The Commonwealth Decision

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Investors and participants in bank partnership programs – where an FDIC-insured bank partners with a nonbank that acts as marketer, and later purchaser or servicer, of the bank-originated loans – have been eagerly awaiting U.S. Supreme Court action in *Madden v. Midland Funding* and have been closely monitoring pending litigation for any cases that may affect the bank partnership space. In *Madden*, the U.S. Court of Appeals for the Second Circuit held that non-national bank entities that purchase loans originated by national banks cannot rely on the National Bank Act to protect them from state-law usury claims.

A recent case out of the U.S. District Court for the Eastern District of Pennsylvania, in *Commonwealth of Pennsylvania v. Think Finance*, has raised eyebrows. In ruling on a Motion to Dismiss, the court declined to allow the nonbank servicing partners of a federal bank to assert federal preemption as a basis to avoid a claim that the loans originated by the bank – and subsequently purchased by the nonbank partners – were usurious.

The nonbank entities partnered with First Bank of Delaware (“FBD”), a Delaware state-chartered, FDIC-insured bank exporting Delaware interest pursuant to Section 521 of the Depository Institutions Deregulation and Monetary Control Act (“DIDMCA”). Delaware allows its banks to contract for interest on a loan at any rate, thus making it a favorable bank partner. The nonbank entities argued that federal law preempted the causes of action in the Commonwealth’s complaint that pertained to their partnership with FBD. They specifically argued that preemption applies to *any* challenge to interest or fees assessed on a bank-issued loan, even when brought against a non-bank. They further asserted that preemption rights do not disappear when a loan is assigned or transferred from the bank to a nonbank entity, a statement seemingly incongruous with the holding in *Madden*, which suggests that a bank could retain some ownership interest in a loan purchased by the nonbank to continue to “cloak” the loan in federal preemption

In support of their position *Commonwealth*, the nonbank entities highlighted two cases that concluded that federal law preempted state law claims even when the defendants were not the banks themselves. In *Sawyer v. Bill Me Later, Inc.*, the U.S. District Court for the District of Utah found that where the bank essentially “rented out” its charter, the state law claims were preempted. In *Hudson v. ACE Cash Express, Inc.*, the U.S. District Court for the Southern District of Indiana found that state law preemption applied even when the state-chartered bank played an “insignificant” role in the loan that had been designed by the non-bank “for the sole purpose of circumventing Indiana usury law.” The *Hudson* court found that to draw jurisdictional boundaries to distinguish between non-banks “renting” a bank’s charter and other non-bank entities would

create “uncertain(ty) and unpredictab(ility).”

However, the *Commonwealth* court looked to a decision where the U.S. Court of Appeals for the Third Circuit, which includes Delaware, New Jersey and Pennsylvania, distinguished, for purposes of preemption, between claims against banks and claims against non-banks. In *In re Community Bank*, the Third Circuit found state law claims against a non-bank were not preempted by DIDMCA and the National Bank Act. The court relied on two determining issues: 1) that the “complaint asserted no claims against a national or state chartered federally insured bank” and 2) “the complaint asserted no usury claims against any party under Pennsylvania law.” In *Commonwealth*, the Commonwealth asserted Pennsylvania usury law claims, but not against FBD.

On that basis, the *Commonwealth* court held that even though the complaint contained state usury claims, those claims were not asserted against the bank, and thus, preemption did not apply. The *Commonwealth* court concluded that *In re Community Bank* allowed state usury claims to go forward against nonbank entities. The court’s conclusion did not depend on the finding that there were no state usury claims. Additionally, the *Commonwealth* court distinguished *In re Community Bank* from *Krispin v. The May Department Stores Company* by noting that “[a]lthough there were no claims against a national or state-chartered bank (in *Krispin*), the loans were issued by a national bank, which was a wholly owned subsidiary of the department store.” Other courts, the *Commonwealth* court noted, have also observed that the close relationship between the bank and the store made *Krispin* a unique situation not generally applicable to the typical bank partnership.

Because the Commonwealth alleged the nonbank entities, not the bank, were the real parties in interest and they were not closely tied to FBD, the *Commonwealth* court found *Krispin* inapplicable. The fact that FBD retained interest in the loans did not place *Commonwealth* in the category of cases like *Krispin*, because the nonbank entities were alleged to be the *de facto* lender. Accordingly, the *Commonwealth* court concluded that Third Circuit precedent distinguished between banks and nonbanks in determining whether state law usury claims were preempted. Because the claims asserted by the Commonwealth were not against the bank, the court declined to dismiss the claims on federal preemption grounds. The ultimate holding in *Commonwealth*should give investors and others guidance as to the best way to structure a bank partnership program to ensure that the bank will be considered the true lender on the loan and thus entitled to invoke federal preemption.