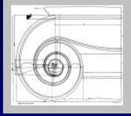

DREHER TOMKIES LLP

ALERT

FOR CLIENTS AND FRIENDS OF DREHER TOMKIES LLP

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## *MADDEN V. MIDLAND FUNDING*: THE FALL OUT

When a case gets off course it can be challenging to get back on track. On remand, the New York district court in *Madden v. Midland Funding* had an opportunity to clarify the U.S. Court of Appeals' vague and misguided opinion and to set forth the proper usury analysis for loan assignees. Instead, the district court added to the financial world's great concern of the meaning and impact of *Madden* by (i) applying the New York contractual choice-of-law analysis improperly and (ii) failing to complete the usury analysis after finding that New York law applied. See our ALERT of March 13, 2017 for details on the district court's recent opinion.

### Choice of Law

The district court identified the proper New York contractual choice-of-law analysis but applied the analysis improperly to disregard the parties' Delaware choice-of-law provision.

The court ultimately concluded that the New York criminal usury statute represents a "fundamental" public policy of New York. To support its determination, the court cited a handful of federal cases in sister courts and New York trial court cases. The court characterized New York's criminal usury prohibition as a reflection of a "deep-rooted tradition of the common weal." The court also noted New York's choice to make charging an interest rate greater than 25% a felony. The court argued that criminalization demonstrates a "fundamental" public policy.

The district court's conclusion that criminal usury represents a "fundamental" public policy is wrong for three reasons. First, New York case law does not clearly support this conclusion. A federal court applying state law must follow state law decisions. The New York Court of Appeals (the highest New York court) has indicated that the public policy exception in a choice-of-law analysis is reserved for those foreign laws that are "truly obnoxious." No New York Court of Appeals case recognizes criminal usury as a "fundamental" public policy.

The district court cited two New York trial cases, one from 1984, to support its "fundamental" public policy determination. The federal cases in the opinion cited the same two New York trial court cases but characterize New York's criminal usury prohibition as a "strong" public policy, as distinct from an overriding "fundamental" one.

Second, the court focused on the criminalization of charging an interest rate greater than 25% without appreciating the statutory text of the criminal usury prohibition. The criminal usury statute contains a broad and express exemption for persons that are "authorized or permitted by law" to charge an interest rate greater than 25%. This broadly written exemption encompasses numerous types of laws, including the valid-when-made doctrine, which the U.S. Supreme Court has called a "cardinal" rule of usury and which predates the New York criminal usury statute by more than 100 years. If criminal usury represents an overriding *fundamental* public policy, why would the New York legislature provide such a broad express exemption? Moreover, why would the legislature require a person to "knowingly" charge an usurious interest rate instead of using a lower criminal intent standard, such as of negligence or recklessness?

Finally, contrary to the district court's characterization, criminal usury is a creature of relatively recent statute and does not represent a "deep-rooted tradition" in New York. The New York legislature enacted the criminal usury statute in 1967. For over 100 years, New York had a civil usury statute but no criminal sanctions for usury. The legislature enacted the criminal usury statute in response to a study on the increase in organized crime involving loan sharking. The specific objective of the criminal usury statute's enactment indicates that the legislature did not intend for the criminal usury statute to represent a broad "fundamental" public policy but rather address the particular problem of organized crime.

Given (i) the New York Court of Appeals' general treatment of the fundamental public policy exception in a choice-of-law analysis, (ii) the text of the criminal usury statute (including the broad exemption for persons charging an interest rate greater than 25% "as authorized or permitted by law") and (iii) the history of the criminal usury statute as a relatively recent, targeted legislation, the New York Court of Appeals should, if faced with the question, conclude that the criminal usury statute is not a "fundamental" public policy, however "strong" it may be.

### Completing the Usury Analysis

After finding that New York law applied, the district court denied Midland's motion to dismiss and granted Madden's motion for class certification without further usury analysis. The district court should have continued the usury analysis as outlined in the U.S. Solicitor General's and the Office of the Comptroller of the Currency's ("OCC")

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amicus brief filed with the U.S. Supreme Court. See our ALERT of May 25, 2016.

The Solicitor General and OCC stated that if New York law applied rather than Delaware law, Midland could still prevail on remand if New York usury law incorporates the valid-when-made doctrine. The district court's opinion omits any discussion of the Solicitor General's brief or the valid-when-made doctrine. The U.S. Supreme Court and New York courts have recognized the valid-when-made doctrine. Thus, Midland was "authorized or permitted by law" (*i.e.,* the valid-when-made doctrine) to charge the interest rate lawfully agreed to by the bank-creditor and debtor notwithstanding New York's criminal usury limit of 25%. The district court should have granted Midland's motion to dismiss.

It is greatly concerning that for the second time in this case, a court has failed to mention the valid-when-made doctrine. The valid-when-made doctrine is a long-standing doctrine that has been applied without question since the U.S. Supreme Court recognized the doctrine in the early 1800s. The valid-when-made doctrine is a fundamental building block of our financial world. Any financial product that is sold and resold, including mortgages and student loans, and any investment backed by such a product is put at risk by the continuing inadequate analysis adopted by the courts in this case.

We are already witnessing the fallout of *Madden*. Recently, the Colorado Attorney General filed lawsuits against two marketplace loan programs alleging "true lender" and *Madden*-based claims. See our forthcoming ALERT. While courts address and hopefully dismiss *Madden*-based claims, attorneys should counsel their clients to modify loan programs to address the program features that regulators and plaintiffs are attacking, but without complete understanding of the issues involved. ❑

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