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Southern District of New York Issues Decision on Remand in *Madden*

Marc P. Franson, Peter C. Manbeck, and Lindsay S. Henry*

The U.S. Court of Appeals for the Second Circuit's decision in Madden v. Midland Funding, LLC, *raised significant questions as to whether non-bank assignees of loans from an originating bank would be able to enforce the loans in accordance with their terms. These questions have been further complicated by the long-awaited remand decision from the U.S. District Court for the Southern District of New York. The authors of this article discuss the decision and its implications.*

The May 2015 decision of the U.S. Court of Appeals for the Second Circuit in *Madden v. Midland Funding, LLC*[1] sent shockwaves through the marketplace lending industry, and nearly two years later the questions generated by this case remain largely unanswered. The Second Circuit held that a non-bank assignee of loans originated by a national bank was not entitled to the federal preemption afforded to the bank with respect to claims of usury. This controversial decision raised significant questions as to whether non-bank assignees of loans from an originating bank would be able to enforce the loans in accordance with their terms. These questions have been further complicated by the long-awaited remand decision from the U.S. District Court for the Southern District of New York, which was issued on February 27, 2017.[2]

THE DISTRICT COURT DECISION

The issue before the district court on remand was whether New York or Delaware law governed the contractual relationship of the parties. The account agreement specified Delaware law as the governing law, and the national bank that issued and administered the credit card account involved in *Madden* prior to default and assignment of the debt to Midland Funding had its principal place of business in Delaware. Delaware law authorizes creditors to charge any interest rate agreed upon by the borrower in a written contract. On remand, the district court held that applying Delaware law per the account agreement would

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[1] *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015).

[2] *Madden v. Midland Funding, LLC*, 11-CV-8149 (S.D.N.Y., Feb. 27, 2017).

violate a fundamental public policy of New York—namely, its criminal usury statute, which limits interest to 25 percent per year. Broadly interpreted, this decision could prevent the enforcement of choice of law provisions in credit agreements against New York consumers when the interest rate exceeds 25 percent, as is the case for many credit cards, marketplace loans and other consumer loans.

The district court also found that New York's civil usury rate does not apply to defaulted debt and the New York criminal usury law does not provide a private right of action. As a result, usury-based claims were dismissed. However, the court held that Midland Funding's violation of the criminal usury limit could serve as a predicate for Madden's Fair Debt Collection Practices Act ("FDCPA") and state unfair and deceptive acts and practices ("UDAP") claims, which the court allowed to proceed on a class basis.

Although *Madden* did not involve a performing loan, these rulings have created problematic precedent by undermining common law principles that are routinely relied upon by creditors and their assignees. The Second Circuit's decision undercut the doctrine that loans are "valid when made" and do not become invalid when they are assigned to a third party, while the district court called into question the enforceability of a choice of law provision in a credit contract against New York consumers where the interest rate exceeds the state law usury limits. If the *Madden* holding were applied to a non-bank assignee of an existing bank loan, it could prevent the assignee from enforcing the loan in accordance with its terms or expose the assignee to claims of damages for charging excess interest. In addition, this precedent threatens the enforceability of governing law provisions in consumer credit agreements—at least those involving consumers in New York and other states that have criminal usury statutes. How similar cases in the Second Circuit (New York, Vermont, and Connecticut) will be decided remains to be seen, as *Madden* has not been adopted specifically by any other court to date. In addition, since federal preemption was not at issue in the remand decision, a case involving an institution subject to federal preemption may reach a different result. Other lenders relying on choice of law provisions in their agreements should reexamine their practices in light of these decisions.

CONCLUSION

The *Madden* rulings may affect online marketplace lending programs. In light of this unfavorable precedent, some marketplace participants may choose to reexamine their program structure to mitigate the risks that remain post-*Madden*. For example, a funding bank could retain some ownership or servicing rights or other continuing interest in loans that are sold to third

parties, such as by retaining the accounts and only selling the receivables. Other considerations from a risk perspective include the allocation of origination fees between the funding bank and marketplace platform and whether the program agreement gives the marketplace platform the exclusive right to own the loans and collect payments from the borrowers.