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NY Credit Card Securitization Class Action Misuses Madden

By **Walter Zalenski** (July 18, 2019, 3:29 PM EDT)

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The U.S. Court of Appeals for the Second Circuit's decision in Madden v. Midland Funding LLC[1] is deservedly notorious. The Madden court erroneously held that state usury laws may prohibit a national bank's assignee from enforcing the interest rate on a credit agreement that was valid under the law of the state in which the national bank is located.

This holding conflicts with the valid-when-made doctrine, long recognized in common law, as well as with key preemption principles stemming from a national bank's Section 85 authority to charge interest up to the maximum permitted by its home state and the express power in 12 U.S.C. § 24 (Seventh) to sell loans that it so originates. Many commentators recognize the manifest problems of Madden, as does the Office of the Comptroller of the Currency and the solicitor general, as expressed in an amicus brief to the Supreme Court filed in connection with a failed petition for certiorari to the Supreme Court.

Madden, which remains controlling law in the Second Circuit, is not only wrong, but pernicious due to its potential ramifications on credit markets. It would seem unlikely, therefore, that a plaintiff suing a bank under a Madden theory would be hoist on the petard of the Madden opinion itself, but that seems to be the likely scenario in Cohen v. Capital One Funding LLC,[2] a putative class action lawsuit recently filed in the U.S. District Court for the Eastern District of New York.

The plaintiffs are suing special purpose trusts that purchased and securitized credit card receivables originated and sold by Capital One Bank, a national bank. Relying on Madden, the plaintiffs contend that (1) federal preemption no longer attaches to the receivables once Capital One Bank sold the receivables to the trusts, and (2) the trusts unlawfully charged and collected interest rates in excess of New York's usury limits.

It is likely unfortunate for the plaintiffs that their neat theory seems unfettered by such inhibiting factors as the actual text and analysis of Madden. The Second Circuit's decision states clearly that it would not have ruled as it did if the bank had "retained substantial interests in the credit card accounts so that application of state law to those accounts would have conflicted with the bank's powers authorized by the [National Bank Act]."[3] What is sufficient interest in the credit card accounts?

One example cited with approval by the Madden court is the set of facts at issue in Krispin v. May Department Stores Co.,[4] a U.S. Court of Appeals for the Eighth Circuit decision rejecting a usury-type challenge under a fact pattern similar to that at issue in Cohen. Specifically, Krispin involved a challenge to late fees charged to holders of a department store credit-card account.[5] May National Bank of Arizona, a wholly owned subsidiary of the store, originated the credit card accounts with a late fee permissible under its home state law. The store "purchased the bank's receivables on a daily basis."[6] The plaintiffs unsuccessfully argued that the late fees, which are exportable under Section 85 of the United States Code, violated state law,[7] the Court of Appeals holding that the National Bank Act preempted the claims.[8]

As the Madden court noted, "the point of the Krispin holding was … that notwithstanding the bank's sale of its receivables to May Stores," the bank continued to own the account

relationship.[9] “In Krispin,” the Madden court observed, “when the national bank’s receivables were purchased by May Stores, the national bank retained ownership of the accounts, leading the court to conclude that ‘the real party in interest is the bank.’”[10]

The bank’s retention of the account relationship (as opposed to the receivables generated by the accounts) and its maintenance of an ongoing credit relationship with each account holder is typical, if not essential, in most credit card or other open-end credit receivables sales because each subsequent draw on the credit lines must be covered by the bank’s rate exportation and preemption authority.[11] The Madden facts, which the Second Circuit distinguished from those in Krispin, involved a sale of credit card debt that the bank in that case had charged off as uncollectable and thus retained no interest in the accounts whatsoever.[12]

The Capital One securitization structure at issue in the Cohen lawsuit seems to be on the more typical Krispin model, where the bank continues to own the account relationship. The Madden decision has answered in the affirmative whether this specific type of interest in the credit card accounts precludes the application of state usury law. Hence, the plaintiffs’ theory in the Cohen lawsuit is neither an application nor a logical extension of Madden. Rather, it contradicts the most relevant part of Madden and should fail.

While this Madden-type class action challenging the fundamentals of securitizations has caused some alarm, on the merits there is less here than first meets the eye. Nevertheless, what remains is that Madden will continue to have a chilling effect on credit markets. The case casts a cloud not only over bank sales of charged-off credit card debt but also over bank sales, via securitizations or otherwise, of closed-end loans to borrowers in the Second Circuit states. Madden has also been invoked outside the Second Circuit in so-called “true lender” challenges to common bank partnership programs. Given the failure of Congress to enact a “Madden fix,” and the lack thus far of any administrative solution from the banking agencies, perhaps new cases, like Cohen, will present opportunities for the Second Circuit itself to reconsider what it has wrought.

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[1] 786 F.3d 246 (2d Cir. 2015), cert. denied, Midland Funding LLC v. Madden, 136 S. Ct. 2505 (2016).

[2] No. 19-cv-03479-KAM-RLM (E.D.N.Y. filed June 12, 2019).

[3] 786 F.3d at 252 n.2.

[4] 218 F.3d 919 (8th Cir. 2000).

[5] Id. at 921-22.

[6] Id. at 923.

[7] Id. at 921-22.

[8] Id. at 924.

[9] 786 F.3d at 252 n.2.

[10] Id. at 252 (quoting 218 F.3d at 924).

[11] Bank retention of account relationships also is a feature of loan participation arrangements.

[12] The Solicitor General and OCC's amicus brief to the Supreme Court, which, as noted, was otherwise harshly critical of Madden, agreed with this distinction and concluded that the decision did not create a circuit split with the Eighth Circuit. Brief for the United States as Amicus Curiae at 13-16, 136 S. Ct. 2505 (No. 15-610).