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Recent Developments in Madden and True Lender Litigation

Consumer Finance Monthly Breakfast Briefing

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Overview of Today's Program

- Madden
- True Creditor
- State Actions
- Rent-Rite Superkegs
- Possible Ways to Mitigate the Risks

Madden v. Midland

- Class of claims arising from Second Circuit decision in *Madden v. Midland Funding, LLC (786 F.3d 246)* in 2015
  - Facts: A non-bank debt buyer charged interest on a defaulted credit card account at rates permissible at origination only because the original creditor was a bank.
  - Holding: The non-bank could not rely on preemption arguments available to the bank that permitted charging interest in excess of state law limitations.
- Serious questions as to the breadth of the ruling and whether the defendant raised the right arguments at trial to avoid waiving defenses
- While cited by other courts, not adopted outside of Second Circuit.

Madden v. Midland

- Recent cases against JPMC (WDNY) / Capital One (EDNY)
- In June 2019, plaintiffs filed class action lawsuits against various Capital One and Chase affiliated entities (but not the banks) involved in the banks' credit card securitization programs.
- The lawsuits allege that the bank affiliates purchasing the receivables from the national banks cannot collect interest at the rate permitted by the Cardholder Agreement based upon *Madden*.
- Plaintiffs emphasize "true sale" nature of the securitizations.
- Neither Chase nor Capital One had arbitration clauses in their cardholder agreements.

Madden v. Midland

- Motions to dismiss, supported by SFA/BPI amicus brief
  - These claims seek to over-extend *Madden*.
  - *Madden* involved sale of the entire account, emphasized that the bank had no ongoing role.
  - Credit card securitization involves the ongoing sale of receivables only, bank continues to:
    - Be the party to cardholder agreement
    - Set interest rates
    - Collect interest
    - Fund new advances

Madden v. Midland

- Express Preemption Regarding Interest Rates –
  - National Bank Act § 85 - Permits national banks to "charge on any loan . . . Interest at the rate allowed by the laws of the State, Territory, or District where the bank is located . . . "
  - FDIA § 27(a) (12 USC 1831d) - Provides that any federally insured state-chartered bank "may, notwithstanding any State constitution or statute, which is hereby preempted for the purposes of this section, . . . charge on any loan interest . . . At the rate allowed by the laws of the State, territory or district where the bank is located . . . "

Madden v. Midland

- Implied, or Conflict Preemption Under *Barnett Bank*, 517 U.S. 25 (1996)
- Absent express preemption, implied preemption may be found where:
  - (i) the federal statute creates a scheme of federal regulation "so pervasive as to make reasonable the inference that Congress left no room for the States to make reasonable the inference that Congress left no room for the States to supplement it."
  - (ii) federal law may be in "irreconcilable conflict" with state law, where compliance with both laws is a "physical impossibility," or where state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."

Madden v. Midland

- Dodd-Frank Section 1044 (12 USC § 25b) –
- State consumer financial laws are preempted only if
  - Application of a State consumer financial law would have a discriminatory effect on national banks (compared to state chartered banks)
  - In accordance with *Barnett,* the state consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers and any preemption determination under this subparagraph may be made by a Court or the OCC on a case-by-case basis
  - Preemption arises other than from Title 62

Madden v. Midland

- Valid-when-made doctrine provides that a loan that is valid at its origination cannot become usurious based upon subsequent sale or other events after origination.
- US Supreme Court originally recognized this doctrine almost 200 years ago.
- New York and other states have long recognized that a loan that is non-usurious at its inception cannot become usurious by reason of any subsequent transaction. *See, e.g., Munn v. Comm'n Co.*, 15 Johns. 44, 55 (N.Y. Sup. Ct. 1818); *Tuttle v. Clark*, 4 Conn. 153, 157 (1822); *Knights v. Putnam*, 20 Mass. (3 Pick.) 184, 185 (1825).

Madden v. Midland

- Possible Legislative or Regulatory Fixes
  - In 2017, the House passed legislation that would have addressed the *Madden* decision. However, the Senate did not act on this legislation before the end of the session.
  - In July 2018, the US Treasury Department issued a report calling on Congress to help mitigate the uncertainty surrounding *Madden* by codifying the valid-when-made doctrine and addressing true creditor.
  - The lack of a legislative solution likely increases the need for the OCC and the FDIC to address this issue.
  - Last Thursday House Republicans sent a letter to the OCC asking for continuing action to address *Madden*.

True Creditor

- Bank partner program structure is critical to determining whether loans are validly originated and remain valid through the various transfers involved in marketplace lending.
  - Valid origination = The bank must be the "true lender" in the relationship.
  - Maintaining validity through transfers = Programs must address the "*Madden*" risk.
- The "true lender" issue is not unique to marketplace lending and case law has developed in connection with credit cards and payday lending.
- Courts have applied a number of legal standards to analyze "true creditor", including named lender, totality of the circumstances and predominant economic interest.

True Creditor

- *Krispin v. May Dep't Stores Co.*, 218 F.3d 919 (8th Cir. 2000) – "It makes sense to look to the originating entity (the bank), and not the ongoing assignee (the store), in determining whether the NBA applies."
- *Sawyer v. Bill Me Later, Inc.*, 23 F.Supp.3d 1359 (D.Utah2014) – Bank true lender on facts, but "court would still be required to dismiss … claims as preempted by Section 27 "even if it were not the true lender"
- *CashCall, Inc. v. Morrisey*, 2014 WL 2404300 (W.Va. Sup. Ct. 2014) – "the 'predominant economic interest test' [is] the proper standard to determine the true lender"

State Actions

- States regulators have been more active in scrutinizing relationships.
- One state, Colorado, has sued licensees, Avant and Marlette, and contacted others licensed as supervised lenders.
- As more entities obtain state licenses to perform marketing and servicing activities, state oversight will continue to increase.

Colorado Litigation (Avant and Marlette)

- During examination, the Administrator of the Colorado Credit Code concluded that serviced loans had rates and fees in excess of those permitted by Colorado law and the choice-of-law provisions also violated applicable law.
- The Administrator filed a lawsuit against Avant and Marlette, and their bank partners unsuccessfully tried to intervene and move it to federal court.
- The lawsuit further alleges that banks are not true lenders and seeks reimbursement for consumers plus penalties from Avant/Marlette.

Colorado Litigation (Avant and Marlette)

- On November 30, 2018, the Administrator filed an amended complaint listing as defendants a number of trusts and their trustees (Wilmington Trust and WSFS) who had allegedly purchased or accepted assignments of loans.
- The amended complaints indicate that the trustees are not being named in their individual capacity but solely as trustee of the trusts.
- The Trustees' motion to dismiss on jurisdictional grounds was denied by the court in April 2019.

Trusts as Defendants – NCSLT

- Inclusions of trusts and trustees raises a number of concerns for secondary market participants (including trustees, investors and financing sources).
- Similar to what has been happening in the NCSLT/CFPB litigation. In that case:
  - The CFPB filed a Complaint and Proposed Consent Judgment against NCSLT Trusts
  - Allegations based on misconduct of Servicers and Sub-servicers
    - Affidavits: lack of personal knowledge and not properly notarized
    - Collections lawsuits: no chain of assignment to trusts; can't locate promissory note; outside statute of limitations
  - Entered Consent Order against Sub-servicer at same time

Trusts as Defendants – NCSLT

- CFPB asserted Trusts are "Covered Persons" because they service loans and collect debt
  - Covered person definition includes "acquiring, purchasing, selling or brokering or other extensions of credit"
  - Complaint acknowledges Trusts have no employees and act through servicers
- Servicers and sub-servicers alleged to have acted as "agents" of the Trusts
- Claims that servicers' conduct on behalf of Trusts was
  - Deceptive: affidavits falsely stating personal knowledge; affidavits improperly notarized; lawsuits filed without chain of assignment or promissory note or after SOL expired
- Litigation is ongoing

Rent-Rite Superkegs

- *Rent-Rite Superkegs West, Ltd., v. World Business Lenders, LLC*, 2019 WL 2179688 (US Bankr. Court D. Colo. May 2019)
  - Bank of Lake Mills, a Wisconsin state chartered bank, agreed to loan $550,000 to Colorado-based corporation
  - Interest on the loan at the rate of 120.86% per year.
  - Note governed by federal law and Wisconsin law.
  - Colorado was added as additional security for the loan
  - Note was subsequently assigned by bank to finance company
- Bankruptcy Court denied debtor's attempt to have the loan declared usurious under Colorado law based upon valid-when-made doctrine.

Rent-Rite Superkegs

- Case was appealed to US District Court and OCC/FDIC submitted amicus brief on September 19, 2019 arguing that bankruptcy court had correctly decided that the interest rate in the note was valid when the note was made and remains valid despite the note's later assignment.
- OCC and the FDIC made the following arguments:
  - (i) interest rate in the promissory note was valid when made because Section 1831d allowed the bank to charge the rate,
  - (ii) interest rate in the promissory note remains valid and enforceable despite the note's assignment under "valid-when-made" rule, and
  - (iii) an assignee of a contract succeeds to assignor's right in the contract, including the right to receive interest at the rate agreed upon rate.

Possible Ways to Mitigate the Risks

- Participation interests
- Eligibility criteria/concentration limits
  - Limits on Second Circuit and Colorado loans above permitted rates of interest under state usury laws
  - Consider additional parameters on loans to residents located in Iowa, Georgia, Puerto Rico and West Virginia
- Bank partner program documentation
- Inclusion of enforceable arbitration clause with class action waiver in underlying cardholder or loan agreement

Questions?

Americas Asia Europe Middle East