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Fintech Charter Interest Could Be Shaped By Litigation

By **Jon Hill**

Law360, New York (October 5, 2018, 9:40 PM EDT) -- How much appetite financial technology firms show for pursuing the Office of the Comptroller of the Currency's so-called fintech charter could depend in part on the wave of litigation testing their business model of partnering with banks, legal experts said Friday.

Speaking in New York at a Practising Law Institute conference on alternative finance, panelists from the legal and fintech worlds addressed the uncertainty surrounding how many fintech firms will take the OCC up on its invitation to apply for special-purpose charters that would give them access to many of the powers enjoyed by full-service, traditional banks in exchange for tougher, bank-like supervision by the OCC.

"The question is whether the benefits of the charter will outweigh its burdens and the risks involved," panelist Randy Benjenk of Covington & Burling LLP said. "I think you'll see some fintechs conclude that, if they're going to be regulated like a bank, they may as well apply for a full-service charter and get access to deposit funding and [Federal Deposit Insurance Corp.] insurance."

The OCC said at the end of July that it would start accepting special-purpose charter applications from fintech firms that engage in "core" banking activities like lending but don't take deposits. Without deposits, these fintechs won't have to get deposit insurance, and while that may have its perks, it also forecloses a prime source of funding that many banks rely on.

That's not the only hitch. OCC oversight could be stricter than many fintech firms are used to and would come with certain capital, liquidity and other standards that have not been nailed down yet, for example. Among other things, it is also unclear whether chartered fintechs will get access to the Federal Reserve's payments system, and there is even the risk that the OCC's move to issue fintech charters could be sunk by legal challenges from turf-conscious state regulators.

But as firms weigh these trade-offs to the fintech charter, panelists said the scales could be tipped by what happens in the courts.

"For a fintech company that thinks it has a great lending platform but won't be able to use it in the way it otherwise would because of Madden litigation or true lender litigation, I think the preemptive value of the charter by itself would be more of a benefit," Benjenk said.

Madden refers to the Second Circuit's 2015 decision in Madden v. Midland Funding, which called into question the validity of interest rates on bank loans that are later transferred to nonbank partners. The decision has been criticized by many financial services attorneys, but the Supreme Court declined in 2016 to review the ruling.

True lender cases, meanwhile, take aim at the bank partnership model, in which a nonbank fintech firm will team up with a bank to recruit customers and make loans. While the nonbank may supply the marketing and technological infrastructure, the loans are actually issued through the partner bank in this model and then transferred back to the nonbank to hold, sell or securitize.

Some consumer advocates and state regulators have dubbed these "rent-a-bank" schemes, arguing that the fintech firms involved are just taking advantage of their bank partners' preemption authority to skirt state consumer financial laws that would otherwise apply to these loans, such as interest rate caps.

That view has turned up in lawsuits like the one that the Colorado administrator of the Uniform Consumer Credit Code is now pursuing in Denver state court against the company behind online lender Best Egg, which partners with the New Jersey-chartered Cross River Bank to make loans.

According to the suit, Best Egg is the true lender in this relationship because Cross River does not "bear the predominant economic interest" in the Best Egg loans. That means Cross River's preemption authority doesn't apply, so Best Egg has charged more for its loans than it is allowed to as a nonbank under Colorado law, the regulator's suit alleges.

Panelist Arlen W. Gelbard, general counsel at Cross River, pushed back on that characterization at Friday's PLI event.

"We think the Colorado administrator of the UCCC is wrong in their opinion that we are not the true lender," Gelbard said. "The way that we have structured our program, and I'll speak only for us, we are so actively involved in every step of the way of what our partner does."

But if fintech firms do start getting tagged in these cases as the true lenders, the resulting uncertainty about the continued viability of the bank partnership business model could increase the appeal of the OCC's fintech charter, which would offer those firms a way to tap into preemption authority on their own.

"When balancing the burdens of the fintech charter versus the benefits, some of the answers are going to present themselves in the tension we see in these [true lender] cases in district courts and ... state-law cases," panelist Preetha P. Gist of Chapman and Cutler LLP said. "The resolution of those, I think, is going to drive in large part how attractive the OCC charter is."

--Editing by Peter Rozovsky.