Madden in the Supreme Court: Where It Is, and Where It Could Be Going

Nearly everyone in the consumer finance industry is familiar with the May 2015 decision of the United States Court of Appeals for the Second Circuit in *Madden v. Midland Funding, LLC*[1] ("*Madden*"). In *Madden*, the United States Court of Appeals for the Second Circuit held that the National Bank Act ("NBA") did not preempt New York's state usury law for an assignee of a national bank-originated loan because the assignee was not itself a national bank or collecting the debt on behalf of a national bank.

The defendants in the case, Midland Funding, LLC and Midland Credit Management, Inc. (collectively, "Midland") have petitioned the United States Supreme Court for a writ of certiorari. This alert reports on the proceedings in the Supreme Court, including the Court's request that the Solicitor General's Office file an *amicus* brief addressing whether the Court should review the case, and discusses possible outcomes for the industry.

I. Background

A. PROCEEDINGS BELOW

In May 2015, the Second Circuit held that the NBA did not preempt New York's state usury law for an assignee of a charged off credit card loan that had been originated by a national bank, at least not if the national bank did not continue to be involved with the debt in some way (such as retaining an interest in the debt or continuing to be the servicer). The Second Circuit held this despite the fact that it was undisputed that the NBA did preempt the New York usury law for the national bank that made the loan at issue.[2]

The defendants in the case were Midland Funding, LLC and Midland Credit Management, Inc. (collectively, "Midland"). After losing in the Second Circuit, Midland petitioned for *en banc* review. After that petition was denied, Midland filed a petition for a writ of certiorari with the Supreme Court. On March 21, the Supreme Court asked the Solicitor General to file an *amicus* brief addressing whether the Court should grant certiorari. The Solicitor General will now consult with the Office of the Comptroller of the Currency ("OCC") (and other bank regulators) and make a recommendation to the Court.

Note that Midland is only asking the Court to review the question of whether federal law preempts state usury laws for assignees of a national bank. Midland had also made the alternative argument that Delaware law applied pursuant to conflict of laws principles because the choice of law provision in the agreement designated Delaware law. The district court did not reach this issue because it decided that the New York usury law would be preempted even if New York law applied pursuant to conflict of law principles. The Second Circuit also did not decide this issue; it instructed the district court to evaluate the issue on remand. Even if Midland cannot convince the Supreme Court to reverse the Second Circuit, it is still possible that

Midland will ultimately prevail based on its choice of law argument.

Note also that the Second Circuit's holding does not address whether state usury laws are preempted for assignees of first-lien mortgage loans covered by Section 501(a) of the Depository Institutions Deregulation and Monetary Control Act ("DIDMCA"). Section 501(a) contains broad preemption language which appears to make clear that periodic rate restrictions do not apply to the loan, even after it is assigned. Additionally, the impact of the decision might be less acute for mortgage loans and other types of loans that have periodic interest rates below usury thresholds in most states[3] (although the decision might still have an impact with respect to restrictions on fees and other loan terms).

B. ARGUMENTS OF THE PARTIES

In its petition for a writ of certiorari, Midland argued that the Court should review the Second Circuit's decision for several reasons:

- The Decision Creates a Circuit Split. Midland argues that *Madden* directly conflicts with decisions of the Eighth and Fifth Circuits, which Midland argues stand for the principle that the identity of the originator, not the assignee, generally is what determines whether the state law is preempted.[4]
- The Second Circuit Decision is Important. Midland argues that the Second Circuit's decision will have calamitous consequences for the financial services industry if it is allowed to stand. Specifically, Midland argues that *Madden* undercuts a principle on which the secondary market depends.
- *Madden* is Incorrectly Decided. Midland argues that:
    1. the common law "valid when made" doctrine under usury law is embedded in 12 U.S.C. § 85 ("Section 85"), the federal usury provision for national banks (which permits national banks to charge interest at the rate allowed by the laws of the state where the bank is located); and
    2. allowing a state to prohibit an assignee from collecting interest lawfully contracted-for by a national bank would "significantly interfere" (within the meaning of *Barnett*[5]) with a national bank's authority to contract for interest at the rate permitted by Section 85.[6]

Midland also argued that there are no unresolved factual issues, making this case a good vehicle for the Court to address the legal issue of whether state usury laws are preempted for assignees of national banks.

In her reply, Madden argued:

- There Is No Circuit Split. Madden argues that the facts of *Madden* are distinguishable from other circuit court decisions holding that the application of NBA preemption turns on the identity of the originator. These decisions, she says, involved situations where a national bank continued to be involved with the loan at the time that the usury law was allegedly violated.
- The Impact of the Decision Is Limited. Madden argues that Midland exaggerates the impact of the Second Circuit decision. Madden argues that even if defaulted debt buyers are forced to follow state usury limits, it is unlikely that this will impact their willingness to purchase debt from national banks or the price that they will pay the banks. This is because defaulted debt buyers do not buy debt anticipating that they will collect the full principal due, much less any interest. Madden points out that the disastrous consequences posited by Midland and its *amici* all assume that the Second Circuit would follow *Madden* in a case involving *performing* loans. If applying state usury laws to assignees of performing loans would significantly interfere with the powers of national banks, Madden argues, then this would distinguish a case involving such

loans—and a court, even a court in the Second Circuit, would not be obligated to follow *Madden*. Put differently, Madden argues that if the concern is that *Madden* will apply to performing loans, then the Supreme Court should wait until the Second Circuit actually applies the *Madden* holding to performing loans. It should not review the issue now based solely on the *possibility* that the Second Circuit will do this.

- The Case Is Not the Right Vehicle. Madden contends that there are substantial questions about whether Midland has waived its two primary substantive arguments in the proceedings below, creating a complication that she says makes this case a poor vehicle to address these critical issues.
- The Case Involves Superseded Law. The case involves facts that occurred before various provisions of the Dodd-Frank Act took effect. Madden notes that the Dodd-Frank Act eliminated the ability of parties affiliated with national banks (including their subsidiaries and agents) to invoke NBA preemption. Madden argues that this is likely to color how courts view preemption claims by parties (like Midland) that have *no* affiliation with national banks. It will be difficult, Madden argues, for courts to conclude that there is preemption for parties unaffiliated with national banks but no preemption for their subsidiaries and agents. Madden argues that there will be little value to the Court clarifying the application of pre-Dodd-Frank law.
- The Second Circuit Decided the Case Correctly. Madden argues that the valid-when-made doctrine as it existed when the NBA was passed was a relatively limited doctrine that does not support the broad proposition for which Midland cites it—even if the doctrine is incorporated into Section 85. She also argues that applying the state usury laws to distressed debt buyers would have a negligible impact on national banks, because debt buyers do not anticipate collecting any interest when they make a decision whether, and at what price, to purchase charged off debt from national banks.

II. Possible Outcomes

A. THE COURT DENIES CERTIORARI

If the Court decides not to grant the petition, then the Second Circuit's decision will stand and continue to be binding precedent for federal courts within that circuit.[7] At that point, several things might happen:

- The Second Circuit Backs Away From *Madden* and Aligns With the Other Circuits. As explained above, Madden is arguing that the *Madden* decision is a narrow decision largely confined to situations where a debt buyer purchases charged-off debt from a national bank. Madden argues that the interference with a national bank's powers from applying usury laws to a debt buyer are insignificant in this situation. Madden concedes that applying usury laws to an assignee of performing bank debt might significantly interfere with a national bank's powers. In fact, Madden argues that the consternation within the financial industry about the *Madden* decision results from the industry's lawyers prematurely jumping to the conclusion that *Madden* compels the same outcome in the performing debt context. It is possible that the Second Circuit will take up this line of argument in the future and distinguish *Madden* in cases not involving charged-off debt. This would severely limit the impact of the *Madden* decision and align the Second Circuit with other circuits. Note, however, that it will take years for the Second Circuit to distinguish *Madden* in enough decisions that the financial industry can get comfortable that *Madden* is an anomaly.
- Other Circuits Follow *Madden*. One possibility would be that other circuits follow *Madden*, and either overturn existing decisions holding that state laws are

preempted for assignees or distinguish those cases to the point that they are limited to their facts. If this happens, then the practical ability of banks to rely on preemption for any loans that they might sell or securitize might be limited.

- The Circuit Split Festers, and the Supreme Court Reviews the Issue Eventually. If the circuit does not find a way to align *Madden* with *Krispin* and *Lattimore*, then the split among the circuit will become more pronounced and undeniable. If so, we predict that the Supreme Court will eventually accept a case to resolve this split. In the meantime, the financial industry will face uncertainty. The practical ability of banks to rely on preemption for loans that they plan to sell or securitize might be limited.

Note that the decisional path taken by the Second Circuit and other courts of appeals following a denial of certiorari could be influenced by the substantive position advanced by the United States in its *amicus* brief in the Supreme Court. The government's brief will address the merits of the question presented as well as whether certiorari should be granted. If the government takes a narrow view of preemption, that could influence subsequent decisions by the courts of appeals—and the same is true if the government adopts a broader view of preemption.

B. THE COURT GRANTS CERTIORARI AND HOLDS THAT THE NBA PREEMPTS STATE USURY LAWS APPLICABLE TO MIDLAND

The best outcome for the financial services industry would be a grant of review by the Supreme Court and a holding that the NBA preempts state usury laws for Midland. However, the long-term effect of the decision will depend on which of Midland's two arguments the Court adopts.

As explained above, Midland has two distinct substantive arguments. The first is that the common law valid-when-originated doctrine is incorporated into Section 85 and that Section 85 thus directly preempts state usury laws for national bank assignees. Midland's second argument is that state usury laws are preempted for national bank assignees due to the interplay of Section 85 and *Barnett*. Under this second argument, Midland contends that applying state usury laws to a national bank assignee would "significantly interfere" with the power to set interest rates granted to a national bank by Section 85.

If the Court adopts Midland's first argument, then the decision will stand only for the proposition that state *usury* laws are preempted for national bank assignees. Lower courts probably will conclude that the result is the same for federal savings banks and state banks.[8] The Court's decision would not provide any guidance whether non-usury laws are preempted for an assignee.

However, if the Court adopts Midland's *second* argument, it should be reasonably clear to lower courts that any state law is preempted for an assignee of a national bank if applying the state law to the assignee would significantly interfere with the national bank's authority to operate without regard to the state law.[9] The prognosis for state banks will be less clear. *Barnett* does not apply to state banks. However, a general principle of conflict preemption is that a state law will be preempted any time it stands as an "obstacle to accomplishment" of the objectives of a federal law.[10] (In fact, *Barnett*'s "significant interference" standard is a specific application of this general principle.) It is possible that courts will conclude that state usury laws are still preempted for assignees of state banks, because, otherwise, state usury laws would stand as an obstacle to the accomplishment of the state bank analogue of Section 85.

C. THE SUPREME COURT GRANTS CERTIORARI AND AFFIRMS THE SECOND CIRCUIT

The worst outcome for the financial industry would be if the Supreme Court grants certiorari and then affirms the Second Circuit. The degree of damage inflicted by such a decision will depend on the Court's rationale.

If the Court adopts sweeping reasoning that the NBA never or rarely preempts state laws applicable to third parties that are not national banks, then the decision will significantly curtail the practical ability of a national bank to rely on preemption, especially (but not only) with respect to loans that a national bank plans to sell or securitize. If the Court holds only that applying usury laws to assignees of charged-off debt does not significantly interfere with a national bank's powers, then the impact could be more limited. That approach would leave open the possibility that lower courts can hold that state usury laws are preempted for assignees of national banks in some situations. However, it likely will be years before lower courts reach consensus on what these situations are (if they ever do). In the meantime, the ability of national banks to rely on preemption when making loans likely will be limited.

D. THE COURT GRANTS CERTIORARI, AND REVERSES WITHOUT ADDRESSING THE PREEMPTION ISSUE

A final possibility is that the Court might grant review and decide the case in a way that does not resolve the underlying issue. These outcomes are unlikely, however: the Court typically assesses issues such as these at the certiorari stage and—if it concludes that they preclude reaching the question presented in the certiorari petition—would simply deny review.

- Court Decides Midland Did Not Preserve the Arguments. First, the Court might decide that Midland failed to preserve (or even waived) the two principal arguments that it is making now. Madden is arguing that Midland did not advance either of its two principal arguments—and arguably even explicitly waived them—until its petition for *en banc* review.
- It is indisputable that Midland refined its arguments when it hired new counsel after the Second Circuit panel decision. But it is less clear whether the Court will conclude that Midland's theory of the case changed so dramatically that it failed to preserve the arguments it is making now. In any event, if the Court decides this, then its decision will not resolve the underlying substantive question. The result for the industry would be similar to a denial of certiorari.
- Court Remands for Factual Development. Second, the Court might decide that the factual record with respect to whether application of state law will "significantly interfere" with a national bank's powers needs to be further developed. *This would be a bad result for the financial industry, because it would imply (and perhaps hold explicitly) that* Barnett *presents a question of fact rather than a question of law*. If the question of whether a state law significantly interferes with a national bank's powers is a factual determination, then no decision holding that a state law is preempted under a *Barnett* standard would be precedential. Indeed, it is entirely possible that a state law would be preempted for one national bank and not the others. The net result is that a national bank could never know in advance whether a state law is preempted. The result is that the bank would need to endeavor to comply with state law in most instances. The only alternative would be a thorough factual assessment every time a bank wanted to rely on preemption. This would be impractical in most instances.
- Court Remands to Resolve the State Law Questions. Courts typically do not decide whether a statute is invalid (*e.g.*, because the statute is preempted) unless it is necessary to do so. Generally, this means that a court

should not decide whether a state law is preempted until the court decides that the state law actually applies. Neither the district court nor the Second Circuit definitively concluded that the New York usury law actually prohibits Midland from collecting interest in excess of 25% under the facts of the case. Although the statute does prohibit any person from "charging" or "receiving" interest in excess of that cap, it is possible that state courts would conclude that the valid-when-made doctrine is part of state usury law and that, pursuant to this doctrine, there is no violation *as a matter of state law* for the assignee if the loan was valid when made (because of preemption or otherwise). It is possible that the Court will decide that this state law question must be resolved before the courts decide the preemption question. This result would mean that *Madden* is technically overturned. However, its core holding would not be repudiated, and it would be a specter haunting the financial industry.

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Endnotes

1 786 F.3d 246 (2nd Cir. 2015).

2 New York's usury law prohibits both contracting for and receiving interest in excess of the usury cap. The plaintiff in *Madden* claims that Midland Funding (as defined) violated the usury law by collecting (and also violated the Fair Debt Collection Practices Act by attempting to collect) interest in excess of New York's usury ceiling.

3 Note, however, that the usury limits in some states are fairly low. For example, in Delaware, for certain loans, the usury cap is 5% over the Federal Reserve discount rate.

4 *See Krispin v. May Department Stores Co.*, 218 F 3d 919 (8th Cir. 2000) (where a department store purchased credit card receivables originated by a national bank, but it is "the bank, and not the store, that issues credit, processes and services customer accounts, and sets such terms as interest and late fees . . . it makes sense to look to the originating entity (the bank), and not the ongoing assignee (the store), in determining whether the NBA applies"); *FDIC v. Lattimore Land Corp.*, 656 F.2d 139 (5th Cir. Unit B Sept. 1981) (applying usury law applicable to the state-chartered originator, not the national bank assignee).

5 *Barnett Bank of Marion County v. Nelson*, 517 U.S. 25 (1996). In *Barnett*, the Supreme Court held that the NBA preempts any state law that "prevents or significantly interferes" with a national bank's exercise of its powers.

6 Under the first argument, Midland contends that 12 U.S.C. § 85, on its own, preempts the state usury law for a national bank's assignee. Midland's second argument is that the interplay of 12 U.S.C. § 85 and *Barnett* preempts the state usury law for the national bank's assignee.

7 The states in the Second Circuit are Connecticut, New York, and Vermont.

8 Federal savings banks and state banks derive their authority to charge interest from Section 4(g) of the Home Owners' Loan Act and Section 27 of the Federal Deposit Insurance Act, respectively. These provisions were modeled on Section 85, and courts historically have interpreted them to mirror Section 85 in substance. If the Court holds that Section 85 incorporates the "valid when made" doctrine, then we predict that lower courts will conclude that Section 4(g) of HOLA and Section 27 of the FDIA do as well.

9 This does not automatically mean that any state law preempted for a national bank will be preempted for an assignee of the bank. We could imagine a court holding, for example, that certain state laws that regulate the manner in which the assignee services the loan do not significantly interfere with the national bank's authority to set the terms of the loan without regard to state law restrictions.

10 *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941).

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