The Journal of Business, Entrepreneurship & the Law

Volume 10 | Issue 1 Article 4

12-15-2016

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Benjamin Lo, *Online Lenders Shouldn't Get Mad Over Madden*, 10 J. Bus. Entrepreneurship & L. 63 (2016)
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# ONLINE LENDERS SHOULDN'T GET MAD OVER *MADDEN*

BENJAMIN LO*

I. Introduction .......... 63
II. Madden v. Midland Funding in Context .......... 65
III. Critiques of a Maddening Decision .......... 67
IV. Online Marketplace Lenders Should Stay Calm .......... 71
V. Prudent Considerations to Minimize *Madden*'s Impact .......... 76

## I. INTRODUCTION

Much doubt has been cast over the continued vitality of banks in a world where traditional banks compete against the shadow banking sector and agile financial technology (fintech) startups.[1] Research from the Federal Reserve has shown that as financial intermediation grows increasingly complex, it also becomes more decentralized, admitting nonbank competitors like hedge funds and asset managers into securitization roles traditionally dominated by banks.[2] While nonbank financial institutions batter at the back doors of high finance, fintech companies are storming the front gates of retail banking.[3] McKinsey and Company, a consultancy, believes that "[a]bsent any mitigating actions by banks . . . in [several] major retail banking businesses . . . , 10% to 40% of bank revenues . . . could be at risk by 2025."[4] Against this wave of competition, one could be forgiven for believing the banking industry to be under threat.

Reports of the industry's death, however, have been greatly exaggerated.[5]

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[1] *See* Nicole Cetorelli & Stavros Peristiani, *The Role of Banks in Asset Securitization*, 18 FRBNY ECON. POL'Y REV. (Special Issue) 47, 48 (2012).

[2] *See id.* at 59. Cetorelli and Peristiani, however, conclude that banks "remained formidable players" in many phases of securitization. *Id.* at 58–59.

[3] *See* Patrick Jenkins & Martin Arnold, *Beyond Banking: Under Attack on All Sides*, FIN. TIMES (Nov. 10, 2015), http://www.ft.com/cms/s/2/8e45c69e-8226-11e5-a01c-8650859a4767 (describing fintech attackers such as marketplace lenders, payments, and asset managers).

[4] SOMESH KHANNA ET AL., CUTTING THROUGH THE FINTECH NOISE: MARKERS OF SUCCESS, IMPERATIVES FOR BANKS 5 (2015), http://www.mckinsey.com/industries/financial-services/our-insights/cutting-through-the-noise-around-financial-technology.

[5] Chris Myers, *Fintech is Hot, but the Demise of Traditional Banking Has Been Greatly Exaggerated*, FORBES (Apr. 8, 2016, 4:53 PM), http://www.forbes.com/sites/chrismyers/2016/04/08/fintech-is-hot-but-the-demise-of-traditional-banking-has-been-greatly-exaggerated/#698af491a2fd.

Banks remain an indispensable part of the modern financial system and, in fact, have been instrumental in the rise of cutting edge financial services.[6] Online lending by nonbanks, for example, has long been held as a major financial innovation,[7] but is largely dependent on partnerships with banks to avoid the operation of state and national banking law.[8] A recent Second Circuit decision in *Madden v. Midland Funding* highlights precisely how dependent the financial revolution is on traditional banks, and just how much of our economy and innovation would be threatened without those partners.[9]

*Madden* sharply disturbed long-standing expectations about the permitted relationship between banks and their partners. Commentators have observed that such a ruling could sink the trillion-dollar secondary credit market.[10] But the other plausible impact of *Madden*, though unlikely, has gone relatively unnoticed in the commentary: the potential to halt the fast-growing, $9 billion online lending industry in its tracks.[11] This Note critiques *Madden*'s reasoning and argues that the Second Circuit has impermissibly constrained banking activities through an overly narrow reading of the National Bank Act (NBA).[12] It further argues that *Madden*'s holding should not extend to the online lenders (and other businesses) that partner with banks to deliver beneficial consumer innovation.[13] Part I overviews the Second Circuit's decision.[14] Part II critiques *Madden* based on its misconstruction of the NBA.[15] Part III applies *Madden* to online lenders and argues that, even as it stands, online lenders and other fintech startups are distinguishable from *Madden*.[16] Finally, Part IV describes several

[6] *See* René Lacerte, *Banks Vs. Fintech? No Contest, Banks Win*, AM. BANKER (Jan. 8, 2016), http://www.americanbanker.com/bankthink/banks-vs-fintech-no-contest-banks-win-1078738-1.html (noting that Apple Pay and online lenders depend on bank partners).

[7] *See* Kevin Wack et al., *Innovation of the Year: Online Marketplace Lending*, AM. BANKER (Dec. 17, 2014), http://www.americanbanker.com/news/bank-technology/innovation-of-the-year-online-marketplace-lending-1071693-1.html.

[8] *See* Ryan Lichtenwald, *Banks and Marketplace Lending Platforms: Ideal Partners?*, LEND ACADEMY (Aug. 17, 2016), http://www.lendacademy.com/bank-partnerships-marketplace-lenders/.

[9] *See* Madden v. Midland Funding, L.L.C., 786 F.3d 246, 247 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016).

[10] *See* Walt Zalenski et al., BuckleySandler LLP, *Special Alert: Second Circuit Decision Threatens to Upset Secondary Credit Markets* 3 (June 12, 2015), http://www.buckleysandler.com/uploads/1082/doc/Special-Alert-re-Madden-v-Midland_Funding_LLC.pdf.

[11] *See* Kevin Wack, *Supreme Court Throws Curveball in Big Case for Online Lenders*, AM. BANKER (Mar. 21, 2016), http://www.americanbanker.com/news/marketplace-lending/supreme-court-throws-curveball-in-big-case-for-online-lenders-1080015-1.html; *see also* Colin Wilhelm, *Regulatory Road Likely to Get Bumpier for Alternative Lenders*, AM. BANKER (May 15, 2015), http://www.americanbanker.com/news/marketplace-lending/regulatory-road-likely-to-get-bumpier-for-alternative-lenders-1074363-1.html (providing $9 billion market size estimate for alternative lenders).

[12] *See infra* Part II.

[13] *See infra* Part III.

[14] *See infra* Part I.

[15] *See infra* Part II.

[16] *See infra* Part III.

modifications online lenders should make to their banking partnerships to minimize their exposure to *Madden*.[17]

## II. MADDEN V. MIDLAND FUNDING IN CONTEXT

*Madden v. Midland Funding* concerns the dynamic and constantly changing world of financial asset ownership.[18] Plaintiff Saliha Madden opened a Bank of America credit card account.[19] This was later consolidated into the credit card program of another national bank, FIA Card Services.[20] Plaintiff ended up owing $5,000 on her account, which FIA Card Services eventually charged off and sold to a third-party debt collector, Midland Funding.[21] Midland subsequently sought payment of the purchased debt at the contracted interest rate of 27% per year.[22] Plaintiff sued Midland Funding arguing that they "charged a usurious rate of interest in violation of New York law . . . (proscribing interest from being charged at a rate exceeding 25% per year)."[23] The district court denied summary judgment to the plaintiff on grounds that the NBA "would preempt any state-law usury claim against the defendants."[24] The Second Circuit, however, found that "extension of NBA preemption to third-party debt collectors such as the defendants would be an overly broad application of the NBA" and would "create an end-run around usury laws for non-national bank entities that are not acting on behalf of a national bank."[25]

At the outset, it is useful to explain why the NBA figures so prominently in this decision. Congress passed the NBA in 1864 to ensure that national banks would be free from intrusive state regulation at a time when the power of states to interfere with nationally chartered bank activities was at its peak.[26] The NBA "provides for the chartering, regulation and supervision of national banking associations" and consistently has been held to preempt state law.[27] In *Barnett Bank of Marion County, N.A. v. Nelson*, the Supreme Court found that the NBA

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[17] *See infra* Part IV.

[18] *See* Madden v. Midland Funding, L.L.C., 786 F.3d 246 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016).

[19] *Id.* at 247.

[20] *Id.* at 248.

[21] *Id.*

[22] *Id.*

[23] *Id.* (citation omitted).

[24] *Id.*

[25] *Id.* at 251–52. Several months after this Note was first written, the Supreme Court denied certiorari, leaving the Second Circuit's decision undisturbed. *See* Midland Funding, LLC v. Madden, 136 S. Ct. 2505 (2016). Per the Second Circuit's decision, the case has been remanded to the district court for further consideration of the choice-of-law question. *See* Madden v. Midland Funding, L.L.C., 786 F.3d 246 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016).

[26] *See* Raymond Natter & Katie Wechsler, *Dodd-Frank Act and National Bank Preemption: Much Ado About Nothing*, 7 VA. L. & BUS. REV. 301, 314 (2012).

[27] *Id.* at 311.

granted national banks broad preemptive authority, stating that the history of the NBA "is one of interpreting grants of both enumerated and incidental 'powers' to national banks as grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law."[28] A decade later, the Supreme Court seemingly expanded the scope of that preemptive authority by stating that "state law may not significantly burden . . . , curtail or hinder a national bank's efficient exercise of any other power, incidental or enumerated under the NBA."[29]

The NBA grants to banks and their duly authorized officers and agents "all such incidental powers as shall be necessary to carry on the business of banking."[30] These powers include loaning money.[31] Additionally, the Office of the Comptroller of the Currency (OCC) provides another source of preemptive power for national banks.[32] "The OCC 'bears primary responsibility for surveillance of the business of banking authorized' by the NBA"[33] and "has the power to promulgate regulations and to use its rulemaking authority to define the 'incidental powers' of national banks beyond those specifically enumerated in the statute."[34] This authority, however, is "limited to the activities of the national bank and its direct operating subsidiary."[35] The OCC has promulgated regulations defining the authority of national banks to "make, sell, purchase, participate in, or otherwise deal in loans and interests in loans."[36] State law only applies to national banks "to the extent consistent with the decision of the Supreme Court in *Barnett Bank*."[37] While agency regulations may preempt state law, the Dodd-Frank Act of 2012 affirmed the OCC's power to promulgate preemptive regulations for national banks (with conditions).[38]

The central question posed in *Madden* is not whether the NBA and OCC regulations may preempt state criminal usury law, but whether a national bank's authority to charge interest rates that are higher than those allowed by the state may be assigned to third parties who purchase the underlying loan. The *Madden* court recognized that the NBA expressly provides that national banks may

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[28] Barnett Bank of Marion Cnty., N.A. v. Nelson, 517 U.S. 25, 32 (1996).

[29] Watters v. Wachovia Bank, N.A., 550 U.S. 1, 13 (2007).

[30] 12 U.S.C.A. § 24 (West 2016).

[31] *Id.*

[32] Natter & Wechsler, *supra* note 26, at 316–17.

[33] *Id.* at 317 (quoting National Bank of N.C., N.A. v. Variable Annuity Life Ins., 513 U.S. 251, 256 (1995) (citation omitted)).

[34] *Id.* (quoting Martinez v. Wells Fargo Home Mortg., 598 F.3d 549, 555 (9th Cir. 2010) (citation omitted)).

[35] *Id.*

[36] 12 C.F.R. § 7.4008(a) (2016).

[37] *Id.* § 7.4008(e).

[38] *See* 12 U.S.C.A. § 25b(c) (West 2016) ("No regulation or order of the Comptroller of the Currency . . . shall be interpreted or applied so as to invalidate, or otherwise declare inapplicable to a national bank, the provision of the State consumer financial law, *unless substantial evidence . . . supports the specific finding regarding the preemption of such provision* in accordance with the legal standard of the decision of the Supreme Court . . . in *Barnett Bank*.") (emphasis added).

charge "'interest at the rate allowed by the laws of the State, Territory, or District where the bank is located'"[39] and also "'provides the exclusive cause of action' for usury claims against national banks."[40] "Thus, there is 'no such thing as a state-law claim of usury against a national bank.'"[41] However, the *Madden* court decided that while certain nonbank entities acting on behalf of national banks (e.g., agents and operating subsidiaries) could enjoy NBA preemption, such power could not be extended to third-party debt purchasers.[42] "To apply NBA preemption to an action taken by a non-national bank entity, application of state law to that action must significantly interfere with a national bank's ability to exercise its power under the NBA."[43]

In *Madden*, Midland Funding's efforts to collect on the originally contracted interest rate of 27% did not interfere with Bank of America or FIA's ability to exercise NBA powers.[44] Effectively, the Second Circuit took a strictly textual view of what constituted the banks' NBA powers (i.e., the ability to contract for interest rates higher than permitted in the borrower state).[45] Since the power had already been exercised when the interest rate was set, and the banks had "sold the credit and retain[ed] no further interest in it,"[46] the defendants were acting "solely on their own behalves, as the owners of the debt."[47]

## III. CRITIQUES OF A MADDENING DECISION

This decision has sparked significant controversy among practitioners within the financial services industry.[48] As a practical matter, *Madden* would prevent buyers of bank-originated debt from collecting the contracted interest from borrowers if the interest rate exceeded state usury caps in the Second Circuit.[49] Nor would this be confined to a small portion of the market.[50] To take one example, the secondary market for home mortgages was $7.7 trillion in 2013.[51] To provide more credit on limited balance sheets while managing con-

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[39] Madden v. Midland Funding, L.L.C., 786 F.3d 246, 250 (2d Cir. 2015) (citing 12 U.S.C. § 85 (2016), *cert. denied*, 136 S. Ct. 2505 (2016).

[40] *Id.* (quoting Beneficial Nat'l Bank v. Anderson, 539 U.S. 1, 11 (2003)).

[41] *Id.*

[42] *Id.* at 250–51.

[43] *Id.* at 250.

[44] *See id.* at 252–53.

[45] *See id.*

[46] *Id.* at 252 n.2.

[47] *Id.* at 251.

[48] *See* Global Banking and Payment Systems Practice*,* Paul Hastings, *Madden v. Midland Funding, LLC: Potentially Far-Reaching Implications for Non-Bank Assignees of Bank-Originated Loans* (June 11, 2015), http://www.paulhastings.com/publications-items/details/?id=e695e469-2334-6428-811c-ff00004cbded.

[49] *See id.*

[50] *See id.*

[51] *See* Economic Policy Program, *The Role of the Secondary Market in Mortgage Financing*,

centration risk, banks must securitize home mortgages and sell them to other institutional investors.[52] The secondary loan market, of course, encompasses a variety of other important consumer loans such as auto finance, credit cards, and student loans.[53] However, *Madden* unsettles the body of law stipulating that "loan assignees [may] step into the shoes of the lender and are entitled to enforce the rights of the lender pursuant to agreement terms determined at [origination]."[54] According to some practitioners, *Madden* has already caused "parties to existing loan sale agreements to review and renegotiate the terms of such agreements."[55]

A narrow construction of both the scope of the NBA's powers and preemptive authority is appealing as a bright-line rule but ultimately inconsistent with the purpose of the NBA. The Supreme Court held that "in analyzing whether state law hampers the federally permitted activities of a national bank, [we] focused on the exercise of a national bank's powers, not on its corporate structure."[56] To prevail, Midland Funding would have to show that preventing assignees from enforcing original contract rights would limit or hamper national bank powers, even if the bank no longer held a continuing interest in the loan.[57] As the *Madden* court demonstrated, a narrow view of national bank powers would limit the inquiry into whether a national bank fully exercised its power to make loans and set interest rates.[58] The narrow view is mistaken as it ignores the valid-when-made doctrine, which must be read into the bank's lending powers as provided by the OCC.[59] Additionally, it fails to give sufficient weight to the Supreme Court's preemption principles in *Barnett Bank*, the OCC's explicitly adopted guiding case on this topic.[60]

First, the valid-when-made doctrine is central to achieving the correct result in *Madden*. This doctrine principally holds that a non-usurious loan will not become usurious simply by way of transfer.[61] However, critics of *Madden* differ on why the valid-when-made doctrine matters. Several parties that support Midland Funding asserted that § 85 of the NBA, which preempts state law with re-

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BIPARTISAN POLICY CENTER 2 (Dec. 6, 2013), http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/SecondaryMarket-final.pdf.

[52] *See* Cetorelli & Peristiani, *supra* note 1, at 61.

[53] *See id.* at 55.

[54] Global Banking and Payment Systems Practice, *supra* note 48.

[55] *Id.*

[56] Watters v. Wachovia Bank, N.A., 550 U.S. 1, 18 (2007).

[57] *See* Madden v. Midland Funding, L.L.C., 786 F.3d 246, 251–52 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016).

[58] *See id.*

[59] *See* 12 C.F.R. § 7.4008 (2016).

[60] *See id.*

[61] Gaither v. Farmers' & Mech. Bank of Georgetown, 26 U.S. 37, 43 (1828) ("[I]f the note [is] free from usury, in its origin, no subsequent usurious transactions respecting it, can affect it with the taint of usury.").

gard to interest rates, must have somehow incorporated the valid-when-made doctrine.[62] Other commentators believe that the federal preemption issue is a red herring. These commentators believe that the *Madden* court simply failed to consider whether the valid-when-made doctrine and the law of contract assignment violated New York's criminal usury law.[63] Both of these approaches have shortcomings when considered in isolation. The former approach does not enjoy a close nexus to the business of banking, since the activity intruded upon is related to interest rates. Interest rates are set at origination, and the national bank's power to do so arguably is not disturbed further down the chain of transactions. The ability to collect on such interest may indeed be disturbed by *Madden*, but the collecting entity is not an agent or subsidiary of a national bank and is not entitled to NBA protection. Discounting the preemption issue in favor of the valid-when-made doctrine is also a risky maneuver because it could spark a conversation regarding the variety of state-specific contract law permutations that derogate the validity of the contract terms.

I offer a third interpretation of the valid-when-made doctrine, which combines the above approaches. The doctrine properly modifies a national bank's power to "make, sell, purchase, participate in, or otherwise deal in loans and interests in loans" in 12 C.F.R. § 7.4008(a).[64] Under this interpretation, a state's criminal usury law interferes with the ability of banks to make and sell loans when it violates the long-standing principle of retaining the loan's non-usurious character.[65] By allowing state criminal usury laws to operate with full force against a transferred loan, state laws may effectively restrict banks from being able to sell such loans to their chosen counterparties, since assets would have their legal attributes transformed—from non-usurious to potentially usurious—at the moment of sale. This approach has the advantage of tying the valid-when-made doctrine to a specific, enumerated national bank power. It also places the state's interference closer to an actual banking activity—the ability to sell such loans—and does not require the bank to retain a cognizable legal interest for its

[62] *See, e.g.*, Brief of The Clearing House Ass'n, et al. as Amici Curiae in Support of Rehearing and Rehearing En Banc at 6, Madden v. Midland Funding, L.L.C., 786 F.3d 246 (2003) (No. 14-2131-cv) (June 26, 2015) ("Accordingly, the credit markets have always functioned on the understanding that the rule was incorporated in and formed an integral part of Section 85."); Brief of Structured Finance Industry et al. as Amici Curiae in Support of Defendants-Appellees' Petition for Rehearing and Suggestion for Rehearing En Banc at 8, Madden v. Midland Funding, L.L.C., 786 F.3d 246 (2003) (No. 14-2131-CV) (June 26, 2015) ("Courts must interpret Section 85 in accordance with both the 'historical context' of the National Bank Act . . . and 'the basic policy foundations of the statute' . . . . When Congress enacted the NBA in 1864, it already was well-established that loans that are valid under a usury law when made are not invalidated by a subsequent event.").

[63] *See* Zalenski et al., *supra* note 10, at 3.

[64] 12 C.F.R. § 7.4008(a) (2016).

[65] *See* Zalenski et al., *supra* note 10, at 2.

statutory powers to be curtailed.[66]

Such an approach is crucial to surviving the Second Circuit's "cognizable interest" analysis.[67] The *Madden* court distinguished its holding from a case in the Eighth Circuit where the plaintiffs challenged assigned financial instruments in which the bank held a continuing interest.[68] In *Krispin v. May Department Stores*, the defendant assigned credit card accounts to a national bank.[69] Subsequently, the bank raised its late fees above Missouri's permitted level and sold the credit card receivables to the store on a daily basis.[70] The Eighth Circuit found that the plaintiffs' state law usury claims implicated the NBA because "the real party in interest [was] the bank, not the store," which continued to retain some control over the credit card accounts.[71] *Krispin* appears to stand for the proposition that "courts must look at the originating entity (the bank), and not the ongoing assignee . . . in determining whether the NBA applies."[72] However, the Second Circuit reasonably argued that this only makes sense when the originating entity retains *some* interest in the assignment, such that an ongoing exercise of its NBA powers may be infringed.[73] When the national bank leaves the picture entirely, its activities and corresponding NBA preemptions must follow suit.[74]

Beyond the specific reading of the valid-when-made doctrine into 12 C.F.R. § 7.4008, *Madden* may also have misapplied the preemption standards laid out in *Barnett Bank*, which have precedential weight via both the Supreme Court and the OCC.[75] *Barnett Bank* appears to introduce a "significantly interfere[s]" preemption standard for the NBA.[76] The Supreme Court offers several descriptions of preempted state law interactions with the NBA, such as if state

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[66] The Government submitted an amicus brief shortly after this Note was submitted for publication. Brief for the United States as Amicus Curiae, Midland Funding, LLC v. Madden, 136 S. Ct. 2505 (2016) (No. 15-610), 2016 WL 2997343. The Government clearly repudiated the Second Circuit's reasoning, arguing that "a national bank's Section 85 authority 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. *That understanding is reinforced by 12 U.S.C. 24 (Seventh), which identifies the power to sell loans as an additional power of national banks*." (emphasis added). *Id.*, at *6. Notably, this reasoning incorporates the approach proposed here, i.e., that the national bank power being impaired is the ability to sell loans, not that of setting interest rates.

[67] *See* Madden v. Midland Funding, L.L.C., 786 F.3d 246, 253 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016).

[68] Krispin v. May Dep't Stores Co., 218 F.3d 919, 919 (8th Cir. 2000).

[69] *Id.* at 921.

[70] *Id.* at 922.

[71] *Id.* at 924.

[72] *Id.*

[73] *See* Madden v. Midland Funding, L.L.C., 786 F.3d 246, 252 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016).

[74] *See id.* at 252–53.

[75] *See* Barnett Bank of Marion Cty., N.A. v. Nelson, 517 U.S. 25 (1996).

[76] *See id.* at 32. *But see* Natter & Wechsler, *supra* note 26, at 339 (arguing that the "significantly interferes" standard is only dicta and has no precedential weight).

law were to "forbid," "impair significantly," or "hamper" the national bank's exercise of its powers.[77] This indicates a fairly broad scope of preemption and stands in tension with the *Madden* court's unduly narrow interpretation.[78] As stated above, abrogating the valid-when-made doctrine has already generated turmoil amongst financial industry participants.[79] More importantly, it would likely dramatically shrink the size of the secondary market for loans and "undermine the liquidity and efficiency of the secondary loan market because it makes asset values contingent upon [non-financial attributes]" such as the identity of the buyer and the litigation venue.[80] This will certainly interfere with the bank's ability to make and sell loans. Ultimately, a court will have to balance the large impact of the interference against the somewhat attenuated nature of the interference, which operates via indirect impacts on the secondary market. Thus, prevailing on the application of a "significantly interfere[s]" standard may be more difficult, since defendants would have to show that the anticipated effects of the ruling would actually occur. Some reputable commentators have outlined reasons as to why *Madden's* effect on credit markets may be overstated; these would certainly have to be taken into account in a balancing test.[81]

The Supreme Court has declined to hear *Madden* and resolve the important issue of the scope of a bank's powers and corresponding preemption rights. However, should other opportunities arise to litigate similar issues in sister circuits, the bank-assignee would have strong options to incorporate the valid-when-made doctrine and practical concerns into their arguments.

## IV. ONLINE MARKETPLACE LENDERS SHOULD STAY CALM

While much of the financial industry's attention has been devoted to the secondary loan market, another set of industry participants has been watching this case with concern. Online marketplace lending startups (online lenders)

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[77] *See Barnett* Bank, 517 U.S. at 33.

[78] The Second Circuit stated that "state usury laws would not prevent consumer debt sales by national banks to third parties. Although it is possible that usury laws might decrease the amount a national bank could charge for its consumer debt in certain states . . . such an effect would not 'significantly interfere' with the exercise of a national bank power." *See* Madden v. Midland Funding, L.L.C., 786 F.3d 246, 251 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016). The use of the word "prevent" implies that the loan market would have to be non-functional for the "significantly interferes" standard to be met. *See id.*

[79] *See supra* notes 61–63 and accompanying text.

[80] Brief of The American Bankers Ass'n et al. as Amici Curiae in Support of Rehearing and Rehearing En Banc at 8, Madden v. Midland Funding, L.L.C., 786 F.3d 246 (2d Cir. 2015) (No. 14-2131-CV) (June 26, 2015), 2015 WL 4153962.

[81] *See, e.g.*, Adam Levitin, *Madden v. Marine Midland Funding*, CREDIT SLIPS (July 2, 2015), http://www.creditslips.org/creditslips/2015/07/madden-v-marine-midland-funding.html (arguing that the policy rationale for reversing *Madden* is poor for the following reasons: only usurious credit will be restricted; representations and warranties as to compliance with state usury laws are already made; and the availability of insurance to mitigate regulatory risk).

such as Lending Club, Prosper, and Avant greatly fear effects from the *Madden* ruling.[82] Online lending "refers to the segment of the financial services industry that uses investment capital and data-driven online platforms to lend either directly or indirectly to consumers and small businesses."[83] The industry is large and continues to grow, having issued some $5.5 billion in loans in 2014,[84] which could increase to $90 billion by 2020.[85] Its popularity is driven by several key advantages that online lenders have over traditional banks.[86] Online lenders typically provide credit applicants with funding decisions within forty-eight to seventy-two hours—a much faster turnaround than the traditional face-to-face credit application process.[87] They also offer smaller loans with shorter term maturities to better suit consumer needs, and they use non-traditional data sources and technology-enabled underwriting models[88] that may offer better rates to consumers.[89]

The transaction structure required to realize these advantages, however, is far from straightforward. To make loans at speed and at scale, online lenders often cooperate with banks in a variety of ways.[90] In a direct model, the direct lender (e.g., OnDeck, a small business lender) makes loans directly to the borrower.[91] These loans are initially funded through an equity or warehouse line to a capital source that often includes depository institutions.[92] The originated loans can also be transferred to a third party and securitized to free up additional

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82 *See LendingClub to Change Its Fee Model*, WALL ST. J. (Feb. 26, 2016, 4:28 PM), http://www.wsj.com/articles/fast-growing-lending-club-to-change-its-fee-model-1456488393.

83 U.S. TREASURY DEPARTMENT, OPPORTUNITIES AND CHALLENGES IN ONLINE MARKETPLACE LENDING, 5 (2016), https://www.treasury.gov/connect/blog/Documents/Opportunities%20and%20Challenges%20in%20Online%20Marketplace%20Lending%20vRevised.pdf [hereinafter ONLINE TREASURY LENDING REPORT].

84 PricewaterhouseCoopers, *Peer Pressure: How Peer-to-Peer Lending Platforms are Transforming the Consumer Lending Industry*, PWC.COM 2 (Feb. 2105), http://www.pwc.com/us/en/consumer-finance/publications/assets/peer-to-peer-lending.pdf.

85 Suzanne Barlyn, *U.S. Sees 'Potential for Abuse' in Online Lending: DOJ's Caldwell*, REUTERS (June 6, 2016, 8:56 PM), http://www.reuters.com/article/us-usa-justice-lending-idUSKCN0YS1UV.

86 PricewaterhouseCoopers, *supra* note 84.

87 ONLINE TREASURY LENDING REPORT, *supra* note 83.

88 *Id.*

89 *See* Andrew Verstein, *The Misregulation of Person-to-Person Lending*, 45 U.C. DAVIS L. REV. 445, 458 (2012) (explaining that borrowers turn to platform lenders to refinance costlier debts); *see also* Benjamin Lo, *It Ain't Broke: The Case for Continued SEC Regulation of P2P Lending*, 6 HARVARD BUS. L. REV. ONLINE 87, 99 (describing the empirically better rates and less abusive practices P2P borrowers enjoy).

90 *See* John Ginovsky, *Community Banks, Alternative Lenders, Can Coexist*, BANKING EXCHANGE (Oct. 16, 2015), http://www.bankingexchange.com/community-banking/c-suite/item/5810-community-banks-alternative-lenders-can-coexist?utm_content=buffer10463&utm_medium=social&utm_source=twitter.com&utm_campaign=buffer.

91 *See* ONLINE TREASURY LENDING REPORT, *supra* note 83, at 5.

92 *See id.* at 5, 15.

balance sheet capacity.[93] In a platform model, the platform lender (e.g., Lending Club, a peer-to-peer marketplace consumer lender) will "partner with an issuing depository institution to originate loans [using] the institution's charter to make loans nationally without obtaining individual state licenses."[94] Platform lenders buy the loans originated by their partner banks several days after origination and sell them to investors or funnel them into the securitization market.[95] These platform arrangements often provide that originating banks earn a service fee for originating the loan,[96] while all economic risk and return is offloaded to the platform (and their subsequent buyers).[97]

*Madden* has clear implications for the platform model.[98] Platform lenders rely on an originate-to-sell agreement with their partner banks, since this structure allows the platform lender to "purchase the loans without needing to obtain individual state banking/lending licenses; and . . . charge interest rates that are legal in the partner bank's state but may not be in the borrowers' state."[99] If *Madden* were applied to platform lenders, the validity of the purchased loans' interest rates could be challenged on a state-by-state basis, effectively rolling back the nationwide lending footprint most platform lenders have been developing. Therefore, it would not be a stretch to extend *Madden* to these activities. The main banks involved in online lending—WebBank and Cross River Bank—are state-chartered banks in Utah and New Jersey, respectively.[100] *Madden* technically deals only with the NBA, which governs nationally-chartered banks.[101] However, a state bank's authority to "export" its home state's maximum interest rate to other states is provided for in § 27 of the Federal Deposit Insurance Act (FDIA), which is, "patterned after and has been construed *in pari materia* with . . . 'Section 85' of the National Bank Act."[102] The FDIC has not issued a regulation on point, but has opined that § 27 of the FDIA should be

[93] *See id.* at 6.

[94] *Id.*

[95] *Id.*

[96] *Id.* at 8.

[97] *See id.* at 6.

[98] Direct lenders may have less cause for concern under *Madden*, since they are presumably originating loans under their own licenses and in compliance with relevant state usury laws. They may, however, be affected by a constrained securitization market if the valid-when-made doctrine is not respected.

[99] W. Scott Frame, *Marketplace Lending's Role in the Consumer Credit Market*, CENTER FOR FINANCIAL INNOVATION AND STABILITY (September 2015), https://www.frbatlanta.org/cenfis/publications/notesfromthevault/1509.

[100] *See Who is WebBank?*, WEBBANK, http://www.webbank.com/history (last visited Apr. 22, 2016); *see also About Cross River Bank*, CROSS RIVER BANK, https://www.crossriverbank.com/intro.php (last visited Apr. 22, 2016).

[101] *See* Madden v. Midland Funding, L.L.C., 786 F.3d 246 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016).

[102] *See* FDIC, General Counsel's Opinion No. 11, Interest Charges By Interstate State Banks, 63 Fed. Reg. 27282-01 (May 18, 1998).

construed similarly to § 85.[103] Thus, a ruling affecting the preemptive power of § 85 of the NBA might very well carry over to the FDIC's interpretation of § 27 of the FDIA, thereby limiting the ability of state banks to assign intact contracts to their online lending partners. Given the potential risk of parallel construction, especially in a rising interest rate environment, commentators question the viability of the online lending model.[104] Even the ratings agency Moody's has weighed in, predicting that a Supreme Court affirmance would be "the worst outcome for marketplace lenders" and would "spread the risk of losing preemption of state usury laws to [states outside the Second Circuit]."[105]

These concerns are valid but perhaps overstated. While banks and third-party loan purchasers certainly have much to be concerned about, online lenders and their partner banks occupy a different position. The startups are often acting as agents on behalf of the partner banks, and are thus afforded clearer statutory protections than third-party debt purchasers.[106] For the sake of argument, I will assume that the NBA's provisions govern—either directly or by analogy to the FDIA—the relationship between partner banks and online lenders. The NBA explicitly provides the agents of these banks the same right to exercise powers incidental to the business of banking.[107] The activities performed "on behalf" of the banks further indicate a much closer relationship than that found in *Madden*, which basically described an arms-length relationship between the debt originator and third-party purchaser.[108] For example, Lending Club arguably performs various customer acquisition functions for WebBank by providing a website and collecting customer information electronically to facilitate underwriting.[109] Such activities are likely "part of the business of banking" as defined by the OCC.[110] Admittedly, the latter half of the loan transaction may look similar to *Madden* (i.e., WebBank assigns the loan to Lending Club and transfers collection and servicing rights).[111] However, an agency relationship could be read into the whole transaction because Lending Club and WebBank work together to solicit

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[103] *See* FDIC, General Counsel's Opinion No. 10, Interest Charges Under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. 19258-01 (Apr. 17, 1998).

[104] *See* Kadhim Shubber, *This Court Case Could Spell Trouble for Online Lenders as Rates Rise*, FT ALPHAVILLE (Dec. 15, 2015), http://ftalphaville.ft.com/2015/12/15/2148025/this-court-case-could-spell-trouble-for-online-lenders-as-rates-rise/.

[105] Moody's Investors Service, *Moody's: Ongoing Litigation Poses Risks to Current Marketplace Lending Model and Related ABS*, MOODY'S (Nov. 16, 2015), https://www.moodys.com/research/Moodys-Ongoing-litigation-poses-risks-to-current-marketplace-lending-model--PR_338986.

[106] *See* 12 U.S.C.A. § 24 (West 2016).

[107] *Id.*

[108] *See id.*; *see also* Madden v. Midland Funding, L.L.C., 786 F.3d 246, 253 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016).

[109] *See* ONLINE TREASURY LENDING REPORT, *supra* note 83, at 8.

[110] 12 C.F.R. § 7.5001(c) (2016) (identifying factors used to determine whether a particular electronic activity is considered part of the business of banking).

[111] This model appears to have changed in response to *Madden*. *See infra* Part IV.

and underwrite the customer.[112] Indeed, *Madden* lays out a seemingly low bar for what would constitute an agency relationship, noting that "if [the nonbank entity] was paid a 'finder's fee,' it would benefit from NBA preemption as an agent of the national bank."[113] Under this reasoning, a payment from WebBank to Lending Club for the procurement of these customers might balance out the absence of an ongoing economic interest in the loan once it is assigned to Lending Club.[114]

In addition to scrutinizing the character of the entire deal, agency relationships between online lenders and their bank partners might be found through their written agreements.[115] The parties need not rely solely on the vagaries of state-specific agency law. Bank partners may already have contracts in place that effectively authorize the online lender to act on the bank's behalf, especially in terms of finding and underwriting customers. An analogous field of law has given significant weight to written agency contracts that exempt startups from the operation of state law.[116] Many state money transmitter statutes, for example, exempt banks from having to acquire licenses for money transmission activities,[117] since money transmissions are typically a combination of well-defined banking activities (e.g., fulfilling a bill of exchange requires a bank to receive and remit a customer's money).[118] The exemption often extends to their agents by statute, so long as these agents are acting pursuant to a defined set of agency contracts.[119] Within the money transmitter context, regulators have provided additional guidance to determine what agreements point towards a valid agency relationship versus simply a business partnership.[120] In Texas, for example, (1)

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[112] Noah Buhayar, *Where Peer-to-Peer Loans Are Born*, BLOOMBERG BUSINESSWEEK (Apr. 16, 2015, 3:00 AM), http://www.bloomberg.com/news/articles/2015-04-16/webbank-where-peer-to-peer-loans-are-born.

[113] *Madden,* 786 F.3d at 253.

[114] However, the Second Circuit's prior jurisprudence casts doubt on whether an agency relationship (versus an operating subsidiary relationship) suffices for NBA protection. *See* SPGGC, L.L.C. v. Blumenthal, 505 F.3d 183, 190 (2d Cir. 2007) ("At best . . . SPGGC had a close agency or business relationship with [Bank of America]; but that is not sufficient to entitle it to protection under the NBA.") (quoting SPGGC, Inc. v. Blumenthal, 408 F.Supp.2d 87, 95 (D. Conn. 2006), *aff'd in part, vacated remanded sub nom.*). *Madden*'s own language confirms the agency exception, and thus, the possible diminution of agency relationships in *SPGGC* should be construed as dicta. *See Madden,* 786 F.3d at 253.

[115] *See generally* Benjamin Lo, *Fatal Fragments: The Effect of Money Transmission Regulation on Payments Innovation*, 19 YALE J. L. & TECH. 111, 142 [hereinafter *Effect of Money Transmission Regulation*] (describing licensure exemptions for certain parties acting as agents of payees, licensees, or banks).

[116] *See id.* at 129–30.

[117] *See, e.g.*, TEX. FIN. CODE. ANN. §§ 151.003(5), 151.302(a)(2) (West 2016); OHIO REV. CODE ANN. § 1315.02(A)(4) (West 2016); *see also Effect of Money Transmission Regulation*, *supra* note 115, at 117–19.

[118] *See Effect of Money Transmission Regulation*, *supra* note 115, at 112.

[119] *See, e.g.*, TEX. FIN. CODE. ANN. § 151.003(5) (West 2016).

[120] *See Effect of Money Transmission Regulation*, *supra* note 115, at 112.

the written appointment agreement must have terms that show a wide yet precise scope of the relationship; (2) the agent must offer the principal's products and co-brand with the principal; (3) the agent must be compensated by the principal; and (4) the customers must be aware of, and have a contractual relationship with, the principal.[121] While these factors cannot simply be ported over to the far more consequential NBA preemption context, they nevertheless illustrate why arms-length third-party buyers would not be considered agents, but online lenders might be bank agents.

Lower courts are already searching for indications of an agency relationship to determine whether the challenged activities may be protected. *Edwards v. Macy's* was a recent case from the Southern District of New York that concerned a plaintiff that had allegedly been enrolled without notice in a payment protection plan.[122] The plaintiff sued Macy's department store and its national bank partner.[123] The court found that Macy's was providing "marketing, credit processing, collections and customer service related to the [payment protection] program, and it was [being] compensated for so doing. Macy's was, therefore, conducting those activities on [the national bank's] behalf."[124] Drawing an analog to the online lending context, courts may start scrutinizing relationships between online lenders and their bank partners to ensure that the relationship is not a naked rent-a-charter scheme. While courts have yet to determine the precise contours of an agency relationship, there are several steps that parties may take to provide better evidence of such.

## V. PRUDENT CONSIDERATIONS TO MINIMIZE *MADDEN*'S IMPACT

The foregoing discussion raises several key considerations for online lenders. While startups appear to be better insulated from any *Madden* fallout, there are some precautionary steps that they may take to further minimize regulatory risk. As in the previous section, I will assume that the FDIC may apply *Madden* to govern relationships between state-chartered banks and online lenders.

The first and perhaps most obvious step is to ensure that the bank has skin in the game. Lending Club has already taken this step by making significant changes to its relationship with WebBank in accordance with the Second Circuit's opinion.[125] Lending Club has "increase[ed] . . . fees paid to the bank . . . ,

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[121] *See* Charles G. Cooper, *Supervisory Memorandum—1038*, TEXAS DEPARTMENT OF BANKING 2–3 (Oct. 13, 2014), http://www.dob.texas.gov/public/uploads/files/Laws-Regulations/New-Actions/sm1038.pdf.

[122] Edwards v. Macy's Inc., No. 14 CIV. 8616(CM), 2016 WL 922221, at 1 (S.D.N.Y. Mar. 9, 2016).

[123] *Id.*

[124] *Id.* at 7.

[125] *See* Richard P. Eckman & Philip Hoffman, *Lending Club Makes Big Changes in Response*

[and] WebBank has agreed to maintain an ongoing economic interest in all loans made after they are sold and will have a continuing contractual relationship with the borrower."[126] Specifically, it appears that Lending Club modified its agreement with WebBank to defer payments over the life of the loans and tie payments to loan performance, ensuring that "the issuing depository institution maintains an economic interest in the loans it sells to the platform lender and maintains a contractual relationship with the borrower even after the loans are sold."[127] This appears to satisfy *Madden*'s implied restrictions, since the bank's continued involvement in the loan will extend NBA preemption over all its activities. Even less-obviously affected direct lenders such as OnDeck "have now developed hybrid models, selling some whole loans to institutional investors while retaining servicing responsibilities."[128] Thus, Lenders should discuss with their bank partners the appropriate allocation of risk and required compensation to ensure that banks retain an interest in any assigned loans. Notably, such an arrangement may apply to the securitization market as well, but would likely be more difficult due to the complex multi-party and multi-asset nature of a securitization transaction.

Second, lenders should formalize their agency relationships and emphasize the role of their bank partners to customers. A written agency agreement should encapsulate the roles played by each party in the transaction, highlighting the ways in which online lenders are "acting on behalf" of their bank partners in activities integral to the business of banking. Partner banks should expressly delegate authority to the online lender for purposes of customer targeting, customer acquisition, and data collection for underwriting purposes. However, the online lender's role should be cast as performing clerical, ministerial, and non-discretionary functions on behalf of the bank. This characterization would be better supported if the bank adopts the lending program's policies as its own and establishes clear and enforceable supervision policies over the lending entity. Lenders should also emphasize the role of their partner banks in the loan issuance and servicing process—something online lenders already do to varying degrees. Affirm, an online personal loan provider, clearly describes Cross River Bank as "the lender for all Affirm loans" in its FAQs.[129] In contrast, Kabbage, an online small business loan provider, announced that it was partnering with a bank to offer "the same great product" but chose not to describe the bank or its relationship.[130]

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*to Madden v. Midland*, PEPPER HAMILTON LLP (Feb. 29, 2016), http://www.pepperlaw.com/publications/lending-club-makes-big-changes-in-response-to-madden-v-midland-2016-02-29/.

[126] *Id.*

[127] ONLINE TREASURY LENDING REPORT, *supra* note 83, at 8.

[128] *Id.*

[129] *See FAQs*, AFFIRM, https://www.affirm.com/faqs/ (last visited Apr. 23, 2016).

[130] *See* Madie Hodges, *Kabbage Hasn't Changed—Just Our Terminology!*, KABBAGE, https://www.kabbage.com/blog/kabbage-hasn-t-changed-just-our-terminology (last visited Oct. 25,

Finally, a choice-of-law issue raised in *Madden* may offer online lenders and securitization participants some relief by contract. Midland Funding contended that plaintiff Madden had received and accepted a change of terms containing a Delaware choice-of-law provision.[131] Delaware law permits a bank to charge any contractually agreed-upon interest rate,[132] but caps the rate non-bank lenders may charge at 5% over the Federal Reserve discount rate.[133] The court declined to decide the choice-of-law issue but indicated that it could be dispositive to whether Midland Funding had charged a permissible rate.[134] Given the potential impact of choice-of-law, online lenders could specify that Utah law shall govern interpretation of the agreement. Since Utah has no usury cap,[135] no criminal usury charges apply if Utah law governs. However, lenders would forego the well-established body of Delaware or New York law that could better apply to other provisions of the loan agreement. That tradeoff alone may render the use of this choice-of-law protection unattractive.

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2016). Kabbage is partnered with Celtic Bank, a Utah-chartered state bank. *See Orchard Platform and Kabbage Announce Partnership to Provide Investors' Access to Karrot Consumer Loans*, ORCHARD (Mar. 26, 2015), https://www.orchardplatform.com/company/press/orchard-platform-and-kabbage-announce-partnership-to-provide-investors-access-to-karrot-consumer-loans/.

[131] *See* Madden v. Midland Funding, L.L.C., 786 F.3d 246, 253 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016).

[132] *See* Del. Code Ann. tit. 5, § 943 (2016).

[133] *See id.* tit. 6, § 2301.

[134] *See Madden*, 786 F.3d at 254.

[135] Matt Scully, *Peer-to-Peer Lenders Face Legal Blow in Usury Ruling*, BLOOMBERG (Aug. 14, 2015, 7:38 AM), http://www.bloomberg.com/news/articles/2015-08-14/peer-to-peer-lenders-losing-court-battle-over-state-usury-laws.