PAUL HASTINGS

STAY CURRENT

June 2015

Follow @Paul_Hastings

Madden v. Midland Funding, LLC: Potentially Far-Reaching Implications for Non-Bank Assignees of Bank-Originated Loans (Updated August 12, 2015)

By The Global Banking and Payment Systems Practice

A recent decision issued by the U.S. Second Circuit Court of Appeals, *Madden v. Midland Funding, LLC*,[1] has created quite a stir within the investor market for bank-originated loans. In holding that a debt collector that purchased charged-off consumer (credit card) loans from a national bank was not entitled to rely on the bank's federal preemption of New York's usury law, the Appeals Court reversed a U.S. District Court ruling that upheld the availability of federal preemption for the debt collector. Specifically, the Appeals Court ruled that federal preemption was not available to the debt collector in collecting the debt pursuant to the terms of the loan agreement because the debt collector was acting on behalf of itself rather than the bank. In explaining its preemption analysis, the Appeals Court posited 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]."[2]

The court remanded the case to the District Court, however, to address the issue of what state law—Delaware or New York—is the appropriate state law that should be applied for purposes of the plaintiff's usury claim against the debt collector. The issue generally hinges on whether the law of the state of the borrower (New York) should apply or whether a choice-of-law provision in a "Change in Terms" provision in the Cardholder Agreement designating Delaware as the contract state is the appropriate state controlling the usury determination. If, on remand, the District Court finds that New York law is the applicable law for purposes of determining the usury rate, then the non-bank debt collector may also be subject to claims under the Fair Debt Collection Practices Act ("FDCPA") for making false representations or engaging in an unfair practice insofar as the debt collector engaged in communications with the debtor indicating that the debt collector (as assignee) was legally entitled to charge interest in excess of the state's usury law.[3]

Unaddressed by the Appeals Court in its ruling and instructions to the District Court on remand is the potential impact of a New York criminal usury law restricting annual interest rate charges to 25%. The interest rate at issue in the *Madden* case was an annual interest charge of 27%. Assuming New York law is the appropriate law for the usury rate analysis, it appears that the debt collector's efforts to collect on the debt at that rate could potentially subject it to the New York criminal usury law, which allows for felony prosecution of a lender (assuming the debt collector would be deemed to be standing in the shoes of the bank lender) for exceeding New York's 25% criminal usury rate.

The holding in *Madden* creates a significant precedent of bad law that unsettles the relatively well-established body of law stipulating 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. While the banking and financial services industry awaits further guidance and clarity on the import and potential impact of *Madden*—whether by the courts, the Office of the Comptroller of the Currency, as the regulator of national banks, or by the federal banking agencies generally—the *Madden* decision has triggered a visceral response from certain segments of the industry. Among these, the decision is causing: (1) non-bank assignees of bank loans to question their rights to enforce the terms of loans that are purchased outright from banks that originated the loans, i.e., involving circumstances in which the bank does not retain a continuing interest in the loan; (2) banks relying on an originate-to-sell model to reevaluate their business models and strategies; and (3) parties to existing loan sale agreements to review and renegotiate the terms of such agreements—and ancillary agreements—to account for the uncertainty created by *Madden*.

While it may be a truism that bad facts make bad law, the circumstances in the *Madden* case present a particularly bad set of facts for establishing precedent in the federal preemption context, particularly relative to loan sale activities, and potentially create serious complications in related areas such as loan securitizations. As a result, since issuance of the *Madden* decision, the industry has tried to dissect and distinguish *Madden* from other loan sale scenarios, e.g., arrangements not involving consumer loans originated by a national bank or debt collectors enforcing the terms of loans that have been charged off by the selling bank. However, the broad language of the Appeals Court's holding in the *Madden* case is not limited to the specific facts of the case and, thus, has potential applicability to commercial as well as consumer loans originated by national banks and federal thrifts relying on federal preemption from state usury laws, as well as for state-chartered banks and thrifts relying on analogous authority for federal preemption of state usury laws set forth in Section 27 of the Federal Deposit Insurance Act.[4] Thus, the *Madden* case has potentially far-reaching implications that, if the court's decision is not reversed or distinguished and/or if it is adopted or affirmed by other courts, could result in a fundamental restructuring of the extensive secondary market for loan sales, as well as the way in which many such bank programs are currently conducted.

Perhaps most troubling about the opinion of the Appeals Court is a cursory statement, which was made without explanation or supporting data, indicating that application of state usury laws to third-party assignees of bank-originated loans would not prevent or "significantly interfere" with the exercise of national bank powers, which the court noted includes the power to sell debt to debt buyers for a fee.[5] Inexplicably, the court failed to recognize the significance that its ruling would have on the ability of banks to sell their loans in the secondary market. Given that non-bank purchasers will be unable to enforce the terms of a loan according to the original agreement terms between the bank and borrower, *Madden's* application of state usury laws to non-bank purchasers who become loan assignees will undoubtedly chill 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. Further complicating the situation is the potential for the application of a criminal usury statute in some states, such as New York and Florida.[6]

Action Plan

While the industry awaits much-needed guidance and clarification from the courts and/or the OCC and other federal banking regulators, banks and their assignees should consider taking certain protective measures to minimize the business risks associated with their loan sale/purchase activities due to the *Madden* decision. Such protective measures may include:

- Reviewing the terms of existing agreements and taking steps to ensure that the bank retains some aspect of an ownership or other continuing interest in loans that are sold to third parties, e.g., by retaining the accounts and only selling the associated receivables, or maintaining skin-in-the-game through a continuing ownership interest in loans that are sold to secondary market investors even where not required under the federal securities laws.

- Alternatively, banks and their assignees may consider reviewing existing and pending loan sale/purchase agreements for potential violation of usury laws in states where borrowers reside, starting with the Second Circuit states (New York, Connecticut, and Vermont).[7] Where issues or potential risks are evident, the parties can address such risks, as appropriate, by amending existing and any ancillary agreements.

- Banks and their loan program managers should also consider reviewing existing loan sale program activities to determine states that may present significant risks and vulnerabilities due to the volume of loans and/or particular state laws that may present obstacles to the program under *Madden*.

The *Madden* case has significant implications for the loan sale market, particularly for non-bank assignees of bank loans that may be left holding a portfolio of de-valued loans that are unenforceable in the hands of the non-bank assignee. We anticipate that clarification on the implications of the *Madden* case and, in particular, the rights of non-bank assignees of bank loans, will be forthcoming; thus, interested parties should continue to closely monitor the case and any related court, legislative, or regulatory activity.

✧ ✧ ✧

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

Atlanta

Todd W. Beauchamp
1.404.815.2154
toddbeauchamp@paulhastings.com

Chris Daniel
1.404.815.2217
chrisdaniel@paulhastings.com

Erica Berg Brennan
1.404.815.2294
ericaberg@paulhastings.com

Heena A. Ali
1.404.815.2393
heenaali@paulhastings.com

Kevin P. Erwin
1.404.815.2312
kevinerwin@paulhastings.com

Meagan E. Griffin
1.404.815.2240
meagangriffin@paulhastings.com

Diane Holden
1.404.815.2326
dianeholden@paulhastings.com

London

Ben Regnard-Weinrabe
44.020.3023.5185
benregnardweinrabe@paulhastings.com

Nikki Johnstone
44.020.3023.5112
nikkijohnstone@paulhastings.com

Miah Ramanathan
44.020.3023.5178
miahramanathan@paulhastings.com

Palo Alto

Cathy S. Beyda
1.650.320.1824
cathybeyda@paulhastings.com

San Francisco

Thomas P. Brown
1.415.856.7248
tombrown@paulhastings.com

Stan Koppel
1.415.856.7284
stankoppel@paulhastings.com

Paul M. Schwartz
1.415.856.7090
paulschwartz@paulhastings.com

Ryan M. Decker
1.415.856.7237
ryandecker@paulhastings.com

Molly E. Swartz
1.415.856.7238
mollyswartz@paulhastings.com

Washington D.C.

V. Gerard Comizio
1.202.551.1272
vgerardcomizio@paulhastings.com

Behnam Dayanim
1.202.551.1737
bdayanim@paulhastings.com

Lawrence D. Kaplan
1.202.551.1829
lawrencekaplan@paulhastings.com

Gerald S. Sachs
1.202.551.1975
geraldsachs@paulhastings.com

Alexandra L. Anderson
1.202.551.1969
alexandraanderson@paulhastings.com

Laura E. Bain
1.202.551.1828
laurabain@paulhastings.com

Ryan A. Chiachiere
1.202.551.1767
ryanchiachiere@paulhastings.com

Lauren Kelly D. Greenbacker
1.202.551.1985
laurenkellygreenbacker@paulhastings.com

Amanda Kowalski
1.202.551.1976
amandakowalski@paulhastings.com

[1] On August 12, 2015, the Second Circuit denied Midland's request for rehearing en banc. Accordingly, at least in the Second Circuit – encompassing New York, Connecticut, and Vermont -- the Appeals Court's decision will remain in effect unless ultimately overturned by the U.S. Supreme Court, another case in the Second Circuit limits or distinguishes Madden. Given that the Second Circuit's decision is inconsistent with decisions in other circuits, we expect that a petition to the U.S. Supreme Court will be filed requesting that the Madden decision be reviewed to address the circuit splits and the significant disruption in the financial markets. No assurances can be given that the Court will accept such petition or issue a contrary ruling on an expedited basis. Accordingly, lenders and purchasers of debt should continue to follow through on the Action Plan set forth below.

[2] --- F.3d ---, 2015 WL 2435657 (2d Cir. May 22, 2015).

[3] *See id*. at *7.

[4] 12 U.S.C. § 1831d.

[5] 2015 WL 2435657 at *4.

[6] See N.Y. PEN. LAW § 190.42 and Fla. Stat. § 687.071.

[7] We note that the Second Circuit remanded the Madden case back to the District Court to resolve the choice-of-law issue created by the fact that Delaware was designated as the governing law pursuant to a choice-of-law provision in the loan agreement, but the borrower resided in New York and brought the usury claim under New York law. In remanding the case, the Circuit Court noted that the "parties appear to agree that if Delaware law applies, the rate the defendants charged Madden was permissible." Madden, 2015 WL 2435657 at *7. However, even if Delaware law is determined to be the applicable law on remand, lenders and their assignees relying on choice-of-law provisions are not immune from being subjected to the jurisdiction of courts located in states based on the residence of the borrower and on the specific facts of each case. See, e.g., id., fn. 7, citing various cases where a court has applied the law of a state, other than the state designated as the governing law state, pursuant to a choice-of-law provision. 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 favorable usury statute).