Madden Update – Petition Request Bodes Well for High Court Review but Raises New Questions

March 2016

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The US Supreme Court's recent request for an opinion from the US Solicitor General to help inform the Court's decision on whether to review the Second Circuit's decision in *Madden v. Midland Funding, LLC* indicates that the Court may be inclined to decide, once and for all, whether a non-bank assignee of a bank-originated loan is allowed to step into the shoes of the bank when enforcing terms of the loan in accordance with the agreement between the bank and borrower.

On March 21, 2016, the US Supreme Court asked the US Solicitor General to provide an opinion on a petition for writ of certiorari in an important case for banks and marketplace lenders that is currently pending before the Court. The petition for certiorari at issue was filed by Midland Funding, LLC, one of the nation's largest delinquent debt purchasers, and its affiliates (collectively, "Midland") on November 10, 2015, asking the court to review the Second Circuit Court of Appeal's decision in *Madden v. Midland Funding, LLC* (hereinafter "*Madden*").[1] The Second Circuit's decision in *Madden*, which held that an assignee of consumer (credit card) loans originated by a national bank could not invoke federal preemption pursuant to the National Bank Act to defend a state law usury claim, reversed the ruling of the US District Court for the Southern District of New York on the matter and created a circuit split regarding the issue of whether a loan that is non-usurious at inception can become usurious in the hands of a non-bank assignee. In addition, the *Madden* decision unsettled a relatively well-established body of law that stipulates that loan assignees step into the shoes of the lender and are entitled to enforce the rights of the lender pursuant to agreement terms determined at the time the loan is made.

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

The Supreme Court's decision to solicit a brief from the Solicitor General expressing the views of the United States is significant for several reasons. First, the practice of inviting the Solicitor General to file a brief analyzing the petition for certiorari requires a vote of the Justices and is rarely invoked,[2] which indicates that the Justices have concluded that the issue(s) presented are significant and should be carefully considered in light of the views of the United States. Petitions for certiorari are approximately 47 times more likely to be granted in cases where a brief has been requested from the Solicitor General, and the Solicitor General's recommendation on whether review should be granted is typically, but not always, followed.[3]

In addition, the Court's decision indicates that it is interested in clarifying the scope and applicability of the National Bank Act's preemptive powers to non-bank assignees. The underlying issue presented in *Madden*—whether a non-bank assignee of a loan originated by a national bank is subject to state law usury restrictions that are inapplicable to the national bank assignor—implicates two fairly distinct legal principles: the Constitutional principle of federal preemption and the common law usury principle known as the "valid-when-made" doctrine.[4] By requesting the views of the United States, which are typically solicited only in cases involving complex statutory systems, national policy goals or interests of the federal government,[5] the Supreme Court has indicated that the preemptive effect of the National Bank Act is dispositive to the issue presented and that the opinion of the United States should be considered in reaching a decision.

The import of the *Madden* case is significant for both banks and nonbanks that have a substantial interest in transactions involving the sale or purchase of loans. If the Second Circuit's holding is left undisturbed or unclarified, the disruption that the *Madden* decision has already caused will continue to impede the efficient functioning of the primary and secondary lending and debt sales markets. By reaching the seemingly untenable result that the terms of a loan agreement are amorphous and susceptible to change depending on the nature of the creditor's assignee, the *Madde*n decision could potentially negate the enforceability of loans originated by national banks and subsequently purchased by and/or assigned to non-bank entities.

Background – The Controversial *Madden* Decision

The Second Circuit's holding in *Madden* created significant uncertainty 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 reaching its decision 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 reached two particularly concerning conclusions of law.

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]."[6] The constitutional principle of federal preemption posits that federal law displaces, or preempts, state law whenever federal law and state law conflict.[7] Typically, courts broadly construe the preemptive effect of the

2 The views of the Solicitor General are requested in only about a dozen cases per term, whereas upwards of 8,000 petitions for writ of certiorari are filed per term. David C. Thompson & Melanie F. Wachtell, *An Empirical Analysis of Supreme Court Certiorari Petition Procedures: The Call for Response and the Call for the Views of the Solicitor General*, 16 Geo. Mason L. Rev. 237, 242 (2008-2009).

3 David C. Thompson & Melanie F. Wachtell, *An Empirical Analysis of Supreme Court Certiorari Petition Procedures: The Call for Response and the Call for the Views of the Solicitor General*, 16 Geo. Mason L. Rev. 237, 245 (2008-2009).

4 The Second Circuit's decision solely considered whether the National Bank Act's preemptive authority over state law usury restrictions extends to non-bank assignees without addressing whether the "valid-when-made" doctrine applied to the transaction at issue.

5 David C. Thompson & Melanie F. Wachtell, *An Empirical Analysis of Supreme Court Certiorari Petition Procedures: The Call for Response and the Call for the Views of the Solicitor General*, 16 Geo. Mason L. Rev. 237, 279 (2008-2009).

6 *Madden*, 786 F.3d at 251.

7 Under the Supremacy Clause of the Constitution, federal law may preempt state or local law in three different ways: (1) Congress may explicitly displace state law ("express preemption"); (2) preemption may be inferred when federal regulation in a particular field is "so pervasive" that Congress appears to have left no room for the states or localities to supplement it ("field preemption"); and (3) preemption may be implied when state law conflicts with federal law

National Bank Act, and its implementing regulations, which negate the application of any state law that "significantly interferes with [a] national bank's exercise of its [enumerated or incidental] powers."[8]

In *Madden*, the Second Circuit noted that the National Bank Act grants national banks the power, albeit incidentally, to pursue collection of delinquent accounts by selling the debt to buyers for a fee.[9] The court ruled squarely and exclusively on the facts at issue, but failed to ascertain the potential effect its ruling could have on the ability of banks to sell delinquent loans in the secondary market. Instead, the court summarily concluded that "such application would limit only activities of the third party which are otherwise subject to state control."[10] Given that non-bank purchasers will be unable to enforce the terms of a loan according to the original agreement between the bank and borrower, *Madden*'s application of state usury laws to non-bank loan assignees has already impacted and, if left undisturbed, could further affect the market for purchasers of bank loans as well as related activities, such as securitizations and bank loan programs with third parties involving an originate-to-sell model. As noted by Midland in its petition to the Supreme Court, it is difficult to comprehend how the Second Circuit concluded that its decision would not have the effect of allowing state law to interfere, albeit indirectly, with enumerated and incidental powers of national banks.

Second, the Second Circuit's decision in *Madden* 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."[11] The court reasoned that since the national bank that originated the loan at issue did not have or exercise any control over the actions of Midland, a third-party (i.e., unaffiliated) debt collector that subsequently purchased the loan, the National Bank Act does not preempt the application of state usury laws because Midland was acting on behalf of itself rather than the bank in attempting to collect the outstanding loan obligation pursuant to the terms of the original loan agreement. However, as highlighted in Midland's petition for certiorari, the Second Circuit did not apply the proper focus in its preemption analysis.[12] Whether federal preemption is available to a third party should not depend on the structural relationship between the third-party loan purchaser and the national bank loan seller; rather, the focus of a preemption analysis should be based on the *effect* that applying a state law to the third party would have on the national bank's business.[13]

Additionally, the *Madden* decision completely ignored the well-established common law principle that upholds an assignee's right to charge the same interest rate that the assignor (original creditor) charged the debtor in accordance with a loan agreement that was valid when made (the "valid-when-made" principle). In *Olvera v. Blitt & Gaines*, a case comprised of facts very similar to those presented by *Madden*, the Seventh Circuit Court of Appeals concluded that the common law of assignments prevented Illinois law from "impos[ing] statutory interest ceilings on assignees of creditors who are authorized to charge interest rates higher than those ceilings."[14] Judge Posner of the Seventh Circuit also noted that prohibiting the purchaser of delinquent debt from charging the same rate of interest that the original creditor permissibly charged the debtor would

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("conflict preemption"). *Barnett Bank v. Nelson*, 517 US 25, 31 (1996). Conflict preemption may arise when federal law "irreconcilably conflicts" with state law, such as when compliance with both federal and state law is physically impossible, or when state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Barnett Bank v. Nelson*, 517 US 25, 31 (1996).

8 *Barnett Bank v. Nelson*, 517 US 25, 31 (1996); *see also Watters v. Wachovia Bank*, 550 US 1, 18 (2007) ("[I]n analyzing whether state law hampers the federally permitted activities of a national bank, we have focused on the exercise of a national bank's powers, not on its corporate structure.).

9 *Madden*, 786 F.3d at 251 (quoting OCC Bulletin 2014–37, Risk Management Guidance (Aug. 4, 2014), *available at* http://www.occ.gov/news-issuances/bulletins/2014/bulletin-2014-37.html) ("Banks may pursue collection of delinquent accounts by . . . selling the debt to debt buyers for a fee.").

10 *Madden*, 786 F.3d at 251.

11 *Madden*, 786 F.3d at 251.

12 Petition for Writ of Certiorari at 18, *Midland Funding, LLC v. Madden*, No. 15-610 (US petition for cert. filed Nov. 10, 2015).

13 *Id.* An interesting departure from the current analysis of the case would be if the Court decides to rely on language added to the National Bank Act by the Dodd-Frank Act providing that the National Bank Act does not preempt "the applicability of state law to a subsidiary, affiliate or *agent* of a national bank" (emphasis added). 12 USC. § 25b(h)(2). The Court, in *Madden*, could look to the language of Section 1045 either as an expression of congressional intent to limit the availability of federal preemption beyond a national bank itself (i.e., regardless of the effect on the bank's business) or to narrow what, in the Court's view, is the legitimate scope of the bank's business for federal preemption purposes.

14 *Olvera v. Blitt & Gaines, PC*, 431 F.3d 285 (7th Cir. 2005).

only “make the credit market operate less efficiently.”[15] While the “valid-when-made” principle 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.[16] Furthermore, an argument can be made that the “valid-when-made” principle is part and parcel of the National Bank Act and necessarily expands its preemptive scope.[17]

Current Status

Foreseeing the significant effect that the *Madden* decision could have on the primary and secondary loan markets if left undisturbed or unclarified, various banking and financial institution associations—including The Clearing House Association L.L.C., The American Bankers Association, The Loan Syndications and Trading Association, and ACA International—filed amicus curiae briefs in December 2015 in support of Midland’s petition urging the Supreme Court to review the Second Circuit’s ruling in the case.[18] Reasons cited by an amicus curiae group in favor of review were that the “circuit split created by the [*Madden* decision] disrupts the national uniformity critical to the efficient operation of the banking system” and the “practical effects on the secondary and primary loan markets are wide-ranging and potentially catastrophic.”[19] Another amicus curiae group argued that the *Madden* decision “upsets long-settled expectations concerning usury law and thus threatens disarray in the marketplace” and “creates serious problems for the availability and pricing of credit and the efficient functioning of the credit markets,” further noting that the Second Circuit’s decision is “*already* affecting the ability of market participants to sell and securitize loans.”[20]

ACA International, another amicus curiae that represents the interests of third-party collection agencies, asset buyers, attorneys, creditors and vendor affiliates, asserted that the “National Bank Act is ‘an enabling statute, not a restraining one,’ whose purpose is to foster a robust national credit market”; the “national credit economy depends on the credit-and-collection industry, whose efficient operation depends on a secondary market in hard-to-collect debt,” and the “Second Circuit’s decision will hamper the flow of credit, and disadvantage both national banks and their customers.”[21] In particular, Midland and its amicus curiae emphasized to the Supreme Court that the Second Circuit violated the “cardinal rule of usury” when it subjected loans issued and later sold by national banks to restrictions following the sale based on state interest rate laws.

If the Supreme Court chooses not to grant certiorari, the *Madden* case will be remanded back to the US District Court for the Southern District of New York to resolve the remaining choice-of-law issue identified by the Second Circuit. Although Delaware was designated as the governing law pursuant to a choice-of-law provision in the loan agreement, the borrower resided in New York and brought the usury claim under New York law, so if certiorari is not granted (or if the Supreme Court affirms that federal preemption does not apply) the District Court will have to determine whether Delaware or New York law applies without regard to federal preemption. Determinations on the enforceability of choice-of-law provisions are generally fact-specific, and even when a choice-of-law provision purports to govern a consumer loan agreement, courts may apply the consumer’s home state law on public policy grounds. Therefore, a subsequent finding by the District Court that Delaware law applies would give little, if any, comfort to assignees attempting to enforce loan agreements with borrowers located in states other than the state designated by contract (which usually has a usury statute, if any, favorable to the lender).

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15 431 F.3d at 288.

16 *See FDIC v. Lattimore Land Corp.*, 656 F.2d 139, 148–49 (5th Cir. 1981) (invoking the “cardinal rule in the doctrine of usury” that “[t]he non-usurious character of a note should not change when the note changes hands” to exempt loan from state usury law and accordingly finding it unnecessary to determine whether same result would occur under analysis of National Bank Act).

17 Borrowing from Judge Posner’s line of reasoning in *Olvera*, in its petition for writ of certiorari, Midland asserted that the National Bank Act necessarily “incorporates the principle that an interest rate set by an originating bank cannot be invalidated by a subsequent assignment of the loan” because “Congress legislated against that common-law backdrop.” Petition for Writ of Certiorari at 15, *Midland Funding*, No. 15-610.

18 *See* Brief for ACA Int’l as Amicus Curiae Supporting Petitioner, *Midland Funding*, No. 15-610; Brief for Am. Bankers Ass’n, et al. as Amici Curiae Supporting Petitioner, *Midland Funding*, No. 15-610; Brief for Clearing House Ass’n, et al. as Amici Curiae Supporting Petitioner, *Midland Funding*, No. 15-610.

19 Brief for Am. Bankers Ass’n, et al. as Amici Curiae Supporting Petitioner, *Midland Funding*, No. 15-610.

20 Brief for Clearing House Ass’n, et al. as Amici Curiae Supporting Petitioner, *Midland Funding*, No. 15-610 (emphasis added).

21 Brief for ACA Int’l as Amicus Curiae Supporting Petitioner, *Midland Funding*, No. 15-610.

The uncertainty of the federal appellate process has already prompted participants in the primary and secondary loan markets to negotiate for and implement protections in their loan sale and purchase structures to guard against so-called "*Madden* risk," i.e., the risk that the Second Circuit's May 2015 decision is left to stand. On February 26, 2016, Lending Club, the world's largest online marketplace connecting borrowers and investors, announced changes to its business model with WebBank (Lending Club's issuing, or "sponsor," bank) to mitigate the risk that state usury laws could be found to apply to non-bank assignees of bank-originated loans.[22] Lending Club stated that the reason for implementing such changes was to "provide additional investor protection and maintain access to affordable credit in light of concerns created by the *Madden vs. Midland* decision rendered by the Second Circuit Court of Appeals in May last year."[23] Thus, while the *Madden* decision has already prompted a shift in—and certain changes to—practices within the markets for loan sale and purchase transactions, such that a Supreme Court decision to grant certiorari may reinstate uncertainty in the short term (i.e., by calling into question any changes already implemented to address *Madden* risk), review of the Second Circuit's decision will provide much-needed guidance and certainty for the loan markets in the long term by clarifying the scope of federal preemption and the viability of the "valid-when-made" principle that forms the bedrock of the secondary loan market.

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[22] Lending Club Press Release dated Feb. 26, 2016, *Lending Club Enhances Relationship with Issuing Bank*, available at http://ir.lendingclub.com/file.aspx?IID=4213397&FID=33116294. As noted in the press release, "[u]nder the enhanced program structure, the issuing bank maintains an on-going economic interest in all loans made after they are sold … [and the] bank maintains an ongoing contractual relationship with borrowers, who may seek additional credit through the Lending Club program in the future." *Id*.

[23] *Id*.

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