Client Alert

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OCC Weighs In On Madden, But Leaves Open Issues

On November 18, 2019, the Office of the Comptroller of the Currency (OCC), partially in response to the court ruling in *Madden v. Midland Funding* (*Madden*),[1] released a notice of proposed rulemaking on the "valid when made" doctrine. The proposed rule is intended to clarify that "when a national bank or savings association sells, assigns, or otherwise transfers a loan, interest permissible prior to the transfer continues to be permissible following the transfer." Comments on the proposal are due 60 days after publication of the proposal in the Federal Register, but in no event earlier than January 17, 2020. A similar FDIC proposal is forthcoming, but was not available at the time of this client alert.

Madden

In 2011, Saliha Madden, a New York resident, sued Midland Funding LLC (Midland) in the Southern District Court for New York for violations of New York state usury laws. Midland had purchased the plaintiff's defaulted credit card account from Bank of America (a national bank) and charged the plaintiff the valid and contracted for interest rate. However, this rate was in excess of New York usury limitations.

In 2013, the district court ruled in favor of Midland, holding that 12 U.S.C. § 85 preempted state usury claims against Midland. However, on appeal in 2015, the Second Circuit held that the national bank's preemption authority did not extend to Midland, a non-bank purchaser of the loans. The Second Circuit decision contradicted the "valid when made" theory: an obligation is considered valid under the law that applied at the time of origination. The US Supreme Court declined to hear an appeal of Madden and the parties ended up settling in 2019.

Madden's Impact

Madden brought into question the marketability of bank loan portfolios and the viability of the bank-partnership model.[2] Banks have had to grapple with the applicability of *Madden* outside of the Second Circuit and how *Madden* could or should impact their strategic planning, including with respect to potential partnerships with marketplace and other nonbank lenders. Debt purchasers and marketplace lenders, on the other hand, face the risk that they may be engaging in illegal (and sometimes criminal) conduct merely by enforcing the terms of the debt they purchased. In a 2018 report, the US Treasury Department recommended that Congress bring legal certainty to the issue by codifying the "valid when made" doctrine.[3] In September of 2019, Republicans from the House Financial Services Committee called on the OCC to address *Madden* through a rulemaking.[4]

The OCC's Proposal

The OCC proposes adding a new provision to its interest rate regulation:

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[1] *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2nd Cir. 2015).
[2] According to the *Wall Street Journal*, the decision in *Madden* "has been cited by investors as one reason that LendingClub shares are down about 43% from the company's December 2014 initial public offering" through 2016. Wall Street Journal, *LendingClub to Change its Fee Model* (Feb. 26, 2016).
[3] U.S. Department of Treasury, *A Financial System that Creates Economic Opportunities* (Jul. 2018), page 93.
[4] Letter dated September 19, 2019 from members of Congress to the OCC.

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(e) *Transferred loans.* 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.[5]

The proposal claims that "multiple legal principles support the OCC's interpretation."

- First, is an 1833 Supreme Court case that states that "a contract which in its inception is unaffected by usury can never be invalidated by any subsequent usurious transaction."[6]
- Second, is that the "valid when made" doctrine is implicit in the authority of banks to assign their loan contracts to third parties.[7]
- Third, Congress would not have intended to limit banks' authority to assign loans by making such assignments subject to the application of different usury regimes.
- Fourth, the "valid when made" doctrine is consistent with the purpose of 12 U.S.C. 85 "to facilitate banks' ability to operate across state lines by eliminating the burden of complying with each state's interest laws."

Impact of the OCC's Proposal

While the OCC's attempt to bring legal certainty to the "valid when made" doctrine is welcome, it is unclear exactly what impact the proposal will have.

1. Because the rulemaking is framed as a "clarification," we assume the OCC intends for the rulemaking to apply to all loans that have already been made rather than simply on a going-forward basis. If this assumption is wrong, the impact of the proposal would be greatly curtailed.
2. As with the OCC's support of the FinTech charter, we suspect this proposal will be challenged in court by a state regulator (potentially, the New York Department of Financial Services). If so, the proposal will have limited impact until such litigation is resolved.[8]
3. The proposal does not address whether the "valid when made" doctrine also applies to loan fees that may be permissible under federal law, but not state law.
4. The proposal does not address, and expressly disclaims addressing, the "true lender" doctrine. This doctrine goes to the question of which entity "originates" a loan. While a plaintiff in theory might agree with the OCC's application of the "valid when made" doctrine, a plaintiff could still challenge the payment of interest on state usury grounds by arguing that a third party, rather than a national bank, "originated" a loan. This would imply that the national bank usury rules do not apply to such loans.

It is interesting that the OCC has declined to address the "true lender" doctrine in this rulemaking. The OCC, as the regulator of national banks, clearly has the authority to settle the legal question of whether a national bank (rather than a third party) makes a loan by defining what is meant by "loaning money." This is

[5] 12 C.F.R. § 7.4001. Similar language is proposed for savings association regulation at 12 C.F.R. § 160.110.
[6] *Nicholas v. Fearson*, 32 U.S. 7 Pet. 103 (1833).
[7] On this point, the OCC cites (i) restatements of law ("An assignment does not normally change the borrower's obligation to repay in any material way. *See* 29 Williston on Contracts § 74:10") and (ii) a court case ("*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.').")
[8] We also note that the proposal does not mention coordination with state regulators, suggesting that there has been no coordination (or, if there has, that there has not been any agreements). This heightens the risk of a court challenge.

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a federal law question interpreting a power expressly given by Congress to national banks under 12 U.S.C. § 24(Seventh).[9]

Contrastingly, the OCC's authority to unilaterally address the "valid when made" doctrine is less than clear. Future court cases, like *Madden*, will have to continue to grapple with the argument that rejecting the "valid when made" doctrine "prevents or significantly interferes with the exercise by the national bank of its powers."[10] Given that *Madden* does not impact the sale of bank loans to other banks,[11] it is conceivable that a court could find that *Madden* does not "prevent or significantly interfere" with a bank's lending authority and reject the adoption of the "valid when made" doctrine. Comment letters in favor of this proposal should carefully focus on demonstrating why rejecting the "valid when made" doctrine prevents or significantly interferes with a bank's lending authority.

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[9] In an analogous context, courts have consistently held that the meaning of the term "branch" "is a question of federal law to be determined initially by the Comptroller of the Currency and review[able] by the federal courts." *Driscoll v. Northwestern Nat'l Bank*, 484 F.2d 173, 175 (8th Cir. 1973). States should not be able to indirectly infringe on permissible national bank activities by redefining key terms.

[10] 12 U.S.C. § 25b(b)(1)(B).

[11] Because all banks are federally insured and federally insured banks are governed by a usury statute (12 U.S.C. §1831d) similar to the national bank usury statute.