OCC Issues Final "Valid-When-Made" Rule: Does it End the Madness of Madden v. Midland Funding?

By Alexander R. Green, Joann Needleman / Jun 02, 2020

Last Friday, the Office of the Comptroller of the Currency ("OCC") issued a final rule providing that interest rates established on debt originated by a national bank remain valid even after the debt is transferred to a nonbank entity, including a third-party debt purchaser. The move was an answer to the case of *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015) where the U.S. Court of Appeals for the Second Circuit held that a purchaser of a loan originated by a national bank was not entitled to the interest rate protections afforded under the National Bank Act ("NBA"). Specifically, the NBA permits a bank to charge interest at the highest rate allowed by the state where the bank is located and to export this rate to borrowers in other states. Given the Second Circuit's narrow focus on the NBA to banks rather than non-banks, it remains to be seen whether the OCC's rule will survive judicial scrutiny. However, the rule certainly is a step towards restoring certainty to the financial services industry following the confusion left by *Madden*.

Background: Madden Out-of-Place in the NBA

The NBA is a century's old law which provides for a system of national banks to serve as "instrumentalities of the federal government," *Davis v. Elmira Sav. Bank*, 161 U.S. 275, 283 (1896), which are "designed to be used to aid the government in the administration of an important branch of the public service." *Farmers' & Mechanics' Nat'l Bank v. Dearing*, 91 U.S. 29, 33 (1875). The NBA permits national banks to operate nationwide and provides such banks with "protection from 'possible unfriendly State legislation.' *Beneficial Nat'l Bank v. Anderson*, 539 U.S. 1, 10 (2003) (quoting *Tiffany v. Nat'l Bank of Mo.*, 85 U.S. 409, 412 (1873)).

One such protection afforded national banks is the ability to preempt state's usury laws. Section 85 of the NBA allows national banks to charge interest rates allowed by their home state, notwithstanding the usury limits found in other states. See 12 U.S.C. § 85; see also *id.* at § 1463(g) (providing the same protection to "savings associations"). This is commonly known as the "most favored lender" doctrine. As explained by the OCC in its analysis of the proposed rule, the purpose of Section 85 is "to facilitate banks' ability to operate across state lines by eliminating the burden of complying with each state's interest laws." 84 Fed. Reg. 64231 (November 21, 2019).

Madden put the scope of Section 85 of the NBA to the test. There, a customer sued a third-party debt purchaser for applying a usurious interest rate. Although the debt originated with a national bank located in Delaware, it was subsequently charged-off and sold to the defendant, which in turn attempted to collect the debt in New York. The issue arose because the interest rate, while permissible in Delaware, was considered usurious in New York.

In allowing the lawsuit to proceed, the Second Circuit held that, while the NBA preempts "analogous state-law usury claims," such preemption can only be extended to non-national bank entities under "certain circumstances" – namely, where "application of state law to that action must significantly interfere with a national bank's ability to exercise its power under the NBA." *Madden*, 786 F.3d at 250. Ultimately, the Second Circuit determined that an interest rate cap imposed on third-party debt purchasers does not constitute a significant interference with the operations of a national bank. In reaching its determination, the Second Circuit relied heavily on the then-current guidance from the OCC which "made clear that third-party debt buyers are distinct from agents or subsidiaries of a national bank." Id.

Absent from the *Madden* opinion was any discussion of the long-standing "valid-when-made" doctrine. Under this longstanding doctrine, if the interest rate in the original loan agreement was non-usurious, then the loan cannot become usurious upon assignment. See, e.g., *Gaither v. Farmers' & Mechs. Bank of Georgetown*, 26 U.S. 37 (1828); *Nichols v. Fearson*, 32 U.S. 103, 109 (1833). In other words, any assignee of a loan may lawfully charge interest at the original rate.

The Second Circuit's incomplete holding in *Madden* resulted in uncertainty across the country. Some courts have upheld and confirmed the opinion. See, e.g., *Edwards v. Macy's Inc.*, 2016 WL 922221, at *7 (S.D. N.Y. 2016) ("The Second Circuit has indeed held that OCC preemption extends to an entity that is not a national bank only where that entity is an agent or subsidiary of a national bank or is otherwise acting on behalf of the national bank in carrying out the bank's business.") (citing *Madden*). Other courts have rejected it. See, e.g., In re *Rent-Rite Superkegs W.*, Ltd., 603 B.R. 41, 66, 67 n. 57 (Bankr. D. Colo. 2019) (expressly disagreeing with *Madden* and observing that, "[i]n the Court's view, the 'valid-when-made' rule remains the law").

The OCC Provides a New Interpretation of the NBA

Hoping to "resolv[e] the legal uncertainty created by the *Madden* decision," the OCC clarified last Friday that a national bank may transfer a loan without impacting the permissibility or enforceability of the interest rate in the original loan agreement. The OCC explained that Section 85 of the NBA not only establishes that a national bank may lend money but also permits the bank to "subsequently transfer that loan and assign the loan contract." The OCC, however, noted that the NBA did not "expressly address how the exercise of a national bank's authority to transfer a loan and assign the loan contract affects the interest term." The OCC, therefore, sought to interpret Section 85 to resolve this silence. In doing so, it observed that multiple commenters provided "evidence that *Madden* restricted access to credit for higher-risk borrowers in states within the Second Circuit and that it caused a rise in personal bankruptcies due to a decline in marketplace lending, especially for low-income households." The agency also noted that its interpretation is consistent with the principals of the "valid-when-made" doctrine.

Takeaway

It is believed that the OCC's final rule will be challenged, given that the Second Circuit did, rely, to some extent, on the OCC's current guidance which distinguished third-party debt purchasers from agents/subsidiaries of national banks. The agency readily acknowledged in its commentary that several commenters questioned the OCC's authority to issue such a rule. While the OCC's final rule may be a significant step towards restoring certainty to whether debt purchasers benefit from the NBA's preemption of state usury laws, it is unlikely this is the end to the madness.

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