Financial Services & Products / Financial Services Litigation ADVISORY ■

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Second Circuit's *Madden v. Midland* Decision Could Upend Secondary Credit Markets

The Second Circuit Court of Appeals' May 22, 2015, decision in *Madden v. Midland Funding, LLC* held that a nonbank entity taking assignment of debts originated by a national bank is not entitled to protection under the National Bank Act (NBA) from state law usury claims. (*Madden v. Midland Funding, LLC*, No. 14-2131-cv, 2015 WL 2435657, at *1, *8 (2d Cir. May 22, 2015.)) The Second Circuit and the Southern District of New York both appear to have not considered the "Valid-When-Made Doctrine" – a longstanding principle of usury law that if a loan is not usurious when made, then it does not become usurious when assigned to another party.

The *Madden* holding could significantly disrupt secondary markets for consumer and commercial credit, impacting a broad cross section of financial services providers and other businesses that rely on the availability and post-sale validity of loans originated by national or state-chartered depository institutions. However, until the case on remand and the potential appeal play themselves out, the marketplace must deal with the uncertainties of the Second Circuit opinion and decide what actions to take, or not take, depending upon their business models. During this period of uncertainty (which could last up to a year), marketplace participants must also address what, if anything, to do about existing loans made in the Second Circuit (Connecticut, New York and Vermont) that are directly impacted by the holding.

The Court's Holding

In *Madden*, the Second Circuit addressed the rights of purchasers or assignees of loans to collect interest as set forth in the original note or credit agreement. Under the facts of the case, the credit was originated by a national bank, the card agreement specified Delaware law and the debt was later assigned to a nonbank debt buyer (Marine Midland).

There was no question that the interest rate contracted for by the national bank was lawful, even though it exceeded the 16 percent usury rate cap of the consumer-debtor's home state of New York, because the origination of the loan was a national bank with preemption over New York's usury ceiling. The Second Circuit acknowledged that Section 85 of the NBA permits national banks to charge interest at any rate permitted under the laws of the state in which it is located and to "export" that rate notwithstanding the state law of where borrowers are located. (State chartered banks have parallel rights under 12 U.S.C. § 1831d.) However, when the court addressed the question of whether the nonbank purchaser of the national bank's credit obligation could continue to charge the contract rate of interest, the conclusion was no. The application of state usury laws to the third-party assignee "would limit [ ] only activities of [a] third party which are otherwise subject to state control … and which are not protected by federal banking law or subject to [Office of the Comptroller of the Currency] oversight. (quoting *SPGGC, LLC v. Blumenthal*, 505 F.3d 183, 191 (2nd Cir. 2007)). The Second Circuit opined that allowing the assignee to enforce the credit agreement as written "would create an end-run around usury laws for non-national bank entities that are not acting on behalf of a national bank."

Impact of the Court's Decision

The *Madden* decision potentially has far-reaching ramifications. The entire secondary market for credit relies on the Valid-When-Made Doctrine to enforce credit agreements pursuant to their terms. Buyers of defaulted debt, like the defendant in *Madden*, generally will not have the same interest rate authority as the creditors selling such debt. Unfortunately, however, the same is true for securitization vehicles, hedge funds and other purchasers of whole loans, including those who purchase loans originated by banks pursuant to private-label arrangements and other bank relationships, such as those common to the peer-to-peer and marketplace lending industries and various types of online consumer credit.

Under the Second Circuit's decision in *Madden*, the liquidity and resale value of certain loan assets is uncertain and at risk.

What Has Happened Since May in the *Madden* Case?

The Madden case is pending in the Southern District of New York (White Plains Division) and is being handled by Judge Cathy Seibel. On June 19, Midland filed a petition for rehearing in the Second Circuit and was supported in that effort by amicus briefs filed by all of the financial services related industry groups. On August 12, 2015, the Second Circuit denied Midland's petition for panel rehearing, or in the alternative, rehearing en banc. [Order Denying Rehearing, No. 14-2131-cv, ECF No. 140 (2d Cir. Aug. 12, 2015)]. On August 21, the mandate was filed in the remanded case. On August 24, Judge Seibel set a scheduling conference in the case for September 9. Presumably, she will discuss with counsel the process and timing for deciding the remanded issue of whether the Delaware choice of law clause in Madden's credit card agreement controls or New York's usury law applies.

Midland has 90 days from August 12, the date the rehearing petition was denied, to file a certiorari petition to the U.S. Supreme Court requesting judicial review. It could take several months before we hear whether the certiorari is accepted, and that rarely happens.

In the meantime, the industry must deal with the risks and unknowns.

What Is the Industry Doing?

- Reviewing loan documents of varying loan types to analyze the risks to current portfolios of loans when the borrower or property is located in New York, Connecticut or Vermont.
- Understanding the legal effects (civil and criminal) under the laws of New York, Connecticut and Vermont of a loan being potentially usurious, the impact of any usury savings clauses and potential damages/fees.
- Contemplating changes to default servicing practices for loans that may be deemed usurious New York, Connecticut and Vermont.
- Considering risk disclosures about the potential import of the *Madden* holding.
- Analyzing choice of law clauses in the originating bank contracts (e.g., Delaware or Utah) to determine whether these clauses would be enforced in New York, Connecticut and Vermont.
- Monitoring the progress of the *Madden* case on remand.
- Deciding best practices for new loans being made in New York, Connecticut and Vermont in terms of whether to buy, on what terms and potential structural transaction changes to mitigate risk.
- Considering the implications of the lending framework to jurisdictions outside the Second Circuit.

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