EXPERT ANALYSIS

MADDEN V. MIDLAND FUNDING: THE FALLOUT

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When a case gets off course it can be challenging to get back on track.

The U.S. District Court, Southern District of New York in *Madden v. Midland Funding* had an opportunity on remand[1] to clarify the 2d U.S. Circuit Court of Appeals' vague and misguided opinion and to set forth the proper usury analysis for loan assignees. The U.S. Solicitor General and the Office of the Comptroller of the Currency provided a roadmap.

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 proper usury analysis after finding that New York law applied.

Two lawsuits filed by the Colorado Attorney General's office against two marketplace bank loan programs represent the latest fallout of *Madden*. The Colorado district court has the opportunity to do what the New York district court failed to do — limit the 2d Circuit's misguided opinion.

Well-reasoned decisions that clarify the limited scope of the 2d Circuit's decision and set forth the proper usury analysis, including recognizing the "valid-when-made doctrine," will be the most efficient and effective vehicle to limit further fallout.

Choice of law

The New York district court in *Madden* 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 an overriding "fundamental" public policy of New York based on a handful of federal cases in sister courts and two New York trial court cases, and the criminalization of charging interest at a rate greater than 25 percent.[2]

The district court characterized New York's criminal usury prohibition as a reflection of a "deep-rooted tradition of the common weal." The court's conclusion is wrong for three reasons.

- First, New York case law does not clearly establish criminal usury as a "fundamental" public policy. The district court cited two New York trial cases, one from 1984, but no appellate cases. The federal cases cited by the court considered the same two New York trial court cases but characterized New York's criminal usury prohibition as merely a "strong" public policy, not an overriding "fundamental" one. No New York Court of Appeals case recognizes criminal usury as an overriding "fundamental" public policy.
- Second, the court focused on the criminalization of charging an interest rate greater than 25 percent without appreciating the statutory text of the criminal usury prohibition. Importantly, 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 percent.[3] 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.[4] If criminal usury represents an overriding fundamental public policy, why would the New York legislature provide such a broad express exemption?
- Finally, contrary to the district court's characterization, criminal usury is a creature of relatively recent statute and so does not represent a "deep-rooted tradition" in New York. The New York legislature enacted the criminal usury statute in 1967 in response to a study on the increase in organized crime involving unauthorized loan sharking.[5] For over 100 years, New York had a civil usury statute with no criminal sanctions for usury.

The appellate court should, if faced with the question, conclude that the criminal usury statute is not an overriding "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 *amicus* brief filed with the U.S. Supreme Court by the Solicitor General and the OCC.[6]

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," which it does.[7] The district court's opinion omits any discussion of the Solicitor General's brief or the "valid-when-made doctrine."

As related in detail by the Solicitor General and the OCC, 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 percent. The district court should have granted Midland's motion to dismiss.

Addressing the 2d Circuit's *Madden* decision

The uncertainty arising from the 2d Circuit's flawed preemption analysis could be resolved if a court (i) recognizes the limited scope of Madden and (ii) clarifies the proper analysis for usury claims against loan assignees under the valid-when-made doctrine.[8] The Solicitor General's *amicus* brief, which characterized the 2d Circuit decision as patently "incorrect," provided persuasive authority to distinguish the 2d Circuit's decision.

Yet the *Madden* district court not only failed to limit the scope, and thus, the impact, of the 2d Circuit's opinion, but also failed to mention the "valid-when-made doctrine" — the second time that a court in *Madden* has failed to mention it. The valid-when-made doctrine is a long-standing "cardinal" principle of usury law that has been applied by courts in many states without question since before the U.S. Supreme Court recognized the doctrine in the early 1800s.

The 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 *Madden*.

Other litigation

The fallout of *Madden* is not limited to banking law.

The Colorado AG filed lawsuits in February 2017 against two marketplace bank loan programs alleging *Madden*-based claims as well as "true creditor" claims in U.S. District Court, District of Colorado.[9] This action represents the most recent fallout from *Madden*. The AG wrongfully asserts that, pursuant to the 2d Circuit's *Madden* decision, a nonbank purchaser of marketplace bank loans cannot enforce a bank's federal interest rate exportation rights because banks cannot validly assign such rights to nonbanks.[10]

The AG seeks to ignore the valid-when-made doctrine and to reject the Solicitor General's and the OCC's briefs, which explain that a bank's preemptive powers include the power to transfer loans to other entities at the original rate. Wisely, the respective banks have intervened, filing declaratory actions against the Colorado AG and championing proper federal banking principles, including the "valid-when-made doctrine."[11]

The pending Colorado lawsuits present an opportunity for a well-reasoned decision addressing the various issues raised by *Madden*, although the district court could end up avoiding the *Madden* claims if the court determines that the nonbank servicers are the "true creditors" of the marketplace programs.

Other potential cures

Beyond well-reasoned decisions addressing *Madden*, federal legislation and rulemaking may provide limited relief.

The Protecting Consumers' Access to Credit Act was introduced in the U.S. House of Representatives in July 2016.[12] This legislation addresses the "valid-when-made doctrine," but only with respect to loans made by federally insured banks.

A plethora of nonbank products that are sold also rely on the "valid-when-made doctrine." Passing legislation that recognizes the doctrine only for banks and leaves uncertain the status of nonbank loans could unfairly disadvantage lenders of nonbank products and their assignees.

An interpretative rule from a prudential bank regulator could settle *Madden* concerns, but again only with respect to bank loans. The *OCC* has already provided persuasive guidance on national bank's powers and the proper usury analysis in the *Madden* case and has used its rulemaking authority to address troubling litigation in the past, so there is adequate precedent for the OCC to take action here.

Well-reasoned court decisions continue to be the most effective and efficient vehicle to recognize the continued supremacy of valid-when-made doctrine and establish the proper usury analysis for assignees of bank and nonbank loans. Perhaps the Colorado district court will render a clarifying decision that will begin to provide the certainty the financial world is eager to have.

Notes

1 *Madden v. Midland Funding*, No. 11-8149, 2017 WL 758518 (S.D.N.Y. 02/27/17).

2 *Id.* at *10.

3 N.Y. Penal Law § 190.40.

4 *Nichols v. Fearson*, 32 U.S. 103, 109 (1833).

5 *Hammelburger v. Foursome Inn Corp.*, 54 N.Y.2d 580, 584 (1981).

[6] Brief for the United States as Amicus Curiae, *Midland Funding, LLC v. Madden*, No. 15-610 (U.S. 05/25/16).

[7] *See, e.g., Modern Indus. Bank v. Hegeman*, 54 N.Y.S.2d 251, 253 (N.Y. Sup. Ct. 1945).

[8] Michael C. Tomkies and Susan Manship Seaman, *Stay Far from the 'Madden-Ing Crowd: When Preemption Meets Contract Law*, 69 Consumer Fin. L.Q. Rep. 227 (2015).

[9] The lawsuits were originally filed in state court, but have since been removed to federal court.

[10] Amended Complaint, *Meade v. Marlette Funding, LLC*, No. 17-99575 (D. Colo. 03/03/17).

[11] Complaint for Declaratory Judgment and Injunctive Relief, No. 17-00832 (D. Colo. 04/03/17).

[12] H.R.5724, 114th Cong. (2016).