NOTE

PORT IN A STORM: COLORADO'S "SAFE HARBOR" SETTLEMENT AS A TEMPLATE FOR ONLINE LENDING REFORM

Zachary R. Hunt†

Innovations in financial technology have enabled nonbank firms to market, originate, and service consumer loans entirely online via web-based lending platforms. These online lenders promote themselves as a faster, disintermediated alternative to traditional lending that leverages technology to provide borrowers with convenient and near-instantaneous access to a wider variety of credit products. Yet despite its claimed advantages, the online lending industry remains perpetually entangled in litigation and controversy surrounding its prevailing business model. Most prominently, lawmakers, regulators, and courts are sharply divided as to whether online lending platforms should be able to escape otherwise applicable state usury laws by "partnering" with chartered depository institutions to originate high-interest loans. Experts also question the (mis)alignment of incentives between parties at each stage of the lending process, particularly given that the online lender performs a traditionally bank-like role in the transaction but typically bears no economic interest in the loans it originates. In response, this Note argues that a recent settlement between Colorado authorities and two online lenders offers a uniquely practicable template for resolving these interrelated challenges by applying pressure to the incentive mechanisms that lead online lenders to originate high-risk—and therefore high-interest—loans that state usury laws would ordinarily prohibit.

† J.D. Candidate, Cornell Law School, 2024. M.S. in Finance, University of South Florida, 2021. Senior Articles Editor, Cornell Law Review Vol. 109. The author would like to thank Professor Saule Omarova for her comments, suggestions, and extraordinary mentorship. The author would also like to thank the editors of Cornell Law Review for their thoughtful editing and diligence in preparing this Note for publication.

Introduction

At the height of the global financial crisis, commercial banks faced a severe, unprecedented liquidity shortage.[1] Measures of system-wide financial stress spiked to record levels,[2] while the costs of corporate and bank borrowing climbed dramatically.[3] By 2009, an estimated $4.1 trillion had evaporated from balance sheets across the global banking system.[4] In response, lawmakers compelled financial institutions to

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1 Ari Aisen & Michael Franken, *Bank Credit During the 2008 Financial Crisis: A Cross-country Comparison* 3 (Int'l Monetary Fund, Working Paper No. 10/47, 2010), https://www.imf.org/external/pubs/ft/wp/2010/wp1047.pdf [https://perma.cc/4CDT-YN99] ("[T]he crisis was unprecedented in its global scale and severity, hindering credit access to businesses, households and banks, and choking economic activity. Banks, in particular, faced unparalleled liquidity stress hurting their ability to lend.").

2 *See id.* ("Libor-OIS spreads, a conventional measure of liquidity stress and confidence between banks, hit an all-time high of 366 basis points . . . in October 2008, soon after Lehman Brothers bankruptcy on September 15, 2008. Libor-OIS spreads in other currencies showed similar interbank market strains.").

3 Victoria Ivashina & David Scharfstein, *Bank Lending During the Financial Crisis of 2008*, 97 J. Fin. Econ. 319, 320 (2010) ("[T]he prices of most asset classes and commodities fell drastically, the cost of corporate and bank borrowing rose substantially, and financial market volatility rose to levels that have rarely, if ever, been seen.").

4 Mark Landler, *I.M.F. Puts Bank Losses from Global Financial Crisis at $4.1 Trillion*, N.Y. Times (Apr. 21, 2009), https://www.nytimes.com/2009/04/22/business/global/22fund.html [https://perma.cc/FK8X-N92V].

reduce their balance sheets, hold more capital, and tighten their lending standards.[5]

Starved of credit by a market that had once embraced them, subprime borrowers faced widespread credit scarcity in the wake of the financial crisis.[6] Obtaining bank loans became difficult or prohibitively expensive for millions of consumers, changing how they prioritized and repaid their debts.[7] Meanwhile, public trust in financial institutions cratered, reflecting hesitancy among prospective borrowers to place themselves in a vulnerable position vis-à-vis institutions they believed to be incapable, opportunistic, or untrustworthy.[8]

These conditions spurred demand for disintermediated, nonbank sources of credit, particularly among consumers seeking to refinance their existing debts.[9] Thus emerged Lending Club, one of the first nonbank lending platforms to operate by connecting prospective borrowers with investors entirely via

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5 Christopher Jan, *The Evolution of the Online Marketplace, and its Viability as an Institutional Asset Class* 6–7 (Harv. Kennedy Sch., Working Paper No. 94, 2018), https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/files/94_awp_final.pdf [https://perma.cc/Z4CS-3QES]; *see also* Dwight Smith, *The Impact of Dodd-Frank and Capital Requirements on Commercial Lending*, LexisNexis: Prac. Guidance J. (Aug. 4, 2016), https://www.lexisnexis.com/community/insights/legal/practical-guidance-journal/b/pa/posts/the-impact-of-dodd-frank-and-capital-requirements-on-commercial-lending [https://perma.cc/VY6X-HTZG].

6 *See* John V. Duca, *Subprime Mortgage Crisis*, Fed. Rsrv. Hist. (Nov. 22, 2013), https://www.federalreservehistory.org/essays/subprime-mortgage-crisis [https://perma.cc/A55C-RYJT]. Even prime borrowers and larger enterprises saw the credit supply dwindle as banks began rationing credit. *See, e.g.*, 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 xvi–xvii (2011), https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [https://perma.cc/JY47-6V3P]; Jan, *supra* note 5, at 6–7.

7 *Financial Crisis – 10 Years Later: Consumer Credit Market on an Upward Curve*, TransUnion (Aug. 22, 2018), https://newsroom.transunion.com/financial-crisis—10-years-later-consumer-credit-market-on-an-upward-curve/#:~:text=Ten%20years%20after%20the%20biggest,of%20consumers%20has%20broadly%20improved. [https://perma.cc/CN8Q-WA8S].

8 Ed Saiedi, Ali Mohammadi, Anders Broström & Kourosh Shafi, *Distrust in Banks and Fintech Participation: The Case of Peer-to-Peer Lending*, 46 Entrepreneurship Theory & Prac. 1170, 1172-73 (2022) ("Distrust in banks represents consumers' reluctance to put themselves in a vulnerable position with respect to banks because they perceive banks to be incapable, exhibit opportunistic behavior, violate or breach obligations, act against consumers' interests, or even intentionally take advantage of consumers.").

9 *See* Josh Beckerman, *Nonbank Lender OnDeck Capital Files for IPO*, Wall St. J. (Nov. 10, 2014), https://www.wsj.com/articles/nonbank-lender-ondeck-capital-files-for-ipo-1415655224 [https://perma.cc/EB6F-VQSF] ("Online nonbank lenders have seen their share of business and personal loans rise as big banks have scaled back lending due in part to regulatory pressure. Some borrowers unable to get traditional bank loans have turned to online lenders.").

the Internet.[10] "There was no better time for the company to emerge than when the banks were essentially frozen for a couple of years," said Rebecca Lynn, an investor in the company's Series B round, which closed just months after the height of the financial crisis.[11] Observers heralded Lending Club as a fintech pioneer, extolling the potential for online platforms to take on the risky lending that commercial banks increasingly sought to avoid.[12]

The industry's rapid growth and billion-dollar valuations spawned myriad competitors.[13] By March 2019, nearly half of all unsecured personal loans in the United States were originated through online lenders.[14] In lieu of traditional credit evaluations, these lenders claim to use "alternative" data and sophisticated computer algorithms to detect creditworthy borrowers, including some who might otherwise slip through the

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10 Aarti Shahani, *With Lending Club Disgraced, An Industry Looks For Lessons*, NPR (June 10, 2016), https://www.npr.org/sections/alltechconsidered/2016/06/10/481474919/with-lending-club-disgraced-an-industry-looks-for-lessons [https://perma.cc/2AEB-MH29].

11 Maria Armental & Lizette Chapman, *Lending Club Files for IPO; Startup Emerged During Credit Crisis*, WALL ST. J. (Aug. 27, 2014), https://www.wsj.com/articles/BL-VCDB-15348 [https://perma.cc/L7AA-JSTC].

12 *See* Neha Dimri, *Loan Platform Operator LendingClub's Shares Soar in Debut*, REUTERS (Dec. 11, 2014), https://www.reuters.com/article/us-lendingclub-ipo/loan-platform-operator-lendingclubs-shares-soar-in-debut-idUSKBN0JP1U420141211 [https://perma.cc/BD47-L7HU].

13 *See* Armental & Chapman, *supra* note 11.

14 *Experian Study Finds Fintechs More than Doubled Personal Loan Marketshare in Four Years*, EXPERIAN (Sept. 24, 2019), https://www.experianplc.com/media/latest-news/2019/fintechs-more-than-doubled-personal-loan-market-share-in-four-years/ [https://perma.cc/ZEL7-DWWX]. In 2021, SoFi Technologies, another online lender that has since diversified into full service online banking, even acquired the naming rights to SoFi Stadium in Los Angeles for $625 million. In doing so, SoFi joined the ranks of blue-chip American companies like Ford Motor Company, Bank of America, and AT&T and placed its name on the most expensive NFL stadium ever built. *See* David Broughton, *SoFi Stadium Naming-rights Deal to Total $625M by End of Contract*, SPORTS BUS. J. (June 11, 2021), https://www.sportsbusinessjournal.com/Daily/Issues/2021/06/11/Facilities/SoFi.aspx [https://perma.cc/DBT6-BFGY]; Tom Joyce, *Super Bowl Location Shows Why Stadiums Don't Need Taxpayer Money*, WASH. EXAM'R (Feb. 13, 2022), https://www.washingtonexaminer.com/opinion/super-bowl-location-shows-why-stadiums-dont-need-taxpayer-money [https://perma.cc/AMA4-MFPD] (describing SoFi Stadium as "the most expensive stadium in NFL history"); Bill Shea, *From Paycor to Acrisure to Lambeau, Here's How Each NFL Stadium Got Its Name*, ATHLETIC (Aug. 12, 2022), https://theathletic.com/3498266/2022/08/12/nfl-stadium-names-paycor-acrisure/ [https://perma.cc/42D5-XPYX] (describing the sponsorship histories of Ford Field, Bank of America Stadium, and AT&T Stadium).

cracks of traditional credit evaluations.[15] Yet online borrowers tend to have far lower observable credit quality and higher default rates compared to traditional bank borrowers, implying that the purported benefits of these tactics are dubious if not illusory.[16]

Far from using technology to uncover hidden indicators of creditworthiness that traditional models might fail to detect, empirical research strongly suggests that online lenders primarily target borrowers with the fewest options from which to choose.[17] For instance, one study analyzing loan data from one of the largest online lenders found that online borrowers had six more debt-related accounts and credit scores nineteen points lower than statistically similar bank borrowers.[18] Online borrowers reportedly also have twice as many credit cards as the average bank borrower, and the balances and utilization ratios on those cards are twice as high, evidencing lower observable credit quality and greater reliance on debt compared to their bank counterparts.[19]

Consistent with this behavior, online lending rates spiked dramatically during the COVID-19 pandemic, with household debt reaching an all-time high "in part due to a rise in online fintech borrowing."[20] Over half of Americans "lack[ed] the savings

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[15] Christopher K. Odinet, *Predatory Fintech and the Politics of Banking*, 106 Iowa L. Rev. 1739, 1756–57 (2021).

[16] *See* Sudheer Chava, Rohan Ganduri, Nikhil Paradkar & Yafei Zhang, *Impact of Marketplace Lending on Consumers' Future Borrowing Capacities and Borrowing Outcomes*, 142 J. Fin. Econ. 1186, 1187–88 (2021).

[17] Deborah Goldstein, Joint Ctr. for Hous. Stud. of Harvard Univ. & Neighborhood Reinvestment Corp., Understanding Predatory Lending: Moving Towards a Common Definition and Workable Solutions (1999), https://www.jchs.harvard.edu/sites/default/files/goldstein_w99-11.pdf [https://perma.cc/RKJ8-7ZPJ].

[18] Chava, Ganduri, Paradkar & Zhang, *supra* note 16, at 1191.

[19] *Id.* One possible explanation for the higher default rates among online borrowers is that many of these loans are disproportionately taken for credit card repayment or debt consolidation, suggesting adverse selection. Tetyana Balyuk & Sergei Davydenko, *Reintermediation in FinTech: Evidence from Online Lending* 5–6 (Michael J. Brennan Irish Fin. Working Paper Series, Working Paper No. 18-17, 2018), https://www.fdic.gov/analysis/cfr/bank-research-conference/annual-18th/22-balyuk.pdf [https://perma.cc/XMQ2-T6FV]. However, other empirical research has found that online borrowers' show significantly higher total indebtedness *after* obtaining a loan, suggesting that many of these borrowers might initially use the proceeds to repay existing debts but subsequently use their replenished lines of credit to support additional expenditures. *See* Marco Di Maggio & Vincent Yao, *Fintech Borrowers: Lax-screening or Cream-skimming?* 6 (Nat'l Bureau of Econ. Rsch., Working Paper No. 28021, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3723258 [https://perma.cc/WPY9-3CB8].

[20] Sabrina Minhas, *Stopping Predatory Fintech Lending*, Reg. Rev. (Jan. 14, 2021), https://www.theregreview.org/2021/01/14/minhas-stopping-predatory-fintech-lending/ [https://perma.cc/K6DU-NZZ9].

to cover their expenses, and these hand-to-mouth households [were] devastated as the unemployment rate reached an unprecedented high."[21] Online lending platforms reportedly "targeted" these low-income households during the pandemic, strategically charging higher interest rates to economically vulnerable borrowers.[22]

By targeting borrowers with few or no alternative sources of credit, online lenders are free to demand interest rates far beyond ordinary risk-based pricing, with many routinely charging annualized rates as high as 225 percent.[23] Yet numerous acts of state and federal policies are explicitly grounded in the presumption that annualized rates above 36 percent are not calculated to give borrowers a fair or realistic chance at repayment.[24] Indeed, online lending has become infamous for generating pernicious "debt spirals" in which borrowers "becom[e] increasingly indebted over time as greater proportions of their income are channeled towards repayment of the

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21 *Id.* Although Congress issued stimulus payments during the pandemic, these relief funds "sustained one-third of households for only less than a month." *Id.*

22 *Id.*

23 *See* Letter from Accountable.US et al., to Martin Gruenberg, Acting Chairman, Fed. Deposit Ins. Corp., Rohit Chopra, Director, Consumer Fin. Prot. Bureau, & Michael Hsu, Acting Comptroller, Off. of the Comptroller of the Currency 1, 3 (Feb. 4, 2022), https://www.nclc.org/wp-content/uploads/2022/10/FDIC-rent-a-bank-letter-2.4.22.pdf [https://perma.cc/BV84-9N7D] (listing numerous online lenders and the interest rates they charge on various credit products).

24 *See, e.g.*, Military Lending Act, 10 U.S.C. § 987 (prohibiting consumer loans to military servicemembers above 36 percent APR); Illinois Predatory Loan Prevention Act, 815 Ill. Comp. Stat. 123/15-5-5 (2022) (prohibiting loans above 36 percent to Illinois consumers). In a hearing before the Senate Banking Committee on predatory lending to military servicemembers that precipitated bipartisan support for the Military Lending Act, which capped loans to military servicemembers at 36 percent APR, Under Secretary of Defense for Personnel and Readiness David Chu commented that loans above 36 percent APR "do not consider service members' ability to repay their debt." *A Review of the Department of Defense's Report on Predatory Lending Practices Directed at Members of the Armed Forces and Their Dependents: Hearing Before the Committee on Banking, Housing, and Urban Affairs*, 109th Cong. 10 (2005) (statement of Under Secretary Chu); Paul E. Kantwill & Christopher L. Peterson, *American Usury Law and the Military Lending Act*, 31 Loy. Consumer L. Rev. 498, 509–11 (2019) (describing the legislative history of the Military Lending Act and policy justifications offered for a 36 percent interest rate limit on loans to military servicemembers). Similarly, Illinois lawmakers explicitly characterized the Predatory Loan Prevention Act as an effort to address a "growing understanding among Illinoisans that these financial systems target people of color and entrench racial poverty" and to "stop[] predatory, high-cost lending practices, which have widened the racial wealth gap and disproportionately targeted communities of color with payday and car title lending." Press Release, State of Illinois, Gov. Pritzker Signs Equity-centric Legislation Expanding Economic Access and Opportunity Across Illinois (Mar. 23, 2021), https://www.illinois.gov/news/press-release.22987.html [https://perma.cc/AB68-VRZN].

loans and their associated fees," leaving many with "severely diminished capacities to channel credit to improve their standards of living."[25]

Nonetheless, some observers maintain that these firms have revolutionized lending, furnishing wider access to affordable credit by using "sophisticated machine learning algorithms and alternative data to reshape credit scoring and open the market to those who have long been shut out of mainstream finance."[26] Others cast them as tricksters who exploit the reach of the Internet by systematically baiting consumers into unaffordable repayment terms with promises of instant cash.[27] This Note posits that these views are not mutually exclusive and, counterintuitively, may both be accurate under the prevailing model of online lending.

Part I of this Note describes the online lending business model and explores a misalignment of incentives between parties to the loan origination process. This misalignment, familiar from the subprime mortgage crisis, stems from the fact that the online platform evaluates applications, chooses which loans to originate, and performs other traditionally bank-like functions but typically bears no economic interest in the loans it originates.

Part II outlines several interrelated legal concerns with online lending. Most prominently, it observes that lawmakers, regulators, and courts are sharply divided as to whether online lenders should be entitled to the interest rate exportation rights of the chartered financial institutions with which they partner to originate loans, particularly when those rights permit the online lender to evade otherwise applicable state usury laws. It also notes the difficulty of configuring a solution that properly resolves the platform's risk-taking incentives without simultaneously implicating traditional, systemically important loan trades between banks and nonbanks in secondary markets.

Finally, Part III argues that a recent settlement between Colorado authorities and two online lenders provides a uniquely practicable template for online lending reform by applying pressure to the incentive mechanisms that motivate online lenders to originate high-risk—and therefore high-interest—loans that state usury laws would ordinarily prohibit. Implemented at the

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25 Vivien Chen, *Online Payday Lenders: Trusted Friends or Debt Traps?*, 43 U. New S. Wales L.J. 674, 678 (2020).

26 *See* Odinet, *supra* note 15, at 1741.

27 *Id.* at 1745, 1756–57.

federal level, the solution advanced in this Note would protect consumers, reconcile existing tensions in online lending regulation, and provide industry participants with a much-needed framework for determining the legality of their loans.

I
The Online "Lending" Model

A. The Anatomy of an Online Lending Transaction

Unlike commercial banks, online "lenders"[28] do not take deposits, perform liquidity transformation, or monitor loans post-origination.[29] Under the online lending model, prospective borrowers submit applications directly to the online lending platform, which screens the applicant pool, conducts credit evaluations, underwrites accepted applications, and prices the loans internally.[30] Once it has selected a pool of approved loans, the platform then partners with a chartered bank who originates the loans under its charter and sells them to the platform, typically through a committed forward flow agreement.[31]

After it purchases the loans from the partner bank, the platform completes the process by selling the loans to third party investors in the secondary market.[32] Most of these end purchasers are institutional investors, including depository institutions, private equity firms, and hedge funds.[33] The partner bank generates revenue by charging a service fee to the platform, while the online lending platform generates revenue

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28 Although these firms are often referred to as *lenders*, they are more aptly understood as lending *platforms* (and are referred to as such in this Note) in that their profits primarily derive from fees for facilitating transactions and not from the spread between the cost of capital and the net interest paid by borrowers. *See* Itzhak Ben-David, Mark J. Johnson & René M. Stulz, *Why Did Small Business Fintech Lending Dry Up During the COVID-19 Crisis?* 9 (Nat'l Bureau of Econ. Rsch., Working Paper No. No. 29205, 2022), https://www.nber.org/papers/w29205 [https://perma.cc/C7LW-U2KA].

29 Balyuk & Davydenko, *supra* note 19, at 4.

30 *Id.* at 2 ("[T]he lending platform not only carries out essentially all of the traditional banks' functions related to consumer loan evaluation, pricing, and servicing, but also performs almost all of the loan screening.").

31 By design, the online platform almost always purchases all or most of the loans after origination. *FinReg Round-up Vol. 1, No. 7*, Loeb & Loeb LLP (Sept. 2020), https://www.loeb.com/en/insights/publications/2020/09/finreg-round-up-vol-1-no-7 [https://perma.cc/KY4P-D9LU].

32 Deloitte, Marketplace Lending – A Temporary Phenomenon? 5 (2016), https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-fs-marketplace-lending.pdf [https://perma.cc/39LU-PK6V].

33 *Id.*

from transaction fees charged to the partner institution for matching it with prospective borrowers and from service fees charged to third party investors.[34] Once investors have purchased the loans, the platform retains no economic interest in their performance.[35]

Because the platform's primary source of revenue—transaction fees—corresponds to origination volume rather than loan performance, the online lending model creates a powerful incentive for the platform to maximize its origination volume.[36] Specifically, because the platform does not retain the loans on its own balance sheet, the originate-to-distribute model creates an opportunity for the platform to increase revenue with little to no additional risk simply by orchestrating additional transactions from which to collect fees.[37] And although incentives do not always translate to corresponding modes of behavior, empirical evidence suggests that online lending platforms do in fact behave strategically to maximize origination volume, particularly when investor demand exceeds the platform's supply of observably creditworthy borrowers.[38]

Tellingly, one study of loan data from online lending platforms found that when demand from institutional investors is low and therefore the marginal value of additional origination volume is high, platforms preferentially allocate loans with lower default rates to institutional investors, suggesting strategic behavior to stimulate additional capital commitments and maximize origination volume.[39] Likewise, periods of high institutional demand coincide with lower rejection rates in the screening process and higher aggregate default rates among borrowers, and the platform's preferential allocation to

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34 U.S. DEP'T. TREASURY, OPPORTUNITIES AND CHALLENGES IN ONLINE MARKETPLACE LENDING 8 (2016) [hereinafter TREASURY WHITE PAPER], https://home.treasury.gov/system/files/231/Opportunities_and_Challenges_in_Online_Marketplace_Lending_white_paper.pdf [https://perma.cc/YK3D-6A4P].

35 *Id.* at 6 (observing that under this model, "platform lenders do not retain credit risk if the borrowers do not pay").

36 *See* Li Ting Chiu, Brian Wolfe & Woongsun Yoo, *Do FinTech Lenders Fairly Allocate Loans Among Investors?* Quid Pro Quo *and Regulatory Scrutiny in Marketplace Lending* 2–3 (Conf. on Fin. Innovation at Stevens Inst. of Tech., 2021), https://www.jbs.cam.ac.uk/wp-content/uploads/2021/06/ccaf-2021-06-conference-paper-chiu-wolfe-yoo.pdf [https://perma.cc/ZM35-LUFX] (noting that platform lending firms operating under a fee-based, originate-to-distribute model "seek to maximize profit by increasing origination volume").

37 *Id.*

38 *See id.*

39 *Id.* at 3.

institutional investors diminishes.[40] Together, these findings suggest that as institutional demand increases and platforms become constrained in their ability to produce similar quality borrowers, they strategically relax their lending standards in an effort to match supply with demand and thereby maximize revenue from transaction fees.[41]

B. Familiar Faces of the Originate-to-Distribute Model

That online lending platforms are incentivized to continue originating loans even after their supply of creditworthy borrowers becomes constrained closely echoes the proliferation of originate-to-distribute arrangements that precipitated the subprime mortgage crisis.[42] Prior to the crisis, many lenders began originating mortgages squarely to collect origination fees with the expectation that they would be able to avoid holding the debt on their own balance sheets by securitizing it for sale in the collateralized debt market.[43] As a result, their profits "were driven by volume, regardless of the likelihood of default. Turning down a borrower meant getting no revenue. Approving a borrower meant earning a fee."[44]

In its infancy, the online lending model focused on directly connecting individual borrowers with retail investors.[45] However, the peer-to-peer structure largely disappeared when platforms began securitizing portfolios of their loans to attract institutional investors.[46] During this period, some of the larger

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40 *Id.*

41 *See id.*

42 *See, e.g.*, Saiedi, Mohammadi, Broström & Shafi, *supra* note 8, at 1173 ("[A]n important factor that precipitated the financial crisis was financial institutions' moral hazard in loan securitization, as they had limited skin in the game."); Cem Demiroglu & Christopher M. James, *Works of Friction? Originator-Sponsor Affiliation and Losses on Mortgage-Backed Securities* 3 (AFA 2012 Chicago Meetings Paper, 2011), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1787813 [https://perma.cc/35D9-E5WX] (finding that "originators' screening incentives for these loans is likely to depend largely on whether they retained any skin in the game when the loans are securitized"); *id.* at 8 (finding that "even a little skin in the game" like that proposed under Dodd-Frank "is significantly related to loan performance").

43 Arnold Kling, *The 2008 Financial Crisis*, Econlib, https://www.econlib.org/cee/2008FinancialCrisis/ [https://perma.cc/D2M9-5EJY] (last visited Dec. 10, 2022).

44 *Id.*

45 Treasury White Paper, *supra* note 34, at 5.

46 *Id.* (describing the business model as evolving such that "the market as a whole is no longer accurately described as a 'peer-to-peer' market"). *See also* Balyuk & Davydenko, *supra* note 19, at 2 ("Today, the P2P lending market in the

online lending platforms even formed internal hedge funds and registered affiliate entities as investment advisors to participate in securitizations.[47]

One might presume that yield-seeking institutional investors, who today constitute the bulk of online lending investors,[48] would check the platform's incentive to maximize origination volume by screening out loans of dubious value.[49] But to the contrary, these investors passively fund nearly all loans on offer without attempting to monitor or evaluate individual loans, instead outsourcing those decisions to the platform.[50] By design, loan securitization enables investors to invest in platform-originated loans without the costs of screening individual loans, tacitly countenancing the possibly lower marginal returns vis-à-vis an actively selected portfolio in exchange for shifting those costs to the originator.[51] Illustrating the prevalence of passive investing in this market, one study even found that online lending investors agreed to fund 98 percent of loans on offer to them "even though the platform's software subsequently screens out and cancels 30 [percent] of them as too risky or possibly fraudulent."[52]

Echoing the subprime mortgage crisis, the widespread securitization of online loans isolates the platform's individual lending decisions from the investors who ultimately absorb

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U.S. is by and large neither *peer-to-peer*, nor a lending *market* in which creditors decide who to lend to.").

47 Treasury White Paper, *supra* note 34, at 9.

48 Deloitte, *supra* note 32, at 5.

49 *See* Chiu, Wolfe & Yoo, *supra* note 36, at 5 ("If institutional investors are conscious of the quality decline implied in our *quid pro quo* channel, why continue to invest on the platform? Alternatively, why would the platform pursue such a strategy given the risk that institutional investors may leave as a result?"). "While it is possible some or all institutional investors may be unaware of the quality shift, we believe it is more plausible that they willingly accept the quality/quantity tradeoff from the platform." *Id.*

50 Balyuk & Davydenko, *supra* note 19, at 2. Balyuk and Davydenko also note that most of these loans "are funded within seconds" by algorithms. *Id.*

51 *See* Chiu, Wolfe & Yoo, *supra* note 36, at 5.

52 Balyuk & Davydenko, *supra* note 19, at 2. "After the loan attracts funding or sufficient time has passed, Prosper initiates a pre-funding review, which can result in loan cancellation by the platform if . . . Prosper's screening algorithms determine the loan to be too risky or possibly fraudulent." *Id.* at 7. According to the authors, "[t]he intermediary's moral hazard problem may be particularly acute in [peer-to-peer] lending. . . . Given investors' reliance on the platform for loan evaluation, a platform may be tempted to relax its lending standards in order to inflate loan origination volume and thus its fees." *Id.* at 4.

the loan pool's aggregate credit risk.[53] As a result, market discipline pressures the platform only to the extent that if total portfolio performance fell low enough that investors could not expect to benefit ex-ante from market participation, or if their investments did not persistently outperform other assets ex-post on a risk-adjusted basis, investors would withdraw from the market.[54] So long as total loan performance does not fall below investors' break-even constraint, the platform can continue introducing high-risk loans into the pool without investors detecting a drop in total performance large enough (and persistent enough) to balk.[55]

II
Legal Challenges and Concerns

A. "Rent-a-Bank" Schemes: An Ethos of Evasion

The tactic of "renting" the partner bank's charter for the purpose of originating loans has drawn persistent scrutiny from lawmakers, regulators, and courts as to whether these platforms should benefit from the privileges ostensibly reserved to banks under those charters, including federal preemption of otherwise applicable state usury laws.[56] Most states limit by statute the maximum permissible interest rate on consumer loans, and by default, consumer loans originated through the Internet must comply with the usury laws of the borrower's state of residence.[57] But unsurprisingly, lenders often wish to charge borrowers higher interest rates than the applicable

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53 *See* Kling, *supra* note 43 ("There was moral hazard in the sub-prime mortgage sector because the lenders were not holding on to the loans and, therefore, not exposing themselves to default risk."). *See also* Balyuk & Davydenko, *supra* note 19, at 29 (noting that because default rates are only observed as loans age, the quality of securitized loans is revealed to investors with a substantial lag, "which makes it difficult for investors to detect any deterioration in loan underwriting standards in a timely manner").

54 *See* Balyuk & Davydenko, *supra* note 19, at 29.

55 *But see id.* at 29 n.26 ("[T]he platform may have incentives to increase the proportion of bad loans in the mix *beyond* investors' break-even constraint, if by doing so it can boost volume sufficiently to outweigh future losses from potential investor retaliation.").

56 Marc Franson, Chapman & Culter LLP, The Regulation of Marketplace Lending: A Summary of the Principal Issues 79 (2022), https://www.chapman.com/media/publication/15044_Regulation-of-Marketplace-Lending-2022.pdf [https://perma.cc/R3VY-4GE8].

57 *Id.* at 67.

state's usury laws would permit.[58] And since one of the stated goals of online lending is to provide access to credit for riskier borrowers who are unable to obtain traditional bank loans, "[i]n order to make loans to these individuals, the lender will need to set interest rates high enough to offset expected losses."[59]

Usury laws operate against this behavior by limiting the level of credit risk that the platform can accept across the lending program, as the platform can raise interest rates only so long as no individual borrower's interest rate exceeds the interest rate cap.[60] But conveniently for online lending platforms, under the doctrine of federal preemption, banks whose deposits are insured by the Federal Deposit Insurance Corporation ("FDIC") are permitted to lend at any interest rate allowed under the laws of the bank's home state to borrowers located in other states, preempting any stricter usury laws in

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58 *Id.*

59 *Id.* at 67–68. *See also* Lisa Chen & Gregory Elliehausen, *The Cost Structure of Consumer Finance Companies and Its Implications for Interest Rates: Evidence from the Federal Reserve Board's 2015 Survey of Finance Companies*, FED. RSRV. (Aug. 12, 2020), https://www.federalreserve.gov/econres/notes/feds-notes/the-cost-structure-of-consumer-finance-companies-and-its-implications-for-interest-rates-20200812.html [https://perma.cc/KN2K-B93B] (finding that break-even interest rates are higher on average for smaller loans than for larger loans because fixed costs relative to the loan amount are higher). "This consideration looms especially important in consumer lending, where loan amounts often are quite small." *Id.*

60 To illustrate, suppose that a platform has secured $1,500,000.00 in commitments from its funding partners and has approved $1,000,000.00 of loan volume by exhausting its supply of observably creditworthy borrowers. The platform, through its own internal policies, has assigned interest rates at an average of 10 percent per annum across these loans. The platform estimates that losses on these loans from nonperformance will equal 0.5 percent of the total principal volume; thus, the expected return to investors, excluding fees for simplicity, is 9.5 percent.

Because the platform primarily earns revenue from charging fees in each transaction, it has an incentive to match investor demand by originating another $500,000.00 in loan volume. The platform has received an additional $500,000.00 in applications, but it has determined that these applicants are riskier; if approved, the platform expects that losses from nonperformance will equal 10 percent of the total principal volume. Aiming to maximize its revenue from transaction fees, the platform approves the applications and assigns interest rates at an average of 19.5 percent across these loans, thereby maintaining an average expected return for investors of 9.5 percent across the aggregate loan pool. However, if applicable usury laws set a limit on interest rates lower than 19.5 percent, the platform cannot charge rates high enough to lend to some of its higher-risk applicants. The observably creditworthy borrowers will still receive credit, but many of the highest-risk borrowers will be selected out of the pool because their inclusion under the interest rate cap would reduce expected returns across the pool below investors' break-even constraint, leading investors to withdraw from the market.

the borrower's state.[61] Originally intended to foster the development of a national banking system, the online lending industry asserts that the interest rate exportation power allows platforms to export interest rates legal in the partner bank's state to borrowers in states with stricter usury laws under the pretense that the partner bank is the true lender in the transaction.[62] Predictably, platforms thus tend to partner with banks whose loans are governed by relatively permissive usury laws, allowing them to "make extremely high-cost, predatory loans on a nationwide basis to borrowers in states where such loans would otherwise be illegal."[63]

Recent courts and regulators have struggled with the question of when, if ever, nonbank firms operating under a "rent-a-bank" arrangement should be allowed to benefit from the partner bank's interest rate exportation power.[64] Industry groups contend that platforms should be allowed to benefit because a bank's power to sell loans includes the power to assign the loan under its original terms.[65] These groups often invoke the general standard for evaluating federal preemption under the National Banking Act—the "*Barnett Bank* test," which holds that federal law preempts state laws which "significantly

61 *See* Jay B. Sykes, Cong. Rsch. Serv., RL45726, Federal Preemption in the Dual Banking System: An Overview and Issues for the 116th Congress (2019), https://crsreports.congress.gov/product/pdf/R/R45726 [https://perma.cc/KS25-6HXP] (describing the development and expansion of the interest rate exportation power). Under 12 U.S.C. § 85, "[a]ny association may take, receive, reserve, and charge on any loan or discount made, or upon any notes, bills of exchange, or other evidences of debt, interest at the rate allowed by the laws of the State, Territory, or District where the bank is located." 12 U.S.C. § 85. In Marquette National Bank v. First of Omaha Service Corp., 439 U.S. 299 (1978), the Supreme Court unanimously held that 12 U.S.C. § 85 allows a nationally chartered bank to charge any interest rate permitted under the laws of the state designated on its charter even when lending to residents of another state. Congress subsequently extended this power to FDIC-insured state banks. 12 U.S.C. § 1821d(a).

62 John Hannon, *The True Lender Doctrine: Function Over Form as a Reasonable Constraint on the Exportation of Interest Rates*, 67 Duke L.J. 1261, 1262 (2018).

63 Odinet, *supra* note 15, at 1784. For example, under Utah law, "[t]he parties to a lawful written, verbal, or implied contract may agree upon any rate of interest for the contract, including a contract for services, a loan or forbearance of any money, goods, or services, or a claim for breach of contract." Utah Code Ann.15-1-1(1) (West 2019).

64 Sykes, *supra* note 61, at 19.

65 *See* Motion for Leave to File Brief of the Structured Finance Industry Group, Inc., and the Securities Industry and Financial Markets Association as *Amici Curiae* in Support of Defendants-Appellees' Petition for Rehearing and Suggestion for Rehearing *En Banc* at 6–7, Madden v. Midland Funding LLC, 786 F.3d 246 (2d. Cir. 2015) (No. 14-2131-CV) [hereinafter SIFMA Motion].

interfere with [a] national bank's exercise of its powers."[66] Applying the *Barnett Bank* test, industry groups argue that the usury laws governing a bank loan at the time of origination travel with the loan because a contrary rule would significantly interfere with banks' power to manage risk and liquidity by selling loans in secondary markets.[67]

In response, opponents contend that interest rate exportation should not follow the loan once sold because banks are permitted to assign only rights they possess under contract, whereas the exportation power is an extraneous right they possess by operation of their charters.[68] They also contend that denying federal preemption benefits to nonbanks would only marginally affect the marketability of loans in secondary markets, which would not rise to the level of "significant interference" under *Barnett Bank*.[69]

Some regulatory officials have sought to resolve these debates by directly expanding jurisdictional perimeter of individual agencies.[70] In December 2016, the Office of the Comptroller of the Currency ("OCC") proposed a framework for issuing special-purpose national bank charters to non-depository fintech companies, offering online lending platforms clear, uniform regulatory guidance and guaranteed federal preemption of state usury laws in exchange for subjecting them to bank-like prudential regulation and supervisory requirements.[71] The so-called "fintech charter" would enable platforms to establish uniform lending programs nationwide without the need for a partner bank, but it has drawn controversy and litigation since

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66 *Id.* at 11; Barnett Bank of Marion Cnty., N.A. v. Nelson, 517 U.S. 25, 33 (1996). "The ability of national banks to manage their balance sheets, and to reduce the credit and interest rate risks of loan ownership, would be substantially impaired. Without a robust securitization market, national banks will originate fewer loans, be less profitable and be prevented from fully carrying out their purpose." SIFMA Motion, *supra* note 65, at 11.

67 *Id.* "The ability of investors to collect the interest rate for which loan originators lawfully contract is a cornerstone on which the secondary loan market is built." *Id.* at 2. "Securitizations and other secondary market transactions are founded on the ability of national banks' assignees to charge interest at the rates allowed for national banks. Subjecting national bank loans to a separate state usury analysis after they are transferred would disrupt securitizations to the substantial detriment of national bank operations." *Id.* at 11.

68 Sykes, *supra* note 61, at 2.

69 *Id.*

70 For a discussion of this particular regulatory strategy, see Saule T. Omarova, *Dealing with Disruption: Emerging Approaches to Fintech Regulation*, 61 Wash. U. J.L. & Pol'y 25, 41–48 (2020).

71 Franson, *supra* note 56, at 35–36.

its inception for purportedly exceeding the OCC's statutory authority.[72]

In addition to guaranteed preemption of state usury laws, a national bank charter offers several benefits for online lenders, including "exemption from state licensing requirements, operationally being able to maintain a uniform national program, and autonomy and control by the marketplace lender."[73] However, "[a]ll but the largest marketplace lenders may find certain of the requirements, such as the capital and compliance risk management requirements, sufficiently burdensome to outweigh the benefits of obtaining a national bank charter."[74] Because obtaining a national bank charter is an expensive, complex, and lengthy process,[75] nearly all online lending platforms have declined to pursue a fintech charter, particularly insofar as the OCC's statutory authority to issue such a charter remains in doubt.[76]

B. The "Valid When Made" and "True Lender" Doctrines

Despite compelling arguments on both sides of the exportation debate, the normative question whether a nonbank lender *should* be allowed to benefit from a partner bank's exportation power is complicated by the fact that much of the broader financial system critically depends on the efficiency of secondary loan markets. Illustrative is the Second Circuit's ruling in *Madden v. Midland Funding, LLC*.[77] In *Madden*, the court held that a nonbank purchaser of debt from a national bank could not benefit from the bank's federal preemption power.[78] Applying the *Barnett Bank* test, the court reasoned that preemption of state usury laws does not apply to a nonbank purchaser unless applying the state law would significantly interfere with the bank's exercise of its banking powers.[79] Finding that applying state law to the plaintiff's debt would not constitute substantial interference, the court concluded that the usury laws

72 *Id.* at 35–37.

73 *Id.* at 36.

74 *Id.* at 37.

75 *Id.* at 36.

76 *See* Rachel Witkowski, *Google and PayPal Explored OCC's Fintech Charter, Then Walked Away*, AM. BANKER (June 16, 2019), https://www.americanbanker.com/news/google-and-paypal-explored-occs-fintech-charter-then-walked-away [https://perma.cc/S382-QLAP].

77 786 F.3d 246 (2d Cir. 2015).

78 *Id.* at 251–53.

79 *Id.*

of the borrower's state governed the debt even after the originator had sold it to a nonbank purchaser.[80]

Industry groups argued that the Second Circuit erred in failing to consider whether the rule for which the plaintiff advocated would significantly interfere with national banks' power to sell loans by subjecting those loans to a second usury analysis upon transfer.[81] But even so, the court's decision almost immediately destabilized secondary loan markets in the Second Circuit states of New York, Connecticut, and Vermont.[82] Indeed, in the wake of *Madden*, prices of notes backed by above-usury loans to borrowers in Connecticut and New York sharply declined, the consumer credit supply contracted, and lending to low-income households fell by 64 percent as higher-risk borrowers were rationed out of lending markets.[83]

The market's reaction sparked a concerted regulatory effort to resolve the legal uncertainty created by *Madden*.[84] In August 2020, both the OCC and the FDIC enacted rules declaring that terms valid at a loan's origination remain valid after the loan is sold, transferred, or assigned, codifying the longstanding "valid when made" doctrine that the *Madden* court rejected.[85] Shortly thereafter, state officials filed suits against the OCC and the FDIC claiming that the rules violated the Administrative Procedure Act and that the agencies did not have the authority to enact them.[86] Ruling on cross motions for summary judgment, the United States District Court for the Northern District

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80 *Id.*

81 SIFMA Motion, *supra* note 65, at 11.

82 *See* Colleen Honigsberg, Robert J. Jackson, Jr. & Richard Squire, *How Does Legal Enforceability Affect Consumer Lending? Evidence From A Natural Experiment*, 60 J. L. & ECON. 673, 675 (2017).

83 *See* TREASURY WHITE PAPER, *supra* note 34, at 89.

84 *See OCC Adopts Final Rule to Resolve Uncertainty Created by* Madden, BALLARD SPAHR LLP (June 1, 2020), https://www.consumerfinancemonitor.com/2020/06/01/occ-adopts-final-rule-to-resolve-uncertainty-created-by-madden/ [https://perma.cc/ZS4F-YE5A].

85 *See* Federal Interest Rate Authority Rule, 85 Fed. Reg. 44,146, 44,149 (July 22, 2020) (to be codified at 12 C.F.R. pt. 331); Permissible Interest on Loans That Are Sold, Assigned or Otherwise Transferred, 85 Fed. Reg. 33,350, 33,532 (June 2, 2020) (to be codified at 12 C.F.R. pts. 7 & 160). *See also* Pratin Vallabhaneni, *FDIC and OCC Attempt to Settle Uncertainty Created by Second Circuit's* Madden *Decision*, WHITE & CASE (Dec. 5, 2019), https://www.whitecase.com/insight-our-thinking/fdic-and-occ-attempt-settle-uncertainty-created-second-circuits-madden [https://perma.cc/SM3Y-BXDT].

86 *See* Complaint for Declaratory and Injunctive Relief, People v. Off. of the Comptroller of the Currency, 584 F. Supp 3d 844 (N.D. Cal. 2022) (No. 4:20-cv-05200); Complaint for Declaratory and Injunctive Relief, People v. Fed. Deposit Ins. Corp., 584 F. Supp. 3d 834 (N.D. Cal. 2022) (No. 4:20-cv-05860).

of California found in favor of both agencies, concluding that the rules did not regulate the conduct of nonbanks and were within the agencies' jurisdictions.[87] Although *Madden* remains precedential in the Second Circuit, "the trend is for courts to give deference to those agency determinations, providing a modicum of certainty in the midst of the storm that occurred after the *Madden* decision."[88]

With the "valid when made" rules in effect, regulatory attention has since shifted to so-called "true lender" determinations,[89] which today represent one of the most consequential legal risks for the online lending industry.[90] As its moniker might suggest, in a "true lender" action, a borrower or regulator claims that the true lender of a loan originated through an online platform is the platform, not the partner bank.[91]

Courts generally adopt one of two approaches in resolving true lender claims.[92] Under the first approach, courts look to the form of the arrangement, focusing on the bank's status as a documented party to the loan agreement and as the entity who actually disperses the loan proceeds.[93] This approach typically results in a finding that the bank, not the platform, is the true lender on the loan, and therefore state usury laws do not apply.[94] Under the second approach, the court more broadly considers the platform's role in originating and underwriting the loan and its real economic interest in the loan's performance, as well as any economic interest—or lack thereof—that the partner bank retains on its own balance sheet after origination.[95] These courts disregard the form of the bank partnership "in favor of a searching examination of its substance, consider-

87 *See* Order Resolving Cross-Motions for Summary Judgment, 584 F. Supp 3d 844 (N.D. Cal. 2022); Order Resolving Cross-Motions for Summary Judgment, 584 F. Supp. 3d 834 (N.D. Cal. 2022).

88 Franson, *supra* note 56, at 4 ("Since the regulations have been enacted, it appears that the trend is for courts to give deference to those agency determinations, providing a modicum of certainty in the midst of the storm that occurred after the *Madden* decision.").

89 *See id.* ("[T]he shift of focus of both regulation and litigation has been toward true lender issues.").

90 *Id.* at 4.

91 *Id.* at 4–5.

92 *Marketplace Lending Update #9: To Thine Own Self Be True? Not Necessarily*, Cadwalader, Wickersham & Taft LLP (May 21, 2021), https://www.cadwalader.com/resources/clients-friends-memos/marketplace-lending-update-9-to-thine-own-self-be-true-not-necessarily [https://perma.cc/97X5-E9X3].

93 *Id.*

94 *Id.*

95 *Id.*

ing a variety of factors designed to determine which entity is the actual lender."[96]

In October 2020, the OCC took aim at the "true lender" split with a rule declaring that the partner bank in a lending partnership with a nonbank is considered the true lender on program loans if it is named as the lender in the loan agreement or funds the loan.[97] The "true lender rule" was met with immediate backlash from lawmakers and state regulators, who criticized the rule for simultaneously undermining both state efforts to curb predatory lending and the OCC's own previous opposition to rent-a-bank schemes.[98] In January 2021, seven states and the District of Columbia sued to challenge the rule, claiming it overstepped the OCC's statutory authority, relied upon an unreasonable interpretation of federal law, violated provisions of the Dodd-Frank Act, and contradicted the agency's longstanding opposition to rent-a-bank schemes.[99] Later that year, Congress passed a bipartisan resolution to repeal the rule under the Congressional Review Act, which President Biden signed into law on June 30, 2021.[100]

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96 Hannon, *supra* note 62, at 1265. "In contrast to the inflexible and overbroad approach of the *Madden* court, the true lender doctrine looks past the superficial form of rent-a-charter arrangements in order to ascertain whether the bank that is entitled to the preemption of state laws is the real lender receiving such protection." *Id.* Only then will the court decide whether the platform is entitled to the "broad protections granted to chartered[,] insured depository institutions," including preemption of state licensing requirements and usury laws. *Id.*

97 Press Release, Off. of the Comptroller of the Currency, Office of the Comptroller of the Currency Issues True Lender Rule (Oct. 27, 2020), https://www.occ.gov/news-issuances/news-releases/2020/nr-occ-2020-139.html [https://perma.cc/6VZU-CWXV].

98 *See* Brooke Reczka, *Continuing Uncertainty After Colorado Compromise: The Limited Impact of the Avant-Marlette Settlement on True Lender Risk for Nonbank-Bank Partnerships*, Duke Fin. Econ. Ctr.: The FinReg Blog (Feb. 2, 2021), https://sites.duke.edu/thefinregblog/2021/02/02/continuing-uncertainty-after-colorado-compromise-the-limited-impact-of-the-avant-marlette-settlement-on-true-lender-risk-for-nonbank-bank-partnerships/ [https://perma.cc/DQ78-ABFY]; John A. Stoker, *Preemption Update and Future Implications: Congress Repeals The OCC's True Lender Rule*, Moore & Van Allen PLLC (July 22, 2021), https://www.mvalaw.com/investigations-and-regulatory-advice/preemption-update-and-future-implications-congress-repeals [https://perma.cc/7GGU-NV6V].

99 Reczka, *supra* note 98.

100 Charlene Crowell, *President Biden Signs Bipartisan Bill to Curb Predatory Lending*, L.A. Sentinel (July 8, 2021), https://lasentinel.net/president-biden-signs-bipartisan-bill-to-curb-predatory-lending.html [https://perma.cc/A6EM-K3EQ]. At the signing ceremony, President Joe Biden said of the targeted business models, "[t]hese are so called 'rent-a-bank' schemes. . . . And they allow lenders to prey on veterans, seniors, and other unsuspecting borrowers tapping in the — trapping them into a cycle of debt." *Id.*

C. Tensions in the Existing Legal Environment

Industry groups and market participants closely monitor true-lender-recharacterization risk as a critical threat to the online lending business model.[101] If a court finds that the platform, not the partner bank, is the true lender on a loan, the court then turns to whether the platform, as lender, has violated state lending laws, including licensing and usury laws.[102] Since the right to preempt state law arises solely from the partner bank's charter, an adverse true lender ruling can have severe consequences for the platform, including reduction or elimination of interest or principal and other penalties under state law.[103]

However, even though the specter of true-lender recharacterization requires the platform to at least contemplate whether its loans could survive a true lender inquiry, the doctrine's uneven application across jurisdictions, the relatively small number of cases resolved on the merits, and the inherently limited ability for fact-intensive judicial decisions to guide industry behavior undermine the doctrine's utility in practice.[104] And since the rent-a-bank model allows platforms to export interest rates nationwide, if true-lender-recharacterization risk in a particular jurisdiction became too high, the platform could simply choose not to lend to borrowers in that jurisdiction, as replacement borrowers from elsewhere are readily obtainable via the Internet.[105]

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101 FRANSON, *supra* note 56, at 5 ("[T]rue lender litigation is closely followed by market participants, and adverse rulings can have a significant impact on the marketability of loans extended by particular lenders and/or extended to borrowers in particular states.").

102 *See* Reczka, *supra* note 98 ("By recharacterizing the nonbank fintech as the lender of the loan, the nonbank becomes subject to claims under state law that it is operating without a license or making usurious loans.").

103 FRANSON, *supra* note 56 at 5 ("Potential consequences of the platform and not the Funding Bank being deemed the true lender include violation of state lending license laws and violation of usury laws, which could result in reduction or elimination of interest and or principal and/or penalties or damages under state law."); *see also* Vallabhaneni, *supra* note 85 ("'[T]rue lender' litigation significantly increases legal and business risks for non-banking entities purchasing loans originated by banks. If successful, a 'true lender' challenge exposes the non-bank entity to significant penalties for usury and unlicensed lending as well as threatens the validity and enforceability of the loan under state law.").

104 *See* Hannon, *supra* note 62, at 1290.

105 *See* Yizhu Wang, *Repeal of Fintech 'True Lender' Rule Could Embolden State Banking Regulators*, S&P GLOB. (July 15, 2021), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/repeal-of-fintech-true-lender-rule-could-embolden-state-banking-regulators-65354390 [https://perma.cc/6KGN-Y5RA] (reporting that Illinois's stricter scrutiny of rent-a-bank

Furthermore, although courts often articulate true lender analyses primarily by reference to predominant economic interest in the loan, this approach is inapt for a model in which neither of the potential suitors for its "lender" label expects to retain any meaningful economic interest in the subject loans.[106] Under the online lending model, the partner bank is explicitly guaranteed a buyer through its forward flow agreement with the platform, while the platform by design expects to sell or securitize its loans in the secondary market. Hence, the true lender doctrine's focus on identifying a single entity as the true lender does little to address the underlying motives to engineer rent-a-bank arrangements in the first place—namely, to maximize origination volume (and fees) by relaxing approval standards.

But the true lender doctrine is not inevitable. The *Madden* court, perhaps recognizing this, was prudent in its desire to effectuate state usury laws. Under any rent-a-bank arrangement, the platform must assign interest rates such that investors' expected net returns exceed expected returns on similarly risky assets; otherwise, investors will balk.[107] As a result, for the platform to increase origination volume by lending to riskier borrowers, it must set interest rates high enough to offset the increase in expected losses those borrowers present.[108]

Unlike true lender inquiries, usury laws operate directly against this behavior by capping the interest rates that non-bank lenders can charge to borrowers who enter the loan pool by way of relaxed lending standards. Yet as the *Madden* fallout illustrates, a contrary rule that requires loans valid at origination to undergo a second usury analysis once transferred would have intolerable ramifications for secondary loan markets. Hence, for a solution that effectuates state usury laws to be feasible in practice, the usury laws that apply to the loan at origination must remain in effect after it is sold.

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arrangements may be preventing online platforms from marketing loans in the state).

106 *See* Adam J. Levitin, *Rent-a-Bank: Bank Partnerships and the Evasion of Usury Laws*, 71 Duke L. J. 329, 397 (2021) (noting that courts primarily articulate the "true lender" analysis by reference to predominant interest); *id.* at 401 (noting that no single party in online lending "neatly fits the bill" of lender).

107 *See* Franson, *supra* note 56, at 67–68.

108 *See id.*

III
COLORADO'S "SAFE HARBOR" SETTLEMENT: A TEMPLATE FOR REFORM

A. The Avant-Marlette Settlement

Amid conflicting efforts by regulators, lawmakers, and courts to furnish a durable strategy for regulating online lenders, in January 2017, the Administrator of the Colorado Uniform Consumer Credit Code filed true lender actions against two online lending platforms, Marlette Funding LLC and Avant of Colorado LLC.[109] Both platforms had partnered with FDIC-insured, state-chartered banks—Marlette with Cross River Bank, a New Jersey-chartered bank, and Avant with WebBank, a Utah-chartered bank—to originate the subject loans online.[110] Asserting that a lender must bear the predominant economic interest in a loan to qualify as the true lender, the Administrator argued that the banks did not qualify as the true lenders, and, therefore, the defendants could not rely on the banks' interest rate exportation privileges to evade Colorado's usury laws.[111] In response, the defendants maintained that WebBank and Cross River Bank were the true lenders on the subject loans, that Colorado's usury laws were, thus, preempted, and that the assignment of the loans does not affect the assignee's right to enforce their original terms.[112]

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109 Anthony R.G. Nolan, Judith Rinearson & Mehreen Ahmed, *Rocky Mountain Low? Implications of the Settlement of Colorado's Challenge to Partnerships Between Banks and Marketplace Lenders*, K&L GATES (Sept. 10, 2020), https://www.klgates.com/Rocky-Mountain-Low-Implications-of-the-Settlement-of-Colorados-Challenge-to-Partnerships-Between-Banks-and-Marketplace-Lenders-9-10-2020 [https://perma.cc/CUU7-G5WJ].

110 *Id.*

111 *See id.* "In the Colorado administrator's view of the law, a lender must 'bear the predominant economic interest in the loans' in order to qualify as a true, originating lender. Therefore, even if the federal preemption could transfer over when Marlette and Avant took on the loans from Cross River Bank and WebBank, respectively, those banks did not qualify as the true, originating lenders under this theory because they did not bear the predominant economic interest in the loans." *Id.* The Administrator also argued that "because Avant and Marlette are not banks, they (and their investors) could not rely on the 'valid when made' doctrine under the rule of *Madden*." *Id.*

112 *See id.* "The defendants argued that WebBank and Cross River Bank, rather than Marlette and Avant, were the respective 'true lenders' of the loans funded on those programs." *Id.* Because WebBank and Cross River Bank were state-chartered, FDIC-chartered banks, "the defendants argued that that the Colorado usury laws are preempted by federal law and, furthermore, that the assignment of the loans does not affect the ability of the assignee to enforce the loans on their original terms as a matter of Colorado state law or as a matter of federal law," including under the then-recent "valid when made" rules, which were adopted

After three years of litigation, the parties settled in an agreement that allowed Avant and Marlette to continue lending in Colorado so long as they complied with a settlement-defined "safe harbor" framework.[113] Hailed as a "win for Colorado borrowers as well as all parties to the litigation,"[114] the settlement operates by suspending true lender inquiries against the platforms so long as their bank partnership programs comply with a set of safe harbor provisions that, in light of the challenges outlined in Part II of this Note, offer a uniquely promising template for online lending reform.

Under the settlement, the Administrator agreed to bring no claims alleging that the loans are not subject to federal preemption, that the banks are not true lenders on the loans, or that the assignment of loans affects the assignee's ability to enforce their terms at origination so long as their bank partnership programs comply with the settlement's safe harbor provisions.[115] Under the terms, the platform cannot originate loans at rates higher than 36 percent annualized, and the process for transferring loans below 36 percent but above Colorado's statutory cap of 21 percent[116] must comply with one of three settlement-defined structural options,[117] each of which restricts the volume of those loans for which the platform can serve as a committed buyer.[118]

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during the pendency of the litigation "for the express purpose of clarifying existing law." *Id.*

113 *Id.*

114 John Redding, *Colorado "True Lender" Matters Settle*, JD SUPRA (Aug. 20, 2020), https://www.jdsupra.com/legalnews/colorado-true-lender-matters-settle-26868/ [https://perma.cc/8GKM-RGMB].

115 The settlement agreement was filed as an exhibit to a stipulation to dismiss. Stipulation to Dismiss ex. A at 15, Fulford v. Marlette Funding, LLC, No. 17-CV-30376 (Colo. Dist. Ct. Aug. 18, 2020) [hereinafter Colorado Settlement].

116 The terms of the settlement rely on a distinction between "supervised loans" and "Specified Loans." "Supervised loans" are defined by statute as loans with annualized percentage rates between 12 percent and 21 percent. Reczka, *supra* note 98. "Specified Loan" is a settlement-created term for consumer loans exceeding the supervised loan cap of 21 percent. *Id.* Because the settlement's Consumer Terms set an upper limit of 36 percent APR on all Specified Loans, loans subject to the requirements of the structural criteria are those with annualized percentage rates between 21 percent and 36 percent. *Id.*

117 This Note describes three of the four structural options in detail. The fourth is a catch-all provision that grants the Administrator authority to approve an "additional acceptable alternative" in writing. Colorado Settlement, *supra* note 115, at ex. A at 14.

118 *Id.* at ex. A at 9–14. Committed forward flow agreements are contractual arrangements under which a party commits in advance to purchase loans from another party. *Id.* at ex. A at 10.

The Uncommitted Forward Flow Option prohibits the partner bank from entering into a committed forward flow agreement with the platform as to loans with interest rates above Colorado's usury limit.[119] The parties may still enter into committed agreements with respect to loans below the limit, but for loans above the limit, the platform cannot serve as a committed buyer, forcing the partner bank to internalize risk due to the possibility that the platform will not repurchase some or all of the loans.[120]

Under the Maximum Committed Forward Flow Option, the partner bank may sell loans to the platform on a committed basis subject to two restrictions.[121] First, during a calendar year, if the partner bank agrees to sell to the platform more than 25 percent of the total volume of loans above Colorado's usury limit on a committed basis, it can only sell additional economic interest in those loans on an uncommitted basis.[122] Second, if the partner bank sells to the platform more than 49 percent of the total volume of loans that exceed Colorado's usury limit on a committed basis, it cannot transfer any additional economic interest in such loans to the platform on a committed or uncommitted basis.[123] This option again forces the partner bank to internalize a share of the risk in loans above Colorado's usury limit, incentivizing it to reject loans that it would not be comfortable holding on its own balance sheet.

Finally, the Maximum Overall Transfer Option prohibits the bank from transferring more than 85 percent of the economic interest in all loans originated under the partnership

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119 *Id.*

120 *Id. See also* Reczka, *supra* note 98 ("The result is that the bank has to internalize some risk of the Specified Loans because of the possibility that the nonbank will not purchase the loans. This can help reduce moral hazard inherent in originate-to-distribute lending models by forcing the bank to more closely examine the underlying creditworthiness of borrowers and the underwriting standards used by the nonbank.").

121 Colorado Settlement, *supra* note 115, at ex. A at 12.

122 *Id.* Under the settlement's terms, "economic interests" in a loan refer to any or all of the following: "[w]hole loans;" "[p]articipation interests, receivables in Loans, or any other ownership interest in Loans where the Bank maintains the contractual relationship with borrowers;" "[a]ny economic risk of loss in the Loan, including when separated from ownership of the Loan, such as by requiring the assignee to hold the assignor harmless for credit losses on a Loan during the life of the Loan;" "[s]ecurities backed by Loans, unless the securities are part of a broadly subscribed securitization made available to non-Affiliate investors;" and "[a]ny other form of economic interest in a Loan that is the functional equivalent" of the interests previously set forth. Colorado Settlement, *supra* note 115, at ex. A at 2.

123 Colorado Settlement, *supra* note 115, at ex. A at 13.

program to the platform regardless of whether the loans exceed Colorado's usury limit.[124] Additionally, loans above Colorado's usury limit cannot exceed 35 percent of the total volume of all loans originated under the program, creating a threshold beyond which the platform can no longer increase origination by lending to riskier borrowers.[125] Rather than targeting committed forward-flow agreements, this option imposes a risk-retention requirement on the partner bank, giving it "skin in the game" by requiring it to retain at least 15 percent of the total economic interest in all loans under the partnership program.[126]

Each of the structural options requires the partner bank to internalize risk in the loans it helps originate, either by capping the volume of those loans for which it is guaranteed a buyer or by forcing it to hold some of the loans on its own balance sheet.[127] For example, under the Uncommitted Forward Flow Option, the platform very well might choose to purchase every last loan from the partner bank; the catch, however, is the possibility that the platform will choose not to purchase some or all of the loans. As a result, the bank has to screen out high-risk loans that it (or its regulators) would not feel comfortable

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124 *Id.*

125 *Id.*

126 *Id.* Note that Section 941 of the Dodd-Frank Act created a "skin in the game" in reference to requiring securitizers "to retain an economic interest in a portion of the credit risk for any asset that [they] transfer[], sell[], or convey[] to a third party." Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 941, 124 Stat. 1376, 1890–96 (codified as amended at 15 U.S.C. § 78o-11(b)). "The skin-in-the-game requirement reflects an assumption that the originate-to-distribute model contains a moral hazard because loan originators do not hold the credit risk on the loans they make and instead are compensated through upfront fees and the sale of the loans." Adam J. Levitin, *Skin-in-the-game: Risk Retention Lessons from Credit Card Securitization*, 81 GEO. WASH. L. REV. 813, 815 (2013).

127 *Colorado Establishes Safe Harbor for Bank/Fintech Lending Programs*, KATTEN (Aug. 19, 2020), https://katten.com/files/877772_2020_08_19_frm_sf_colorado_establishes_safe_harbor_for_bank-fintech_lending_programs.pdf [https://perma.cc/C6FF-B97N]. The settlement also requires the partner bank to use its own sources of funding—such as deposits, retained earnings, credit facilities, reserves, or the bank's own capital—to originate loans and cannot accept funds from the platform for the express purpose of originating loans under the program. Colorado Settlement, *supra* note 115, at ex. A at 8. Hence, without a committed buyer, the partner bank risks depleting its own funding sources if the platform does not purchase some or all of the program loans. Moreover, the settlement empowers the partner bank to exert direct control over the platform's lending determinations by expressly providing that the partner bank has "ultimate approval authority" over all loans originated through the partnership, "controls all terms of credit" under the partnership, has "absolute right" to change the policies under which the platform determines whether to originate a loan and sets the terms of approved loans. *Id.* at ex. A at 6–7.

holding on its own balance sheet, providing a check on the platform's incentives to maximize origination volume by relaxing its lending standards.[128]

Moreover, the Colorado settlement tracks the careful distinction between banks and nonbanks that the *Madden* ruling sought to preserve.[129] The federal banking regime and the privileges it grants to chartered banks are premised upon the strict regulatory burdens that accompany those charters.[130] In exchange for the privilege to export interest rates nationwide, banks are expected to follow a detailed regime of prudential regulation that deters them from making the very types of excessively-risky, high-interest loans that state usury laws are designed to prevent.[131] Allowing banks to rent out this privilege for a fee undermines this distinction by creating a regulatory vacuum where loans are subject neither to state usury laws nor federal regulation, particularly when the loans do not impact the bank's balance sheet and therefore do not implicate safety and soundness.[132]

True lender inquiries alone do little to close this vacuum. Unlike the bright-line rule of *Madden*, the doctrine's uneven application across jurisdictions and the few cases decided on the merits make it difficult for participants to predict ex ante whether any particular transactional design will survive a true lender inquiry.[133] This opacity reduces the expected value of reformulating the partnership in response to perceived true

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128 Reczka, *supra* note 98. Retaining dubious loans on its own balance sheet would also implicate the bank's capital obligations and likely draw scrutiny from examiners. *See generally* FED. DEPOSIT INS. CORP., RISK MANAGEMENT MANUAL OF EXAMINATION POLICIES § 2.1, https://www.fdic.gov/regulations/safety/manual/section2-1.pdf [https://perma.cc/JR44-ZSGV] (2022).

129 *See* Levitin, *supra* note 106, at 409 (stating that the *Madden* ruling "respects the clear statutory boundaries of federal banking law while effectuating state usury laws" and "captures [the] regulatory distinction between banks and nonbanks").

130 *See id.* (noting that "banks are subject to an extensive and detailed regime of regulation" and "have certain privileges that accompany that regulatory regime").

131 *Id.*; *see also id.* at 341 ("[B]y preventing banks from making risky (and therefore high-cost) loans, the bank regulatory system is assumed to compensate or substitute for usury laws.)"

132 *See id.* at 408–409 (stating that exempting a nonbank from both state law and federal regulation creates a regulatory vacuum); *id.* at 359 ("It is hard for a regulator concerned with safety and soundness to tell a bank to cease engaging in a profitable activity because a bank is only safe-and-sound if it is profitable.").

133 *See id.* at 409 ("The doctrinal confusion about how to handle disaggregated lending makes it difficult to predict ex ante how any particular lending arrangement will hold up if challenged as violating state usury or licensing laws.").

lender risk, as participants will have difficulty determining whether any particular reformulation actually reduces true lender risk enough to justify the expected drop in revenue. And even if the partnership were reformulated to give the bank a nominally larger role in the lending process, the bank nonetheless has no meaningful incentive to second guess the platform's underwriting decisions.[134]

The safe-harbor framework, on the other hand, demands that the partner bank contribute more to the transaction than just the privileges of its charter; it must, as it should, have real "skin in the game." And unlike the true lender doctrine, which relies on compelling the *platform* to screen out transactions that would increase its recharacterization risk, the safe harbor framework places that burden where it belongs—with the regulated depository institution under whose charter these loans gain the privilege to evade state usury laws in the first place.

Finally, the safe harbor provisions are far more easily administrable than the true lender doctrine. Whereas the true lender doctrine's opacity incentivizes participants to simply gamble on whether their loans could survive a true lender inquiry ex post, under the safe harbor framework, reformulating the transactional design to obtain safe harbor offers direct, noncontingent financial value by suspending the risk of a true lender action. The safe harbor provisions, thus, operate not as a replacement for true lender inquiries but as an additional, preliminary layer of security that better captures the platform's underlying incentives to engineer rent-a-bank schemes while also providing much-needed clarity as to when a subsequent true lender analysis may or may not apply.

B. Dropping Anchor: A Federal "Safe Harbor" Provision

Although each state could, at least in principle, adopt its own regulatory framework akin to the Colorado settlement's terms, states would almost certainly set different requirements as to interest rate thresholds or the degree of "skin in the game" that the partner bank must retain.[135] Without uniform standards nationwide, platforms could easily engage in regulatory

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134 *Id.* at 360 ("[T]he bank might maintain nominal control over underwriting decisions, but in practice, the bank is unlikely to ever second guess the nonbank, lest the nonbank decline to purchase the loans and leave the bank holding a bunch of loans that it would never have made on its own account.").

135 *See* Reczka, *supra* note 98 ("The wide range of state usury caps is a testament to the differing views that states have regarding the appropriate level of protection and regulation for consumer credit services and products. State statutes

arbitrage by focusing on borrowers in more permissive jurisdictions, much like they already do by partnering with banks in states with the most permissive usury laws.[136]

However, the fragmented architecture of federal banking regulation in the United States, where regulators are largely confined to exclusive control within specific jurisdictional siloes, frustrates placing the safe harbor framework within the authority of an individual agency.[137] The OCC could certainly promulgate safe harbor rules, but their reach would be limited to nationally chartered banks, and the vast majority of partner banks in the online lending industry are state-chartered banks jointly regulated by the FDIC and the Federal Reserve.[138] The FDIC would face no such obstacle, as it is precisely a bank's FDIC-insured status that gives rise to the exportation privilege; however, compelling banks to abandon a profitable, near-riskless mode of activity in favor of retaining *more* risk on their own balance sheets would hardly promote safety and soundness, particularly insofar as banks being profitable reduces risk to the broader financial system.[139] Even the Consumer Financial Protection Bureau, which might appear well-suited by virtue of its broad authority to regulate unfair and abusive practices, is prohibited by statute from enacting a usury limit, which would likely bar at least some components of the settlement framework.[140]

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creating safe harbors would set diverging standards, increasing the regulatory burden for nonbanks reliant on bank partnership models.").

136 *See* Present Value Podcast Team, *Present Value: Saule Omarova Discusses Financial Sector Pversight and Fintech*, CORNELL SC JOHNSON SCH. BUS. (May 20, 2019), https://business.cornell.edu/hub/2019/05/20/saule-omarova-financial-oversight-fintech/ [https://perma.cc/NVU7-SBWT]; Odinet, *supra* note 15, at 1784.

137 *See* Omarova, *supra* note 70, at 38 (describing regulatory arbitrage).

138 *See* Jonathan L. Pompan, Andrew E. Bigart, D.E. (Ed) Wilson, Jr., Ellen Traupman Berge & Connor J. Webb, *Fintech Guide to Bank Partnerships: A Practical and Legal Roadmap*, VENABLE LLP (Mar. 1, 2021), https://www.venable.com/insights/publications/2021/03/fintech-guide-to-bank-partnerships/ [https://perma.cc/WEN2-M8TT].

139 *See* Levitin, *supra* note 106, at 359 ("It is hard for a regulator concerned with safety and soundness to tell a bank to cease engaging in a profitable activity because a bank is only safe-and-sound if it is profitable.").

140 12 U.S.C. § 5517(o) ("No provision of this title shall be construed as conferring authority on the Bureau to establish a usury limit applicable to an extension of credit offered or made by a covered person to a consumer, unless explicitly authorized by law."). Moreover, the threat of private litigation is often a weak one due to the proliferation of binding arbitration agreements in contracts for consumer financial products. *See* Robert W. Emerson & Zachary R. Hunt, *Franchisees, Consumers, and Employees: Choice and Arbitration*, 13 WM. & MARY BUS. L. REV. 487, 500–01 (2022).

Ultimately, implementing a federal safe-harbor provision will likely fall to either coordinated rulemaking between regulators or an act of Congress. Federal legislation would certainly be more durable than agency rulemaking, and lawmakers have recently indicated that they are willing to take aim at online lenders. In November 2022, members of Congress introduced the Stopping Abuse and Fraud in Electronic Lending Act, which would set registration requirements and prohibit lead generation for small-dollar, payday-type loans from online lending platforms.[141] Though the bill's trajectory remains to be seen, its introduction signals that broader reforms might be on the table, particularly in a Congress with an eye toward course-correcting from a period of atypically aggressive financial deregulation.[142]

Conclusion

Historically, even the most aggressive predatory lenders were largely confined to their surrounding communities. Today, they can exploit the near-limitless reach of the Internet to target borrowers anywhere in the country with promises of instant cash at the highest permissible rates in any jurisdiction they choose. Yet the conflicting, uneven patchwork of judicial and regulatory decisions that purports to address these behaviors is not an adequate substitute for the state usury laws that online platforms seek to evade through their rent-a-bank arrangements. And even the industry itself, long encumbered by perpetual litigation and controversy, would likely welcome a clear, uniform framework for determining the legality of an online loan.

Colorado's "safe harbor" settlement offers a template for a better path forward by creating an additional, preliminary layer of security that targets the underlying incentives behind rent-a-bank schemes while also providing much-needed clarity as to when a subsequent true lender analysis may or may not apply. However, for this approach to reach its full potential, policymakers can and should implement a federal safe-harbor provision that blocks regulatory arbitrage by implementing uniform thresholds nationwide.

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141 SAFE Lending Act of 2022, H.R. 9307, 117th Cong. (2022); SAFE Lending Act of 2022, S. 5099, 117th Cong. (2022).

142 *See* Mark Lebovitch & Jacob Spaid, *In Corporations We Trust: Ongoing Deregulation and Government Protections*, Harvard L. Sch. F. on Corp. Governance (Feb. 6, 2019), https://corpgov.law.harvard.edu/2019/02/06/in-corporations-we-trust-ongoing-deregulation-and-government-protections/ [https://perma.cc/6SL3-CQTS].