well as regulatory risk, the court concluded that CashCall, not Western Sky, was the "true lender."[125] With CashCall as the true lender, the borrowers did not have a substantial relationship to CRST—they applied online and never entered CRST territory.[126] Also, the servers for the application page was hosted by CashCall's servers in California as per its agreement with Western Sky, and all payments were made to CashCall.[127] Without a substantial relationship to CRST, the court rejected the tribal choice of law provision argument advocated by CashCall.[128] The court also noted that sixteen states have expressed a public policy interest against usurious loans extended to their citizens, and this public policy interest was stronger than CRST's interests in the application of CRST's laws to interest rates and licensing.[129] As a result, CashCall was liable for the violation of the CFPA.[130]

In both of these cases, the court looked at which party had a predominant economic interest in the loans but did not state a percentage or delineate a rubric by which to assess the arrangement, instead surveying the circumstances surrounding the loan.[131] Without further clarification, "predominant" economic interest could be "50.1% or greater," since "predominant" can

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[121] *Id.* at *5.
[122] Restatement (Second) of Conflict of Laws § 187(2) (Am. Law Inst. 1971).
[123] CFPB, 2016 WL 4820635, at *5–6.
[124] *Id.* at *6.
[125] CFPB, 2016 WL 4820635, at *6.
[126] *Id.* at *7.
[127] *Id.*
[128] *Id.* at *7–8.
[129] *Id.*
[130] *Id.* at *9–10.
[131] Morrisey, 2014 WL 2404300, at *24 n.19; CFPB, 2016 WL 4820635, at *6 (stating that courts ". . . generally consider the totality of the circumstances and apply a 'predominant economic interest'. . . .").

mean "having or exerting control or power."[132] This implies a wide range of percentages, up to 50%, that could be allowable without a party being considered a "true lender." Without guidance from the court, it is uncertain what circumstance or percentage would definitively tip the scales towards the bank being considered a "true lender," potentially causing confusion amongst marketplace lenders regarding the status of their loans. Also, these two *CashCall* rulings apply the predominant economic interest test to different circumstances—both a national bank as well as a tribal lender. In doing so, there is a risk that this approach becomes overly broad since it sets the precedent for two different forms of financial institutions.[133] While the benefits of this approach is its flexibility in allowing courts to assess the circumstances surrounding a loan to identify the de facto lending party, it is a subjective standard, and could place an undue burden on parties to comport their business model to fact patterns of favorable precedent cases. Additionally, decisions could be unpredictable, and courts could apply the standard differently.[134]

B. Economic Form and Bright-line Test

An alternative test used by the courts is a bright-line test, which does not consider the circumstances surrounding the loan, but rather just the economic form of the loan. Under this test, a court will look strictly at the face of the contract and how it is written, and will not assess beyond that to determine usurious intent.[135] Hence, the court determines the lender based solely on the structure of the loan documents. Another version of the bright-line test looks to whether the type of loan extended is covered by federal law, thus preempting state usury laws.

The same court in *Consumer Financial Protection Bureau v. CashCall, Inc.* chose to apply the economic form test in *Beechum v. Navient Solutions, Inc.*, rather than the predominant economic interest test.[136] Navient, along with the Student Loan Marketing Association ("SLMA") and the SLM Corporation, was a student loan servicer for loans made by Stillwater National Bank and Trust Company, a national bank.[137] The plaintiffs alleged that Navient was servicing loans that illegally charged greater than ten percent

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[132] *Predominant*, OXFORD DICTIONARY OF ENGLISH (3d ed. 2010).
[133] George Schneider, *Stage Set for Ninth Circuit to Weigh in on "True Lender" Test*, GOODWIN: LENDER LAW WATCH (Jan. 18, 2018), https://www.lenderlawwatch.com/2017/01/18/stage-set-for-ninth-circuit-to-weigh-in-on-true-lender-test/.
[134] *See supra* note 22–23.
[135] Beechum v. Navient Sols., Inc., No. EDCV 15-8239-JGB-KKx, 2016 WL 5340454, at *7 (C.D. Cal. Sept. 20, 2016), judgment entered, No. CV 15-8239 JGB (KKx), 2016 WL 5329553 (C.D. Cal. Sept. 21, 2016), and appeal dismissed sub nom (noting that two California appellate decisions hold that the Court must look only to the face of a transaction when assessing whether it falls under a statutory exemption from the usury prohibition and not look to the intent of the parties).
[136] *Id.* at *7.
[137] *Id.* at *1–2.

interest, and that SLMA and related parties were the de facto lenders, rather than Stillwater.[138] Originally, the loan was issued by Stillwater who entered into an agreement with SLMA and related parties, with terms to sell loans to SLMA within ninety days at cost.[139] The arrangement involved SLMA "originat[ing], underwrit[ing], market[ing] and fund[ing] [certain private student] loans for which Stillwater would be identified as the lender, and which the SLMA would then purchase from Stillwater."[140] SLMA was committed to funding and purchasing a minimum of $120 million in Eligible Private Loans, including student loans, during a three-year initial commitment period.[141] The action alleges that since the loans were funded by an account maintained by SLMA, SLMA purchased 100% of all loans made by Stillwater under the agreement within 90 days, and SLMA controlled all major aspects of the loan transaction, including bearing the risk of loss, SLMA should be considered the "true lender" and not Stillwater, the partner-bank.[142]

In declining to adopt the predominant economic interest test, the court instead cited California law instructing a court to determine if the intent of the parties to an agreement is consistent with the form of the agreement, when the agreement was structured to make it appear non-usurious.[143] Under California law, an exemption from usury laws is provided for loans made by U.S.-based banks.[144] Thus, taking the loan agreements on their face and determining that the partner-bank and not the servicer was the lender, the court held that the loans were exempt and no "true lender" analysis was necessary.[145] Specifically, while courts are instructed that they "pierce the veil of any plan designed to evade the usury law and in doing so . . . disregard the form and consider the substance," there is also precedent that as long as requirements to a statutory exemption to usury laws are met, courts should not look beyond those requirements to determine if there was an intent to circumvent usury laws.[146]

In *Sawyer v. Bill Me Later, Inc.*, a consumer purchased a computer using PayPal's affiliated financing service, Bill Me Later.[147] Bill Me Later provided a service that vetted consumers in real time, deciding whether the consumer met credit requirements for financing.[148] The purchaser of the computer signed a contract with CIT Bank, a FDIC insured bank registered in Utah, specifying that the loan was made in Utah with a 19.99% interest rate

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[138] *Id.*
[139] Beechum, 2016 WL 5340454, at *1.
[140] *Id.* at *2.
[141] *Id.*
[142] *Id.* at *1.
[143] *Id.* at *7.
[144] *Id.* at *5.
[145] *Id.* at *8.
[146] Beechum, 2016 WL 5340454, at *4, *7 (citation omitted).
[147] Sawyer v. Bill Me Later, Inc., 23 F. Supp. 3d 1359, 1360 (D. Utah 2014).
[148] *Id.* at 1361.

along with a late fee if the principal was not repaid within thirty days.[149] WebBank, another FDIC insured bank registered in Utah, later acquired all of CIT Bank's loans under the Bill Me Later program, and took over the servicing of all existing loans, as well as the extending of new credit under the program.[150] WebBank would sell new loans to PayPal two days after extending credit, but retained a portion of the accruing interest, sharing in the financial upside for good portfolio performance.[151] The action alleged that Bill Me Later's agreement with WebBank was designed to circumvent usury laws in California by using a bank's federal preemption right to charge a higher interest rate.[152]

Here, the court found that the "true lender" was WebBank, and not Bill Me Later.[153] Specifically, the court identified that WebBank was a party in the consumer loan agreements, the source of funding was from WebBank and ownership of credit accounts were retained by the bank, WebBank held onto the loans for two days before selling it to PayPal, and WebBank participated in the financial upside of the loan transaction. Additionally, the court upheld federal preemption of state usury laws as a bright-line standard, stating that "[u]nder Section 27 of the Federal Deposit Insurance Act (the "FDIA"), a state-chartered, federally insured bank is authorized to impose finance charges and late fees under the governance of the usury laws of the state where the bank is located."[154] As such, since the types of charges and fees fall under federal preemption, WebBank was the lender, regardless of "true lender" analysis.

In *Krispin v. May Dept. Stores Co.*, customers of May Department Stores were issued credit card accounts governed by agreements under Missouri law that provided for finance charges "which will not be in excess of that permitted by law."[155] Missouri law prohibits late fees higher than $10, or $5 if the total monthly installment is less than $25.[156] The agreements allowed unilateral modification by May Department Stores provided that cardholders were given at least fifteen days' notice.[157] In 1996, May Department Stores gave customers notice that credit would be extended by a new partner-bank, May National Bank of Arizona, a subsidiary created by May Department Stores.[158] Late fees were increased to the maximum allowed by Arizona, which was higher than the original Missouri limits.[159] All credit accounts were assigned to May National Bank, with May Department Stores

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[149] *Id.*
[150] *Id.* at 1360.
[151] *Id.* at 1360–61.
[152] *Id.* at 1362–63.
[153] *Id.* at 1370.
[154] *Id.* at 1363.
[155] Krispin v. May Dep't Stores Co., 218 F.3d 919, 921 (8th Cir. 2000).
[156] *See* MO. REV. STAT. § 408.330 (1994).
[157] Krispin, 218 F.3d at 921.
[158] *Id.*
[159] *Id.* at 921–22.

purchasing receivables from May National Bank on a daily basis, and delinquent cardholders who signed their loan agreements subject to Missouri late fee limits were charged the higher Arizona fee.[160]

The court held that federal preemption was applicable.[161] Although May Department Stores purchased receivables from May National Bank on a daily basis, the bank retained control of credit accounts assigned by May Department Stores, charged late fees and retained an economic interest in credit accounts, thus federal preemption applied.[162] Instead of focusing on the assignee of the loans, the court looked to the loan's originating entity to determine if federal preemption existed.[163] The court also reaffirmed that when an originally non-usurious loan is assigned to another party, it retains its non-usurious character.[164]

In the cases discussed in section A and B, the courts determined "true lender" status either using a bright-line test or by assessing whether the bank had a sufficient interest in the loans to prevent the servicing partner from being the de facto lender.[165] This has led to different outcomes, with either the bank or the marketplace lender being considered the "true lender" depending on the standard used. However, despite this confused legal landscape, one pattern emerges—in their analysis, courts seem to give weight to whether the bank has an economic interest in the loans. This results in a lack of clarity of what causes a court to determine there is predominant, or even sufficient economic interest. Moreover, the economic form test as used in *Beechum* would be an unfair standard since it would inherently favor the bank as the de facto lender.[166] By its nature, the agreement is drafted so a marketplace lender can take advantage of a bank's charter and federal preemption rights; a strict look at the agreement would result in a victory for the bank partner model every time.

C. Recent Pending Cases of True Lender Litigation

Two prominent cases regarding the identity of the "true lender" are pending in Colorado.[167] In *Meade v. Marlette*, Marlette, a marketplace lender, marketed loans made by Cross River Bank, a New Jersey-chartered bank.[168] Under the agreement, Cross River Bank would hold the originated

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[160] *Id.* at 921–23

[161] *Id.* at 924.

[162] *Id.*

[163] Krispin, 218 F.3d at 924.

[164] *Id.*

[165] *Compare* Beechum, 2016 WL 5340454, at *1 *with* CFPB, 2016 WL 4820635, at *1; Morrisey, 2014 WL 2404300, at *24; Sawyer, 23 F. Supp. 3d at 1359; Krispin, 218 F.3d at 919.

[166] Beechum, 2016 WL 5340454, at *8.

[167] Amended Complaint, Meade v. Marlette Funding LLC, No. 17CV30376 (D. Colo. Mar. 3, 2018); Meade v. Avant of Colorado*, LLC*, 307 F. Supp. 3d 1134 (D. Colo. Mar. 1, 2018).

[168] Marlette Funding LLC, No. 17CV30376, at 4.

loans for two days and sell approximately ninety percent of the loans to Marlette.[169] This is different from cases such as *CashCall* because Cross River Bank retained approximately ten percent of the loans it made.[170]

Another pending case is *Meade v. Avant of Colorado, LLC*. Avant, a marketplace lender, operates a website where customers can apply for loans to be fulfilled by a Utah-chartered partner-bank, WebBank.[171] Avant also applied for a lending license in Colorado to make loans of $1,000 or less.[172] Meade, the administrator of the Colorado Uniform Consumer Credit Code, argued that WebBank is not the "true lender" since Avant initiated the program, determined loan eligibility, paid all of WebBank's legal fees and expenses relating to the program, indemnified WebBank, and retained 99% of the profits on loans under this program.[173]

As seen in these two cases, the types of agreements made under the bank partner model can vary, and different fact patterns make subjective tests unwieldly, leading to potentially unpredictable results. For this reason, there is a need for a clear bright-line test that is applicable to a variety of fact patterns.

D. True Lender Litigation Summary

As seen in the cases above, there have been no consensus amongst courts on the best method to analyze true lender cases. The increase in "true lender" litigation, including the pending cases in Colorado, only serve to further destabilize the legal environment and lead to unpredictable outcomes.[174] The differing legal standards of the predominant interest test and the economic form test stem from a lack of consensus over what the right level of bank involvement should be before they can be deemed the true lender, resulting in the current fractured legal environment.

E. History Behind the Risk Retention Rule

One of the key factors contributing to the Great Recession was a collapse in the housing market, which had a knock-on effect on the subprime mortgage industry.[175] The housing market, which had become an economic bubble, was fueled by mortgage-backed securities ("MBS") and collateralized debt obligations ("CDO").[176] A CDO is a financial instrument that entitles holders to receive money generated from underlying assets.[177]

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[169] *Id.*
[170] *Id.*
[171] Avant of Colorado, 307 F. Supp. 3d at 1137, 1147.
[172] *Id.* at 1138.
[173] *Id.*
[174] Eckman et al., *supra* note 96.
[175] John V. Duca, *Subprime Mortgage Crisis*, FED. RES. HIST. (Nov. 22, 2013), https://www.federalreservehistory.org/essays/subprime_mortgage_crisis.
[176] *Id.*; Roosevelt Institute, *What is a Collateralized Debt Obligation (CDO)*?, NEXT NEW DEAL (May 27, 2009), http://rooseveltinstitute.org/what-collateralized-debt-obligation-cdo/.
[177] *Id.*

Consisting of different tranches, each tranche represents a different risk level based on the soundness of the underlying fixed-income asset.[178]

With the low interest rate environment and increase in housing prices in the early 2000s, the volume of mortgages and loans issued correspondingly rose as purchasers and lenders in the housing market developed greater appetite for risk.[179] Borrowing requirements were relaxed and many high-risk, subprime borrowers were approved by lenders—the underlying asset subject to foreclosure, housing, was perceived to retain its ever-increasing value even if the borrower were to default.[180] The combination of a housing bubble, historically low interest rates, and a surge in subprime lending all played a role in the crisis.[181]

From early 2007 to 2008, mortgage default rates began rising as a result of high-risk borrowers being unable to meet their payments.[182] By then, the size of the market for financial instruments and derivatives, including CDOs, had increased to over $596 trillion.[183] As the core assets within CDOs declined in value, so did the value of the derivative itself, leading to large losses amounting to billions of dollars for institutional investors holding these ABSs.[184] Moreover, since the market for CDOs is not frictionless and involves "significant transaction costs," the illiquidity prevented asset managers owning CDOs from unloading them on the market.[185] In addition to CDOs, other financial derivatives such as credit default swaps ("CDS") also experienced a significant amount of growth, leading to a ballooning of the derivatives market.[186]

Ultimately, the Government Accountability Office (GAO) estimated that the financial crisis of 2008 may have caused over $10 trillion in losses.[187] In response to the crisis, legislators passed the Dodd–Frank Wall Street

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[178] *Id.*

[179] Steve Denning, *Lest We Forget: Why We Had a Financial Crisis*, FORBES (Nov. 22, 2011, 11:28 AM), https://www.forbes.com/sites/stevedenning/2011/11/22/5086/#17007356f92f.

[180] *Id.*

[181] *See generally* Katalina M. Bianco, *The Subprime Lending Crisis: Causes and Effects of the Mortgage Meltdown* (2008), https://business.cch.com/images/banner/subprime.pdf.

[182] *See* CHRIS MAYER ET AL.,THE RISE IN MORTGAGE DEFAULTS 2 (2009).

[183] Naohiko Baba & Paola Gallardo, *OTC* Derivatives Market Activity *in the* Sec*ond* H*alf of 2007*, BANK FOR INTERNATIONAL SETTLEMENTS 1 (2008), https://www.bis.org/publ/otc_hy0805.pdf.

[184] Al Yoon & Dan Wilchins, *Wall Street's Subprime CDO Write-downs Seen $64 billion: Citi*, REUTERS (Nov. 8, 2007, 2:50 PM), https://www.reuters.com/article/us-mortgages-writedowns-cdo/wall-streets-subprime-cdo-write-downs-seen-64-billion-citi-idUSN0823401520071108.

[185] *See* ROBERT A. JARROW, THE ROLE OF ABS, CDS AND CDOS IN THE CREDIT CRISIS AND THE ECONOMY 9 (Sept. 20, 2011).

[186] Baba & Gallardo, *supra* note 183, at 1.

[187] U.S. GEN. ACCOUNTING OFFICE, GAO-13-180, FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT (2013).

Reform and Consumer Protection Act ("Dodd-Frank") on July 21, 2010.[188] Dodd-Frank introduced major reforms to the financial industry, including but not limited to the regulation of derivatives, regulation of credit-rating agencies, introduction of the Volcker Rule prohibiting banks from performing proprietary trading, and creation of the Consumer Financial Protection Bureau ("CFPB"). Importantly, Dodd-Frank required that six federal agencies, the Board of Governors of the Federal Reserve System, Department of Housing and Urban Development, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Office of Comptroller of the Currency and the Securities and Exchange Commission, implement a risk retention rule.[189] The Great Recession highlighted the dangers of moral hazard, where originators, with the knowledge that they would not incur losses after offloading their subprime loans to others, did not consider the consequences of default when approving low quality loans.[190]

F. The Risk Retention Rule

The risk retention rule obliges a sponsor of an ABS transaction or a majority-owned affiliate to retain a minimum of five percent (5%) of the collateral's aggregate credit risk.[191] The goal is to ensure that sponsors of securitization transactions are exposed to risk of loss which should incentivize them to originate higher-quality securitizations.[192] The minimum 5% retained economic interest (also known as "skin-in-the-game") acts as a tool to align the interests of investors and ABS sponsors.[193] Prior to the recent financial crisis, "[s]ome lenders loosened their underwriting standards, believing that the loans could be sold through a securitization . . . and that . . . the lender . . . would retain little or no continuing exposure to the loans."[194] The risk retention rule would "provide securitizers an incentive to monitor and ensure the quality of the securitized assets . . . [and] help align the interests of the

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[188] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[189] *See generally* BAIRD WEBEL, CONG. RESEARCH SERV., R41350, THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: BACKGROUND AND SUMMARY (2017); Joint Press Release, Board of Governors of the Federal Reserve System, *Six Federal Agencies Jointly Approve Final Risk Retention Rule* (Sept. 4, 2013) (on file with author).
[190] *See* BERNDT & GUPTA, *supra* note 19, at 2.
[191] 17 C.F.R. § 246.4 (2017).
[192] Georges Duponcheele et al., *The 5% Securitisation Retention Threshold: A Short Technical History*, BNP PARIBAS 1 (2016), http://www.riskcontrollimited.com/wp-content/uploads/2016/07/5_Percent_Securitisation_Retention.pdf.
[193] Duponcheele et al., *supra* note 192, at 1–2.
[194] Credit Risk Retention; Rule, 79 Fed. Reg. 77, 602, 77, 604–05 (Dec. 24, 2014) (to be codified at 12 C.F.R. pt. 43, 12 C.F.R. pt. 244, 12 C.F.R. pt. 373, 12 C.F.R. pt. 1234, 12 C.F.R. pt. 246, 12 C.F.R. pt. 267).

securitizer with the interests of investors"[195] by removing inherent conflicts of interest in the process of securitization.[196]

Initially proposed in March 2011 and re-proposed in August 2013 (the "Re-Proposal"), the Final Rule came into effect on December 24, 2016.[197] The Final Rule made minor edits to the Re-Proposal, but otherwise followed the requirements set forth in the Re-Proposal.[198] Under the Final Rule, an ABS sponsor must retain an exposure of at least 5% to the transaction risk, using three approved methods. These methods include an eligible vertical interest, an eligible horizontal residual interest ("EHRI"), or a combination of the two (an "L-shaped interest").[199]

The risk retention rule applies to sponsors of an ABS.[200] An ABS sponsor is defined as someone who "organizes and initiates" a securitization.[201] Under an eligible vertical interest method, an ABS sponsor must retain a vertical slice of the risk at every tranche of the securitization. This means that 5% of each tranche within an ABS are kept on the sponsor's books. Under the EHRI method, a 5% interest in the first-loss tranche of an ABS is retained. This refers to the tranche of the ABS suffering the first economic loss when the assets decline in value. Finally, the L-shaped interest method allows for combining the eligible vertical interest and EHRI methods as long as the total interest held by the sponsor is at least 5% at the closing date of the transaction.

G. 5% Threshold of the Risk Retention Rule

When the risk retention rule was originally proposed, there was much debate over the appropriate percentage of retained risk to be written into the rule. The goals of the risk retention rule were to rein in the originate-to-distribute business model which was a contributing factor to the Great Recession, and to ensure that the interests of the bank and the investors in ABS issuances were aligned.[202] With these goals in mind, varying percentages were offered, including proposals as high as 20%.[203] Ultimately, the 5%

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[195] *Id*. at 77, 604–05.
[196] Saltuk Ozerturk, *Moral Hazard, Skin In the Game Regulation and CRA Performance*, 52 INT. REV. OF ECON. AND FIN. 148 (2017).
[197] Faulkner, *supra* note 8; David M. Lynn, *A Closer Look at US Credit Risk Retention Rules*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Nov. 14, 2015), https://corpgov.law.harvard.edu/2014/11/16/a-closer-look-at-us-credit-risk-retention-rules/.
[198] Lynn, *supra* note 197.
[199] *Id.*
[200] 12 C.F.R. § 43.4(a) (2018).
[201] 12 C.F.R. § 43.2 (2018).
[202] Duponcheele et al., *supra* note 192, at 2.
[203] *Id.* at 1.

threshold was viewed as a sufficiently high percentage to accomplish these goals while remaining in compliance with International Accounting Standards ("IAS") applied in the European Union ("EU") as well as U.S. Generally Accepted Accounting Principles ("GAAP").[204]

The issue with higher percentages stemmed from section 18(a) and section 20(a) of IAS 39, which delineates what kinds of securitizations a bank has to recognize on its balance sheet.[205] Section 18(a) of IAS 39 is part of an accounting decision tree on securitizations and asks "[h]as the entity transferred its rights to receive the cash flows from the asset?"[206] Usually, the answer is 'Yes' since the bank no longer receives any cash after selling the securitized asset.[207] A 'Yes' response to section 18(a) requires an answer down the decision tree in section 20(a), which asks "[h]as the entity transferred substantially all risks and rewards?"[208] An issue in the debate on risk retention percentages was the lack of definitions for "substantially all" and "risks and rewards" under section 20(a).[209] With the definition of "substantially all" being hotly debated in the past, U.S. and EU accountants have interpreted this to mean "90% or more."[210] Therefore a 10% or higher risk retained requirement might conflict with this provision.[211] For example, requiring 20% risk retained would mean that banks cannot derecognize the securitized asset from their balance sheets, since retaining 80% of the securitization would result in a 'No' answer to section 20(a). By forcing banks to recognize all securitized assets on their balance sheet, the rule would incentivize banks to find alternative solutions, including potentially not recognizing the assets in the first place.[212] After considering these implications, the 'not less than 5%' rule was implemented.

H. Risk Retention Rule in Relation to the Bank Partner Model

The risk retention rule, mandating "skin in the game" to align the interests of securitizers and investors, solves a similar problem plaguing the bank partner model.[213] By retaining a slice of the risk, securitizers face a risk of loss depending on the quality of the asset. Similarly, one of the criticisms

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[204] *Id.*
[205] *Id.* at 1–2.
[206] *Id.* at 5.
[207] Duponcheele et al., *supra* note 192 at 1.
[208] *Id.* at 5.
[209] *Id.* at 2.
[210] *Id.*
[211] *Id.* at 3.
[212] *Id.* at 2.
[213] *Id.*

levied at the bank partner model is that the bank often does not suffer a risk of loss since the loans are wholly sold to the marketplace lender a short time after origination under some arrangements.[214] Without the bank bearing any risk, courts have at times determined subjectively that the marketplace lender is the "true lender."[215]

By using an objective standard instead, the market can gain clarity on how the courts will interpret the partner bank-marketplace lender relationship. Since the risk retention rule is already in use in another segment of finance to tackle a similar problem, it is worth considering adopting it as a framework in analyzing "true lender" cases. The bank partner model is subject to different agreements between the bank and marketplace lender, with factors including: how long a bank holds onto originated loans; the amount of loans generated; the party in control of underwriting policies; and the percentage of loans sold to the marketplace lender. Changing from agreement to agreement, a subjective test would be unwieldly and lead to unpredictable results depending on each case's individual fact pattern. By adopting an analogue to the risk retention rule and applying a standard of no less than 5% risk retained by a bank in a bank partner model transaction, we can obtain a clear rule on the level of economic interest a bank has in a transaction to be considered a "true lender."

Moreover, the policy justification for a "skin in the game" risk retention rule address many of the analogous issues surrounding the "true lender" debate. As such, implementing the risk retention rule framework to true lender cases can offer clarity in a destabilizing legal environment. When an issuer is faced with the possibility of economic loss suffered in correlation to the buyers of ABS, they may be incentivized to exert costly compliance regimes to improve the quality of origination as well as monitor portfolio performance.[216] This is akin to the bank partner model relationship between marketplace lenders and banks, which ultimately impacts consumers. In many implementations of bank partner models, including ones used in the two *CashCall* cases, the bank had no 'skin in the game'—the marketplace lender effectively bought all of the issued loans.[217] Thus any losses would be borne by the marketplace lender only and the bank would generate revenue from its origination activities with minimal risk. Furthermore, in some cases, such

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[214] Alan S. Kaplinsky et al., *Installment Lender Using Bank Partner Model Needs Maryland License, Court of Appeals Rules,* BALLARD SPAHR (July 15, 2016), http://www.ballardspahr.com/alertspublications/legalalerts/2016-07-15-installment-lender-using-bank-partner-model-needs-maryland-license-court-of-appeals-rules.aspx.
[215] *Id.*
[216] *See generally* Ozerturk, *supra* note 196.
[217] CFPB, 2016 WL 4820635, at *6; Morrisey, 2014 WL 2404300, at *7.

as in *Cashcall*, the marketplace lender pays for costs, issues underwriting guidelines, and services the loan.[218] Banks incur no cost in maintaining the loan portfolio and bear little to no economic risk; this directly leads to a decline in the quality of underwritten loans. The business then becomes 'quantity over quality,' with the bank safe in the knowledge that they will not suffer negative consequences by originating poor quality loans. This contravenes established public policies on usury in many states.[219]

I. Resolving the Bank Partner Model Relationship

The crucial question to answer in light of the litigation surrounding the bank partner model is how to characterize the relationship between the marketplace lender and the bank entity; in other words, is the relationship substantive or merely a sham. The answer has been complicated by the different standards adopted by courts in "true lender" cases. With the growth of the marketplace lending industry and increased consumer dependence on loans obtained from marketplace lenders, there is a public policy benefit in clarifying who the "true lender" is in a bank partner model arrangement.[220] The decision to recognize either the bank or the marketplace lender will impact the interest rate charged on marketplace lending loans—recognition of the latter will nullify the federal preemption right.

The risk retention rule is a ready-made analogue to the problems facing the marketplace lending industry. While the 'no less than 5%' threshold was informed by IAS accounting standards which do not apply in a "true lender" analysis, the concept of "skin in the game" is analogous to the marketplace lending problem. The risk retention rule was borne out of misaligned incentives by originators and loan purchasers, where the former does not have skin-in-the-game and thus would not be negatively impacted if the latter suffers an economic loss.[221] This originator–purchaser relationship is analogous to the bank–marketplace lender relationship that has vexed multiple courts. There has been no consensus on what amount of "skin in the game" is sufficient for banks when partnering with marketplace lenders to avoid designation as a sham. When marketplace lenders utilize banks' federal preemption rights to circumvent usury laws of borrowers' states of residence and taking

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[218] CFPB, 2016 WL 4820635, at *3.

[219] *Id*. at *7 (noting that the fundamental public policies of sixteen states are to protect citizens from unlicensed lending and usurious loans; some with statutes written to render such contracts void).

[220] Walter E. Zalenski et al., *Special Alert: More Turbulence for Marketplace Lending – CFPB Prevails in "True Lender" Litigation*, BUCKLEY SANDLER LLP (Sept. 2, 2015), https://buckleysandler.com/articles/2016-09-06/special-alert-more-turbulence-marketplace-lending-cfpb-prevails-true-lender-litigation.

[221] *See* Duponcheele et al., *supra* note 192, at 1.

assignment of loans almost immediately after they are made, the bank has minimal or no risk of economic loss. This creates moral hazard, since the bank partner model incentivizes banks to prioritize quantity over quality of loans and subsequently assign them to the marketplace lender.

A rule requiring a bank to retain a minimum of 5% economic interest in all loans originated under a bank partner model for the partnership to be considered substantive would effectively clarify true lender status. By adopting the '5% economic interest' standard derived from the risk retention rule, a bright-line test can be established to clarify the uncertain legal environment. As an example, the bank-partner in *Marlette* would not be subject to recharacterization because it held 10% economic interest in the loans, which is higher than the proposed 5% threshold. On the other hand, the two *CashCall* cases would be subject to recharacterization for not meeting this threshold.[222] Courts will have a clear framework for analysis based on the partnership agreement in a true lender case, and market participants can structure their partnerships in line with the '5% economic interest' standard to eliminate recharacterization risk. With "skin in the game," banks are incentivized to exercise greater discretion when originating loans, which will help ensure the bank partner model is not used for improper purposes.

There are challenges in calibrating the appropriate amount of "skin in the game" a bank partner should have while still ensuring that the marketplace lending business is viable. If the amount is too high, a bank might decline to participate in a bank partner model arrangement, and this would hamper the ability of marketplace lenders to make loans. This ultimately harms consumers who depend on such loans in credit markets underserved by banks. However, too low a percentage would be ineffective and not create enough financial risk for the partner-bank to achieve the desired goals. The 5% economic interest is an appropriate amount to be considered 'skin-in-the-game'. The 5% threshold is considered sufficient when used in the risk retention rule to reign in irresponsible ABS origination practices. Analogously in true lender cases, this percentage would prove that the bank has substantial economic interest in the loan.

There may be concerns that imposing a '5% economic interest' is itself too high a burden for the industry. However, the ABS sector shows such concerns to be unfounded. In the years after introduction of the risk retention rule, credit markets, such as the commercial mortgage backed security market, continued to perform well with no significant negative impact on the

[222] CFPB, 2016 WL 4820635, at *2; Marlette Funding LLC, No. 17CV30376, at 4; Morrisey, 2014 WL 2404300, at *6.

volume of originations.[223] In fact, the quality of the ABS market appears to have improved according to the head of U.S. CMBS for Fitch Ratings.[224] Even when factoring in the economic recovery post-Great Recession, the 100% surge in CLO volume in the six months after the risk retention rule showed the rule had little impact on market activity.[225] While there is a large difference in the size of the ABS market compared with the marketplace lending market, both are large and active enough to bear this regulatory burden without significantly harming growth in the market.[226] Furthermore, an increase in certainty would be favorable to the market—parties under a bank partner model would no longer have the specter of true lender litigation brought against them if they conform to the '5% economic interest' rule.

Finally, this '5% economic interest' rule provides a more market-friendly solution to the predominant interest test. Any new rule proposal should be calibrated to reign in the excesses of the marketplace lending industry yet not restrict liquidity; the ultimate goal should be to continue supporting the financially-important marketplace lending sector. A test that imposes too high an economic burden on banks would cause them to cease participating in bank partner models and cause a chilling effect on the industry; too low an economic burden would mean the test becomes ineffective at its purpose. Since the risk retention rule has not led to a downturn in the ABS sector, the 5% threshold is likely to be effective in the marketplace lending industry as well.[227]

CONCLUSION

True lender litigation poses a risk to the industry due to the risk of recharacterization and also its potential chilling effect. With courts unable to reach a consensus on the best way to analyze true lender cases, the lack of a uniform legal test has caused an unpredictable and destabilizing legal environment. The risk retention rule is a ready-made analogue to the problems

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[223] Kristen Haunss, *LPC: CLO volume jumps 100% in first half of 2017*, REUTERS, (July 14, 2017), https://www.reuters.com/article/usclo-volume/lpc-clo-volume-jumps-100-in-first-half-of-2017-idUSL1N1K50PR.

[224] Huxley Somerville, *One Year Later, Risk Retention Is a 'Nice to Have' Feature for CMBS*, COMMERCIAL OBSERVER (Dec. 8, 2017, 12:50 PM), https://commercialobserver.com/2017/12/one-year-later-risk-retention-is-a-nice-to-have-feature-for-cmbs/.

[225] Haunss, *supra* note 223.

[226] *Compare* SIFMA, *US ABS Issuance and Outstanding*, available at: https://www.sifma.org/resources/research/us-abs-issuance-and-outstanding/ *with* Jagtiani & Lemieux, *supra* note 10 (~$112.3 billion in CDOs/CLOs issued in 2015 versus $28.5 billion in consumer Fintech loans issued in 2015).

[227] Haunss, *supra* note 223.

facing the marketplace lending industry. The moral hazard problems addressed by the risk retention rule are similar to the problems of the bank partner model, where banks have no incentive to provide high quality loans to marketplace lenders if they can assign essentially all of the loans to a marketplace lender, retaining no interest in the loan portfolio and no exposure to any risk of economic loss. By mandating that banks retain no less than 5% of the economic risk on loans sold to marketplace lenders, the incentives of the bank and the marketplace lender would be aligned—their financial performance would be correlated, with the bank participating in both the profits and losses stemming from the loan portfolio. The risk retention rule has worked well in the ABS industry and adopting it in marketplace lending can confer the same benefits of reducing moral hazard, promoting industry growth by removing recharacterization risk, and establishing a clear bright-line standard for courts and market participants. As such, bank-partners should be subject to a regulation requiring retention of 5% economic interest in all loans originated in a bank partner model.