Financial Institutions Regulation and Alternative Investments Groups

Client Alert

OCC and FDIC Proposed Rules Seek to Neutralize *Madden* Holding and Restore "Valid-When-Made" Principle

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On November 18, 2019, the Department of the Treasury's Office of the Comptroller of the Currency ("**OCC**") issued a notice of proposed rulemaking (the "**OCC Proposed Rules**") that would codify the OCC's position that when a national bank "sells, assigns, or otherwise transfers a loan, interest permissible prior to the transfer continues to be permissible following the transfer."[1] The Federal Deposit Insurance Corporation (the "**FDIC**") issued a parallel notice of proposed rulemaking the following day (the "**FDIC Proposed Rules**" and, together with the OCC Proposed Rules, the "**Proposed Rules**") that similarly set forth the FDIC's position that whether interest on a loan is permissible under section 27 of the Federal Deposit Insurance Act should be determined at the time the loan is made, and should not be affected by subsequent events such as "the sale, assignment, or other transfer of the loan."[2] The Proposed Rules seek to reaffirm well-established federal law, Congressional intent and basic contract law principles that dictate that a loan's interest rate remains legal if it was legal at the time of origination of the loan, regardless of the legal status of the assignee as a bank or non-bank.[3] The OCC Proposed Rules would apply to national banks and savings associations, while the FDIC Proposed Rules would apply to state-chartered banks and insured branches of foreign banks (collectively, "**banks**").[4] The Proposed Rules would not apply to loans originated by non-bank lenders.

[1] OCC Proposed Rules, *Permissible Interest on Loans That Are Sold, Assigned, or Otherwise Transferred*, 84 FR 64229 (November 21, 2019).

[2] *See* FDIC Notice of Proposed Rulemaking at https://www.fdic.gov/news/board/2019/2019-11-19-notice-dis-c-fr.pdf.

[3] We note that the Comptroller of the Currency is a member of the board of the FDIC.

[4] Uninsured state-licensed branches of foreign banks are generally subject to the same laws and regulations as those of their state-chartered counterparts, while uninsured federally-licensed branches or agencies of foreign banks are generally subject to the same laws and regulations as apply to national banks, with certain exceptions. *See*, *e.g.*, 12 U.S.C. 3102(b). Together, then, the Proposed Rules would effectively apply to every chartered or licensed banking entity in the United States.

BACKGROUND

Madden case

The Proposed Rules are being promulgated largely in response to the decision of the 2nd Circuit Court of Appeals in the case of *Madden v. Midland Funding LLC*[5] ("**Madden**"). *Madden* cast into doubt whether assignees of loans originated by national banks would be protected from the application of state usury laws. Prior to the Madden decision, market participants had assumed that assignees could "step into the shoes" of the national bank originator and enforce the interest term of the loan. The Second Circuit held in *Madden*, however, that a non-national bank assignee of a credit card debt originated by a national bank could not rely on the National Bank Act ("**NBA**") for preemption of state usury laws.

Under the NBA, national banks may be sued for usury only if they charge an interest rate higher than the maximum rate allowed by their home state, and all other usury claims against national banks are preempted by the NBA. Traditionally, it was common practice for assignees of loans originated by national banks to rely on NBA pre-emption, even if the assignee were not a national bank. Madden upset reliance on this "valid-when-made" doctrine by holding that preemption under the NBA protects non-national bank entities only if application of state law would significantly interfere with a national bank's ability to exercise its power under the NBA.[6] Implicit in that holding was the apparent assumption that burdening the assignees of loans originated by national banks does not significantly burden the banks themselves or inhibit the exercise of their powers, despite the reduction in liquidity with respect to loans extended by those banks. To wit, the *Madden* Court held that no significant interference would exist in the case of application of state usury laws where a national bank assigns a loan to a non-national bank assignee. The *Madden* case thereby injected significant uncertainty into the secondary loan market. As we stated in our client alert of October 8, 2015, secondary loan markets have historically been liquid in part *because* this doctrine provided financial institutions comfort that loans originated by federal or state-chartered depositary institutions would remain non-usurious after assignment.[7]

Valid-When-Made Doctrine

The valid-when-made doctrine "provides that if a loan is non-usurious at origination, the loan does not subsequently become usurious when assigned."[8] This principle has existed in common law since before the passage of the NBA.[9] While the Court in *Madden* did not even directly address the valid-when-made doctrine, the OCC staff cite it as an important legal basis for the conclusion that "banks may assign their loans without impacting the validity or enforceability of the interest."[10] The OCC Proposed Rules apply the valid-when-made doctrine in interpreting 12 U.S.C. §85 (with respect to national banks) and 12 U.S.C. 1463(g) (with respect to savings associations), while the FDIC Proposed Rules apply the doctrine in the context of 12 U.S.C. 1831d, which the FDIC interprets in a manner consistent with 12 U.S.C. § 85.

SCOPE OF THE PROPOSED RULES AND WHAT THEY COULD MEAN FOR THE SECONDARY LOAN MARKET

If finalized as proposed, the Proposed Rules would formally codify the FDIC and OCC's stance that if a loan originated by a bank is not usurious when made, it would not become usurious because of an assignment to a non-bank entity. As such, the Proposed Rules seek to effectively return the legal environment to a pre-*Madden* state, where lenders and purchasers of loans in the secondary market could rely on the valid-when-made principle. This should benefit banks as well as participants in the secondary loan markets, including participants in structured finance and securitization markets. The OCC specifically noted the benefits of loan assignments and securitization as risk management tools for banks.[11]

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[5] 786 F.3d 246 (2d Cir. 2015).

[6] *Madden*, 786 F.3d at 250.

[7] https://www.milbank.com/images/content/2/1/v6/21810/AIP-Client-Alert-Madden-v.-Midland-Funding-LLC-Oct-2015.pdf

[8] 84 FR 64229 at 64231, citing *Nichols v. Fearson*, 32 U.S. (7 Pet.) 103, 109 (1833).

[9] 84 FR 64229 at 64231.

[10] *Id.*

[11] *Id.*

We expect that the Proposed Rules will face pushback from consumer advocates. The best reading of the proposals, however, is that they do not constitute a novel effort to loosen consumer protections but rather seek to restore certainty to the secondary loan market—and thereby eliminate an unnecessary barrier to underserved borrowers accessing credit—by restoring confidence in well-established legal principles and longstanding industry practice. Viewed in this light, and given the fact that the *Madden* court failed to address at all the longstanding valid-when-made doctrine, as a matter of law, we do not believe the Proposed Rules should be controversial. However, we note that while the Proposed Rules set forth the FDIC and OCC's interpretation of the law, courts are not necessarily *obligated* to adopt the agencies' approach, and as a result, the Proposed Rules are not likely in themselves to provide final legal certainty on these issues.

Both Proposed Rules also explicitly decline to address the "true lender" question, an issue arising in a number of court cases that examined whether a nonbank entity should be considered the true lender where a bank makes a loan and then assigns it to that nonbank third party.[12] In certain of those cases, courts have articulated the view that a nonbank entity may be considered the true lender (and therefore would not be entitled to preemption under the NBA) because, while the loan may have been extended by a national bank, the substance of the transaction indicated that the nonbank entity was the true lender.[13] The FDIC Proposed Rule further notes that, notwithstanding the clarity it intends to provide under the FDIC Proposed Rule, the FDIC will take an "unfavorable" view of entities that partner with a state bank with the sole goal of evading a lower interest rate established under the law of the entity's licensing state(s). These issues, which often arise in the context of "rent-a-charter" schemes, remain unsettled.

[12] *See*, *e.g., Ubaldi v. SLM Corp.*, 852 F. Supp. 2d 1990, 1200 (N.D. Cal. 2012).

[13] *Id.*

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