FDIC and OCC Attempt to Settle Uncertainty Created by Second Circuit's *Madden* Decision

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The FDIC and OCC have each issued a proposed rulemaking to clarify that when a bank[1] sells, assigns or otherwise transfers a loan, interest permissible prior to the transfer continues to be permissible following the transfer.

The proposed rules are intended to address—at least partially—the uncertainty created by the US Second Circuit Court of Appeals' 2015 decision in *Madden v. Midland Funding, LLC*, which called into question longstanding "valid-when-made" and "stand-in-the-shoes" principles relied upon by loan originators, securitizers and investors. The proposed rules, however, may not completely resolve the ambiguity that the *Madden* decision created, even if finalized. The proposed rules would not directly overturn *Madden* and, as a result, their significance may ultimately turn on how much deference courts are willing to give the agencies. Interested stakeholders may submit comments on the proposals within 60 days following their respective publication in the Federal Register.

Key takeaways	
What the proposed rules would do	▪ Codify the agencies' long-held interpretation of federal law that non-usurious loans originated and then transferred from a bank to a non-bank entity could not then be deemed usurious under state usury restrictions. ▪ Make this clarification for national and state-chartered banks and the US branches of non-US banks.
What the proposed rules would *not* do	▪ Overturn the Second Circuit's *Madden* decision. ▪ Constitute legislative action to invalidate *Madden* or otherwise amend the National Bank Act, which *Madden* interpreted, or similar FDIC authority. ▪ Address the "true lender" doctrine that some courts use to evaluate the substance and economic reality of a lending arrangement to determine the actual lender. ▪ Preclude the Second Circuit or other courts from finding that the proposed rules are incorrect interpretations and implementations of federal law. ▪ Promote or endorse the practice of partnering with a bank for the *sole* goal of evading a lower interest rate and related requirements, which the agencies continue to view unfavorably.

[1] *E.g.*, a national bank, savings association, state-chartered bank, or a branch of a non-US bank.

Rationale for the proposed rules

The proposed rules seek to address confusion that the *Madden* decision caused concerning a loan's permissible interest rate when a bank originates the loan and then assigns it to a third-party non-bank entity. Federal law permits banks, both national and state-chartered banks, to charge interest at the maximum rate permitted to any state-chartered or licensed lending institution in the state where the bank is located, regardless of the location of the borrower. Federal law also explicitly authorizes banks to enter into contracts, and, inherent in that power, to assign those contracts. A bank's ability to both originate and assign loans is a core underpinning of US loan and securitization markets.

The proposed rules seek to clarify the agencies' view that interest permissible on a loan when originated by a bank is not affected by the bank's sale, assignment or other transfer of the loan. In other words, the interest permissible for the bank to charge prior to the sale, assignment or other transfer will continue to be permissible following such transfer, regardless of whether the assignee would be permitted to charge such interest if it were the originator of the loan. The agencies point to several longstanding pre-*Madden* legal principles and policy arguments as support:

1. **Valid-when-made**. The US Supreme Court has recognized, since at least 1833, the common law doctrine that provides that a non-usurious loan at origination does not become usurious by its subsequent assignment. An assignee (and any subsequent assignee), therefore, has the right to charge the same interest rate that the assignor (*i.e.*, the original creditor) charged the borrower in accordance with a loan agreement that was *valid when made*.

2. **Assignment authority**. Banks rely on the valid-when-made doctrine to know that they will be able to sell, assign or otherwise transfer a loan on its original terms, including the interest rate. A bank's lending appetite may be unduly curtailed if the bank cannot be certain that interest permissible prior to the transfer will remain permissible after the transfer. The agencies recognize that banks routinely rely on the ability to assign and securitize loans as a means to access alternative funding sources, manage concentrations, address interest rate risk, improve financial performance ratios and more efficiently meet customer needs. A bank's ability to deploy these risk management tools would be significantly weakened if the permissible interest on loans, once transferred, were uncertain or if assignment of the permissible interest were limited only to third parties that would be subject to the same or higher usury caps. Such limitations could ultimately affect the safety and soundness of banks.

3. **Interstate banking**. The agencies point to statutory provisions intended to facilitate a bank's ability to operate across state lines by eliminating the burden of complying with interest laws on a state-by-state basis. Limiting the reach of such statutes to apply only to loans that a bank holds on its books would undermine the statutes' purpose and be inconsistent with the "valid-when-made" principle and assignment authorities.

Of note, and as discussed further below, the proposed rules do not address the question of whether a bank is the real party in interest or has an economic interest in the loan (*i.e.*, the "true lender") under state law with respect to a loan that the bank originates and subsequently assigns in whole or in part.

The *Madden* decision

The proposed rules were precipitated by the 2015 *Madden* decision, which called into question the enforceability of interest rates of loan agreements following assignment from a national bank to a non-bank entity.[2] In deciding that a debt collector that purchased charged-off consumer (credit card) loans from a national bank was not entitled to rely on the National Bank Act's federal preemption of New York's usury law to the same extent as the originating national bank, the Second Circuit in *Madden* reached two particularly significant conclusions of law that have reverberated through the market.

- First, the Second Circuit found that application of New York's usury law to the non-bank debt collector "would not significantly interfere with any national bank's ability to exercise its powers under the [National Bank Act]." Under the Supremacy Clause of the US Constitution, however, federal law displaces, or preempts, state law whenever federal law and state law conflict. Typically, courts have broadly construed the preemptive effect of the National Bank Act and the OCC's implementing

2 *Madden* concerned the assignment of a loan by a national bank. However, the uncertainty created by the decision extended to state-chartered banks, as the federal law provisions governing state banks' authority with respect to interest rates are modeled after and interpreted consistently with corresponding sections of the National Bank Act.

regulations over state laws that significantly interfere with a national bank's exercise of its enumerated or incidental powers. The Second Circuit, however, did not find such significant interference in *Madden.*

- Second, the *Madden* decision implies that the preemptive effect of the National Bank Act extends to non-bank entities only when they are "acting on behalf of a national bank in carrying out the national bank's business." The Second Circuit reasoned that because the national bank that originated the loan did not have or exercise any control over the third-party debt collector that subsequently purchased the loan, the debt collector was acting on its own behalf (rather than the bank's) in attempting to collect the outstanding loan obligation, and therefore, the National Bank Act did not preempt the application of New York's usury laws. Generally, whether federal preemption is available to a third party does not depend on the relationship between the third-party loan purchaser and the national bank loan seller; rather, a preemption analysis evaluates the effect that applying a state law to the third party would have on the national bank's business.

Additionally, *Madden* did not address the "valid-when-made" doctrine. While the "valid-when-made" doctrine is distinct from the issue of federal preemption considered by the Second Circuit, the two doctrines have been concurrently invoked by several federal courts in the context of the National Bank Act to preempt the application of state usury law. In addition, an argument can be made that the "valid-when-made" doctrine is part and parcel of the National Bank Act and necessarily buttresses any preemption analysis.

Uncertainty resulting from *Madden*

The *Madden* decision created significant uncertainty and a lack of uniformity within the secondary market for purchasers of and other investors in bank-originated loans, and had a collateral effect on the primary market involving bank-originated loans that rely on the secondary market for bank liquidity and funding needs. In light of the *Madden* ruling, non-bank purchasers began to reconsider purchasing loans from banks in the Second Circuit states (*i.e.*, New York, Connecticut and Vermont) that exceed state usury caps, or to restructure such purchases. Loans with interest in excess of state usury limits could be deemed uncollectible in the hands of such non-bank parties, and could expose such parties to liability under state criminal usury laws. In addition, the *Madden* decision affected securitization activities, as many securitizers that purchase loans originated by banks became wary, along with investors, of loans originated in New York, Connecticut or Vermont.

The *Madden* decision also increased legal and business risks for marketplace lending and bank-non-bank lending partnerships, adding to the uncertainty faced by such partnerships from the "true lender" questions discussed below. In addition, at least one academic study has found a chilling effect on credit availability in the Second Circuit states. Hopes of a relatively quick judicial resolution were dashed when the US Supreme Court declined to hear a *Madden* appeal in June 2016, and despite critiques of *Madden* by the Obama and Trump Administrations, federal banking agencies, certain members of Congress, and industry, *Madden* remains in force in the Second Circuit. Those generally in favor of the *Madden* ruling include consumer advocates and certain state regulatory bodies.

Implications of the proposed rules by market segment

Market segment	Implications
Banks	• May provide more certainty to banks as originators of loans that benefit from federal preemption of state usury laws that there will be a secondary market for such loans. • May reduce need to maintain different procedures when assigning loans with Second Circuit nexus. • May provide some additional certainty as to permissible structures of non-bank fintech partnerships (although "true lender" issues persist).
Non-bank fintechs	• May provide more certainty as assignee of loans from banks in bank-fintech partnership models, and when subsequently assigning the loans downstream. • May reduce need to pursue different deal structures when loans have a Second Circuit nexus.

	• May provide some additional certainty as to permissible structures of non-bank fintech partnerships (although “true lender” issues persist).
Non-bank debt purchasers	• May provide more certainty as assignee of loans from banks, and when subsequently assigning these loans downstream. • May reduce need to conduct due diligence regarding whether loans have a Second Circuit nexus. • May reduce need to pursue different deal structures when loans have a Second Circuit nexus.
Securitization desks and investors	• May provide more certainty as assignee of loans from banks. • May reduce need to conduct due diligence regarding whether loans have a Second Circuit nexus. • May reduce need to pursue different deal structures when loans have a Second Circuit nexus.

Additional considerations

“True lender” uncertainty remains

While the proposed rules seek to remediate the legal uncertainty resulting from the *Madden* decision, the agencies explicitly do not address the validity of certain bank-fintech partnership models that remain subject to “true lender” challenges and regulatory scrutiny.[3] The “true lender” issue has arisen in the context of certain lending arrangements between a bank and a non-bank entity, which critics have described as “rent-a-charter” or “rent-a-bank” schemes. These critics argue that a “rent-a-charter” model—in which the non-bank entity typically markets the loan, makes the credit decision and directs its bank-partner to originate and temporarily hold such loan before purchasing it from the bank—improperly permits the non-bank entity to benefit from the broad protection of the exportation doctrine as to the loan’s interest rate and to claim its own exemption from applicable state lender licensing and usury limits by not acting as the lender. These critics believe that the non-bank entities should be considered the “true lender” in the transactions because the bank is not sufficiently engaged in the lending program and does not receive the benefits or take the risks expected of a true lender. However, such a structural view of bank-fintech partnerships may be overly simplistic. In practice, the nature of such partnerships is nuanced and their structures can be highly variable on a case-by-case basis.

The origin of the “true lender” challenge can be traced back to the Georgia legislature’s efforts in 2004 to prevent certain payday lenders from circumventing state’s usury laws by entering into lending programs with out-of-state banks. Since then, private plaintiffs and state regulators have pursued “true lender” challenges against various bank-partnership programs beyond payday lending for violations of state usury and consumer protection laws. As a result, some courts have started to examine the economic realities of such lending arrangements by considering a variety of factors designed to determine which entity is the actual lender in the transaction. While courts have adopted differing analytical approaches, their analyses generally seek to determine which of the bank or its non-bank partner holds the “predominant economic interest” in the loan and is, thus, the “true lender.”

Similar to *Madden*, “true lender” litigation significantly increases legal and business risks for non-banking entities purchasing loans originated by banks. If successful, a “true lender” challenge exposes the non-bank entity to significant penalties for usury and unlicensed lending as well as threatens the validity and enforceability of the loan under state law. In an effort to mitigate such risks, non-bank and bank partners have moved towards more participation-based partnership structures in which the bank only sells a participation interest up to a certain percentage of the loan receivables to the non-bank partner. While increased bank involvement in the lending program provides a better fact pattern to defend against “true lender” challenges, the lack of formal agency guidance or rulemaking concerning true lender issues perpetuates legal uncertainty for banks and non-banks that participate in such lending arrangements.

3 The FDIC’s proposal specifically states that the agency continues to view “unfavorably” the practice of partnering with a bank for the *sole* goal of evading a lower interest rate cap and state licensing requirements. This policy is consistent with positions taken by the OCC.

Legislative outlook

Several attempts were made in the last Congress to pass legislation to remediate the legal uncertainty created by *Madden*. Of note, the Financial CHOICE Act (H.R.10) and the Protecting Consumers' Access to Credit Act (H.R.3299), both introduced in 2017, would have invalidated the *Madden* decision and made the "valid-when-made" doctrine federal law for loans made under various federal statutes by regulated financial institutions.[4] Despite gathering significant support, proposed legislation to fix the *Madden* decision stalled in the Senate.

More recently, the US Treasury Department called for a legislative solution to the *Madden* decision in a July 2018 report recommending that Congress enshrine the "valid-when-made" doctrine in federal law and specify that a partnership with a fintech firm does not negate the bank's status as the "true lender." Federal legislation would likely offer the most definitive means to provide a clear and well-settled standard for the treatment of bank-fintech origination models. Given the current environment in Congress, however, it is unlikely that *Madden* or "true lender" legislation would gather sufficient bipartisan support to become law in the near term. While not as effective as legislative action, the proposed rules would nevertheless offer an improved, albeit imperfect, basis on which industry participants may reasonably rely to challenge *Madden*-type claims.

4 Similar efforts were made to provide a legislative fix to the "true lender" challenge. Such efforts, however, also failed to gather sufficient support in Congress.

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