Madden v. Midland Funding: A Sea Change in Secondary Lending Markets

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The Second Circuit's decision in *Madden v. Midland Funding, LLC* limits the ability of non-depository institutions to acquire debts originated by depository institutions pursuant to federal preemption of state law usury limits.[1] The court's decision reaches much further than the court appears to have contemplated and potentially threatens business models ranging from debt purchasers to marketplace lenders.

This article is the first of a two part series. This article explains the *Madden* decision, the state of the law prior to *Madden*, and discusses the impact of the *Madden* decision moving forward. The second article in this series discusses potential ways to mitigate the impacts of the *Madden* decision.

The Decision

In *Madden*, Saliha Madden ("Madden") opened a credit card account with Bank of America ("BoA"), a national bank, in 2005.[2] A year later BoA's credit card program was consolidated into another national bank, FIA Card Services, N.A. ("FIA").[3] In 2008, FIA charged off Madden's account as uncollectable and sold the debt to Midland Funding, LLC ("Midland Funding").[4] Midland Funding utilized its affiliate, Midland Credit Management, Inc. ("Midland Credit") as the servicer to collect Madden's debt.[5] Neither Midland Funding nor Midland Credit is a national bank.[6] In late 2010, Midland Credit sent Madden a letter seeking payment of the debt and informing her that an interest rate of 27% per year applied pursuant to the agreement creating the debt.[7]

Madden filed suit against Midland Funding and Midland Credit asserting a violation of the Fair Debt Collection Practices Act ("FDCPA") and a violation of New York's usury law, which imposed a maximum interest rate of 25%.[8] The district court held that the National Bank Act's ("NBA") preemption of state usury limits applied to the debt effectively preempted Madden's state law usury claim.[9] The Second Circuit reversed the district court's decision and held that the NBA did not preempt Madden's state law usury claim because Midland Funding and Midland Credit are not national banks, or a subsidiary or agent of a national bank, were not acting on behalf of a national bank, and thus were not entitled to NBA preemption.[10] The court concluded that NBA preemption did not apply because the application of New York's usury law

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[1] *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2nd Cir. 2015).
[2] *Id*. at 247.
[3] *Id*. at 248.
[4] *Id*.
[5] *Id*.
[6] *Id*.
[7] *Id*.
[8] *Id*.
[9] *Id*.
[10] *Id*. at 249.

to Midland Funding and Midland Credit would not significantly interfere with either BoA or FIA's ability to exercise their powers as a national bank under the NBA.[11]

In the course of its decision, the Second Circuit distinguished the Eighth Circuit's decision in *Krispin v. May Dept. Stores*.[12] In *Krispin*, May Department Stores Company ("May Stores") issued credit cards to the plaintiffs, the underlying agreements of which expressly contracted for the application of Missouri law and therefore limited the permitted delinquency fees to $10.[13] May Stores then notified the plaintiffs that their accounts had been transferred to May National Bank of Arizona ("May Bank") and that May Bank would now charge delinquency fees of $15.[14] May Stores subsequently acquired May Bank's receivables and maintained a role in account collection, but did transfer all authority over the terms and operations of the accounts to May Bank.[15] The plaintiffs asserted that the assessment of a delinquency charge in excess of $10 violated Missouri law.[16] May Stores responded that the state law claims were preempted by the NBA because the accounts had been transferred to May Bank.[17] The Eighth Circuit agreed, noting that the bank is now the entity that issues credit to the plaintiffs and the entity that processes and services customer accounts.[18] The Second Circuit distinguished *Krispin* by noting that neither BoA nor FIA retained any interest in Madden's account.[19] As a result, the Second Circuit concluded that, unlike in *Krispin*, the decision to not extend federal preemption to Midland Funding or Midland Credit would not significantly interfere with a national bank's ability to exercise its powers.[20]

<u>The State of the Law Before *Madden*</u>

Debt purchaser and bank partnership models were traditionally constructed in reliance upon the "valid when made" doctrine. The valid when made doctrine is based upon longstanding federal court precedent holding that a transaction that is not usurious when consummated may not become usurious based upon subsequent events.[21] The *Madden* decision failed to acknowledge, much less analyze, this longstanding precedent. The fact that the Second Circuit did not address the valid when made doctrine means that it remains unclear what impact, if any, the *Madden* decision has on the future of the valid when made doctrine.

Prior to the *Madden* decision, the challenges posed to the valid when made doctrine typically came from so called "true creditor" cases.[22] Bank partnership programs that have

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[11] *Id*.
[12] *Id*. at 252 (citing *Krispin v. May Dept. Stores*, 218 F.3d 919 (8th Cir. 2000)).
[13] *Id*.
[14] *Id*.
[15] *Id*.
[16] *Id*.
[17] *Id*.
[18] *Id*.
[19] *Id*.
[20] *Id*. at 249.
[21] *Nicholas v. Fearson*, 32 U.S. 103, 109 (1833); *see also FDIC v. Lattimore Land Corp.*, 656 F.2d 139, 148-49 (observing that the "non-usurious character of a note should not change when the note changes hands") (citations omitted).
[22] *See People of the State of N.Y., et al. v. County Bank of Rehoboth Beach, et al.*, No. 6046-03; 01-04-080549 (N.Y.).

endured true creditor challenges typically involve a non-bank partner that acts as marketer for the loan program and facilitates the making of the loans. The non-bank partner may also purchase the loans after they are made or act as servicer, or both. A true creditor challenge asserts that the non-bank partner involved in a bank partnership model is actually the true creditor to the loan, notwithstanding the fact that a depository institution is the actual creditor on the loan documents and is the party extending credit. Under the true creditor challenge, the non-bank partner is alleged to have violated state and/or federal law because the loans were not made in the manner required of a non-bank lender authorized to lend money in the state at issue. Thus far, true creditor challenges have not seen wide acceptance. This is likely due to the fact that any attempt to argue that loans made by a depository institution are invalid due to the depository institution's relationship with a third party would necessarily interfere with the depository institution's ability to operate and make loans as authorized by federal law.

The Impact of *Madden*

The *Madden* decision has the potential to impact far more than just debt purchasers. The impact on depository institutions will be significant even if the application of the *Madden* decision is limited to third parties that purchase charged off debts. Depository institutions will likely see a reduction in their ability to sell loans originated in the Second Circuit due to significant pricing adjustments in the secondary market. To the extent that the *Madden* decision is extended nationwide, secondary markets will also likely reflect a dramatic reduction in the price that purchasers are willing to pay for loans originated by depository institutions nationwide. Debt purchasers will have to reduce the price that they pay due to the reduced interest rates that they may assess and increased state law compliance concerns, and some may leave the market. These concerns will only increase if *Madden* is extended to market participants other than purchasers of defaulted debt.

The *Madden* decision also threatens the ability of bank partner companies to facilitate the extension of credit by depository institutions. The Treasury Department issued a request for information seeking to determine how best to support the expanding online marketplace lending industry.[23] The request for information notes the great potential for this industry to expand access to credit, particularly to the underserved.[24] The *Madden* decision threatens to destabilize this industry due to the high number of participants that operate through a bank partnership model. Marketplace lenders, and other bank partnership program participants, could see their ability to acquire loans originated by depository institutions limited due to their inability to collect the interest permitted by the underlying credit agreements. Borrowers would also see their access to marketplace lenders and other bank partnership programs cut off, denying them their choice of lender.

Concluding Thoughts

The primary specter raised by the *Madden* decision is the impact of state laws on an extension of credit not subject to them at the time of consummation. In many states, the usury

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[23] *Public Input on Expanding Access to Credit Through Online Marketplace Lending*, Office of the Undersecretary for Domestic Finance, Department of the Treasury, 80 Fed. Reg. 42866 (July 20, 2015).
[24] *Id*.

limits and licensing requirements will pose new compliance challenges to market participants to the extent they are impacted by the *Madden* decision. In some cases, however, state law may provide a safe harbor from the *Madden* decision and allow such programs to continue.[25] It is doubtful that debt purchasers and participants in bank partnership programs may use choice of law clauses to apply the law of a particular state, given the fact that many regulators take the position that such clauses do not prevent state regulators or attorneys' general from seeking to enforce the laws of the state where the borrower resides. In other words, many regulators take the position that the parties to a contract may not contract away the power of the regulator to regulate an extension of credit, or the power of the attorney general to enforce violations of state law. None of the federal regulatory agencies have issued any type of opinion on the *Madden* decision and its potential impact as of this writing. As a result, it appears that the future impact of *Madden* outside the Second Circuit will depend upon whether the Supreme Court decides to hear the appeal, which is expected to be filed shortly.

As noted above, the second article in this series will discuss potential ways to mitigate the impacts of the *Madden* decision and outline some options as to how market participants may proceed in the future.

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[25] For example, the California *Strike* doctrine distinguishes loan purchasers from originating lenders. *See Strike v. Trans-W. Disc. Corp.*, 92 Cal. App. 3d 735, 745 (Ct. App. 1979) (noting that "a contract, not usurious in its inception, does not become usurious by subsequent events") (citations omitted).