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COMPTROLLER OF THE CURRENCY AND FEDERAL DEPOSIT INSURANCE CORPORATION PROPOSE RULES ON MAXIMUM INTEREST RATE AUTHORITY

To Our Clients and Friends:

On November 18, 2019, the U.S. Office of the Comptroller of the Currency (OCC) issued a proposed regulation (OCC Proposal) that would codify, for national banks and federal thrifts, the common law "valid when made" doctrine of usury law. Yesterday, the Federal Deposit Insurance Corporation (FDIC) issued a similar proposal (FDIC Proposal) for FDIC-insured state banks and thrifts. In so doing, the agencies entered a lively debate that has gone on since the Second Circuit's 2015 decision in *Madden v. Midland Funding, LLC*, with significant ramifications for banks, thrifts, and nonbank lending companies. This Client Alert discusses the OCC and FDIC Proposals. The OCC and FDIC will receive comments on their proposals for 60 days from their publication in the Federal Register.

I. The "Valid When Made" and "Most Favored Lender" Doctrines

The "valid when made" doctrine is a common law doctrine that states that a loan that is not usurious at inception cannot subsequently become usurious by reason of its sale. It has been traced back to Supreme Court cases in the first half of the 19th century,[1] and has been cited by federal courts frequently since then.[2] With respect to loans made by a national bank or federal thrift, this doctrine has operated in tandem with the "most favored lender" doctrine, which also dates to the 19th century. Under the latter doctrine, which derives from court interpretations of 12 U.S.C. § 85, a national bank or federal thrift that has operations in more than one state may choose the law of its home state to govern interest rates on all its loans – including home states that have no usury limitations in their statutes.[3]

II. *Madden v. Midland Funding*

Taken together, the "valid when made" and "most favored lender" doctrines provide significant benefits to national banks and federal thrifts – such institutions that operate in a state without usury limitations not only have made loans nationwide with higher interest rates than permitted in some states, but those rates have also applied when the loans were assigned to third parties for value.

These benefits, however, were opened to challenge when the United States Court of Appeals for the Second Circuit handed down its decision in *Madden v. Midland Funding, LLC* in 2015.[4] In *Madden*, the plaintiff lived in New York, a state that has usury limits, but had a credit card with a national bank located in Delaware, which places no limitations on the amount of interest that can be charged. The national bank sold the plaintiff's credit card debt to Midland Funding, which sought to collect it at an interest rate of 27%, a rate higher than permitted in New York.

Although the Second Circuit recognized the "most favored lender" doctrine in *Madden*, it did not apply the "valid when made" doctrine. Rather, it analyzed the case as a question of federal preemption of state usury limits under the National Bank Act. It held that although courts had extended National Bank Act preemption to benefit subsidiaries and affiliates of national banks, it would not be appropriate to permit Midland Funding, a non-affiliate, to benefit from such preemption.[5] Refusing to give Midland Funding the benefit of preemption, in the Second Circuit's view, would not – under the relevant preemption test – "significantly interfere" with a national bank's ability to exercise its powers under the National Bank Act.[6]

Although the Second Circuit's *Madden* holding was extremely controversial and arguably in conflict with decisions in other circuits, the United States Supreme Court denied Midland Funding's petition for certiorari. Congress has taken no action to amend the National Bank Act since *Madden* was decided.

III. The Proposed Rules

The OCC styled its proposal as a clarification of doctrine under the National Bank Act; the text of the OCC Rule states that "[i]nterest on a loan that is permissible under 12 U.S.C. 85 [and 1463(g) (the Most Favored Lender doctrine)] shall not be affected by the sale, assignment, or other transfer of the loan."[7]

The OCC set forth the following arguments in support of the Proposed Rule. First is the "valid when made" doctrine itself: "this longstanding rule relating to usury certainly applies here; a loan by a bank that complies with section 85 or 1463(g) is by definition not usurious when it is originated, and a subsequent assignment of the loan does not render the loan usurious."[8] Second, the interpretation flows from the valid bank power to assign loan contracts to third parties: "[b]ecause the assignee steps into the bank's shoes upon assignment, the third party receives the benefit of and may enforce the permissible interest term."[9] The OCC stated further that the Supreme Court recognized this principle as prudent risk management in the mid-19th century: "[banks] must be able to assign or sell [their] notes when necessary and proper, as, for instance, to procure more specie in an emergency . . . ."[10] Finally, in what is the preamble's strongest point, the OCC stated that Congress had extended the "most favored lender" doctrine – with the implicit "valid when made" gloss – to federal thrifts, state-chartered insured depository institutions, and insured credit unions in 1980.[11] Then, in 2010, while revisiting federal preemption generally in the Dodd-Frank Act, Congress expressly preserved national banks' authority under 12 U.S.C. § 85 and thereby reaffirmed the importance of that provision in the banking system.[12]

The FDIC Rule is similar to the OCC Rule, but reflects the different statutory scheme applicable to FDIC-insured state banks and savings associations. That scheme dates from 1980, when Congress amended the Federal Deposit Insurance Act (FDIA) to add Section 27, which provides that:

> In order to prevent discrimination against State-chartered insured depository institutions, . . . if the applicable rate prescribed in this subsection exceeds the rate such State bank . . . would be permitted to charge in the absence of this subsection, such State bank . . . may, notwithstanding any State constitution or statute which is hereby preempted for the purposes of this section, take, receive, reserve, and charge on any loan or discount made . . . interest at a rate of not more than 1 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 such State bank . . . is located *or at the rate allowed by the laws of the State, territory, or district where the bank is located, whichever may be greater*.[13]

The FDIC has interpreted Section 27 to provide parity with national banks, and therefore insured state banks can export the interest rates permitted by their home states even if they have a branch in a different state in which the borrower resides.

In the preamble to its proposal, the FDIC stated that it was filling a statutory gap – Section 27 does not "state at what point in time the permissibility of interest should be determined" for purposes of judging compliance with Section 27.[14] The FDIC stated that its proposal would fill that gap by providing that this time is when the loan is first made, not when interest is taken or received.[15] The FDIC therefore, unlike the OCC, did not rely on the "valid when made" doctrine, but it stated that its interpretation was consistent with it. Like the OCC, the FDIC also relied on the inherent power of banks to assign their loans, and noted that the *Madden* decision made the power of a state bank to make a loan at Section 27's rate "illusory."[16]

IV. Conclusion

The Proposed Rules are likely to generate substantial comment, from both the banking industry and consumer advocates. The proposals are highly likely to be controversial with certain members of the latter constituency. Tellingly, and in likely reaction to recent skepticism over bank regulatory "guidance," the OCC and FDIC issued their interpretations in the traditional form of a rule proposal subject to notice and comment. If the rules are adopted as proposed, it would not be surprising if they are challenged as an impermissible construction of the National Bank Act and FDIA, thus raising again the issue of how much deference to accord bank regulators in interpreting federal banking law. Whether the proposals will restore uniformity to the secondary market for loans – an area where there is undoubtedly a federal interest, and where *Madden* was an unfortunate departure – therefore remains to be seen.

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[1] *See Nichols v. Fearson*, 32 U.S. (7 Pet.) 103, 109 (1833).

[2] *See, e.g., FDIC v. Lattimore Land Corp.*, 656 F.2d 139, 148-49 (5th Cir. 1981).

[3] In 1980, Congress granted this benefit to federal thrifts. *See* 12 U.S.C. § 1463(g).

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

[5] *See id.*

[6] *See id.*

[7] Office of the Comptroller of the Currency, Notice of Proposed Rulemaking: Permissible interest on loans that are sold, assigned, or otherwise transferred (November 18, 2019).

[8] *Id.* at 9.

[9] *Id.* at 10.

[10] *Id.* (quoting *Planters' Bank of Miss. v. Sharp*, 47 U.S. 301, 323 (1848)).

[11] *See* 12 U.S.C. §§ 1463(g), 1785, and 1831d.

[12] *See* Office of the Comptroller of the Currency, Notice of Proposed Rulemaking: Permissible interest on loans that are sold, assigned, or otherwise transferred (November 18, 2019), at 11-12.

[13] 12 U.S.C. § 1831d (emphasis added).

[14] *See* Federal Deposit Insurance Corporation, Notice of Proposed Rulemaking: Federal Interest Rate Authority (November 19, 2019), at 14.

[15] *See id.*

[16] *See id.* at 12.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work in the firm's Financial Institutions practice group, or the following:

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