Valid When Made 2.0: Attacking the Trusts

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I. Introduction

Though a legal concept in existence in our nation's jurisprudence for more than two hundred years, "valid when made" continues to be a heated topic of debate. Such controversy is to be expected given the treatment (or nontreatment) of this concept in *Madden v. Midland Funding, LLC*.[1] In *Madden*, the U.S. Court of Appeals for the Second Circuit—which includes Connecticut, New York, and Vermont—held that non-national bank entities that purchase loans originated by national banks cannot rely on the National Bank Act (NBA)[2] to protect them from state-law usury claims.[3] The decision in *Madden* undermined the valid-when-made theory on which assignees of loans originated by banks relied for many years. *Madden* also impeded the ability of national banks to sell the loan obligations they originate, thus reducing their ability to lend. Although *Madden* was argued under the NBA, its reasoning also applied to state-chartered banks. The *Madden* effect has shown up in a few lawsuits over the last few years, and a recent development is ramping up the pressure on the bank partner model by suing the trusts that are typically created to hold the assets originated by the bank. Although most of the originating banks in the bank partnership space are state-chartered banks, the trustees involved on the back-end are national banks, as national banks enjoy broader preemption authority than their state counterparts.

In *Cohen v. Capital One Funding, LLC*,[4] a number of holders of Capital One credit cards sued the originator, the entities involved in the securiti-

1. Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015).
2. National Bank Act, ch. 343, § 1, 18 Stat. 123 (codified in 1864, and as amended in scattered sections of Title 12 of the United States Code).
3. *Madden*, 786 F.3d at 250.
4. Cohen v. Capital One Funding, LLC, Case No. 1:19-cv-03479-KAM-RLM (E.D.N.Y. filed June 12, 2019).

zation trust that held the originated receivables, and the bank that acted as the trustee of the securitization trust. The lawsuit alleged that Capital One and the entities to which it sold the receivables imposed usurious rates of interest in excess of New York's civil usury cap of 16% per year and, in some instances, New York's criminal usury cap of 25% per year. The *Cohen* plaintiffs sought to certify a class of consumers who have paid interest to Capital One and the other defendants in connection with a Capital One credit card at a rate that exceeded 16% per year at any time since June 12, 2013.[5] To understand why the plaintiffs in *Cohen* pursued these claims—and why others in the future may also do so—it is important to have a detailed understanding of *Madden*.

II. *Madden v. Midland Funding LLC*

Saliha Madden, a New York resident, obtained a Bank of America (BoA) credit card in 2005. As a national bank, BoA can export interest rates and certain fees permitted in its home state or any state in which it has a branch and performs certain activities, as discussed above. At some point, BoA collapsed its credit card program with MBNA, a Delaware-headquartered national bank that BoA purchased in 2005. The new credit card program, FIA Card Services (FIA), sent Madden a change in terms document that allegedly advised Madden that Delaware law would now apply to the credit card agreement.[6]

After Madden failed to pay some $5,000 that she owed, FIA charged off the account and sold the debt to Midland Funding LLC, a debt buyer. Midland Credit Management LLC, an affiliate of Midland Funding, began to service the account. None of the Midland entities were a national bank and, after the sale, neither FIA nor BoA possessed any further interest in the account. In November 2010, Midland Credit sent Madden a letter seeking to collect the debt, with interest accruing at a rate of 27% per year. This rate exceeds the 25% per year criminal usury cap in New York, but is a rate permissible to a national bank in Delaware.[7]

Madden filed a class action lawsuit in federal court asserting, among other claims, a state-law usury violation.[8] The federal trial court denied Midland's motion for summary judgment, concluding that genuine issues of material fact existed as to whether Madden received the notice that changed the applicable law and whether FIA assigned the debt to Midland.[9] The trial court stated, however, that if Madden had received the change of terms notice specifying that Delaware law applied, Madden would lose her usury claim because Delaware law allows the rate of interest

5. Complaint at 2–5, Cohen v. Capital One Funding, LLC, Case No. 1:19-cv-03479-KAM-RLM (E.D.N.Y. filed June 12, 2019). It is unclear why plaintiffs selected this date.
6. *Madden*, 786 F.3d at 248.
7. *Id*.
8. *Madden*, 786 F.3d at 247.
9. *Madden*, 786 F.3d at 248.

Midland sought pursuant to the terms of the bank's agreement.[10] The trial court further held that such a ruling would necessarily kick out the FDCPA claim, as it is not a violation of the FDCPA to collect a lawfully owed debt.[11]

In denying Madden's motion for class certification, the trial court found that "assignees are entitled to the protection of the NBA if the originating bank was entitled to the protection of the NBA."[12] Madden appealed, arguing that because Midland is not a national bank or a subsidiary or agent of a national bank, or otherwise acting on behalf of a national bank, and because application of the usury law does not "significantly interfere" with the national bank's ability to exercise its powers under the NBA, NBA preemption does not apply. The U.S. Court of Appeals for the Second Circuit agreed with Madden.[13]

The Second Circuit's decision is notable for at least two reasons. First, its discussion of what constitutes a "significant interference" with the business of banking under the NBA is cursory and appears to ignore years of well-established case law. Second, and most importantly, there is no discussion of the valid-when-made theory, a doctrine that has been widely accepted for decades.

In addressing preemption under the NBA, the Second Circuit correctly noted that there is no such thing as a state-law claim of usury against a national bank. Section 85 of the NBA authorizes a national bank to export interest charges permitted by the state where the national bank is located to the bank's out-of-state debtors. The NBA provides, in relevant part, that:

> Any [national bank] may take, receive, reserve, and charge on any loan or discount made, or upon any notes, bills of exchange, or other evidences of debt, interest at the rate allowed by the laws of the State, Territory or District where the bank is located or at a rate of one per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located, whichever may be the is greater.[14]

In 1978, the United States Supreme Court held in *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.* that Section 85 "plainly provides that a national bank may charge interest 'on any loan' at the rate allowed by the laws of the State in which the bank is 'located.'"[15] As such, a national bank can charge and collect interest rates and interest fees allowed in its home state without regard to other state laws that mandate a lower rate of interest.

In order to apply NBA preemption to an action by a non-national bank entity, the Second Circuit reasoned that application of state law to that

10. *Madden*, 786 F.3d at 247.
11. *Id*.
12. *Madden*, 786 F.3d at 248.
13. *Madden*, 786 F.3d at 249.
14. 12 U.S.C. § 85 (2012).
15. Marquette Nat'l Bank of Minneapolis v. First of Omaha Service Corp., 439 U.S. 299, 308 (1978).

action must significantly interfere with a national bank's ability to exercise its power under the NBA, a standard derived from the U.S. Supreme Court's 1996 decision in *Barnett Bank of Marion County, N. A. v. Nelson*,[16] and codified in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in 2010.[17] In applying this standard, the *Madden* court concluded summarily, that application of state law to this scenario would not significantly interfere with the bank's ability to exercise its powers under the NBA. The ruling in *Madden* is not consistent with valid-when-made case law or with Dodd-Frank, but it is the law of the Second Circuit.

III. The Effects of *Madden*

The new challenge to the bank partner model seen in *Cohen* and arising in the wake of *Madden*, going after the trusts established to hold the assets and the national banks that act as trustees, requires an analysis of Dodd-Frank's preemption standards. Dodd-Frank amended the NBA to establish a preemption standard that preempts state consumer financial laws, defined as state laws that do not directly or indirectly discriminate against national banks and that (1) directly and specifically regulate the manner, content, or terms and conditions of any financial transaction (as may be authorized for national banks to engage in); or (2) any account related to a financial transaction, with respect to a consumer. This standard preempts state laws as they apply to national banks in three circumstances:

1. Application of a state consumer financial law has a discriminatory effect on national banks, in comparison with the effect of the law on a state-chartered bank;
2. Other federal law preempts the state consumer financial law; or
3. In accordance with the legal standard for preemption in the decision of the Supreme Court of the United States in *Barnett*, the state consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers.

Thus, as relevant to *Madden*, Dodd-Frank preempts state consumer-financial laws that prevent or significantly interfere with a national bank's exercise of its powers and confirms the validity of *Barnett* and its progeny.

In *Barnett*, the State of Florida tried to enforce a state law that prohibited banks from selling insurance, while a federal law expressly authorized national banks to engage in such sales. The U.S. Supreme Court determined that Florida's law was preempted. In doing so, the Court said that, in determining whether a law is preempted, courts generally take the view that "Congress would not want States to forbid, or to impair significantly, the exercise of a power that Congress explicitly granted."[18] The *Barnett* Court further noted that prior decisions by the Supreme Court did not deprive

16. Barnett Bank of Marion Cty., N.A. v. Nelson, 517 U.S. 25 (1996).
17. Pub. L. 111–203, 124 Stat. 1386 (2010).
18. *Barnett*, 439 U.S. at 33.

states of the power to regulate national banks, where doing so does not "prevent or significantly interfere with the national bank's exercise of its powers."[19] Thus, a national bank cannot rely on preemption doctrine to invalidate a state law that only interferes with a national bank's exercise of its powers in an insignificant way.

After *Barnett*, more than 500 court decisions have weighed whether specific state laws "prevent or significantly interfere with" a national bank's powers to warrant a finding of preemption.[20] For example, since *Barnett*, courts have found that the NBA preempts state law requirements that a "convenience check" includes specific disclosure language.[21]

Had the Second Circuit engaged in an analysis of whether application of state law to a consumer obligation originated, but later sold, by a national bank would interfere with the bank's business, perhaps it would have reached a different conclusion in *Madden*. A bank's ability to sell loans or debts in the secondary market is an exercise of bank powers, and an important one. The OCC recognizes this in its Risk Management Guidance concerning consumer debt sales (a document cited by the Second Circuit in its decision),[22] that debt sales turn nonperforming assets into immediate cash proceeds and assist banks in meeting their responsibility to shareholders to recover losses. At best, the application of state usury caps significantly decreases the value of loans that banks sell and could preclude some loan sales altogether. Certainly, if requiring a bank to include disclosure language on a convenience check or limiting non-interest fees is considered a significant impairment of bank powers, reducing the value of a bank's loans would meet this standard. Indeed, it seems to be a "significant interference" to tell a national bank, which is entitled under federal law to charge the interest permitted by its charter state, that such power is subject to state usury laws when the obligations are sold.

Instead of focusing on the *Barnett* standard, the *Madden* court focused on the fact that NBA preemption generally applies to the non-bank where the non-bank is acting on the bank's behalf and carrying out the bank's business.[23] This fact pattern is distinguishable from the facts in *Madden*, where the debt buyers act on their own, as debt owners. Notably absent from this decision is any discussion of the valid-when-made theory, a bedrock principle that provides certainty and validity to the secondary market. Under this theory, an obligation is considered valid under the law that applied at the time of origination. The obligation continues to be valid

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19. *Id.*
20. Catherine M. Brennan and Meghan S. Musselman, *Insights Today's Trends in Credit Regulation: Madden v. Midland Funding*, "Counselor Library" (June 2015), https://www.counselorlibrary.com/insights/article.cfm?articleID=887.
21. *See* Rose v. Chase Bank USA N.A., 513 F.3d 1032 (9th Cir. 2008).
22. Office of Comptroller of the Currency, OCC Bull. No. 2014-37, Consumer Debt Sales: Risk Management Guidance (2014).
23. Madden v. Midland Funding, LLC, 786 F.3d 246, 249 (2d Cir. 2015).

under that law even after it is transferred to subsequent parties. If not for this theory, loan terms would be subject to change each time the accounts are transferred. From a review of the record, it does not appear that the valid-when made-theory was argued or briefed.

Finally, and importantly for non-bank partners and other purchasers of loans from national banks, the court noted that extending preemption to non-bank third parties "would create an end-run around usury laws for non-national bank entities that are not acting on behalf of a national bank."[24] In reaching this conclusion, the court discussed two cases regularly discussed in bank partnerships: *Phipps v. FDIC*,[25] and *Krispin v. May Department Stores*.[26]

Midland attempted to rely on *Krispin* for the proposition that, as a non-bank, it was entitled to NBA preemption, just as the store was, because the "originating lender" (i.e., the bank) was permitted to impose the fee. But the *Madden* court noted that in *Krispin*, the language regarding the "originating lender" was misleading—the bank only sold its receivables and retained ownership of the accounts, a fact that supported the finding in *Krispin* that the bank was the real party-in-interest. In *Madden* (and in most bank partnerships where the underlying transactions are closed-end loans), the bank sold the account and the receivables, and retained no further interest in it.[27]

The *Cohen* plaintiffs noted that the trust that purchased the credit card assets was a common law trust. The question of whether a state may require a trust for which a national bank acts as trustee to be subject to pertinent state law depends on the scope of the federal preemption of state laws.

Specifically, section 25b of Dodd-Frank provides, in pertinent part, that a state law is also preempted if the state law "is preempted by a provision of Federal law other than title 62 of the Revised Statutes."[28] National banks

24. Madden v. Midland Funding, LLC, 786 F.3d 246, 252 (2d Cir. 2015).
25. Phipps v. FDIC, 417 F.3d 1006 (8th Cir. 2005).
26. Krispin v. May Dept. Stores Co., 218 F.3d 919 (8th Cir. 2000).
27. In June 2015, Midland filed a petition for rehearing before the Second Circuit. Brief for Defendant at 1, *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d. Cir. 2015) (No. 14-2131-cv). That petition was denied. Order Denying Rehearing, *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d. Cir. 2015) (No. 14-2131-cv). Midland appealed to the U.S. Supreme Court, which also denied the petition. Midland Funding, LLC v. Madden, 136 S. Ct. 2505 (2016). The trial court found New York law applied, and the case has since settled. Madden v. Midland Funding, LLC, 237 F. Supp. 3d 130, 146 (S.D.N.Y. 2017).
28. 12 U.S.C. § 25b(b)(1)(C) (2012). The specific statutes excepted from Dodd-Frank section 25b preemption are as follows: Title 62 of the Revised Statutes, referred to in subsecs. (b)(1)(C), (2), (4), (5)(A), (e), (f), (h)(2), (i)(1), and (j), was in the original "this Title" meaning Title LXII of the Revised Statutes, consisting of R.S. §§ 5133 to 5244, which are classified to this section and 12 U.S.C.A. §§ 16, 22 to 24a, 25a, 25b, 26, 27, 29, 35 to 37, 39, 43, 52, 53, 55 to 57, 59 to 62, 66, 71, 72 to 76, 81, 83 to 86, 90, 91, 93, 93a, 94, 141 to 144, 161, 164, 181, 182,

derive their trust authority from section 92a, which is discussed in more detail below. Section 92a is not listed as being among the codified sections of the U.S. Code that comprise title 62 of the Revised Statutes.

Because a national bank's authority to act as a trustee is found in federal law other than title 62, whether that law preempts a state law is analyzed under pre-Dodd-Frank Act, OCC preemption precedent, and is not expressly subject to the *Barnett* standard discussed above. Under such precedent, state laws are preempted as they apply to a national bank operating under its authority to act as a trustee.

National banks are chartered under federal law. A state requirement that a national bank obtain state approval or a state license to exercise a power authorized under *federal law* is an assertion by the state that it has supervisory or regulatory authority over national banks. This is in direct conflict with the federal law providing that the OCC has exclusive visitorial powers over national banks except as otherwise provided by federal law.[29] "A state law that purports to vest this authority in a state is preempted."[30] Accordingly, national banks are generally not subject to state interest rate laws and licensing regimes by virtue of federal law. The *Cohen* plaintiffs did not address these issues in their complaint; rather, the complaint noted simply that "Defendant Capital One Master Trust . . . is a common law trust for which Defendant The Bank of New York Mellon Corporation is the Trustee[.]"[31] The *Cohen* plaintiffs further alleged that this trust is not a bank, seemingly not appreciating that a common law trust is part of the bank, not a separate entity.

Federal law authorizes a national bank to act as a trustee. Section 92a(a) expressly provides for a national bank to serve as trustee and provides, in pertinent part:

> The Comptroller of the Currency shall be authorized and empowered to grant by special permit to national banks applying therefor, when not in contravention of State or local law, *the right to act as trustee* . . . or in any other fiduciary capacity in which State banks, trust companies, or other corporations which come into competition with national banks are permitted to act under the laws of the State in which the national bank is located . . . . Whenever the laws of such State authorize or permit the exercise of any or all of the foregoing powers by State banks, trust companies, or other corporations which compete with national banks, the granting to and exercise of such powers by national banks shall not be deemed to be in contravention of State or local law . . . .[32]

192 to 194, 196, 215c, 481 to 485, 501, 541, 548, and 582; 12 U.S.C.A § 25b historical and statutory notes on references in text (West 2019).

29. 12 U.S.C. § 484; OCC Visitorial Powers with Respect to National Banks, 12 C.F.R. § 7.4000 (2015).

30. OCC Interpretive Letter No. 939, at 7 n.22 (Oct. 15, 2001).

31. Complaint at 5, Cohen v. Capital One Funding, LLC, Case No. 1:19-cv-03479-KAM-RLM (E.D.N.Y. filed June 12, 2019).

32. § 92a(a), (b) (emphasis added).

We are not aware of any case expressly addressing whether a state law that applies to a national bank acting as a trustee would be preempted.[33] However, the OCC has addressed that issue. In an opinion dated October 8, 1999, the OCC addressed the ability of a Michigan-based national bank to engage in fiduciary activities from its Michigan office. OCC Interpretive Letter No. 866 states:

> Similarly, state laws that would require the Bank to obtain a certificate of authority, approval, or other license requirement from the state before soliciting and engaging in the proposed trust arrangements with customers in those states conflict with the Bank's federal authority under section 92a, and so are preempted. If a national bank is authorized under federal law to exercise a granted power, it does not require the additional permission of a state to exercise that power. To conclude otherwise would run counter to the paramount authority of the federal government over national banks, including the OCC's exclusive visitorial power over national banks.[34]

Accordingly, as interpreted by the OCC, a national bank may exercise its powers to act as a trustee without being subject to state law requirements.

Although courts are not required to grant the OCC's Interpretive Letters the same level of deference accorded a formal regulation, the position taken by the OCC in the Interpretive Letter cited above is consistent with section 92a and regulations the OCC adopted regarding a national bank's ability to engage in fiduciary activities, including acting as a trustee.[35] Therefore, a court would likely give significant consideration to the OCC's views concerning a national bank's ability to act as a trustee without being subject to state usury and licensing requirements. Note that Interpretative Letter No. 866 specifically cites to *Barnett* as one of the sources of authority for its preemption determination.[36]

In addition to imposing a new preemption standard, the Dodd-Frank Act also changed the deference that a court shows to a preemption deter-

33. There is case law addressing the application of state licensing requirements to a national bank outside of the trust context. For example, see *Watters v. Wachovia Bank, N.A.*, 550 U.S. 1, 15 (2007), where the Supreme Court acknowledged as a conceded point that Michigan mortgage licensing requirements would not apply to a national bank. See also *Wells Fargo Bank N.A. v. Boutris*, 419 F.3d 949, 965 (9th Cir. 2005), where the U.S. Court of Appeals for the Ninth Circuit indicated that the chartering of national banks by the federal government is inconsistent with state mortgage-lending licensing requirements.
34. OCC Interpretive Letter No. 866, at 10–11 (Oct. 8, 1999) (footnotes omitted).
35. *See* OCC Multi-State Fiduciary Obligations, 12 C.F.R. § 9.7(e)(2) (2001) (stating "[e]xcept for the state laws made applicable to national banks by virtue of 12 U.S.C. § 92a, state laws limiting or establishing preconditions on the exercise of fiduciary powers are not applicable to national banks."). "Fiduciary powers" includes acting as a trustee under section 92a. 12 C.F.R. § 9.2(g).
36. OCC Interpretive Letter No. 866, at 3 n.9 (Oct. 8, 1999).

mination by the OCC, in certain instances. Specifically, section 25b provides that a court reviewing the preemption determinations made by the OCC must "assess the validity of such determinations," based on a number of factors.[37] Thus, as amended by the Dodd-Frank Act, OCC preemption determinations are not given the deference that they are afforded under prior law. Instead, a court is required to conduct an independent review of each preemption determination.

However, again, that revised deference standard applies, in pertinent part, to only a determination regarding "preemption of a state law by title 62 of the Revised Statutes."[38] Thus, the OCC's determination that a national bank trustee acting under section 92a is not subject to state law should not be subject to the heightened review standard under the Dodd-Frank Act.

IV. Conclusion

It does not appear that states have the authority to require a national bank, acting as trustee of a common law trust, to be subject to state usury or licensing regimes, nor do they have the ability to require a common law trust to be licensed. This litigation is unfolding, and it remains to be seen how the court will resolve it.

37. 12 U.S.C. § 25b(b)(5)(A).
38. *Id*.