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BANK PARTNERSHIP AND THE VALID WHEN MADE DOCTRINE: UPDATE ON MADDEN V MIDLAND

Catherine M. Brennan, Meghan Musselman and Joseph Vitale

BANK PARTNERSHIP AND THE VALID WHEN MADE DOCTRINE: UPDATE ON MADDEN V. MIDLAND

- Bank Partnerships have operated for years without much upheaval, relying on federal law and related guidance;
- Prior to 2015, case law generally affirmed bank partnerships;
- Partnerships relied on the "valid when made" doctrine, wherein a loan not usurious when made does not become usurious when assigned to another party.

How Do Bank Partnerships Work?

- Nonbank entity partners with a state FDIC-insured chartered bank or a federally chartered bank to help the bank originate the loan;
- Federal law gives the bank the ability to charge the interest rate permitted to it by its home state to people in every state ("rate exportation");
- Nonbank partner provides marketing and loan processing assistance up front, as well as purchasing, servicing and collections activities on the back end.

How Do Bank Partnerships Work?

1) A non-bank partner enters into a contractual relationship with a Bank.
2) Under the terms of the relationship, the Bank originates the loans, applying its own credit underwriting guidelines.
3) The non-bank partner, through its employees, may act as an agent for the bank in the states where borrowers are located.
4) The non-bank partner may receive the borrower's loan application and forward it, usually by electronic means, to the Bank.
5) The Bank approves or rejects the application. If approved, the Bank funds the loan from its location.
6) After the Bank makes the loan, the non-bank partner who acted as the bank's agent for purposes of loan origination may purchase it. The purchase usually takes place within seconds of the loan being made and the entire transaction is usually handled electronically.
7) By agreement with the non-bank partner, the Bank often retains a small (perhaps 5%) participation interest in the loan or sells the whole loan.
8) By agreement, the non-bank lender often guarantees or indemnifies the bank for the risk it assumes in originating the loans.

How Do Bank Partnerships Work?

Numerous cases have affirmed bank partnerships. The key elements of a successful partnership include:

- Bank must be the lender and named as such on credit documents;
- Bank must approve loan underwriting criteria – and any and all exceptions;
- Loan funds must come from the Bank; and
- The Bank must control the terms of the loan program, the fee schedule, and the terms and conditions of the contractual relationship with the consumer.

How Do Bank Partnerships Work?

The FDIC has recognized the validity of bank partnerships:

In its Winter 2015 issue of Supervisory Insights, the FDIC discusses marketplace lending. The FDIC instructs banks to take steps to mitigate risk before entering into a partnership with a nonbank entity, including due diligence and ongoing monitoring of the partner's compliance with applicable federal law, consumer protection requirements, anti-money laundering rules and fair credit obligations, as well as applicable state laws such as licensing or registrations necessary to engage in the partnership.

Valid When Made Doctrine

The general rule is that a contract must charge unlawful interest at its inception to violate the usury law. That is, a contract that is valid when made does not become void for usury simply because it was later purchased by or assigned to a third party who lacked the authority to charge that rate of interest in the first place.

That is, whether a loan is usurious is determined at origination of the loan.

Now Comes Madden

In *Madden*, the U.S. Court of Appeals for the Second Circuit - which includes Connecticut, New York, and Vermont - held that the National Bank Act ("NBA") preemption of state usury laws did not apply to accounts owned and serviced by Midland Funding, LLC ("Midland"), a non-bank debt buyer, even though the accounts had been originated by a national bank. The decision undermines the "valid when made" theory and impedes the ability of national banks to sell loans they originate, thus reducing their ability to lend. *Madden* was argued under the NBA, but its implications are larger. *Madden* could affect anyone involved in a bank partnership model of lending, including partnerships with state-chartered banks. And, if the decision means the "valid when made" theory is no longer valid, it could also affect anyone that purchases loans or lines of credit originated by a bank or a licensed lender at interest rates higher than those the buyer could have otherwise imposed.

Madden Facts

Saliha Madden, a New York resident, opened a credit card account with Bank of America ("BoA") in 2005. BoA collapsed its credit card program into FIA Card Services, N.A. ("FIA"), and Madden received a change in terms notice informing her that the credit card account would thence forward be subject to Delaware law. When Madden failed to pay on her account for some period, FIA charged off the account and sold the debt to Midland, a debt buyer. In November 2010, Midland sent Madden a letter seeking to collect the debt at an interest rate of 27% per year. Apparently the 27% rate, which is a rate permissible to a national bank in Delaware, was the rate imposed by FIA on Madden's account. The rate, however, exceeds the 25% per year criminal usury cap in New York.

Procedural History

- Madden filed a class action lawsuit in federal court asserting violations of the federal Fair Debt Collections Practices Act and a state law usury violation. The federal trial court denied Midland's motion for summary judgment and motion for class certification, finding that the NBA would preempt any state law usury claim against Midland.

- Madden appealed to the Second Circuit, arguing that NBA usury preemption does not extend to non-bank debt buyers where the national bank retains no interest or control of the accounts and the national bank and debt buyer are unrelated entities. Madden also argued that because Midland is not a national bank or a subsidiary or agent of a national bank, or otherwise acting on behalf of a national bank, and because application of the usury law does not "significantly interfere" with the national bank's ability to exercise its powers under the NBA, NBA preemption does not apply.

Second Circuit Decision

- The Second Circuit agreed with Madden and vacated the trial court's order. The Second Circuit reasoned that NBA preemption can be extended to non-national bank entities only where application of state law significantly interferes with a national bank's ability to exercise its powers under the NBA.
- The significant interference standard is derived from the U.S. Supreme Court's 1996 decision in *Barnett Bank of Marion County, N. A. v. Nelson, Florida Insurance Commissioner, et al.* and codified in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in 2010. 517 U.S. 25 (1996).

Second Circuit Decision

- In applying the *Barnett* standard, the *Madden* court concluded that application of state law to this scenario would not significantly interfere with the bank's ability to exercise its powers under the NBA. The Second Circuit did admit "it is possible that usury laws might decrease the amount a national bank could charge for its consumer debt in certain states . . ." But did not explain why this decrease in the value of a national bank's loan portfolio was not "significant interference." After *Barnett*, more than 500 court decisions have weighed whether specific state laws "prevent or significantly interfere with" a national bank's powers to warrant a finding of preemption. For example, since *Barnett*, courts have found that that the NBA preempts state law licensing requirements, state law requirements that a "convenience check" include specific disclosure language, and state law restrictions on the amount of non-interest fees a national bank can charge.

Second Circuit Decision

- The Second Circuit's analysis focused on the application of NBA preemption to Midland, the entity holding the obligation, rather than focusing on the application of NBA preemption to the underlying obligation itself. In doing so, the Second Circuit ignored completely the "valid when made" theory, a bedrock principle that provides certainty and validity to the secondary market. Under this theory, an obligation is considered valid under the law that applied at the time of origination. The obligation continues to be valid under that law even after it is transferred to subsequent parties. If not for this theory, loan terms would be subject to change each time the accounts are transferred. From a review of the record, it does not appear that the "valid when made" theory was argued or briefed. Courts have consistently recognized the "valid when made" theory.
- *See Nichols v. Fearson*, 32 U.S. 103, 109-110 (1833); *Olvera v. Blitt & Gaines, P.C.*, 431 F.3d 285, 287-288 (7th Cir. 2005); *LFG National Capital, LLC v. Gary, Williams, Finney, Lewis, Watson, & Sperando P.L*, 874 F. Supp. 2d 108, 125 (N.D.N.Y. 2012).

Midland's Appeal Status

- On June 19, 2015, Midland filed a petition for rehearing *en banc* before the Second Circuit. In other words, Midland has asked the entire Second Circuit to revisit the unanimous decision of the three judge panel that decided *Madden.* That petition was denied August 12, 2015. Midland sought remand to the trial court to adjudicate the outstanding choice-of-law issue. Midland also appealed the Second Circuit decision to the U.S. Supreme Court on November 10, 2015.
- We note that with the recent passing of Antonin Scalia, there is some speculation that it is even more unlikely that the high court would overturn the decision, even if it granted cert. The reasoning of these observers is that the votes of five Republican-appointed justices would have been enough for a reversal in *Madden*. With Scalia's death, at least one of the four Democratic appointees, who more typically side with consumers in disputes with businesses, would have to be persuaded to overturn.

Questions?

CONTACT INFORMATION

Catherine M. Brennan
Hudson Cook, LLP
7037 Ridge Road, Suite 300
Hanover, MD 21076
☎ 410-865-5405
✉ cbrennan@hudco.com

Meghan S. Musselman
Hudson Cook, LLP
7037 Ridge Road, Suite 300
Hanover, MD 21076
☎ 410-865-5403
✉ mmusselman@hudco.com

Joseph P. Vitale, Partner
Schulte Roth & Zabel LLP
919 Third Avenue
New York, NY 10022
☎ 212-756-2485
✉ joseph.vitale@srz.com