Stay Far from the *Madden*-ing Crowd: When Preemption Meets Contract Law

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I. Introduction

A case from the United States Court of Appeals for the Second Circuit has created uncertainty in the secondary loan market by potentially challenging the common understanding that third-party assignees of loans can enforce the legal rights of the assignor, including charging the contract rate of interest established at the time of loan origination. As a consequence, *Madden v. Midland Funding LLC*[1] has alarmed the financial services industry because the decision may be interpreted to subject assignees of bank loans to state interest rate limitations and invalidate the long-standing so-called "valid-when-made" (VWM) doctrine.[2] Plaintiffs have begun to introduce *Madden*-related arguments in their filings.[3] Is the sky falling? We think not. In our opinion, properly framed, the Second Circuit merely clarified a fine point of federal law regarding the scope of federal preemption[4] and did not overturn

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1. 786 F.3d 246 (2nd Cir. 2015).

2. *See, e.g.*, Brief for ACA International, as Amicus Curiae in Support of Petition for Writ of Certiorari, Madden v. Midland Funding LLC, No. 15-610, 2015 WL 9184797 (U.S. Dec. 10, 2015).

3. *See, e.g.*, Brief for Appellants at 25, Avila v. Riexinger & Associates, LLC, No. 15-1584 (2d Cir. July 6, 2015); Bethune v. Lending Club Corp., No. 16-cv-02578 (S.D.N.Y. Apr. 6, 2016); *see also* Edwards v. Macy's Inc., No. 14-cv-8616, 2016 WL 922221 (S.D.N.Y. Mar. 9, 2016).

4. Various federal statutes establish federal preemption of state usury laws for federally-chartered and federally-insured financial institutions. *See, e.g.*, 12 U.S.C. §§ 85 & 1831d; *see also* Smiley v. CitiBank (South Dakota) N.A., 517 U.S. 735, 737 (1996). This article discusses the VWM doctrine for assignees of loans originated by a national bank. The analysis is similar for loans originated by federally-insured state banks under section 521 of the Depository Institution Deregulation and Monetary Control Act (DIDMCA). *See*: Greenwood Trust Co. v. Massachusetts, 971 F.2d 818, 823 - 24 (1st Cir. 1992); FDIC Letter No. 10 from James D. La Pierre, Dept. Exec. Sec. (Apr. 17, 1998) (opining that section 521 of DIDMCA and section 85 of the National Bank Act have been and should be construed

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centuries of case law regarding the VWM doctrine. However, *Madden* could have a significant impact on the VWM doctrine if subsequent courts misinterpret the effect of *Madden* to subject loan assignees generally to state interest rate limitations.

On June 27, the United States Supreme Court denied Midland Funding's petition for writ of certiorari.[5] Fortunately, the U.S. Supreme Court had requested that the United States Solicitor General file a brief in the case.[6] In the government's strongly-worded brief, submitted with the Office of the Comptroller of the Currency (OCC), the Solicitor General labeled the Second Circuit's decision in *Madden* as "incorrect."[7] Nonetheless, the Solicitor General recommended that the Supreme Court deny Midland Funding's petition, in part because of the parties' poor presentation of the issues. Without guidance from the Supreme Court, it will be critical that the financial services industry combat a potentially adverse precedent by vigorously defending against and proactively addressing *Madden*-related challenges in subsequent cases, *e.g.*, by: (1) clarifying the limited scope of *Madden*; (2) citing the Solicitor General's brief in support; and (3) establishing the proper usury analysis for assignees of loans.

II. Why the Confusion?

A. Federal Usury Preemption for National Banks and the Valid When Made Doctrine

Some confusion regarding the scope of the Second Circuit's decision stems from a misunderstanding of the nuanced relationship between statutory federal usury preemption and the common law VWM doctrine in state usury claims, particularly in the context of nonbank assignees of bank loans.

Together, the National Bank Act (NBA) and the VWM doctrine enable nonbank assignees to collect interest at the rate charged by originating national banks notwithstanding any interest rate limits in the borrower's home state. However, NBA preemption and the VWM doctrine are distinct concepts.

B. Preemption under the National Bank Act

The NBA specifically applies to national banks[8] and contains two sections that are generally relevant to preemption of state usury claims. Section 85 authorizes national banks to charge interest "to any borrower at the rate allowed by the laws of the state in which the bank is located."[9] Because section 85 governs the rate applicable for "any borrower," section 85 operates effectively as a federal choice-of-law provision.[10] While section 85 establishes the permissible rate of interest, section 86 provides the exclusive remedy for violations of section 85 (*i.e.*, the penalty for usury) for national banks.[11] Courts have interpreted sections 85 and 86 to completely preempt state usury law as to both the permissible interest rate and remedy for usury.[12] In addition to complete preemption, courts have found that the NBA can preempt state law based on conflict preemption if the application of state law "significantly interferes" with a national bank's ability to exercise its power under the NBA.[13]

C. The VWM Doctrine

Distinct from NBA preemption is the VWM doctrine, which is based on long-standing case law. The VWM doctrine provides that an assignee may collect interest at the rate charged by the originating assignor if the loan was valid when it was made. In other words, a loan that is not usurious in its inception cannot subsequently become usurious by reason of its sale to another party.[14] The VWM doctrine is based on contract law and is related to the principle that an assignee steps into the shoes of an assignor.[15] Insofar as the terms of a contract are set, an assignee should succeed to the same rights as the assignor -- no more, no less.[16] The VWM doctrine has been recognized by the United States Supreme Court, other federal courts and state courts, including those in New York.[17] Not only does the VWM doctrine apply to loan assignments from a bank to a nonbank entity, but the VWM doctrine also applies to loan assignments between any two parties, including licensed lenders, nonlicensed lenders and their assignees.[18]

D. The District Court's Opinion

The district court's oral ruling in *Madden* failed to distinguish between NBA preemption and the VWM doctrine. In addressing the debt buyer's motion for

4. *(Continued from previous page)*

in pari materia because section 521 is patterned after section 85 and the provisions embody similar terms and concepts).

5. *Order*, Midland Funding, LLC v. Madden, No. 15-610 (U.S. June 27, 2016). (https://www.supremecourt.gov/orders/courtorders/062716zor_4fbi.pdf).

6. Brief for the United States as Amicus Curiae, Midland Funding, LLC v. Madden, No. 15-610 (U.S. May 25, 2016). (https://justice.gov/sites/default/files/osg/briefs/2016/06/01/midland.invite.18.pdf).

7. *Id.* at 6.

8. 12 U.S.C. § 21.

9. 12 U.S.C. § 85.

10. Marquette Nat'l. Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299 (1978).

11. 12 U.S.C. § 86; *see also* Beneficial Nat'l. Bank v. Anderson, 539 U.S. 1, 11 (2003).

12. *Beneficial*, 539 U.S. at 11.

13. Barnett Bank of Marion Cnty., N.A. v. Nelson, 517 U.S. 25 (1996); *see also* 12 U.S.C. § 25b(b)(1).

14. Gaither v. Farmers & Mech. Bank of Georgetown, 26 U.S. 37, 43 (1828). The plaintiff in *Madden* agreed that the interest imposed by the bank prior to the debt sale was permissible, but disputed the assignee's authority to impose subsequently accruing interest charges.

15. Olvera v. Blitt & Gaines, P.C., 431 F.3d 285, 289 (7th Cir. 2005).

16. *Id.* at 287 ("The plaintiffs argue that the only interest rates that nonexempt entities are authorized to charge are the statutory rates, and these assignees – the bad debt buyers – are nonexempt. This is a semantically unexceptionable reading, but it produces a senseless result. If the credit card company hires a lawyer to collect a debt from one of its customers, the debt will until paid or abandoned accrue interest at the rate originally charged by the company. Why should the interest rate be lower if instead of collecting the debt directly the credit card company assigns (sells) the debt to another company, which hires the lawyer to collect it?") (Posner, J.).

17. *See, e.g.:* Nichols v. Fearson, 32 U.S. 103, 109 (1833); FDIC v. Lattimore Land Corp., 656 F.2d 139, 148-49 (1981); Modern Indus. Bank v. Hegeman, 54 N.Y.S.2d 251, 253 (N.Y. Sup. Ct. 1945), *citing* Morford v. David, 28 N.Y. 481 (1864).

18. *See, e.g.*, *Olvera*, 431 F.3d at 289.

summary judgment, the district court framed the issue in the case as: "whether the National Bank Act *applies* to the [d]efendants as assignees of a national bank."[19] The district court noted that sections 85 and 86 of the NBA preempt state usury claims against a national bank[20] and that, according to a number of federal cases, courts must look to the originating entity (the national bank) and not the ongoing assignee to determine whether the NBA applies. The district court continued by citing the "cardinal rule" of usury that a contract that is unaffected by usury when it is made is valid in the hands of a subsequent assignee. Based on these principles, the district court reasoned that assignees are entitled to the protections of the NBA if the original bank was entitled to the protections of the NBA.[21] In other words, any assignee of a national bank is subject to complete preemption under sections 85 and 86, not state usury law. The district court arrived at the correct conclusion that a debt buyer may charge the interest rate charged by the national bank, but incorrectly based its conclusion on the application of federal preemption of state usury claims *directly to* the assignee as distinct from the *effect* of federal rate preemption on the loan contract *pursuant to* the VWM doctrine. Thus, confusion began with the district court's framing of the issue in the case.

III. Clarifying the Scope of the Second Circuit's Opinion

A. Finding a Limit to NBA Preemption

On appeal, the Second Circuit was asked whether the NBA preempts a state usury claim against a nonbank assignee.[22] When read in context, the Second Circuit disposed of this question by clarifying the scope of NBA preemption and not by invalidating the VWM doctrine.

As noted above, the NBA expressly applies to national banks and preempts state usury claims against a national bank. The Supreme Court and federal courts have previously found that section 86 of the NBA (the federal usury provision) extends to certain nonbank entities that are the equivalent of national banks and exercise the powers of national banks by acting on behalf of the national bank to carry out the national bank's business.[23] These entities include: (1) operating subsidiaries of national banks; and (2) agents of national banks that facilitate the processing of loans.[24] In *Madden*, the defendant-assignee was not related to the national bank and acted solely on its own behalf to collect charged-off debt. The assignee did not fall into a recognized group of nonbank entities to which NBA preemption (*i.e.*, sections 85 and 86) could extend and the Second Circuit refused to extend NBA preemption to such an assignee. The court found that extending NBA preemption to an unrelated entity that acts independently of a national bank would be an overly broad application of the NBA and would provide an "end-run around" of state usury laws for non-national bank entities.[25] We agree. But this conclusion, while disposing of the question presented, does not address the grounds upon which an assignee can properly benefit (indirectly) from the exercise of federal preemption by a bank.

B. The Second Circuit Did Not Overturn the VWM Doctrine

Although the Second Circuit did not expressly address the VWM doctrine, certain aspects of the *Madden* opinion create uncertainty as to the court's view of the VWM doctrine. We believe these aspects of the court's opinion do not, and should not be interpreted to, overturn the VWM doctrine or impair its relevance.

First, the Second Circuit included dicta in its analysis on whether the NBA preempts New York usury law based on conflict preemption. The Second Circuit concluded that subjecting the debt buyer to New York usury law would not significantly interfere with the national bank's ability to exercise its powers under the NBA because such an application would limit only the activities of a third party, which is otherwise subject to state control.[26] Without supporting its conclusion, the Second Circuit asserted that state usury laws "would not prevent consumer debt sales by national banks to third parties."[27] The court continued that "although it is possible that usury laws might decrease the amount a national bank could charge for its consumer debt in certain states, such an effect would not 'significantly interfere' with the exercise of national bank powers."[28]

Although most of the assumed facts are incorrect on their face, the Second Circuit might have been defensible if it had completed the analysis. In this view, application of state usury laws to nonbank assignees would not prevent consumer debt sales by national banks, and thus significantly interfere with a national bank's power, *because*, as explained below, the VWM doctrine enables nonbank assignees of bank loans to charge the interest

19. Transcript of Record at 7, Madden v. Midland Funding LLC, No. 14-2131 (S.D.N.Y. Aug. 15, 2014) (emphasis added).

20. *Id.* at 8.

21. *Id.* at 22.

22. Brief for Plaintiff-Appellant at 2, Madden v. Midland Funding LLC, 786 F.3d 246 (2d Cir. 2015) (No.14-2131); Brief for Defendant-Appellees at 6, Madden v. Midland Funding LLC, 786 F.3d 246 (2d Cir. 2015) (No.14-2131).

23. Watters v. Wachovia Bank, N.A., 550 U.S. 1, 18 (2007). The plaintiff properly notes that the Dodd-Frank Wall Street and Consumer Protection Act (Dodd-Frank Act) has since limited the scope of the direct exercise of federal preemption, but the Dodd-Frank Act does not limit the indirect effect of the proper exercise of federal authority by a national bank. Brief in Opposition at 4, Madden v. Midland Funding LLC, No. 15-610 (U.S. Feb. 12, 2016).

24. *See*: Wachovia Bank, N.A. v. Burke, 414 F.3d 305, 313 (2d Cir. 2005); Pac. Capital Bank N.W. v. Connecticut, 542 F.3d 341, 353 - 54 (2d Cir. 2008).

25. *Madden*, 786 F.3d at 251 - 52.

26. *Id.* at 251. As noted by the plaintiff and the Solicitor General, the record before the court was underdeveloped with regard to the issue of "significant interference" under a conflict preemption theory. Brief in Opposition at 25; Brief for the United States at 17. The Second Circuit's discussion of conflict preemption can only be taken as dicta in light of the court's speculation.

27. *See Madden*, 786 F.3d at 251 - 52.

28. *Id.*

rate initially charged by the national bank notwithstanding state interest rate limitations. Assignees are subject to state usury penalties only if they exceed the rate authority permitted pursuant to the VWM doctrine. The Second Circuit's dicta on the effect of state usury law on the price of consumer debt has contributed to the concern that *Madden* subjects assignees of bank loans to state interest rate limitations and overturns the VWM doctrine.

Second, the Second Circuit distinguished two federal preemption cases that include an analysis that is similar to a VWM analysis. *Krispin v. May Department Stores*[29] and *Phipps v. FDIC*[30] instruct courts to look at the originating entity and not the ongoing assignee to determine whether sections 85 and 86 of the NBA apply. In *Krispin*, a borrower pursued a state usury claim against a nonbank receivables holder of accounts to which a national bank held title. In *Phipps*, a borrower brought a claim directly against the national bank. Unlike *Krispin* and *Phipps*, the national bank in *Madden* had no interest in the state usury claim against the debt buyer, either as a named party or as the titleholder of accounts. Thus, the role of the national banks in *Krispin* and *Phipps* justifies the application of NBA preemption in those cases. The same justification for NBA preemption is not present in *Madden*. In distinguishing *Krispin* and *Phipps*, the Second Circuit merely recognized that the scope of NBA preemption is limited.

These aspects of the *Madden* court's opinion do not inexorably lead to the conclusion that the *Madden* decision has overturned the VWM doctrine or that nonbank assignees should be subject to state interest rate limitations. The narrow question on appeal was whether the NBA *extends* to a third-party nonbank assignees, which the court addressed by discussing only the scope of NBA preemption. *Madden* omits discussion of the VWM precedents cited by the district court, in particular the Supreme Court's decision in *Nicholas v. Fearson*[31] and the decision of the United States Court of Appeals for the Fifth Circuit in *FDIC v. Lattimore Land Corporation*.[32] When overturning a doctrine recognized since at least the early 1800s, one would expect a court to address at least one relevant Supreme Court precedent. Thus, absent such an intention, the Second Circuit merely clarified a natural limitation of federal preemption: sections 85 and 86 of the NBA do not *extend directly* to independent nonbank assignees of bank loans.

IV. Guidance from the Solicitor General and the OCC

The United States Supreme Court declined to provide much desired guidance on the scope of the Second Circuit's decision in *Madden*; however, the Solicitor General and OCC provided strongly-worded specific guidance in their brief. The brief described the Second Circuit's decision as "incorrect," explaining at length the significance of the VWM doctrine with respect to loans originated by national banks and showing the shortcomings of the Second Circuit's analysis, which the Solicitor General attributed in part to the parties' imprecise and incomplete preemption arguments.

The Solicitor General reasoned that section 85 confers broader power to national bank than simply the express power to make loans at the interest rate permitted in the bank's home state. Section 85 implicitly confers to national banks the power to (1) sell loans and (2) to assign to others the right to charge the interest rate permitted under Section 85 (*i.e.*, VWM doctrine).[33] Consequently, state interest rate limitations are preempted to the extent that the application of state usury laws (meaning the application of state interest rate limitations) to the assignee of bank loans prevents or significantly interferes with a national bank's exercise of an inherent power under section 85.[34] The Second Circuit failed to appreciate the full powers conferred to a national bank by sections 85.[35] The brief framed the VWM doctrine as an inherent power of national banks to transfer loans at the permitted rate of interest under section 85 as distinct from a separate common law doctrine based in contract law. While the Solicitor General's characterization of the VWM doctrine as an inherent bank power is persuasive in usury claims involving a loan originated by a bank that characterization is not helpful in usury claims against assignees of nonbank loans insofar as section 85 does not provide the interest rate authority for nonbank loans.

The Solicitor General's brief can effectively be used by the financial services industry to argue that the Second Circuit's decision did not overturn the VWM doctrine. According to the brief, the Second Circuit "overlooked" the VWM principle and failed "to appreciate the potential significance of the [VWM] rule."[36] As discussed above, the Second Circuit's discussion of conflict preemption created uncertainty with regard to the court's treatment of the VWM doctrine. The Solicitor General's brief stated that the Second Circuit took an "unduly narrow conception of" conflict preemption when the court suggested that application of state usury laws must (totally) prevent a national bank's loan sales to third parties to "significantly interfere" with a national banks's powers.[37] Just as the Solicitor General and OCC discounted the Second Circuit's conflict preemption discussion, so too should other courts refuse to interpret the Second Circuit's conflict preemption dicta as overturning the VWM doctrine.

Courts should consider the Solicitor General's brief highly persuasive

29. 218 F.3d 919, 924 (8th Cir. 2000).

30. 417 F.3d 1006, 1013 (8th Cir. 2005).

31. 32 U.S. 103 (1833).

32. 656 F.2d 139 (1981).

33. *Id.* at 7. The brief reasoned that Congress enacted section 85 when it was already established that banks had the power to sell loans and courts had recognized the VWM doctrine. *Id.* Thus, Congress intended to incorporate these concepts into section 85. *Id.* at 10.

34. *Id.* at 11.

35. *Id.* at 11.

36. *Id.* at 17, 19.

37. *Id.* at 12 - 13.

in so much as the brief reflects the considered analysis of the OCC, the prudential regulator of national banks.[38]

V. Approaching a Usury Claim Against a Loan Assignee: The Proper Analysis

When placed in proper context, *Madden* merely clarifies the limits of direct federal preemption. Subsequent courts should not read *Madden* as overturning the VWM doctrine and assignees like Midland Funding should not be subject to state interest rate limitations when enforcing contracts validly made by banks. Counsel representing loan assignees in usury cases must understand how federal or state interest rate authority (*e.g.*, section 85) and the VWM doctrine interact in usury analysis.

Madden concluded that a third-party assignee is subject to state usury law. We agree. *Black's Law Dictionary* defines "usury" as "the charging of an illegal rate of interest as a condition of lending money."[39] To determine whether an assignee committed usury, the court should analyze: (1) whether the interest rate in the loan agreement is permissible under applicable law; and (2) if the answer is yes, whether the assignee charged or collected interest above the contract rate. The first question requires an examination of the underlying contract; the second question involves a question of fact. Under the VWM doctrine, the first question requires an analysis of the lending authority of the originating creditor -- in *Madden*, the application of section 85 of the NBA.

In 1833, the Supreme Court confirmed that it is a "cardinal rule" of usury that the determination of whether the loan is usurious occurs at the time of loan origination,[40] when the terms of the contract are set. A loan that is not usurious in its inception (*i.e.*, that is valid when made) will not become usurious in the hands of an assignee,[41] regardless of the interest rate that that assignee could have charged if the assignee made the loan directly to the borrower. Under the VWM doctrine, a court should determine whether the originating entity, here a national bank, charged a legal rate of interest on the loan when it originated the loan.

Section 85 of the NBA determines the interest rate that a national bank may charge, which is the interest rate allowed by the laws of the state in which the bank is located. Under federal law, a national bank can charge this interest rate to residents in other states notwithstanding any interest rate limitation in the other states.[42] As *Madden* correctly concluded, sections 85 and 86 (the federal usury provision) do not directly apply to, and so do not directly preempt, state usury claims against third-party nonbank assignees. However, through the application of the VWM doctrine, nonbank assignees can *indirectly* benefit from: (1) a national bank's rate authority under section 85; and (2) section 85's preemption of state law. Thus, the VWM doctrine allows assignees of national banks to charge interest at the rate permitted under section 85, without regard to the location of the borrower or to any interest rate limit in the borrower's home state. If an assignee collects interest at a rate greater than the legally authorized rate under VWM, then the assignee could be subject to penalties under the usury laws of the borrower's home state.[43] Section 86 of the NBA is irrelevant to the analysis insofar as section 86 applies only to national banks.

The opinion of the United States Court of Appeals for the Seventh Circuit in *Olvera v. Blitt & Gaines, P.C.*[44] supports this analysis. The *Olvera* court addressed whether the assignee of a charged-off debt in Illinois could charge the same interest rate that the assignor (there, the original creditor) charged the debtor, rather than the lower statutory rate that would apply if the assignee extended credit directly.[45] First, the Seventh Circuit determined that the originating credit card companies did not violate Illinois law by charging a higher rate of interest than provided in the Illinois Interest Act because one of the originating credit card companies was a licensed lender and the other company was a bank.[46] Second, the court noted that the debt buyer charged an interest rate no higher (and actually lower) than the original, lawful contract rate.[47] Thus, although the unlicensed assignee would not be authorized to contract directly for the interest rate it charged, the VWM doctrine preserved the terms of the original bargain and enabled the assignee to charge the interest rate that the assignor was authorized to charge.[48] Although the Seventh Circuit did not discuss federal banking law, the *Olvera* opinion outlines the proper analysis of usury claims under the VWM doctrine.

In summary, a nonbank assignee of a bank loan, as in *Madden*, is subject to state usury law with regard to penalties for usury (since section 86 does not apply), but commits usury only if the nonbank assignee collects interest at a rate greater than the originating national bank is permitted to charge under the laws of its "home" state (pursuant to section 85), because the VWM doctrine requires courts to analyze whether a loan was usurious when it was made.

(Continued on page 263)

38. The Solicitor General and OCC recommended that the United States Supreme Court deny Midland Funding's petition for review because: (1) there is a circuit split on the question presented; (2) the parties did not fully brief the preemption arguments to the courts below; and (3) Midland Funding may prevail on remand to the district court. *Id.* at 6. The Solicitor General and OCC's recommendation to deny review should not affect the persuasiveness of the Solicitor Generals and the OCC's analysis of *Madden*.

39. Black's Law Dictionary 1685 (9th ed. 2009); *see also* Del. Code Ann. tit. 6, § 2304.

40. *Nichols*, 32 U.S. at 109.

41. *Gaither*, 26 U.S. at 43.

42. *See supra* note 4.

43. The Solicitor General noted that Midland Funding could prevail on remand even if the district court determines that New York law applies if New York usury law incorporates the VWM doctrine and Midland Funding preserved a VWM argument. Brief of the United States at 19 - 20. Midland Funding's VWM argument should follow the analysis set forth in this article.

44. 431 F.3d 285 (7th Cir. 2005).

45. *Id.* at 286.

46. *Id.* at 287.

47. *Id.*

48. *Id.* at 289.

Stay Far Away from the *Madden*-ing...

(Continued from page 231)

VI. Conclusion

Madden has caused tremendous concern in the financial services industry because the decision has been interpreted by some to subject nonbank assignees to state interest rate limits and to invalidate the VWM doctrine. However, if the decision is properly limited, the sky is not falling. The Second Circuit's decision should be recognized as merely clarifying the limits of NBA "complete preemption" in answering the specific, narrow question posed on appeal.[49] While the Supreme Court has for the moment passed on providing controlling guidance on *Madden*, the Solicitor General's brief, supported by the OCC, contains a well-reasoned analysis of the case and the relevant principles of federal preemption, VWM and usury analysis. The financial services industry should continue to pursue cases in other circuits, such as the Seventh Circuit, to: (1) recognize the limited scope of *Madden*; and (2) clarify the proper analysis in usury claims against assignees of loans. Courts within the Second Circuit should accept the Solicitor General's view that the Second Circuit overlooked VWM and therefore, did not overturn the doctrine. Such courts can side-step the Second Circuit's flawed preemption analysis by focusing on VWM and choice of law in future cases.

49. The district court's discussion of the VWM doctrine remains undisturbed and may be supported by further consideration of the Delaware choice-of-law question on remand.