



Federal Banking Regulators Can and Should Resolve *Madden* and True Lender Developments¹

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Contents

- I. Executive Summary 1
- II. The *Madden* and True Lender Developments Challenge Core Bank Lending Activities and a Nationwide Lending Market 1
 - A. *Madden v. Midland Funding* 2
 - B. The “True Lender” Concept..... 4
 - C. Concerns Raised by *Madden* and True Lender Developments 5
- III. Federal Banking Regulators Can, and Should, Provide Certainty Through Regulation 6
- IV. Statutory Authority for Federal Regulatory Action 8
- V. Conclusion 10

I. Executive Summary

The ability of banks to sell the loans they originate is a core element in the development and sustainability of a nationwide lending market. Recent legal developments threaten to undermine this ability, jeopardizing the foundation of a U.S. nationwide loan market and the core lending activities of banks.

A long-settled legal principle known as the “valid-when-made” doctrine has served for almost two centuries as the bedrock for bank lending. This doctrine has been threatened by a court case, *Madden v. Midland Funding, LLC*, which failed to acknowledge or address the doctrine.² At the same time, in the face of extreme facts in the payday lending context, state legislatures and courts have also been seeking to restrict the ability of banks to assign or sell loans, applying a so-called “true lender” analysis in certain limited circumstances to deem an entity that does *not* extend a loan to be “the true lender.” These developments, while intended in many cases to address important consumer protection concerns arising in payday lending, threaten to interfere with the core powers afforded to banks under federal law and undermine the smooth functioning of our financial system.

This white paper argues that federal banking regulators should take action to protect the existence of a national consumer and small business lending market and clarifying uniform standards for consumer protection. We believe that balancing the important goals of consumer protection, availability of credit through a national lending market, and safe and sound bank lending—especially at a time of rapid technological change and innovation—is better achieved by federal banking regulators, who can establish standards across banks rather than through piecemeal efforts by courts deciding on individual cases that often present extreme facts. A national lending market, where consumers and businesses are able to access credit from many potential bank lenders through online services, will flourish best under uniform nationwide lending and consumer protection standards rather than a state-by-state patchwork of requirements.

In support of a federal regulatory approach to address the *Madden* and true lender challenges, this white paper:

- describes the uncertainty to bank lending caused by *Madden v. Midland Funding, LLC* and the emergence of the true lender concept;
- describes a federal regulatory approach to resolve this uncertainty; and
- supports a federal regulatory approach by identifying the statutory authority for the federal banking regulators to promulgate the proposed regulations.

II. The *Madden* and True Lender Developments Challenge Core Bank Lending Activities and a Nationwide Lending Market

A critical component of the U.S. financial system and traditional bank lending involves the ability of banks to originate loans and transfer loan risk off their balance sheets to the markets. Banks routinely sell loans to third parties in the normal course of their lending activities as a means of managing risk and expanding their ability to provide credit to customers.

² *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015), cert. denied, 136 S. Ct. 2505 (2016).

U.S. banks have increasingly partnered with nonbank service providers to gain economies of scale, manage risks, and innovate and expand their lending services, particularly to individuals and small businesses. For example, banks partner with third parties to syndicate and securitize loans. In addition, the development of partnerships with marketplace lending platforms have expanded access to credit by allowing banks to more efficiently identify qualified borrowers and engage in loan origination and servicing.

These core lending activities of U.S. banks are based upon a long-standing legal principle: the “valid-when-made” doctrine. This doctrine, recognized by Supreme Court precedent almost two hundred years ago, provides that a loan that is valid at its inception cannot become usurious upon subsequent sale or transfer to another person.³ In 1828, the U.S. Supreme Court confirmed that a non-usurious loan could not subsequently become usurious by reason of its sale, observing that “the rule cannot be doubted, that if the note [is] free from usury, in its origin, no subsequent usurious transactions respecting it, can affect it with the taint of usury.”⁴ In 1833, the U.S. Supreme Court stated that one of the “cardinal rules” of usury is that the determination of whether a loan is usurious occurs at the time of its origination:⁵

There are two cardinal rules in the doctrine of usury, which we think must be regarded as the common-place to which all reasoning and adjudication upon the subject should be referred. The first is, that to constitute usury, there must be a loan in contemplation by the parties; and the second, that a contract, which, in its inception, is unaffected by usury, can never be invalidated by any subsequent usurious transaction.

Recent court cases have created uncertainty in the application of the valid-when-made doctrine, including the *Madden* case in 2015. In addition, the development by some state legislatures and state courts of a “true lender” concept in the context of payday lending creates further uncertainty in the ability of banks to sell loans they have originated.

A. *Madden v. Midland Funding*

The most prominent decision creating uncertainty in the application of the valid-when-made doctrine is *Madden v. Midland Funding, LLC*. This decision has been broadly criticized by a wide range of policy makers and regulators.

The case involved a putative class action brought by Saliha Madden, a New York resident who opened a credit card account with Bank of America, a national bank, in 2005.⁶ A year later, Bank of America’s credit card program was consolidated into another national bank, FIA Card Services, N.A. (**FIA**), which subsequently charged off Madden’s account as uncollectible and sold the debt to Midland Funding, LLC

³ American and English courts recognized this cardinal valid-when-made rule before the U.S. Supreme Court. See, e.g., *Watkins v. Taylor*, 16 Va. 424, 436 (1811) (“[I]f it was not usury at the time when the contract was entered into, no after circumstance can make it so; and any argument, therefore, drawn from after circumstances, would be improper.”); *Munn v. Comm’n Co.*, 15 Johns. 44, 55 (N.Y. Sup. Ct. 1818) (stating that where a loan is “free from usury, between the immediate parties to it, no after transaction with another person can, as respects those parties, invalidate it”); *Tuttle v. Clark*, 4 Conn. 153, 153 (1822) (“[I]t was an effective instrument in his hands, and not being usurious in its original concoction, it did not become so, by the subsequent sale to the plaintiffs.”); *Tate v. Wellings*, 100 Eng. Rep. 716, 721 (K.B. 1790) (opinion of Buller, J.) (“Here the defence set up is that the contract itself was illegal; and in order to support it, it must be shewn that it was usurious at the time when it was entered into; for if the contract were legal at that time, no subsequent event can make it usurious.”); see also 1 William Blackstone, *Commentaries* 355, 379 n.32 (18th ed. 1838) (“The usury must be part of the contract in its inception. . . .”).

⁴ *Gaither v. Farmers & Mechs. Bank of Georgetown*, 26 U.S. (1 Pet.) 37, 43 (1828).

⁵ *Nichols v. Fearson*, 32 U.S. (7 Pet.) 103, 109 (1833).

⁶ *Madden*, 786 F.3d at 247.

(Midland Funding).⁷ Through its affiliate, Midland Credit Management, Inc. (**Midland Credit**), Midland Funding sought to collect Madden's debt at an interest rate of 27% per year, pursuant to the terms of the credit card agreement with Bank of America, as amended.⁸ Neither Midland Funding nor Midland Credit is a national bank. In response, Madden filed suit against Midland Funding and Midland Credit on behalf of herself and a putative class asserting, among other things, a violation of New York's state usury law, which imposed a maximum interest rate of 25%.⁹

The district court held that the National Bank Act's preemption of state usury limits applied to the debt, which precluded Madden's state law usury claim.¹⁰ The U.S. Court of Appeals for the Second Circuit reversed the district court's decision and held that the National Bank Act did not preempt Madden's state law usury claim because Midland Funding and Midland Credit are not national banks or subsidiaries or agents of a national bank, were not acting on behalf of a national bank, and thus were not entitled to National Bank Act preemption.¹¹ The Second Circuit's decision thus is inconsistent with the valid-when-made doctrine,¹² but the Second Circuit failed to analyze—or even acknowledge—the doctrine.

The Second Circuit's decision in *Madden* was swiftly met with criticism from a remarkably wide range of legal experts. In a series of amicus briefs in support of rehearing by the U.S. Court of Appeals for the Second Circuit of its decision in *Madden* and a petition for a writ of certiorari, various industry groups argued that *Madden* contradicts long-standing precedent and industry expectations regarding usury law, and poses serious challenges to the efficient functioning of credit markets.¹³ In a brief for the United

⁷ *Id.* at 248.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.* at 249.

¹² Several state attorneys general recently asserted in a letter to Congress that the holding in *Madden* is not contrary to the long-standing valid-when-made doctrine because that doctrine addresses a "very different legal principle" than the one addressed in *Madden*—that "a valid loan is not invalidated by a later usurious transaction involving the loan." Letter from Various State Att'ys Gen. to Mitch McConnell, Majority Leader, U.S. Senate, et al. (June 27, 2018), <http://www.ncdoj.gov/getattachment/946a5ba8-3eaa-423f-a720-6210bd4aec1e/Real-FINAL-Multistate-Letter-to-Congress-re-HR-3299-and-4439.pdf.aspx> (writing in opposition to HR 3299 ("Protecting Consumers' Access to Credit Act of 2017") and HR 4439 ("Modernizing Credit Opportunities Act")). The letter supports its assertion by looking to the specific facts underlying the U.S. Supreme Court's decision in *Nichols* in 1883, stating that the *Madden* decision would implicate the valid-when-made doctrine only if "the consumer borrower in *Madden* had argued that the bank sold her loan to a debt buyer at a usurious discount, and that this usurious loan from the debt buyer to the bank somehow invalidated the consumer's own loan." *Id.* But the letter's argument defeats itself: if a loan remains valid even if it is later part of a usurious transaction, then, *a fortiori*, it remains valid when it simply changes hands without introducing an element of usury. And, while a comprehensive analysis of all cases implicating the valid-when-made doctrine is outside the scope of this white paper, courts have not limited the valid-when-made doctrine to those instances in which a loan is sold or otherwise transferred at an allegedly usurious discount and instead have applied it to a wide range of circumstances involving the transfer or assignment of a loan. See, e.g., *Olvera v. Blitt & Gaines, P.C.*, 431 F.3d 285, 289 (7th Cir. 2005) (observing that "once assignors were authorized to charge interest, the common law kicked in and gave the assignees the same right, because the common law puts the assignee in the assignor's shoes, whatever the shoe size."); *FDIC v. Lattimore Land Corp.*, 656 F.2d 139, 148-49 (5th Cir. 1981) (stating that "[t]he non-usurious character of a note should not change when the note changes hands."); *Strike v. Trans-West Disc. Corp.*, 155 Cal. Rptr. 132 (Cal. Ct. App. 1979) (holding that the purchaser of a loan from a bank is exempt from usury law because the bank was exempt). See generally 44B Am. Jur. 2d Interest and Usury § 65 (2018) ("[t]he usurious nature of a transaction is established at the inception of the transaction. The essential elements of usury therefore must exist at the inception of the contract. It is the agreement to exact and pay usurious interest, and not the performance of the agreement, which renders it usurious. Stated otherwise, a contract is not usurious on its face merely because of the fact that circumstances may arise in the future which could result in the contract becoming usurious.").

¹³ See Brief of the Clearing House Association, L.L.C. et al. as Amici Curiae Supporting Petitioners, *Midland Funding, LLC v. Madden*, 786 F.3d 246 (2d Cir. 2015) (No. 14-2131-CV), 2015 WL 4153963; Brief of the American Bankers Ass'n et al. as Amici Curiae Supporting Petitioners, *Madden*, 786 F.3d 246 (No. 14-2131-CV) 2015 WL 4153962; Brief of the Structured Finance Industry (*cont.*)

States as amicus curiae, the Obama Administration’s Solicitor General (**SG**) and the Office of the Comptroller of the Currency (**OCC**) called the decision “incorrect” with an “analysis reflect[ing] a misunderstanding” of section 85 of the National Bank Act and Supreme Court precedent. The SG and OCC’s brief stated that the Second Circuit failed to properly consider the valid-when-made doctrine and “a loan that was valid when made will not be rendered usurious by the transfer.”¹⁴

Representative Patrick McHenry has stated that *Madden* “will restrict the expansion of credit and restrict innovation [and] poses a risk to the secondary credit markets.”¹⁵ Senator Pat Toomey described *Madden* as “a big departure from the practice and the precedent that had prevailed under the valid when made principle,” and asserted that *Madden* has resulted in “uncertainty on the part of a potential buyer of a bank asset, uncertainty as to whether or not these usury laws will apply” and “a dramatic reduction in credit access for low income people.”¹⁶ Comptroller of the Currency Otting has agreed that the *Madden* ruling was “inaccurate.”¹⁷ Former deputy director of the Bureau, Raj Date, cautioned that *Madden* “is not just legally wrong; it is also bad public policy, because it moves us further away from creating a more effective and inclusive financial system,” and called upon Congress to reverse it.¹⁸

B. The “True Lender” Concept

Recent “true lender” developments also threaten banks’ chartered powers to originate and sell loans.¹⁹ The true lender theory—which has principally been asserted in the context of payday lending—involves a

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Group, Inc. et al. as Amici Curiae Supporting Petitioners, *Madden*, 786 F.3d 246 (No. 14-2131-CV), 2015 WL 4153964; Brief of ACA Int’l et al. as Amici Curiae Supporting Petitioners, *Madden*, 786 F.3d 246, (No. 15-610) 2462015 WL 9184797; Brief of the Structured Finance Industry Group, Inc. et al. as Amici Curiae Supporting Petitioners, *Madden*, 786 F.3d 246 (No. 15-610), 2015 WL 9184796; Brief of the American Bankers Ass’n et al. as Amici Curiae Supporting Petitioners, *Madden*, 786 F.3d 246 (No. 15-610) 2015 WL 8959419; Brief of the Clearing House Association, L.L.C. et al. as Amici Curiae Supporting Petitioners, *Madden*, 786 F.3d 246 (No. 15-610) 2015 WL 8489383.

¹⁴ Brief for the United States as Amici Curiae Supporting Respondent at 20, *Madden*, 786 F.3d 246 (No. 15-610) 2016 WL 2997343. The SG and OCC ultimately asserted that the petition for a writ of certiorari should be denied, but on other grounds, including because *Madden* would have been a poor vehicle for the Court to consider these issues, in part because of the poor briefing and the failure of the Second Circuit even to have considered the valid-when-made doctrine in its opinion.

¹⁵ Rachel Witkowski, *Legislation Proposed to Counteract Court Ruling on State Usury Caps*, WALL ST. J. (July 11, 2016, 7:16 PM), <https://www.wsj.com/articles/legislation-proposed-to-counteract-court-ruling-on-state-usury-caps-1468278817>. For additional examples of Congressional criticism of the *Madden* decision, see Rachel Witkowski, *Bill to unwind Madden ruling clears House, but Senate is question mark*, AM. BANKER (Feb. 14, 2018, 5:21 PM) (“The [*Madden*] decision has caused considerable uncertainty and risk for many types of bank lending programs . . . [b]eing able to offer consistent terms nationwide is vital to scaling the marketplace lending business, which in turn allows lenders to access cheaper investment capital and then pass the savings on to the borrowers.” (quoting Rep. Hensarling)), <https://www.americanbanker.com/news/bill-to-unwind-madden-ruling-clears-house-but-senate-is-question-mark?tag=00000156-32ff-d79b-a377-3effa4570000>; 164 CONG. REC. H1151 (daily ed. Feb. 14, 2018) (statement of Rep. Rothfus) (“At the Financial Services Committee, we have extensively discussed the difficulty that many Americans face in getting credit. *Madden v. Midland* will only intensify that challenge for families and Main Street businesses as it jeopardizes the ability of banks to sell loans into the secondary market.”); Zach Carter, *This Democrat Is About To Give Payday Lenders A Big Boost*, HUFFINGTON POST (Nov. 14, 2017, 8:00 AM) (“The Second Circuit in *Madden v. Midland* upset well over a century of established practice when it limited national banks’ ability to sell loans to purchasers in other states.” (quoting spokesperson on behalf of Sen. Warner)), https://www.huffingtonpost.com/entry/payday-lenders-democrats_us_5a0a211ee4b0bc648a0d5325.

¹⁶ *Update from the Comptroller of the Currency: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 115th Cong. (2018) (testimony of Joseph M. Otting, Comptroller, Off. of the Comptroller of the Currency).

¹⁷ *Id.*

¹⁸ Raj Date, *Madden ruling was a step backward. Congress should fix it*, AM. BANKER: BANKTHINK (Dec. 4, 2017, 9:30 AM), https://www.americanbanker.com/opinion/madden-ruling-was-a-step-backward-congress-should-fix-it?utm_campaign=bankthink-c-Dec%204%202017%E2%80%A6.

¹⁹ See, e.g., *CashCall, Inc. v. Morrissey*, No. 12-1274, 2014 WL 2404300 (W.Va. May 30, 2014); *Meade v. Avant of Colo., LLC*, No. 17-CV-0620-WJM-STV, 2018 WL 1101672 (D. Colo. Mar. 1, 2018); *Meade v. Marlette Funding, LLC*, No. 17-CV-00575-PAB-MJW, 2018 WL 1417706 (D. Colo. Mar. 12, 2018); *Consumer Fin. Prot. Bureau v. CashCall, Inc.*, No. 2:15-CV-07522-JGB, 2018 WL (cont.)

claim by a borrower or regulator that the supposed “true lender” of a loan funded by a bank is a nonbank partner of the bank, rather than the bank itself. Some state courts adopting this approach have applied a new test, asking whether the bank or its nonbank partner holds the so-called “predominant economic interest” to determine which is the “true lender.”

The true lender concept appears to have originated in Georgia in 2004 as the result of efforts by Georgia’s state legislature to address concerns about certain payday lending practices in that state.²⁰ The Georgia Payday Lending Law codified a predominant economic interest test to determine when a “purported agent shall be considered a de facto lender” for purposes of applying state usury laws to payday loans.²¹ In 2007, the Supreme Court, Appellate Division, Third Department of New York cited the predominant economic interest test in the context of payday lending arrangements.²² In 2014 the West Virginia Supreme Court, citing the aforementioned New York case, affirmed the trial court’s application of the predominant economic interest test to conclude that CashCall, Inc. (**CashCall**), a nonbank payday lender, was the “true lender” of the payday loans at issue, and in turn that the payday loans were usurious.²³ Courts in other jurisdictions, including California²⁴ and Maryland²⁵ have looked to *CashCall* and its predecessors in applying a true lender and predominant economic interest theory to payday lending. And plaintiffs and state regulators have recently sought to extend the “true lender” analysis beyond the narrow context of payday lending to undermine marketplace lending partnerships.²⁶

This true lender approach and the associated predominant economic interest test thus have spread to a number of states, and plaintiffs and regulators are seeking to apply it to non-payday lenders. We believe this is an unprincipled and unwarranted extension of the doctrine that poses a growing threat to banks’ ability to enter into responsible, safe and sound partnerships with nonbank service providers to extend responsible credit products. If a test like the predominant economic interest test were to be applied wholesale to our financial system as a caveat to the established lending powers of national and state-chartered banks and the validity of their originated loans, there would be substantial disruption to the financial system upon which all Americans rely. As with the *Madden* case, these true lender developments bring uncertainty into an area of law that should be straightforward.

C. Concerns Raised by *Madden* and True Lender Developments

The *Madden* decision and the true lender developments likely reflect efforts by courts and state legislatures to address important consumer protection concerns arising from extreme and abusive conduct in payday lending. As the uncertainty resulting from *Madden* and the true lender concept demonstrates, however, policy makers seeking to address abusive conduct in the payday lending context

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485963 (C.D. Cal. Jan. 26, 2018). Additional true lender actions are in progress in a number of jurisdictions. See, e.g., *Indelicato v. Kabbage, Inc.*, No. 1:17-CV-11976 (D. Mass. Oct. 12, 2017) (court entered an order on March 6, 2018 staying the proceedings pending the outcome of arbitration); *Granger v. Great Plains Lending, LLC*, No. 1:18-CV-00112 (M.D.N.C. Feb. 16, 2018).

²⁰ See John Hannon, *The True Lender Doctrine: Function over Form as a Reasonable Constraint on the Exportation of Interest Rates*, 67 DUKE L.J. 1261, 1280 (2018).

²¹ Ga. Code Ann. § 16-17-2(b)(4) (2011). The predominant economic interest test is found in similar statutes in Nevada and New Hampshire. See Nev. Rev. Stat. Ann. § 675.035(3) (2017); N.H. Rev. Stat. Ann. § 399-A:2(III) (2017).

²² *People ex rel. Spitzer v. Cty. Bank of Rehoboth Beach, Del.*, 45 A.D.3d 1136, 1138, 846 N.Y.S.2d 436, 438-49 (2007).

²³ See *Morrissey*, 2014 WL 2404300 at *15.

²⁴ *Consumer Fin. Prot. Bureau v. CashCall, Inc.*, No. 2:15-CV-07522-JGB, 2018 WL 485963 (C.D. Cal. Jan. 26, 2018).

²⁵ *CashCall, Inc. v. Maryland Comm’r of Fin. Reg.*, 139 A.3d 990, 995 n.12 (Md. 2016).

²⁶ See, e.g., *Meade v. Marlette Funding, LLC*, No. 17-CV-00575-PAB-MJW, 2018 WL 1417706 (D. Colo. Mar. 12, 2018); *Meade v. Avant of Colo., LLC*, No. 17-CV-0620-WJM-STV, 2018 WL 1101672 (D. Colo. Mar. 1, 2018); *Indelicato v. Kabbage, Inc.*, No. 1:17-CV-11976 (D. Mass. Oct. 12, 2017).

should take care to protect responsible online lending, including by supporting the ability of banks to sell loans that they originate.

If banks are unable to reliably and readily resell loans, or if the value of those loans is significantly reduced as a result of legal uncertainty, their ability to make loans and manage risk by moving loans off of their balance sheets would be severely impaired.²⁷ *Madden* and true lender developments increase legal and business risks to potential purchasers of bank loans, which in turn may reduce overall liquidity in loan markets, limiting the ability of banks to sell loans to manage balance sheet risk. Furthermore, banks may be forced to compensate loan market participants for these increased risks by requiring all borrowers to pay higher interest rates or by simply cutting off already underserved borrowers' access to responsible credit. In addition, *Madden* and the true lender developments threaten the mechanisms by which many banks are able to partner with third-party service providers, especially those which employ technology to aid the credit underwriting decision. The court-by-court and state-by-state nature of these developments further complicates the ability of banks to engage in lending activities as part of a nationwide lending market and significantly interferes with the core powers afforded to banks under federal law.²⁸

III. Federal Banking Regulators Can, and Should, Provide Certainty Through Regulation

We agree with the broad range of policy makers, regulators, and commenters that the *Madden* decision was incorrectly decided. Recent statements and efforts by the Department of the Treasury (**Treasury**), the members of the federal banking regulators, as well as by members of Congress, evidence broad support both for responsible bank partnerships with third-party service providers and openness to regulatory solutions to address the uncertainty regarding core bank powers created by *Madden* and true lender developments.²⁹ While with sufficient time, the *Madden* decision true lender developments may be addressed by courts or congressional action.

²⁷ At least one academic study has found evidence of a decline in consumer lending in jurisdictions directly impacted by *Madden*. Colleen Honigsberg, Robert J. Jackson, Jr., and Richard Squire, How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment, 60 J. L. & ECON. 673 (Nov. 2017).

²⁸ Comptroller Otting recently recognized the importance of maintaining banks' ability to originate and sell loans, in his June 14, 2018 testimony before the Senate Banking Committee: "national banks need the ability to originate [loans] per the National Banking Act" and to "distribute and sell those loans," which creates "capacity in the marketplace for the originators," and thereby "expands the choices for consumers." *Update from the Comptroller of the Currency: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 115th Cong. (2018) (testimony of Joseph M. Otting, Comptroller, Off. of the Comptroller of the Currency).

²⁹ In its July 2018 fintech report, Treasury recommended that the federal banking regulators "reaffirm... that the bank remains the true lender under [service or economic] partnership arrangements [with third parties]." U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities: Nonbank Financials, Fintech, and Innovation* (July 2018) at 92. In addition, Treasury recognized that a broader adoption of *Madden* could restrict credit in a variety of markets and recommended that the federal banking regulators "address challenges posed by *Madden*." *Id.*, at 94. During a June 14, 2018 hearing of the Senate Banking Committee, several senators called on the OCC to take steps to resolve the uncertainty created by *Madden* and the true lender developments. Senator Toomey encouraged the OCC to pursue, "as much as [the OCC] can," steps to solve the problems created by *Madden*, because *Madden* is "making credit less available, especially to low income borrowers." *Financial Industry Regulation: the Office of the Comptroller of the Currency: Hearing Before the H. Comm. on Fin. Servs.*, 115th Cong. (2018) (testimony of Joseph M. Otting, Comptroller, Off. of the Comptroller of the Currency). In addition, during the June 13, 2018 hearing of the United States House Committee on Financial Services (House Financial Services Committee), Representative Meeks urged Comptroller Otting to develop clear guidance to clearly distinguish between true fintech partnerships and rent-a-charter schemes, noting that such guidance is "absolutely key and essential" and, in the absence of such guidance, "the bad can hurt the good, and the potential that . . . fintechs have." *Financial Industry Regulation: the Office of the Comptroller of the Currency: Hearing Before the H. Comm. on Fin. Servs.*, 115th Cong. (2018) (testimony of Joseph M. Otting, Comptroller, Off. of the Comptroller of the Currency). Comptroller Otting expressed support for such guidance, particularly with respect to defining a true vendor relationship. *Id.* In addition, statements of (cont.)

In the meantime, however, these developments have the potential to foster uncertainty for nationwide lending markets and stymie technology and partnerships that enhance access to credit, particularly to individuals and small- and medium-sized businesses. To resolve the uncertainty created by court actions like *Madden* and recent true lender developments, federal banking regulators should adopt regulation to reaffirm the valid-when-made doctrine and limit and remediate the damage to the nationwide lending markets caused by true lender developments.

We recognize the importance of efforts by states and federal regulators to regulate abusive lending practices. However, these efforts must also take into consideration the negative effects for bank safety and soundness that may arise from the added uncertainty for lending markets, particularly where bank partnerships with third-party service providers are well regulated and the activities do not raise the same types of consumer protection concerns targeted by recent state and federal efforts. For example, the OCC recently and appropriately clarified that national banks may not form partnerships with nonbank payday lenders offering short-term loan products with certain characteristics.³⁰ There is a risk, however, that without clarification, the guidance may be misconstrued as raising questions about the treatment of other bank-nonbank lending partnerships outside this context and that do not raise the same concerns that underlie the OCC's guidance.

To appropriately balance the legitimate concerns expressed by state legislatures and courts regarding abusive lending practices with the importance of preserving traditional bank powers and bank safety and soundness, we believe that the federal banking regulators should issue clarifying regulations, which look to existing guidance issued by federal banking regulators and are informed by the long-standing principles of the valid-when-made doctrine as articulated by courts. In light of increased scrutiny on regulatory guidance that may qualify as "rules" under the Congressional Review Act, Congress's increased use of the Congressional Review Act procedure to override rules and the greater deference typically paid by courts to regulation over guidance, we believe that issuing regulation pursuant to full public notice and comment is the preferred approach to resolving the uncertainty raised by the *Madden* and true lender developments.³¹

We believe that federal regulations would restore much needed certainty for banks in originating and selling loans and would restore the important legal foundations of a nationwide lending market. This

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Former Acting Comptroller of the Currency, Keith Noreika, before the Online Lending Policy Summit in September 2017 are consistent with the view that the OCC may be willing to consider regulatory fixes to *Madden* and the true lender line of cases. See Keith A. Noreika, Acting Comptroller of the Currency, Remarks at the Online Lending Policy Summit (Sept. 25, 2017), <https://www.occ.gov/news-issuances/speeches/2017/pub-speech-2017-110.pdf> ("The Congressional 'fix' supported by the OCC would provide that the rate of interest on a loan made by a bank, savings association, or credit union that is valid when the loan is made remains valid after transfer of the loan. This proposal reduces uncertainty by reestablishing well-settled law and would create a uniform standard eliminating the differences in treatment of loans made in different judicial circuits."); see also Scott M. Pearson, *Acting Comptroller Noreika Comments on Madden "Fix," Other OCC Initiatives*, NAT'L L. REV. (Sept. 26, 2017), <https://www.natlawreview.com/article/acting-comptroller-noreika-comments-madden-fix-other-occ-initiatives> ("Mr. Noreika responded that the OCC would 'not be hesitant' to formally address the 'valid when made' rule."). The FDIC has, with Financial Institution Letter 50 and elsewhere, recognized that banks can provide significant benefits to borrowers through partnerships with third-party service providers, such as marketplace lenders, by offering responsible and innovative credit products, within a strong regulatory framework. See FDIC, FIL-50-2016, EXAMINATION GUIDANCE FOR THIRD-PARTY LENDING (2016), <https://www.fdic.gov/news/news/financial/2016/fil16050b.pdf>.

³⁰ OFFICE OF THE COMPTROLLER OF THE CURRENCY, *Core Lending Principles for Short-Term, Small-Dollar Installment Lending*, OCC Bulletin 2018-14 (May 23, 2018), available at: <https://www.occ.gov/news-issuances/bulletins/2018/bulletin-2018-14.html>.

³¹ This focus on more clearly distinguishing guidance from rules extends beyond Congress to the Agencies as well. Comptroller Otting has voiced clear support for these efforts, stating during his recent testimony before the House Financial Services Committee that he has communicated to his exam force and throughout the OCC that "rules are rules, and guidance is guidance." *Financial Industry Regulation: the Office of the Comptroller of the Currency: Hearing Before the H. Comm. on Fin. Servs.*, 115th Cong. (2018) (testimony of Joseph M. Otting, Comptroller, Off. of the Comptroller of the Currency) ("We have issued memos within the agencies to make sure that all examiners are aware of that . . . [t]he agency issues Q&A and guidance from time to time internally, and we clearly -- our people recognize that, as you said, rules are rules and guidance is guidance.").

certainty would benefit not only the banks that originate loans but also the consumers who receive the loans and need to clearly understand the costs, risks and benefits of the loans they undertake.

The federal banking agencies could also consider additional actions to protect the core powers afforded to banks under federal law. For example, the agencies could submit amicus briefs regarding ongoing court cases implicating *Madden* and true lender issues, particularly where the plaintiffs in such cases mischaracterize existing agency guidance to attempt to call into question the validity of banks' traditional and well-established lending powers or their powers to partner with third-party service providers. We believe, however, that while such additional actions are helpful, regulation pursuant to full public notice and comment is the only step short of legislative action that will truly mitigate the uncertainty created by *Madden* and the true lender developments.

IV. Statutory Authority for Federal Regulatory Action

We believe that federal banking regulators have the statutory authority to adopt regulations acknowledging and reaffirming the valid-when-made doctrine and clarifying when a bank should be considered the true lender of a loan.

Section 39 of the Federal Deposit Insurance Act³² (the “**FDI Act**”) gives federal banking regulators broad authority to address unsafe or unsound practices, violations of law, unsafe or unsound conditions or other practices. Specifically, sections 39(a) and 39(b) of the FDI Act require each agency to establish the following types of safety and soundness standards by regulation or by guidelines for all insured depository institutions:³³

- operational and managerial standards relating to, among other things, loan documentation, credit underwriting, interest rate exposure and compensation, and fees and benefits; and
- standards relating to asset quality, earnings and stock valuation that the Agencies determine to be appropriate.

We believe that these sections of the FDI Act authorize the agencies to issue regulation articulating the valid-when-made doctrine and addressing true lender developments. The application of the valid-when-made doctrine or the true lender approach fundamentally affects banks' ability to manage their balance sheets, efficiently and effectively control credit risk and partner with nonbank service providers in a responsible manner, thereby affecting the banks' overall ability to operate in a safe and sound manner. Further, these sections of the FDI Act explicitly authorize the agencies to issue standards on the types of lending activities that would be addressed by this regulation—for example, credit underwriting and administration standards, and loan documentation—to ensure that banks operate in a safe and sound manner.³⁴

Another basis for this regulation is found in sections 24(Seventh), 85 and 93a of the National Bank Act. Section 85 of the National Bank Act specifically permits a national bank to “charge on any loan . . . interest at the rate allowed by the laws of the State, Territory, or District where the bank is located,” or a rate one percent above the Federal Reserve discount rate, whichever is higher, “and no more.”³⁵ A

³² 12 U.S.C. § 1831p-1.

³³ 12 U.S.C. § 1831p-1(a)–(b).

³⁴ 12 U.S.C. § 1831p-1 (a)(1)(B)–(C).

³⁵ 12 U.S.C. § 85.

national bank's authority under section 85 to charge interest up to the maximum permitted by its home state encompasses the power to convey to an assignee the right to enforce the interest-rate term of the agreement.³⁶ That understanding is reinforced by section 24(Seventh) of the National Bank Act, which identifies the power to sell loans as an additional power of national banks.³⁷ Because the application of the valid-when-made doctrine or the true lender approach to national banks would prevent or significantly interfere with those banks' power to charge the interest rates authorized by section 85 and to transfer a loan, including the agreed-upon interest-rate term, to an entity other than a national bank, we believe that sections 24(Seventh) and 85 of the National Bank Act authorize the OCC to issue regulation articulating the valid-when-made doctrine and addressing true lender developments.

Further, section 93a of the National Bank Act reserves to the OCC broad authority to regulate the conduct of national banks to assure the safety and soundness of, and compliance with laws and regulations, fair access to financial services, and fair treatment of customers by, national banks, where the authority to issue such regulations has not been expressly and exclusively given to another federal regulatory agency.³⁸ As with section 39 of the FDI Act, we believe that section 93(a) of the National Bank Act authorizes the OCC to issue regulation articulating the valid-when-made doctrine and addressing true lender developments.

³⁶ The SG and the OCC recognized in their amicus brief in *Madden* that, "when Congress enacted Section 85's earliest statutory antecedent, it was already established that a bank's power to sell loans was a 'necessarily implied' corollary of the power to originate loans." Brief for the United States as Amicus Curiae at 7, *Midland Funding, LLC v. Madden*, 136 S. Ct. 2505 (2016) (No. 15-610) (citing *Planters' Bank of Miss. v. Sharp*, 47 U.S. (6 How.) 301, 322 (1848)).

³⁷ Section 24(Seventh) of the National Bank Act expressly authorizes national banks to carry on the business of banking by "discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt." 12 U.S.C. § 24(Seventh). This authority includes the power to sell loan contracts. See 12 C.F.R. § 7.4008 ("A national bank may make, sell, purchase, participate in, or otherwise deal in loans . . . subject to such terms, conditions, and limitations prescribed by the Comptroller of the Currency and any other applicable Federal law.").

³⁸ Under section 93a of the National Bank Act, Congress vested in the OCC broad authority to prescribe rules and regulations for national banks to carry out the OCC's responsibilities, except where the authority to issue such regulations has been "expressly and exclusively" given to another federal regulatory agency. 12 U.S.C. § 93a. Under section 1(a) of the National Bank Act, Congress charged the OCC with "assuring the safety and soundness of, and compliance with laws and regulations, fair access to financial services, and fair treatment of customers by, the institutions and other persons subject to its jurisdiction." 12 U.S.C. § 1(a).

V. Conclusion

We believe that a federal regulatory fix to the uncertainty and damage caused by *Madden* and the true lender developments is necessary and well within the statutory authority delegated to federal banking regulators. Regulation acknowledging and reaffirming the valid-when-made doctrine and clarifying the true lender developments will have a positive effect for both consumers and small business borrowers, our banking system and the credit markets. We believe that a federal regulatory solution will help to facilitate the smooth functioning of our financial systems and, in turn, America's continued economic growth.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Randall D. Guynn	212 450 4239	randall.guynn@davispolk.com
Jai R. Massari	202 962 7062	jai.massari@davispolk.com
Margaret E. Tahyar	212 450 4379	margaret.tahyar@davispolk.com