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Alternative Investments Practice Client Alert: *Madden v. Midland Funding LLC* – Implications and Potential Responses

This client alert focuses on the implications of the Second Circuit's decision in *Madden v. Midland Funding, LLC*[1] ("***Madden***") and considers strategies for secondary market loan transactions that may mitigate its effects.

BACKGROUND AND MARKET RESPONSE

Under the National Bank Act ("**NBA**"), national banks may be sued for usury only if they charge an interest rate higher than that allowed by their home state.[2] All other usury claims against national banks are preempted by the NBA. On May 22, 2015, the United States Court of Appeals for the Second Circuit held in *Madden* that a non-national bank assignee of debt originated by a national bank could not rely on the NBA for preemption of state usury laws.

Citing the relevant preemption standard set forth by the Supreme Court in *Barnett Bank of Marion County, N.A. v. Nelson*[3], the Second Circuit wrote that "[t]o apply NBA preemption to an action taken by a non-national bank entity, application of state law to that action must significantly interfere with a national bank's ability to exercise its power under the NBA."[4] The Court then held that no such "significant interference" would occur if assignees of debt originated by national banks were prevented from relying on NBA preemption of state usury laws:

> [S]tate usury laws would not prevent consumer debt sales by national banks to third parties. Although it is possible that usury laws might decrease the amount a national bank could charge for its consumer debt in certain states

[1] 786 F.3d 246 (2d Cir. 2015).
[2] 12 U.S.C. § 85; 12 C.F.R. § 7.4001.
[3] 517 U.S. 25, 33 (1996).
[4] *Madden*, 786 F.3d at 250.

(*i.e.*, those with firm usury limits, like New York), such an effect would not "significantly interfere" with the exercise of a national bank power.[5]

The Court reached this conclusion apparently without considering any empirical data that may have shed light on the likely effects of this holding on the business of national banks.

In reaching its decision, the Second Circuit also did not address at all an independent basis for finding that the interest charged by Defendants was valid: The longstanding and widely relied-upon common law principle that "[t]he non-usurious character of a note should not change when the note changes hands"—the so-called Valid-When-Made Doctrine.[6]

Defendants requested rehearing of the Second Circuit's decision, seeking to focus the Second Circuit on the Valid-When-Made issue and encourage the Court to reconsider whether its ruling would substantially interfere with national banks' ability to exercise their authority under the NBA, but the Second Circuit denied their petition for rehearing on August 12, 2015. Defendants are expected to file a petition for writ of certiorari to the Supreme Court prior to the November 19, 2015 deadline. At least for now, however, the Second Circuit's decision in *Madden* is binding on federal courts in New York, Connecticut and Vermont.

As it stands, *Madden* is causing substantial uncertainty in the lending industry as a whole and especially in secondary loan markets. Secondary loan markets have historically been liquid in part because the Valid-When-Made Doctrine provided financial institutions comfort that loans originated by federal or state-chartered depositary institutions would remain non-usurious after assignment. Unless it is overturned or qualified, *Madden* has important implications for the lending market.

MADDEN'S SCOPE

Analyzing *Madden*'s substantive and jurisdictional scope is crucial to understanding the likely implications of the decision.

Madden does not explicitly address the Valid-When-Made Doctrine.

The Second Circuit did not mention the Valid-When-Made Doctrine when deciding *Madden*. This leaves room to argue—even in the Second Circuit—that the Valid-When-Made Doctrine compels the conclusion that loans that are valid when originated remain valid after assignment, even if NBA preemption does not apply. Any defendant arguing against the application of *Madden*—whether as binding authority inside the

[5] *Id.* at 251.
[6] *FDIC v. Lattimore Land Corp.*, 656 F.2d 139, 148-49 (5th Cir. 1981) (citing cases).

Second Circuit or persuasive authority outside of it—should emphasize the Valid-When-Made Doctrine.

Madden is not binding with respect to state-chartered banks, but loans originated by those banks may be treated similarly.

Madden interprets the scope of a particular provision of the NBA that preempts the application of state usury laws to national banks. *Madden* does not analyze the similar—but distinct—federal law provision that preempts the application of usury laws to state-chartered banks: Section 27 of the Federal Deposit Insurance Action ("**FDIA**").[7] For this reason, *Madden* is not expressly binding with respect to loans originated by state-chartered banks. That said, defendants seeking to draw a distinction been national and state-charted banks vis-à-vis *Madden* may face challenges from plaintiffs. The NBA and FDIA preemption provisions are similar, and the stated purpose of the FDIA provision relating to state-chartered banks is to "prevent discrimination" against them—*i.e.*, to prevent them from being outcompeted by national banks. If a court believes national banks are subject to the *Madden* rule, there is a risk it may conclude that state-chartered banks are subject to the same rule. Moreover, a number of courts have noted the similarities between the two usury law preemption provisions and held that they should be construed together.[8]

Madden's importance may be fairly limited with respect to loans transferred between depository institutions.

The potential effects of *Madden* may be fairly limited with respect to loans transferred between national banks and state-chartered banks because these depository institutions are independently entitled to preemption of state usury laws via the NBA and FDIA respectively. For example, if a national bank originated a loan and assigned it to a state-chartered bank, a court considering a usury claim may look to whether the assignee state-chartered bank was permitted to charge the interest rate at issue under the usury law applicable to loans originated by that state-chartered bank. Pursuant to FDIA preemption, the usury law of the state-chartered bank's home state—and only that usury law—arguably applies in this scenario.

Madden could apply to loans originated outside of the Second Circuit.

While some commentators have suggested that parties may insulate themselves from *Madden* by excluding from securitization pools loans to borrowers in the Second Circuit, that may not completely eliminate the risk of the *Madden* decision being applied to such parties. Whether *Madden*'s interpretation of NBA preemption directly

[7] Codified at 12 U.S.C. § 1831d.
[8] *See, e.g., Greenwood Trust Co. v. Massachusetts*, 971 F.2d 818, 827 (1st Cir. 1992).

applies to a particular case will turn on whether the potential defendant is *subject to jurisdiction* in the Second Circuit. If it is, the assignee can be sued in the Second Circuit, and *Madden* will apply. For example, if the assignee's headquarters or principal place of business is in the Second Circuit, it is subject to "general" jurisdiction there and can be sued there regardless of whether it transacted any business there in connection with the loans at issue.[9] Even if the assignee is not subject to general jurisdiction in a Second Circuit forum, it may be subject to "specific" jurisdiction in such a forum if there is a relationship between the loan at issue and the forum sufficient to satisfy the relevant state's jurisdictional requirements. Something as minor as maintaining a bank account in the Second Circuit related to the loan or securitization pool may be sufficient to create jurisdiction.[10]

It is, of course, also possible that courts outside of the Second Circuit will adopt the holding of *Madden*, which would make it even more difficult to escape its jurisdictional reach. However, the risk of other circuits adopting the same rule may be limited given that (1) the Valid-When-Made Doctrine was not expressly considered by the Second Circuit, and (2) the Second Circuit did not appear to fully consider the disruptive effects of its decision under the relevant preemption standard, which arguably required a fuller analysis of whether the *Madden* rule "substantially interfered" with the business of national banks.

POST-*MADDEN* CONSIDERATIONS WHEN STRUCTURING LOAN SECURITIZATIONS

In the context of structuring post-*Madden* securitizations of consumer loans, parties may want to consider the following:

1. <u>Attempting to Avoid Second Circuit Jurisdiction</u>.

For the reasons discussed above, *Madden* is directly binding if a defendant to a usury claim is sued in and subject to personal jurisdiction in the Second Circuit. Excluding loans to borrowers located in the Second Circuit may reduce the risk of a usury lawsuit being filed in that circuit, but may not eliminate such risk completely if the defendant is otherwise subject to personal jurisdiction in the Second Circuit (for example, because it maintains operations or other contacts that create jurisdiction in the Second Circuit).

Parties subject to personal jurisdiction in the Second Circuit may seek to avoid such jurisdiction by attempting to persuade originators of loans to insert forum selection clauses selecting a non-Second Circuit forum in the underlying loans. This would require advance planning and likely would be more feasible with respect to "originate-to-sell" loans. Of course, the costs and benefits unrelated to *Madden* of selecting a

[9] *See Daimler AG v. Bauman*, 134 S. Ct. 746, 760 (2014).
[10] *See, e.g., Ge Dandong v. Pinnacle Performance Ltd.*, 966 F. Supp. 2d 374, 381-85 (S.D.N.Y. 2013).

particular forum would need to be weighed. Further, statutory venue would have to exist in the forum—in most cases, the forum would have to "be a judicial district in which a substantial part of the events or omissions giving rise to the claim occurred, or a substantial part of property that is the subject of the action is situated."[11]

This approach, however, will not provide parties with complete certainty—although forum selection clauses are often honored by the courts, they may not be honored where public policy concerns are implicated or where they are considered to be imposed on consumers with limited bargaining power.[12] In addition, there is some risk that courts in other circuits could follow *Madden*'s holding with respect to NBA preemption. Finally, to the extent criminal usury laws are a concern, they cannot be avoided with a contractual provision like a forum selection clause.

2. Including choice-of-law provisions in each loan.

Similar to a forum selection clause, a choice-of-law provision designating a state with a favorable usury statute, such as Delaware or Utah, is a potential option for avoiding the application of strict usury laws. (In *Madden*, the Second Circuit declined to determine whether New York or Delaware law should apply and remanded the issue to the district court, noting that the "parties appear to agree that if Delaware law applies, the rate the defendants charged Madden was permissible."[13]) However, as with forum selection clauses, choice of law provisions may not be enforced if found to undermine public policy[14] and do not prevent the application of criminal law.

3. Having a national bank act as trustee and take title to loans for the benefit of the securitization issuer.

Securitizations can be structured to have a national bank act as trustee and take title, in its own name, to the loans that are held in the grantor trust. The idea is that having a trustee take title to the loans might mitigate the *Madden* risk where the trustee is a national bank and therefore entitled to preemption of state usury laws under the NBA. More typically, in a grantor trust structure, the trust itself would hold title to the loans.

There is a risk, however, that such a structure would be viewed as merely form over substance. Because the loans would be held by the trustee solely for the benefit of a non-bank, the owner trust, it is conceivable that a court could choose to disregard the trustee's title to the securitized loans and apply state usury laws to the trust under *Madden*. Given that having the trustee hold title directly has the potential to increase

[11] *Atlantic Marine Const. Co. v. U.S. Dist. Court for W. Dist. of Texas*, 134 S. Ct. 568, 577 (2013) (quoting 28 U.S.C. § 1391).
[12] *See id.* at 583.
[13] *Madden*, 786 F.3d at 253.
[14] *See id.* at 254 n.7 (noting split in Second Circuit district courts regarding enforceability of choice-of-law provisions with respect to usury laws).

transaction execution costs in various respects, structures that would contemplate this method may merit careful cost-benefit analyses.

4. Having the originating bank retain an interest in each loan.

In distinguishing an Eighth Circuit case—which held that a non-bank purchaser of receivables on loans originated by a national bank was entitled to federal preemption under the NBA—the *Madden* court noted that, though the non-bank purchased the national bank's receivables, the national bank had retained ownership of the accounts and remained a party in interest. The court found that defendants in *Madden*, however, were acting solely on their own behalves as the current debt owner and servicer, and thus were not entitled to NBA preemption of state usury laws. Thus, having the originating national bank retain some interest in, or portion of, each loan may make it eligible for federal preemption under *Madden*. This may be achievable in some cases through loan participation agreements.

While this solution is likely to satisfy the requirements of *Madden* so long as it cannot be characterized as form over substance, it may not be practical for some seller banks. Banks may be unwilling or unable to hold an interest in each securitized loan. Thus, though viable in theory, having the originating bank retain an interest in each loan likely is not a global solution.

5. Excluding loans that may be usurious under any potentially applicable law.

In response to *Madden*, some lenders have begun to exclude from their securitization vehicles loans that might be considered usurious under potentially applicable state usury laws. While this approach likely eliminates *Madden* risk, it may result in extremely narrow pools of eligible loans. Moreover, loans capped at applicable usury rates may not produce the level of returns typically required to successfully price a loan securitization. Sourcing loans from limited pools is therefore not likely to be a long-term solution.

* * *

Madden has important implications for the loan markets. While there is no silver bullet for eliminating the risks presented by *Madden* when structuring loans, and no one-size-fits-all approach, taking into account considerations like those discussed above, among others, may help mitigate these risks. Market participants should also actively monitor developments with respect to *Madden* and related cases to structure loans as effectively as possible.

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