DREHER TOMKIES LLP ALERT

FOR CLIENTS AND FRIENDS OF DREHER TOMKIES LLP

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DISTRICT COURT CITES OCC RULE TO UPHOLD VALID-WHEN-MADE PRINCIPLE

The U.S. District Court for the District of Colorado cited to the Office of the Comptroller of the Currency's ("OCC") new valid-when-made rule ("VWM Rule") when it determined that a promissory note with an interest rate that was valid when made under Section 523 of the Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDA"), codified at 12 U.S.C. § 1831d ("Section 1831d"), remains valid upon assignment to a non-bank. *Rent-Rite Superkegs West LTD v. World Business Lenders, LLC*, 1:19-cv-01552 (D. Colo., filed Aug. 12, 2020). *See* our prior ALERT of June 26, 2019.

The case involves a convoluted fact pattern. A federally insured state-chartered Wisconsin bank made a loan to a Colorado-based corporation with an annualized interest rate of 120.86% under a note that included provisions for federal and Wisconsin law to govern, for bank acceptance in Wisconsin and for payments to be received in Wisconsin. A third party executed a deed of trust pledging its Colorado real property as security for the Colorado corporation's promissory note (the "Encumbered Property"). Two months after the bank made the loan, the bank assigned its rights under the promissory note and deed of trust to a New York non-bank entity ("Non-Bank Entity"). The Colorado corporation then defaulted on the promissory note, and the third-party that had pledged its property sold the Encumbered Property to a sister company at a discount ("Encumbered Property Purchasing Company"). Eight days later, the Encumbered Property Purchasing Company filed for bankruptcy.

The Non-Bank Entity filed a proof of claim in the bankruptcy proceedings, claiming the Encumbered Property as security for the balance of the bank loan. The Encumbered Property Purchasing Company then commenced adversary proceedings against the Non-Bank Entity claiming that Colorado law governed the interest rate in the promissory note and that the interest rate was usurious under Colorado law.

The parties jointly moved to vacate trial in the bankruptcy court, asserting that "the facts of the case are largely uncontested. It is the parties' position that a determination by the Court on the legal principles at issue in the case would resolve the matter without the need for trial." The court accepted the motion and asked the parties to submit stipulated facts, stipulated exhibits and written closing arguments in lieu of trial, focusing on state choice of law principles. Upon review, the court found that the parties failed to cover all pertinent legal issues, including the role of Section 1831d, and requested supplemental briefs and argument.

Ultimately, the bankruptcy court ruled that as Section 1831d governed the interest rate on the bank loan and dictated the application of Wisconsin law, the interest rate in question was valid. Even if Section 1831d did not control, the court concluded that various state and federal choice of law principles lead to the same result. The Encumbered Property Purchasing Company then appealed the bankruptcy court's decision, arguing, among other things, that Section 1831d could not apply because the note was assigned to a non-bank, as Section 1831d provides only that a federally insured state bank may charge interest "at the rate allowed by the laws of the State . . . where the bank is located."

On appeal the district court noted that the parties did not dispute the fact that the promissory note's interest rate was valid when made by the bank under Section 1831d, but only whether the promissory note's interest rate remained valid upon assignment to a non-bank entity. As the court found no relevant precedent directly addressing whether Section 1831d extends to loans that have been assigned from state banks to non-bank entities, the court reviewed (i) the recent decision in *Meade v. Avant of Colorado, LLC*, (ii) the Second Circuit's *Madden v. Midland Funding, LLC* decision, (iii) an *amicus* brief filed jointly by the Federal Deposit Insurance Corporation and the OCC in support of the Non-Bank Entity and (iv) an *amicus* brief filed by Professor Adam J. Levitin of Georgetown University Law Center in support of Encumbered Property Purchasing Company. The court determined that *Meade* was inconclusive for the court's purposes because the *Meade* court merely concluded that the cause of action provided by Section 1831d does not on its face apply to actions against non-banks, expressly noting that Section 1831d does not establish complete preemption or permit removal. The *Meade* court did not consider the use of Section 1831d as a defense.

The court then considered the *amicus* briefs and the *Madden* decision. The banking agencies argued that *Madden* was wrongly decided because prohibiting assignees from enforcing otherwise valid bank interest rates was, in practice, a prohibition on banks' ability to assign those interest rates, creating a direct conflict with federal rate authority, as established by the National Bank Act ("NBA") and repeated in Section 1831d, that banks are authorized to charge interest at rates allowed by their respective home states. The

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banking agencies also asserted that *Madden* is irrelevant because the Second Circuit did not analyze the deciding factors raised in the instant case: the common law valid-when-made doctrine and the common law stand-in-the-shoes doctrine, both of which are recognized by Colorado and Wisconsin law.

Although the district court was persuaded by the Second Circuit's discussion in *Madden* and by Professor Levitin's argument in his *amicus* brief that the common law valid-when-made doctrine is a modern invention that could not have been incorporated into the NBA or subsequently into the DIDA, the court ultimately concluded that a promissory note with an interest rate that was valid when made under Section 1831d does remain valid upon assignment, even to a non-bank, citing the OCC's new VWM Rule. The court observed that the OCC only recently finalized the VWM Rule that upholds the common law valid-when-made doctrine, clarifying by rule that when a bank transfers a loan, the interest permissible before the transfer continues to be permissible after the transfer. The court noted that the stated purpose of the VWM Rule was to resolve legal uncertainty created by the *Madden* decision. The court reasoned that as the OCC cited the NBA as authority for the rule, and that the NBA and the DIDA are mirror images and generally interpreted in be in accord, the OCC's reasoning with respect to the VWM Rule should extend to federally insured state-chartered banks under Section 1831d as well.

The district court noted that the VWM Rule does not address which entity, in the case of assignment, is the "true lender", however, a material factual dispute that was touched upon briefly in argument during the lower court proceedings but not specifically addressed by the bankruptcy court. The district court noted that Section 1831d could not apply to a promissory note with a non-bank true lender. The district court took note of the decision in *Striker v. Trans-West Discount Corp.,* 92 Cal. App. 3d 735 (1979), mentioned in Professor Levitin's *amicus* brief, with its "assignment from inception" exception under California law. Consequently, the district court remanded the case for further consideration of the "true lender" aspect.

Upon remand the bankruptcy court likely will have the opportunity consider the OCC's proposed "true lender" rule and perhaps either adopt and validate the OCC's objective standard or provide helpful guidance on relevant "true lender" factors.

We will continue to monitor and report on emerging valid-when-made and true creditor case law. We can provide advice on how to structure programs to minimize the risks associated with either a *Madden* or "true lender" challenge. ❑

✧ *Mike Tomkies and Lindsay Valentine.*