SULLIVAN & CROMWELL LLP

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# OCC and FDIC Propose Rules to Override *Madden* v. *Midland Funding, LLC*

## Proposed Rules Reaffirm that a Valid Interest Rate on a Loan Originated by a Bank Remains Valid After the Loan Is Sold or Assigned to a Non-Bank.


### SUMMARY

Under Section 85 of the National Bank Act ("NBA"), a national bank may originate loans with interest rates permissible under that bank's home state's usury laws, even if the borrower lives in a state with lower permissible usury rates.[1] Section 27 of the Federal Deposit Insurance Act ("FDIA") provides state banks with the same preemption protection against state usury laws. For centuries—pre-dating the enactment of the NBA in 1864—caselaw and market practice had established that an interest rate valid at the origination of the loan remained valid even after the originator (whether or not a bank) sold or assigned the loan to another party (whether or not a bank).[2]

In 2015, the U.S. Court of Appeals for the Second Circuit issued a decision in *Madden* v. *Midland Funding, LLC*,[3] which radically broke with this longstanding legal principle and held that a non-bank entity taking assignment of a loan originated by a national bank is not entitled to preemption under the NBA from state usury laws. In other words, a loan that was valid when originated by a national bank could become usurious under state law if sold or assigned to a non-bank. The judicial impact of *Madden* has been felt most acutely in the Second Circuit, although parties have attempted to extend the case's influence in other jurisdictions.[4] Since the *Madden* decision, there has been a flurry of activity in Congress,[5] the courts, and by the banking regulators to address the uncertainties arising from *Madden*. For more information about recent activity in the courts, please refer to our June 17, 2019 and March 2, 2017 client memoranda.

On November 18th and 19th, respectively, the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC") separately issued notices of proposed rulemaking ("NPRs") providing that when a loan originated by a national or state bank is sold, assigned, or otherwise transferred to a non-bank, the interest permissible at origination remains permissible following the transfer. The OCC NPR can be found here,[6] and the FDIC NPR can be found here.[7] The NPRs are designed to override the *Madden* decision.[8] The agencies are soliciting comments on all aspects of the NPRs that are due by January 21, 2020.

If finalized, the NPRs have potentially significant implications for credit and securitization markets, by returning credit markets in the Second Circuit to the *status quo ante*, reducing litigation risk in other jurisdictions, and by increasing the willingness of non-banks to purchase bank-originated loans. The NPRs could thus increase credit availability and market liquidity and enhance bank safety and soundness.

## BACKGROUND

Under the NBA, national banks have the powers to make contracts and lend money, as well as "all such incidental powers as shall be necessary to carry on the business of banking." 12 U.S.C. § 24(Seventh). Since the NBA's enactment, the industry and courts have understood that an inherent part of a bank's power to make contracts and lend money—as well as a power incidental to those powers—was the ability of a national bank to assign loans to non-banks, including through securitizations, with the various terms and preemptive protections of the loans remaining fully intact. That way, the terms of the loans—and thus their liquidity and value—would not change based on who or what purchased the loans from the bank.

In addition to the NBA, a common law doctrine known as "valid-when-made"[9]—which pre-dated the NBA by at least a half-century[10]—had firmly established that a loan that was valid when originated could not become invalid simply because it was assigned to a different holder. The U.S. Supreme Court had acknowledged the doctrine decades before the enactment of the NBA.[11]

Despite this clear history, the *Madden* court held that federal preemption of New York's usury laws no longer applies once the originating national bank transfers a loan to a non-bank. To analyze this question, *Madden* looked to the U.S. Supreme Court's 1996 decision in *Barnett Bank of Marion County, N.A.* v. *Nelson*,[12] which held that, under the NBA, a state law is preempted if it "prevent[s] or significantly interfere[s] with the national bank's exercise of its powers." Without any legal or data-based explanation, the *Madden* court held that the application of state usury laws to loans originated by national banks, but sold or assigned to non-banks, did not significantly interfere with a national bank's powers. *Madden* did not even address the valid-when-made doctrine.

Although *Madden* has been widely criticized—including by the U.S. Department of Justice, OCC and FDIC[13]—as contrary to the NBA's text, economic reality, and hundreds of years of industry practice and custom, it remains law within the Second Circuit (which covers New York, Connecticut and Vermont). There have been attempts to overturn the *Madden* decision by the House via the Financial CHOICE Act of 2017[14] and the Protecting Consumers' Access to Credit Act,[15] but neither advanced in the Senate.

In the U.S. Department of the Treasury's ("Treasury") July 2018 report titled *Nonbank Financials, Fintech and Innovation*, Treasury recommended that "the federal banking regulators should use their available authorities to address challenges posed by *Madden*."[16] In a July 30, 2019 letter, members of the Senate Banking Committee urged the federal banking regulators "to use all available authorities to clarify uncertainties introduced by *Madden*, and to weigh in with courts considering outstanding cases."[17] Further, in a September 19, 2019 letter, members of the House Financial Services Committee wrote to the OCC, urging the agency to update its interpretation of the definition of "interest" under the NBA to limit the impact of the *Madden* decision.[18] The House Financial Services Committee letter argued that *Madden* deviated from the longstanding valid-when-made doctrine and has "caused significant uncertainty and disruption in many types of lending programs."

The OCC and the FDIC have now proposed rules describing the "clear authorities" that contradict *Madden*, and establish that, when a bank sells, assigns or otherwise transfers a loan, interest rates permissible prior to the transfer continue to be permissible following the transfer.

## THE OCC'S PROPOSED RULE

In its NPR, the OCC emphasizes that, due to the *Madden* decision, there is now uncertainty regarding whether an interest rate on a loan originated by a bank remains valid once that loan has been sold or assigned to a non-bank. To end the uncertainty, the OCC is proposing to amend 12 C.F.R. § 7.4001 (for national banks) and 12 C.F.R. § 160.110 (for federal savings associations) by adding a new paragraph, which would provide that interest on a loan that is permissible under 12 U.S.C. § 85 and 12 U.S.C. § 1463(g)(1) will not be affected by the sale, assignment or other transfer of the loan.

The OCC notes that "various provisions of federal banking law, taken together, show that Congress created an integrated federal scheme that permits national banks and federal savings associations to operate across state lines without being hindered by differing state laws."[19] The OCC maintains that both the NBA and the Home Owners' Loan Act ("HOLA") provide national banks and federal savings associations with the authority to make loans, and also confer upon them the power to assign loans.[20] The OCC points out that Section 85 of the NBA and Section 4(g) of the HOLA "have been interpreted to permit a bank to charge interest at the highest rate allowed to competing lenders by the state where the bank is located … and to export this rate to borrowers in other states, regardless of any other state law purporting to limit the interest permitted on bank loans."[21] Construing each of these authorities, the OCC

finds that a bank may enter into a loan contract, charge interest at the maximum rate permitted in the state where the bank is located, and subsequently assign the loan with that interest rate remaining intact.

The OCC cites multiple legal principles to support its interpretation of the NBA and the HOLA: (1) the longstanding common law principle of valid-when-made; (2) that banks' ability to assign contracts means that the assignee receives the benefit of and may enforce the permissible interest term, because an assignment does not normally change the borrower's obligation to repay; (3) if a bank cannot be certain that interest permissible prior to the assignment will remain permissible afterwards, its ability to routinely rely on loan assignments and securitization as risk and liquidity management tools (e.g., by accessing alternative funding sources and managing concentrations) would be curtailed, which was not the intent of Congress; and (4) the purpose of 12 U.S.C. § 85 and 12 U.S.C. § 1463(g) to facilitate banks' ability to operate across state lines by eliminating the burden of complying with each state's interest laws.

## THE FDIC'S PROPOSED RULE

The FDIC is proposing a new regulation, 12 C.F.R. § 331, that clarifies the interest rates applicable to loans originated by state banks. The FDIC's NPR cites much of the same authority as the OCC's NPR, but bases its analysis on the FDIC's interest statute, Section 27 of the FDIA (12 U.S.C. § 1831d). The FDIC does not currently have specific regulations that implement 12 U.S.C. § 1831d, although it has for over 20 years interpreted the statute through opinions of the FDIC's General Counsel.[22] Strictly speaking, *Madden* addressed the assignment of a loan by a national bank and not a state bank, but the FDIC is proposing the rule because 12 U.S.C. § 1831d is patterned after, and interpreted in the same manner as, 12 U.S.C. § 85.[23]

The proposed regulation provides for parity between state banks and national banks regarding the applicability of state law interest rate restrictions. Specifically as to *Madden*, part (e) of proposed 12 C.F.R. § 331.4 clarifies that the determination of whether interest on a loan is permissible under 12 U.S.C. § 1831d is made at the time that the loan is made, and that the permissibility of the interest shall not be affected by subsequent events, such as a change in state law, a change in the relevant commercial paper rate, or the sale, assignment or other transfer of the loan. The determination is to be made at the time the loan is made, not when a particular interest payment is "taken" or "received," because doing so "protects the parties' expectations and reliance interests at the time when a loan is made, and provides a logical and fair rule that is easy to apply."[24] Part (e) also makes clear that an assignee can enforce the loan's interest rate terms to the same extent as the assignor.[25]

## ADDITIONAL CONSIDERATIONS

*First,* given the prior litigation relating to this issue, there is a strong chance that the NPRs, if adopted as final rules, will be challenged in federal court, either through a direct challenge under the Administrative Procedure Act or through ordinary course litigation where the parties debate whether the court should

defer to the agencies' regulations. It may be some time, even after the rules are final, before an initial judicial determination on their validity is reached.

*Second,* if the NPRs become final rules as proposed and survive judicial challenge, the OCC and FDIC's regulations would effectively override the *Madden* decision.[26] Overriding *Madden* would restore credit markets in the Second Circuit to the *status quo ante* and reduce litigation risk in other jurisdictions by providing greater certainty to non-bank purchasers and bank securitizers of loans that they can charge interest on those loans without being subject to state usury laws. In addition, the increased liquidity and demand for the loans in the secondary market might help encourage banks to originate loans—an economic study suggests that "hundreds of loans [were] issued to borrowers with FICO scores below 640 in Connecticut and New York in the first half of 2015, but no such loans [were issued] after [the *Madden* decision was issued in] July 2015," and that data demonstrated "not only did lenders make smaller loans in these states after *Madden*, but they also declined to issue loans to the higher-risk borrowers most likely to borrow above usury rates."[27] Another study suggests that marketplace lenders in these states did not grow their loans as fast relative to non-Second Circuit states.[28]

*Third,* the NPRs specifically note that they do not address the "true lender" issue, which concerns whether, and under what circumstances, a bank that partners with another party during the origination process is the "true lender" of the loan, with the loan thus benefitting from NBA, HOLA or FDIA protection from state law usury claims. The FDIC, however, does note that it "will view unfavorably entities that partner with a state bank with the sole goal of evading a lower interest rate established under the law of the entity's licensing state(s)."[29] In view of the number of current arrangements where banks originate loans and transfer them, after a short time, to third parties, we assume that the FDIC did not seek to question these current arrangements.

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## ENDNOTES

1 *See FDIC* v. *Lattimore Land Corp.*, 656 F.2d 139, 148-49 & n.17 (5th Cir. Unit B Sept. 1981); *Krispin* v. *May Dep't Stores Co.*, 218 F.3d 919, 924 (8th Cir. 2000).

2 *See Nichols* v. *Fearson*, 32 U.S. (7. Pet.) 103, 109 (1833) ("a contract, which in its inception, is unaffected by usury, can never be invalidated by any subsequent usurious transaction"); *see also Gaither* v. *Farmers & Merchants Bank of Georgetown*, 26 U.S. 37, 43 (1828) ("[T]he rule cannot be doubted, that if the note free from usury, in its origin, no subsequent usurious transactions respecting it, can affect it with the taint of usury.").

3 *Madden* v. *Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015).

4 For example, the Colorado attorney general initiated litigation against non-bank entities citing *Madden*. *See Meade* v. *Avant of Colorado, LLC*, 307 F. Supp. 3d 1134, 1152 (D. Colo. 2018); *Julie Ann Meade, Administrator, Uniform Consumer Credit Code* v. *Marlette Funding LLC d/b/a Best Egg*, 2017 WL 10606765 (D. Colo.).

5 *Financial CHOICE Act of 2017*, H.R. 10, 115th Cong. 1st Sess. § 581 (2017).

6 OCC, *Permissible Interest on Loans that are Sold, Assigned, or Otherwise Transferred*, RIN 1557-AE73 (Nov. 18, 2019), *available at* https://www.occ.treas.gov/news-issuances/news-releases/2019/nr-occ-2019-132a.pdf.

7 FDIC, *Federal Interest Rate Authority*, RIN 3064-AF21 (Nov. 19, 2019), *available at* https://www.fdic.gov/news/board/2019/2019-11-19-notice-dis-c-fr.pdf.

8 OCC NPR at 9.

9 The valid-when-made doctrine provides that if a loan is non-usurious at origination, the loan does not subsequently become usurious when assigned.

10 American and English courts had long recognized the valid-when-made rule. *See*, *e.g.*, *Watkins* v. *Taylor*, 16 Va. 424, 436 (1811) ("[I]f it was not usury *at the time* when the contract was entered into, no *after* circumstance can make it so; and any argument, therefore, drawn from after circumstances, would be improper." (emphasis in original)); *Tuttle* v. *Clark*, 4 Conn. 153, 157 (1822) (holding that "this note, free from the taint of usury, in its origin," did not become usurious by the subsequent sale); *Tate* v. *Wellings*, 100 Eng. Rep. 716, 721 (K.B. 1790) (opinion of Buller, J.) ("Here the defence set up is that the contract itself was illegal; and in order to support it, it must be shewn that it was usurious at the time when it was entered into; for if the contract were legal at that time, no subsequent event can make it usurious."); *see also* 1 William Blackstone, *Commentaries on the Laws of England* 379-80 n.32 (18th London ed., W.E. Dean 1838) ("The usury must be part of the contract in its inception . . . .").

11 *See supra* at n.2.

12 517 U.S. 25, 33 (1996).

13 *See* Brief for the U.S. (Solicitor General) as *Amicus Curiae* on certiorari for *Midland Funding, LLC* v. *Madden*, 2016 WL 2997343 (U.S.), 2; *see also* Brief for the FDIC and the OCC as *Amicus Curiae* (filed Sept. 10, 2019) for *Rent-Rite SuperKegs W., Ltd.* v. *World Bus. Lenders, LLC (In re Rent-Rite SuperKegs W., Ltd.)*, 603 B.R. 41, 2019 Bankr. LEXIS 1537 (Bankr. D. Colo., May 20, 2019), *available at* https://www.consumerfinancemonitor.com/wp-content/uploads/sites/14/2019/09/Amicus_Brief.pdf.

14 Elements of the Financial CHOICE Act of 2017, not including the provision that sought to overturn the *Madden* decision, were later included in the Economic Growth, Regulatory Relief and Consumer Protection Act that became law on May 24, 2018.

15 *Protecting Consumers' Access to Credit Act of 2017*, H.R. 3299, 115th Cong. 2nd Sess. § 3 (2018).

**ENDNOTES (CONTINUED)**

[16] Treasury, *A Financial System that Creates Economic Opportunities: Nonbank Financials, Fintech and Innovation* at 93 (July 31, 2018), *available at* https://home.treasury.gov/sites/default/files/2018-08/A-Financial-System-that-Creates-Economic-Opportunities---Nonbank-Financials-Fintech-and-Innovation_0.pdf.

[17] Senate Banking Committee Republicans, *Letter to Federal Banking Regulators* at 5 (July 30, 2019), *available at* https://www.banking.senate.gov/imo/media/doc/Powell%20Otting%20McWilliams%20Letter%207-30-19.pdf.

[18] House Financial Services Committee Republicans, Letter to Comptroller Otting at 2 (Sept. 19, 2019), *available at* https://www.consumerfinancemonitor.com/wp-content/uploads/sites/14/2019/09/Letter-to-Otting.pdf.

[19] OCC NPR at 5.

[20] *Id*. at 7.

[21] *Id.* at 8.

[22] FDIC NPR at 17-8. *See* FDIC General Counsel's Opinion No. 10, *Interest Charged Under Section 27 of the Federal Deposit Insurance Act*, 63 FR 19258 (Apr. 17, 1998); FDIC General Counsel's Opinion No. 11, *Interest Charges by Interstate State Banks*, 63 FR 27282 (May 18, 1998).

[23] 12 U.S.C. § 1463(g) of the HOLA is also patterned after 12 U.S.C. § 85 of the NBA.

[24] FDIC NPR at 21.

[25] *Id*. at 27.

[26] The NPRs' focus on the ability of banks to sell, assign, or otherwise transfer their loans with the interest rate at origination remaining valid, as well as the NPRs' descriptions of the legal principles supporting this ability as a core banking power, would seem to hinder future courts from finding that applying state usury laws to loans originated by banks does not "significantly interfere" with a bank's powers as the *Madden* court did.

[27] *See* Colleen Honigsberg, Robert J. Jackson, Jr. & Richard Squire, *How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment*, at 675 (Chicago Journal of Law and Economics, vol. 60 Nov. 2017), *available at* https://pdfs.semanticscholar.org/b68b/39250f72d723e85d480e3927f4957afdc584.pdf.

[28] Piotr Danisewicz and Ilaf Elard, *The Real Effects of Financial Technology: Marketplace Lending and Personal Bankruptcy*, at 3 (July 5, 2018), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3208908.

[29] FDIC NPR at 11.

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