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5 Litigation Areas For Banks To Watch In 2021

By **Jon Hill**

Law360 (January 3, 2021, 12:02 PM EST) -- If what's past is prologue, then 2021 is shaping up to be no exception for the banking industry, as fallout from the coronavirus pandemic and regulatory fights of 2020 continue to ripple through the courts and shape the legal landscape for financial services providers in the coming year.

Here are five areas where financial services attorneys told Law360 they expect to see some of the highest-profile litigation of 2021:

PPP Fallout

The federal government unleashed a torrent of coronavirus relief aid this past year through the Paycheck Protection Program, which enlisted the help of banks and other lenders to channel more than $520 billion in forgivable loans to small businesses struggling to stay afloat amid the pandemic.

By some accounts, the program has been a success. Trump administration officials have credited PPP loans with saving millions of jobs, and lawmakers from both sides of the aisle agreed last month to refuel the program for another round of lending to help businesses weather the latest surge in COVID-19 cases.

But the program has also been beset by compliance headaches, equity concerns and outright fraud, spawning a wave of investigations, litigation and prosecutions this past year. A congressional oversight report from October said that more than $4 billion in PPP loans may have been fraudulent, and federal officials have charged dozens of individuals nationwide with PPP-related crimes.

Lenders, meanwhile, have been hit with numerous class actions related to their participation in the program. For example, not only have financial institutions been accused of improperly blocking certain prospective borrowers from applying, they've also been **accused of stiffing "agents"** on billions in commissions earned on borrowers that did get loans.

Many of these cases have already been dismissed, settled or otherwise booted out of court as federal judges in places like California, Florida and New York have rejected some of the key theories underpinning them. But a sizable portion of the suits are still going, raising the prospect that banks may yet see a plaintiff-friendly court breathe new life into this litigation as the new year unfolds.

At the same time, 2021 could be the year that the federal government broadens its pursuit of PPP fraudsters to include the banks and other lenders that served them. Although the program did not require financial institutions to rigorously vet PPP loan applicants, Covington & Burling LLP senior counsel Jean Veta said some banks could still run into trouble if officials conclude that red flags were missed or ignored.

"The government has been working with banks to try to identify those fraudsters, but it's possible that down the road, the government's focus will turn from the fraudsters to the question of whether a bank's controls should have prevented the fraudster from submitting a loan application in the first place," Veta said.

Mortgage-Backed to the Future

The last major crisis to wallop the U.S. economy was more than a decade ago, when the mid-2000s housing bubble burst, exposing vast amounts of shoddily underwritten and securitized loans. But while the firestorm of credit crisis litigation that ensued has largely burned itself out at this point, John Doherty of Alston & Bird LLP said the COVID-19 crisis is poised to ignite a new conflagration in the courts in 2021 that will share some similarities with the last downturn.

That's because the market is once again facing a profusion of distressed assets, this time due to the pandemic and the havoc it has wreaked on commercial real estate borrowers, according to Doherty. And while relief programs and foreclosure moratoriums put in place at the start of the pandemic helped to forestall the reckoning in 2020, Doherty can't say the same for 2021.

"We will see an uptick in direct enforcement actions in the commercial mortgage lending context, meaning foreclosure actions," said Doherty, who is a partner in his firm's litigation and trial practice group. "We've seen a lot of enforcement activity in the mezzanine loan space in 2020, and I expect to see a jump in real property foreclosures as the state moratoria expire as we move into 2021. And that's both on securitized debt and nonsecuritized debt."

Doherty said he also expects to see the return of so-called putback suits — a type of litigation common after the 2008 financial crisis that seeks to force banks and other originators to buy back loans that have soured in securities trusts — in the commercial mortgage-backed securities space.

"That's been dormant in the CMBS market, but I think we're going to see more of that litigation going forward because junior investors in these trusts are going to incur losses, and they're going to want to explore strategies to try to avoid those losses," Doherty said.

Trump-Era Rules Under Fire

The outgoing Trump administration is leaving behind significant deregulation for financial services, including rollbacks of bank prudential standards, stress testing requirements and proprietary trading restrictions, as well as a tamer watchdog in the Consumer Financial Protection Bureau.

But the administration's deregulatory legacy is in the crosshairs of legal challenges as 2021 begins. In the past year, lawsuits have been filed to restore the CFPB's payday lending underwriting standards, block regulations that make it easier for nonbanks to form lending partnerships with banks, and invalidate a community lending rules overhaul championed by banks, among other things.

Those legal challenges, brought in many cases by progressive advocacy groups and state attorneys general, could get a boost from the new Biden administration, which will have the option of declining to defend Trump-era rulemakings in court.

Such a dynamic has already played out once before with the CFPB's payday lending rules. Issued during the Obama administration, the rules were put on indefinite hold during the Trump administration after trade groups sued and gained the agency's support for a court-ordered stay.

The latest crop of legal challenges could also test courts' willingness to show deference to agencies on rulemakings completed during the pandemic. Although these initiatives predate the outbreak of the coronavirus, plaintiffs have argued in their cases that the agencies rushed to finalize them under the cover of a national crisis.

But whether courts will really have an appetite for second-guessing these Trump-era rulemakings is "sort of the $64,000 question," said Clifford S. Stanford, an Alston & Bird partner who leads the firm's bank regulatory team.

"There will be pressure to undo things that the prior administration did, but a lot may wind up depending on whether the agencies themselves shift gears internally and go after these rulemakings from within the bureaucracy instead," Stanford said.

Ratification Rumbles

If the CFPB swings back in a more progressive direction, it will likely start with the ouster of the agency's current Trump-appointed Director Kathleen Kraninger, whom Democrats have urged President-elect Joe Biden to fire as soon as possible once he takes office later this month.

In doing so, Biden would be capitalizing on the U.S. Supreme Court's decision this past year in Seila Law LLC v. CFPB, in which the high court ruled that the Constitution requires presidents to have unfettered removal authority over the heads of single-director-led independent agencies.

But in striking down Kraninger's "for-cause" removal protection, the court left unresolved the question of what should happen to actions the CFPB took when this removal protection was still in place.

The question has big ramifications for the CFPB's enforcement docket, where defendants have argued that the agency can't purge its past unconstitutionality without dropping, narrowing or rebooting cases. The CFPB, meanwhile, has argued that it doesn't have to do anything of the sort because Kraninger can "cure" past actions through ratification now that she's no longer protected from removal.

Federal district judges to rule on the ratification issue have so far sided with the CFPB, but appellate courts are poised to provide even more authoritative answers as 2021 arrives. Last week, for example, a Ninth Circuit panel upheld the ratification of the civil investigative demand at the root of Seila Law, though the case could conceivably be reheard or appealed. The Second Circuit, meanwhile, could again have an opportunity to rule on the issue after handing it off to a district judge in CFPB v. RD Legal Funding.

If the CFPB's efforts to use ratification are ultimately rejected, it could be fatal for many of the agency's cases that are still pending from the pre-Seila era. But if ratification carries the day, the agency may be able to look back on its trip to the Supreme Court this past year as little more than a detour for enforcement.

Agency Independence on the Line — Again

The Supreme Court could also tackle the consequences of agency unconstitutionality in Collins v. Mnuchin, in which the Federal Housing Finance Agency is facing a challenge similar to the one that carried the day against the CFPB.

Like the CFPB, the FHFA is an independent agency led by a single, removal-protected director, and the Trump administration has agreed with its opponents in the case, a group of investors in Fannie Mae and Fannie Mac, that the FHFA director's removal protection is unconstitutional in light of the Seila Law decision.

But while the administration has argued the justices should strike down this removal protection and call it a day, the investors have pushed for a more radical result: the invalidation of the FHFA's so-called net worth sweep of Fannie and Freddie, an arrangement that yielded more than $200 billion in dividends for the government since 2012.

If the justices side with the investors, the decision could have far-reaching consequences for the FHFA, according to Joseph A. Smith Jr., senior fellow at Duke Law School's Global Financial Markets Center and onetime nominee to become FHFA director under President Barack Obama.

"If the directorship was constitutionally flawed, and it was flawed at inception, why stop at just the net worth sweep?" said Smith, who has also served as North Carolina's commissioner of banks. "How is the conservatorship itself right? And if you get into that, you're opening a whole can of worms."

Such a decision could additionally provide tremendous ammunition to defendants in CFPB cases who say the agency needs to pay more of a post-Seila price for its pre-Seila unconstitutionality. To avoid these ripple effects, Smith said the justices "need to distinguish and limit their decision in a way that doesn't have retrospective effect of that kind."

At the same time, there is hope among some on the right that the high court's conservative majority could use the case as a vehicle to deliver a death blow to Humphrey's Executor, a landmark New Deal-era decision seen as foundational for the concept of agency independence.

Even if the justices side with the government, striking down the FHFA director's removal protection could give Biden an opening to fire the agency's current Trump-appointed leader, whose housing finance reform agenda would then be in doubt. Ruling the FHFA to be unconstitutionally structured could also expose other parts of the federal government to legal challenges, according to those who have advocated for FHFA constitutionality in the case.

"You almost get the feeling this is being argued in a bubble," Smith said. "There's a real world out here, and these things have implications that I don't think can be totally understood and appreciated by people who have hundreds of cases to consider and decide in a term. It's amazing what they do, but getting to be a super legislator in nature and starting to rewrite laws is a risky business."

--Editing by Alanna Weissman.