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New Type of Lawsuit Involving Securitized Debt: Citing *Madden*, Plaintiffs Contend That Credit Card Debt Became Subject to NY Usury Laws Once the Debt Was Securitized

A Successful Outcome for Plaintiffs Could Threaten the Ability to Securitize All Debt—Not Just Credit Card—Because It Would Expose Securitized Debt to State-By-State Regulation

On June 12, 2019, in *Cohen v. Capital One Funding*,¹ certain Capital One credit card holders filed a putative class action lawsuit in the U.S. District Court for the Eastern District of New York against (i) special purpose entities (“Trusts”) that purchased and securitized credit card receivables from Capital One, and (ii) the trustees of those Trusts. Plaintiffs concede that, because Capital One is a national bank, the National Bank Act (“NBA”) preempts the application of New York usury laws to loans made by Capital One to New York credit card holders, and so plaintiffs did not name Capital One itself as a defendant. But Plaintiffs contend that this federal preemption ceased once Capital One sold the credit card receivables to the Trusts, which then securitized them. Thus, according to plaintiffs, the Trusts and trustees are violating New York law by continuing to charge and collect interest rates above New York’s usury limits.

Plaintiffs’ complaint is a result of *Madden v. Midland Funding*,² a 2015 decision from the U.S. Court of Appeals for the Second Circuit, which held that federal preemption of New York’s usury laws no longer applies once the originating national bank sells credit card receivables to a non-bank, third-party debt collector. According to the *Madden* court, removing federal usury preemption from debt once it was sold

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by a bank to a non-bank would not materially hinder the bank's power to originate loans, and so extending preemption to the third-party debt collector was not warranted under the NBA. Although *Madden* has been widely criticized—including by the Office of the Comptroller of the Currency³—as contrary to the NBA's text, economic reality, and hundreds of years of industry expectations, it remains law within the Second Circuit (which covers New York, Connecticut, and Vermont). An attempt to overrule the *Madden* decision via federal legislation stalled last session in the U.S. Congress.

To date, post-*Madden* lawsuits claiming violations of usury laws have tended to focus on tribal, payday, and fintech lenders, and third-party debt collectors. The *Cohen* case appears to be the first case filed based on the securitization of debt by a national bank. If the *Cohen* lawsuit is successful, it could have significant deleterious effects on the lending industry in general, including:

- creating a strong disincentive for non-banks (including securitization trusts) to purchase debt or tranches of securitized debt owed by borrowers within the Second Circuit for fear that the purchasers would either (i) need to lower the interest rate on the debt; or (ii) face lawsuits under the applicable state's usury laws; this fear in turn would make banks less likely to lend to borrowers in the Second Circuit. Already, academic literature suggests that the *Madden* decision has led to reduced access to credit for borrowers in the Second Circuit with low credit scores.
- calling into question federal preemption of all state consumer laws—beyond just usury—that apply to debt owed by borrowers in the Second Circuit. The consequences of losing federal preemption against such other state laws could be significant, including requiring securitization trusts and other non-bank purchasers of debts to establish systems for complying with 50 different sets of consumer protection laws.
- threatening the origination of all debt—not just credit card debt—including mortgage loans. There is nothing in *Madden* or its progeny that suggests *Madden's* logic is limited to credit card debt.

It is important to note the Second Circuit is still the only Circuit to adopt the *Madden* rule. Because New York's civil usury rate is 16% (and its criminal usury rate is 25%), the current low interest rate environment might make *Madden's* impact less dramatic than normal. Other states, however, have much lower usury rates, and, if interest rates rise and *Madden* is adopted in other Circuits, the effect on the lending industry could be dramatic.

Given the importance of the *Cohen* case, we will continue to provide updates on its developments.

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ENDNOTES

¹ *Cohen v. Capital One Funding, LLC, et al.*, 19-cv-03479-KAM-RLM (E.D.N.Y.).

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

³ See Brief for the United States as *Amicus Curiae*, *Midland Funding, LLC v. Madden*, No. 15-610, 2016 WL 2997343 (U.S. May 2016)

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