Buckley Sandler LLP

SPECIAL ALERT: SECOND CIRCUIT DECISION THREATENS TO UPSET SECONDARY CREDIT MARKETS

The Second Circuit Court of Appeals' recent decision in *Madden v. Midland Funding, LLC* held that a nonbank entity taking assignment of debts originated by a national bank is not entitled to protection under the National Bank Act ("NBA") from state-law usury claims.[1] In reaching this conclusion, the Court appears to have not considered the "Valid-When-Made Doctrine"—a longstanding principle of usury law that if a loan is not usurious when made, then it does not become usurious when assigned to another party. If left undisturbed, the Court's decision may well have broad and alarming ramifications. The decision could significantly disrupt secondary markets for consumer and commercial credit, impacting a broad cross-section of financial services providers and other businesses that rely on the availability and post-sale validity of loans originated by national or state-chartered depository institutions.

The Court's Holding

In *Madden*, the Second Circuit addressed the rights of purchasers or assignees of loans to collect interest as set forth in the original note or credit agreement. Under the facts of the case, the credit was originated by a national bank and assigned to a nonbank debt buyer.

There was no question that the interest rate contracted for by the national bank was lawful, notwithstanding the fact that it exceeded the usury rate of the consumer-debtor's home state of New York. The Court acknowledged that Section 85 of the NBA permits national banks to charge interest at any rate permitted under the laws of the state in which it is located and to "export" that rate notwithstanding the state law of where borrowers are located.[2] However, when the Court addressed the question of whether the nonbank purchaser of the national bank's credit obligation could continue to charge the contract rate of interest, the Court concluded that such a purchaser could not.

The Court's Rationale

The Court viewed the question of the rights of an assignee of the credit agreement to collect the rate agreed to between the national bank and consumer-debtor to be purely a question of the scope of federal preemption. The Court noted that, "[i]n most cases in which NBA preemption has been applied to a non-national bank entity, the entity has exercised the powers of a national bank—i.e., has acted on behalf of a national bank in carrying out the national bank's business."[3] In this case, however, the assignee was not acting on the bank's behalf. Therefore, the Court concluded that, rather than significantly interfering with

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[1] Madden v. Midland Funding, LLC, No. 14-2131-cv, 2015 WL 2435657, at *1, *8 (2d Cir. May 22, 2015).

[2] State chartered banks have parallel rights under 12 U.S.C. §1831d.

[3] Id. at *4.

a national bank's exercise of its powers, application of state usury laws to the third-party assignee "would 'limit [ ] only activities of [a] third party which are otherwise subject to state control … and which are not protected by federal banking law or subject to [Office of the Comptroller of the Currency] oversight."[4] In the Court's view allowing the assignee to enforce the credit agreement as written "would create an end-run around usury laws for non-national bank entities that are not acting on behalf of a national bank."[5] Although we do not agree with the Court's preemption analysis, perhaps more critical is what the Court failed to consider.

What the Court Missed

The Second Circuit's reasoning in *Madden* ignored long-standing precedent upholding an assignee's right to charge and collect interest in accordance with an assigned credit contract that was valid when made. Over 100 years ago, the Supreme Court put it this way:

> There are two *cardinal rules* in the doctrine of usury, which we think must be regarded as the common-place to which all reasoning and adjudication upon the subject should be referred. The first is, that to constitute usury, there must be a loan in contemplation by the parties; and the second, *that a contract, which, in its inception, is unaffected by usury, can never be invalidated by any subsequent usurious transaction*.[6]

The Fifth Circuit has stated the rule even more succinctly: "The non-usurious character of a note should not change when the note changes hands."[7] This rule is generally referred to as the "Valid-When-Made Doctrine" – a fundamental principle that was not even mentioned in the *Madden* opinion.

We view the Valid-When-Made Doctrine in part as a specific application of the basic contract law principle that a contractual right can be assigned unless the substitution of the assignee for the assignor would (a) materially change the duty of the obligor, (b) materially increase the burden or risk imposed on the obligor, (c) materially impair the risk of obtaining return performance, or (d) materially reduce the contract value to the obligor.[8] This principle is not only reflected in the *Restatement (2d) of Contracts*, but the official comments to the *Restatement* reach the obvious conclusion that "[w]hen the obligor's duty is to pay money, a change in the person to whom the payment is to be made is not ordinarily material."[9]

These basic principles are distinct from the federal preemption issue that the Second Circuit seized upon to the exclusion of all others. The only critical preemption question should have been whether the national bank had the right to contract for and collect the rate specified in the credit agreement – whether

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[4] Id. at *5 (quoting SPGGC, LLC v. Blumenthal, 505 F.3d 183, 191 (2d Cir. 2007)).

[5] Id. at *5.

[6] Nichols v. Fearson, 32 U.S. 103, 109 (1833). (Emphasis Added)

[7] FDIC v. Lattimore Land Corp., 656 F.2d 139, 148-49 (5th Cir. 1981).

[8] Restatement (Second) of Contracts § 317 (1981).

[9] Restatement (Second) of Contracts § 317 (1981), Comment d. See also *Olvera v. Blitt & Gains, P.C.* 431 F. 3d 285, 288 (7th Cir. 2005) (Common law of assignments allows assignees to collect interest rate allowed to original creditor).

the debt was valid when made. The Court rightly concluded that it was. It failed, however, to consider whether, under the Valid-When-Made Doctrine and the law of contract assignment, New York state law was in fact violated.

Importantly, the Valid-When-Made Doctrine does not depend on the existence of federal preemption. It likewise applies when a licensed nonbank lender has interest rate authority that is not available to non-licensees and that lender sells or assigns a loan to an unlicensed third party.

Potential Impact of the Court's Decision

The *Madden* decision potentially carries far-reaching ramifications. The entire secondary market for credit relies on the Valid-When-Made Doctrine to enforce credit agreements pursuant to their terms. Buyers of defaulted debt, like the defendant in *Madden*, generally will not have the same interest rate authority as the creditors selling such debt. Unfortunately, however, the same is true for securitization vehicles, hedge funds, other purchasers of whole loans, including those who purchase loans originated by banks pursuant to private-label arrangements and other bank relationships, such as those common to the peer-to-peer and marketplace lending industries and various types of on-line consumer credit.

Needless to say, banks are not immune from the financial implications of *Madden*. Under the Court's decision, the liquidity and resale value of their current loan assets is practically diminished.[10]

What Happens Next?

The defendant appellee in *Madden* has stated its intent to petition the Court to rehear its case, and it must do so by June 19th, a week from today. While only a small percentage of such petitions are granted, one can only hope that the Court in this instance can be convinced of its error.

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Questions regarding the matters discussed in this Alert may be directed to any of our lawyers listed below, or to any other BuckleySandler attorney with whom you have consulted in the past.

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[10] Based on the broad scope of federal rate preemption for mortgage loans, which is available to banks and nonbanks alike, we would argue that the secondary mortgage market should be immune from the impact of *Madden*. Certain open-end credit receivables sale structures might also be immune.