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PUBLISHED: MARCH 16, 2022

Fintech Seeks "True Lender" Ruling to Stop Regulator From Enforcing a California Interest Rate Limit

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On March 7, 2022, a fintech filed a lawsuit in California state court asking the court to declare that an interest rate limit under the California Financing Law (CFL) does not apply to the short-term consumer loans made by an FDIC-insured Utah bank in a partnership program with the fintech (Program). *See Opportunity Financial, LLC v. Clothilde Hewlett*, No. 228TCV08136 (Ca. Sup. Ct., Cnty. of L.A., March 7, 2022).

The fintech also asked the court to enjoin the California Department of Financial Protection and Innovation (DFPI) from enforcing the CFL interest rate limit on Program loans. The lawsuit focuses on the 36% interest rate limit for loans between $2,500 and less than $10,000 made by finance lenders subject to the CFL. The interest rate limit was established by the California Fair Access to Credit Act (Assembly Bill 539) and became effective in January 2020.

The fintech argues that a California interest rate limit should not apply

The complaint includes two arguments that the 36% interest rate limit should not apply to Program loans. The fintech asserted that “as a matter of California law, a loan made by an [out-of-state, federally insured bank] is not subject to any maximum interest rate prescribed by California law” and cited the California constitution, an express bank exemption under the CFL, and legislative history from Assembly Bill 539. In the alternative, the fintech argued that even if the CFL applied to Program loans, the CFL interest rate “would be expressly and impliedly preempted by Section 27 of the Federal Deposit Insurance Act,” which permits FDIC-insured state banks to charge the interest rates permitted in their “home” state on loans to residents in other states. Both arguments depend on a court finding that the Utah bank (not the fintech) is the “true lender” of the Program loans.

The fintech proffered that it is not the “true lender” of the Program loans because the Utah bank (i) approves all underwriting criteria for the Program loans, (ii) uses its own funds to make the Program loans, (iii) enters into loan agreements with consumers, and (iv) retains title to a Program loan for the life of the loan and a beneficial interest in a portion of the principal and interest in the Program loans. According to the complaint, the fintech provides technology-based services to allow the Utah bank to perform these activities. In exchange, the fintech receives a servicing fee and the right to purchase a percentage of the beneficial interest in the Program loans. The Utah bank receives monthly fees from the fintech. The complaint noted that the fintech’s partnership with the Utah bank predates the passage of interest rate limit in Assembly Bill 539 by several years and the partnership was not an attempt to evade the new law.

The fintech filed this lawsuit in response to a February 2022 correspondence from the DFPI, in which the DFPI concluded that the Program loans are subject to and in violation of the CFL’s interest rate cap. According to the complaint, the fintech views the threat of an immediate enforcement action by the DFPI as posing a “potentially fatal threat” to the fintech’s business in California. The complaint also notes that the California assemblyperson who sponsored Assembly Bill 539 has named the Program specifically in public documents as an example of a company violating Assembly Bill 539’s interest rate limit.

The lawsuit provides an opportunity to add to existing “true lender” case law

This lawsuit is notable in a couple of respects. First, the lawsuit gives a California state court the opportunity to add to existing “true lender” case law. “True lender” questions involve a multi-factor analysis of a particular loan program. Any “true lender” case gives a court the opportunity to provide more guidance on how a court in a particular jurisdiction may weigh loan program facts and rule on “true lender” challenges.

In addition, it is unusual for a nonbank service provider to proactively file a lawsuit asking a court to decide whether the bank or a nonbank is the “true lender” of a loan because it is hard to predict how a particular court will view the roles of the bank and nonbank in a loan program and ultimately rule on a “true lender” question. The fintech’s complaint notes that a federal court in California dismissed a lawsuit in April 2021 by a consumer asserting that the fintech was the “true lender” of the Program loans and violated the CFL’s interest rate caps. According to the fintech, the federal court’s ruling is dispositive in the current case because the ruling squarely considered the “true lender” theory upon which the DFPI bases its claim that the Program loans violate the CFL. This prior federal court ruling may be part of the reason that the fintech made the unusual decision to seek a declaratory ruling essentially asking the state court to determine who is the “true lender” of the Program loans.

What the lawsuit may mean for bank partnership programs

Banks and nonbanks that partner to offer loan programs to California residents should track this case as its result could impact the "true lender" risk facing existing bank partnership programs and the structure of future bank partnership programs.

Contact us

If you have questions about this update and how it might affect your business, contact Susan Seaman or your Husch Blackwell attorney.