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Bank Regulators' Madden Fixes May Not Be Quick Ones

By **Jon Hill**

Law360 (November 22, 2019, 11:02 PM EST) -- Federal banking regulators have proposed rules to curb uncertainty in the consumer credit and securitization markets that the industry has blamed on the Second Circuit's Madden decision, but attorneys say it could take some time before the agencies' efforts pay off.

This past week, the Office of the Comptroller of the Currency and Federal Deposit Insurance Corp. released draft regulations that take aim at the Second Circuit's controversial 2015 decision in Madden v. Midland Funding, which upset long-standing industry expectations that the legality of the interest rate charged on a bank-originated loan doesn't change if the bank sells off or securitizes that loan.

Seeking to mitigate industry concerns about litigation and other secondary market uncertainty stemming from Madden, the OCC and FDIC proposals call for codifying regulations that state the validity of a national or state bank loan's interest rate "shall not be affected" by the loan's subsequent sale, transfer or assignment.

"It's a very welcome development for the industry," Scott M. Pearson, a financial services partner at Manatt Phelps & Phillips LLP, told Law360. "This is something that many of us have been urging these agencies to do for a long time."

But Pearson and other financial services attorneys nevertheless cautioned that legal challenges likely lie ahead if the rules are finalized.

"Assuming that the rules are approved after notice and comment, the question will be whether the courts uphold them, and that will require analysis of whether the agencies had the ability to promulgate these rules and whether the rules should be accorded deference by the courts," said Catherine Brennan, a partner in Hudson Cook LLP's fintech and alternative business finance practices.

"There's a long way to go between now and when we have final certainty on Madden," Brennan added.

The financial services industry has warned for years of Madden's potential to threaten the viability of

bank-fintech lending partnerships and gum up secondary credit markets where trillions of dollars in bank-originated loans are sold and securitized. But the U.S. Supreme Court declined to review the decision, and efforts to overturn Madden through legislation have sputtered out several times in Congress.

Meanwhile, Madden has helped fuel litigation targeting not only these partnership arrangements but also credit card securitizations and other instances in which higher-interest debt has been assigned by banks. One 2017 study of marketplace lender data even connected the decision to a reduction in credit availability in Second Circuit states, especially among borrowers with lower credit scores.

The industry's concerns stem from the decision's apparent inconsistency with the "valid-when-made" doctrine, which holds that a loan's interest rate will remain legal so long as it was legal when the loan was made, regardless of who ends up holding the loan later on.

In contrast, the Second Circuit ruled in Madden that a nonbank buyer of charged-off credit card debt from a national bank was not legally shielded from having state interest rate caps applied to that debt, even though they hadn't applied before the sale. That subverted long-held industry expectations.

"If you think about it, it's contract law," said Karen Solomon, senior of counsel at Covington & Burling LLP and a former top lawyer at the OCC. "The terms of a contract are decided at the time of origination, and it is unusual to say that those terms change because the contract is sold or assigned."

The OCC and FDIC's proposed rules are intended to restore the pre-Madden status quo by essentially formalizing the valid-when-made doctrine, in the form of regulations implementing sections of federal banking laws that govern the interest rate authorities of national banks, federal savings associations and state banks.

In doing so, the agencies have argued that they would merely be codifying the way they and the industry have long interpreted these laws, and indeed, the regulators have previously filed amicus briefs in courts affirming their support for the valid-when-made doctrine and criticizing Madden when the issue has been raised.

"These [proposed rules] go a long way toward establishing that national banks and state-chartered banks, as part of their powers as banks and as part of the business of banking, have the ability to transfer assets and that when they do so, those assets are not somehow converted into nonbank assets," Brennan said. "This would clarify Madden and, if the rules are promulgated, will be the first line of defense from these Madden challenges."

Pearson agreed that the rules should help give banks some confidence that if they originate a loan to a Second Circuit borrower and sell off that loan to a nonbank third party, the interest rate on the loan would withstand a challenge from private plaintiffs or a state authority.

"It's more ammunition for the industry," Pearson said.

But echoing Brennan, Pearson acknowledged that what the OCC and FDIC are proposing is not necessarily a quick fix, given that the agencies' conclusions on the valid-when-made doctrine are likely to be contested and courts are not strictly bound to follow a regulator's interpretation of law.

"I'm sure that there will be legal challenges, claiming that perhaps the agencies don't have authority to issue these regulations," Pearson said. "Then there will be arguments about preemption generally, and whether the issuance of these regulations is going to overcome state law."

One of the ways a court could be presented with an opportunity to decide whether to accept the OCC and FDIC valid-when-made interpretations is in the context of a lawsuit much like the original Madden case, where a plaintiff objects to the interest being charged by a debt collector or other nonbank acquirer of a bank loan.

Another opportunity could come if the agencies themselves are sued over the regulations, and already, consumer advocates have made their opposition to the proposed rules known.

"It's the latest Trump administration effort to legitimize predatory lending — and it would expose even more consumers to the debt trap by attempting to render state-level protections useless," Jeremy Funk, spokesman for Allied Progress, said in a statement Wednesday.

Lauren Saunders, associate director of the National Consumer Law Center, similarly warned that the agencies' proposals would facilitate "rent-a-bank" schemes where unscrupulous lenders exploit banks' federal interest rate authorities to skirt state usury laws.

"The courts rejected the OCC's first effort to eviscerate state interest rate caps through a fintech 'bank' charter … and I expect courts to strike down this effort as well," Saunders said in a Nov. 18 statement.

Given such objections, Brennan said she expects consumer advocates will attempt to block the valid-when-made regulations through litigation, perhaps even before the regulations are finalized.

"The valid-when-made doctrine is not a statutory doctrine — it's a doctrine from common law and is constructed through case law," Brennan said. "Consumer advocates could attack it from both angles. They could say that the [federal banking laws] weren't clear on this point and this is an unreasonable interpretation, and they can also say valid-when-made is not a valid doctrine."

But Brennan and other attorneys who spoke to Law360 said they believed such arguments wouldn't be very strong ones and noted that the agencies were careful to stay in their regulatory lanes, framing their proposals in terms of promoting the interests of banks they regulate and supporting the safety and soundness of those institutions.

"At the end of the day, the courts end up making the final decisions on these issues," Pearson said, adding that it could still be months before the notice-and-comment process wraps up and final rules are issued for the courts to chew over.

“There may be pockets of litigation that are going to have to run their course if anybody does in fact challenge either or both of the agencies’ interpretations,” Solomon said.

Still, Solomon and others were optimistic that the OCC and FDIC’s proposed rules will eventually succeed in tamping down Madden-related uncertainty.

“Investors and creditors in this space want to follow the law and do the right thing, so having clarification is a positive development,” Brennan said. “I think that people are happy to see this, but you know, they're just going to wait and see how it shakes out.”

--Editing by Aaron Pelc and Emily Kokoll.

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