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Madden *Remand Muddles Contract Law: A SDNY Decision or Sign of a National Trend?*

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On February 27, the Southern District of New York (the "District Court") ruled in the remand of *Madden v. Midland Funding, LLC*[1] that New York's fundamental public policy against usury overrode a credit card agreement's Delaware choice-of-law provision.[2] The District Court's opinion was issued after the Second Circuit Court of Appeals remanded the debt collection case in 2015 and the U.S. Supreme Court denied *certiorari*; two decisions that disrupted well-settled consumer debt collection law.[3] While the *Madden* decision does not impact loans collected by a national or state bank exporting rates from a state in which it is located, the decision does raise manageable compliance issues for non-bank collectors of bank originated debt within the Southern District of New York. Moreover, we note that the *Madden* decision is another example of a court using public policy reasons to override voluntarily entered into contractual choice-of-law provisions.

Procedural History and Analysis of *Madden*

In 2015, the Second Circuit held that a debt collector that purchased charged-off consumer (credit card) debt from a national bank was not entitled to rely on the bank's federal preemption from New York's usury law. In *Madden*, a New York resident entered into an initial contract with a choice-of-law provision stating that Arizona and federal law govern the contract. However, a year after the account had been opened the bank sent a change in terms notification stating that, pursuant to the new terms, the account was issued by and would be serviced by another bank with a choice-of-law provision stating that Delaware and federal law would govern the contract. Delaware, as opposed to New York and Arizona, has no usury cap. The bank sold the defaulted debt to a non-bank debt collection company, which attempted to collect the debt, including outstanding interest at a rate above New York's civil and criminal usury caps. The Second Circuit upset the well-established body of law stipulating that loan assignees step into the shoes of the original lender and are entitled to enforce the rights of the lender pursuant to agreement terms determined at the time the loan is made. Further, the Second Circuit remanded the case for determination of, among other issues, whether a usury claim should follow a Delaware choice-of-law provision in a "Change in Terms" notification or the consumer debtor plaintiff's state of residence (New York).

On remand, the District Court found that, notwithstanding the parties' agreement that Delaware law should apply, Delaware's lack of any usury cap could not be reconciled with New York public policy to protect consumers from accepting predatory loan terms. Thus, the court decided that the choice-of-law analysis favored the application of New York law and that New York's usury cap was applicable.

The District Court held that in applying New York law, the state's civil usury law did not apply to defaulted obligations, such as the instant case. Further, the court found that while the plaintiff did not have the right to enforce New York's criminal usury law, this law did apply to a bank-issued, but subsequently sold, credit card contract being collected by a non-bank entity. Thus, the District Court granted judgment in favor of the defendant relating to the plaintiff pursuant to enforcing New York's criminal and civil usury laws. However, the District Court allowed the plaintiff to proceed with class action claims against the non-bank creditor that collection of interest above New York's 25% criminally usurious rate violates the Fair Debt Collection Practices Act ("FDCPA") and New York General Business Law ("GBL").[4]

Ramifications of *Madden* on Remand

The *Madden* remand decision continues to create some uncertainty regarding the uniform application of consumer lending laws, especially in the Second Circuit. While national and state banks can still originate consumer loans at an interest level permissible by the state in which the bank is located, non-bank lenders and purchasers of national banks' loans now risk liability if they make, purchase, enforce, or collect consumer loans at an interest rate above 25% if the borrower resides in New York, regardless of whether that borrower is a New York resident at the time the loan is made.

While we expect that the District Court's decision will be appealed by the defendants, the decision, unless overturned, has several ramifications:

- Non-bank entities collecting defaulted consumer debt within New York that is not partially owned by a national or state bank outside of New York must ensure that the interest terms of the loan and collection activity do not impose an annual percentage rate greater than 25%.

- The parties' agreed-upon interest rate may not be enforceable in the long term. The validity of an agreed-upon interest rate could be subject to change when a loan is sold or assigned from a bank to a non-bank, a borrower moves to New York, or when the usury laws of New York are more restrictive than the state designated by the choice-of-law provision in the initial credit agreement.

- The decision creates uncertainty in situations where a loan agreement's choice-of-law provision designates a state with a higher usury cap than that of New York. The court notes a usury cap of 25.1% might not be deemed to violate New York's fundamental public policy, but as found in *Madden* a rate of 32.24% could be deemed in violation. Regrettably, the remand decision does not establish a threshold or provide any guidance in this regard.

- Banks with consumer loans to New York residents may be unable to sell loans to non-banks if the interest rate charged exceeds 25%. This could result in banks sourcing New York collection activities in-house, holding troubled loans on their balance sheets for longer, or reducing the number of loans extended to riskier or subprime borrowers in New York.

- Although consumers in New York may benefit from reduced interest rates, less creditworthy borrowers may face greater challenges gaining access to credit from regulated non-bank financial institutions due to those institutions' inability to offset the risk of default by charging higher interest.

A National Trend Invalidating Choice-of-Law Provisions?

In addition to the concerns noted above, *Madden* is the latest decision to look past the contractual agreement of the parties to apply state usury and other consumer protection requirements to consumer credit and collections activity. Various courts have taken up some version of the issues presented in *Madden*, but none have held that bank originated loans sold are subject to interest rate determinations based on the location of collection (as opposed to the location of origination).

The most recent federal case looking past contractual terms accepted by both parties, involves an online Native American Tribal-based lender. As discussed in greater detail in our prior Client Alert Online Lenders Beware – Cash Call Decision another Example of True Lender Risks, in *Consumer Financial Protection Bureau v. CashCall, Inc.*, a federal district court looked past the face of a multi-party lending transaction and imposed state usury interest requirements.[5] In *CashCall*, the Consumer Financial Protection Bureau (the "CFPB") challenged non-bank CashCall's structure to offer and collect on consumer loans whereby the lender of record was an entity of the Cheyenne River Sioux Tribe. CashCall argued that the loans were subject to Tribal laws, which preempted state usury laws. The court held that the facts suggested otherwise and that the non-bank CashCall was the "true lender." Thus, notwithstanding the contractual terms and choice-of-law provision, the court found that the loans were offered by the non-tribal entity and subject to the usury laws of the state where the borrower resided.

Similarly, in *Commonwealth of Pennsylvania v. Think Finance*, in granting a motion to dismiss, a Pennsylvania district court looked past the agreement of a bank and a non-bank, online marketplace lender to determine that, despite a contractual agreement designating a Delaware-chartered bank as the lender, the "true lender" was the non-bank partner and thus the loans at issue were subject to Pennsylvania usury restrictions.[6]

These cases suggest that some courts may be departing from the traditional rules of contractual interpretation. Instead of emphasizing the actual text of an agreement and the parties' intent, courts appear to be more strongly considering public policy to determine whether a choice-of-law provision and state usury laws should apply to collection and lending activities. Each of these cases can be narrowed based on the specific activity described in the particular cases; however, the trend of the more subjective prong of a choice-of-law analysis being used more frequently to override a voluntarily entered into agreement, years after the entry of that agreement, is a troubling trend.

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

[2] No. 11-CV-8149, 2017 WL 758518 (S.D.N.Y. Feb. 27, 2017).

[3] The Second Circuit's decision in *Madden v. Midland Funding LLC* is discussed in more depth in our previous Client Alert, *Madden v. Midland Funding, LLC*: Potentially Far-Reaching Implications for Non-Bank Assignees of Bank-Originated Loans (Updated August 12, 2015).

[4] The District Court narrowed the plaintiff class to include only the following subset of debtors: all persons residing in New York that received a letter from the defendant attempting to collect interest above 25% per annum on consumer debt, whose credit card agreements: (i) contain choice-of-law provisions that designate the law of state that provides for no usury cap, or (ii) select New York law.

[5] *Consumer Financial Protection Bureau v. CashCall, Inc. et al.*, CV 15-7522-JFW (Aug. 31, 2016).

[6] Civil Action No. 14-cv-7139, (E.D. Pa. Jan. 14, 2016), https://www.paed.uscourts.gov/documents/opinions/16D0048P.pdf.