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Spotlight Remains On Marketplace Lenders Post-Madden

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Following the U.S. Supreme Court's denial of certiorari in *Madden v. Midland Funding LLC*, the focus on online marketplace lenders spawned by the Second Circuit's decision has only intensified, significantly impacting lenders, investors and consumers. In the wake of *Madden*, online lenders such as LendingClub Corp. have become the subject of new lawsuits and could be subject to further claims. This potential legal exposure has caught the attention of at least one rating agency, which has warned of potential losses in securitizations backed by online marketplace loans. The prospect of further litigation and losses by consumers and investors, in turn, has caused regulators to step up their efforts to develop clearer regulations for the industry that would not unnecessarily limit access to credit. Marketplace lenders will need to adjust their business operations and expectations as the legal landscape evolves post-*Madden*.

How *Madden v. Midland* Drew Attention to Legal Issues in Online Marketplace Lending

In *Madden*, a case that did not involve marketplace lending, the Second Circuit held that a nonbank assignee of a national bank's loan is not afforded the preemption benefits available to a national bank if the national bank does not hold a continuing interest in the loan. Consequently, lawful interest rates charged by a selling national bank may be rendered illegal upon a nonbank's purchase of an assigned debt. By denying Midland Funding's petition for certiorari, the U.S. Supreme Court left in place, at least for the time being, the Second Circuit's decision, which remains binding on courts located within New York, Connecticut and Vermont.

Although *Madden* involved a debt collector and credit card debt, the decision has had an immediate and significant impact on online marketplace lenders due to similarities between the preemption rules under a National Bank Act, which was at issue in *Madden*, and the Federal Deposit Insurance Act, which is relevant to marketplace lenders. Marketplace lenders use online platforms to make loans to small businesses and consumers by matching investors and borrowers. Many of these lenders utilize a partner bank origination model, whereby the loans are initially originated by a state-charted bank and then immediately purchased by the online lender (lenders utilizing this model are sometimes referred to as "platform lenders"). The purpose of this structure is to allow the lender to take advantage of the bank's ability under the FDIA to charge interest rates in excess of the rates permitted by the borrower's home state. Similar to the NBA, the FDIA preempts the application of state usury laws to federally insured state-charted banks. Therefore, the holding in *Madden* has the potential to severely disrupt the partner bank origination model.

New Legal Actions Will Keep Attention on Marketplace Lending Practices

The holding in *Madden* has prompted shareholders and borrowers to commence class actions against one of the nation's most prominent platform lenders, LendingClub. In the shareholder suits, plaintiffs assert violations of federal securities laws in connection with LendingClub's initial public offering, alleging, among other things, that the offering materials failed to disclose that LendingClub utilizes an unsustainable business model that is predicated on making usurious loans. Such allegations have also given rise to a shareholder derivative suit against LendingClub's directors and officers. In the borrower suit, the plaintiff alleges that the interest rates charged by LendingClub violate state consumer usury laws and give rise to claims under the Racketeer Influenced and Corrupt Organizations Act. To the extent plaintiffs are able to maintain their claims, similarly situated investors and borrowers will be emboldened to commence litigation against other platform lenders.

The LendingClub suits have cast a spotlight on so-called "true lender" challenges. The preemption benefits afforded a bank are available only if the bank, and not some nonbank assignee, is the true lender. As *Madden* continues to draw attention to the bank origination model, questions have arisen as to whether a platform lender, and not the partner originating bank, is the true lender. In fact, in a May 2016 report, Moody's Investors Service had advised that even if *Madden* was overturned, platform lenders could still face true lender challenges. Evidencing this risk, Moody's noted that the plaintiff in the borrower suit against LendingClub focuses on the partner bank's limited role in loan transactions. The plaintiff appears poised to argue that LendingClub, and not the partner bank, is the true lender and therefore should not be afforded any preemption benefits.

An additional issue that may become hotly contested in the LendingClub lawsuits and other actions where preemption and application of state usury laws are in question is the "valid-when-made" rule. Under the long-standing doctrine, a loan that is not usurious at inception cannot become usurious based upon subsequent transactions. The Second Circuit in *Madden* did not consider its application, and thus it remains to be seen how the rule may be applied in the context of online marketplace lending.

More broadly, as the industry carefully watches the LendingClub suits, it is reasonable to expect the focus on marketplace lending will spark additional claims against lenders. In fact, scrutiny of marketplace lenders' businesses practices has already begun to sprout concerns regarding consumer protection. The U.S. Treasury has warned that the use of "big data" and automated systems could have a disparate impact on protected classes and lead to fair lending violations. In addition, platforms' sharing of consumer information, credit decisions and the bases for those decisions may become subject to challenges under consumer privacy laws.

Securitization Losses Could Result in Further Litigation

The frequency and size of securitizations backed by loans originated through marketplace lenders has grown significantly in recent years. According to PeerIQ, a provider of marketplace lending data, the first half of 2016 saw the issuance of $3.2 billion in marketplace lending securitizations — a 77 percent increase from the prior year.

According to Moody's, the recent borrower lawsuit against LendingClub is a "credit negative" for securitizations backed by loans issued through marketplace lenders that utilize a bank origination model. Moody's reports that victories by borrowers in similar actions and legal challenges over whether loans are exempt from state usury limits could reduce cash flows to marketplace lending loans and securitizations. Moody's also advises that if an adverse ruling jeopardizes online lending platforms, lenders could be left unable to service loans or fulfill their obligation to repurchase loans that breach loan-level representations and warranties.

Losses to securitizations could in turn lead to claims by investors and trustees against marketplace lenders that issued the underlying loans and underwriters that marketed the related securities, similar to the recent wave of lawsuits commenced in connection with residential mortgage-backed securities. Any such claims could be based on representations in the underlying transaction documents and statements in the offering materials related to the enforceability of the underlying loans and compliance with applicable laws. As in RMBS lawsuits, the causes of action could include common law fraud and violations of federal and state securities laws, as well as breach of contract claims, which may give rise to repurchase obligations by the marketplace lender.

Additionally, in the event securitizations suffer losses and appropriate measures are not taken to enforce the trust's remedies (securitized loans are often held by a trust), investors may look to assert claims against the trustee and any other entity appointed to administer the trust. The trustee of a securitization trust often has a contractual or fiduciary duty to pursue claims on behalf of the trust and to maximize the value of trust assets. A trustee's failure to comply with these duties may give rise to breach of contract and/or fiduciary duty claims based on losses caused by the trustee's failure to act. The viability of such theories will depend on how the case law develops in connection with the numerous suits that have been commenced against trustees in the RMBS context for failing to notify investors of loan-level breaches of representations and warranties and to pursue repurchase claims on behalf of trusts.

Regulatory Agencies Will Have Their Say

The fast growth of marketplace lending and potential for additional litigation has recently caught the attention of regulatory agencies, which are at the beginning stages of proposing new rules to govern the industry. In May 2016, the U.S. Treasury released a white paper regarding the central complexities facing the industry and made certain policy recommendations, including enhanced protections for small-business borrowers, greater transparency and increased regulatory clarity. The Consumer Financial Protection Bureau has indicated it likely will propose new regulations before year-end. Marketplace lenders themselves are expected to take an active role in developing clearer rules, which would benefit lenders, borrowers and investors alike. In fact, in the past year, various industry associations have proposed blueprints for self-regulation to address the increased interest expressed by regulators.

The Industry Will Continue to Adjust Its Practices to Reflect the Legal Challenges

As potential issues crystallize through lawsuits and regulations, the opportunity exists for marketplace lenders to adjust their practices and steer away from unintended consequences. As an example, in response to the Second Circuit's preemption analysis in *Madden*, LendingClub has reportedly restructured its operations so that its partner bank, WebBank, maintains an economic interest in the loans it originates and sells. Under the modified structure, WebBank retains a contractual relationship with borrowers and is paid a monthly fee for each loan that LendingClub purchases. By tying the monthly fee to loan performance, WebBank is said to maintain an economic interest in the assigned loans. A similar structure could also potentially alleviate true lender issues going forward for other lenders.

There are other measures marketplace lenders can implement to create greater certainty that business expectations are met and litigation is avoided, although the effectiveness of such measures will depend on how case law develops:

Use of Choice-of-Law Provisions. Lenders could include a choice-of-law provision in their loan agreements that mandate the application of the originating bank's home state's laws, including usury laws. The effectiveness of such a provision may be case-specific, however, because a borrower may overcome it by demonstrating that application of the chosen law would undermine a fundamental policy of the borrower's home state. In *Madden*, this issue will likely be determined by the district court on remand from the Second Circuit.

Use of Forum-Selection Clauses. To avoid being hailed into a court within the Second Circuit or other unfavorable jurisdictions as the law develops, lenders may revise their loan documents to include forum-selection clauses designating where litigation must take place. Such clauses, although generally enforceable, could be subject to challenge based on public-interest considerations.

Avoiding Unfavorable Jurisdictions. Lenders could avoid making loans to borrowers within the Second Circuit and jurisdictions with unfavorable usury laws. This approach, however, narrows the borrower pool and may significantly curtail profits. Moreover, intentionally avoiding borrowers in specific areas could give rise to discrimination claims.

Excluding Borrower Information. To avoid being accused of fostering discrimination, lenders may begin concealing a borrower's place of residence. In fact, some marketplace lenders have already begun implementing such measures, including LendingClub, which only provides investors with the first three digits of an applicant's zip code (although in many instances this would not prevent an investor from ascertaining an applicant's state of residence). Any such measures, however, would need to be balanced against the need to attract investors and fund loans.

Conclusion

The online marketplace lending industry has had the good fortune of emerging at a time of low interest rates and strong demand for fast credit; however, many foreseeable legal challenges may lie ahead, including new rules and regulations, and it remains to be seen whether marketplace lenders can sufficiently adjust their business expectations and operations accordingly. Should investors in marketplace lending securitizations suffer losses or marketplace lenders run afoul of consumer protection laws, litigation exposure for lenders may intensify.

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