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Madden Uncertainty Remains for Secondary Loan Market

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The US Supreme Court last week delivered another blow to the unsteady secondary loan market industry by denying a request for certiorari in an important case for banks and buyers and sellers of loans and other debt obligations.[1] 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*").[2]

The Second Circuit's decision in *Madden* 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 asserted against it, reversing the ruling of the US District Court for the Southern District of New York on the matter. The Second Circuit decision also ignored the "valid-when-made" principle, a relatively well-established body of law that stipulates that loan assignees step into the shoes of the lender (assignor) and are entitled to enforce the rights of the lender pursuant to the terms of agreement at the time the loan is made.

When the Second Circuit's decision in *Madden* was issued in May 2015, it created significant uncertainty regarding the issue of whether a bank-originated loan that is non-usurious at inception can become usurious in the hands of a non-bank assignee.

The implications of the Second Circuit decision raised a number of issues impacting a variety of financial institutions, including banks and other participants in the secondary loan market. As a result, participants in the secondary loan market closely followed developments in the case and filed amici briefs in support of Midland's petition for certiorari which set forth compelling reasons regarding the need for the Supreme Court's review and guidance.[3]

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The importance of the *Madden* decision was further highlighted by the Supreme Court's request for views of the Solicitor General in considering Midland's petition for certiorari.[4] Specifically, in considering whether to grant or deny the request for certiorari, the Supreme Court requested the Solicitor General to submit a brief providing the views of the United States on whether certiorari should be granted.[5] With the support of the Office of the Comptroller of the Currency ("OCC") (the regulator of national banks), the Solicitor General responded with a brief on May 24, 2016, arguing that the preemptive effect of the National Bank Act extends to loan assignees of national banks but nevertheless recommending that the Court deny certiorari.[6] Given that the Court almost always follows the Solicitor General's recommendation on whether review should be granted,[7] the Court's decision to deny certiorari was anticipated by Court and industry observers.

Notwithstanding that the Court denied certiorari, negating the possibility that the *Madden* decision would be overturned in 2016, the Solicitor General's brief to the Court should provide some comfort to banks and loan assignees that the Second Circuit's ruling in *Madden* will <u>not</u> become the law of the land and will present significant challenges for any other court seeking to rely on the Second Circuit's decision as precedent. In particular, the Solicitor General, joined by the OCC, strongly disavowed the Second Circuit's holding, stating that the "court of appeals' decision [in *Madden*] is incorrect."[8] The Solicitor General further affirmed that loan assignees of national banks are allowed to charge the same rate of interest previously agreed upon by the borrower and the national bank by reason of the federal preemption standard articulated in *Barnett Bank of Marion County v. Nelson,*[9] the preemption standard affirmed by the Dodd-Frank Act.[10]

Thus, given that the United States is of the view that the National Bank Act preempts the application of state usury laws that would prohibit a non-bank loan assignee from enforcing a loan at the same rate of interest that the national bank loan assignor was permitted to charge, there is a considerable basis for doubting that future courts will reach the same conclusion as the Second Circuit going forward. Nonetheless, in failing to provide nationwide, binding precedent to settle the issue once and for all, the Court's decision to deny Midland's petition perpetuates the continuing uncertainty for marketplace lenders and other buyers and sellers of bank loans and other debt.

Effect of the Supreme Court's Decision and the Path Forward

Because the Supreme Court turned down the request for certiorari, the *Madden* case will now be remanded 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.[11] Although Delaware was designated as the governing law pursuant to a choice-of-law provision in the loan agreement at issue, the borrower resided in New York and brought the usury claim under New York law.[12] The Second Circuit did not decide that issue and, thus, the District Court now has to determine whether Delaware or New York law applies. Although the Solicitor General is of the opinion that "[Midland] will likely prevail on remand if the district court accepts their reading of the credit-card agreement,"[13] determinations on the enforceability of choice-of-law provisions are generally fact-specific. For example, courts sometimes apply the consumer's home state law on public policy grounds even when a choice-of-law provision purports to govern a consumer loan agreement.[14] Therefore, a finding by the District Court that Delaware law applies would provide little, if any, comfort to assignees attempting to enforce loan agreements with borrowers located in states other than the state designated by the terms of the contract (which typically has a usury statute, if any, favorable to the lender). On the other hand, if the District Court finds that New York law applies, such a ruling would highlight the significant and prohibitive consequences for a non-bank assignee of potentially being subject to criminal usury laws due to an inability to rely on the loan originator's/assignor's right to charge the rate of interest that is specified in the loan agreement.[15]

While the Supreme Court's denial of Midland's petition for certiorari may have been disappointing to some in the industry, it was not a complete surprise, as industry participants have had some time now, particularly in recent months, to make contingency plans to promote business certainty. Specifically, the uncertainty surrounding *Madden* 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 holding in *Madden* is left to stand. These provisions include both legal and business/operational changes. On February 26, 2016, Lending Club, an online marketplace lender, 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.[16] 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 [v.] Midland* decision rendered by the Second Circuit Court of Appeals in May last year."[17]

While Supreme Court review of *Madden* could have provided greater clarity for secondary market loan purchasers and others on the scope of federal preemption under the National Bank Act, as well as certainty for loan markets in the longer term, the Solicitor General's brief should provide some comfort to the industry that *Madden* will not likely be viewed as binding law with a broad effect going forward. Should a future court be asked to decide a case similar to *Madden*, the arguments set forth in the Solicitor General's brief provide a sound basis for the deciding court to reach an outcome that is contrary to, or can be distinguished from, the Second Circuit's holding. In particular, the Solicitor General's brief provides a persuasive preemption analysis that the court could rely on in holding that non-bank assignees of national bank-originated loans stand in the shoes of the bank assignor and thus are entitled to federal preemption pursuant to the National Bank Act.

Of particular note, should another federal court of appeals reach a decision that *does* present a direct conflict with existing law[18] regarding the ability of an assignee to step into the shoes of the assignor in enforcing loan terms, the question of whether the National Bank Act continues to have preemptive effect after an originating national bank has sold or otherwise assigned a loan to another (non-bank) entity may again be presented to the Supreme Court for review. Faced with such a circuit split, the Court would be more likely to exercise its discretionary jurisdiction and grant certiorari. Until a case with such attributes winds its way through the judiciary system, however, the legal conclusions set forth in the Solicitor General's brief may moderate the impact of *Madden* in the secondary loan market. Ultimately, of course, the solution desired by the secondary loan market industry is for the courts to provide greater business certainty for loan assignors and assignees by holding that assignees may enforce the terms of loan agreements between a national bank and borrower, regardless of whether the party ultimately seeking to enforce those terms is a non-bank third party.

Next Steps for the Secondary Loan Market Industry

Until further clarity is available to the secondary loan market (for both sellers and purchasers of loans), banks and non-bank participants must continue to take certain preventative or cautionary measures to guard against being caught in the fallout of *Madden*. As noted above, defensive actions taken to date by the industry include negotiating for and implementing protections in loan sale and purchase agreements to guard against "*Madden* risk."

Relatedly, marketplace lending programs that rely on bank partnerships should include provisions aimed at removing any uncertainty that the originating bank is the "true lender." Several courts look to the nature of the "true lender" in determining whether a loan originated by a bank and subsequently assigned to a non-bank entity is exempt from the usury law of the state where the borrower is located pursuant to the preemptive effect of either the National Bank Act, which allows federally chartered banks to "export" the interest rate of their home state, or the Federal Deposit Insurance Act, which allows FDIC-insured state banks to "export" the interest rate of their home state.[19] Courts evaluate a variety of factors in determining whether a bank is the "true lender"—or, real party in interest—with some courts finding it sufficient that the bank is named the creditor in the loan agreement and others requiring the bank to retain an economic interest in order to be considered the true lender. Among the factors important in this regard are ensuring that the originating bank:

(i) makes all credit decisions regarding the program loans, including setting the terms and conditions of the loan program; (ii) retains a portion of the credit risk for the program loans; (iii) maintains an account relationship with the borrower; and (iv) retains ultimate control (or veto power) with respect to the administration of the loan program.

In this regard, the extent to which these factors must be met in order for federal preemption to apply to loans originated by banks and assigned to marketplace lenders may soon be examined by the Southern District of New York.[20] A class action complaint recently filed in the Southern District against a prominent marketplace lender alleges that the non-bank loan assignee was the "true lender" and relied on bank partnerships to evade state law interest rate restrictions and thus violated consumer protection, usury and racketeering laws.[21]

Other notable measures that some industry participants have already implemented and may be under consideration by others include carving out loans originated in Second Circuit states, New York, Connecticut and Vermont—as well as West Virginia and Maryland, which are jurisdictions with state court decisions that raise challenges for marketplace lenders and other non-bank parties that participate in lending programs with banks that originate program loans[22]—for separate treatment from loans originated in all other states. Notably, many of these responses are being implemented by originating banks, as well as banks serving as warehouse lenders providing liquidity to secondary market programs.

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[1] *Midland Funding, LLC v. Madden*, 579 US__, No. 15-610 (order dated June 27, 2016).

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

[3] A month after Midland's petition for certiorari was filed, various banking and financial institution associations filed amicus curiae briefs urging the Supreme Court to review the Second Circuit's ruling in support of Midland's petition. *See* Brief for ACA Int'l as Amicus Curiae Supporting Petitioner, *Midland Funding*, *LLC v. Madden*, No. 15-610 (US Dec. 10, 2015); Brief for Am. Bankers Ass'n, et al. as Amici Curiae Supporting Petitioner, *Midland Funding*, *LLC v. Madden*, No. 15-610 (US Dec. 10, 2015); Brief for Clearing House Ass'n, et al. as Amici Curiae Supporting Petitioner, *Midland Funding*, *LLC v. Madden*, No. 15-610 (US Dec. 10, 2015).

[4] In March, the Court invited the Solicitor General to submit an opinion on Midland's petition for certiorari. *Midland Funding, LLC v. Madden*, 577 US __,No. 15-610 (Mar. 21, 2016). A vote of at least four Justices is required before the Court will request the views of the Solicitor General, suggesting that several of the Justices were interested in reviewing *Madden* and believed the issue(s) presented to be significant. 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 & n.22 (2008-2009).

[5] *Midland Funding, LLC v. Madden*, 577 US __, No. 15-610 (Mar. 21, 2016).

[6] Brief for the United States as Amicus Curiae, *Midland Funding, LLC v. Madden*, No. 15-610 (US May 24, 2016).

[7] For terms commencing October 1998 through October 2004, the Court followed the Solicitor General's recommendation to deny certiorari in about 80% of cases. 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. 274–76 (2008-2009).

[8] Brief for the United States as Amicus Curiae at 6, *Midland Funding, LLC v. Madden*, No. 15-610 (US May 24, 2016).

[9] 517 US 25 (1996).

[10] Pub. L. No. 111-203, § 1044(a), 124 Stat. 2017 (codified at 12 USC. 25b(b)(1)(B)).

[11] *Madden*, 786 F.3d at 253.

[12] *Madden*, 786 F.3d at 247–48.

[13] Brief for the United States as Amicus Curiae at 19, *Midland Funding, LLC v. Madden*, No. 15-610 (US May 24, 2016).

[14] *See, e.g.*, *2002 Lawrence R. Buchalter Alaska Trust v. Phila. Fin. Life Assurance Co.*, 96 F. Supp. 3d 182 (S.D.N.Y. 2015) ("[A] choice-of-law clause . . . may . . . be invalidated upon a showing 'that its enforcement would be unreasonable, unjust, or would contravene public policy.'") (quoting *Boss v. Am. Exp. Fin. Advisors, Inc.*, 15 A.D.3d 306, 791 N.Y.S.2d 12, 14 (App. Div. 2005)); *Hubbert v. Dell Corp.*, 835 N.E.2d 113 (Ill. App. Ct. 2005) (noting that a contractual choice-of-law provision will not be given effect if the provision contravenes Illinois public policy).

[15] *E.g.*, under New York's criminal usury statute, "[a] person is guilty of criminal usury in the second degree when, not being authorized or permitted by law to do so, he knowingly charges, takes or receives any money or other property as interest on the loan or forebearance of any money or other property, at a rate exceeding twenty-five per centum per annum or the equivalent rate for a longer or shorter period." New York Penal Law § 190.40.

[16] 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*.

[17] *Id*.

[18] The Solicitor General's brief noted that "[a]lthough the [Madden] decision below is incorrect, there is no conflict among the circuits on the question presented here." Brief for the United States as Amicus Curiae at 13, *Midland Funding, LLC v. Madden*, No. 15-610 (US May 24, 2016).

[19] *See e.g., Krispin v. May Dep't Stores*, 218 F.3d 919 (8th Cir. 2000) (applying the National Bank Act to assess legality of charges for credit accounts originated by a national bank and subsequently assigned to department store after finding that "the real party in interest is the bank, not the store," despite the fact that the bank retained no economic interest in the accounts); *Sawyer v. Bill Me Later*, Inc., 23 F. Supp. 3d 1359 (D. Utah 2014) (rejecting plaintiffs arguments that the non-bank loan assignee should be subject to state usury law because it is the "true lender" and entered an agreement with the originating bank for the purpose of circumventing state usury laws); *Hudson v. ACE Cash Express, Inc.*, No. 01-1336, 2002 US Dist. LEXIS 11226 (S.D. Ind. May 30, 2002) (finding the originating bank to be the "true lender" based on based, in part, on retention of 5% interest in loan subsequently assigned to non-bank entity).

[20] *See* Complaint, *Bethune v. Lending Club Corp.*, no. 1:16-cv-02578 (S.D.N.Y. Apr. 6, 2016).

[21] *Id*.

[22] *CashCall, Inc. v. Morrisey*, No. 12-1274, 2014 W. Va. LEXIS 587 (W. Va. May 30, 2014); *CashCall, Inc. v. Md. Comm'r of Fin. Regulation*, No. 80 2016 Md. LEXIS 371 (Md. June 23, 2016).