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December 2019 Follow **@Paul_Hastings**

Federal Regulators Propose Madden Fix

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The Office of the Controller of the Currency ("OCC")[1] and the Federal Deposit Insurance Corporation ("FDIC")[2] recently issued notices of proposed rulemakings, the effect of which is to clarify that interest rates on loans originated by national banks, federal savings associations, and state banks can only be determined to be usurious at the time of the loan's origination, which is a common law concept frequently referred to as the "valid when made" doctrine.[3] Under such doctrine, a loan validly originated by a bank remains valid and fully enforceable even if sold or assigned to a third party.

The regulatory action by the OCC and FDIC addresses the significant uncertainty resulting from the 2015 decision of the U.S. Second Circuit Court of Appeals in *Madden v. Midland Funding, LLC* ("Madden").[4] *Madden* arose from a challenge to the interest rate charged by a debt collector that had purchased a charged-off credit card loan that had been originated by a national bank. The Second Circuit held that New York law, not the law invoked in the underlying loan agreement, governed the rate that the debt collector could charge.

The Supreme Court subsequently denied the petition for *certiorari* filed by the debt collector in the face of concerns expressed by numerous *amici* that *Madden* would create significant uncertainty about the enforceability of loans originated by banks and credit unions and sold to third parties. The Supreme Court's decision to deny *cert* was supported by the OCC, though the agency noted in its own *amicus* brief that the Second Circuit decision was incorrect.[5]

Consistent with the predictions about the havoc that *Madden* would cause, plaintiffs filed a host of cases in its wake, arguing that third parties that had purchased loans from banks or other chartered institutions could not invoke the originating bank's ability to charge a rate of interest above whatever cap was set by the law of the state in which the consumer resided. Plaintiffs also sought to invoke *Madden* in contexts other than debt collection.[6] For example, recent class action suits against a credit card issuer have cited the *Madden* decision, asserting that, through the securitizations and the transfers of receivables, the subsequent holder of the receivable collected interest from New York consumers in excess of the state's usury cap.

The consumer finance industry initially attempted to use the legislative process to resolve the uncertainty created by *Madden.*[7] That effort became mired in debates about usury and Federalism. Some members of Congress took the position that non-bank partnerships with banks to originate loans were simply efforts to evade state interest rate caps and claimed that a legislative fix to *Madden* would subject consumers to predatory lending. The Treasury Department, on the other hand, recommended in the FinTech report that it released in July 2018, that Congress codify the "valid when made" doctrine to preserve the functioning of the U.S. credit markets and the longstanding ability of banks and other financial institutions, including marketplace lenders, to buy and sell validly made loans without the risk of coming into conflict with state interest rate limits.[8] Treasury also recommended that the federal banking regulators should exercise their authority to address challenges posed by *Madden*, particularly if Congress proved unable to act. In the absence of Congressional action, the federal banking regulators followed Treasury's recommendation. While addressing the same topic, the OCC and FDIC are now engaging in a joint rulemaking, and are taking different routes to the same destination. Specifically, the OCC seeks to add a single sentence to its federal preemption rules applicable to national banks and federal savings associations, merely requiring that interest on a loan "that is permissible under 12 U.S.C. § 85 shall not be affected by the sale, assignment, or other transfer of the loan."[9] Similarly, in the context of federal savings associations, the OCC provides that "[i]nterest on a loan that is permissible under 12 U.S.C. 1463(g)(1) shall not be affected by the sale, assignment, or other transfer of the loan."[10]

The OCC noted in the preamble to its regulations that national banks and federal savings associations have all such incidental powers as necessary to carry on the business of banks, including the power to make contracts and the power to lend money under Section 85 of the National Bank Act ("NBA") and Section 1463(g) of the Home Owners' Loan Act ("HOLA"). Similarly, national banks and federal savings associations have the powers to assign some or all of the benefits of a contract to a third party,[11] who upon assignment, steps into the shoes of the bank and may enforce the rights the bank assigned to it under the contract. The OCC noted that a loan does not become usurious after the assignment simply because the third party is enforcing the contractually agreed upon interest term.[12] Moreover, an assignment does not normally change the borrower's obligation to repay in any material way.[13] Accordingly, applying Sections 85 and 1463(g) only to loans that a bank holds on its books, thwarts both the statutory scheme of lending and assignability principles of common law.

The FDIC, on the other hand, uses its rulemaking to expound upon the rate exportation authority of Section 27 of the Federal Deposit Insurance Act ("FDIA"), which is applicable to federally-insured state-chartered banks. The FDIC notes that state banks' authority to make loans implicitly carries with it the power to assign loans, and thus, a state bank's statutory right to make loans includes the power to assign loans at the same rate of interest. The FDIC's proposed rules, which specifically address Section 27, would codify that the permissibility of interest on a loan is determined as of the date the loan is made, and not affected by any subsequent events, including changes in state law or sales, assignments, or transfers of the loans.

The OCC and FDIC rules are functionally identical. Each proposes to codify the "valid-when-made" doctrine, which the *Madden* decision casts doubt upon. In essence, the proposed rules provide that whether interest on a loan originated by a bank is legally permissible is a matter determined exclusively at the time the loan is made, and that the interest rate on a loan is not affected by subsequent events, such as the sale, assignment, or other transfer of the loan or a change in state law.

Neither of the proposed rules addresses the so-called "true lender" issue. The "true lender" issue arises when a bank originates a loan and subsequently divests such loan to a nonbank pursuant to an agreement that predates the origination of the loan. Such agreements are quite common in the lending industry and serve as the backbone for nearly all marketplace lenders. The preamble to the FDIC's rulemaking expressly acknowledges that the FDIC's regulation does not address such "rent-a-bank" arrangements, but it goes on to explain that the FDIC takes a dim view of such arrangement when they are entered into solely for the purpose of evading a state rate cap. The preamble to the OCC rule also notes that the issue is outside the scope of their rulemaking.

Assuming that the rules are ultimately issued as drafted, they would fix the problem created by the Second Circuit in the *Madden* case. That case, as the Solicitor General and others have noted, cannot be reconciled with several hundred years of case law dealing with the enforceability of contracts subsequent to an assignment and at least a century of case law dealing with loan assignments and state usury laws. Nevertheless, we expect that the agencies' efforts to clarify that the assignment of a loan agreement does not change the rights of the parties under such loan agreement to run into the objections that stymied the legislative efforts to fix *Madden—i.e.*, that permitting the assignment and sale of a loan enables non-banks to evade state restrictions on the rates of interest that non-banks can charge in lending agreements. Indeed, six United States Senators have already asked the agencies to reverse course on the issue, citing the possibility non-banks could act like banks to avoid consumer protection laws.[14]

As noted in the Treasury FinTech report, the uncertainty in the marketplace for loan sales must be addressed. Because Congress has not acted, the banking agencies are stepping into the void, as suggested. Yet, by seeking to use their interpretative authority related to bank lending (Section 85 of the NBA, Section 1463(g) of the HOLA and Section 27 of the FDIA), the agencies are creating a potential for challenges that they lack the authority to preempt underlying state contract and debt collection laws,[15] thus creating a new conflict as to whether the agencies' proposed actions should be accorded deference by courts. Nonetheless, pending formal Congressional action to codify the "valid-when-made" doctrine, the agencies' actions will protect the ability of banks to sell or assign their loan production without changing key terms, thereby providing stability to the credit markets. Moreover, the agencies' actions would protect the growing bank-fintech partnership model that the Treasury and federal regulators have endorsed to facilitate Fintech-bank relationships.

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Paul Hastings attorneys are actively working with clients to address the challenges raised by *Madden* as addressed in the OCC and FDIC proposed rulemakings. Given the need for legal certainty, banks and loan purchasers should consider submitting comment letters to the OCC and FDIC during the respective 60-day comment period, which is scheduled to close mid-January 2020. Please reach out to your Paul Hastings contact if you would like to discuss any of these issues in further detail.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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1 The OCC's notice of proposed rulemaking is available at: https://www.occ.gov/news-issuances/news-releases/2019/nr-occ-2019-132.html.

2 The FDIC's notice of proposed rulemaking is available at: https://www.fdic.gov/news/board/2019/2019-11-19-notice-dis-c-fr.pdf.

3 Such concept is longstanding, dating back in the United States to a 1833 U.S. Supreme Court case that provided "[y]et the rule of law is everywhere acknowledged, that a contract free from usury in its inception, shall not be invalidated by any subsequent usurious transactions upon it." *See,* e.g., *Nichols v. Fearson*, 32 U.S. 103 (1833).

4 *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015); cert. denied, *Midland Funding LLC v. Madden*, 136 S. Ct. 2505 (2016).

5 The OCC advised the Supreme Court that: "The court of appeals' decision is incorrect. Properly understood, a national bank's Section 85 authority to charge interest up to the maximum permitted by its home State encompasses the power to convey to an assignee the right to enforce the interest-rate term of the agreement." *See Brief for the United States as Amicus Curiae available at* https://www.justice.gov/sites/default/files/osg/briefs/2016/06/01/midland.invite.18.pdf.

6 More recently, both the OCC and FDIC filed an *amici* in *In re: Rent-Rite Super Kegs West Ltd,* where the agencies noted that "Madden failed to consider the valid-when-made rule and the stand in-the-shoes rule, either of which defeats the Debtor's usury claim."

7 *See* e.g., H.R. 3299 ("Protecting Consumers' Access to Credit Act of 2017"), passed by the U.S. House of Representatives in February 2018 and H.R. 4439 ("Modernizing Credit Opportunities Act"), referred to the House Financial Services Committee in 2017.

8 Nonbank Financials, Fintech, and Innovation, U.S. Department of the Treasury (2018), available at:https://home.treasury.gov/sites/default/files/2018-08/A-Financial-System-that-Creates-Economic-Opportunities---Nonbank-Financials-Fintech-and-Innovation.pdf.

9 84 Fed. Reg. 64229, 64232 (Nov. 21, 2019), *to be codified* at 12 CFR 7.4001.

10 84 Fed. Reg. 64299, 64232 (Nov. 21, 2019), *to be codified* at 12 CFR 160.110.

11 *See Planters' Bank of Miss. v. Sharp*, 47 U.S. 301, 322-23 (1848).

12 *See Olvera v. Blitt & Gaines, P.C.*, 431 F.3d 285, 286, 289 (7th Cir. 2005) ("[T]he assignee of a debt . . . is free to charge the same interest rate that the assignor . . . charged the debtor . . . even if the assignee does not have a license that expressly permits the charging of a higher rate.").

13 *See* 29 Williston on Contracts § 74:10.

14 *See* Letter to Joseph Otting, Comptroller and Jelena McWilliams, Chairman of the FDIC, November 21, 2019.

15 The OCC has repeatedly noted in its regulatory guidance that certain types of state laws are not preempted, including contract law and the rights to collect debts. *See* e.g., 60 Fed. Reg. 1904, 1912 (Jan. 13, 2004).