14-2131-cv

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

SALIHA MADDEN, on behalf of herself and all others similarly situated,

Plaintiff-Appellant,

—against—

MIDLAND FUNDING, LLC, MIDLAND CREDIT MANAGEMENT, INC.,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF THE CLEARING HOUSE ASSOCIATION L.L.C., FINANCIAL SERVICES ROUNDTABLE, CONSUMER BANKERS ASSOCIATION, AND LOAN SYNDICATIONS AND TRADING ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF REHEARING AND REHEARING *EN BANC*

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1, The Clearing House Association L.L.C. ("The Clearing House"), the Financial Services Roundtable ("FSR"), the Consumer Bankers Association ("CBA"), and the Loan Syndications and Trading Association ("LSTA"; together, "*Amici*") state that they are not subsidiaries of any other corporation. The Clearing House is a limited liability company and as such has no shareholders. Each member of the Clearing House holds a limited liability company interest in The Clearing House that is equal to each other member's interest, none of which is more than a 10% interest. The FSR, CBA, and LSTA are non-profit trade groups and have no shares or securities that are publicly traded.

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INTRODUCTION

Amici submit this brief requesting that the Court grant rehearing or rehearing *en banc* of its decision in *Madden* v. *Midland Funding, LLC*, *et al*. ("Decision").[1] *Amici* submit this brief out of concern that the Panel's Decision (i) upsets the long-standing and settled expectations of the credit markets, and (ii) consequently threatens to cause significant harm to those markets, the banking industry, and the millions of families and businesses they serve.

Since the first half of the nineteenth century, numerous courts, including the U.S. Supreme Court, have recognized that a "cardinal rule" of usury law is that a loan is determined to be usurious or not *only* at the time of its origination. The Supreme Court recognized that this was an important subject of "general mercantile interest," and, as Judge Posner wrote for the Seventh Circuit, a different result would "make the credit markets operate less efficiently" and would create "higher interest rates" for borrowers.

The Panel here departed entirely from this well-established and crucial legal precedent relating to the law of usury. In doing so, the Panel

[1] Pursuant to Federal Rule of Appellate Procedure 29(c)(5) and Second Circuit Local Rule 29.1(b), *Amici* state as follows: (1) neither party's counsel authored the brief in whole or in part; (2) neither party nor their counsel contributed money that was intended to fund preparing or submitting the brief; and (3) no person other than *Amici*, their members or their counsel contributed money that was intended to fund preparing or submitting the brief.

thoroughly undermined the power of Section 85 of the National Bank Act ("NBA"), which (a) indisputably allows a national bank to charge on any loan it originates the rate of interest allowable in the State in which the bank is located, and (b) until the Panel's Decision, had always been understood to allow a secondary purchaser of the loan to charge that same rate. *Amici* submit that rehearing or rehearing *en banc* is crucial for two reasons.

First, the Decision directly contravenes the foundational and long-standing principles of the law of usury, as well as the considered framework Congress erected governing the powers of national banks in light of its requirement that a single federal scheme should govern, among other things, the rate of interest that may be charged on a loan. By doing so, the Decision strikes at the heart of the settled expectations upon which the credit markets are built.

Second, the Decision thus injects significant uncertainty into the purchase or sale of *any* loans (not just the charged-off credit card debt at issue in the Decision), whether by *national banks, state-chartered banks, or non-bank entities*[2] and whether through a single transaction between counterparties, the

[2] Although the Decision dealt with preemption for national banks, its logic would apply to any entity that buys or sells any form of loan. This includes state-chartered banks, which enjoy much the same preemption of state usury laws enjoyed by national banks, *see* FDIC Advisory Opinion, Letter No. 93-27, *12 U.S.C. § 1831d Preempts Contrary State Common Law Restrictions on Credit Card Loans*, 1993 WL 853492, at *1 (F.D.I.C. 1993), as well as non-bank entities.

secondary credit markets, securitizations, or participations. The result will be confusion as to which state's interest laws would apply if the loan were sold.[3] This doubt, in turn, threatens to lessen the liquidity and value of loans held by national banks, thus reducing credit availability and increasing the cost of credit, particularly for small businesses and low income families. By threatening to lessen the liquidity and value of loans, the Decision could ultimately have ramifications for the safety and soundness of banks, which hold trillions of dollars in loans.

STATEMENT OF INTEREST OF *AMICI CURIAE*

TCH. Established in 1853, The Clearing House is the United States' oldest banking association. It is owned by the world's largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. The Clearing House is a nonpartisan advocacy organization representing, through regulatory comment letters, *amicus* briefs, and white papers, the interests of its member banks on a variety of systemically important banking issues.

[3] The Panel's holding also appears to apply to *fees* associated with credit products. The Supreme Court has held that, under the NBA, certain fees are considered interest, and are thus exempt from state law separately regulating fees if that state is not where the national bank is located. *See Smiley* v. *Citibank (South Dakota), N.A.*, 517 U.S. 735, 745-46 (1996). Applying the Panel's reasoning, although an originating national bank would be exempt from state law concerning such fees, a non-national bank assignee may face potential liability.

FSR. As advocates for a strong financial future™, FSR represents 100 integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. FSR member companies provide fuel for America's economic engine, accounting directly for $98.4 trillion in managed assets, $1.1 trillion in revenue, and 2.4 million jobs.

CBA. Founded in 1919, CBA is the trade association for today's leaders in retail banking—banking services geared toward consumers and small businesses. The nation's largest financial institutions, as well as many regional banks, are CBA corporate members, collectively holding well over half of the industry's total assets. CBA's mission is to preserve and promote the retail banking industry as it strives to fulfill the financial needs of the American consumer and small business.

LSTA. The LSTA is a financial trade association whose mission is to promote a fair, orderly, efficient, and growing corporate loan market and to provide leadership in advancing and balancing the interests of all market participants. Among its 380 members are national and state-chartered banks as well as institutional lenders such as insurance companies and fund managers who make, purchase, and trade hundreds of billions of dollars in corporate loans to American companies.

Amici have a substantial interest in this action because the Panel's holding (i) contradicts the long-settled industry expectations regarding usury law on which *Amici's* members rely, and thereby (ii) poses serious challenges to the efficient functioning of the credit markets in which *Amici's* members participate.

ARGUMENT

I. THE DECISION UPSETS LONG-SETTLED EXPECTATIONS CONCERNING USURY LAW AND THUS THREATENS DISARRAY IN THE MARKETPLACE.

A. For Almost Two Hundred Years, It Has Been Well-Established in America That a Valid Loan Cannot Be Rendered Usurious by Selling or Assigning the Rights to the Loan to a Third Party.

In 1828, the U.S. Supreme Court confirmed that a non-usurious loan could not subsequently become usurious by reason of its sale. *Gaither* v. *Farmers & Mech. Bank of Georgetown*, 26 U.S. 37, 43 (1828) ("[F]or the rule cannot be doubted, that if the note free from usury, in its origin, no subsequent usurious transactions respecting it, can affect it with the taint of usury."). And in 1833, the Court confirmed that it was a "cardinal rule" of usury that the determination of whether a loan is usurious occurs at the time of origination. *Nichols* v. *Fearson*, 32 U.S. 103, 109 (1833). Even prior to the *Gaither* and *Nichols* decisions, American and English courts had recognized this cardinal rule as well.[4]

[4] *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

Thus, this rule was firmly in place in American jurisprudence and must be presumed to have been understood by Congress at the time of its enactment of Section 85 of the NBA in 1864. Accordingly, the credit markets have always functioned on the understanding that the rule was incorporated in and formed an integral part of Section 85. *See Republic of Iraq* v. *ABB AG*, 768 F.3d 145, 163 (2d Cir. 2014) ("[W]here a common-law principle is well established . . . the courts may take it as given that Congress has legislated with an expectation that the principle will apply except when a statutory purpose to the contrary is evident.") (quoting *Astoria Fed. Sav. & Loan Ass'n* v. *Solimino*, 501 U.S. 104, 108 (1991)). Given that debt, for hundreds of years, had been routinely purchased and sold,[5] Section 85's protection would have been significantly reduced if it had not

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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 (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 Blackstone, Commentaries 355, 379 n.32 (18th ed. 1838) ("The usury must be part of the contract in its inception . . . .").

[5] *See generally* John Munro, *The Origins of the Modern Fin. Revolution: Responses to Impediments from Church and State in W. Eur., 1200-1600* (Dep't of Econ. & Inst. for Policy Analysis, Univ. of Toronto, Working Paper No. 2, 2001).

provided certainty that loans validly originated by a national bank could be sold or transferred without a buyer being subject to usury claims under state law.

More recently, the "cardinal rule" enunciated in *Nichols* has been officially recognized by the Office of the Comptroller of the Currency, OCC Interpretive Letter No. 115 (Aug. 10, 1979) (citing *Nichols*), and has been consistently followed by courts around the country, *Olvera* v. *Blitt & Gaines, P.C.*, 431 F.3d 285, 289 (7th Cir. 2005) (Posner, J.); *FDIC* v. *Lattimore Land Corp.*, 656 F.2d 139, 148-49 (5th Cir. 1981); 44B Am. Jur. 2d *Interest and Usury* §§ 82, 205.

B. The Decision Conflicts with This "Cardinal Rule," As Well As Opinions from Other Circuits.

Prior to the Panel's ruling, each Court of Appeals to have considered the issue had followed the "cardinal rule" of usury law. The credit markets thus functioned under the rational view that this age-old rule was binding.

In *Lattimore*, for example, the Fifth Circuit faced the very same issue presented to the Court here: whether a loan that was valid in its inception could be rendered usurious simply by being bought or sold. 656 F.2d at 146. In *Lattimore*, a national bank in Tennessee obtained an interest in a loan made by an affiliated mortgage company to a Georgia corporation and subject to Georgia law at its inception. *Id.* at 140-41, 147. Although it was undisputed that the loan was not usurious under Georgia law, plaintiff argued that once the national bank obtained an interest in the loan, Section 85 of the NBA subjected the bank to the more restrictive usury laws of Tennessee. *Id.* at 146-47. Citing the Supreme Court's "cardinal rule" decision in *Nichols*, the Fifth Circuit rejected the borrowers' argument, explaining that "[t]he non-usurious character of a note should not change when the note changes hands." *Id.* at 148-49 & n.17 (citing *Nichols*, 32 U.S. at 109-11).

The Seventh Circuit faced a similar question in *Olvera*, where plaintiffs brought an action alleging that purchasers of bad debts violated the Fair Debt Collection Practices Act by charging usurious interest under Illinois law. 431 F.3d at 286-87. The purchasers had acquired the loans from licensed entities that were permitted to charge the rates at issue. *Id.* at 287. Plaintiffs argued that although the rates charged by the debt purchasers were "no higher (actually lower) than the original, lawful interest rates," the charges were usurious because the debt purchasers were not subject to the same interest rate exemptions as the originators. *Id.* Writing for the Seventh Circuit, Judge Posner affirmed the dismissal of these claims, explaining that "once assignors were authorized to charge interest, the common law . . . gave the assignees the same right, because the common law puts the assignee in the assignor's shoes, whatever the shoe size." *Id.* at 289. Judge Posner described the consequences of a contrary decision as "higher interest rates" for customers and a "credit market [that would] operate less efficiently," and concluded that, "even if the plaintiffs have a decent technical argument for their preferred interpretation, its unreasonable consequences weigh heavily against it." *Id.* at 288-89.

Both *Lattimore* and *Olvera* clearly recognized the vitality and necessity of the cardinal rule that the law governing the loan at origination is the law that applies throughout the loan's life. Unfortunately, the Panel here failed to properly consider this cardinal rule when it concluded that the usury laws applicable to a loan may change when the loan is assigned from a national bank to a non-national bank.

II. THE DECISION CREATES SERIOUS PROBLEMS FOR THE AVAILABILITY OF CREDIT AND THE EFFICIENT FUNCTIONING OF THE CREDIT MARKETS.

A. The Decision Creates Uncertainty in the Credit Markets.

By departing from the settled expectations of the credit markets, the Decision injects confusion into the markets for all types of debt (not just the charged-off debt at issue in this case), because the determination of whether a loan is usurious after sale could now depend on the state in which the borrower resides, the state in which the purchaser resides, and/or the Circuit in which the borrower files suit. If, for example, a plaintiff files usury claims against a purchaser of debt in the Fifth Circuit (or any other Circuit that follows *Nichols*), courts will apply *Lattimore* (and *Nichols*) and assess the usurious nature of the loan at the time of origination. Conversely, if the same plaintiff files suit in the Second Circuit, courts applying the Panel's Decision will look to see whether the loan was rendered usurious through assignment or sale.

Thus, the Decision could significantly alter the legal protections of purchasers and assignees of bank-originated loans when (i) the borrower is a resident of a state with restrictive usury limits, or even a different methodology of calculating or defining interest, and (ii) the purchaser or assignee is subject to suit in the Second Circuit. The fact that New York City is the country's primary financial center magnifies the confusion the Decision will cause.

B. The Availability of Credit Plays a Central Role in the Operation of the Nation's Economy.

The doubt the Decision creates for the credit markets could seriously harm the U.S. financial system and economy. "Credit availability is a crucial ingredient in any advanced economy's recipe for economic growth because credit can support investment in productive enterprises and can smooth household spending from fluctuations in income."[6] And, commercial banks provide vital access to capital and credit for small businesses and consumers.[7]

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6 James McAndrews, Dir. of Research, Fed. Reserve Bank of N.Y., *Credit Growth and Econ. Activity after the Great Recession*, Remarks at the Econ. Press Briefing on Student Loans, Fed. Reserve Bank of N.Y. (Apr. 16, 2015).

7 *See* Bd. of Governors of the Fed. Reserve System, Report to the Congress on the Availability of Credit to Small Business, 2 (Sept. 2012); *Consumer Credit &*

As of March 31, 2015, FDIC-insured institutions held over $8 trillion in outstanding loans.[8] Banks and other financial services companies provide loans to businesses of all sizes, residential and commercial real estate loans, credit card loans, auto loans, and other consumer loans. *See id.* Because of banks' central role in the credit markets, researchers have recognized that "the impairment of banks' ability to extend credit . . . has the potential to hinder investment and adversely affect the overall economy," including small businesses and the labor markets.[9]

C. The Freedom to Sell or Assign Loans Is Essential to the Availability of Credit.

Banks depend on the ability to sell loans they originate to provide liquidity to support their lending operations. While banks and other FDIC-insured

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Payments Statistics, Fed. Reserve Bank of Philadelphia (May 8, 2015), https://www.philadelphiafed.org/consumer-credit-and-payments/statistics/.

[8] *Statistics on Depository Institutions Report—Net Loans and Leases*, FDIC (Mar. 31, 2015), https://www2.fdic.gov/SDI/SOB/; *see also* Trefis Team, *U.S. Banks Witness Highest Post-Recession Growth In Loans Over 2014*, Forbes (Mar. 11, 2015), http://www.forbes.com/sites/greatspeculations/2015/03/11/u-s-banks-witness-highest-post-recession-growth-in-loans-over-2014/.

[9] McAndrews, *supra* note 6; Bercu Duygan-Bump et al., *Fin. Constraints & Unemployment: Evidence from the Great Recession* 1 (Fed. Reserve Bank of Bos. Working Paper No. QAU10-6, 2011) ("Unlike larger firms, which have broader access to capital markets, small businesses are highly dependent on bank financing. An important implication is that any kind of disruption in the flow of bank credit may have significant real effects on the labor markets.").

institutions hold more than $8 trillion in loans of all types, lenders, including banks, have also sold approximately $9 trillion of loans into outstanding securitizations,[10] which does not reflect the volume of loans that are sold in other transactions. These sales generate funds that banks then use to lend out to other customers. If loans could not be resold by banks, the amount of credit available would likely be vastly reduced.

After the Decision, market participants must consider the following factors in originating and purchasing debt that they did not have to consider before:

- How easily will the originator, or a subsequent purchaser, be able to sell, or resell, the rights to the loan to another party in the post-Decision market?
- Will the assignee be subject to suit in this Circuit, or only in courts that apply the traditional *Nichols* rule?
- What state law will govern the rate of interest collectible on the loan?
- Will the purchaser be able to collect based on the original loan terms?

The uncertainty created by the Decision thus will constrict the demand for debt in the credit markets, because market participants likely will be less willing, indeed even unwilling, to purchase loans or securitizations of loans that may be subject to state law usury limits that are lower than the stated rate of the loan. And, to the extent market participants do purchase such loans or

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10 *See* First Quarter 2015 Research Report, SIFMA Res. Q., at 8-9, *available at* http://www.sifma.org/WorkArea/DownloadAsset.aspx?id=8589954778.

securitizations of loans, they are likely to discount the value to reflect the risk they take of receiving lower rates of interest than allowed on the face of the loan, or even the voiding of the loan.

For example, loans of all types are often securitized, *i.e.*, pooled together and divided into smaller pieces (securities) and then sold to various investors in order to spread the risk and the reward of owning those loans. *See id.* To do so, banks typically transfer the loans to a third-party entity to hold the loans before they are securitized. The Panel's Decision could be read to remove the cardinal rule of usury and the NBA's preemption protection for these and other securitized loans on their sale to the third-party entity.

In addition, sales of loans usually include representations and warranties that the loan is collectible in accordance with its terms and that the sale does not violate any law. However, sellers may be unable to make those representations and warranties after the Decision, which could further depress the price of any loans sold by originators or, at worst, render such sales infeasible.[11]

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[11] Moreover, the Decision's impact is not limited to future loan sales. Any entity that has purchased or sold loans in the past now faces the possibility that those prior transactions—entered into in reliance on the Supreme Court's cardinal rule of usury—may now become the subject of innumerable disputes, including lawsuits against purchasers for collecting interest as permitted in loan agreements that were valid at origination and claims by purchasers against loan sellers seeking to recover for the loss in value of the loans that they purchased.

By threatening to reduce the value and liquidity of the multi-trillion-dollar portfolio of loans that banks currently hold, the Decision, if upheld, could ultimately create implications for the safety and soundness of the banking system. Moreover, if loans are rendered illiquid, banks may be forced to compensate for the greater attendant risk by imposing higher interest costs or other protective terms. *See Lattimore*, 431 F.3d at 288-89. The Decision thus could lead to significant negative effects for consumers and small businesses, who may be unable to obtain loans going forward.

An example of the negative effects that could result from the Decision occurred in Georgia in the early 2000s. In 2002, Georgia passed a statute that, among other things, imposed unrestricted liability for assignees of certain higher-cost mortgage loans for any claim that could be asserted against the originator. *See* 2002 Ga. Laws 488, § 7-6A-6. In response, ratings agencies ceased rating securities backed by mortgage loans originated in Georgia, explaining that they could not effectively evaluate the potential risk to investors resulting from this law.[12] As a result, investment banks and other financial institutions refused to buy mortgage loans originated in the state, and a number of lenders withdrew or substantially limited their operations in the state. *Id.* Faced with an impending

[12] Henry Unger & Robert Luke, *Compromise Reached on Georgia Lending Law*, Atlanta J. Const., Feb. 1, 2003, F1.

crisis in the mortgage market, Georgia amended the law to limit assignee liability. *See id.*; 2003 Ga. Laws 1, § 1.

The Decision creates similar uncertainty for buyers of all forms of loans, and threatens to have a similar effect. And the groups that are likely to be most impacted by the credit crunch generated by this uncertainty will be low income individuals and small businesses. As scholars have long pointed out with respect to consumer loans, "restrictions in credit markets hurt highest-risk borrowers the most."[13] Small businesses will be similarly impacted because they lack access to the broader capital markets, and are more dependent on bank financing than are large corporations.[14] Rehearing is necessary to prevent the potentially severe disruption to the credit markets, the liquidity of the banking industry, and the availability of credit to consumers and small business, as well as to prevent a potential impairment of banks' safety and soundness.

CONCLUSION

For these reasons, *Amici* respectfully request that the Court grant rehearing or rehearing *en banc*.

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[13] William F. Baxter, *Section 85 of the Nat'l Bank Act and Consumer Welfare*, 1995 Utah L. Rev. 1009, 1023 (1995).

[14] *See* Karen Gordon Mills & Brayden McCarthy, *The State of Small Business Lending: Credit Access during the Recovery and How Tech. May Change the Game* (Harvard Bus. Sch. Working Paper No. 15-004, 2014).

Dated: New York, New York
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