IN THE NEWS

Colorado Among States to Sue over True Lender Rule

AGs say rule violates administrative law and enables predatory lending, banking regulator says rule offers clarity for "innovative" lending partnerships

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Colorado joined a half dozen other states and the District of Columbia in suing the Office of the Comptroller of the Currency earlier this month over a new rule they say undermines state usury laws.

New York, California, Colorado, Massachusetts, Minnesota, New Jersey, North Carolina and the District of Columbia filed the lawsuit Jan. 5 in a New York federal court. The states allege the OCC violated the Administrative Procedure Act when it adopted its True Lender Rule, which took effect in December.

The True Lender Rule determines who is the "true lender" when a loan is made through a partnership between a national bank and a third party. Under the rule, the bank is the true lender if, as of the origination date, it is either named as the lender in the loan agreement or funds the loan. If one bank is named as the lender in the loan agreement and another bank funds the loan, the bank named on the agreement is the true lender.

The distinction matters because it determines the interest rate that can be charged. Under the National Bank Act of 1864, national banks may charge the maximum interest rate allowed in the bank's home state, allowing them to preempt the usury laws of other states, including those where the borrower resides. But the NBA doesn't apply to non-bank entities, which are subject to state interest rate caps.

Fintech companies and other non-bank lenders frequently partner with national banks to offer loans, sometimes at triple-digit interest rates. Under so-called "rent-a-bank" schemes, the non-bank entity may market, underwrite and fund the loans while the national bank is listed as the originator on loan documents. Critics of the arrangements say they allow non-bank lenders to evade state usury laws by "exporting" the interest rates of the bank's home state to consumers in other states. National banks based in Utah have been popular partners in these schemes as the state has no limit on interest rates.

When these partnerships have been targets of lawsuits, courts have had to scrutinize the substance, rather than the form, of the lending relationship to determine who is the true lender. According to the OCC, leaving the "true lender" question up to the courts has led to "divergent standards" and "uncertainty concerning the legitimacy of lending partnerships between banks and third parties."

In a high-profile 2015 case, Madden v. Midland Funding, the U.S. 2nd Circuit Court of Appeals ruled that a national bank's preemption authority doesn't extend to the non-bank purchaser of the loans, creating uncertainty about whether non-bank entities can charge the same rates as their national bank partners.

The OCC issued the final True Lender Rule last fall to clear up this uncertainty, which the banking regulator says can have a chilling effect on financial sector innovation and restrict access to credit. "The OCC believes that this rule provides a simple, bright-line test to determine when a bank has made a loan and, therefore, is the true lender in a lending relationship," the agency stated when issuing the rule. "The only required factual analysis is whether the bank is named as the lender or funds the loan."

However, the states allege the True Lender rule "constitutes an unreasonable interpretation of federal law" by, among other things, radically deviating from the true lender analysis used by courts for centuries and allowing non-banks to "enjoy the benefits of NBA preemption without submitting to any type of oversight." The states also claim the OCC failed to comply with provisions of the Dodd-Frank Act and reversed its prior policy without justification when issuing the True Lender Rule.

"The True Lender Rule is contrary to longstanding policy of the OCC, which has strongly condemned rent-a-bank schemes in which a National Bank merely acts as a conduit for loans that are illegal under states' usury laws," the complaint states.

The states further allege the True Lender Rule harms their quasi-sovereign interests in promoting a fair lending marketplace and their fiscal interests as the state will have to assist consumers who "fall into a cycle of debt and are unable to provide for their basic needs."

"Perhaps as objectionable as the substance of the True Lender Rule are the circumstances under which it was issued," the states say, noting the rule was finalized less than two months after the OCC received 4,000 comments on its initial proposal. The final rule was also issued just one week before a presidential election that, the states say, "had the potential to — and ultimately did — usher in a new administration with potentially different policies regarding predatory lending."

The attorneys general have asked the court to declare that the OCC violated the APA and to set aside the True Lender Rule.

Banking and financial services industry groups had generally welcomed the OCC's attempt to clear up ambiguity and unpredictability with the new rule.

"The banking industry greatly prefers clarity and certainty so that they can know what they can and can't do," said Sarah Auchterlonie, shareholder at Brownstein Hyatt Farber Schreck. No matter one's views on high-interest loans, she added, "it's almost always a good thing for the regulator to be specific about what they expect in any given situation."

"I think that it would be unfortunate if this case were to make a decision on the True Lender Rule that was based entirely on dislike for high-interest, short-term loans because the True Lender Rule actually affects so much more of our economy than just small-dollar lending," Auchterlonie said.

Auchterlonie said there are many types of loans where, if you don't take the document at face value about who the lender is and instead have to "peel back the onion every single time there's more than one party involved on the back end of the loan," it can create confusion about who a consumer owes debt to or where to direct complaints about the loan.

Holland & Hart partner Timothy Crisp said that if upheld, the True Lender Rule will "bring a lot of comfort to national banks." But there are a lot of ways the challenge to the rule could play out. President Joe Biden has nominated Michael Barr to lead the OCC as Comptroller of the Currency and, Crisp said, there's nothing to stop him from repealing or changing the True Lender Rule.

"There's not any question in my mind that the states filed the lawsuit [in the Southern District of New York] and with New York as the lead plaintiff for strategic reasons," Crisp said, adding that the 2nd Circuit has previously been sympathetic to the arguments offered by the states, including in the Madden case. If the rule stays in place under the new administration and lawsuits over the rule proliferate, Crisp said, the case could make it to the U.S. Supreme Court, where the conservative majority might be inclined to uphold the rule.

Partnerships between national banks and fintech or consumer finance companies are relatively new, Crisp said, and banks have only recently been willing to participate. "If they start losing in court, they're going to get very, very anxious about continuing to engage in this and in their willingness to work with these fintech and finance company partners," he said.

"So I think that there's real money at stake," Crisp added. "And there's real public policy issues at stake for the states as well as the federal government." •

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