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ALERT

Asset Management

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Second Circuit Decision Could Disrupt Secondary Market for Bank-Originated Loans

A May 22, 2015 decision by the U.S. Court of Appeals for the Second Circuit appears to disturb the generally settled body of law concerning the status of non-bank investors with respect to applicable usury laws for bank-originated loans. As assignees of a national bank, such non-bank investors were generally deemed to stand in the shoes of the bank with respect to applicable usury laws. However, in *Madden v. Midland Funding, LLC*,[1] the Second Circuit rejected this principle and held that the usury laws of the debtor's jurisdiction could apply to non-bank investors. Consequently, unless reversed, *Madden* could significantly disrupt the secondary market for bank loans originated by national banks, as well as affect the valuation of such loans already held by non-bank investors. Bank lenders, securitization platforms and non-bank investors, including specialty debt funds, could be affected.

Background

The National Bank Act (the "Bank Act") permits a national bank to charge any interest rate allowed by the usury laws of the state in which the bank is located, while providing "the exclusive cause of action" for usury claims against a national bank. The Bank Act thus preempts the application of other state usury laws to any loan made by a national bank.

In *Madden*, the plaintiff had a credit card account with Bank of America, N.A., a national bank, which sold the account to FIA Card Services, N.A. ("FIA"), a national bank based in Delaware. FIA notified the plaintiff that, prospectively, the account agreement would be governed by Delaware law. The plaintiff subsequently failed to make required account payments. FIA sold plaintiff's account to Midland, which is not a national bank. As a result of the sale, FIA no longer had an interest in the plaintiff's account. Midland attempted to collect on the plaintiff's account.

The plaintiff, a New York resident, brought a putative class action against Midland in the U.S. District Court for the Southern District of New York, claiming that Midland had violated both New York's usury statute, by charging an interest rate that exceeded New York's permitted rate, and the Fair Debt Collection Practices Act (the "FDCPA"), which prohibits a debt collector (such as Midland) from employing any false or misleading representations in collection of any debt. Midland responded that it was a valid assignee of the account from a national bank and, therefore, that New York usury statute did not apply due to preemption under the Bank Act. The District Court agreed with Midland, holding that the New York usury statute was preempted by the Bank Act, and that the FDCPA claims failed because the interest rate applied by Midland was permitted under the account agreement, which was governed by Delaware law.

The Second Circuit's Holding

The Second Circuit reversed the District Court's decision and held that Midland could not avail itself of preemption under the Bank Act. The Second Circuit reasoned that the Bank Act preempts state law for the benefit of non-banks only when application of the state law would "significantly interfere" with a national bank's ability to exercise its power under the Bank Act. The court observed that preemption may be appropriate when a national bank's agents and subsidiaries exercise the national bank's powers. However, the court held that preemption would be inappropriate in this case because Midland was acting solely on its own behalf as the current owner of the debt, and

[1] No. 14-2131-cv, ___ F.3d ___, 2015 WL 2435657 (2d Cir. May 22, 2015).

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there was no reason to believe that applying state usury laws to non-bank assignees such as Midland would significantly interfere with a national bank's ability to exercise its Bank Act power.

The Second Circuit also reversed the District Court's judgment for Midland on the plaintiff's FDCPA claims. The Second Circuit determined that the District Court's judgment was based upon its erroneous federal preemption holding and upon the assumption that Delaware law controlled the account agreement instead of New York law. The Second Circuit remanded the case to the District Court to consider the choice of law issue.

Implications

Midland already has indicated that it intends to seek an en banc reconsideration of the *Madden* decision by the Second Circuit. At a minimum, the decision appears to conflict with decisions by the U.S. Court of Appeals for the Eighth Circuit, as well as long-established market practice.

The Second Circuit's ruling that federal preemption is available only when debt is held by a national bank, *but not after sale of the debt to a non-bank investor*, is a troubling precedent with respect to sales of bank-originated loans. The *Madden* decision is particularly troubling due to its assertion that application of various local state law usury claims to non-bank investors would not significantly interfere with a national bank's ability to exercise its powers under the Bank Act. Unless reversed, *Madden* could significantly disrupt and cause restructuring of the secondary market for loans originated by national banks, including the manner in which bank syndicated credits and securitization platforms operate. *Madden* also has the potential to affect the valuation of bank loans already held by non-bank investors.

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney.

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