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Federal Court Decision Creates Uncertainty for Non-Bank Loan Assignees Regarding the Scope of Federal Preemption of State Usury Laws

Marc P. Franson, Michael S. Himmel, Peter C. Manbeck, and Kenneth P. Marin*

In Madden v. Midland Funding, LLC, *the U.S. Court of Appeals for the Second Circuit recently held that a non-bank assignee of loans originated by a national bank was not entitled to the benefits of National Bank Act preemption as to state law claims of usury. The authors of this article discuss the decision and its implications.*

The U.S. Court of Appeals for the Second Circuit recently issued a significant decision interpreting the scope of federal preemption under the National Bank Act (the "NBA"). In *Madden v. Midland Funding, LLC*,[1] the Second Circuit held that a non-bank assignee of loans originated by a national bank was not entitled to the benefits of NBA preemption as to state law claims of usury. Specifically, the court stated that the NBA preempts the application of state law to non-banks only when application of the state law would "significantly interfere" with a national bank's ability to exercise its powers under the NBA. Applying this standard to a non-bank assignee which had purchased certain consumer loans from a national bank, the court held that the purchaser did not qualify for federal preemption and would remain subject to New York's usury laws in enforcing the purchased loans even though preemption had exempted the originating bank from the usury laws when it made the loans.

BACKGROUND

In 2005, plaintiff Saliha Madden, a New York resident, opened a credit card account at a national bank. In 2006, this bank's credit card program was

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[1] No. 14 2131 cv.

consolidated with that of another national bank (the "Bank"). At that time, the Bank sent the plaintiff a notice stating that their account relationship would be governed by Delaware law. By 2008, the plaintiff owed $5,000 on her credit card account and had defaulted in making payments on the debt. The Bank charged off the account and sold the debt to Midland Funding, LLC ("Midland"). Midland, a debt collection firm, is not a bank or bank agent or affiliate.

In 2010, an affiliate of Midland acting as servicer sent a communication to the plaintiff demanding payment of her debt and calculating interest on the unpaid amount at 27 percent per annum. In response, the plaintiff filed a class action lawsuit against Midland and its affiliate in the U.S. District Court for the Southern District of New York, alleging that they had violated New York's usury laws (which cap the per annum interest rate on certain consumer loans at 25 percent). The plaintiff also claimed that the co-defendants had violated the Fair Debt Collection Practices Act (the "FDCPA") by attempting to collect interest at a higher rate than New York law allows.

THE SECOND CIRCUIT'S DECISION

Usury

The co-defendants based their defense in the district court upon a claim of federal preemption. Rooted in the Supremacy Clause of the United States Constitution, federal preemption is the concept that federal law trumps certain conflicting or overlapping state laws. The NBA permits national banks to charge any interest rate allowed by the bank's state of location, regardless of the borrower's location, and therefore overrides individual state usury laws. The Bank (the loan originator) is located in Delaware, and Delaware law permits banks to extend consumer loans at any rate provided for in the governing contract. The Bank therefore was entitled under federal preemption to extend loans to the plaintiff at rates exceeding the New York usury cap. The co-defendants argued that since they had purchased loans lawfully made by a national bank, they too were exempt from the New York usury laws.

The district court agreed with the co-defendants and entered judgment in their favor. Upon appeal, however, the Second Circuit reversed the district court's decision and held that the co-defendants did not qualify for preemption. The Second Circuit concluded that the NBA preempts state law for the benefit of non-banks only when application of the state law would "significantly interfere" with a national bank's exercise of its powers under the NBA. The court noted that preemption may be appropriate in favor of a bank subsidiary, affiliate or agent that is acting on behalf of a national bank in carrying on the bank's business. In contrast, the co-defendants were acting "solely on their own

behalves" and in the court's view had failed to demonstrate that "applying state usury laws to . . . third-party debt buyers would significantly interfere with [a national bank's] ability to exercise its powers under the NBA." The court further stated that extending NBA preemption to the co-defendants would be "overly broad" and would "create an end run around the usury laws."

Fair Debt Collection Practices Act

The Second Circuit also vacated the district court's judgment for the co-defendants on the plaintiff's FDCPA claim. The Second Circuit determined that the district court's judgment was based upon its erroneous finding that federal preemption applied and also upon a "premature" assumption that Delaware law governed the credit card account agreement.

Choice of Law

As noted previously, the Bank sent the plaintiff a notice stating that their account relationship was to be governed by Delaware law. If the Delaware choice of law clause were effective, Delaware law would permit the co-defendants to assess interest at 27 percent per annum. In such event, the co-defendants would not have violated any applicable usury laws even if federal preemption did not apply. The Second Circuit's decision that preemption does not, in fact, apply makes it necessary to determine whether the plaintiff's account is governed by Delaware or New York law. As the district court did not make any ruling on the choice-of-law question, the Second Circuit remanded the case to the district court to consider that issue.

IMPLICATIONS

The Second Circuit decision is binding only in the three states included in the Second Circuit: Connecticut, New York, and Vermont. The decision nonetheless may significantly affect non-bank assignees of loans, including in relation to the purchase and collection of outstanding bank loans and the loan origination practices of certain marketplace and other lenders. Potential consequences include the following:

- Non-bank assignees/purchasers of bank loans may face uncertainty as to their ability to rely upon federal preemption of state usury laws.
- A number of marketplace and other lending platforms purchase loans from state-chartered banks promptly after origination and rely upon federal preemption to exempt the loans from state usury caps. The Second Circuit decision, although directly ruling on purchasers of national bank loans, could be applied by courts considering the scope of federal preemption under a similar provision in the Depository

Institutions Deregulation and Monetary Control Act of 1980 (which generally preempts state usury laws in favor of federally insured state-chartered banks).

- The breadth of the wording in the decision could impact commercial as well as consumer loans.
- The decision should not impair the ability of national banks to securitize loans. Any special purpose vehicle that acquires loans from a sponsor bank, assuming that the sponsor bank has a continuing interest in such entity, would likely be deemed to be engaged in carrying on the bank's business (and therefore eligible for preemption). The decision also appears to provide for continued preemption if the securitized assets are revolving accounts receivable and the sponsor bank has a continuing interest in the account relationship.
- The *Madden* decision appears to be contrary to other federal circuit court decisions and inconsistent with longstanding commercial practice. On August 12, 2015, the Second Circuit nonetheless denied the co-defendants' request that the Second Circuit reconsider the case en banc. It is not known at the time of submission of this article whether the co-defendants will seek to appeal the case to the U.S. Supreme Court or, if they do, whether the Supreme Court will agree to hear the case.