SULLIVAN & CROMWELL LLP

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# U.S. District Court Ruling Raises Important Considerations for Debt Origination and Collection in New York

## U.S. District Court Rules That New York's Fundamental Public Policy Against Usury Overrides a Delaware Choice of Law Provision, and Thus Allows a Class Action to Proceed Against a Debt Collector for Unfair Collection Practices.

### SUMMARY

On February 27, 2017, the U.S. District Court for the Southern District of New York issued an opinion in *Madden* v. *Midland Funding, LLC* holding that New York's fundamental public policy against usury overrides provisions in a credit card agreement specifying that the debt was governed by the law of another State—in this case, Delaware, which had no relevant usury caps. Accordingly, the District Court allowed the plaintiff-debtor to proceed to trial with class action claims against the defendant-debt collector under the Fair Debt Collection Practices Act on the grounds that the defendant was seeking to collect impermissibly high interest rates, although claims based on a usury violation itself were denied.

The District Court's ruling follows a novel August 2014 opinion in the same case from the U.S. Court of Appeals for the Second Circuit holding that entities that purchase debt originated by national banks are not entitled to protection under the National Bank Act's provisions preempting State usury laws against debt originated by national banks.

Together with the Second Circuit's ruling, the District Court's recent decision has potentially significant implications for purchasers of debt, as well as lenders who rely on choice of law provisions to protect against State usury laws. The decision might contribute further to an already observed decline in debt originated to higher-risk borrowers in the Second Circuit.[1]

## BACKGROUND

Saliha Madden brought class action claims under the Fair Debt Collection Practices Act ("FDCPA") and New York State usury law against Midland Funding, LLC ("Midland") on the grounds (among others) that the rate of interest Midland was charging Madden on her defaulted debt was in excess of New York's civil and criminal usury rates of 16% and 25%, respectively. The District Court originally held that the National Bank Act ("NBA") foreclosed all Madden's claims to the extent they were based on usury, because the NBA allows an originating national bank—here, Bank of America's Delaware-headquartered credit card bank called FIA Card Services, N.A. ("FIA")—to export into any State the rate of interest allowable in that national bank's home State, and Delaware has no usury laws for credit cards. Specifically, the District Court held that the NBA's protection extended to entities such as Midland that purchase debt from national bank originators. The Second Circuit reversed, holding that the NBA's provisions did not protect such entities.[2] The Second Circuit's decision is in conflict with the decisions of other Circuit Courts.[3] The U.S. Supreme Court declined to review the Second Circuit's decision and the case was remanded to the District Court.

## DISTRICT COURT DECISION

On February 27, 2017, the District Court allowed Madden's FDCPA claims to proceed to trial, and certified a class.[4]

***First***, the District Court dismissed Madden's claims under New York's usury laws.[5] The Court held that (i) New York's civil usury laws do not apply to defaulted debt, and (ii) although New York's criminal usury laws do apply to defaulted debt, private individuals cannot bring claims under New York's criminal usury laws.

***Second***, nonetheless the District Court held that, despite the choice of law provision in Madden's credit card agreement specifying Delaware law, New York's prohibition against charging usurious rates applied,[6] and thus Midland's attempt to collect rates above New York's legal limit could constitute unfair collection practices under the FDCPA even if not actionable under the New York usury statutes.[7] The District Court reached this conclusion because it found that New York had a fundamental public policy not to allow usurious rates of interest to be charged to in-State residents, which was in significant conflict with Delaware's policy of having no relevant usury law. (The District Court noted that New York's public policy might not require the Court to override choice of law provisions specifying the law of a State that had a usury law allowing for rates close to, but above 25%, because there would be less conflict with New York policy in that situation.)

***Third***, the District Court also stated that the choice of law clause was likely unenforceable, because the agreement, parties, and transaction had little connection to Delaware, and Midland did not submit sufficient evidence at this stage of the case to show that FIA was headquartered in Delaware.[8]

***Fourth***, the District Court did not address the longstanding "valid-when-made" doctrine, which provides that a loan that is validly originated cannot become invalid simply because it is assigned or sold to another entity.[9] Even if it had addressed the valid-when-made doctrine, the District Court could have rejected that argument at this stage of the litigation given the District Court's statement that Midland had not adequately shown that FIA was headquartered in Delaware, and so there would have been an open question as to whether FIA was entitled at the time the debt was originated to charge rates permissible under Delaware (as opposed to New York) law under the NBA.

## IMPLICATIONS

The District Court's opinion has several potentially significant implications.

***First***, in opposing Midland's request for the U.S. Supreme Court to review the Second Circuit's earlier opinion, the United States federal government argued that, although the Second Circuit's decision was wrong, the U.S. Supreme Court should not review the case because the District Court might reject Madden's claims on other grounds, or that class certification could be denied following the Second Circuit's remand back to the District Court.[10] If this case continues and is again in position for potential U.S. Supreme Court review, arguments in favor of such review will be stronger.

***Second***, the District Court's ruling exacerbates the risks created by the Second Circuit's earlier decision for any debt purchaser seeking to collect from a New York resident at a rate of interest above 16% on regular debt and above 25% on defaulted and non-defaulted debt. As noted in a recent academic study, the Second Circuit's decision "reduced credit availability for riskier borrowers, who are more likely to borrow at rates above usury limits" in the Second Circuit.[11] It is not clear whether the District Court found that New York's civil usury laws constituted a fundamental public policy, or whether the District Court's reasoning was limited to New York's criminal usury laws. However, the District Court cited a New York State court case that held that the civil usury laws constituted a fundamental public policy.[12]

***Third***, the ruling also has implications for non-bank lenders and purchasers of bank loans that rely on choice of law clauses to export interest rates above 16% into New York. Taken together with the Second Circuit's decision limiting the preemptive effect of the NBA, the choice-of-law analysis may be increasingly important for non-bank lenders and purchasers of bank loans—other courts could similarly hold that other States' usury laws are fundamental public policies that override choice of law provisions.

***Fourth***, the implications of this case (and similar cases) on the valid-when-made doctrine remain unaddressed.

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## ENDNOTES

[1] *See* Colleen Honigsberg, Robert J. Jackson, Jr. & Richard Squire, What Happens when Loans Become Legally Void? Evidence from a Natural Experiment, at 2 (Columbia Bus. Sch. Research Paper No. 16-38, Dec. 12, 2016), https://papers.ssrn.com/sol3/papers2.cfm?abstract_id=2780215.

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

[3] *See Olvera* v. *Blitt & Gaines, PC*, 431 F.3d 285 (7th Cir. 2005); *Krispin* v. *May Dep't Stores Co.*, 218 F.3d 919 (8th Cir. 2000); *FDIC* v. *Lattimore Land Corp.*, 656 F.2d 139 (5th Cir. Unit B Sept. 1981).

[4] *Madden* v. *Midland Funding, LLC*, 11-CV-8149 (CS), 2017 WL 758518 (S.D.N.Y. Feb. 27, 2017).

[5] *Id.* at *9.

[6] *Id.* at *8-11.

[7] *Id.* at *8, 12.

[8] *Id.* at *8-10.

[9] *See, e.g.*, *Nichols* v. *Fearson*, 32 U.S. (7 Pet.) 103, 105 (1833) ("[A] contract which in its inception is unaffected by usury can never be invalidated by any subsequent usurious transaction.").

[10] Brief for the United States as Amicus Curiae, at 19-20, Petition for Writ of Certiorari, *Madden* v. *Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016) (No. 15-610). The Solicitor General's *amicus* brief was joined by the Office of the Comptroller of the Currency.

[11] *See* Honigsberg, Jackson, & Squire, *supra* note 1.

[12] *See Madden*, 2017 WL 758518, at *10 (citing *N. Am. Bank* v. *Schulman*, 474 N.Y.S. 2d 383, 387 (Cty. Ct. Westchester Cty. 1984) ("[T]he policy underlying our state's usury laws is in fact of a fundamental nature.")).

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## CONTACTS

### New York


| | | |
|---|---|---|
| Thomas C. Baxter Jr. | +1-212-558-4324 | baxtert@sullcrom.com |
| Jason J. Cabral | +1-212-558-7370 | cabralj@sullcrom.com |
| Whitney A. Chatterjee | +1-212-558-4883 | chatterjeew@sullcrom.com |
| H. Rodgin Cohen | +1-212-558-3534 | cohenhr@sullcrom.com |
| Elizabeth T. Davy | +1-212-558-7257 | davye@sullcrom.com |
| Mitchell S. Eitel | +1-212-558-4960 | eitelm@sullcrom.com |
| Michael T. Escue | +1-212-558-3721 | escuem@sullcrom.com |
| Jared M. Fishman | +1-212-558-1689 | fishmanj@sullcrom.com |
| C. Andrew Gerlach | +1-212-558-4789 | gerlacha@sullcrom.com |
| Wendy M. Goldberg | +1-212-558-7915 | goldbergw@sullcrom.com |
| Charles C. Gray | +1-212-558-4410 | grayc@sullcrom.com |
| Shari D. Leventhal | +1-212-558-4354 | leventhals@sullcrom.com |
| Erik D. Lindauer | +1-212-558-3548 | lindauere@sullcrom.com |
| Mark J. Menting | +1-212-558-4859 | mentingm@sullcrom.com |
| Sharon L. Nelles | +1-212-558-4976 | nelless@sullcrom.com |
| Camille L. Orme | +1-212-558-3373 | ormec@sullcrom.com |
| Matthew A. Schwartz | +1-212-558-4197 | schwartzmatthew@sullcrom.com |
| Rebecca J. Simmons | +1-212-558-3175 | simmonsr@sullcrom.com |
| William D. Torchiana | +1-212-558-4056 | torchianaw@sullcrom.com |
| Donald J. Toumey | +1-212-558-4077 | toumeyd@sullcrom.com |
| Marc Trevino | +1-212-558-4239 | trevinom@sullcrom.com |

| | | |
|---|---|---|
| Mark J. Welshimer | +1-212-558-3669 | welshimerm@sullcrom.com |
| George H. White III | +1-212-558-4328 | whiteg@sullcrom.com |
| Michael M. Wiseman | +1-212-558-3846 | wisemanm@sullcrom.com |
| **Washington, D.C.** | | |
| Eric J. Kadel, Jr. | +1-202-956-7640 | kadelej@sullcrom.com |
| William F. Kroener III | +1-202-956-7095 | kroenerw@sullcrom.com |
| Stephen H. Meyer | +1-202-956-7605 | meyerst@sullcrom.com |
| Jennifer L. Sutton | +1-202-956-7060 | suttonj@sullcrom.com |
| Andrea R. Tokheim | +1-202-956-7015 | tokheima@sullcrom.com |
| Jeffrey B. Wall | +1-202-956-7660 | wallj@sullcrom.com |
| Samuel R. Woodall III | +1-202-956-7584 | woodalls@sullcrom.com |
| **Los Angeles** | | |
| Patrick S. Brown | +1-310-712-6603 | brownp@sullcrom.com |
| William F. Kroener III | +1-310-712-6696 | kroenerw@sullcrom.com |
| **Paris** | | |
| William D. Torchiana | +33-1-7304-5890 | torchianaw@sullcrom.com |
| **Melbourne** | | |
| Robert Chu | +61-3-9635-1506 | chur@sullcrom.com |
| Burr Henly | +61-3-9635-1508 | henlyb@sullcrom.com |
| **Tokyo** | | |
| Keiji Hatano | +81-3-3213-6171 | hatanok@sullcrom.com |