May 26, 2016

United States Recommends that the Supreme Court Deny Review in *Midland Funding* v. *Madden*

Government's Brief Argues that the Second Circuit Erred in Finding No Preemption, but Supreme Court Consideration is Not Warranted

In its decision last year in *Madden* v. *Midland Funding, LLC,* the Second Circuit held that, after a national bank sells its loans to a third party, the National Bank Act no longer preempts state usury laws that would otherwise apply to the interest rates on those loans.[1] The decision has caused considerable uncertainty among banks, debt buyers, and the securitization industry, among others. Various industry groups filed amicus briefs in support of the defendants' petition for Supreme Court review.

On May 24, 2016, the Solicitor General—joined by attorneys from the Office of the Comptroller of the Currency, which administers the National Bank Act—filed an amicus brief at the Supreme Court's invitation.[2] While the brief argues that the Second Circuit erred in its preemption holding, the brief nevertheless recommends that the Supreme Court deny review because there is no circuit split and the case is not a good vehicle for considering the issue presented.

The government's mixed brief adds to the complexity that already surrounds whether the eight-member Court will take up the case. While the Supreme Court generally gives weight to the Solicitor General's recommendation on whether to grant review, it is likely that the Court will find the government's views on the merits of the preemption issue of most interest. By contrast, the nature of the circuit split and the potential "vehicle" issues were more or less apparent, and the government's brief does not meaningfully address, one way or the other, the practical consequences of allowing the Second Circuit decision to stand. Given the government's view on the preemption issue, and in light of the broad concern about the decision's effects on the financial services sector in New York, it remains possible that the Court will decide to hear the case.

Background

Section 85 of the National Bank Act (NBA) permits a national bank to charge interest on loans at the rate permitted by the bank's home state and preempts the usury laws of other states. In this case, defendant Midland Funding purchased charged-off credit card debt from a national bank and attempted to charge interest at the credit card agreement's 27% interest rate.[3] The debtor sued, arguing that this attempt to enforce a 27% interest rate violated New York's civil and criminal usury laws.[4] The Second Circuit rejected the defendants' argument that the NBA preempted the application of New York's usury law, reasoning

that defendants were neither a national bank nor the agents of a national bank. The court further reasoned that applying state usury laws to a third-party debt purchaser would not "significantly interfere" with the exercise of a national bank's power to make loans because national banks could still sell those loans to third parties, although for a lesser price.

The United States' Amicus Brief

Preemption analysis. The Solicitor General's brief argues that the Second Circuit erred in its preemption holding. According to the government, a national bank's right under the NBA to originate loans that charge interest up to the rate allowed in the bank's home state would be "significantly impaired" if the bank's assignee could not continue to charge that rate. For this proposition, the brief cites the "long-established 'valid-when-made rule,'" which says that if the bank's original interest rate was not usurious, the loan does not become usurious upon assignment, "and so the assignee may lawfully charge interest at the original rate." The Second Circuit "failed to appreciate the significance of that principle in this case." The brief also states that, in the aggregate, the value of a national bank's loan portfolio could be "significantly diminished" if the bank could not transfer to assignees the right to charge the original rate of interest.

The government also maintains that the Second Circuit's analysis reflects an "unduly crabbed" concept of NBA preemption and of implied-conflict preemption generally. The brief explains that a state law that precludes a national bank from "fully exercising" its power under the NBA—which includes conveying to an assignee the right to charge the original interest rate—is preempted. Preemption does not require a showing that usury laws would reduce the price that a national bank could command for its loans, "let alone a showing that state law would 'prevent consumer debt sales by national banks to third parties.'"

Recommendation against review. Despite its conclusion that the Second Circuit erred, the Solicitor General's brief argues that Supreme Court review is not warranted at this time. The brief states that there is no circuit split on the issue presented and that the cases identified by the defendants as creating a circuit split are all distinguishable.

The brief also asserts that the case would be a "poor vehicle" for resolving the question presented. First, the parties failed to present the full range of preemption arguments in the courts below, including a failure clearly to make a conflict-preemption argument and a lack of emphasis on the valid-when-made rule. The second vehicle issue is that the Second Circuit's decision is interlocutory and resolving the question presented might not affect the outcome of the case. For instance, the brief points out that the Second Circuit remanded for consideration of the Delaware choice-of-law provision in the credit card agreement. The brief states that the parties "appear to agree" that the interest rate charged would be permissible under Delaware law.

In addition, the defendants could prevail on remand if the courts below determine that New York usury law incorporates the valid-when-made rule. On this issue, the brief goes on to say that the "practical importance of the preemption issue presented in this case depends significantly on the extent to which individual States decline to incorporate the valid-when-made rule into their own usury laws," and that the defendants "have made no effort" to demonstrate that state-law departures from this rule have been widespread.

Conclusion

In the near term, companies will continue to have great uncertainty as to how to structure financial transactions in light of the Second Circuit's *Madden* decision. For example, the decision impacts national banks' ability to sell loans to third parties who may securitize loans on the secondary market. One *amici curiae* brief cites a large market of securitized loans that could potentially be affected: $178 billion in automobile loan securitizations, $135 billion in credit card securitizations, $216 billion in student loan securitizations and $136 billion in other consumer loan securitizations.[5] Excluding loans that could be subject to usury laws in various states from securitization vehicles may be infeasible or could damage the value of the securitization.

It is unclear how the Solicitor General's brief will affect the Supreme Court's decision to grant review. The government's criticism of the Second Circuit's preemption analysis was cogently made, and the Court may be concerned about the practical effects of allowing the Second Circuit's decision to stand. The Court does sometimes grant review over the Solicitor's General's contrary recommendation.[6]

A copy of the Solicitor General's amicus brief is available here.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Susanna M. Buergel
212-373-3553
sbuergel@paulweiss.com

Jay Cohen
212-373-3163
jaycohen@paulweiss.com

Roberto J. Gonzalez
202-223-7316
rgonzalez@paulweiss.com

Brad S. Karp
212-373-3316
bkarp@paulweiss.com

Jane B. O'Brien
202-223-7327
jobrien@paulweiss.com

Elizabeth M. Sacksteder
212-373-3505
esacksteder@paulweiss.com

Jordan E. Yarett
212-373-3126
jyarett@paulweiss.com

T. Robert Zochowski Jr.
212-373-3762
rzochowski@paulweiss.com

Associate Julian Nahuel Radzinschi contributed to this client alert.

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[1] *Madden* v. *Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015).

[2] Brief for the United States as Amici Curiae, *Midland Funding, LLC* v. *Madden*, (No. 15-610), 2016 WL 2997343.

[3] The other defendant is Midland Credit Management, Inc., which services Midland Funding's accounts.

[4] A 27% interest rate is permitted by Delaware, which was the home state of the originating national bank, but is usurious under New York law.

[5] Brief for the Structured Fin. Indus. Grp., Inc., and the Sec. Indus. and Fin. Markets Ass'n as Amici Curiae Supporting Petitioners, *Midland Funding, LLC* v. *Madden*, (No. 15-610), 2015 WL 9184796.

[6] *See, e.g.*, *Bank Markazi* v. *Peterson*, 136 S.Ct. 1310 (2016).