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Madden Creates More Uncertainty For Marketplace Lenders

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The ongoing case of Madden v. Midland Funding has dealt marketplace lenders another blow. The first strike came in 2015, when the U.S. Court of Appeals for the Second Circuit ruled that a nonbank assignee of a bank loan was not afforded the preemption benefits of the National Bank Act and therefore could be subject to a borrower's home state's usury laws (Madden I). The district court, on remand from the Second Circuit, has now delivered a second blow, invalidating a Delaware choice-of-law clause that, if enforced, would have rendered the Second Circuit's decision moot (Madden II). Although the district court ultimately concluded that claims for violations of civil or criminal usury could not be asserted, it nonetheless permitted criminal usury to form the basis of violations of the Fair Debt Collection Practices Act (FDCPA) and comparable New York law. Madden II not only eliminates a potential Madden I workaround, but seemingly creates another layer of uncertainty for marketplace lenders, this time concerning New York's usury statutes.

Madden I

In Madden I, the Second Circuit held that Midland Funding, a nonbank assignee of a loan originated by a national bank, could be subject to New York's (Madden's home state) usury laws, notwithstanding that under the National Bank Act, the bank was subject to Delaware law (the bank's home state) when it held the loan. The Second Circuit sent the case back to the district court to determine the separate issue of whether Delaware law nonetheless applied in light of a Delaware choice-of-law clause in the governing agreement. If enforceable, the choice-of-law clause would have rendered the Second Circuit's decision moot since Delaware does not have a usury cap.

Madden II

Through a choice-of-law analysis, the district court concluded that New York law, and not Delaware law, applied because applying Delaware law would have violated a fundamental public policy of New York — namely, New York's criminal usury statute. New York recognizes two categories of usury: (1) civil usury and (2) criminal usury. The civil usury cap forbids charging interest in excess of 16 percent, and the criminal usury cap makes it a felony to charge interest in excess of 25 percent.

Applying New York law, the district court held that Madden could not assert violations of civil usury because the loan was in default and civil usury does not apply to defaulted obligations. As to criminal usury, although Madden's default did not impact the applicability of criminal usury (unlike civil usury),

the district court held that a claim could not be asserted because private litigants lack the authority to enforce criminal statutes.

Nevertheless, the district court held that the criminal usury statute could form the basis of claims under the FDCPA and comparable New York law since Madden's default did not impact the applicability of criminal usury. As set forth by the district court, various sections of the FDCPA prohibit a lender from seeking to collect more than it is entitled under applicable law. The district court concluded that charging interest in excess of New York's criminal usury cap could give rise to claims under these sections of the FDCPA.

Analysis

Madden I creates significant risk for marketplace lenders that originate loans in the Second Circuit (New York, Connecticut and Vermont) and rely on a partner bank origination model to avoid state usury caps. Indeed, investors have begun shying away from loans issued in the Second Circuit by such lenders, and rating agencies have warned that asset-backed securities (ABS) backed by such loans may suffer losses if borrowers can successfully assert claims based on violations of state usury laws. After Madden I came down, the industry was hopeful that the simple fix was the use of a choice-of-law clause in their loan agreements. Those hopes, however, were dashed when the district court issued its decision in Madden II.

If there is any silver lining for marketplace lenders, it is that, although the district court struck down the choice-of-law provision, it concluded that Madden was barred from asserting violations of civil usury because the loan was in default. Also helpful was the court's holding that Madden lacked standing to assert claims for violations of criminal usury. It is unclear, however, whether the court considered the anomalous potential results from its holdings. With regard to civil usury, it appears that pursuant to the court's holding, even if a loan is originated with an unenforceable interest rate that exceeds 16 percent (but is below 25 percent), that interest rate becomes enforceable upon the borrower's default. Thus, an interest rate can be usurious one day and nonusurious the next.

With regard to criminal usury, under the court's ruling, if a loan is originated with an interest rate below 16 percent, but provides for an interest rate above 25 percent upon default, the loan could be viewed as enforceable when it is current, but unenforceable when it is in default. Clarity here would be beneficial for both borrowers and consumer lenders generally.

As to investors in ABS backed by loans issued by marketplace lenders that rely on a partner bank origination model, Madden II appears to be neutral, but could ultimately be problematic. Unlike claims for violations of state usury laws, claims by borrowers for violations of the FDCPA only give rise to monetary penalties and do not impact the enforceability or collectability of the underlying loan. Thus, claims like those that survived in Madden II would not impact the income stream to investors. However, given that continued enforcement of usurious rates may give rise to repeated violations, claims under the FDCPA and comparable state law may put downward pressure on interest rates and, in turn, impact distributions to certificateholders. Moreover, to the extent Madden II forecloses civil usury claims when a borrower is in default, even if the loan was originated with a usurious rate, borrowers may be able to preserve civil usury claims by curing any defaults prior to bringing suit. Any such claims could threaten the enforceability of certain marketplace loans backing ABS deals.

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