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Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015): The Second Circuit Threatens to Disrupt Capital Markets (White Paper)

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MADDEN v. MIDLAND FUNDING, LLC, 786 F.3d 246 (2d Cir. 2015): The Second Circuit Threatens to Disrupt Capital Markets

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I. Introduction

The American consumer, once viewed as the unsuspecting and impotent target of predatory corporate behemoths,[1] has evolved into the beneficiary of a far-reaching arsenal of weaponry bestowed through regulatory and judicial efforts.[2] As the jurisprudential pendulum has swung from historical treatment of consumers as defenseless sheep to the era of the warrior-consumer, wielding powerful weapons against businesses peddling goods and services, some unintended economic casualties have been left in the wake.[3] In some areas of the economy, that pendulum of "social justice"[4] has started to take on more of the complexion of a wrecking ball, laying waste to foundational principles upon which commerce relies so heavily on a day-to-day basis. The proclivity of courts to mandate social justice for consumers through the theory *du jour* can produce some quirky and odd results in the form of outcome-driven decisions that, in turn, create what can only be described as bad law and deleterious economic effects.[5]

Legal decisions exhibiting a facial consumer-friendly orientation can result in unforeseen disruption of critical components within the wider spectrum of business economics. Take, for instance, the feature of liquidity, a cornerstone of commercial investments and assets, and a

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[1] *See* Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1258 (2002) (arguing that "government intervention is needed to curb . . . lending abuses" and to prevent the "burden of harm" from being unduly put upon the consumer).

[2] *See* Arthur E. Wilmarth, Jr., *The Dodd-Frank Act's Expansion of State Authority to Protect Consumers of Financial Services*, 36 J. CORP. L. 893, 895 (2011) ("When President Obama signed Dodd-Frank into law, he declared that the statute would create the 'the strongest consumer financial protections in history.'").

[3] *See* Madden v. Midland Funding, LLC, 786 F.3d 246 (2d. Cir. 2015); *see also* Greg Stohr & Elizabeth Dexheimer, *Lenders Rejected by Supreme Court on State Interest Caps*, BLOOMBERGPOLITICS (June 27, 2016 8:31 AM). In light of the Second Circuit's holding in *Madden v. Midland Funding, LLC*, marketplace lenders claim that the decision "is already having far-reaching effects by undercutting the burgeoning internet lending business and raising questions about debt-backed securities that contain high-interest loans." *Id.*

[4] *See* Michael Novak, *Social Justice: Not What You Think It Is*, HERITAGE FOUNDATION (2009). The phrase "social justice" in modern parlance "implies, among other things, equality of the burdens, the advantages, and the opportunities of citizenship. Indeed . . . social justice is intimately related to the concept of equality, and that the violation of it is intimately related to the concept of inequality." *Id.*

[5] *See* William F. Baxter, *Section 85 of the National Bank Act and Consumer Welfare*, 1995 UTAH L. REV. 1009, 1027 (1995) ("[T]he empirical evidence on the effects of stricter state regulation is relatively unambiguous and consistent with the long-standing observation that regulatory restrictions in credit markets hurts most the least well-off.").

quality to which much of the value of such assets and investments may be attributed.[6] Liquidity refers to "the degree to which an asset or investment can be quickly bought or sold" in the marketplace.[7] When an investment or asset becomes illiquid, its value substantially erodes or entirely evaporates.[8] Maintaining liquidity enables the asset's owner to exchange that asset for other things of value, and pledge that asset as collateral in the undertaking of indebtedness—two critical functions of nearly every commercial enterprise. When an investment or asset becomes illiquid, on the other hand, its value substantially erodes or entirely evaporates, causing dysfunction and resulting in diminished efficacy.[9] Nowhere is liquidity more important than in the arena of commercial lending, where myriad transactions rely upon the premise that lenders have unfettered ability to sell, purchase and finance packaged and repackaged pools of debt instruments.[10]

Recognizing the paramount importance of the unencumbered ability to sell and transfer assets in the commercial world, courts long ago established a fundamental principal known as the "valid-when-made" doctrine.[11] The doctrine is simple, instructing courts to honor the original terms of promissory notes and other forms of loans and evidence of indebtedness, so

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[6] *See* Yair Listokin, *Taxation and Liquidity*, 120 YALE L.J. 1682, 1685 (2011) ("Asset returns depend upon the liquidity of a security.").

[7] *See Liquidity*, INVESTOPEDIA (2016), http://www.investopedia.com/terms/l/liquidity.asp.

[8] *See* Thomas E. Plank, *The True Sale of Loans and the Role of Recourse*, 14 GEO. MASON U. L. REV. 287, 301 (1991) ("External factors that increase or decrease demand for a particular type of loan will also affect the loan's market value. These may include regulatory changes that affect the purchasing ability of a class of buyers, a perception in the marketplace that the type of loan is less desirable, or concern about an increase or decrease in the supply of similar loans.").

[9] *See* Brief of the Clearing House Association L.L.C. et al as Amici Curiae at 3, Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015) (No. 14-2131-cv).

[10] It is quite telling that a number of high-profile companies in the commercial lending and structured finance industry offered amicus briefs explaining how the *Madden* decision could lead to illiquidity and could inflict a significant degree of damage to economy generally. *See* Brief for the Structured Finance Industry Group, Inc. et al as Amici Curiae at 2, *Madden*, 786 3d. 246 (No. 14-2131-cv); Brief of the Clearing House Association, *supra* note 9, at 3.

[11] One of the earliest cases found to adopt the valid-when-made doctrine nearly two centuries ago, and oft-cited, was *Nichols v. Fearson*, 32 U.S. 103, 106 (1833). *See also* Henry G. Morriello et al, *The Uncertain Legacy of Madden*, 22 No. 24 WESTLAW J. DERIVATIVES 1, 3 (Oct. 20, 2016) (expounding upon "the 'valid-when-made' doctrine (i.e., the common law principle that the usurious nature of a loan should be judged at inception and not thereafter.").

long as those terms were valid at the time the debt was created. The "valid-when-made" doctrine operates even—indeed, especially—when the debt is subsequently sold to a buyer who may not have been legally permitted to enter into the original debt transaction.[12] This protection, enabling the original lender to pass its rights to a subsequent buyer of the debt, prevailed as a deeply rooted concept in the courts and established an orderly reliance in sales of debt for centuries.[13]

Enter the Second Circuit decision in *Madden v. Midland Funding, LLC*.[14] The *Madden* Court[15] found itself at the intersection where competing concerns—state usury restrictions, the valid-when-made doctrine, the National Bank Act, federal preemption, and an indefatigable desire to empower the consumer borrower—all collided.[16] In *Madden*, a national bank originated a credit card loan to Saliha Madden, and charged a rate of interest as permitted under the usury statutes of the state in which the originating bank was located.[17] The originating bank then sold this credit card receivable to Midland Funding, a debt buyer located in a different state in which the usury rate was lower than that of the rate charged in the loan to Madden.[18]

The Second Circuit's decision in *Madden* ripped asunder traditional usury law and precipitated a tectonic shift from the bedrock valid-when-made doctrine, to a new analysis of whether the interest rate originally provided for in the transferred note satisfies the usury law of

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[12] *See, e.g.*, FDIC v. Lattimore Land Corp., 656 F.2d 139, 149 n.17 (5th Cir. 1981) (stating that the Fifth Circuit has long observed rule as "one of the 'cardinal rules, in the doctrine of usury" that a non-usurious instrument cannot become usurious by a subsequent transaction (citing *Nichols*, 32 U.S. at 109–11).

[13] *See, e.g.*, Gaither v. Farmers & Mech. Bank of Georgetown, 26 U.S. 37, 43 (1828); Olvera v. Blitt & Gaines, P.C., 431 F.3d 285, 286–87 (7th Cir. 2005).

[14] *Madden*, 786 F.3d at 248.

[15] The decision in *Madden* was attributed to a three judge-panel. The Second Circuit has yet to consider the efficacy of the valid-when-made doctrine in a context similar to *Madden* on an en banc basis.

[16] *Madden*, 786 F.3d at 248.

[17] *Id.*

[18] *Id.*

the state where the borrower is located.[19] This shift has triggered seismic reverberations throughout the realm of debt originations and sales, and has thrown secondary market purchases, securitizations and the structured finance industry into a state of tumult.[20]

This Note will examine the well-founded underpinnings of the valid-when-made doctrine, evaluate the role that federal preemption played in the analysis of *Madden v. Midland Funding, LLC* and its predecessors, and demonstrate how the Second Circuit simply missed the mark in its flawed approach.[21] For purposes of grappling with the Second Circuit's decision in *Madden* until these issues are resolved, this Note will suggest some defensive maneuvers that sellers, buyers and financers of debt may consider to ameliorate the unintended negative fallout from the *Madden* decision.

II. Background

A. History of Usury Law and the Valid-When-Made Doctrine

The Second Circuit's decision in *Madden* casts considerable doubt upon certain aspects of usury law, and its relation to contractual rights accorded to assignees, that were once thought of as well-settled doctrine.[22] Since *Madden* implicates certain fundamental principles of usury law, it may prove useful to trace the trajectory of this area of law. By sketching the path of usury law from its English common law origins to its application in the modern era, the reader may gain a

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[19] *Id.*; *see also* Nichols v. Fearson, 32 U.S. 103, 106 (1833).

[20] Peter Rudegeair & Telis Damos, *LendingClub to Change its Fee Model*, THE WALL STREET JOURNAL (Feb. 26, 2016 4:28 PM), http://www.wsj.com/articles/fast-growing-lending-club-to-change-its-fee-model-1456488393.

[21] This Note will primarily analyze the valid-when-made in the context of national banks because the originating entity in the case at bar was a national bank. It must be noted, however, that the uncertainty and tumult interpolated into the market by the Second Circuit's decision extends to institutions other than national banks. State-chartered banks, federal and state savings associations and federal and state credit unions all may face illiquidity issues stemming from *Madden*. *See* FDIC Gen Counsel Op No. 11 (May 18, 1998) (stating that a state-chartered bank has an ability to export interest charges to out-of-state borrowers from the state in which it was chartered" that is similar to a national bank).

[22] *See* Morriello, *supra* note 11, at 3 ("[T]he court did not address the 'valid-when-made' doctrine (i.e., the common law principle that the usurious nature of a loan should be judged at inception and not thereafter.").

more robust understanding of the policy reasons that undergird traditional usury law, and the far-reaching implications of *Madden* Court's apparent departure from such well-settled doctrine.

This brief history begins with one of the "cardinal rules" of usury, first enunciated by the United States Supreme Court in 1828.[23] In *Gaither v. Farmers & Mechanics Bank of Georgetown*, the Court set forth the rule that if the note be "free from usury, in its origin, no subsequent usurious transaction respecting it, can affect it with the taint of usury."[24] The Court in *Nichols v. Fearson* again recognized that "the rule of law is every where acknowledged, that a contract, free from usury in its inception, shall not be invalidated by any subsequent usurious transactions upon it."[25] This emphatic statement by the Court captures the essence of the rule now known as the valid-when-made doctrine: when determining whether a contract loan is usurious or valid, the key moment in time is when the contract is made. If the contract is valid at the moment of its making, that same contract cannot later become vulnerable to the challenge of usury.[26]

Since the United States Supreme Court's early formulations of the valid-when-made doctrine, there has been a seemingly unbroken chain of fidelity to this rule by both scholars and courts. J.A. Webb's influential treatise on usury law published in 1899 found that in England and America, it is "well-settled doctrine" that a "valid debt can never be avoided by any subsequent usurious contract."[27] The Office of the Comptroller of Currency ("OCC") gave the

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[23] *See* Gaither v. Farmers & Mech. Bank of Georgetown, 26 U.S. 37 (1828); *Nichols*, 32 U.S. at 109.
[24] *Gaither*, 26 U.S. at 43. The *Gaither* Court's laconic announcement may be viewed more as a confirmation of a long-standing rule rather than the formulation of a newfound doctrine. For the roots of this basic principle of usury law can be traced back to the incipiency of American jurisprudence and English common law. *See, e.*g, Watkins v. Taylor, 16 Va. 424, 436 (1811) (stating that "if it was not usury at the time when the contract was entered into, no after circumstance can make it so."); 1 BLACKSTONE, COMMENTARIES 355, 379 n.32 (18th ed. 1838) ("The usury must be part of the contract in its inception . . . .").
[25] *Nichols*, 32 U.S. at 106.
[26] *See* Morriello, *supra* note 11, at 3 ("[T]he court did not address the 'valid-when-made' doctrine (i.e., the common law principle that the usurious nature of a loan should be judged at inception and not thereafter.").
[27] J.A. WEBB, A TREATISE ON THE LAW OF USURY (1899).

"cardinal rule" of usury its imprimatur in 1979.[28] As recently as 2015, another treatise similarly acknowledged, that the "essential elements of usury . . . must exist at the inception of the contract."[29]

In the time period between *Gaithers* and *Madden*, courts have treated the valid-when-made doctrine as an almost incontestable component of the law of usury. In *FDIC v. Lattimore Land Corp.*, a national bank, located in Tennessee, acquired a valid loan from a mortgage company, located in Georgia.[30] In light of the fact that Tennessee had more restrictive usury laws than did Georgia, the plaintiffs argued that when the national bank charged the same rate of interest as the mortgage company, the national bank violated Tennessee usury law.[31] The plaintiffs reasoned that the NBA, which governs national banks, required the national bank to charge the interest rates allowed in its home state of Tennessee.[32] Moreover, the plaintiffs contended that the national bank should be prohibited from exercising the right to charge the same interest rates as the assignor if those rates violated Tennessee usury law.[33]

The Fifth Circuit squarely rejected this argument.[34] Instead, the Court determined that the national bank could charge the same interest rates as the mortgage company notwithstanding the fact that such rates were usurious under Tennessee law. Relying upon the precedent established in *Fearson*, the Court directly employed the valid-when-made doctrine in reaching its holding, and stated that "the note, initially non-usurious, remains so."[35] The Court also made

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[28] OCC Interpretive Letter No. 115 (Aug. 10, 1979).
[29] 44B Am Jur. 2d Interest and Usury § 82 (2015).
[30] FDIC v. Lattimore Land Corp., 656 F.2d 139 (5th Cir. 1981).
[31] *Lattimore Land Corp.*, 656 F.2d at 147.
[32] *Id.*; *see also* 12 U.S.C. § 85 (1980) (providing rate of interest on loans, discounts, and purchases).
[33] *Lattimore Land Corp.*, 656 F.2d at 147.
[34] *Id.* ("Under these circumstances, the Tennessee interest of 10% does not apply because a transfer of pre-existing debt to a national bank does not cause the National Bank Act to mandate the application of the usury law of the state where the national bank is located.").
[35] *Id.* at 148–49.

clear that "[t]he non-usurious character of a note should not change when the note changes hands."[36]

The Seventh Circuit, in *Olvera v. Blitt & Gaines, P.C.*, addressed a situation where the plaintiff alleged that a debt purchaser assignee charged usurious interest rates despite the fact such rates were no higher than the rates charged by the originating entity.[37] In roundly dismissing the claims of usury law violation, the *Olvera* Court held that an assignee, even when located in a state with more restrictive usury rates than the originating entity, may charge the same interest rate as the assignor since a valid assignment gives assignees "the same right" as the assignor.[38] The Seventh Circuit added that the "common law puts the assignee in the assignor's shoes, whatever the shoe size."[39] In his faithful adherence to the valid-when-made doctrine, Judge Posner described assignments as a transaction "whereby the assignee steps in the shoes of the assignor, assuming his rights as well as his duties."[40] Judge Posner also stressed the black letter nature of such common law assignee rights, stating that "no one until now had thought to advocate" an interpretation to the contrary.[41]

While courts and scholars have adopted a seemingly monolithic view favoring the valid-when-made doctrine, the doctrine also enjoys persuasive public policy underpinnings, which have a meaningful and palpable impact on consumers.[42] Judge Posner provided an eloquent, in-depth explanation of how the "cardinal rule" effectuates the expectations of both consumers and marketplace participants. Judge Posner also offered a view to the possible deleterious impact upon the credit market if courts were to adopt an interpretation of usury law contrary to the

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[36] *Id.*
[37] Olvera v. Blitt & Gaines, P.C., 431 F.3d 285, 286–87 (7th Cir. 2005).
[38] *Id.* at 289.
[39] *Id.*
[40] *Id.* at 288.
[41] *Id.* at 289.
[42] *See* Gaither v. Farmers & Mech. Bank of Georgetown, 26 U.S. 37 (1828); Nichols v. Fearson, 32 U.S. 103, 109 (1833); FDIC v. Lattimore Land Corp., 656 F.2d 139, 149 n.17 (5th Cir. 1981).

valid-when-made doctrine.[43] Judge Posner posited that, under a judicial interpretation undermining the rule, "[b]orrowers would not benefit on average, because creditors, being deprived of the assignment option as a practical matter . . . would face higher costs of collection and would pass much of the higher expense on to their customers in the form of even higher interest rates."[44] Additionally, Judge Posner eschewed the idea that the valid-when-doctrine only works to benefit the predatory secondary marketplace participant and stated that "[t]here is an innocent reason that creditors can reduce their costs or increase their yield by assigning collection to other firms rather than doing it themselves . . . Specialists in debt collection are likely to be better at it than specialist in creating credit debt in the first place."[45] Posner added, "while it is easy to see why consumer-protection concerns would lead a state to want to license firms that charge very high interest rates to consumers, assignees do not deal with consumers. It was the assignors who persuaded the plaintiffs to pay high interest rates; the plaintiffs could hardly have supposed that the rates would plummet if they defaulted!"[46]

B. National Bank Act and the Preemption Doctrine

Despite the unanimous jurisprudential approval of the valid-when-made doctrine, the *Madden* Court, and several other courts have curiously begun to stray or even depart from the pure valid-when-made doctrinal analysis when faced with state law usury regulation of national banks.[47] Instead, such courts have increasingly analyzed usury law principles through the prism of the "federal preemption doctrine."[48] Courts have deployed this doctrine to decide whether to supplant state usury laws with the NBA. Thus, it is critical to understand the foundational

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[43] *Olvera*, 431 F.3d at 288–89.
[44] *Id.* at 288.
[45] *Id.*
[46] *Id.*
[47] *See, e.g.*, Krispin v. May Dept. Stores Co., 218 F.3d 919, 922 (8th Cir. 2000); Phipps v. FDIC, 417 F.3d 1006, 1009–10 (8th Cir. 2005); Munoz v. Pipestone Financial, LLC, 513 F. Supp.2d 1076 (D.Minn. 2007).
[48] Beneficial Nat'l Bank v. Anderson, 539 U.S. 1, 10–11 (2003).

principles of the federal preemption doctrine, and how it interacts with the NBA to preempt (or not preempt) state law regulation of national banks.

The preemption doctrine presents a unique area of law whereby certain "extraordinary" federal statutes automatically convert state law claims into federal claims.[49] Courts have deemed Sections 85 and 86 of the NBA to qualify as such "extraordinary" federal statutes that work to preempt "state law claims of usury brought against a national bank."[50] Section 85 provides, in relevant part, that a national bank "may take, receive, reserve, and charge on any loan or discount made, or upon any notes, bills of exchange, or other evidences of debt, interest at the rate allowed by the laws of the State . . . where the bank is located."[51] Thus, a national bank may "export" the interest rates permitted in its jurisdiction to out-of-state consumers "even if that rate would otherwise be illegal in the state where the consumer resides."[52]

In turn, Section 86 provides "the exclusive remedy for violations of section 85."[53] Since actions against national banks for violation of usury law must be made under federal law, there can be no state law usury claim against a national bank.[54] As such, when a state law usury claim is made against a national bank, the NBA "completely preempts" this claim.[55] The United States Supreme Court has expounded upon the reason for this unique treatment of national banks: "Uniform rules limiting the liability of national banks and prescribing exclusive remedies for their overcharges are an integral part of a banking system that needed protection from 'possible unfriendly State legislation.'"[56]

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[49] *Krispin*, 218 F.3d at 922.
[50] *See id.* at 919; *Phipps*, 417 F.3d at 1009–10.
[51] 12 U.S.C. § 85 (1980).
[52] Marquette v. Nat'l Bank v. First of Omaha Svc. Corp., 439 U.S. 299, 313–19 (1978).
[53] *Krispin*, 218 F.3d at 922.
[54] Beneficial Nat'l Bank v. Anderson, 539 U.S. 1, 10–11 (2003).
[55] *Id.* at 11.
[56] *Id.* at 10–11.

While there is uniform agreement that the text of Sections 85 and 86 put any state law usury claim *against a national bank* within the NBA's preemptive reach, the issue becomes somewhat less clear where, as in *Madden*, state law usury claims are directed *against a non-national bank entity*.[57] In an effort to provide clarity to this convoluted issue, the Supreme Court has developed three general guidelines to determine where preemption may occur: "where Congress has expressly preempted state law, where Congress has legislated so comprehensively that federal law occupies an entire field of regulation and leaves no room for state law, or where federal conflicts with state law."[58] Since the Second Circuit's decision in *Madden* only implicates preemption that occurs when "federal law conflicts with state law", the analysis in this Note will be confined to such "conflict preemption."[59]

Conflict preemption "occurs when compliance with both state and federal law is impossible, or when the state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[60] In order to determine if the NBA will preempt state law usury claims against a non-national bank entity—that is to say, in order to determine if application of state usury law to a non-national bank entity would stand "as an obstacle to . . . the full purposes and objectives" of the NBA—the state regulation must "significantly interfere" with a national bank's exercise of its powers granted by the NBA.[61] The Court has determined that when non-national bank entities act "equivalent to national banks with respect to powers

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[57] *See, e.g.*, *Krispin*, 218 F.3d at 919; *Phipps*, 417 F.3d at 1006.

[58] Wachovia Bank, N.A. v. Burke, 414 F.3d 305, 313 (2d Cir. 2005); *see also* Barnett Bank of Marion County v. Nelson, 517 U.S. 25, 31 (1996) (stating that the Court's inquiry should ultimately determine whether "Federal and State statutes are in irreconcilable conflict").

[59] United States v. Locke, 529 U.S. 89, 109 (2000).

[60] *Locke*, 529 U.S. at 109.

[61] *Barnett Bank*, 517 U.S. at 33 ("In defining the preemptive scope of statutes and regulations granting a power to national banks, these cases take the view that normally Congress would not want States to forbid, or to impair significantly, the exercise of a power that Congress explicitly granted. To say this is not to deprive States of the power to regulate national banks, where (unlike here) doing so does not prevent or significantly interfere with the national bank's exercise of its powers.").

exercised under federal law", enforcement of state usury laws against such entities would "significantly interfere" with a national bank's exercise of its powers.[62] Courts have specifically identified two situations where a non-national bank entity acts in such an "equivalent" manner. Where a non-national bank entity acts as an "operating subsidiary" of a national bank, or as an "agent" of a national bank, the NBA applies to such entities as it would to national banks.[63]

Regulators charged with implementing the NBA have also provided some instructive guidelines for when a non-national bank entity may qualify for NBA preemption status. The Office of the Comptroller of the Currency ("OCC"), the agency primarily responsible for regulating national banks, has recognized various situations where, in order to not interfere with a national bank's exercise of its full powers, the NBA must apply to non-national banks. With respect to debt collection, The OCC has explained that the NBA must preempt state usury laws when such state laws would interfere with a national bank's ability to "pursue collection of delinquent accounts by (1) handling the collections internally; (2) using third parties as agents in collecting the debt, or (3) selling the debt to debt buyers for a fee."[64] Thus, when state regulation of non-banks would interfere with the national bank's exercise of such powers, the NBA preempts this type of state regulation. Absent from any OCC regulations is any sort of demand that the national bank retain some interest or maintain involvement in order for a non-bank to have NBA protection when a national bank makes an assignment to a non-bank. The regulating agency has, however, recognized that the valid-when-made doctrine does apply in the context of the NBA.[65]

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[62] Watters v. Wachovia Bank, N.A., 550 U.S. 1, 18 (2007); *Burke*, 414 F.3d at 309.
[63] *Watters*, 550 U.S. at 18; *Burke*, 414 F.3d at 309; Pac. Capital Bank, N.A. v. Connecticut, 542 F.3d 341, 352 (2d Cir. 2008); SPGGC, LLC v. Ayotte, 488 F.3d 525, 532 (1st Cir. 2007).
[64] OCC Bulletin 2014–37, Risk Management Guidance (Aug. 4, 2014), http://www.occ.gov./news--issuances/bulletins/2014/bulletin-2014-37.html.
[65] OCC Interpretive Letter No. 115 (Aug. 10, 1979).

While the United States Supreme Court and the OCC have provided extensive guidance on when the NBA applies to non-banks, neither has explicitly answered the narrow question presented in *Madden*: whether, and to what extent, the NBA preempts state law usury claims against assignees of national banks.[66] However, a growing body of case law in the lower courts has helped to shed light upon this issue. In *Krispin v. May Dep't Store Co.*, the Eighth Circuit examined a state law usury claim against a non-bank department store (located in Missouri), which had bought credit card receivables from a national bank (located in Arizona).[67] The plaintiffs, who had purchased the credit cards, alleged that the rates charged by the store, while lawful in the national bank's home state of Arizona, violated the usury laws of Missouri. [68]

The *Krispin* Court found that the NBA preempted the plaintiff's Missouri state law usury claims against the non-bank store.[69] The Eighth Circuit reasoned that where the national bank "issues credit, processes and services customer accounts, and sets such terms as interest and late fees", the national bank should be deemed the originating entity.[70] After settling the inquiry of which entity was, in fact, the originator of the credit cards, the court stated that, "in determining whether the NBA applies", the court should "look to the originating entity (the bank), and not the ongoing assignee (the store)." The reasoning for the Court's holding can be traced to the fact that a national bank has a right, enumerated in the NBA, to set interest rates allowed by its home state; thus, applying a state usury law would have directly interfered with this expressly granted

[66] Madden v. Midland Funding, LLC, 786 F.3d 246, 250 (2d Cir. 2015).
[67] Krispin v. May Dept. Stores Co., 218 F.3d 919, 921–22 (8th Cir. 2000).
[68] *Id.*
[69] *Id.* at 924.
[70] *Id.* *Krispin* presented an odd factual scenario where a non-bank lender assigned its credit card accounts to its national bank subsidiary and the Court ultimately held that the usury rate applicable to the assignee national bank governed, because this assignee was actually the originating entity. *Id.* One may envision or conjure up very ominous opportunities for manipulating the analysis in *Krispin.* Posit the sencario where an unscrupulous party makes loans to borrowers under state usury laws imposing comparatively low interest rates, and then assigns those loans to a bank (or other assignee) located in a state enjoying high or even uncapped usury rates. Would such an assignment, even to an affiliate permit the assignee to elevate the interest rates to sky-high levels under the *Krispin* Court's analysis? In order to prevent predatory lending practices, an analysis more closely tethered to the valid-when-made doctrine would be best suited for such cases.

right.[71] The *Krispin* Court concluded that despite the fact that the store would not have independently qualified for NBA preemption status, it "makes sense" to apply the NBA to the non-bank "in these circumstances."[72]

The Second Circuit, in *SPGGC, LLC v. Blumenthal*, held that when application of a state usury law would merely constrain "activities of the third party which are otherwise subject to state control, and which are not protected by federal banking law or subject to OCC oversight," such regulation would not "significantly interfere" with the national bank's exercise of its powers under the NBA.[73] Thus, if application of state usury laws would merely affect non-national bank entities, and not national banks, the NBA would not preempt such regulation.

A Minnesota District Court, in *Munoz v. Pipestone Financial, LLC*, examined a situation almost directly mirroring the facts of *Madden*.[74] The Minnesota District Court, in reaching its decision, relied upon the precedent established in *Krispin*, and determined that the NBA preempted a state usury law claim that attempted to regulate the assignee of a national bank.[75] The *Munoz* decision stands for the proposition that the NBA automatically preempts any state law usury claim against an assignee when the originating entity was a national bank.[76]

In a spate of recent cases, dubbed "True Lender" or "Rent-a-Charter" cases, courts have analyzed application of the NBA to non-banks in situations where the actual identity of the originating entity becomes unclear because a non-bank has given the appearance that a federally chartered bank has originated a loan in order to receive the benefits that a federal bank would

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[71] *See* 12 U.S.C. § 85 (1980).
[72] *Krispin*, 218 F.3d at 924. The Eighth Circuit, in *Phipps v. FDIC*, again recognized the applicability of the NBA to a non-bank assignee when the originating entity was deemed a national bank. Phipps v. FDIC, 417 F.3d 1006, 1014 (8th Cir. 2005).
[73] SPGGC, LLC v. Blumenthal, 505 F.3d 183, 191 (2d Cir. 2007).
[74] Munoz v. Pipestone Financial, LLC, 513 F. Supp. 2d 1076 (D.Minn. 2007).
[75] *Id.* at 1076–78.
[76] *Id.*

ordinarily receive.[77] In *Ubaldi v. SLM Corp.*, a California District Court determined that "courts should look to the substance and not just the form of the financial transaction when it is alleged that a federally-regulated bank has rented out its charter to a non-bank entity which acts as the true lender."[78] The *Ubaldi* Court was primarily focused on the issue of whether, by sleight of hand, a non-bank made it appear as if a federally-chartered national bank—entitled to preemption status—was the originator when in reality it was the non-bank lender.[79] The California District Court did not conclusively determine that a national bank assignor must retain involvement in order for a non-bank assignee to be entitled to NBA preemption. The Court, in its analysis of *Krispin*, noted that "[t]here the national bank . . . was a wholly-owned subsidiary of the store. In other words, in *Krispin*, the store had a very close corporate relationship with the bank, unlike Stillwater and Sallie Mae here."[80] In *West Virginia v. Cashcall*, the court determined that a non-bank participated in a "rent-a-charter" scheme and thus did not qualify for federal preemption against state law usury claims.[81]

III. Analysis: *Madden v. Midland Funding, LLC*

The Second Circuit's decision not only disregards nearly two centuries of well-settled usury law doctrine, leaving a mangled interpretation of the federal preemption doctrine in its wake, but the opinion also threatens to strike a blow to the very foundation of the modern banking system.[82] In order to appreciate the potential far-ranging effects stemming from the Second Circuit's radical departure from the formerly uncontested valid-when-made doctrine, and

[77] *See, e.g.*, Ubaldi v. SLM Corp., 852 F. Supp. 2d 1990, 1200 (N.D. Cal. 2012); West Virginia v. Cashcall, Inc., 605 F. Supp. 2d 781 (S.D.W.Va. 2009).
[78] *Ubaldi*, 852 F. Supp. 2d 1990, 1200.
[79] *Id.* at 1200–02.
[80] *Id.*
[81] *Cashcall, Inc.*, 605 F. Supp. 2d at 781.
[82] *See* Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp., 439 U.S. 299 (1978) (stating that limiting a national bank's right to export interest rates would "throw into confusion the complex system of modern interstate banking.").

the Court's untenable reading of the preemption doctrine, the basic background information of the case must first be laid bare.

Saliha Madden, took out a credit card with Bank of America, a national bank, and then charged purchases, thus incurring indebtedness.[83] Subsequently, Bank of America transferred Madden's credit card loan to FIA Card Services, N.A. ("FIA"), which is also a national bank.[84] As part of this transfer, the terms of Madden's loan were modified, as permitted in the credit card arrangement, so as to include a Delaware choice-of-law clause.[85] In 2008, after Madden became delinquent on payments on the loan, FIA determined that Madden's debt was "uncollectable."[86] Upon charging off Madden's debt, FIA contracted to sell the debt to a debt-purchasing entity called Midland Funding LLC and its affiliate Midland Funding Credit Management Inc.[87] Neither Midland Funding LLC nor Midland Credit Management Inc. ("Midland Funding") was chartered as a national bank.[88] In 2010, Midland Funding sought to collect payment from Madden for the unpaid loan and increased the annual interest rate to 27%.[89] Midland Funding ostensibly charged this rate of interest because Delaware law governed the originating national bank and Delaware usury law permitted such a rate to be charged.[90]

Upon being notified of the increased interest rate on her credit card, Madden instituted a class action suit against Midland Funding alleging that, inter alia, the debt-purchasing entity had violated the New York state usury statute, which prohibits the charging of interest rates

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83 Madden v. Midland Funding, LLC, 786 F.3d 246, 247–48 (2d Cir. 2015).
84 *Madden*, 786 F.3d at 248.
85 *Id.* at 247–48.
86 *Id.* at 248.
87 *Id.*
88 For the sake of simplicity, this Note will refer to Midland Funding LLC and Midland Funding Credit Management Inc. collectively as "Midland Funding".
89 *Madden*, 786 F.3d at 248.
90 *Id.* at 247–48.

exceeding 25%.[91] Madden, a resident of New York, sought to have the Court substitute the usury rate imposed by the state of the originating entity with the usury rate imposed by New York.[92] The District Court rejected Madden's claims and entered a judgment in favor of Midland Funding.[93] In reaching its decision, the District Court expressly invoked the valid-when-made doctrine and stated that a contract valid at the moment of its making "can never be invalidated by any subsequent usurious transaction."[94] The lower court further explained that since the originating entity was entitled to charge interest at a rate of 27%, the assignee, Midland Funding, had the right to charge the same rate of interest notwithstanding the usury law of the state where Madden resided.[95] In addition to the valid-when-made doctrine, the court also based its determination, in part, on the fact that "assignees are entitled to the protection of the NBA if the originating bank was entitled to the protection of the NBA."[96] Thus, invoking the federal preemption doctrine, the District Court determined that the NBA preempted any state legislation that impinged on a national bank's ability to assign to a non-bank, such as Midland Funding, the right to charge the rate of interest allowed by the national bank's home state.[97]

Though the district court's opinion echoed the results and reasoning of prior case law concerning similar state law usury claims, Madden found unexpected luck when she appealed her adverse ruling.[98] The Second Circuit on appeal, rather conspicuously (and inexplicably), did not even address the effect of the valid-when-made doctrine on the assignee Midland Funding's right to charge the same interest rate as the assignor. The Court did not even give fleeting lip

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[91] *Id.* at 248.
[92] *Id.*
[93] *Id.*
[94] Brief for Defendants-Appellees at 16, *Madden*, 786 F.3d 246 (No. 14-2131-cv).
[95] *Madden*, 786 F.3d at 248.
[96] *Id.*
[97] *Id.*
[98] *See* FDIC v. Lattimore Land Corp., 656 F.2d 139 (5th Cir. 1981); Krispin v. May Dept. Stores Co., 218 F.3d 919, 921–22 (8th Cir. 2000); Phipps v. FDIC, 417 F.3d 1006, 1014 (8th Cir. 2005).

service to the valid-when-made doctrine. Instead, the court's inquiry focused solely on the analysis of whether the federal preemption doctrine rendered Madden's state law claim futile.[99] In a protracted analysis of this doctrine, the Court explained that Madden's state law usury claims against a non-bank such as Midland Funding would be preempted by the NBA only if: enforcing New York state usury law "significantly interferes with the national bank's exercise of its powers."[100]

Directing its analysis toward the inquiry of whether applying New York usury law would "significantly interfere" with a national bank's exercise of its powers, the Second Circuit determined that the NBA may work to preempt such state regulation only "[i]n certain circumstances."[101] The Court took the view that these "certain circumstances" must be limited to situations where non-national bank entities act in a manner "equivalent to national banks with respect to powers exercised under federal law."[102] Thus, if a non-bank acts as a "subsidiary" or an "agent" of a national bank, the NBA may be extended to such entities. [103]

The Second Circuit also 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."[104] The Court took pained efforts to demonstrate that Midland Funding had complete control of all aspects of the debt after it purchased Madden's credit card receivable.[105] The national bank retained no legally cognizable interest in the debt bought by Midland Funding. Thus, Madden's

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[99] *Madden*, 786 F.3d at 249–50.
[100] *Id.*
[101] *Id.* at 250.
[102] *Id.*
[103] *Id.*
[104] *Id.* at 251.
[105] *Id.*

claim, made under New York state law, applied solely to Midland Funding, and interest charged *after* the national bank had relinquished *all interest* in the debt.[106]

The Court concluded that where, as in the case at bar, a non-national bank entity is merely an assignee of a national bank, and the national bank has retained absolutely no legal interest in the debt transaction, the non-national bank assignee cannot be said to act as an agent nor as a subsidiary of the national bank.[107] The Second Circuit determined that Midland Funding's post-assignment actions neither represented nor affected the national bank involved in the transaction.

The *Madden* Court did concede that while enforcing state usury law against assignees of national banks may decrease "the amount a national bank could charge for its consumer debt," such a decrease would not "significantly interfere" with the national bank's exercise of its powers.[108] Further, the Second Circuit found that "no other mechanism appears on these facts by which applying state usury laws to the third-party debt buyers would significantly interfere with either national bank's ability to exercise its powers under the NBA."[109] However, the Court seemed to acknowledge that application of "significantly interfere" standard may have been altered if enforcement of state usury law would have completely prevented the national bank from selling its debt.[110] In light of these findings, a three-judge panel of the Second Circuit held that Midland Funding could not shield itself from state law claims, such as the claims Madden instituted, by invoking the federal preemption doctrine.[111]

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106 *Id.*
107 *Id.* at 251–52. The Second Circuit likened the facts of the case at bar to the situation in *Blumenthal*, where the Court determined that the non-bank did not qualify for preemption status. *See* SPGGC, LLC v. Blumenthal, 505 F.3d 183, 191 (2d Cir. 2007).
108 *Madden*, 786 F.3d at 251–52.
109 *Id.*
110 *Id.*
111 *Id.*

In reversing the District Court's decision, the Second Circuit found that the lower court's interpretation constituted an "overly broad" application of the NBA's preemptive reach.[112] The Second Circuit posited that, absent a national bank having some form of ongoing legal interest in an assignment to non-national bank entity, that non-national bank entity cannot exercise the same rights as the national bank assignor.

Though the Second Circuit did recognize that the Eighth Circuit had repeatedly extended the protection of the NBA to non-bank entities, the Court found such cases distinguishable from the one at bar. The *Madden* Court pointed to a key passage in *Krispin*: "in these circumstances . . . it makes sense to look to the originating entity (the bank), and not the ongoing assignee (the store), in determining whether the NBA applies."[113] The Second Circuit found that the reason the NBA applied to the non-bank assignee in *Krispin* stemmed from the fact that the national bank had an ongoing legal interest in the credit card receivables assigned to the non-bank.[114] These specific facts, the court determined, differed significantly from FIA's lack of involvement in the debt held by Midland Funding. The Second Circuit also distinguished its decision from the Eighth Circuit's holding in *Phipps*.[115] The *Phipps* Court determined that the non-national bank entity only sought to collect interest charged by the national bank and not interest charged after the assignment.[116] Conversely, Midland Funding argued that it could continue to charge the same interest rates as the national bank subsequent to the assignment.

In a petition for writ of certiorari submitted to the Supreme Court, Midland Funding argued that the Second Circuit's holding conflicted with other circuits' understanding of national

[112] *Id.*
[113] *Id.*
[114] *Id.* at 252–53.
[115] *Id.* at 253.
[116] *Id.* at 252–53.

banks' power under the NBA.[117] Midland Funding, quite stunningly, failed to argue that the Second Circuit's decision stood at direct variance with the valid-when-made doctrine.[118] In addition, Midland Funding presented a stunted analysis of the federal preemption doctrine and failed to properly describe the enumerated powers of a national bank[119].

In a brief submitted upon request by the United States Supreme Court, the United States Solicitor General contended that the Second Circuit was in error and found that the NBA should have preempted Madden's state law claim.[120] However, the Solicitor General's brief curiously recommended that the Court should not grant Midland Funding's petition for certiorari because no circuit split existed.[121] The Solicitor General recognized that the court failed to apply—and ignored—the valid-when-made doctrine, and posited an interpretation of the NBA inconsonant with other circuits.[122] However, the Solicitor General seemed to imply that the shortcomings of Midland Funding's legal arguments were a significant reason why the Second Circuit reached the improper holding.[123] After considering the Solicitor General's recommendation, the Supreme Court declined to grant certiorari to Midland Funding.[124]

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[117] Petition for Writ of Certiorari, *Madden*, 786 F.3d 246 (No. 15-610).
[118] Brief for Defendants-Appellees, *supra* note 94, at 16. Though the Supreme Court precedent established in *Nichols v. Fearson* presented one of Midland Funding's most devastating arguments, Midland Funding's counsel stated that such precedent was "not central" and that it did "not change the analysis at all." *Id.*; *see* Morriello, *supra* note 11, at 3.
[119] Brief for Defendants-Appellees, *supra* note 94, at 23. Counsel for Midland Funding did not even deign to address whether application of New York usury laws would "significantly interfere" with a national bank's exercise of its powers because there was "no burden of proof whatsoever to show an interference with a national bank's exercise of powers" and the "entire convoluted argument" constituted "no more than a red-herring." *Id.*
[120] Brief for the United States as Amicus Curiae at 5, 6, *Madden*, 786 F.3d 246 (No. 15-610) ("The court of appeals erred in holding that state usury laws may validly prohibit a national bank's assignee from enforcing the interest-rate term of a debt agreement that was valid under the law of the State in which the national bank is located.").
[121] Brief for the United States as Amicus Curiae, *supra* note 120, at 6.
[122] *Id.*
[123] *Id.*
[124] *Madden*, 786 F.3d 246, *cert. denied*, 84 USLW 3697 (U.S. June 27, 2016) (No. 15-610).

IV. The Folly of the Second Circuit's Decision

The Second Circuit erred on two separate, but related fronts. First, and most glaringly, the Court failed to apply, or even give passing reference to, a "cardinal rule of usury."[125] The time-honored valid-when-made doctrine provides a simple mechanism that would resolve the issue presented in this case in a streamlined and straightforward manner. The rule—followed by the United States Supreme Court and circuit courts across the nation—provides that when a contract is valid at the time of its making, that contract cannot subsequently become usurious when it is assigned to another party.[126] If the Second Circuit had not deviated from this bedrock principle of usury law, Midland Funding would have undoubtedly had the right to charge the same interest rate as the assignor.[127] Thus, Midland Funding could have charged the interest rate of 27% per annum because the originating entity had the right to charge that rate. The debt purchased and the interest rate charged by Midland Funding would not have suddenly morphed into an illegal, usurious instrument simply because the credit card paper changed hands.

In sharp contradistinction, the Second Circuit's unprecedented analysis rests on two implicit points, each of which depend on what can only be described as flawed premises.[128] First, the Court essentially found that whether the contract is usurious or valid at is inception is of no consequence.[129] Consequently, the rate of usury may change when the originating entity merely assigns a promissory note or loan to another party.[130] Such rationale has not been

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[125] *See* Nichols v. Fearson, 32 U.S. 103, 105 (1833).

[126] *See* FDIC v. Lattimore Land Corp., 656 F.2d 139 (5th Cir. 1981); Olvera v. Blitt & Gaines, P.C., 431 F.3d 285 (7th Cir. 2005).

[127] *Madden*, 786 F.3d at 248. The District Court applied this principle and reached a decision consonant with other circuits across the nation.

[128] Brief for Plaintiff-Appellant at 15, *Madden*, 786 F.3d 246 (No. 14-2131-cv).

[129] Brief for Plaintiff-Appellant, *supra* note 128, at 15. The Second Circuit shockingly seemed to accept the argument that the NBA "text frames the relevant regulatory moment not as the moment the contract is entered into but rather the point(s) at which interest is 'charged.'" *Id.*

[130] Brief for Plaintiff-Appellant, *supra* note 128, at 15.

advanced by any other circuit court and directly contradicts Supreme Court precedent, which has enjoyed longstanding support since the mid-nineteenth century.

If only the Second Circuit would have followed the overwhelming weight of well-settled precedent, the tortuous analysis of the federal preemption doctrine would have been wholly unnecessary.[131] The convoluted preemption doctrine, and the complex analysis flowing from the preemption prism need not even be invoked, because the valid-when-made doctrine ensures that the assignee Midland Funding has the right to charge the interest rate that the assignor national bank had the right to charge at origination. Accordingly, the application of the NBA to non-bank entities such as Midland Funding has no relevance.

Though the valid-when-made doctrine would have sufficed to resolve Madden's claim, the Second Circuit also erred in its unnecessary interpretation of the federal preemption doctrine. This doctrine states that to the extent the application of a state law usury claim would significantly interfere with a national bank's exercise of its powers conferred by NBA, such a state regulation is preempted.[132] With respect to the powers that a national bank may exercise, Section 85 of the NBA makes clear that a national bank may charge the rate of interest allowed by the state where it is located.[133] However, national banks also have a number of other enumerated powers that lawmakers have granted in an effort to fulfill the NBA's *raison d'etre*—facilitating a vibrant interstate banking system without encroaching upon traditional state police powers.[134] These enumerated powers granted to national banks include, among others,

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[131] *See, e.g.*, *Lattimore Land Corp.*, 656 F.2d at 139.
[132] Barnett Bank of Marion County, N.A. v. Nelson, 517 U.S. 25, 33 (1996).
[133] *See* 12 U.S.C. § 85 (1980).
[134] Tiffany v. Nat'l Bank of Missouri, 85 U.S. 409, 413 (1873) ("National banks have been National favorites. They were established for the purpose . . . of providing a currency for the whole country, and . . . to create a market for the loans of the General government."); Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp., 439 U.S. 299, 314 (1978) (explaining that the NBA has been interpreted "for over a century" so as to give an advantage to national banks in helping to spur market growth).

"discounting and negotiating promissory notes, drafts, bills of exchange and other evidences of debt."[135]

This power of a bank to manage its portfolio—including selling its debt—has been recognized since the dawn of the NBA's enactment.[136] The United States Supreme Court, in *Planters' Bank v. Sharp*, recognized that in order for a bank to manage its portfolio, a bank "must be able to assign or sell" loans.[137] In an amicus brief issued to the Supreme Court, in response to Midland Funding's petition for certiorari, the Solicitor General confirmed this enumerated right of national banks under the NBA.[138] The Solicitor General set forth that "a national bank's power to charge the interest rate authorized by Section 85 includes the power to transfer a loan, including the agreed-upon interest-rate term, to an entity other than a national bank."[139]

Given the fact that a national bank has the explicit and protected right to manage its portfolio, it is hard to imagine that preventing national banks from being able to assign certain contractual rights would not "significantly interfere" with such a right. In fact, such a reading of the conflict preemption doctrine appears to apply the wrong law while also managing to cut against the very purpose of the NBA. The NBA was created as a tool to favor national banks and allow national banks to serve as an indispensable component of the modern interstate banking system.[140] The Second Circuit, contrariwise, sought to impose state regulation on national banks

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[135] 12 U.S.C. § 24 (Seventh) (2008); *see also* 12 C.F.R. 7.4008 ("A national bank may make, sell, purchase, participate in, or otherwise deal in loans . . . subject to such terms, conditions, and limitations prescribed by the Comptroller of the Currency and other applicable Federal law.").
[136] Planters' Bank v. Sharp, 47 U.S. 301, 323 (1848).
[137] *Id.*
[138] Brief for the United States as Amicus Curiae, *supra* note 120, at 9.
[139] Brief for the United States as Amicus Curiae, *supra* note 120, at 7.
[140] *See* Tiffany v. Nat'l Bank of Missouri, 85 U.S. 409, 413 (1873); Marquette v. Nat'l Bank v. First of Omaha Svc. Corp., 439 U.S. 299, 313–19 (1978).

(or their assignees) in a way that would greatly impinge on such bank's ability to manage assets with respect to debt-buying entities and marketplace lenders.

The Solicitor General also noted that "the marketability (and therefore the value) of a national bank's loan portfolio could be significantly diminished if the national bank could not transfer to assignees the right to charge the same rate of interest that the national bank itself could charge."[141] Since the enforcement of New York usury law would prevents national bank from fully exercising enumerated rights, and could appreciably limit the value of its portfolio, such state regulation does "significantly interfere" with national bank's exercise of its rights under the NBA. Accordingly, federal law should act to preempt such state regulation of Midland Funding insofar as it encroaches on the rights granted to a national bank under the NBA.

V. The Potential Impact of the Second Circuit's decision

The *Madden* decision threatens a deleterious impact upon banks wishing to sell receivables of various types to non-bank purchasers.[142] Immediate fallout from the Second Circuit's decision is illiquidity.[143] For no purchaser wants to take on exposure to potential unending lawsuits and class actions premised upon theories that the receivables, once in the hands of the purchaser, suddenly confer to the obligors talismanic powers to challenge enforceability of fundamental terms such as interest rates and applicability of state consumer protection laws. The repercussions of *Madden* are exacerbated by the fact that it was decided by

[141] Brief for the United States as Amicus Curiae, *supra* note 120, at 7.

[142] The Seventh Circuit recognized the economic and societal benefits flowing from banks' ability to sell their loans and secondary marketplace participation. Olvera v. Blitt & Gaines, P.C., 431 F.3d 285, 286–87 (7th Cir. 2005).

[143] *See generally* Fed. Reserve Bank of N.Y., *Credit Growth and Econ. Activity after the Great Recession*, Remarks at the Econ. Press Briefing on Student Loans, Fed. Reserve Bank of N.Y. (Apr. 16, 2015). Not only does Madden pose a direct threat to liquidity, but the Second Circuit's decision also destabilizes the credit market's ability to lend. It is readily apparent that the lending industry is indispensable to the world economy. *Id.*

the Second Circuit, which exercises jurisdictional control over New York, the hub, and indeed, the spinal nerve center for the bulk of commercial transactions a nationwide basis.[144]

The calamities and vagaries reverberating from the Second Circuit's *Madden* decision are no more pronounced in any area of commerce than in the capital markets and efforts to enhance liquidity through leverage.[145] Securitizations of various classes of receivable assets such as auto loans, credit card loans, mortgage loans and student loans have relied for decades upon bedrock principles recognizing a bank's ability to assign and transfer those asset classes to non-bank transferees, which in turn, issue securities collateralized by the receivables assets.[146] Banks have long utilized securitization and structured finance to remove assets from their balance sheets and thereby reduce burdensome capitalization requirements.[147]

It has become routine and commonplace for rating agencies that rate the bonds issued by the non-bank transferees of these assets in securitization transactions to require that such transferees be structured, from the outset, as special purpose, bankruptcy remote vehicles.[148]

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[144] Brief of the Clearing House Association, *supra* note 9, at 11.

[145] *See* Comptroller of the Currency, *Asset-Based Lending: Comptroller's Handbook* (March 2014) (explaining that the ability to engage in asset-based lending "provides cash to support liquidity needs, eliminating the need to wait for the collection of receivables"), https://www.occ.gov/publications/publications-by-type/comptrollers-handbook/pub-ch-asset-based-lending.pdf; Brief for the Structured Finance Industry Group, *supra* note 10, at 2.

[146] Asset-backed securities represent a massive part of the banking economy and the credit markets. *Securitization Helps US Economy*, MOODYS (March 12, 2015), https://www.moodys.com/research/Moodys-Securitization-helps-support-US-economy--PR_320593. One rating agency estimated that, in 2014, "securitization represented . . . $1.6 trillion of the roughly $6 trillion in U.S. bond issuance." *Id.* The overwhelming popularity of the securitization vehicle and issuance of asset backed securities among investors is largely attributable to the feature of collateral backing up such bonds, as compared to corporate bonds and the like that are naked corporate obligations and thus wholly unsecured. *Id.*

[147] Securitizations are critical to the efficacy of credit markets in general. *See* James McAndrews, *Credit Growth and Econ. Activity after the Great Recession*, Remarks at the Econ. Press Briefing on Student Loans, Fed. Reserve Bank of N.Y. (Apr. 16, 2015) ("Credit availability is a crucial ingredient in any advanced economy's recipe for economic growth because credit can support investment in productive enterprises and smooth household spending from fluctuations in income.").

[148] *See* JASON H.P. KRAVITT et al, SECURITIZATION OF FINANCIAL ASSETS § 3.07 (2016) ("One must plan and prepare carefully to obtain the desired rating for an issue of securities. While a purchaser in a private offering may be willing to take certain risks, the rating agencies tend to rate securities at the level of the weakest link."); Moody's Publishes Methodology for Assessing Bankruptcy Remoteness of Special Purpose Entities, Moody's (Oct. 7, 2014), https://www.moodys.com/research/Moodys-publishes-methodology-for-assessing-bankruptcy-remoteness-of-special-purpose--PR_310025.

These special purpose entities must, by their very nature and as embodied in their organizational documents, limit their business operations to highly restricted activities of purchasing, holding, and pledging the receivables as collateral.[149] These restrictions insulate the transferee entity from potential claims of creditors, greatly diminishing exposure to potential liabilities, and, in turn, minimizing any future need of that entity to file for protection under bankruptcy laws.[150] This is primarily how issuers of bonds in securitizations achieve "bankruptcy remote" status.[151] The bankruptcy remote status of issuers of asset backed paper, in turn, enables the bonds to receive higher ratings from rating agencies and thus makes the paper more marketable to investors in the capital markets.

These two cornerstones goals in securitizations, namely removal of assets from the bank's balance sheets to reduce capitalization requirements, and accomplishing bankruptcy remote status to support rating agency approval of bonds, join in a confluence that necessitates the transfer of receivables to a non-bank purchaser in securitization transactions. Banks, by their inherent nature, cannot be imbued with the restrictive constraints imposed upon bankruptcy remote entities. The special purpose, bankruptcy remote purchaser is essential as a practical pillar in the securitization process.[152]

Thus the violence that the *Madden* decision visits upon issuance of asset-backed securities in the capital markets is both palpable and profound.[153] The Second Circuit strains and

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[149] *See* GARY B. NORTION & NICHOLAS S. SOULELES, SPECIAL PURPOSE VEHICLES AND SECURITIZATION, RISKS OF FINANCIAL INSTITUTIONS (January 2007) (eds. Mark Carey & Rene Stulz), http://www.nber.org/chapters/c9619.

[150] *See* Michael J. Cohn, *Asset Securitization: How Remote is Bankruptcy Remote?*, 26 HOFSTRA L. REV. 929, 931–32 (1998).

[151] KRAVITT, *supra* note 148, at § 3.04 ("Very often sponsors will structure special purpose vehicles that are 'bankruptcy remote.' That is, their sponsors design their ownership, liabilities, assets and cash flow to minimize their risk of bankruptcy.").

[152] Cohn, *supra* note 150, at 931–32.

[153] *See* Greg Stohr & Elizabeth Dexheimer, *Lenders Rejected by Supreme Court on State Interest Caps*, BLOOMBERGPOLITICS (June 27, 2016 8:31 AM) ("Ahead of the [Second Circuit's] ruling some marketplace lenders already have stopped lending at rates above state caps."), http://www.bloomberg.com/politics/articles/2016-06-

potentially breaks an absolutely essential step in the asset-backed securities market. Players in the capital markets have been quick to recognize this powder keg problem.[154]

The headaches rippling from the *Madden* decision are even further exacerbated by a recent, growing practice where banks offer services to originate receivables ultimately aimed into the hoppers of the securitization processes, but hold those receivables only for a de minimus time period as more of a pass-through holder.[155] This fee-based service provided by banks has become the subject of heightening regulatory scrutiny and is pejoratively labeled as the practice by a bank of offering "rent-a-charter" services.[156]

The asset-backed securities industry has developed several tools to combat the dual threat of regulatory pressure on the one hand aimed at purported rent-a-charter arrangements, and exposure to consumer protection lawsuits on the other hand. For example, some securitizations have inserted a new role for a bank to serve in the capacity as a trustee, established for the sole purpose of holding bare legal title to the receivables on behalf of the bond-issuing purchaser of

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27/lenders-rejected-by-u-s-supreme-court-on-state-interest-caps. Immediately after the Madden decision, shares of Lending Club, a major marketplace lender, "fell 7.8 percent" and the "Standard & Poor's Financials Index declined about 2.6 percent, as the broader S&P fell 1.7 percent." *Id.*

[154] *See, e.g*, Rachel Witkowski, *Online Lenders Face Higher Litigation Risks After U.S. Court Ruling*, NASDAQ (September 1, 2016 9:43 PM), http://www.nasdaq.com/article/online-lenders-face-higher-litigation-risk-after-us-court-ruling-20160901-01296; Peter Rudegeair & Telis Damos, *LendingClub to Change its Fee Model*, THE WALL STREET JOURNAL (Feb. 26, 2016 4:28 PM) ("The decision, Madden v. Midland Funding LLC, has been cited by investors as one reason that LendingClub shares are down about 43% from the company's December 2014 initial public offering.") http://www.wsj.com/articles/fast-growing-lending-club-to-change-its-fee-model-1456488393. LendingClub, one of the preeminent names in marketplace lending, acknowledged that it will be forced to change its lending practices in light of the Second Circuit's decision in *Madden*. *Id.*

[155] *See* Telis Damos, *Silicon Valley Looks at Something New: Starting a Bank*, THE WALL STREET JOURNAL (May 1, 2016 7:40 PM) ("[R]ecent regulatory moves and legal decisions may put more pressure on fintech firms to move closer to banks. The Office of Comptroller of the Currency is working on a framework to regulate banks and fintech. A 2015 appeals court decision, Madden v. Midland Funding LLC, made it harder for banks to sell loans immediately back to online firms."), http://www.wsj.com/articles/silicon-valley-looks-at-something-new-starting-a-bank-1462146047. Online lenders, such as Vero Money Inc., have traditionally relied upon a banking partner. *Id.* Due to increasing trepidation over the ever-expanding consumer protection regulation, however, Vero Money Inc. has expressed willingness to seek "its own charter so it can offer the deposits itself." *Id.*

[156] Marketplace lenders such as LendingClub have recently drawn increased attention from regulatory bodies. *See* Witkowski, *supra* note 154.

the receivables.[157] The bank, acting in this limited capacity as trustee holding title, serves to blunt the argument that a bank does not still own some interest in the receivables.

Another newly devised arrow in the structured financing quiver is the developing practice for the bank that originated and sold the receivable to retain an economic interest in the receivables following its sale.[158] For example, the selling bank may retain an undivided participation interest in each of the receivables or reserve an income strip, which preserves intact with the selling bank's ownership interest in the receivables—or at least partial ownership interest.[159] Retention of the partial ownership interest could help mitigate the two-fold threats of the Madden decision and the regulators' dim views of the rent-a-charter façade.

In any event, the originating bank should avoid the almost instantaneous flip of the receivables to the purchaser following origination, and hold ownership for at least several days, or preferably, at least a week following the date the loan is made in order to avoid an appearance of sleight-of-hand. Retention of an interest in the receivables being transferred may cloud the ability of attorneys in the securitization process to continue to furnish "true sale" opinions, which in essence conclude that the transfer is not a mere borrowing and constitutes an absolute sale of the receivables—an opinion that is essential to every securitization transaction.[160] The Madden decision, in any event, throws several wrenches throws into the asset-backed securities machine that evade easy and quick resolution.

[157] *See* Peter Rudegeair & Telis Damos, *LendingClub to Change its Fee Model*, THE WALL STREET JOURNAL (Feb. 26, 2016 4:28 PM), http://www.wsj.com/articles/fast-growing-lending-club-to-change-its-fee-model-1456488393.
[158] *See id.* LendingClub announced—in response to heightened regulation and the Madden decision—that it would restructure its relationship with the originating bank "to ensure . . . the economics of the bank are tied to the loans." *Id.*
[159] Such a practice would closely resemble LendingClub's response to the Second Circuit's decision. *Id.*
[160] *See* Plank, *supra* note 8, at 301.