LEGAL UPDATES

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One Step Closer to Certainty: Court Dismisses States' Challenges to "Valid When Made" Rules

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On February 8, 2022, a federal district court in California issued separate orders[1] concluding that the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) did not violate the Administrative Procedures Act when each regulator promulgated a rule stating that if the interest rate on a loan is permissible under the applicable banking statute, then the interest rate is not affected by the sale, assignment or other transfer of the loan (known as the "valid when made" rules[2]).

The court's rulings dismissed a challenge by the Attorneys General in California, Illinois and New York to the validity of the OCC's valid when made (VWM) rule and a challenge by the Attorneys General in California, the District of Columbia, Illinois, Massachusetts, Minnesota, New Jersey, New York and North Carolina to the validity of the FDIC's VWM rule. It is unclear whether the state Attorneys General will appeal the court's rulings to the U.S. Court of Appeals for the Ninth Circuit. Nonetheless, the court's rulings represent a positive step to providing more legal certainty to banks and secondary loan markets for banks on the permissible interest rates on transferred loans.

The OCC Order

In the challenge to the OCC's VWM rule, the state Attorneys General proffered three arguments that the OCC's rule should be invalidated. First, the state Attorneys General argued that the OCC failed to follow the procedures for making state law preemption determinations as required under 12 U.S.C. § 25b. The court rejected the states' argument that Section 25b applied to the OCC's VWM rule because the "sole legal effect" of the rule was to preempt state interest rate limits for bank loan purchasers. The court viewed the VWM rule

as an interpretation of Section 85 of the National Bank Act (NBA) (national bank's interest rate authority) as opposed to a determination of whether Section 85 preempts a particular state law. Accordingly, the VWM rule was not a preemption determination by the OCC subject to Section 25b.

Second, the court disagreed with the state Attorneys General that the U.S. Court of Appeals for the Second Circuit's decision in *Madden v. Midland Funding LLC*[3] foreclosed the OCC's ability to promulgate its VWM rule. The states argued that the *Madden* decision implicitly construed the unambiguous terms of a national bank's interest rate authority in Section 85. The court observed that the Second Circuit merely distinguished prior cases extending NBA preemption to non-national banks. According to the court, the Second Circuit did not clearly hold that the terms of Section 85 were unambiguous. Thus, the *Madden* decision did not preclude the OCC from interpreting Section 85 through the VWM rule.

Finally, state Attorneys General argued that the VWM rule should not be entitled to Chevron deference because the VWM rule is manifestly contrary to Section 85 and is arbitrary and capricious. The court rejected the states' argument that the VWM rule assigns the statutory right of preemption to nonbanks. The court viewed the VWM rule as addressing a question upon which Section 85 is silent. Ultimately, the court found that the OCC's VWM rule was based on an express banking power under the NBA, the rule was within the OCC's mandate to assure the safety and soundness of national banks, and the record evidenced that OCC considered an important aspect of the problem addressed by its rule including whether the rule would enable "rent-a-bank" schemes. The court denied the state Attorneys General's summary judgment motion and closed the case.

The FDIC Order

In a separate order, the same judge upheld the FDIC's VWM rule and referred to the rationale in its OCC order frequently. The order addresses the different statutory authority (12 U.S.C. § 1831d), under which federally insured state-chartered banks may charge interest rates on loans. First, the court agreed with the FDIC that Section 1831d is silent on the interpretative issues that the FDIC sought to address in its rule. Next, the court found that the FDIC's interpretation was entitled to deference because the FDIC's VWM rule is not manifestly contrary to Section 1831d and is not arbitrary or capricious. According to the court, it was reasonable for the FDIC to determine that greater legal certainty regarding interest rates that may be charged on transferred loans would assist federally insured state-chartered banks to properly maintain capital and liquidity. Finally, the court did not find evidence that the FDIC entirely failed to consider an important aspect of the problem addressed by its rule including whether the rule would enable "rent-a-bank" schemes. The court denied the state Attorneys General's summary judgment motion and closed the case.

The Aftermath

The OCC and FDIC finalized their VWM rules to address legal uncertainty created by the decision in *Madden v. Midland Funding* regarding the interest rates that bank loan purchasers could charge on transferred loans. In *Madden*, the Second Circuit held that usury claims against a nonbank debt collector regarding credit card debt originated by a national bank were not preempted by the NBA. Many readers of the *Madden* opinion questioned whether the Second Circuit had invalidated the longstanding common law "valid when made" doctrine, which provides that a loan contract that is not usurious in its inception does not become usurious in the hands of a subsequent holder upon assignment. Although the VWM doctrine was not expressly addressed in the Second Circuit's opinion, the *Madden* decision caused lenders and investors to question whether interest rates on transferred loans (including loans in large portfolios) had to be evaluated on a state-by-state basis, particularly loans to borrowers within the Second Circuit's jurisdiction.

Subject to an appeal to the Ninth Circuit, the federal court's rulings could provide more legal certainty to the interest rates that may be charged by subsequent loan holders on loans originated by national banks, federal savings banks, and federally insured state-chartered banks. However, the legal clarity provided by the VWM rules may not benefit all types of lenders. The VWM rules apply only to certain depository financial institutions and do not apply directly to nonbank lenders. Subsequent holders of loans originated by nonbank licensed lenders could face *Madden*-like challenges to the interest rates charged on the transferred loans because the common law "valid when made" doctrine applies generally to all loan contracts. While the rationale behind the OCC's and FDIC's VWM rules and the court's rulings could help defeat interest rate challenges on transferred loans originated by nonbanks, the VWM rules do not apply directly to such loans.

Furthermore, even if the VWM rules ultimately withstand the states' validity challenges, interest rates charged on transferred loans originated by nonbanks or banks in partnership programs could still be challenged by arguing that the purported lender was not the "true lender" of the loan and the entity that is the alleged "true lender" does not have the authority under applicable laws to charge the same interest rate on the loans at issue. In June 2021, President Biden signed a Congressional Review Act resolution that invalidated the OCC's "True Lender" rule, which the OCC promulgated to provide certainty on when a traditional bank is the true lender of loans made in a partnership with a nonbank.

For now, the court's rulings represent a positive step towards greater legal certainty for banks and the secondary loan market on the permissible interest rates on transferred bank loans.

Contact us

If you have questions about this update and how it might affect your business, contact Susan Seaman or your Husch Blackwell attorney.

[1] See California v. OCC, No. 20-cv-05200-JSW (N.D. Cal. Feb. 8, 2022); California v. OCC, No. 20-cv-05860-JSW (N.D. Cal. Feb. 8, 2022)

[2] Federal Interest Rate Authority Rule, 85 Fed. Reg. 44,146 (July 22, 2020) (FDIC rule); Permissible Interest on Loans That Are Sold, Assigned or Otherwise Transferred, 85 Fed. Reg. 33,350 (June 2, 2020) (OCC rule).

[3] 786 F.3d 246 (2d Cir. 2015).