Clients&FriendsMemo

It's a Mad, Mad, Madden World

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On Monday, June 27, 2016, the Supreme Court of the United States denied the petition for certiorari in *Midland Funding LLC v. Madden*, No. 15-610. The Supreme Court's denial leaves intact the unusual – and troubling – decision by the U.S. Court of Appeals for the Second Circuit, *Midland Funding, LLC v. Madden*.[1] In that case, the Second Circuit held that the application of state usury laws to nonbank assignees is not preempted by Section 85 of the National Bank Act[2] (the "***NBA***"), but rather such assignees remain subject to state usury limits. The Second Circuit's decision suggests that a nonbank assignee of a bank-originated loan might not be able to collect the amount of interest contracted for by the originating national bank if the rate of interest exceeds the usury rate otherwise applicable to the assignee. See our June 8, 2015 memo, *Second Circuit Holds Application of State Usury Laws to Third-Party Debt Purchasers Not Preempted by National Bank Act*.

To understand the import of the *Madden* decision, it is critical to appreciate the complex patchwork of restrictions that comprise usury law in the United States. In the U.S., usury laws are established by the individual states. All but six states impose some form of numeric usury limit, and the rates vary widely from state to state. A state typically imposes multiple usury limits which can vary depending on the nature of the borrower, the purpose of the loan, the amount of the loan, and the nature of the collateral. While usury is often thought of as a *consumer* issue, slightly less than half the states have usury limits that apply to at least certain forms of *commercial* purpose loans, too (although the permitted limits are often higher than for consumer loans). Some usury rates are fixed by statute, other usury rates are tied to an index (such as the Discount Rate), and others are set periodically by the state bank commissioner. Applicable usury rates for moderately sized consumer loans can be as low as a 6% fixed rate, or 5% plus the Discount Rate. How usury is calculated – in particular, what fees are deemed to be part of "interest" – also varies from state to state. States often take the position – either by statute or by judicial interpretation – that the usury limit applies to

1 786 F.3d 246 (2nd Cir. 2015)

2 12 U.S.C. § 85.

loans made to residents of that state, and cannot be avoided by a choice-of-law clause because such limit reflects a fundamental public policy, at least with respect to consumer loans. The penalties for usury range from the lender (or holder) forfeiting excess interest, to the loan being deemed unenforceable, or possibly the imposition of criminal penalties.[3] As a result, lenders – in particular, consumer lenders – operating on a multistate basis face an enormous burden when complying with these state usury restrictions.

Rate Exportation by Banks

Banks are generally not subject to these limits when lending on a multistate basis. Section 85 of the NBA preempts borrower state usury law, permitting national banks to charge the rate of interest permitted by the law of the state where the bank is located notwithstanding another state's usury law. This concept is known as "rate exportation." A nearly identical statute was adopted in 1980 permitting rate exportation for state-chartered banks.[4] In litigation running from 1978 through 1996, banks successfully defended their right to export interest rates and related fees across state lines.[5] The ability to export rates and fees greatly simplifies the ability of banks to operate multistate loan programs without having to comply with the 50-state crazy quilt of usury laws.[6] The ability to export rates across state lines has grown exponentially more important with rapid expansion of multistate lending over the past thirty years, starting with mail-based credit card lending in the '80s and now, internet-based lending.

The Valid-When-Made Doctrine

Historically, whether a loan was deemed to be usurious is determined when the loan was originated. This concept – referred to as the "valid-when-made" doctrine – has been a fundamental tenet of usury law, and loan purchasers and assignees have long taken comfort that the loan is enforceable by its terms as long as the loan was not usurious when originated.[7] In sum, the ability of banks to export interest rates across state lines allows banks to originate loans bearing a higher rate of interest than allowed by the borrower's state law, and the valid-when-made doctrine permits the bank to sell the loan to a nonbank entity which can then collect the loan at the agreed upon rate of interest.

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[3] In addition, some states recognize "usury savings clauses" whereby the parties agree that the loan is intended to comply with the usury limits, and thus the rate should be written down to the limit if usury is deemed to exist.

[4] 12 U.S.C. § 1831d

[5] *See Marquette National Bank v. First of Omaha Serv. Corp.,* 439 U.S. 299 (1978); *Smiley v. Citibank (South Dakota),* 517 U.S. 735 (1996).

[6] Another advantage enjoyed by banks is that they are generally exempted or excluded from state loan licensing requirements.

[7] *See, e.g., Nichols v. Fearson,* 32 U.S. (7 Pet.) 103, 109 (1833) ("a contract, which, in its inception, is unaffected by usury, can never be invalidated by any subsequent usurious transaction"); *Gaither* v. *Farmers & Mechs. Bank of Georgetown*, 26 U.S. (1 Pet.) 37, 43 (1828) ("[T]he rule cannot be doubted, that if the note be free from usury, in its origin, no subsequent usurious transactions respecting it, can affect it with the taint of usury.").

The Second Circuit's decision in *Madden* raises the specter that assignees of bank-originated loans may no longer be able to rely on the valid-when-made doctrine when acquiring loans that have a nexus to the Second Circuit states (*i.e.*, New York, Connecticut, and Vermont). Admittedly, the Second Circuit did not *expressly* address the valid-when-made doctrine in its opinion; however, the Second Circuit was briefed on the valid-when-made doctrine and simply chose to ignore the doctrine. Rather, the Second Circuit couched the issue as one of preemption, concluding that Midland Funding, the holder of the bank-originated loans, was not entitled to claim preemption of state usury laws as could the originating national bank.

What's Next?

At this point, the *Madden* case is on remand to the District Court for continued proceedings, including whether the Delaware choice of law clause should be honored (thereby preventing application of New York's 16% usury limit), as well as Madden's claims under the Fair Debt Collection Practices Act and her request for class certification. Midland Funding will undoubtedly argue (again) that the valid-when-made doctrine renders the loans non-usurious because the loans were originated by a national bank located in Delaware, where the rate the bank levied on Madden (27%) is permissible, and that New York's usury law should incorporate the valid-when-made doctrine. Midland Funding will also be armed with the written legal analysis prepared by the Solicitor General and the Office of the Comptroller of the Currency ("**OCC**") before the Supreme Court, where the Solicitor General and the OCC repeatedly stated that the Second Circuit's decision was erroneous (but then ironically urged the Supreme Court not to grant the petition for certiorari). It is also hoped that the OCC will file as an amicus at the District Court proceedings, even though it chose not to do so in the prior Second Circuit proceedings.

The *Madden* decision has a number of important implications for lenders, assignees, and securitizers:

- Care should be exercised in acquiring bank-originated loans where (i) the borrower resides in a Second Circuit state (*i.e.*, New York, Connecticut, or Vermont), (ii) the loan has a choice of law or choice of venue clause referencing a Second Circuit state, or (iii) the originating bank is located in a Second Circuit state, if the rate of interest exceeds the otherwise applicable usury limit (generally, 16% in New York, 12% in Connecticut, and 18% in Vermont). This is especially true with respect to loans having a nexus to New York or Connecticut, where the applicable penalty for usury is voiding. Less concern applies to Second Circuit state loans where the underlying loan was originated by a licensed finance company rather than by a bank. This is because the *Madden* decision couched the issue strictly as one of NBA preemption, and thus the *Madden* holding does not appear to call into question the ability of holders of licensed loans to collect interest at the originally agreed rate.[8]

- Loan purchasers should revisit the representations in loan purchase agreements regarding the loan's compliance with usury laws, and should consider seeking a representation that any Second Circuit loan complies with the borrower state's usury laws without regard to rate exportation under either Section 85 of the NBA or Section 1831d of the Federal Deposit Insurance Act.
- Securitizers of consumer loans should update their risk factors to address the uncertainty created by the *Madden* decision, both inside and outside the Second Circuit.
- Commercial-purpose loans pose considerably lower risk under *Madden.* Not only do many states establish higher usury limits for, if not altogether exempt, such loans, many states have provisions that forbid business entities (including partnerships, corporations, and limited liability companies) from pleading usury. Some states impose lesser penalties for commercial usury violations. Most importantly, courts are much more likely to recognize a choice of law clause in a commercial loan transaction than in a consumer transaction.
- Some lenders – in particular marketplace lenders – have announced plans to modify origination practices such that the originating bank maintains an interest in the loan. This is in response to language in the *Madden* decision distinguishing a seemingly contrary Eighth Circuit decision, *Krispin v. May Department Stores,*[9] on the basis that the bank in *Krispin* retained an interest in the loan while the bank in *Madden* did not. It remains to be seen whether retention of a nominal interest in the originated loan would be sufficient to cause the Second Circuit to reach a different conclusion.
- Additional litigation should be expected. Already one class action has been filed citing *Madden* in the Southern District of New York– *Bethune v. LendingClub Corporation*.[10] While at least three circuit courts of appeals – the Fifth, the Seventh, and the Eighth – have issued decisions that are inconsistent with *Madden*, the remaining circuit courts have not expressly addressed the arguments posed in *Madden.* It is likely only a matter of time before plaintiffs' attorneys bring *Madden*-based litigation in those circuits, especially those circuits encompassing states that have low usury rates or impose stiff usury penalties. Loan purchasers therefore should be cognizant of applicable usury rates in states outside the Second Circuit, especially in those states for which the penalty for usury is the imposition of criminal sanctions or the voiding of the loan.

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[8] Licensed lenders are almost always exempted from the usury restrictions of that state's laws, but in turn are required to comply with any interest and fee restrictions typically imposed by the licensing statute.

[9] 218 F.3d 919 (8th Cir. 2000).

[10] No. 1:16-cv-02578 (S.D.N.Y.).

- The *Madden* holding should not be confused with a separate theory used to assert that bank-originated loans are usurious, known as the "true lender" theory. Under this theory, a bank-originated loan is not entitled to preemption of state usury laws by rate exportation if the bank is not deemed the "true lender" in the transaction. This theory is used primarily to assail loans that are originated by a bank that has only a limited connection with the credit transaction – for example, where the loan is sourced by a third-party nonbank entity, referred to the bank for funding, and then immediately re-sold to the third-party nonbank entity, a structure not uncommon with certain marketplace lenders. At least one appellate court – in West Virginia – has relied on the true lender theory to deem bank-originated loans usurious.[11] The true lender theory applies only to bank-originated loans where the bank has limited connection with the transaction, while the *Madden* holding can apply to any bank-originated loan once sold to a nonbank entity.

We hope that, upon remand, the District Court will recognize the absurd result suggested by the Second Circuit's opinion – that is, that a loan seemingly can be usurious or non-usurious depending on who owns the loan at any given time – and that the District Court instead concludes that a loan originated by an out-of-state national bank in full compliance with the law of the state where the bank is located, and thus non-usurious when made, will remain non-usurious in the hands of any subsequent holder.

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[11] *CashCall, Inc. v. Morrissey,* No. 12-1274, 2014 W. Va. LEXIS 587 (W. Va. May 30, 2014), *cert. denied,* 135 S.Ct. 2050 (Mem), 191 L.Ed.2d 956, 2014 WL 2404300, 2015 U.S. LEXIS 2991 (U.S., May 4, 2015). The true lender theory is the primary basis for the lawsuit against LendingClub in the *Bethune* case, mentioned previously. While the true lender theory has had limited success against bank-originated loans, the same theory has been more successful in assailing loans originated by tribal lenders that originate consumer lenders on behalf of third-party nonbank entities, and has resulted in settlements with a number of state attorneys general.