OCC AND FDIC PROPOSE RULES TO CONFIRM "VALID-WHEN-MADE" DOCTRINE

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U.S. Depository Institutions Alert

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Over the last two days, the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC") (together, the "Agencies") each issued a proposed rule (collectively, the "Proposed Rules") that would codify the Agencies' position that the interest on a loan originated by a bank, if permissible when the loan was made, will continue to be a permissible and an enforceable term of the loan following the sale, assignment, or transfer of the loan. This is known as the "valid-when-made" doctrine.

BACKGROUND

The Proposed Rules would effectively overrule the Second Circuit Court of Appeals' decision in the case of *Madden v. Midland Funding* and cases in other judicial circuits that have followed it. [1] In that case, decided in 2015, the Second Circuit made news in the marketplace lending industry — and the market for bank-originated debt more broadly — when it held that a nonbank purchaser of bank-originated credit card debt was subject to New York State's usury laws.

In *Madden*, Midland Funding purchased the plaintiffs' charged-off credit card debt from a national bank, FIA National Bank, which had purchased the debt from Bank of America, the original lender. Midland Funding sought to collect the debt. The Second Circuit held that Midland Funding violated the Fair Debt Collection Practices Act by falsely representing the amount of interest it was entitled to collect. The court held that the purchaser of charged-off debt from a national bank does not inherit the preemptive interest rate authority of the national bank under Section 85 of the National Bank Act. Accordingly, the credit debt was subject to the usury limitations provided by state law, in this case, the law of New York. The interest rate exceeded the allowed amount under New York law. In June 2016, the U.S. Supreme Court denied the defendants' petition for writ of certiorari.

ACTIONS TAKEN SINCE THE DECISION

Following the *Madden* decision, trade press has indicated that lending has plummeted in the states comprising the Second Circuit (Vermont, Connecticut, and New York). The marketplace lending and securitization industries, among others, have engaged lawmakers on the issue frankly since the decision. In 2016, Congressman Patrick McHenry (R-NC) introduced the "Protecting Consumers Access to Credit Act of 2016" (H.R. 5724) to overturn *Madden* by providing that a loan is valid when made as to its maximum rate of interest in accordance with federal law would remain valid with respect to such rate regardless of whether the loan was subsequently sold, assigned, or otherwise transferred to a third party, and it could be enforced by such third party notwithstanding any state law to the contrary. He reintroduced the bill (H.R. 3299) in 2017 with Congressmen Meeks (D-NY), Gwen Moore (D-WI), and Trey Hollingsworth (R-IN), and Senator Warner (D-VA) introduced the bill in the Senate (S. 1642). The

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bill passed the House of Representatives by a vote of 245–171, but it was not taken up by the Senate Banking Committee.

By recognizing the "valid-when-made" doctrine, these bills would have (1) given impetus to the marketplace lending and securitization markets, (2) helped normalize lending in states subject to the *Madden* rule, (3) reduced the bias between primary and secondary loan markets, and (4) assisted the securitization market and other avenues through which consumer loans are sold to nonbank entities. In response to congressional gridlock and requests by various members of Congress to act, [2] the Agencies took action to address *Madden* at the suggestion of the Treasury Department.

OCC AND FDIC PROPOSALS

On Monday, November 18, 2019, the OCC proposed a rule that would codify that: "Interest on a loan that is permissible under 12 U.S.C. 85 shall not be affected by the sale, assignment, or other transfer of the loan." [3] On Tuesday, November 19, 2019, the FDIC proposed a substantively identical rule. [4]

The Agencies take the position that federal law establishes that a national bank or insured state bank may enter into a loan contract, charge interest at the maximum rate permitted in the state where it is located, and subsequently assign the loan with preemption of usury laws in the states where investors may be located. The proposals state that preemption of state usury laws in this manner is a fundamental building block of the nation's banking system, particularly the primary and secondary lending and securitization markets. Stating that banks of all sizes continue to routinely rely on loan assignments and securitizations to access alternative funding sources, manage concentrations, improve financial performance ratios, and more efficiently meet customer needs, the Proposed Rules provide that "this risk management tool would be significantly weakened if the permissible interest rate on assigned loans were uncertain or if assignment of the permissible interest rate were limited only to third parties that would be subject to the same or higher usury caps."

While the Proposed Rules would codify the "valid-when-made" doctrine, neither proposal addresses the companion "true lender" doctrine. Per the "true lender" doctrine, the entity that makes a loan and then assigns it to a third party is the "true lender." This issue has arisen in much litigation that has alleged that the lender of record in loans made through a partnership between a nonbank lender and a regulated bank is not the actual lender but is simply "renting" its charter to a nonbank to permit it to avoid state licensing and usury restrictions. The "true lender" issue is outside the scope of the Proposed Rules because both the FDIC and the OCC are concerned by the use of bank charters to evade valid legal restrictions. As the FDIC stated in the preamble to its proposal, "[The FDIC] will view unfavorably entities that partner with a State bank with the sole goal of evading a lower interest rate established under the law of the entity's licensing State."

EFFECT OF THE PROPOSED RULES

Assuming the Proposed Rules are adopted substantially as proposed, there should be less likelihood of suits affecting the sales of loans by either national or state banks outside of the Second Circuit. Even in the Second Circuit, the final rules may solve the problem in that the court could re-consider its analysis now with the benefit of the federal banking agencies' explanation of the basis for their rules and the fundamental nature of the "valid-when-made" doctrine. Of course, loan sales and enforcement of loans involving the issue of the true lender would still be possible.

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K&L Gates is available to assist interested stakeholders wishing to engage with the OCC, FDIC, and other policymakers about these rules.

NOTES

[1] 786 F.3d 246 (2d Cir. 2015), *cert denied*, 136 S.Ct. 2505 (2016).

[2] Letter from Patrick McHenry, Ranking Member of the House Financial Services Committee, to Comptroller Otting (Sept. 19, 2019).

[3] Notice of Proposed Rulemaking, Permissible interest on loans that are sold, assigned, or otherwise transferred, RIN 1557-AE73 (Nov. 18, 2019).

[4] Notice of Proposed Rulemaking, Federal Interest Rate Authority, RIN 3064-AF21 (Nov. 19, 2019).

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