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Financial Regulation Case Study: Asset Securitization, Marketplace Lending, and the Future After the Madden Decision

Case Study

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Asset Securitization, Marketplace Lending, and the Future After the *Madden* Decision

Memorandum

TO: Chief Legal Officer, American Bankers Association

FROM: Director, American Bankers Association

DATE: November 2016

As you know, the American Bankers Association (ABA) is committed to representing banks of all sizes and charters—from the largest national commercial banks to small state-chartered community banks.[1] In order to serve all of our member institutions, we must strive to follow legal strategies that advance the interests of the entire banking industry. This includes a wide range of responsibilities ranging from advising member banks on legal strategy, initiating strategic lawsuits, filing amicus briefs for cases that have important implications on the banking industry, writing comment letters for proposed legislation and regulations, as well as lobbying members of Congress and administrative agencies to advance the interests of the banking industry. In this capacity, I know you have been tracking some developments regarding the legal rules related to asset securitization programs. Primary among these issues are recent cases where courts have cast doubt upon the legality of certain parts of the loan securitization industry and marketplace lending models. With this memorandum, I am now asking for your help to develop a specific plan of action to address the potentially adverse consequences of these developments for our membership.

Loan Securitization: History and Background

Securitization is the practice of taking a financial asset (such as a bank's right to receive payments from a customer on a loan) and selling the related cash flow (the customer's

[1] *See About the American Bankers Association*, Am. Bankers Ass'n (last visited Nov. 26, 2016), www.aba.com/About/Pages/default.aspx.[perma.cc/KZ3S-GRG5].

This case study was prepared by Dylan M. Aluise, Harvard Law School Class of 2017, under the supervision of Professor Howell E. Jackson. This case study is intended for educational purposes only and is not intended to offer legal advice.

payments) to an investor as a security (called an asset-backed security). The practice of asset securitization in the financial sector dates back to the 1970s, with the structured financing of mortgage pools.[2] Before this practice, banks were essentially portfolio lenders—holding loans until they were paid off or hit maturity.[3] Since the advent of securitization, very few, if any, banks continue to function exclusively as portfolio lending companies, primarily because selling the debt spreads the risk of default and frees up funds to lend to new borrowers. Thus, the U.S. banking industry shifted from an "originate-to-hold" model to an "originate-to-distribute" model.[4] Since their inception in the 1970s, the lending and securitization markets in the United States have grown to enormous levels. As of June 30, 2016, FDIC-insured institutions held nearly $9 trillion in outstanding loans[5]—all of which are assets which could be securitized. In 2015 alone, $1.7 trillion in new loan securitizations were issued, adding to the over $9 trillion in outstanding securitizations that have been originated by various lenders.[6]

In essence, the process of securitization is distilled into two steps: First, the bank or company with an asset (known as the "originator") takes an asset it wants to remove from its balance sheets and puts it into a pool with other assets it wants to sell and then sells this asset pool to an issuer (such as a Special Purpose Vehicle or "SPV" set up by a financial institution).[7] Second, the issuer finances this purchase of pooled assets by selling interest-bearing securities, typically in the form of a bond or collateralized debt obligation ("CDO") to investors in the capital markets.[8] These investors may then trade these securities or otherwise receive payments from a trust account that is funded by the cash flows (borrowers' principal and interest payments) from the pooled assets.[9] This process is illustrated in Figure 1.

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2 Office of the Comptroller of the Currency, Asset Securitization: Comptroller's Handbook 2 (1997), https://www.occ.gov/publications/publications-by-type/comptrollers-handbook/assetsec.pdf [perma.cc/L3CV-KDVY].

3 *Id.*

4 *See* Fin. Crisis Inquiry Comm'n, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States 89 (2011), www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [perma.cc/BQF9-6LWY].

5 *Statistics on Depository Institutions Report—Net Loans and Leases*, Fed. Deposit Ins. Corp. (June 30, 2016), fdic.gov/sdi/main.asp [perma.cc/Z2MH-MCTF].

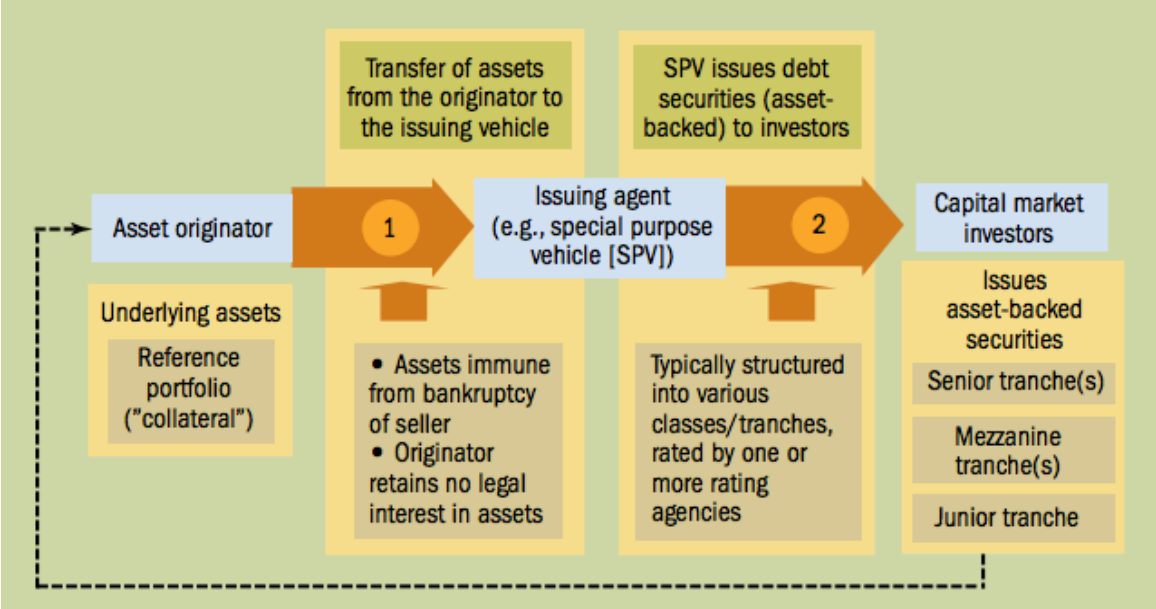
6 *See* Sec. Indus. Fin. Mkts. Ass'n, U.S. Securitization Report, First Half 2016 4 (2016), www.sifma.org/research/item.aspx?id=8589962691 [perma.cc/8NHV-D7FY].

7 *See* Andreas Jobst, *What is Securitization?*, Int'l Monetary Fund (Sept. 2008), www.imf.org/external/pubs/ft/fandd/2008/09/pdf/basics.pdf [perma.cc/88EU-ZPEJ].

8 *Id.*

9 *Id.*

Figure 1: How Securitization Works



Source: Andreas Jobst, *What is Securitization?*, FINANCE & DEVELOPMENT, Sept. 2008, at 48, https://www.imf.org/external/pubs/ft/fandd/2008/09/pdf/basics.pdf.

Banks and other originators seek to take advantage of securitization for a few distinct reasons. First, the securitization market allows originators to transfer some of the risks of loan ownership, such as default risk, to a more diffuse population—including to parties more willing or better able to manage these risks.[10] Second, banks are able to manage their portfolio by moving loans off of their balance sheet to better handle potential asset-liability mismatches and credit concentrations.[11] Furthermore, securitization improves banks' returns on capital by converting an on-balance-sheet asset into an off-balance-sheet income stream that is less capital intensive.[12] Finally, securitization allows banks to increase their liquidity in order to support their lending operations.[13] Each dollar made by selling the securitized asset is another dollar that can be lent out by the bank to new borrowers. Because the business of banking is lending, this extra liquidity and flexibility is crucial to increasing bank revenue.[14] The capital gained by securitizing loans frees

[10] Office of the Comptroller of the Currency, *supra* note 2, at 2.

[11] *Id.*

[12] See *id.* at 4.

[13] Brief for Clearing House Ass'n, et al. as Amici Curiae Supporting Petitioner at *9-12, *Midland Funding, LLC v. Madden*, 136 S. Ct. 2505 (2016) (No. 15-610), 2015 WL 8489383.

[14] *See* Brief for Am. Bankers Ass'n, et al. as Amici Curiae Supporting Petitioner at *2, *Midland Funding, LLC v. Madden*, 136 S. Ct. 2505 (2016) (No. 15-610), 2015 WL 8959419.

up capital for the bank to help meet the credit needs of their communities.[15] According to the ABA, "[i]n today's banking environment, efficient lending requires not only a functioning primary market in which banks make loans to borrowers, but also an efficient secondary market in which banks sell loans to other parties."[16] Similarly, investors stand to benefit from the asset securitization market. In many instances, securitized assets offer better returns than other instruments of similar quality.[17] Additionally, a properly diversified pool of securitized assets obviates the need for investors to obtain a detailed understanding of each underlying asset or loan.[18]

Marketplace Lending: Structure and Brief Background

The modern marketplace lending industry in the United States began in 2006 with the launch of peer-to-peer lender Prosper, quickly followed by its rival, Lending Club.[19] While the marketplace lending industry's peer-to-peer model of connecting the customer/borrowers directly to investor/lenders is meant to disrupt the traditional consumer banking model, some banks have a vested interest in the industry.[20] The FDIC sums up the marketplace lending bank-partnership model as follows:[21] The structure behind marketplace lending begins with a customer using an online platform to submit an application for a loan. The platform then collects information about the borrower's creditworthiness and uses proprietary models to determine credit risk and set an interest rate. The platform then posts the loan request to potential lenders and investors. Once investors have put forth enough capital to fund the loan, the platform then notifies its partner bank, which originates the loan for the customer. The bank then issues a note tying that specific loan to the platform, which in turn sells portions of that note to the investors who expressed interest in funding the loan. These notes are guaranteed by the underlying loan and the investors only receive money when payment has been made by the borrower to the platform to pay off the loan.[22] This model is illustrated in Figure 2.

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15 Cf. *id*.

16 *Id.*

17 Office of the Comptroller of the Currency, *supra* note 2, at 4.

18 *Id.*

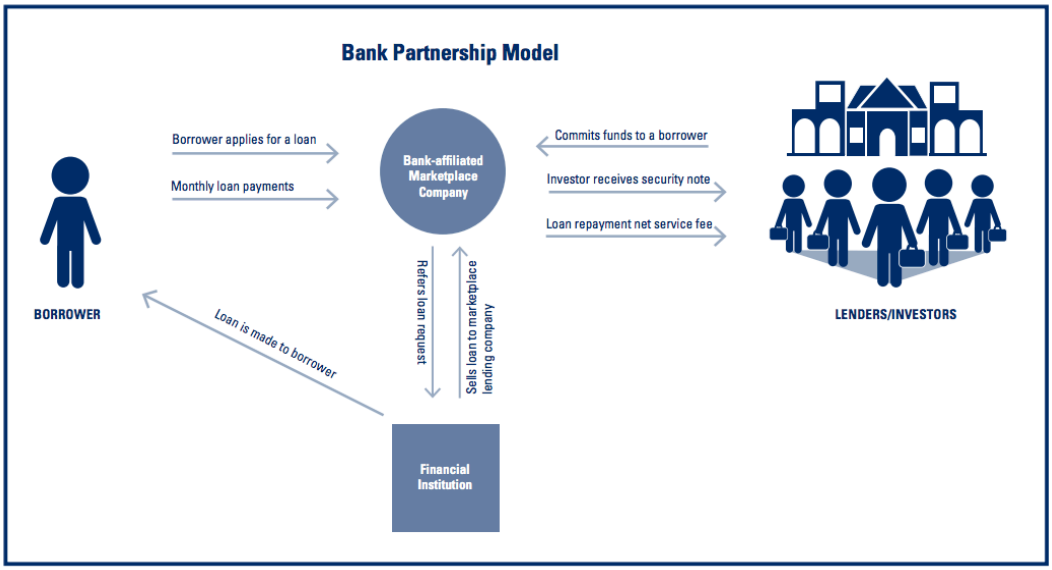
19 *See* Peter Renton*, Peer To Peer Lending Crosses $1 Billion In Loans Issued*, TECHCRUCH (May 29, 2012), techcrunch.com/2012/05/29/peer-to-peer-lending-crosses-1-billion-in-loans-issued [perma.cc/JK33-5BXF].

20 *See* Morrison & Foerster LLP, Practice Pointers on: P2P Lending Basics: How It Works, Current Regulations and Considerations (2016), media2.mofo.com/documents/150129p2plendingbasics.pdf [perma.cc/66WS-EJYY].

21 FED. DEPOSIT INS. CORP., MARKETPLACE LENDING SUPERVISORY INSIGHTS 12-14 (Winter 2015), www.fdic.gov/regulations/examinations/supervisory/insights/siwin15/SI_Winter2015.pdf.[perma.cc/T9WN-S9SV].

22 Morrison & Foerster LLP, *supra* note 20, at 1.

Figure 2: Bank Partnership Model



Source: Angela M. Herrboldt, *Marketplace Lending*, *SUPERVISORY INSIGHTS 12, Issue 2 (Winter 2015), fdic.gov.*

Partnerships between banks and marketplace lending platforms are critical to the functioning of the marketplace lending industry for platforms not utilizing a "direct lending" model, under which the platform would have to become a licensed lender in its own right. The bank-partnership model, more pejoratively known as the "rent-a-charter" model, allows platforms to take advantage of the bank's license to lend, as well as its power to export interest rates under 12 U.S.C. § 85 (for national banks) or 12 U.S.C. § 1831d(a) (for state-chartered banks), derived from the Supreme Court's *Marquette* decision.[23] In this sense, some state-chartered banks, such as Web Bank in Utah, have profited greatly from partnering with marketplace lending platforms to increase their volume of loan origination.[24]

To put this into perspective, Web Bank (which partners with both Prosper and Lending Club) has become one of the most profitable banks in the country, using its chartered status to originate nearly $6 billion in loans annually to Prosper and Lending Club alone.[25] This volume of lending

[23] 12 U.S.C. §§ 85, 1831d(a) (2012); Marquette Nat'l Bank of Minneapolis v. First Omaha Serv. Corp., 439 U.S. 299 (1978).

[24] Zach Fox, SNL Fin., *How Are Marketplace Lenders Doing?*, BANKING EXCHANGE (June 7, 2016, 4:35 PM), www.bankingexchange.com/news-feed/item/6288-how-are-marketplace-lenders-lenders-doing?Itemid=259 [perma.cc/6D4N-F6MQ].

[25] Noah Buhayar, *Where Peer-to-Peer Lenders are Born*, Bloomberg Business Week (Apr. 16, 2015, 6:00 AM), www.bloomberg.com/news/articles/2015-04-16/webbank-where-peer-to-peer-loans-are-born (subscription required) [perma.cc/KM5B-55VG](noting that in 2014, Web Bank's "38 employees generated more than $400,000 in profit apiece, about four times the amount at JPMorgan Chase").

compares drastically to the $226 million in assets on Web Bank's balance sheet, allowing it to amass a 44% return on equity—about five times the average for U.S. banks and 11% better than Goldman Sachs' best year since becoming a public company.[26] However, Web Bank is extremely dependent upon the marketplace lending industry in order to function; its growth has tracked that of the industry precisely. As of Q1 2016, Web Bank reported loans held for sale equal to 62.07% of its total assets (compared to the national average of 0.47%).[27] In short, the viability of banks like Web Bank, and fellow banks reliant upon the bank-partnership model, is tied to the ability to originate and sell loans to their platform partners. It is a vested interest that they will likely go to great lengths to protect.

The Controversy Surrounding Madden v. Midland Funding LLC

The Second Circuit's 2015 decision in *Madden v. Midland Funding LLC*, [28] coupled with the Supreme Court's denial of the petition for certiorari has put both the securitization market and the marketplace lending industry's bank-partnership model into a state of uncertainty. In the *Madden* case, a Bank of America credit card customer, Saliha Madden, challenged the attempts of Midland Funding, a debt collector, to collect on her credit card debt. The challenge was based on the legal premise that the collection attempt violated New York's state usury law. Madden, who was a resident of New York, had previously signed a credit card contract with Bank of America, agreeing to an interest rate of 27% per annum. To charge this interest rate, Bank of America used its power under the National Banking Act[29] to export the usury laws of its home state of Delaware, which allowed any interest rate agreed to by contract.[30] Madden eventually fell behind on her credit card payments and Bank of America ultimately charged off her existing debt of over $5,000 as uncollectible. Bank of America's affiliated entity, FIA, then sold and assigned the debt to Midland Funding, which regularly purchased debt at a fraction of the value and then sought to collect on that debt. When Midland attempted to collect on Madden's outstanding Bank of America credit card debt at the contract's original 27% interest rate, Madden sued

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[26] *Id.* (as of 2014).

[27] Fox, supra note 24.

[28] *Madden v. Midland Funding, LLC,* 786 F.3d 246 (2d Cir. 2015)*, cert. denied,* 136 S. Ct. 2505 (2016).

[29] *See* 12 U.S.C. § 85 (2012).

[30] *See* Del. Code Ann. tit. 5, § 943 (2015) (permitting banks located in Delaware to charge any interest rate agreed to by contract).

Midland on the basis that Midland was attempting to collect interest above New York's 25% criminal usury rate.[31]

Midland's practice here was not unusual. Banks have regularly engaged in the practice of making loans and subsequently selling them to debt collectors, either when they have been charged off as uncollectible or when the bank otherwise wants to increase its liquidity to make new loans. This practice runs parallel to the securitization model, yet the underpinnings of debt assignment are analytically similar. The practice of selling charged-off debt to a third-party non-bank debt collector had been litigated in other circuit courts and was found to be unobjectionable, most notably in the Eighth Circuit's *Phipps* and *Krispin* cases.[32] Additionally, at the *Madden* trial, the District Court for the Southern District of New York followed the reasoning of these decisions to find that Midland was within its legal right to collect on the debt at the original interest rate of 27%, because the debt contract was valid and non-usurious when it was made and did not become usurious simply because of its subsequent assignment.[33]

However, the Second Circuit reversed that finding on the premise that because Midland is not "a national bank nor a subsidiary or agent of a national bank, or is otherwise acting on behalf of a national bank, and because application of the state law on which Madden's claims rely would not significantly interfere with any national bank's ability to exercise its powers under the [National Bank Act]," federal preemption of state usury laws would not be appropriate in this context.[34] Thus, because Bank of America retained no interest in the loan after it was assigned to Midland, the loan became subject to the state usury laws of the borrowers' home state. In a departure from the reasoning behind the Eighth Circuit cases, the Second Circuit's opinion required two controversial steps of logic: first, the long-standing "valid-when-made" principle of contract law was inapplicable here; and second, that this decision would not significantly interfere with

[31] *See* N.Y. Penal Law § 190.40 (2015) (making it criminally usurious for an entity to charge or collect interest at a rate above 25% per year)

[32] *Phipps v. FDIC*, 417 F.3d 1006 (8th Cir. 2005); *Krispin v. May Department Stores Co.*, 218 F.3d 919 (8th Cir. 2000).

[33] *See* Petition for Writ of Certiorari at 26a-32a, *Midland Funding, LLC v. Madden*, 136 S. Ct. 2505 (2016) (No. 15-610), 2015 WL 7008804 (District Judge Seibel's Oral Ruling on Motions).

[34] *Madden*, 786 F.3d at 249.

national banks' powers under the National Bank Act.[35] The Second Circuit ultimately remanded the case in order to determine the applicability of the credit card contract's choice-of-law clause.[36] The Second Circuit's *Madden* decision created a sense of uncertainty in the financial services community because it upset long-held assumptions about the validity of assigned contracts.[37] Despite the remand, the logic of the *Madden* opinion appeared to have broad implications. Loans that a bank assigns to non-bank entities—including asset-backed securities and the marketplace lending loans—would appear to become subject to state usury law in the hands of the assignee. Furthermore, it meant that, in states like New York, these contracts could become valueless in the hands of the assignee, as usurious contracts are void and unenforceable and relieve the debtor of any obligation to pay.[38]

Midland Funding promptly petitioned the Supreme Court for a writ of certiorari to review the case. The ABA, along with several other organizations, filed amicus briefs strenuously urging the Supreme Court to grant certiorari and reverse the ruling.[39] These briefs argued that the *Madden* decision upset a centuries-old understanding, grounded in Supreme Court precedent,[40] that a validly formed contract could not be rendered invalid or have its terms changed simply due to assignment.[41] Midland further argued that three other circuits[42] had recognized this valid-when-made principle in the context of evaluating the usurious nature of debt contracts, with Judge

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[35] *See id.* at 250-51; *see also* 12 U.S.C. § 25b(b)(1)(B) (2012) (codifying the *Watters v. Wachovia* standard of "prevents or significantly interferes with the exercise by the national bank of its powers" for National Bank Act preemption into statute); *Watters v. Wachovia Bank, N.A.*, 550 U.S. 1, 12, 18 (2007) (holding that state laws which would prevent or significantly interfere with "enumerated" or "incidental" powers granted by the National Bank Act would be preempted and extending these powers to bank subsidiaries); *Pac. Capital Bank, N.A. v. Connecticut*, 542 F.3d 341, 353-54 (2d Cir. 2008) (holding that state laws that would prohibit national banks from exercising their incidental powers through agents would be preempted by the National Bank Act).

[36] It should be noted that the Second Circuit remanded the case to the Southern District of New York for a determination on Madden's choice of law clause, which has the potential to negate the Second Circuit's decision outside of its National Bank Act holdings. *See Madden,* 786 F.3d at 253, n.4.

[37] *See* Barkley Clark & Mike Lochmann, A Momentous Court Decision May Hurt Bank Lending Powers, BankDirector.com (July 22, 2015), www.bankdirector.com/issues/regulation/a-momentous-court-decision-may-hurt-bank-lending-powers/ [perma.cc/C23H-WQY] (describing the *Madden* decision as "sen[ding] shockwaves through the banking industry").

[38] N.Y. Gen. Oblig. Law § 5-511(1); *see Seidel v. 18 E. 17th St. Owners, Inc.*, 598 N.E.2d 7, 9 (N.Y. 1992).

[39] *See, e.g.*, Brief for Am. Bankers Ass'n, et al. as Amici Curiae Supporting Petitioner, *supra* note 14.

[40] In 1833, the Supreme Court acknowledged that one of the "cardinal rules" of usury is that "a contract, which, *in its inception*, is unaffected by usury, can *never* be invalidated by any subsequent usurious transaction." *See Nichols v. Fearson*, 32 U.S. 109 (1833) (emphasis added); *see also Gaither v. Farmers & Mech. Bank of Georgetown*, 26 U.S. 37, 43 (1828) ("[F]or the 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.").

[41] *See* Brief for Clearing House Ass'n, et al. as Amici Curiae Supporting Petitioner, *supra* note 13, at 9-12.

[42] *See, e.g.*, *Olvera v. Blitt & Gaines, P.C.*, 431 F.3d 285 (7th Cir. 2005); *Phipps v. FDIC*, 417 F.3d 1006 (8th Cir. 2005); *Krispin v. May Department Stores Co.*, 218 F.3d 919 (8th Cir. 2000); *FDIC v. Lattimore Land Corp.*, 656 F.2d 139 (5th Cir. 1981).

Posner of the Seventh Circuit colorfully concluding "once assignors were authorized to charge interest, the common law kicked in and gave the assignees the same right, because the common law puts the assignee in the assignor's shoes, whatever the shoe size."[43] Furthermore, the briefs posited that the decision was already having a negative effect on the financial services industry.[44] While debt collection is a small but important part of the financial services industry, securitization of assets plays a giant role. The briefs note that banks have relied on the same exportation and assignment methods used in *Madden* to securitize loan assets and render them fully enforceable, even when the bank retains no further interest in the loan. If there is liability in enforcing the interest rate of the securitized assets after assignment, it presents a large hurdle for banks who want to sell their loans in the securitization market. According to the amicus brief of the Clearing House Association, a trade group representing large commercial banks, *Madden* "casts doubt on whether any loan that is sold or transferred by its original lender remains free of usury" which could destabilize the assumptions that the loan securitization market has relied upon for decades.[45]

Midland Funding, as well as the amici curiae supporting the petition for certiorari, also asserted that the *Madden* decision significantly interfered with banks' powers, arguing that the power to sell loans is linked to the power to originate loans under the National Bank Act.[46] Under *Barnett Bank of Marion County, North America v. Nelson*, the Supreme Court held that state laws which "significantly impair the exercise of authority, enumerated or incidental under the [National Bank Act]. . . must give way" and be preempted by federal law.[47] Using this framework, Midland argued that the *Madden* decision allowed New York state usury law to significantly interfere with banks' powers to export interest rates in the wake of the Supreme Court's *Marquette* decision, as well as its subsequent statutory provisions, which allowed national banks to export their home state usury rate unimpaired by any lower usury limit in a customer's state.[48] Thus, Midland

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43 *Olvera*, 431 F.3d at 289.

44 *See* Brief for Clearing House Ass'n, et al. as Amici Curiae Supporting Petitioner, *supra* note 13, at 22-24.

45 *See id.*, at 12; *see also* Richard Kelly, *Are Usury Laws Making a Comeback? Examining Madden v. Midland Funding*, NewOak Capital LLC (June 23, 2015), newoak.com/thought-leadership/usury-laws-making-comeback-examining-madden-v-midland-funding [perma.cc/RM6C-DQTW].

46 Brian S. Korn & Richard E. Gottlieb, *Madden High Court Denial — Much Ado About Not Much*, LAW360 (June 27, 2016, 5:22 PM), www.law360.com/articles/811502/madden-cert-denial-may-be-much-ado-about-nothing (subscription required) [perma.cc/8DRR-PG5Y].

47 Barnett Bank of Marion Cnty., N.A. v. Nelson, 517 U.S. 25, 33 (1996).

48 12 U.S.C. § 85 (2012) (for national banks); 12 U.S.C. § 1831d(a) (2012) (for state-chartered banks); *Marquette Nat'l Bank of Minneapolis v. First Omaha Serv. Corp.*, 439 U.S. 299 (1978).

argued that *Madden* would prevent banks from effectively being able to assign or securitize their loans without being impaired by the customer's state usury rate. In turn, this argument would mean that banks could not effectively export interest rates because they would need a lower interest rate to sell the loans. According to Midland's argument in its petition for certiorari, this amounted to significant interference under the *Barnett* standard and thus preemption of New York's usury laws would be proper.[49]

In response to a petition to review the Madden decision, the Supreme Court issued an order calling for the Solicitor General to weigh in on the case.[50] The Solicitor General filed an amicus brief that was critical of the merits of the *Madden* ruling.[51] First, the brief argued that the Second Circuit failed to recognize that the National Bank Act incorporated the common-law "valid-when-made" principle, which would allow a contract to remain valid after assignment.[52] Second, the Solicitor General claimed that the Second Circuit took an overly-narrow interpretation when it deemed federal preemption inappropriate simply because the national bank did not retain any further interest in the loan it originated after assignment. The Solicitor General asserted that, in effect, the bank *did* have an interest in the loan because if the bank is unable to sell the loan, it would have to keep it on its own balance sheet.[53] Finally, the Solicitor General argued that the *Madden* decision was at odds with the *Barnett* decision because banks engage in the practice of selling loans and the decision would fundamentally impair the ability of national banks to originate and sell loans under federal law, based on the usury rate of a bank's home state.[54] According to the Solicitor General, the proper interpretation of the National Bank Act is to defer to the maximum interest rate allowed in the bank's home state and to completely preclude any other state from imposing a lower maximum rate either directly or indirectly.[55] However, the Solicitor General ultimately urged the Supreme Court not to grant certiorari for three reasons: 1) there was no direct split between the Second and Eighth Circuits; 2) issues of preemption were not properly presented at the court below; and 3) Midland may still win on remand on the

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[49] *See* Petition for Writ of Certiorari, *supra* note 33, at 17-20.

[50] Midland Funding, LLC v. Madden, 136 S. Ct. 1484 (2016)

[51] *See* Brief for the United States as Amici Curiae, *Midland Funding, LLC v. Madden*, 136 S. Ct. 2505 (2016) (No. 15-610), 2016 WL 2997343.

[52] *See id.* at *9-10.

[53] *See id.*

[54] *See id.* at 10-13.

[55] *See id.* at 6-13.

choice-of-law issue despite the Second Circuit's errors.[56] Following the Solicitor General's advice, the Supreme Court denied Midland's petition for certiorari on June 27, 2016.[57]

The Aftermath of the Madden Case

The *Madden* decision has already had an impact on both the loan securitization market and marketplace lending industry. After the Supreme Court's decision not to hear *Madden*, lenders and purchasers of securitized debt assets became concerned about the status of their consumer loans that had any jurisdictional nexus to the Second Circuit and that were originated using banks' exportation power to originate loans in excess of state usury limits.[58] While the *Madden* ruling applies only to New York, Connecticut, and Vermont, a crop of lawsuits across the country have begun to challenge the exportation of interest rates based on contractual assignment to a non-bank assignee in the wake of the Second Circuit's decision.[59] Furthermore, beyond these challenges in other jurisdictions, *Madden* has had a "chilling effect" because customers outside of New York, Vermont and Connecticut seeking to file suit "could find a way to link their cases to Vermont, Connecticut or, more likely, New York."[60]

Madden's impact looms large for banks because it has the power to "significantly disrupt the secondary market for bank loans[.]"[61] On a more immediate level, *Madden* means that banks will no longer be able to effectively securitize or sell their consumer loans made to customers in New York, Vermont, or Connecticut, where the exported interest rate is in excess of the respective state's usury rate, discouraging any potential assignees from purchasing such loans or security in such loans.[62] Because of these usury concerns, firms have already begun removing loans from borrowers in the New York, Vermont, and Connecticut from asset-back securitization markets.[63]

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56 *See id.* at 6.

57 Midland Funding, LLC v. Madden, 136 S. Ct. 2505 (2016).

58 *See* Dan Wheeler, *Banks and Marketplace Lenders Absorb a Blow*, BRYAN CAVE LLP (June 30, 2016), www.bankbryancave.com/2016/06/banks-and-marketplace-lenders-absorb-a-blow [perma.cc/L7NY-VDNS].

59 *See* Dawn Causey, *You Sure? Courts Unsettle Usury Case Law*, AM. BANKER: BANKING JOURNAL BLOG (Apr. 29, 2016), bankingjournal.aba.com/2016/04/you-sure-courts-unsettle-usury-case-law [perma.cc/968T-888V].

60 Evan Weinberger, *Banking Cases to Watch in 2016*, LAW360 (Dec. 24, 2015), www.law360.com/articles/738009/banking-cases-to-watch-in-2016 (subscription required) [perma.cc/4W62-ND5P].

61 *See* Ropes & Gray, *Second Circuit Decision Could Disrupt Secondary Market for Bank-Originated Loans,* Alerts (June 17, 2015), www.ropesgray.com/newsroom/alerts/2015/June/Second-Circuit-Decision-Could-Disrupt-Secondary-Market-for-Bank-Originated-Loans.aspx [perma.cc/7FJ3-8ABJ].

62 *See* Korn & Gottlieb, *supra* note 46.

63 *See* Brief for Clearing House Ass'n, et al. as Amici Curiae Supporting Petitioner, *supra* note 13, at *23 (citing Will Caiger-Smith, *Prospect Capital may rejig ABS deals amid usury worries*, INT'L FIN. REV. (Sept. 4, 2015), http://www.ifre.com/prospect-capital-may-rejig-abs-deals-amid-usury-worries/21214803.article (subscription required).

Madden also means that banks may have to sell other debt assets at a discount as a result of the uncertainty surrounding an assignee's ability to collect on the contract should other circuits opt to follow the Second Circuit's precedent.[64] This, in short, "rais[es] doubt about the enforceability of [a national bank's] loan contracts and decreas[es] the marketability and value of every loan in its portfolio."[65] Furthermore, banks must be wary of assignees exercising put-back rights or indemnity claims against the bank for any potential breaches of representations and warranties regarding the enforceability of the debt contract, creating a huge potential shift of liability to the banks.[66] Finally, *Madden* has caused many third-party debt buyers to restructure their approach to buying debt by pressuring banks to retain an ongoing economic interest in the loans, so that there is a colorable argument that the third-party is "acting on behalf of" a bank to circumvent the logic behind *Madden*'s holding.[67] This restructuring would impair banks' ability to maximize their capital to extend new loans and would also expose banks to an increased risk of default. For example, in the *Madden* case, Bank of America effectively sold a debt they did not believe their customer would pay back. By selling the debt, the bank recouped at least some value for the loan it extended, and this capital—which would otherwise not be at the bank's disposal—would then be available to extend as credit to borrowers in the future.

The *Madden* decision has also had ramifications for other stakeholders in the financial system. For borrowers, *Madden* could potentially increase the cost of credit, as banks will likely shift at least some of the extra risk and uncertainty of not being able to properly securitize and sell the customer's debt to the customer in the form of higher interest rates to even lower-risk borrowers.[68] Additionally, *Madden* has caused the volume of loans to high-risk borrowers under the Second Circuit's jurisdiction to sharply decline, in contrast to the rest of the country. Using data from marketplace lending resources, researchers from Stanford, Columbia, and Fordham law schools tracked the impact of the *Madden* decision. This study revealed that as of May 2016, marketplace lending to high-risk borrowers has increased by 124% since the *Madden* decision in

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[64] *See* Dechert LLP, *Implications of Madden v. Midland Funding*, Dechert OnPoint Blog (July 2016), info.dechert.com/10/7039/july-2016/implications-of-madden-v.-midland-funding.asp [perma.cc/ST6G-XDG4]; Brief for Clearing House Ass'n, et al. as Amici Curiae Supporting Petitioner, *supra* note 13, at *19.

[65] Barkley Clark & Barbara Clark, The Law of Bank Deposits, Collections and Credit Cards § 15.19 (rev. ed. forthcoming 2016).

[66] *See* Kaye Scholer LLP, *Finance Alert: The Uncertain Legacy of Madden* (June 28, 2016), www.kayescholer.com/in-the-market/publications/client_alerts/2016-06-28-finance-alert-the-uncertain-legacy-of-madden [perma.cc/38NJ-HT56].

[67] *Id.*

[68] *See* Wheeler, *supra* note 58.

jurisdictions outside the Second Circuit, while lending to high-risk borrowers in Connecticut and New York *declined* by 52% over the same time frame.[69] This includes a total of *zero* loans issued to borrowers with a FICO score below 625.[70]

Finally, for entities that have purchased debt either as an asset-backed security or as a debt servicer with a jurisdictional nexus to the Second Circuit, the *Madden* ruling means that they may need to renegotiate terms with each borrower on the other side of the loan in order to comply with state usury law.[71] Debt purchasers like Midland have particular cause for concern because they may be subject to criminal liability under state law and sanctions under the federal Fair Debt Collection Practices Act for attempting to collect on assigned contracts that are now considered in excess of state usury limits.[72] For instance, Midland attempted to collect on Madden's debt at a 27% interest rate in New York, where it is a Class C felony to attempt to collect on a debt above a 25% interest rate.[73]

Financial experts have also expressed concerns over the "acute risk" of the *Madden* decision's impact on the growing marketplace lending industry.[74] The specific risk to marketplace lending is the "potential to severely disrupt the partner bank origination model."[75] This impact necessarily extends to the banks who serve as partners to marketplace lending platforms which, like Web Bank, have business models substantially relying on marketplace lending to run a profitable business. While the marketplace lending industry does not typically rely on partnerships with national banks subject to the National Bank Act, they do rely on partnerships with state banks,

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69 *See* Colleen Honigsberg et al., *What Happens When Loans Become Legally Void? Evidence from a Natural Experiment* 10 (Columbia Bus. Sch., Research Paper No. 16-38, 2016), papers.ssrn.com/sol3/papers.cfm?abstract_id=2780215 (subscription required) [perma.cc/2FGC-9ZTF].

70 *See id*. at 20, n. 45.

71 *See* N.Y. Gen. Oblig. Law § 5-511(1); *Seidel*, 598 N.E.2d at 9; Kaye Scholer LLP, *supra* note 66.

72 See Korn & Gottlieb, supra note 46; Lisa M. Ledbetter & Ralph F. MacDonald, III, Secondary Loan Markets Post-Madden: Overcoming Restrictions in Future Loan Transactions and Secondary Market Sales, at 13, STRAFFORD (Nov. 1, 2016), media.straffordpub.com/products/secondary-loan-markets-post-madden-overcoming-restrictions-in-future-loan-transactions-and-secondary-market-sales-2016-11-01/presentation.pdf [perma.cc/NK75-VJPP].

73 *See* N.Y. Penal Law § 190.42 (2015); Korn & Gottlieb, *supra* note 46.

74 *See* Peter Rudegeair, *A New Tariff on 'Interest-Rate Exports?'*, Wall Street J. MoneyBeat Blog (June 30, 2015, 8:48 AM), blogs.wsj.com/moneybeat/2015/06/30/a-new-tariff-on-interest-rate-exports (subscription required)(quoting analysts at Compass Point Research & Trading, LLC); Petition for Writ of Certiorari, *supra* note 33, at *23 n. 8; *see also* Matt Scully, *Peer-to-Peer Lenders Face Legal Blow in Usury Ruling*, BLOOMBERG BUS. (Aug. 14, 2015, 10:38 AM), www.bloomberg.com/news/articles/2015-08-14/peer-to-peer-lenders-losing-court-battle-over-state-usury-laws (subscription required).

75 Joseph Cioffi, *Spotlight Remains On Marketplace Lenders Post-Madden*, LAW360 (July 13, 2016, 4:13 PM), www.law360.com/articles/816802/spotlight-remains-on-marketplace-lenders-post-madden (subscription required) [perma.cc/72DZ-8TJ8].

like Web Bank, who benefit from an identical power under federal law to export interest rates.[76] Thus, following *Madden*'s logic, even a state bank in a partnership with a marketplace lending platform will no longer be able to originate loans with its marketplace lending platform in excess of the borrower's home state usury limit in New York, Connecticut, or Vermont, with the risk that the Second Circuit's holding could be adopted in other circuits as well.[77]

Furthermore, the marketplace lending platforms have been scaling back on extending credit to high-risk borrowers; this is concerning in light of the fact that the U.S. Department of the Treasury has pointed to the potential of the marketplace lending industry to expand access to credit for under-banked populations.[78] Some state-chartered banks also fear that marketplace lenders might avoid using the bank-partnership model and instead opt to directly compete with banks by becoming a licensed lender in their own right and begin utilizing a direct lending model instead.[79]

True Lender Cases: A Related Doctrine Spells Trouble for Marketplace Lenders

A separate, but somewhat related, line of cases has also tested the bank-partnership model through a "true lender" theory. The true lender theory posits that loans arranged by marketplace lending platforms and originated by banks, such as Web Bank, should not be considered bank loans because the true lender-in-interest is the lending platform and not the bank. Most prominently, the Consumer Financial Protection Bureau argued this theory in a case it brought to U.S. District Court for Central District of California against CashCall, Inc., a payday lender that uses partner banks to finance its payday loan products.[80] In the *CashCall* case, the district court judge ruled that CashCall, and not its bank-partner (in this case it was a "tribal lending model" using a Native American tribe as the exempt lending entity, but it is analytically the same for national and a state-chartered banks) was the true lender in interest.[81] The court considered CashCall, and not the bank-partner, to be the lending party based on the following

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[76] *See* 12 U.S.C. § 1831d(a) (2012).

[77] *See* Ryan Lichtenwald, *Supreme Court Denies Petition to Hear Madden v Midland*, LEND ACADEMY (June 27, 2016), www.lendacademy.com/supreme-court-denies-petition-hear-madden-v-midland [perma.cc/H6HF-NZMZ].

[78] *See* Public Input on Expanding Access to Credit Through Online Marketplace Lending, Office of the Undersecretary for Domestic Finance, Department of the Treasury, 80 Fed. Reg. 42866 (July 20, 2015).

[79] *See* Evan R. Minsberg & Allyson B. Baker, *"True Lender" Troubles – More Uncertainty for Partner Origination Models*, Venable LLP (Sept. 28, 2016), www.venable.com/true-lender-troubles--more-uncertainty-for-partner-origination-models-09-28-2016.

[80] *Consumer Fin. Prot. Bureau v. CashCall, Inc.*, No. CV157522JFWRAOX, 2016 WL 4820635 (C.D. Cal. Aug. 31, 2016).

[81] *See id.* at 5-6.

factors: CashCall assumed all of the economic risks and benefits; took assignment of the loan before the customer's first payment was due; funded a collateral account at the bank-partner; guaranteed a monthly fee; took on all of the default and regulatory risk; and had indemnified its bank-partner.[82] In this case, the court looked beyond the form of the transaction and evaluated the totality of the circumstances to determine the substance of the arrangement. Because CashCall was the true lender-in-interest, the loans that the company arranged were deemed to be void and unenforceable on two grounds: 1) the loans were not exempt from usury limits and thus usurious; and 2) the loans were originated by CashCall—an entity that was not licensed to lend under the state laws where many CashCall borrowers were domiciled.[83]

While the Central District of California federal case is the most prominent of the "true lender" cases, state courts have also used similar logic in applying the true lender doctrine to the detriment of entities attempting to take advantage of the bank-partnership model to export bank's preemption powers to avoid usury and licensing laws.[84] While these cases have primarily been aimed at payday lenders, the rationale would seem to apply in equal effect to marketplace lenders utilizing a bank-partnership model to the same ends.[85] Like *Madden*, this line of true lender cases is a threat to state-chartered banks that rely on the bank-partnership model for their business. Due to the emergence of true lender problems, marketplace lenders may decide to forgo the bank-partnership model and adopt a direct lending model instead, which would spell disaster for banks that rely on the bank-partnership model to generate business.[86]

However, it should be noted that the true lender doctrine is not universally followed in all courts. In fact, the Central District of California, the same court that decided the *CFPB v. CashCall* case, opted not to apply the true lender analysis in *Beechum v. Navient Solutions, Inc.*[87] *Beechum* was a student loan case where loans were originated by a national bank in excess of California's usury rate and then assigned to Navient, a student loan servicing company. When Navient sought to

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82 *See id.* at 6.

83 *See id.* at 9.

84 *See*, e.g., CashCall, Inc. v. Maryland Com'r of Fin. Regulation, 139 A.3d 990 (Md. 2016).

85 *See* Chapman & Cutler LLP, The Regulation of Marketplace Lending: Summary of Principal Issues (2016 UPDATE) 3 (2016), www.aba.com/Tools/Offers/Documents/Chapman_Marketplace_Lending_Regulation_Issues_041116.pdf [perma.cc/7Z5E-X86Q].

86 *See* Misberg & Baker, *supra* note 79.

87 *Beechum v. Navient Sols., Inc.*, No. EDCV 15-8239-JGB-KKX, 2016 WL 5340454 (C.D. Cal. Sept. 20, 2016), *judgment entered*, No. CV 15-8239 JGB (KKX), 2016 WL 5329553 (C.D. Cal. Sept. 21, 2016).

dismiss the case, the plaintiffs responded that, following the logic of *CashCall*, Navient was the true lender-in-interest because Navient "originated, underwrote, funded and bore the risk of loss as to the loans."[88] The court, however, rejected the plaintiffs' argument and opted to not look beyond the form of the transaction, as had been done in *CashCall*. The court concluded that, because the California Constitution provided an explicit exemption from its usury laws for banks, the court would decline to look beyond the form of the transaction to apply California's usury laws.[89] The logic applied in *Beechum* also appears to be at odds with the Second Circuit's *Madden* opinion, so it is a case worth keeping an eye on through its appeal to the Ninth Circuit.

Congressional Response

In the wake of the Supreme Court's decision to deny certiorari in the *Madden* case, Representative Patrick McHenry introduced HR 5724 "Protecting Consumer's Access to Credit Act" in the United States House of Representatives.[90] The bill "reaffirms the longstanding legal precedent under the National Bank Act and the Federal Deposit Insurance Act that federal law preempts a loan's interest as valid when made."[91] The bill is aimed as a specific rebuke of the Second Circuit's *Madden* decision and is meant to undo the uncertainty for banks and credit markets created by the "unprecedented" reading by the Second Circuit.[92] However, the bill has had no action in the five months since its introduction and referral to the House Financial Services Committee in July, 2016.[93]

Consumer Issues: Concerns Regarding Payday Lenders and Predatory Debt Collection Practices

Some actors in the financial system have taken advantage of the bank-partnership model and usury preemption decisions to prey upon consumers who are in desperate need for credit. These predatory lending and debt collection practices are a widespread problem in the United States,

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88 *See* Robert Loeb, Howard Altarescu & Christopher Cariello, *Rejecting "True Lender" Arguments, California District Court Dismisses Claims Against Student Loan Servicers*, ORRICK HERRINGTON & SUTCLIFFE LLP (Sept. 26, 2016), www.orrick.com/Insights/2016/09/Rejecting-True-Lender-Arguments-California-District-Court-Dismisses-Claims-Against-Student-Loan-Serv [perma.cc/4HRX-WCU3].

89 *Id.*

90 Jeff Butler, *McHenry Introduces Fintech Bills*, U.S. Congressman Patrick McHenry (July 12, 2016), mchenry.house.gov/news/documentsingle.aspx?DocumentID=398260 [perma.cc/S9BC-RKMF].

91 *Id.*

92 *Id.*

93 *See H.R.5724 - Protecting Consumers' Access to Credit Act of 2016*, CONGRESS.GOV (last visited Nov. 22, 2016), www.congress.gov/bill/114th-congress/house-bill/5724 [perma.cc/74UL-VJRD].

affecting millions of consumers.[94] Payday loans are short-term credit which are generally required to be repaid in a lump-sum single payment upon receipt of the borrower's next paycheck.[95] These loans are generally targeted at credit-strapped low-income borrowers who are desperate for cash in the interim period between pay cycles. Payday lenders are considered predatory because they lend at a high interest rate—with the Consumer Financial Protection Bureau ("CFPB") estimating that the median annual percentage rate on these loans to be 391% on a 14-day loan.[96] According to the CFPB, nearly 12 million borrowers took out payday loans annually in recent years, representing about 15% of all loan obligations, with an estimated $2 billion in payday loans outstanding.[97] Some payday lenders are able to charge such high interest rates because they use a tribal lending model, where the payday lenders partner with federally-recognized Indian tribes that are not subject to state lending laws to originate the loan in excess of usury.[98] This partnership in many ways closely mirrors the bank-partnership model that marketplace lenders use. Payday lenders generally do not use chartered banks to help originate loans due to heightened scrutiny, enforcement actions, and rulemaking initiated by the federal bank regulators to crack down on these relationships.[99] However, payday lenders are closely tracking the same developments regarding the legal status of assigned loans and of the bank-partnership model. The ABA must be cognizant of the ramifications of its legal challenges and lobbying efforts, as they could also be a boon to these predatory practices.

Abusive debt collection practices regarding loans assigned by banks to third party debt collectors is also a concerning consumer protection issue. In 2014, the CFPB handled over 88,300 debt collection complaints, making debt collection the leading source of consumer complaints

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[94] *See* Sarah D. Wolff, Ctr. For Responsible Lending, The Cumulative Costs of Predatory Practices 45 (June 16, 2015), consumermediallc.files.wordpress.com/2015/06/crl-cumulative-impact-final-emb-web.pdf [perma.cc/B865-A2UJ](noting that more than one-in-seven American adults are being pursued by debt collectors, and that the Federal Trade Commission had over 200,000 complaints about predatory collection practices in 2013 – more than any other complaint besides identity theft).

[95] Payday, Vehicle Title, and Certain High-Cost Installments Loans, 81 Fed. Reg. 47864, 47867 (proposed July 22, 2016) (to be codified at 12 C.F.R. pt. 1041), www.regulations.gov/contentStreamer?documentId=CFPB-2016-0025-0001&disposition=attachment&contentType=pdf [perma.cc/9T3L-LXHR].

[96] *See id.* at 47869 (noting that most payday lenders charge $15 for each $100 loaned and basing the estimate on the fact that the median payday loan amount is $350 which, when accompanied by average fees and finance charges on payday loans, amounts to a total cost of a median short-term loan at $402.50).

[97] *See id.* at 47870-71(citing John Hecht, Jefferies LLC, The State of Short-Term Credit Amid Ambiguity, Evolution and Innovation (2016); Pew Charitable Trusts, Payday Lending in America: Who Borrows, Where They Borrow, and Why, at 9 (2012), www.pewtrusts.org/en/multimedia/data-visualizations/2012/payday-lending-in-america [perma.cc/SPC7-MHY2 perma.cc/SPC7-MHY2].

[98] *See id.* at 47877.

[99] *See id.* at 47883-85.

registered with the CFPB.[100] Debt collectors across the country have engaged in various abusive practices such as: "phantom debt collection," whereby collectors attempt to collect debts that either do not exist or are not owed to the phantom debt collector;[101] calling individual debtors thousands of times;[102] and filing suits with faulty or unsubstantiated evidence to support a debt collection claim.[103] To illustrate the point, in *CashCall v. Morrissey*, the West Virginia Attorney General successfully sought action under West Virginia's usury laws against CashCall, a third party debt collector that purchased and attempted to collect loans at interest rates as high as 89% and 96% and also engaged in the unscrupulous practice of calling some customers over 1,000 times.[104] While these abusive practices were not present in the *Madden* case, the ABA should be cognizant moving forward that these practices do exist and that consumer protection is an important issue that ought to be recognized as part of legal challenges moving forward.

What to Do?

Based on the above information, the director of the ABA wishes for you to develop a comprehensive legal strategy in the face of *Madden* and the true lender litigation. The director wishes to hear your proposals regarding the following:

Litigation:

- Is further litigation the correct route? What would this litigation strategy look like and where would you bring the case(s)?
- Is this the right time to try to "seek" a circuit split and attempt to have the Supreme Court finally weigh in on the merits of the *Madden* case? What are the risks of seeking further litigation? Is the possibility of "nationalizing"[105] the *Madden* decision and spreading its deleterious effects to other jurisdictions worth the potential benefits?

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[100] Consumer Fin. Prot. Bureau, Fair Debt Collection Practices Act: CFPB Annual Report 2015 2 (2015); *see also* Wolff, *supra* note 94, at 45 (noting that over the Federal Trade Commission handled over 200,000 predatory collection claims in 2013).

[101] *See* Consumer Fin. Prot. Bureau*, supra* note 95, at 34-35.

[102] *See CashCall Inc. v. Morrisey*, No. 12-1274, 2014 WL 2404300, at *4 (W. Va. May 30, 2014) *cert. denied sub nom. CashCall, Inc. v. Morrissey*, 135 S. Ct. 2050, 191 L. Ed. 2d 956 (2015).

[103] *See* Consumer Fin. Prot. Bureau, *supra* note 95, at 23 (noting that a single firm in Georgia filed over 350,000 debt collection suits in Georgia alone from 2009 to 2013, with a single attorney responsible for over 130,000 of them in a two-year period).

[104] *See*, *CashCall Inc. v. Morrisey*, No. 12-1274, 2014 WL 2404300, at *4.

[105] *See* Korn & Gottlieb, *supra* note 46.

- What other groups or organizations might make for good litigation partners moving forward, and how might you convince them to join your litigation strategy? For example, a consortium of marketplace lenders may wish to seek similar results in litigation, but beyond the few state-chartered bank-partners in the industry, many banks view marketplace lenders as direct competitors. Or, would the surprising step of engaging with consumer groups make sense? Consumer groups have applauded the *Madden* decision because it strengthens state usury laws, but consumers have also been hurt by the decision in the form of higher costs of borrowing and, in some cases, being completely shut out of some lending markets.

- How do you handle the competing interests within the ABA's constituency? Large commercial banks are concerned primarily with the securitization markets and would not necessarily want ABA resources being diverted to deal with the effects of the true lender cases, while smaller state banks that are bank-partners may wish to have true lender cases actively addressed because their entire business relies upon that model.

Lobbying Efforts

- What steps would you take, if any, to lobby policymakers or regulators to best represent the interest of the financial services industry? Are there any outside-the-box solutions beyond Representative McHenry's bill—perhaps a bill that could appease both consumer groups and banks in order to gain consensus to pass into law? How would you aim to build a coalition to achieve this type of consensus?

Advice to Banks

- Finally, in your capacity as a lawyer, what advice would you give both in-house and outside counsel to the ABA's member banks? What steps should they be taking in order to minimize the impact of these recent litigation developments?

- What type of structure might avoid the impact of the *Madden* ruling moving forward? If the *Madden* ruling is premised on banks not having any "skin in the game," because the third-party was not "acting on behalf of" a bank, is there any way to get around this technicality? But, if your advice is for banks to retain some ongoing economic interest in each of their loans, how do you respond to concerns that this might limit future

extensions of credit (because of less capital to lend) and increase the banks' risk of default? Is there any argument to be made to prudential regulators about the increased risk present in the financial system when banks retain too much default risk on their balance sheet, when this risk was previously non-existent because the banks could effectively sell the loans?

- How do you advise banks that have loans to customers in New York, Connecticut, or Vermont that they wish to sell or securitize? What should these banks tell their potential assignees?
- How should banks handle the representations and warranties clauses in their previously-sold loans that have a jurisdictional nexus to the Second Circuit?
- How should banks that have bank-partnership arrangements with marketplace lenders structure the transaction in order to avoid the uncertainty surrounding the true lender doctrine?