

## Madden Has Far-Reaching Implications For Loan Investors

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On May 22, 2015, in *Madden v. Midland Funding LLC*,<sup>[1]</sup> the United States Court of Appeals for the Second Circuit held that the application of state usury laws to third-party assignees is not preempted by the National Bank Act (NBA) but rather such assignees remain subject to state usury limits. The Madden decision has potentially far-reaching implications for investors in, and securitizers of, bank-originated loans to the extent that it casts into doubt the ability of an assignee of a bank loan to collect interest at the rate originally provided for in the agreement.

### Background

The NBA expressly permits national banks to “charge on any loan ... interest at the rate allowed by the laws of the State, Territory, or District where the bank is located.”<sup>[2]</sup> Numerous decisions by the U.S. Supreme Court have recognized that the NBA “completely preempts ... state-law usury claims” because the NBA “provides the exclusive cause of action” for usury claims against national banks.<sup>[3]</sup> According to the Supreme Court, “[u]niform rules limiting the liability of national banks and prescribing exclusive remedies for their overcharges are an integral part of a banking system that needed protection from possible unfriendly State legislation.”<sup>[4]</sup> Thus, as a consequence of the NBA’s preemption of state usury laws, “a state in which a national bank makes a loan may not permissibly require the bank to charge an interest rate lower than that allowed by its home state.”<sup>[5]</sup>

In *Madden*, the plaintiff, a resident of the state of New York, opened a credit card account with Bank of America NA, a national bank, in 2005. Bank of America subsequently transferred the account to FIA Card Services NA, an affiliated national bank headquartered in Delaware. At the same time, the terms and conditions of the account were amended upon receipt by the plaintiff of a contract containing a Delaware choice-of-law provision (the “amended terms”). Delaware law permits interest at any rate agreed upon and therefore, under Section 85 of the NBA, FIA could collect from its cardholders any rate of interest set forth in the amended terms, notwithstanding usury limits established under the state law where its cardholders reside.

In 2008, after the plaintiff failed to make timely payments on the account, FIA charged off the debt on the account and sold the plaintiff’s debt to Midland Funding LLC, a third-party debt purchaser that is not



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a national bank. After Midland Funding acquired the plaintiff's debt, neither FIA nor BANA retained an ownership interest in the account. Under the amended terms, the applicable rate of interest was 27 percent, a rate of interest allowed under Delaware law and, pursuant to the "rate exportation" provisions of the NBA, a permissible rate of interest that could be applied to FIA's borrowers, wherever located.

In November 2010, Midland Credit Management Inc., an affiliate servicer of Midland Funding's consumer debt accounts, sent a letter to the plaintiff seeking to collect on the debt and stating that an annual interest rate of 27 percent applied to the balance due. While the 27 percent rate was provided for under the amended terms and permissible under Delaware law and the NBA, the rate exceeded the general usury rate under New York law.[6]

### **The District Court's Decision**

The plaintiff subsequently brought a putative class action against Midland Funding and Midland Credit (collectively, the "defendants") in the United States District Court for the Southern District of New York, alleging that the defendants violated the Fair Debt Collection Practices Act (FDCPA) and New York's usury law by collecting an usurious interest rate that was higher than that permitted in New York. The defendants argued that, as valid assignees of debt originated by a national bank, the plaintiff's account remained subject to the NBA's preemption of state usury laws. The district court agreed and entered a stipulated judgment in favor of the defendants, holding that (1) Section 85 of the NBA preempted state law usury claims and (2) the FDCPA claims failed because the 27 percent interest rate was permitted under the amended terms in accordance with Delaware law.

### **The Second Circuit's Decision**

On appeal, the Second Circuit reversed, holding that the federal preemption of state usury laws does not extend to non-national bank assignees of national banks, thus subjecting such assignees to state law usury restrictions with respect to interest that accrued after assignment.

As a preliminary matter, the Second Circuit noted that Section 85 of the NBA expressly permits national banks to charge interest at any rate permitted under the laws of the state in which it is located, and "completely preempts analogous state law usury claims." [7] In this regard, the Second Circuit correctly recognized that Section 85 of the NBA expressly provides for complete and unconditional preemption of state restrictions on interest that may be charged. Nonetheless, the Second Circuit, in a somewhat confusing opinion, then concluded that this federal preemption does not extend to assignees of national banks, i.e., that assignees of national bank loans cannot rely on the rate provided for in the agreement for any interest that accrues after the date of assignment.

The Second Circuit reasoned that NBA preemption did not extend to the defendants as assignees because they were acting on their own behalf, and not on behalf of Bank of America or FIA in attempting to collect on plaintiff's debt. In doing so, the Second Circuit relied on vague guidance from the Office of the Comptroller of the Currency that, according to the court, "made clear that third-party debt buyers are distinct from agents or subsidiaries of a national bank." [8] Despite acknowledging that the application of state usury laws "might decrease the amount a national bank could charge for its consumer debt in certain states" — i.e., potentially make uneconomic the origination and sale of such loans — the Second Circuit curiously concluded, without explanation, that "such an effect would not 'significantly interfere' with the exercise of a national bank power." [9]

According to the Second Circuit, extending the NBA's preemption to a third-party debt purchaser "would create an end-run around usury laws for non-national bank entities that are not acting on behalf of a national bank." [10] The Second Circuit did not cite to any precedent construing the express preemption afforded by Section 85, but rather cited precedent relating to other aspects of the NBA. [11]

The Second Circuit distinguished two seemingly contrary Eighth Circuit decisions relied on by the defendants and the district court. In *Krispin v. May Department Stores Co.*, the court held that the NBA preempted usury claims against a department store that purchased the receivables for accounts held by a national bank, and played a role in account collection: "it makes sense to look to the originating entity (the bank), and not the ongoing assignee (the store) in determining whether the NBA applies." [12] The Second Circuit distinguished *Krispin* on the basis that the bank retained ownership of the accounts and thus was the real party in interest. According to the Second Circuit, that the originating entity was a national bank has no significance. [13] In *Phipps v. Federal Deposit Insurance Corp.*, the court cited to *Krispin* in dismissing state usury claims against a national bank and its non-national bank assignees. [14] The Second Circuit distinguished *Phipps* on the basis that the national bank was the entity that charged the challenged interest, whereas in *Madden*, the challenged interest was accrued after the sale of the account to the defendants. [15]

Concluding that the defendants were not acting on behalf of Bank of America or FIA in attempting to collect on plaintiff's debt, the Second Circuit therefore held that the interest rate preemption afforded by Section 85 of the NBA simply did not apply and that the defendants therefore were subject to New York's usury restriction with respect to interest that accrued after assignment.

### **The Implications**

The Second Circuit's decision in *Madden* may have far-reaching — and likely unintended — implications for national banks and their assignees if the rate of interest charged by the bank on a loan may be deemed unenforceable (if not illegal) by the assignment of the loan from the national bank to a nonbank entity. The Second Circuit's decision upends a fundamental and long-standing premise of lending law — that a fully funded loan that is valid and enforceable when made remains valid and enforceable (including with respect to the rate of interest accruing), regardless of to whom that loan is subsequently assigned. Under *Madden*, however, the rate of interest that can be collected on a bank-originated loan may vary after assignment, depending on the identity of the assignee and where the assignee resides (given that usury rates vary depending on the type of creditor as well as from state to state). [16] The *Madden* decision thus calls into question the enforceability of bank- and thrift-originated loans that have subsequently been assigned to nonbank entities such as hedge funds, securitization vehicles, whole-loan purchasers and other investors, and, in some states, may subject such assignees to criminal penalties for attempted enforcement of terms that were indisputably valid when made.

### **Next Steps**

The defendants have filed a petition to the Second Circuit for rehearing en banc. Given the significance of the Second Circuit's decision, we anticipate significant industry efforts to support en banc review and reversal.

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[1] No. 14-2131-cv, ECF No. 75 (2d Cir. May 22, 2015) (“slip op.”), pet. for reh’g filed, ECF No. 96-1 (2d Cir. June 19, 2015).

[2] 12 U.S.C. § 85.

[3] Slip op. at 12 (quoting Beneficial Nat’l Bank v. Anderson, 539 U.S. 1, 11 (2003); Sullivan v. Am. Airlines Inc., 424 F.3d 267, 275 (2d Cir. 2005)). See, e.g., Smiley v. Citibank (South Dakota) NA, 517 U.S. 735, 744 (2008) (citing Marquette Nat’l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299 (1978)).

[4] Beneficial, 539 U.S. at 10 (citation omitted).

[5] Pac. Cap. Bank NA v. Conn., 542 F.3d 341, 352 (2d Cir. 2008).

[6] See N.Y. Penal Law § 190.40 (McKinney 2010 & Supp. 2015) (proscribing interest from being charged at a rate exceeding 25 percent per year).

[7] Slip op. at 12 (quoting Sullivan, 424 F.3d at 275).

[8] Id. at 15 (citing OCC Bulletin 2014-37, Risk Management Guidance (Aug. 4, 2014)).

[9] Id. at 18-19.

[10] Id. at 19.

[11] The Second Circuit cited exclusively to precedents relying on an entirely separate theory of preemption known as “implied preemption.” The theory of implied preemption is altogether different from the preemption of interest rates provided for in Section 85 of the NBA. Implied preemption is not derived from a specific, express statutory mandate (such as Section 85 of the NBA), but rather from the idea that national banks are federal instrumentalities — creatures of the federal government — and therefore are not subject to state laws that significantly interfere with their operations. Barnett Bank of Marion Cnty. NA v. Nelson, 517 U.S. 25, 33-34 (1996). Implied preemption theory is based on the supremacy clause of the Constitution and, unlike express preemption, is conditional, i.e., implied preemption overrides only those state laws that significantly interfere with the operations of federal instrumentalities (such as national banks). Implied preemption has been asserted in matters where Congress has not expressly preempted state law by statute — for example, the ability of a national bank to impose returned check charges or other fees on deposit accounts, or to sell annuities. Preemption of interest rates under Section 85, by contrast, is materially different. Section 85 expressly preempts state laws without exception, and does not require a showing of significant interference with the operations of a national bank.

[12] 218 F.3d 919, 924 (8th Cir. 2000).

[13] Slip op. at 19-22.

[14] 417 F.3d 1006, 1013 (8th Cir. 2005).

[15] Slip op. at 22-24.

[16] Applicable usury rates vary from state to state, depending on the type, size and purpose of the loan, the nature of the borrower, and the nature of the lender. For consumer loans, the applicable statute usury limit can be as low as 7 percent; for commercial loans, the applicable usury limit can be as low as 10 percent.

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