CFPB v. CashCall: Another Concern for Partner Lending Models?

September 12, 2016

On August 31, 2016, the United States District Court for the Central District of California granted the Consumer Financial Protection Bureau's (the CFPB) *Motion for Partial Summary Judgment* and denied CashCall, Inc.'s (CashCall) *Motion for Summary Judgment* in a case based on a loan program offered by the now-defunct lender Western Sky Financial (Western Sky).

While the facts of this case are somewhat unusual, this case appears to be the first instance of the CFPB successfully arguing to a federal court that the named lender was not the 'true lender' for the loans. The CashCall case has been decided only at the trial court level and could be reversed following an appeal to the Ninth Circuit Court of Appeals. The risks that the trial court's decision could pose for "bank partnership" loan programs, however, appear more fundamental than those posed by the Second Circuit's *Madden v. Midland* decision in 2015. The *CashCall* decision calls into question the inherent legitimacy of arrangements similar to bank partnership programs, while the Second Circuit's decision in *Madden* to disregard the "valid when made" doctrine becomes a factor only if the named lender actually is the "true lender."

The facts of the case are as follows. Based on Western Sky's claimed affiliation with the Cheyenne River Sioux Tribe, Western Sky also claimed immunity from state usury limits that would otherwise apply to consumer loans of $10,000 or less. The annual percentage rates ("APRs") of the Western Sky loans ranged between 90% to 343%. CashCall provided a wide variety of services to Western Sky to support the loan program. Those services included marketing, technical support. and customer communication services. CashCall also developed the underwriting criteria used by Western Sky and independently reviewed Western Sky's loan documentation for compliance with the loan program guidelines. In addition, CashCall reimbursed Western Sky for various costs incurred in running the loan program and agreed to indemnify Western Sky for any costs arising from any legal claims made against Western Sky. After Western Sky made the loans, CashCall's wholly-owned subsidiary, WS Funding, bought the loans from Western Sky as soon as three days after funding. Finally, another CashCall wholly-owned subsidiary, Delbert Services Corporation, serviced and collected the Western Sky loans.

The U.S. District Court for the Central District of California found for the CFPB on all significant issues, including the personal liability of the individual who is CashCall's sole owner, but this summary focuses solely on the "true lender" issue. The district court ultimately held that CashCall, not Western Sky, was the "true lender" for the loans based upon the application of the "predominant economic interest test" used by the West Virginia

Supreme Court in *CashCall, Inc. v. Morrisey,* 2014 WL 2404300 (W.Va. May 30, 2014). The factors in the relationship between CashCall and Western Sky that led the court to this conclusion included:

- CashCall had established a reserve account for Western Sky, into which CashCall deposited enough money to fund two days of loans based on the previous month's average loan volume. Western Sky used the reserve account to fund loans.
- CashCall purchased all of Western Sky's loans after waiting a minimum of three days after loan funding and always before the first payment was due.
- The purchase price that CashCall paid for the loans included a premium in addition to the outstanding loan balance.
- All economic risks and benefits of the loans transferred to CashCall upon purchase, including both economic and regulatory risks.
- CashCall guaranteed Western Sky a minimum payment of $100,000 per month, plus a monthly administrative fee of $10,000.
- CashCall agreed to indemnify Western Sky for any costs arising from any legal claims made against Western Sky.

There are several consequences to the court's decision that CashCall was the "true lender" based on the factors referenced above. First, the loan agreement provision stating that the loan was governed by tribal law was held unenforceable because CashCall had no relationship to the tribe. As the stated choice of law was unenforceable, the court then held that, by default, the loan agreements were governed by the law of the state of each borrower. As the court noted, however, this meant the loans were void or uncollectible under the laws in many states where the high APRs imposed under the loan agreements exceeded the applicable state usury limits. Second, Delbert's attempts to collect such unenforceable loans were held to be an unfair, deceptive, or abusive act or practice. Finally, the court pierced the corporate veil and held CashCall's sole owner individually liable for CashCall's conduct.

This case has quickly earned notoriety for its potential impact to the many different types of "lender partner" models, including bank partnership, commonly used in marketplace lending; private student loans; and other lending programs. In our view, this case should be taken seriously and monitored for further developments, as it brings to a head the true-lender risks that have always been latent in such lender-partner models.

We caution, however, that there are aspects of this case that ultimately may lessen its significance. First, it is important to note that this decision concerns a tribal lending arrangement, rather than a bank lending partner arrangement in which the lender is an entity regulated on the state and federal level. In addition, the issue of whether Western Sky was actually a tribal affiliate has itself been the subject of ongoing litigation. The pending litigation raises questions regarding whether a tribal lending arrangement in which the lender is the tribe itself or a true instrumentality of the tribe would survive some of the challenges successfully brought against Western Sky and CashCall.

On a practical level, the fact that the loans were very high-rate loans, rather than more "mainstream" installment loans, undoubtedly encouraged much of the litigation brought against Western Sky and CashCall. Finally, the court's decision mentioned, but did not distinguish, precedent such as *Sawyer v. Bill Me Later*, 23 F. Supp. 3d 1359 (D. Utah 2014), where courts have concluded that a partner bank was the "true lender" based upon an analysis of the formal structure of a bank lending partnership, rather than through the application of an economic reality test. It is possible that the court did not distinguish this precedent because it assumed that its decision would not be applied to bank partnership lending arrangements.

Although these considerations may suggest that this case should not apply directly to a typical bank lender program, there are certain troubling aspects to this case that are worth noting. First, the presence of the CFPB in the case may suggest that the CFPB's interest in "bank partnership" programs is increasing, something that has been a concern since the passage of the Dodd-Frank Act. Second, this case seems to be the first instance in which a federal court has applied an economic reality test for purposes of identifying the "true lender" in a bank-partner loan program. It is also worth noting that many of the factors the court cited in determining that CashCall was the "true lender" in this case are common to the bank partnership arrangements used by marketplace lenders (for example, use of a reserve account to fund the loans). The presence of the same factors, even in a more "mainstream" loan program, could be used by other courts to support the application of an economic reality test to identify the "true lender" and bring the non-bank partner within the jurisdiction of state regulatory agencies and attorneys general.

Finally, it is difficult to parse this *CashCall* decision for guidance on how to structure a loan program that would not fail the economic reality test. The following questions are illustrative of the difficulties of attempting to restructure a loan program in light of this decision.

- Should the lender hold the loans for more than three days before selling them to its non-bank partner? If so, how long until the first payment is due and made?
  - Are reserve accounts no longer viable? If so, could a program without one pose safety and soundness concerns for a bank lender?
- Is the economic reality test met if the bank bears some credit risk exposure? If the bank must bear some credit risk exposure, would holding a proportion of whole loans made in the program, or a fractional interest in each loan, make the bank the "true lender"?

At this point, one wonders how this *CashCall* decision can be reconciled with the proposed guidance that the FDIC recently published with respect to third-party loan programs. While the FDIC's proposed guidance assumes the continued existence of bank-partner loan programs, it focuses on ensuring that any safety and soundness concerns are minimized. However, it is difficult to conceive of a third-party loan program that would meet with the FDIC's approval without also including certain factors that the *CashCall* court used for purposes of applying the economic reality test. This seems to suggest that the FDIC and the CFPB have fundamentally different views of bank lender programs.

Given the high stakes involved in this case, including individual liability, we expect this decision to be appealed to the Ninth Circuit Court of Appeals. As we have seen with *Madden*, however, it is extremely difficult to predict how an appellate court will deal with this type of issue or how to determine whether any federal prudential regulators would intervene in an appeal, particularly due to the controversial nature of tribal lending programs.

For further information on this topic, please contact a member of the firm's Consumer Financial Services Group.

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