SULLIVAN & CROMWELL LLP

July 24, 2020

OCC Proposes a Rule to Establish When a Bank Is the "True Lender" of a Loan

Proposed Rule Would Facilitate Use of Bank-Partnership Model in the Fintech Industry

SUMMARY

On July 20, the OCC issued a proposed rule[1] clarifying that a nationally chartered bank or federal savings association ("*FSA*") is the "true lender" of a loan if, as of the date the loan's origination, the bank "(1) is named as the lender in the loan agreement or (2) funds the loan."[2] The OCC issued this proposed rule primarily to address bank-partnership models, in which a bank partners with a non-bank to facilitate loans to customers. The partnership models are often done through online platforms as part of the growing FinTech industry. Certain regulators and private plaintiffs had contended that it was the banks' partners—not the banks themselves—that were the "true lenders" of the loans, and thus the normal federal protections for loans originated by national banks (including preemption of state usury laws) did not apply. The proposed rule, if adopted, could greatly weaken, or eliminate, such challenges by giving national banks and FSAs a relatively straightforward way to ensure they are the true lenders of the loans.

The OCC further noted that the proposal "would operate together with the OCC's recently finalized *Madden*-fix rule," which provides that federal preemption of state usury laws continues to apply to loans originated by national banks after they are sold to non-banks, to "fulfill[] [the OCC's] responsibility to resolve ambiguities in the Federal banking laws it is charged with administering and ensuring clarity and uniformity for the banks it supervises."[3] When combined with the *Madden*-fix rule, the proposed rule, if finalized, could encourage a growth in originations through the bank-partnership model involving national banks.

The proposed rule emphasized, however, that the bank-partnership model does not relieve a bank from ensuring that the loan is "made" both in a safe and sound manner and in accordance with applicable laws and regulations.

Comments are due on the proposed rule by September 3, 2020. Given strong opposition from certain state regulators and consumer groups, the proposed rule might draw a judicial challenge to its validity, and there could also be Congressional interest in the proposal.

BACKGROUND

Under Section 85 of the National Bank Act ("*NBA*"),[4] a national bank may originate loans with interest rates permissible under that bank's home state's usury laws, even if the borrower lives in a state with lower permissible usury rates.[5] For centuries—predating the enactment of the NBA in 1864—caselaw and market practice had established that an interest rate valid at the origination of the loan remained valid even after the originator (whether or not a bank) sold or assigned the loan to another party (whether or not a bank).[6]

In 2015, the U.S. Court of Appeals for the Second Circuit issued a decision in *Madden* v. *Midland Funding, LLC*,[7] which radically broke with this longstanding legal principle and held that a non-bank entity taking assignment of a loan originated by a national bank is not entitled to preemption under the NBA from state usury laws. In other words, a loan that was valid when originated[8] by a national bank could become usurious under state law if sold or assigned to a non-bank. The judicial impact of *Madden* has been felt most acutely in the Second Circuit, although parties have attempted to extend the case's influence in other jurisdictions.[9] Since the *Madden* decision, there has been a flurry of activity in Congress,[10] in the courts, and by the banking regulators to address the uncertainties arising from *Madden*. For more information about such activity in the courts, please refer to our March 2017 and June 2019 client memoranda.

In November 2019, the OCC and the FDIC separately issued notices of proposed rulemaking[11] providing that when a loan originated by a national or state bank is sold, assigned, or otherwise transferred to a non-bank, the interest permissible at origination remains permissible following the transfer. These proposed rules were finalized by the OCC and the FDIC in May and June 2020,[12] respectively, and, if they survive any subsequent judicial challenge,[13] effectively override the *Madden* decision.

These so-called "*Madden*-fix rules" specifically do not, however, address the "true lender" issue, which concerns whether, and under what circumstances, a bank that partners with another party during the origination process is the "true lender" of the loan, with the loan thus benefitting from protections under the federal banking laws from state law usury claims.[14] As the OCC notes in the proposal, a growing body of caselaw involving judicial challenges in various jurisdictions based on *Madden* has introduced divergent standards for resolving this issue, including fact-intensive balancing tests under which the courts have considered a multitude of factors, none of which is dispositive.[15] In determining which entity has the "predominant economic interest"[16] in the transaction, courts have not considered all of the same factors or given each factor the same weight in their analyses.[17]

The OCC's proposed true lender rule is designed to address this outstanding issue.

THE OCC'S PROPOSED "TRUE LENDER" RULE

To address how to determine if a loan is made by a bank as opposed to by its relationship partner, "the OCC is proposing a clear test to determine when a bank makes a loan."[18] Under the proposal, "a bank makes a loan when, as of the date of origination, it (1) is named as the lender in the loan agreement or (2) funds the loan."[19] Once it has been determined, under this standard, that a loan was in fact made by a bank, the proposal provides that the applicable Federal legal framework will be used to (1) determine the interest permitted on the loan, pursuant to the NBA or HOLA, and (2) permit the loan to be subsequently sold, assigned, or otherwise transferred without affecting the interest term, pursuant to the *Madden*-fix rule.[20]

The OCC notes that a key objective of the proposed true lender rule is to "provide regulatory clarity and certainty" by identifying the lender and thus "pinpoint[ing] key elements of the statutory, regulatory, and supervisory framework applicable to the loan in question."[21] This clarity is intended to "enable banks to more effectively and efficiently work with other market participants to manage their risks and leverage their balance sheets to meet customers' needs for affordable credit."[22]

The OCC notes its belief that extant "applicable statutes and regulations, enforceable guidelines, and other issuances" provide appropriate safeguards, in the context of bank lending relationships with third parties, to address "legitimate safety and soundness concerns" posed by such relationships or "banks' involvement in activities that may not be consistent with applicable laws and regulations, if they are not appropriately managed."[23]

ADDITIONAL CONSIDERATIONS

As we noted with respect to the *Madden*-fix rules in our November 2019 client memorandum, given the prior litigation relating to this issue, there is a strong chance that the OCC's proposed true lender rule, if adopted as a final rule, will be challenged in federal court, either through a direct challenge under the Administrative Procedure Act or through ordinary course litigation where the parties debate whether the court should defer to the agencies' regulations. It may be some time, even after the rule is final, before an initial judicial determination on their validity is reached.

In addition, the FDIC has yet to issue a proposed true lender rule and noted in its *Madden*-fix rule that those rules did not address the true lender issue. Accordingly, there currently is no proposed "true lender" rule concerning state-chartered banks, which have partnered with a number of non-bank FinTech platforms. It remains to be seen whether and in what form the FDIC may propose its own true lender rule.

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ENDNOTES

1 OCC, *National Banks and Federal Savings Associations as Lenders*, RIN 1557-AE97, 85 Fed. Reg. 44223 (Jul. 22, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-07-22/pdf/2020-15997.pdf (the "*true lender proposal*").

2 True lender proposal, at 44225.

3 True lender proposal, at 44227 and 44224-5.

4 12 U.S.C. 85. For federal savings associations, corresponding provisions are found in the Home Owners' Loan Act of 1933 ("*HOLA*"), 12 U.S.C. 1463.

5 *See FDIC* v. *Lattimore Land Corp.*, 656 F.2d 139, 148-49 & n.17 (5th Cir. Unit B Sept. 1981); *Krispin* v. *May Dep't Stores Co.*, 218 F.3d 919, 924 (8th Cir. 2000).

6 *See Nichols* v. *Fearson*, 32 U.S. (7. Pet.) 103, 109 (1833) ("[A] contract, which in its inception, is unaffected by usury, can never be invalidated by any subsequent usurious transaction."); *see also Gaither* v. *Farmers & Merchants Bank of Georgetown*, 26 U.S. 37, 43 (1828) ("[T]he rule cannot be doubted, that if the note free from usury, in its origin, no subsequent usurious transactions respecting it, can affect it with the taint of usury.").

7 *Madden* v. *Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015).

8 In addition to the NBA, a common law doctrine known as "valid-when-made" had firmly established that a loan that was valid when originated could not become invalid simply because it was assigned to a different holder. Put differently, the valid-when-made doctrine provides that if a loan is non-usurious at origination, the loan does not subsequently become usurious when assigned. The U.S. Supreme Court had acknowledged the doctrine decades before the enactment of the NBA (*see supra* at n.6).

9 For example, the Colorado attorney general initiated litigation against non-bank entities citing *Madden*. *See Meade* v. *Avant of Colorado, LLC*, 307 F. Supp. 3d 1134, 1152 (D. Colo. 2018); *Julie Ann Meade, Administrator, Uniform Consumer Credit Code* v. *Marlette Funding LLC d/b/a Best Egg*, 2017 WL 10606765 (D. Colo.).

10 Financial CHOICE Act of 2017, H.R. 10, 115th Cong. 1st Sess. § 581 (2017).

11 OCC, *Permissible Interest on Loans that are Sold, Assigned, or Otherwise Transferred*, RIN 1557-AE73, 84 Fed. Reg. 64229 (Nov. 21, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-11-21/pdf/2019-25280.pdf; FDIC, *Federal Interest Rate Authority*, RIN 3064-AF21, 84 Fed. Reg. 66845 (Dec. 6, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-12-06/pdf/2019-25689.pdf.

12 OCC, *Permissible Interest on Loans that are Sold, Assigned, or Otherwise Transferred*, RIN 1557-AE73, 85 Fed. Reg. 33530 (Jun. 2, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-06-02/pdf/2020-11963.pdf and FDIC, *Federal Interest Rate Authority*, RIN 3064-AF21, 85 Fed. Reg. 44146 (Jul. 22, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-07-22/pdf/2020-14114.pdf.

13 Given the prior litigation relating to this issue, there is a strong chance that the final rules will be challenged in federal court, either through a direct challenge under the Administrative Procedure Act or through ordinary course litigation where the parties debate whether the court should defer to the agencies' regulations. As of the publication of this memo, we are not aware of any such litigation having been filed.

14 Both agencies' NPRs and final rule releases specifically note that they do not address the "true lender" issue. *See supra* at n.11 and n.12.

15 Such factors have included: "(1) How long the entity named as the lender holds the loan before selling it to the third party; (2) whether the third party advances money that the named lender draws on to make loans; (3) whether the third party guarantees minimum payments or fees to the named

ENDNOTES (CONTINUED)

lender; (4) whether the third party agrees to indemnify the named lender; and (5) how loans are treated for financial reporting purposes." *See, e.g.*, *CFPB* v. *CashCall, Inc.*, No. CV 15–7522–JFW, 2016 WL 4820635 (C.D. Cal. Aug. 31, 2016); *CashCall* v. *Morrisey*, No. 12–1274, 2014 WL 2404300 (W.Va. May 30, 2014).

16 *See, e.g.*, *CFPB* v. *CashCall, Inc.*, 2016 WL 4820635, at *5–*6 (examining ''which party or entity has the predominant economic interest in the transaction,'' including by evaluating which party placed its money at risk).

17 True lender proposal, at 44224. *Compare CFPB* v. *CashCall*, 2016 WL 4820635, with *CashCall* v. *Morrisey*, 2014 WL 2404300.

18 True lender proposal, at 44224.

19 True lender proposal, at 44225.

20 True lender proposal, at 44227.

21 True lender proposal, at 44225.

22 True lender proposal, at 44227.

23 True lender proposal, at 44226.

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