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MADDEN V. MIDLAND FUNDING LLC: UPROOTING THE NATIONAL BANK ACT'S POWER OF PREEMPTION

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I. INTRODUCTION

Consumer lending in New York, Connecticut, and Vermont and the securitization thereof may soon deteriorate after the United States Supreme Court balked at the chance to uphold more than 150 years of banking law precedent. To facilitate an active lending market for consumers, nationally chartered banks originate loans and market those loans to investors in the secondary marketplace. This allows the bank to liquefy their debts and redeploy capital in the form of new loans while remaining within their federally-mandated capital requirements. The more investors in the secondary market and the greater access to those investors that national banks have, the more consumers can obtain loans for personal or business use. Unfortunately, the mechanics of this market have frozen up in the wake of the decision by the United States Court of Appeals for the Second Circuit ("Second Circuit") in *Madden v. Midland Funding, LLC* ("Madden").[1] This decision challenges the doctrine of federal preemption of state usury law under the National Bank Act ("NBA"), which has the potential to significantly disrupt the secondary market and national bank lending.

The Second Circuit held that the interest charged by a national bank at a rate up to the bank's home state usury limit does not preempt another state's usury laws when that loan is sold or assigned, despite the guarantee of federal preemption under the NBA.[2] Specifically, the Second Circuit held that a national bank's power of preemption did not extend to Midland Funding LLC ("Midland Funding") because Midland Funding is not a national bank nor a subsidiary or agent of a national bank and, therefore, is subject to its home state usury laws on any loans in which it maintains an interest.[3] This decision uproots decades of legal precedent and industry standards that have sustained the doctrine of federal preemption under the

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1. *See* Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015).
2. *Id.* at 249.
3. *Id.*

NBA. The secondary market depends on federal preemption standards when investors purchase loans originated by national banks; and the national bank depends on these standards to create a liquid market for its loan originations. However, with the Second Circuit's decision in *Madden*, the secondary market has not only frozen up, but secondary market investors and loan purchasers that own what they believed to be non-usurious loans may now be subject to civil and criminal usury charges. This has created urgency and panic throughout the market as indicated by the following headlines:

> "Peer-to-Peer Lenders Face Legal Blow in Usury Ruling"[4]; "A New Tariff on 'Interest-Rate Exports?'"[5]; "Are Changes Coming To The P2P Lending Model?"[6]; "Is marketplace lending cooling off? Regulatory scrutiny impacts alternative lending's growth"[7]; "Don't Let Outdated Laws Shackle Credit Innovation"[8]; "Fitch: Challenges Linger as U.S. Marketplace Lending ABS Rises"[9]; "Moody's: Federal appeals court ruling on Madden v. Midland is credit negative for marketplace lending ABS"[10]; "Madden v. Midland Has Already Hurt Riskier Borrowers, Study Finds"[11]; "Supreme Court Won't Hear Madden Case, Leaving Unanswered Question about Competing State Laws"[12]; "Finance Alert: The Uncertain Legacy of Madden."[13]

4. Matt Scully, *Peer-to-Peer Lenders Face Legal Blow in Usury Ruling*, BLOOMBERG (Aug. 14, 2015), http://www.bloomberg.com/news/articles/2015-08-14/peer-to-peer-lenders-losing-court-battle-over-state-usury-laws.

5. Peter Rudegeair, *A New Tariff on 'Interest-Rate Exports?'*, WALL ST. J.: MONEYBEAT (June 30, 2015), http://blogs.wsj.com/moneybeat/2015/06/30/a-new-tariff-on-interest-rate-exports/.

6. Jayson Derrick, *Are Changes Coming To The P2P Lending Model?*, BENZINGA (Sept. 29, 2015), http://www.benzinga.com/analyst-ratings/analyst-color/15/09/5873715/are-changes-coming-to-the-p2p-lending-model.

7. Lisa Valentine, *Marketplace Lending Cools Off: Regulatory Scrutiny Is Impacting the Growth of Alternative Lending*, BANKING EXCHANGE, Oct.–Nov. 2015, at 10.

8. Brian Knight, *Don't Let Outdated Laws Shackle Credit Innovation*, AM. BANKER (July 28, 2015), http://www.americanbanker.com/bankthink/dont-let-outdated-laws-shackle-credit-innovation-1075677-1.html.

9. *Fitch: Challenges Linger as U.S. Marketplace Lending ABS Rises*, REUTERS (Sept. 10, 2015), http://www.reuters.com/article/2015/09/10/idUSFit93292920150910.

10. *Announcement: Moody's: Federal appeals court ruling on Madden v. Midland is credit negative for marketplace lending ABS*, MOODY'S (July 20, 2015), https://www.moodys.com/research/Moodys-Federal-appeals-court-ruling-on-Madden-v-Midland-is—PR_330508.

11. Sean Murray, *Madden v Midland Has Already Hurt Riskier Borrowers, Study Finds*, DEBANKED (May 28, 2016), http://debanked.com/2016/05/madden-v-midland-has-already-hurt-riskier-borrowers-study-finds/.

12. *Supreme Court Won't Hear Madden Case, Leaving Unanswered Question about Competing State Laws*, ACA INTERNATIONAL (June 29, 2016), http://www.acainternational.org/iap-supreme-court-wont-hear-madden-case-leaving-unanswered-question-about-competing-state-laws-40090.aspx.

13. Henry G. Morriello et al., *Finance Alert: The Uncertain Legacy of Madden*, KAYE SCHOLER LLP (June 28, 2016), http://www.kayescholer.com/in-the-market/publications/client_alerts/2016-06-28-

Indeed, various banking and securities associations have raised serious concerns about the impact of the Second Circuit's decision. Amicus briefs were filed with the Second Circuit by the American Bankers Association, Independent Community Bankers of America, California Bankers Association, Utah Bankers Association,[14] the Clearing House Association,[15] Securities Industry and Financial Markets Association, and the Structured Finance Industry Group, Inc.[16] Conspicuously absent was an amicus brief from the Office of the Comptroller of the Currency ("OCC")—the federal agency that charters and regulates all national banks.[17] Although there may have been discussions within the OCC to file an amicus brief, for some reason, the OCC decided against it. Nevertheless, these organizations have raised concerns that the precedential effect of the decision in *Madden* could present significant problems for the financial services industry.

The Second Circuit's holding has influenced decision making not only by banks and depository institutions, but also hedge funds, securitization vehicles, buyers of defaulted debt, purchasers of whole loans, and other purchasers of loans originated by national banks.[18] The implications are widespread for lenders and borrowers. Indeed, as of March 31, 2015, those institutions insured by the Federal Deposit Insurance Corporation ("FDIC") held over $8 trillion in outstanding loans.[19] Because this decision affects many key players in the financial services industry, it requires a detailed analysis of the Second Circuit's holding in light of legal precedent and how the market should interpret this holding. This note will address the history of the NBA and the concept of federal preemption embedded within the NBA in Section II, the analysis of the Second Circuit's decision in *Madden* in Section III, and the implications going forward in Section IV.

finance-alert-the-uncertain-legacy-of-madden/_pdf/Template=pdf/2016-06-28-finance-alert-the-uncertain-legacy-of-madden.pdf.

14. Brief of the Am. Bankers Ass'n et al. as Amici Curiae in Support of the Petition for Rehearing and Rehearing En Banc, Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015) (No. 14-2131) [hereinafter *ABA brief*].

15. Brief of the Clearing House Ass'n et al. as Amici Curiae in Support of Rehearing and Rehearing En Banc, Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015) (No. 14-2131).

16. Brief of the Structured Fin. Indus. Group, Inc., and the Sec. Indus. and Fin. Markets Ass'n as Amici Curiae in Support of Defendants-Appellees' Petition for Rehearing and Suggestion for Rehearing En Banc, Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015) (No. 14-2131).

17. *See* Gen. Docket, Court of Appeals, 2nd Circuit at 11, Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015) (No. 14-02131).

18. Stephen F.J. Ornstein et al., *Second Circuit's Madden v Midland Decision Could Upend Secondary Credit Markets*, ALSTON & BIRD (Sept. 2, 2015), https://www.alston.com/-/media/files/insights/publications/2015/09/ifinancial-services—products—financial-services/files/view-advisory-as-pdf/fileattachment/15135-madden-v-midland.pdf.

19. Brief of the Clearing House Ass'n et al. as Amici Curiae in Support of the Petition for Rehearing and Rehearing En Banc, *supra* note 15, at 11.

Midland Funding moved for a rehearing with the Second Circuit on June 19, 2015, but that motion was denied by the Second Circuit on August 12, 2015.[20] Midland Funding filed a petition for certiorari with the United States Supreme Court on November 10, 2015.[21] Amicus briefs were filed with the U.S. Supreme Court by the Clearing House Association LLC, ACA International, the Structured Finance Industry Group, and the American Bankers Association.[22] The U.S. Solicitor General was also asked to submit a brief on behalf of the United States, which was submitted to the Court on May 24, 2016.[23] The Solicitor General noted that the Second Circuit erred in holding that state usury laws may validly prohibit a national bank's assignee from enforcing the interest-rate set by the national bank up to the level of the state in which it is located.[24] However, the Solicitor General argued the Court should deny the petition because there was no split among the circuit courts at the time and the Solicitor General believed that Midland Funding would prevail on remand after presenting the key aspects of the preemption analysis.[25]

Based on the Solicitor General's recommendation, the Court denied the petition for certiorari on June 27, 2016.[26] This surprising move by the Court leaves in place the decision of the Second Circuit, which will now subject national banks located in New York, Connecticut, and Vermont to a different standard than other national banks. For national banks outside the Second Circuit's jurisdiction, the inherent uncertainty of whether or not their own courts will make a similar decision has caused them to reevaluate their common lending practices. Only time will tell whether courts will adopt a similar mandate and disregard the federal preemption right of national banks or whether the courts will uphold the right of national banks, thus creating a split among the jurisdictions. The wait and see approach taken by the Solicitor General and the Court will undoubtedly affect the lending marketplace for an indefinite period of time.

20. Ornstein et al., *supra* note 18.

21. Petition for Writ of Certiorari, Midland Funding, LLC v. Madden, 136 S.Ct. 2505 (No. 15-00610).

22. *See* Court Docket, Midland Funding, LLC v. Madden, 136 S.Ct. 2505 (No. 15-00610).

23. *See* Court Docket, Midland Funding, LLC v. Madden, 136 S.Ct. 2505 (No. 15-00610).

24. Brief of the United States as Amici Curiae at 5–6, Midland Funding, LLC v. Madden, 136 S.Ct. 2505 (No. 15-00610) [hereinafter *United States brief*].

25. *United States brief*, *supra* note 24, at 6.

26. *See* Court Docket, Midland Funding, LLC v. Madden, 136 S.Ct. 2505 (No. 15-00610).

II. HISTORY OF THE NBA AND THE VALID-WHEN-MADE DOCTRINE

A. History of the NBA

The NBA, enacted in 1864, created "a federal free banking regime, with federally chartered banks issuing a uniform national currency."[27] Even though the federal government withdrew from the banking system altogether in 1846, the rise of specie currency[28] created the need for the U.S. Treasury to develop a new national banking system.[29] President Abraham Lincoln's Treasury Secretary, Salmon P. Chase, believed that a national system would alleviate the problems with specie currency and that by creating a federal system the majority of state banks would convert to federally chartered banks.[30] Despite state banks' reservations that this was evidence of an expanding federal state, this proposal was popular with the public who viewed a national bank as necessary to finance the Civil War and it created assurance that the notes currently in the market were worth what they portended to be worth.[31] Congress enacted the National Currency Act in 1863, which established the national currency of the United States, and was subsequently refined in the National Bank Act of 1864. The growth of national banks, however, did not come from state banks converting to federally chartered banks. Most state banks remained state banks and national charters were obtained by newly established, or de novo, banks.[32]

As an incentive for becoming a nationally chartered bank, these new national banks were given the benefit of federal preemption to give them an advantage over their state competitors.[33] Federal preemption under the NBA is codified in Title 12 of the United States Code in Section 85, which indicates that "[a]ny association may. . .charge on any loan or. . .other evidences of debt, interest at the rate allowed by the laws of the State, Territory, or District where the bank is located."[34] For purposes of Section 85, a national bank is "located in the State named in its organization certificate."[35] The OCC has promulgated regulations that allow a national bank to "make, sell. . .or otherwise deal in loans. . .subject to such

27. Jonathan R. Macey, Geoffrey P. Miller & Richard Scott Carnell, BANKING LAW AND REGULATION 11 (Aspen Publishers, 3d ed. 2001).

28. Specie currency means a currency that is in coin, as opposed to paper money or soft money.

29. Macey, *supra* note 27, at 10–11.

30. Macey, *supra* note 27.

31. Macey, *supra* note 27.

32. Macey, *supra* note 27.

33. Marquette Nat'l Bank v. First of Omaha Service Corp., 439 U.S. 299, 314 (1978).

34. 12 U.S.C. § 85 (2006).

35. *First of Omaha Service Corp.,* 439 U.S. 310.

terms. . .prescribed by. . .Federal law,"[36] and to make such loans "without regard to state law limitations concerning. . .rates of interest."[37] This statutory and regulatory text permits a national bank to export rates that are permitted by its home state when dealing with customers from other states, even when those rates are higher than the state laws would otherwise permit.[38]

State usury laws were originally enacted to protect borrowers, particularly individual consumers, from unreasonably high interest rates. However, branches and subsidiaries of national banks have traditionally relied on the doctrine of federal preemption to avoid the tapestry of state usury laws and apply the interest rates otherwise allowed under the NBA.[39] Indeed, the U.S. Supreme Court has suggested that this preemption may extend beyond national bank entities in certain circumstances where either the entity is acting as an equivalent of a national bank with the usual powers or where the application of state law would "significantly interfere with a national bank's ability to exercise its power under the NBA."[40] This preemption power under the NBA has "been interpreted for over a century to give 'advantages to National Banks over their State competitors.'"[41]

B. Valid When Made Doctrine

While state usury laws vary from state to state, the U.S. Supreme Court in *Nichols v. Fearson* suggested that there are two cardinal rules in the doctrine of usury: (1) to constitute usury, there must be a loan between the parties; and (2) that a contract, which at its inception is not subject to usury laws, cannot be invalidated by any subsequent usurious transactions.[42] The Court reasoned that if a contract, which is made in a legal and non-usurious manner, is sold to another party that would then be subject to usury laws and thus render the contract for the loan null and void, then the purchaser would have purchased a valueless item and the debtor would be discharged of a debt he justly owes to another.[43] This produces a senseless result. This principle of usury law, often referred to as the Valid-When-

36. 12 C.F.R. § 7.4008(a) (2014).

37. 12 C.F.R. § 7.4008(d) (2014).

38. Petition for Writ of Certiorari at 4, Midland Funding, LLC v. Madden, 136 S.Ct. 2505 (No. 15-00610).

39. 12 U.S.C. § 1831d(a) (2006).

40. Madden v. Midland Funding, LLC, 786 F.3d 246, 250 (2d Cir. 2015).

41. Marquette Nat'l Bank v. First of Omaha Service Corp., 439 U.S. 299, 314 (1978) (quoting Tiffany v. Nat'l Bank of Mo., 85 U.S. 409, 413 (1874)).

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

43. *Id.* at 110

Made doctrine, suggests that if the loan is not usurious when it is made, then it does not become usurious when it is assigned to another party.[44]

The Valid-When-Made doctrine was further applied by the United States Court of Appeals for the Fifth Circuit in 1981 when it noted that "[t]he non-usurious character of a note should not change when the note changes hands."[45] Instead of subjecting every subsequent transaction to state usury laws, the courts have interpreted this as an assignment of a right whereby "the assignee steps into the shoes of the assignor, assuming his rights as well as his duties. . .whatever the shoe size."[46] The contractual right of assignment requires an assignor's intent to transfer the property or instrument, which extinguishes the assignor's right to performance and assigns that power to the assignee.[47] This is what happens when a loan is sold into the secondary market. The purchaser steps into the shoes of the originator of the loan and is given full contractual rights to the loan.

This interpretation of contractual assignment has created another problem in deciding whether the bank maintains a contractual right or a real interest in the loan as the originator, or whether its right is extinguished and why that matters for usury laws. Consider that when a bank assigns all its rights to a second party, it does not maintain any further interest in the loan and the transaction would be considered a typical sale or assignment. This sale to the secondary market is what the Second Circuit deemed problematic in *Madden* and why the state usury law would apply. However, if the bank maintains some interest in the loan, and sells, for instance, only a participation interest in the loan, then usury law may not be applied to the sale. In *Krispin v. May Department Stores* in 2000, the United States Court of Appeals for the Eighth Circuit addressed this issue when dealing with an assignment of credit card debt from a department store to a subsidiary bank.[48] The court held that because the bank was the real party in interest by setting the terms of the agreement and not the store, the bank was not subject to the state usury law where it was not located.[49] Because this assignment implicated the NBA, the bank was able to maintain the interest rights under assignment and exercise its powers as a national bank under federal preemption.

44. Ornstein et al., *supra* note 18, at 1.
45. Fed. Deposit Ins. Corp. v. Lattimore Land Corp., 656 F.2d 139, 148–49 (5th Cir. 1981).
46. Olvera v. Blitt & Gaines, P.C., 431 F.3d 285, 288–89 (7th Cir. 2005).
47. RESTATEMENT (SECOND) OF CONTRACTS § 317 (WESTLAW 1981).
48. Krispin v. May Dep't Stores Co., 218 F.3d 919, 921 (8th Cir. 2000).
49. *Id.* at 924.

Whenever a national bank originates a non-usurious loan, the Valid-When-Made doctrine is implicated and the NBA supports the application of federal preemption to the terms of that loan whenever it is sold or assigned. Indeed, the U.S. Supreme Court has held that where Congress has not explicitly granted a power on the states to regulate and limit banking activities, national banks should not be subject to such limitations.[50] Under the NBA, national banks have the power to make and sell loans so that they may further liquefy their debts and redeploy capital to make additional loans.[51] Indeed, "[t]he entire secondary market for credit relies on the Valid-When-Made doctrine to enforce credit agreements pursuant to their terms."[52] The purpose of having a competitive and easily accessible secondary market is to have the opportunity to make more loans and expand the availability of credit, which benefits consumers.[53]

The ability of national banks to exercise "all such incidental powers as shall be necessary to carry on the business of banking,"[54] as guaranteed in the NBA has now come under scrutiny by the Second Circuit in *Madden*. This decision has contradicted decades of precedent and seemingly ignored the Valid-When-Made doctrine. Interestingly, the Valid-When-Made doctrine was not even mentioned in the *Madden* opinion.[55] Because the U.S. Supreme Court denied Midland Funding's petition, the Second Circuit's decision in *Madden* is the controlling authority within its jurisdiction and it has caused uncertainty in the lending marketplace. Current market participants within the Second Circuit's jurisdiction are left to analyze the Second Circuit's decision and adjust their lending business to remain in compliance.

III. ANALYSIS OF *MADDEN V. MIDLAND FUNDING, LLC*

A. Facts of the Case

In 2005, the plaintiff, Saliha Madden, opened a credit card account with Bank of America, a national bank organized under the laws of the state of Delaware and not subject to New York state usury law. Bank of America's credit card program shortly thereafter was consolidated into

50. Barnett Bank of Marion Cty., N.A. v. Nelson, 517 U.S. 25, 34–35 (1996).

51. *ABA brief, supra* note 14, at 3.

52. BUCKLEY SANDLER LLP, SPECIAL ALERT: SECOND CIRCUIT DECISION THREATENS TO UPSET SECONDARY CREDIT MARKETS 3, http://www.buckleysandler.com/uploads/1082/doc/Special-Alert-re-Madden-v-Midland_Funding_LLC.pdf.

53. *See ABA brief, supra* note 14, at 11.

54. 12 U.S.C. § 24 (2006).

55. BUCKLEY SANDLER LLP, *supra* note 52, at 2.

another national bank, FIA Card Services ("FIA"), which was also organized under the laws of the state of Delaware.[56] By 2008, the plaintiff owed $5,000 on her account.[57] FIA ultimately wrote off her debt as uncollectable and sold the debt to the defendant, Midland Funding, a non-depository debt purchaser.[58] Midland Funding is not a national bank and neither FIA nor Bank of America maintained any participatory interest in the loan after it was sold to Midland Funding.[59] In November 2010, Midland Funding sent a letter to the plaintiff to collect the outstanding debt under the terms of the lending agreement, which included an interest rate of twenty-seven percent per year,[60] a rate that is permissible under Delaware law, but not New York law.[61]

A year later, the plaintiff filed a class action lawsuit against Midland Funding alleging that Midland Funding had engaged in abusive and unfair debt collection practices in violation of the Fair Debt Collection Practices Act ("FDCPA").[62] Furthermore, and of greater precedential concern for national banks, the plaintiff alleged that Midland Funding charged a usurious rate of interest in violation of New York civil and criminal law, [63] which requires that the interest charged on any loan must not exceed twenty-five percent per year.[64] The class to which the plaintiff alleges to be a part of includes 49,780 people who received a similar debt collection letter from Midland Funding.[65]

The District Court stated at trial that if the plaintiff could show that FIA assigned the debt to Midland Funding, then the plaintiff's allegations would fail because the NBA would preempt any state law usury claim against Midland Funding.[66] Furthermore, if these facts were proven, then the plaintiff's claim under the FDCPA should also fail because the interest rates would be permitted.[67] The plaintiff confirmed that she received the terms of the lending agreement and that the terms were subject to Delaware

56. Madden v. Midland Funding, LLC, 786 F.3d 246, 247–48, 250 (2d Cir. 2015).

57. *Id.* at 248.

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.* at 253.

62. *Id.* at 248; Corrected Brief for Plaintiff-Appellant at 4, Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015) (No. 14-02131) [hereinafter *Brief for Plaintiff-Appellant*]; *see generally* 15 U.S.C. § 1692e (2006) ("A debt collector may not use any false, deceptive, or misleading representation or means in connection with the collection of any debt").

63. N.Y. PENAL LAW § 190.40 (CONSOL. 2015); N.Y. GEN. OBLIG. LAW § 5-501 (CONSOL. 2015).

64. N.Y. PENAL LAW § 190.40 (CONSOL. 2015).

65. *Brief for Plaintiff-Appellant*, *supra* note 62, at 4.

66. *Midland Funding, LLC*, 786 F.3d at 248.

67. *Id.*

law, but the complaint alleged violations of New York usury law, which left the plaintiff without a valid claim under New York usury law.[68] Therefore, on May 30, 2014, the parties to the case entered into a *Stipulation for Entry of Judgment for Defendants for Purpose of Appeal*, which stipulated that the FIA had assigned the debt to Midland Funding.[69] Because this stipulation removed the issues of fact, the District Court granted a final judgment for Midland Funding.[70] The Honorable Cathy Seibel of the United States District Court for the Southern District of New York held that "'assignees should be afforded the same protections as those given to the bank itself with regard to charging a particular interest rate.'"[71]

On appeal to the Second Circuit, the court held:

> [T]he District Court erred in holding that NBA preemption bars her state-law usury claims. . .Because neither defendant is a national bank nor a subsidiary or agent of a national bank, or is otherwise acting on behalf of a national bank, and because application of the state law on which Madden's claims rely would not significantly interfere with any national bank's ability to exercise its powers under the NBA, we reverse the District Court's holding that the NBA preempts Madden's claims and accordingly vacate the judgment of the District Court.[72]

The Second Circuit's reasoning can be broken down into the following two principles: (1) Midland Funding is not a national bank, nor a subsidiary or agent of a national bank; and (2) the application of state law in this instance would not "significantly interfere" with the national bank's powers under the NBA.[73]

B. Originator or Possessor: Who is the focus of usury law?

There is no argument that Midland Funding is not a national bank, nor a subsidiary or agent thereof; however, that has not traditionally been the inquiry when the secondary market considers its legal protections. The inquiry is traditionally whether or not the loan was originated by a national bank, which is subject to the protections of the NBA and was deemed non-usurious at the time it was originated.

The U.S. Supreme Court has stated that there is a universal principle that a contract, free from usury laws at its inception, shall not be deemed

68. Brief for Defendants-Appellees at 1, Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015) (No. 14-02131) [hereinafter *Brief for Defendants-Appellees*].

69. *Midland Funding, LLC*, 786 F.3d at 249.

70. *Id.*

71. *Brief for Defendants-Appellees, supra* note 68, at 5 (quoting R. on Appeal at A-109).

72. *Midland Funding, LLC*, 786 F.3d at 249.

73. *Id.*

invalid due to any subsequent usurious transaction.[74] This is one of the two cardinal rules of usury law that has been maintained throughout the history of the NBA's application.[75] Despite this cardinal rule, the Second Circuit pointed to a bulletin from the OCC that clarified that "third party debt buyers are distinct from agents or subsidiaries of a national bank."[76] The guidance from the OCC is meant to provide advice to banks regarding the risk associated with selling loans to third party debt buyers, but this guidance focuses more on the reputational, operational, compliance, and strategic risks associated with selling loans to third party debt buyers and the way those buyers conduct their business, which may have a negative impact on the bank.[77] Aside from the bulletin advising banks to "comply with applicable laws and regulations,"[78] this bulletin falls short of warning banks that state usury laws could override the federal preemption status on loans they originated. Therefore, even though the Second Circuit and the appellant raised the point that third party debt collectors are not operating subsidiaries or bank servicers or agents of a bank and are, therefore, not subject to the same regulations as banks are,[79] this should be of no consequence regarding a loan that was originated by a national bank. However, the Second Circuit seems to have adopted the appellant's position that the extension of the NBA's preemptive powers is proper only when the debt buyer is a subsidiary of the national bank or the national bank retains some interest in the accounts.[80]

The Second Circuit disagreed with the appellee's reliance on two cases in the United States Court of Appeals for the Eighth Circuit where the court upheld federal preemption. In *Phipps v. FDIC*, a bank originated loans and then sold those loans to the other defendants in the case for a fee.[81] The court held that these fees were properly considered interest under the NBA and concluded that the court "must look at 'the originating entity (the bank), and not the ongoing assignee . . . in determining whether the NBA applies.'"[82] The Second Circuit, however, stated that *Phipps* was

74. Nichols v. Fearson, 32 U.S. 103, 106 (1833).

75. *Id.* at 109.

76. *Midland Funding, LLC*, 786 F.3d at 250.

77. OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC BULL. NO. 2014-37, CONSUMER DEBT SALES (Aug. 4, 2014).

78. OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC BULL. NO. 2014-37, CONSUMER DEBT SALES (Aug. 4, 2014).

79. *See Midland Funding, LLC*, 786 F.3d at 251–52; *Brief for Plaintiff-Appellant*, *supra* note 62, at 19.

80. *Brief for Plaintiff-Appellant*, *supra* note 62, at 11.

81. Phipps v. FDIC, 417 F.3d 1006, 1009 (8th Cir. 2005).

82. *Id.* at 1013 (quoting Krispin v. May Dep't Stores Co., 218 F.3d 919, 924 (8th Cir. 2000)).

distinguishable from *Madden* because *Madden* involves interest charged after the account was sold by FIA to Midland Funding.[83] Would the court be more inclined to accept the guiding principle in *Phipps* if the appellant in *Madden* had raised this issue when Bank of America sold the loan to FIA? If we were to accept the Second Circuit's interpretation, we would never know at what point during the origination and assignment of the loan that the loan would become usurious.

The appellant argued that the point at which a rate of interest is usurious should be when the rate is actually charged against the customer, rather than when the loan is made.[84] This standard would thus focus more on the conduct of the non-bank assignee rather than the national bank that originated the non-usurious loan under the NBA.[85] This cannot be relied upon as precedent. This standard would produce even more confusing results because the precedent of the application of the NBA in the courts would be completely overturned to accommodate a statutory interpretation that would go against Congressional intent.[86] If the Second Circuit had applied the NBA as the United States Court of Appeals for the Fifth Circuit had applied it in *Federal Deposit Insurance Corporation v. Lattimore Land Corporation*, then "[t]he non-usurious character of a note should not change when the note changes hands."[87]

While the Solicitor General agreed with this principal in its brief to the U.S. Supreme Court, they noted that the court in *Lattimore* dealt with a set of facts dissimilar to the ones in *Madden* and, therefore, the court's opinion in *Lattimore* would not constitute a split between the Fifth Circuit and the Second Circuit.[88] However, the government's unwillingness to acknowledge any split among circuit courts, regardless of how shallow the circuit split may be, should be swamped by the sheer importance of the question presented and errors in applying the principle of the NBA by the Second Circuit.[89]

The second case the Second Circuit dismissed was the United States Court of Appeals for the Eighth Circuit's holding in *Krispin v. May Department Stores* in 2000. In *Krispin*, a department store issued credit cards to customers with late fees and delinquency rates subject to Missouri state

83. *Midland Funding, LLC*, 786 F.3d at 253.
84. *Brief for Plaintiff-Appellant*, *supra* note 62, at 15.
85. *Id.* at 35.
86. Barnett Bank of Marion Cty., N.A. v. Nelson, 517 U.S. 25, 33 (1996).
87. Fed. Deposit Ins. Corp. v. Lattimore Land Corp., 656 F.2d 139, 148–49 (5th Cir. 1981).
88. *United States brief, supra* note 24, at 17.
89. Supplemental Brief for the Petitioners at 8, Midland Funding, LLC v. Madden, 786 F.3d 246 (2d Cir. 2015) (No. 15-00610).

usury laws.[90] Those delinquent rates were charged off by the department store to the May National Bank of Arizona—a national bank and wholly owned subsidiary of May Department Stores—with delinquency limits as allowed under Arizona state law.[91] The store had assigned all of its interest in the credit card accounts to the bank.[92] The court agreed with the store that the store was acting as an assignee and the real interest in the credit card accounts was transferred to the bank.[93] Therefore, the court held that the agreement between the store and the bank effectuated an assignment of a contractual right and the bank, under the NBA, was allowed to charge up to the state usury rate of the state where it was located.[94] The bank then changed the interest rate on the credit card agreements, notified the customers of the change, and later re-assigned the accounts back to the store.[95]

In determining the application of the NBA, the court in *Krispin* focused on the originating entity that set the terms of the contract by stating that "the store's purchase of the bank's receivables does not diminish the fact that it is now the bank, and not the store, that. . .sets such terms as interest and late fees."[96] Thus, per the court's reasoning, the entity that sets the contractual terms maintains an interest in the accounts.[97] In *Madden*, the contractual terms, including a twenty-seven percent interest rate, were set by a national bank acting under the guarantees of the NBA and Delaware law.[98]

The appellant in *Madden* argued that the circumstances in *Krispin* were different because in *Krispin* not only were the banks and the subsidiaries related by corporate structure, but also the bank in *Krispin* had maintained some interest in the debt.[99] The appellant also argued that other courts have limited the application of the NBA in cases of assignment to only those circumstances where the national bank, as had been done in *Krispin*, maintained "some ongoing, legally cognizable interest" in the transferred accounts or where the national bank is "legally or operationally related to the assignor."[100] The difference between the appellee's assertion that an interest remains when the non-bank entity is enforcing terms origi-

90. Krispin v. May Dep't Stores Co., 218 F.3d 919, 921–22 (8th Cir. 2000).
91. *Id.* at 921.
92. *Id.* at 922.
93. *Id.* at 923.
94. *Id.* at 924.
95. *Brief for Defendants-Appellees, supra* note 68, at 11.
96. *May Dep't Stores Co.,* 218 F.3d at 924.
97. *Id.*
98. Madden v. Midland Funding, LLC, 786 F.3d 246, 248 (2d Cir. 2015).
99. *Brief for Plaintiff-Appellant*, *supra* note 62, at 26.
100. *Id.* at 5.

nated by a national bank and the appellant's assertion that the bank must have a legal interest in the debt collection is the key understanding to the Second Circuit's opinion.

The Second Circuit seemed to agree with the appellant that the circumstances in *Krispin* were not the same as in *Madden.* The court reasoned that the bank in *Krispin* had maintained a real interest in the accounts and, therefore, implicated the NBA.[101] By the Second Circuit's and the appellant's reasoning, were it not for the bank's continued interest in the accounts, the NBA would not have been implicated and the accounts would be subject to state usury laws. This conclusion is based on the Second Circuit's analysis that if the bank does not have a legal interest in the accounts, then subjecting the debt purchaser to state usury laws and ignoring federal preemption would not significantly interfere with the exercise of the bank's powers.[102] Thus, the Second Circuit's holding would seem to rest entirely on whether the application of state usury law significantly interferes with the national bank's powers.

Even though the Second Circuit saw the court's holding in *Krispin* as an issue of interference,[103] the court in *Krispin* saw it as a contractual right of assignment giving weight to the party with the real interest in the account.[104] The specific holding of *Krispin* is that "consumer credit agreements do not lose the protections of the NBA when assigned to non-National Banks."[105] This holding was reaffirmed by the United States District Court for the District of Minnesota in *Munoz v. Pipestone Financial, LLC* where the court held that "state law usury claims against the purchaser of credit card debt from a national bank are preempted."[106] The holding of *Krispin*, together with other case law, including *Munoz*, provides the basis for the determination that the NBA applies even during a contractual assignment. Similar to the circumstances in *Madden*, where "the originating entity qualifies for NBA preemption, this is not lost when the National Bank assigns the account."[107]

The conclusion by the Second Circuit rests on the second issue raised in *Madden*: whether or not applying state usury laws would significantly

101. *Midland Funding, LLC*, 786 F.3d at 252.
102. *Id.* at 252–53.
103. *See id.*
104. Krispin v. May Dep't Stores Co., 218 F.3d 919, 923–24 (8th Cir. 2000).
105. *Brief for Defendants-Appellees, supra* note 68, at 3.
106. Petition for Writ of Certiorari, Midland Funding, LLC v. Madden, 136 S.Ct. 2505 (No. 15-00610); Munoz v. Pipestone Fin., LLC, 513 F. Supp. 2d 1076, 1079 (D. Minn. 2007).
107. *Brief for Defendants-Appellees, supra* note 68, at 3.

interfere with the exercise of a national bank's powers as protected by the NBA.

C. Do State Usury Laws "Significantly Interfere" with a National Bank's Powers?

A national bank's ability to make and sell loans has been a fundamental focus of banking to facilitate market demand for loans as well as to price for and spread the risk that any one of the possible loans enters default. The Second Circuit seems to misinterpret, or worse, misunderstand the intent of "significantly interfere." The appellant noted that because the differences between the NBA and the state usury laws raise a conflict preemption issue, the only way that the federal law may preempt the state law is when the two laws are incompatible or the state law significantly impairs the federal law.[108] This is the basis for the question of whether or not application of state law "significantly interferes" with the NBA's grant of rights and duties to the bank. If the application of the state usury law would significantly interfere with the national bank's powers then the state law will be preempted.[109] However, the determination that a state regulation significantly interferes with a federal power is an affirmative defense and it places the burden of proof on the defendant, or Midland Funding in this case.[110]

The Second Circuit stated, "[Midland Funding] did not act on behalf of [Bank of America] or FIA in attempting to collect on Madden's debt. The defendants acted solely on their own behalves, as the owners of the debt."[111] The appellant in *Madden* relied on this distinction and pointed to the U.S. Supreme Court's holding in *Beneficial National Bank v. Anderson* that stated the NBA sets forth the limits on national banks, but says nothing about non-bank entities.[112] However, even though Midland Funding was not acting as a subsidiary or agent of the bank in collecting on the debt it purchased, the U.S. Supreme Court has also suggested that the federal preemption provision of the NBA may extend beyond the national bank itself so long as the non-national bank entity is acting as the "equivalent to

108. *Brief for Plaintiff-Appellant*, *supra* note 62, at 13–14.

109. Wachovia Bank, N.A. v. Burke, 414 F.3d 305, 314 (2d Cir. 2005).

110. *Brief for Plaintiff-Appellant*, *supra* note 62, at 14; Zink v. First Niagara Bank, N.A., 18 F.Supp.3d 363, 367 (W.D.N.Y. 2014).

111. Madden v. Midland Funding, LLC, 786 F.3d 246, 251 (2d Cir. 2015).

112. *Brief for Plaintiff-Appellant*, *supra* note 62, at 15; Beneficial Nat'l Bank v. Anderson, 539 U.S. 1, 9 (2003).

national banks with respect to powers exercised under federal law."[113] This preemption protection is meant to provide the non-national bank entity the ability to act as the national bank so that the national bank's abilities are not inhibited by state laws restricting the entity's actions.

At least one practical benefit to this right of preemption is that, as was done by Bank of America, national banks often assign their debt collections to third parties to outsource this branch of their business so it can focus on its mandate to offer credit to consumers. This not only benefits the banks, but also benefits the lending market because outsourcing facilitates specialization and specialization facilitates efficiency.[114]

The United States Court of Appeals for the Seventh Circuit in *Olvera v. Blitt & Gaines, P.C.* expanded on this premise in determining whether or not an assignee of a debt could charge the same interest that a licensed loan originator could charge even though the rate was higher than the state usury laws allowed.[115] The assignee was a debt collection agency that specialized in collecting bad debts.[116] The court held that the debt collection agency was able to charge the higher rate because the common law of assignment allows the assignee to step into the shoes of the assignor.[117] The court stated that holding an assignee liable to the state usury rate would "be to make the credit market operate less efficiently," which the court was reluctant to adopt.[118]

Indeed, the Second Circuit noted that it is possible that usury laws would negatively impact the market for these loans by reducing the interest rate banks would be able to charge on these loans, but the Second Circuit swiftly dismissed these ramifications by stating that the effect would not significantly interfere with the exercise of a national bank's powers.[119] The Second Circuit was concerned that "extending [NBA] protections to third parties would create an end-run around usury laws."[120] Therefore, the court was more concerned with the policy implications of extending this preemption rather than protecting the bank's exercise of "all such incidental pow-

113. *Midland Funding, LLC*, 786 F.3d at 250 (quoting Watters v. Wachovia Bank, N.A.*,* 550 U.S. 1, 18 (2007)).

114. Olvera v. Blitt & Gaines, P.C., 431 F.3d 285, 288 (7th Cir. 2005).

115. *Id.* at 286–87.

116. *Id.* at 286.

117. *Id.* at 288–89.

118. *Id.* at 288.

119. Madden v. Midland Funding, LLC, 786 F.3d 246, 251 (2d Cir. 2015).

120. *Id.* at 252.

ers as shall be necessary to carry on the business of banking."[121] This implication goes against the Congressional intent of the NBA.[122]

The U.S. Supreme Court held in *Barnett Bank N.A. v. Nelson* that the NBA, a federal statute, explicitly grants a national bank authorization, permission, or power with no indication that Congress intended the national bank to be subject to local restrictions.[123] The Court further explained that normally Congress would not want the States to forbid or impair significantly the exercise of a right that Congress explicitly granted.[124] Because the state law may significantly interfere with a national bank's exercise of its powers even if it does so indirectly, the level of interference that gives rise to preemption is "not very high."[125]

However, the Second Circuit seems to have decided that states can limit this exercise of power whenever a national bank relinquishes an interest in the loan and that this practice does not significantly interfere with the national bank's powers. The Second Circuit stated that subjecting third party debt purchaser activities to state usury laws would not "significantly interfere" with loan sales by banks.[126] But the court disregards the marketability of those types of loans compared to loans sold by state chartered banks specifically subject to state usury laws.

Perhaps the Second Circuit's decision was motivated by an elevation of consumer protection standards over the established authorities of national banks. If so, the Second Circuit's policy implications are misguided. Consumer protection is clearly a significant concern for the court, especially in enforcing the FDCPA,[127] but these third-party purchasers do not offer credit to consumers, nor do they set the terms of the agreements.[128] If the debtors agree to the terms of the loan with the originator (i.e. the national bank), then the debtor should be held to those agreed upon terms of such contracts, regardless of whether or not the debt is, or may be, assigned to another party. The debtor could hardly believe that the interest rates would

121. 12 U.S.C. § 24 (2006).

122. Barnett Bank of Marion Cty., N.A. v. Nelson, 517 U.S. 25, 33 (1996).

123. *Id.* at 34–35.

124. *Id.* at 33.

125. Petition for Writ of Certiorari, Midland Funding, LLC v. Madden, 136 S.Ct. 2505 (No. 15-00610) (quoting Monroe Retail, Inc. v. RBS Citizens, N.A., 589 F.3d 274, 283 (6th Cir. 2009)).

126. Madden v. Midland Funding, LLC, 786 F.3d 246, 251 (2d Cir. 2015).

127. *See generally* 15 U.S.C.S. § 1692(e) (Lexis 2016) ("It is the purpose of this title to eliminate abusive debt collection practices by debt collectors, to insure that those debt collectors who refrain from using abusive debt collection practices are not competitively disadvantaged, and to promote consistent State action to protect consumers against debt collection abuses.").

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

plummet if the contract exchanged hands.[129] If consumer protection were to be raised to the level of the Second Circuit's opinion, then national banks would likely simply stop making these loans to high-risk debtors, so that they could minimize their lending risk.

Fewer banks would be willing to offer loans to customers within the New York area because the loans could not be resold at the competitive rate of interest and, therefore, would be kept on the bank's balance sheets or sold with an uncompetitive interest rate. A requirement to maintain the loans on the national bank's accounts implicates national bank capital requirements, which require the bank to maintain certain levels of liquidity in accordance with the assets and liabilities held by the bank. The ability to sell off defaulting or troublesome loans allows the bank the ability to remain within its capital requirements and to lend to more individuals.

Furthermore, there is a concern over the impact to credit risk now that the bank is liable for collecting these outstanding debts. The risk of defaulting on a loan is now something that could directly impact the liquidity and other financials of the bank. Banks often use the secondary market to adjust risk exposures. Where loans have already defaulted, the bank can sell off the loan to the secondary market quickly and balance its risk; however, with the precedent set in *Madden*, the bank's ability to manage its risk in case of default presents another concern for the regulators.[130]

Although the Second Circuit may be trying to protect consumers from usurious interest rates, the court has presented a new problem: lack of available credit. This policy choice would, in fact, significantly interfere with a national bank's power by forcing them to comply with individual state usury laws and then be forced to only sell that loan to that state or another state with similar usury rates. The national banks would be forced to either reduce the amount it charges on its interest—an action the Second Circuit stated would not significantly interfere with the bank's powers[131]—or make fewer loans above the state usury rates, which would significantly disrupt the national market. Either way, this decision significantly interferes with the national bank's powers entrusted to it by Congress.

129. *Id.*
130. *See ABA brief, supra* note 14, at 13–14.
131. *Midland Funding, LLC*, 786 F.3d at 251.

IV. IMPLICATIONS GOING FORWARD

A. Impact on the Banks

The court's decision in *Madden* chills the secondary market and goes directly against Congressional intent to allow banks to liquefy their debt and make new loans to new consumers.[132] The Second Circuit did address some concern that usury laws may prevent banks from carrying out their lending powers,[133] but the court stated that the usury laws would not "significantly interfere" with the powers of the national banks.[134] However, if a bank cannot sell a loan according to its terms without being subject to criminal usury penalties then the usury laws have significantly interfered with the powers of national banks. Indeed, a potential debt-buyer could be subject to criminal usury laws in New York if that person "knowingly charges . . . at a rate exceeding 25% per annum."[135] The looming threat of criminal charges has halted the purchase of these loans until the doctrine of federal preemption has been reviewed and some certainty is granted.

The appellant in *Madden* argued that the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") had attempted to narrow the scope of national bank's powers by adding Section 25(b) into Title 12 of the United States Code, which outlines the specific preemption standards.[136] These standards again include the significantly interfere test set out in *Barnett Bank* and considers any discriminatory effects on national banks.[137] The appellant states that "Congress had expressed concern that, through its excessively broad preemption positions, the OCC had 'actively created an environment where abusive mortgage lending could flourish without State controls.'"[138] And, indeed, Dodd-Frank did authorize states to bring lawsuits against national banks for violating the NBA and restricted the federal preemption of national banks to only state consumer finance laws that regulate financial accounts.[139] However, nowhere in Section 25(b)

132. *ABA brief, supra* note 14, at 3.
133. *See Midland Funding, LLC*, 786 F.3d 251.
134. *ABA brief, supra* note 14, at 6 (quoting *Midland Funding, LLC*, 786 F.3d 251).
135. N.Y. PENAL § 190.40 (CONSOL. 2015).
136. 12 U.S.C. § 25b(b)(1) (2006).
137. *Id.*
138. *Brief for Plaintiff-Appellant*, *supra* note 62, at 39 (quoting S. REP. NO. 111-176, at 17 (2010)).
139. JOSEPH L. BARLOON ET AL., BANK PREEMPTION AFTER THE DODD-FRANK ACT 4 (Sept 13, 2010), https://www.skadden.com/sites/default/files/publications/Bank_Preemption_After_the_Dodd_Frank_Act_0.pdf; Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1044, 124 Stat. 1376, 2014-17 (codified as amended at 12 U.S.C. § 25b (2010)).

of the code does it repeal Section 85 of Title 12—the NBA.[140] The NBA's federal preemption and the precedent upholding preemption were largely left in place after Dodd-Frank.[141] Furthermore, Dodd-Frank preserved the provisions of the NBA that allows a national bank to export its interest rates from its home state.[142]

Even though Congress, in enacting Dodd-Frank, was concerned with consumer protection laws, the laws supporting the effectiveness of the NBA federal preemption were maintained. Despite this, the Second Circuit expanded the minor amendments to the NBA to preclude a standard of exporting interest rates and assigning the rights of the creditor to a non-bank. The impact reaches farther than the Second Circuit must have considered as banks not only rely on the secondary markets to sell defaulting debt, but also to securitize loans and make additional credit available.[143]

B. Effect on the Lending Market

As a result of this decision, national banks located within the Second Circuit's jurisdiction may be deterred from making loans because the loans will be subject to state usury laws should they be sold to the secondary market.[144] The Second Circuit's decision makes those loans less valuable because there will be a smaller and less prosperous market. Fewer loan purchasers would be willing to agree to contractual terms that would now be deemed usurious and thus face criminal penalties for agreeing to enforce the contract. This also means that fewer consumers would be able to enjoy the active lending market as it was before the *Madden* decision. This risk of uncertainty will indirectly impact high-risk low-income individuals and small businesses that depend heavily on bank financing.[145] The effect will be particularly harsh in real estate, commercial, credit card, and automobile loans, which make up a major part of the $5 trillion lending market by national banks.[146]

140. 12 U.S.C. § 25b(f) (2006).

141. BARLOON, *supra* note 139, at 2.

142. *Id.* at 4.

143. Petition for Writ of Certiorari at 18, Midland Funding, LLC v. Madden, 136 S.Ct. 2505 (No. 15-00610). Securitizing loans means to package groups of loans and sell them to third parties in the form of asset backed securities, which allows the banks to create liquidity and make additional credit available.

144. *See ABA brief, supra* note 14, at 12.

145. Brief of the Clearing House Ass'n et al. as Amici Curiae in Support of the Petition for Rehearing and Rehearing En Banc, *supra* note 15, at 15.

146. Brief of the American Bankers Association et al. as Amici Curiae in Support of the Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit at 9, Midland Funding, LLC v. Madden, No. 15-00610.

This uncertainty and risk will be gobbled up by the shadow banking market. Shadow banks are non-bank financial institutions, including broker-dealers, mortgage finance firms, asset-backed commercial paper conduits and money market mutual funds, that offer loans to individual and institutional borrowers.[147] Shadow banks often offer higher returns for high-risk loans. Even though there is a market and purpose for these shadow banks, consumer lending may not yet be the best place for them. The concern is that whereas traditional banks are regulated by the OCC, the FDIC, and the Federal Reserve System, these shadow banks offering high-risk loans do not have such clear regulatory demarcations. Therefore, the growth of the shadow banking market in this area may increase the risk to the whole economy. The years leading up to the 2007–2009 financial crisis in the United States were characterized by the development of a new set of financial institutions that formed the so-called shadow banking system.[148] "In fact, the rise in defaults among subprime lenders triggered runs in different shadow banking markets, causing the collapse of most of these unregulated institutions and also affecting the traditional banking system."[149] In 2013, the Financial Stability Board estimated the total assets of the shadow banking market at $75 trillion, $5 trillion more than the previous year.[150] Given the impact of the Second Circuit's decision, shadow banks may offer opportunities for consumers who are turned away from traditional banks. This increase in shadow bank lending could destabilize the economy and impact this high-risk lending market in a way the Second Circuit did not consider.

History has already proven that improper regulation of the secondary market can create unwarranted friction in the lending market. In 2002, the state of Georgia passed a statute that imposed unrestricted liability for assignees of certain higher-cost mortgages for any claim that could be asserted against the originator.[151] In response, the rating agencies decided not to rate the securities that were backed by mortgage loans that were originated in Georgia.[152] The ill effects of the statute simply removed the evaluation that the ratings agencies provided on the securities and, therefore, left the

147. Francesco Ferrante, *A Model of Endogenous Loan Quality and the Collapse of the Shadow Banking System*, 1 (Fed. Reserve Bd., Finance and Economics Discussion Series, Working Paper No. 2015-21, 2015), http://www.federalreserve.gov/econresdata/feds/2015/files/2015021pap.pdf.

148. *Id.*

149. *Id.* at 1–2.

150. *Id.* at 2.

151. Brief of The Clearinghouse Association et al. as Amici Curiae in Support of the Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit at 21, Midland Funding, LLC v. Madden, No. 15-00610.

152. *Id.*

investors without any idea of what they were investing in.[153] The ultimate effect was that the financial institutions refused to buy mortgages that originated in Georgia and the lenders withdrew or limited their operations in the state until, ultimately, Georgia was forced to amend the statute to limit assignee liability.[154]

C. Solutions

The overall uncertainty of this litigation has concerned not only banks and other depository institutions, but also hedge funds, securitization vehicles, buyers of defaulted debt, purchasers of whole loans, and those who purchase loans originated by banks, especially those who are now in possession of usurious loans. Two options moving forward include having the originating bank maintain an interest in the loan or amending the current agreements to comply with individual state usury laws.[155]

As determined in *Krispin*, if the bank maintains an interest in the loan, the loan may be protected by the NBA and not deemed usurious.[156] The dueling precedential definitions of "interest" are at odds though, which creates uncertainty as to whether the bank maintains an interest. On one end, the bank may be required to maintain a "legally cognizable interest,"[157] and on the other end the interest is automatically maintained throughout the life of the loan because it is the bank that "sets such terms as interest and late fees."[158] The latter definition would continue to favor national banks federal preemption power while the former definition would cause banks to maintain these loans on their books either in whole or in part.

Indeed, Lending Club, the largest marketplace lending platform in the United States, altered its operations after the Second Circuit's decision. Lending Club stated that it incorporated a new "enhanced program structure" whereby the bank will maintain an ongoing economic interest in any loan that it originates and sells to the secondary market until the borrowers make all the payments on the loan. This transition by one of the biggest

153. *Id.*

154. *Id.* at 22.

155. PAUL HASTINGS, MADDEN V MIDLAND FUNDING, LLC: POTENTIALLY FAR-REACHING IMPLICATIONS FOR NON-BANK ASSIGNEES OF BANK-ORIGINATED LOANS 3 (Aug. 12, 2015), http://www.paulhastings.com/docs/default-source/PDFs/stay-current-madden-v-midland-funding34064e66923346428811cff00004cbded.pdf.

156. Krispin v. May Dep't Stores Co., 218 F.3d 919, 924 (8th Cir. 2000).

157. *Brief for Plaintiff-Appellant*, *supra* note 62, at 5.

158. *May Dep't Stores Co.*, 218 F.3d at 924.

marketplace lending platforms may lead to accounting issues for the bank that now must maintain the loan on its balance sheet.[159]

The industry has also been advised by law firms to review its loan portfolios for any loans within the Second Circuit's jurisdiction, including the financial capital of the United States, New York, and to understand the potential civil and criminal penalties they may be exposed to because of the now usurious nature of their loans.[160] They may need to renegotiate the terms of the loans and bring the loan's interest rates under the state usury requirement or just maintain those loans on its books and make fewer loans. However, problems lie at the heart of both solutions. Litigation from plaintiffs' attorneys may run rampant because of this decision and it may require loans under the Second Circuit's jurisdiction to be amended to comply with state usury laws, thereby increasing the risk to national banks. As in the lead up to the 2008 financial crisis, increased risk to high risk debtors could lead to higher speculation and overall uncertainty in the marketplace.

Additionally, forcing banks to maintain the loans on their balance sheet would decrease the ability of banks to lend to creditworthy borrowers because increases in capital requirements have set higher standards to ensure a bank's liquidity. For example, in July of 2015, the Federal Reserve approved a new rule that took effect on January 1, 2016 and forces eight major banks to "hold additional capital to increase its resiliency in light of the greater threat it poses to the financial stability of the United States."[161] This rule forces these banks to "either hold substantially more capital, reducing the likelihood that they will fail, or . . . shrink their systemic footprint."[162] This rule was made in continuance of Dodd-Frank's requirements for minimum risk-based capital reserves for those insured depository institutions.[163] Because banks must remain in compliance with these requirements, a national bank's abilities would be limited in the amount of lending they could undertake if they had to maintain such loans on their balance sheets.

159. JD Alois, *Lending Club Reacts to Concerns Over Madden vs. Midland Decision*, CROWDFUND INSIDER (Feb. 26, 2016), http://www.crowdfundinsider.com/2016/02/82246-lending-club-reacts-to-concerns-over-madden-vs-midland-decision/.

160. *See* Ornstein et al., *supra* note 18, at 3.

161. Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Board approves final rule to hold additional capital to increase its resiliency (July 20, 2015), https://www.federalreserve.gov/newsevents/press/bcreg/20150720a.htm.

162. *Id.*

163. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 171(b)(2), 124 Stat. 1376, 1436 (2010) (to be codified at 12 U.S.C. § 5371).

In effect, the only options for national banks are to maintain the loans on its balance sheet, or create riskier loans with lower interest rates so that it may sell it off to the secondary market. This difficulty in balancing the Second Circuit's interest and the bank's lending performance is the reason why the U.S. Supreme Court should have granted the petition for certiorari, but national banks are forced to wait for another case to cause a split among the courts to fully regain its protections granted under the NBA.

V. CONCLUSION

The Second Circuit's holding that federal preemption under the NBA did not apply in *Madden* has significantly impacted the marketability of loans originated by national banks and thus interfered with the authority of national banks. The court's determination that loans originated by national banks and assigned by the bank to a third-party non-national bank entity are subject to state civil and criminal usury penalties has put national banks and purchasers of debt on high alert, not only within the Second Circuit's jurisdiction, but also around the country. While no other court has yet made a similar determination, the potential cases being litigated around the country could be amended to include a usury rate claim. In fact, the Second Circuit has already decided another case while upholding the NBA's preemption authority and a national bank's power to export interest rates where the bank is located.[164]

The NBA's grant of federal preemption should be recognized in the courts because it was Congress's intent to grant this power to chartered and regulated national banks so that credit may be available for individuals and small businesses. Limiting this power would limit available credit to consumers and have a negative impact on the economy. The availability and accessibility of credit is the "crucial ingredient" for growth of the nation's economy and the banks providing the trillion-dollar market for these loans are essential for small businesses.[165] If high-risk consumers are unable to acquire credit through a trustworthy and regulated source of financing, it is likely that lending by alternative lenders, including shadow banks, would increase. An increase in this market could put the economic stability of the country at risk.

164. *See* Llewellyn v. Asset Acceptance, LLC, No. 15-3681-cv, 2016 U.S. App. LEXIS 18420, at *2 (2d Cir. Oct. 13, 2016).

165. Brief of The Clearinghouse Association et al. as Amici Curiae in Support of the Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit at 6, Midland Funding, LLC v. Madden, No. 15-00610.

To avoid this downfall and mitigate economic risk, federal preemption under the NBA should remain in full force. Hopefully, other courts will appropriately examine the congressional intent behind Section 85 of Title 12 of the United States Code and the Second Circuit will uphold that intent in the future. Until the U.S. Supreme Court recognizes a split among the jurisdictions, we are left to reorganize a standard practice that is 150 years old.