Banking Agencies Seeking to Make "Valid When Made" Valid for Fintech

June 16, 2020

In a statement upon appointment, Brian Brooks, the newly appointed Acting Comptroller of the Currency, said "Innovation is a personal passion of mine, and the OCC can build on its foundation of innovation to provide banks and thrifts the regulatory certainty, the flexible framework, and oversight that allows them to evolve and capitalize on technology and innovation to deliver better products and services, to operate more efficiently, and to reduce risk in the system."[1]

As one element of that focus,[2] on June 2, 2020, the Office of Comptroller of the Currency (the "OCC") published a final rule (the "OCC Final Rule") intended to provide certainty and support to national banks and their nonbank Fintech and other counterparties (collectively referred to herein as "Fintech") by clarifying that interest rates that are permissible for a national bank before transfer continue to be permissible after the transfer of the loan to the Fintech (commonly known as the "valid when made doctrine").[3] The Chair of the Federal Deposit Insurance Corporation (the "FDIC"), Jelena McWilliams, has shown similar interest in promoting the collaboration of banking and Fintech, through the agency's ILC proposal[4] and its own proposal supporting the valid when made doctrine.[5]

The courts, however, supported by state bank regulators,[6] have raised concerns about the valid when made doctrine and the relationship between banks and Fintech more generally, focusing on the concern of evasion of state usury laws that protect their

---

[1] OCC, Brian P. Brooks Statement on Becoming Acting Comptroller, May 29, 2020, found here.

[2] The OCC has also recently issued an advance notice of proposed rulemaking ("ANPR") inviting public comment on its regulations broadly relating to the "digital activities" of national banks and federal savings associations. For a Debevoise update on this ANPR, see here.

[3] OCC, Permissible Interest on Loans That Are Sold, Assigned, or Otherwise Transferred, 84 FR 64229 (Nov. 21, 2019).

[4] For a Debevoise update of this proposal, see here.

[5] FDIC, Federal Interest Rate Authority, 84 Federal Register 66845 (December 6, 2020).

[6] *See, e.g.*, New Task Department of Financial Services, "Statement by Superintendent of Financial Services Linda A. Lacewell on Proposed Madden 'Fix'" (December 19, 2019); Conference Of State Bank Supervisors, Statement For The Record To The U.S. House Financial Services Committee Hearing On "Rent-A-Bank Schemes And New Debt Traps: Assessing Efforts To Evade State Consumer Protections And Interest Rate Caps" (February 5, 2020), found here.

citizenry. This Client Update focuses on these issues. Given the size of this symbiotic relationship between bank loan sellers and Fintech purchasers, the outcome of this debate is very important to the continued evolution of banking and Fintech.

Background

Federal law establishes that banks—including national banks (under Section 85 of the National Banking Act (the "NBA")[7]), savings associations (under the Home Owners' Loan Act[8]) and state banks (under Section 27 of the Federal Deposit Insurance Act (the "FDIA")[9])—may charge interest on loans at the maximum rate permitted to any state-chartered or licensed lending institution in the state where the bank is located or one percent in excess of the ninety-day commercial paper rate, whichever is greater. Subsequent case law has interpreted these statutes to generally allow both national and state banks to "export" the interest rates of their home states to borrowers residing in other states, notwithstanding the usury laws of those other states.[10]

In conjunction with the above, for many years banks sold loans to Fintech in reliance on the valid when made doctrine. That changed in 2015, with the decision of the U.S. Court of Appeals for the Second Circuit in *Madden v. Midland Funding, LLC.*[11] In *Madden*, the Second Circuit held that a nonbank purchaser of bank-originated credit card debt was subject to New York State's usury laws. The court concluded that Section 85—which, as noted above, authorizes national banks to charge interest at the rate permitted by the law of the state in which the national bank is located, regardless of interest rate restrictions by other states—does not automatically make that interest rate permissible for nonbank assignees of loans.

The Second Circuit reasoned that the preemption in Section 85 is limited to banks and should not extend to a nonbank, unless the application of state law to that action would significantly interfere with a national bank's ability to exercise its power under the NBA. The court acknowledged that this ruling could decrease the amount a national bank could charge for its consumer debt in certain states, but found that such effects would not, unto itself, constitute significant interference. The court also stressed that extending these protections to nonbank third parties would create an end run around usury laws for Fintech.

---

[7] 12 U.S.C. 85.

[8] 12 U.S.C. 1463(g).

[9] 12 U.S.C. 1831d.

[10] *See e.g., Marquette National Bank v. First of Omaha Service Corporation*, 439 U.S. 299 (1978); *Greenwood Trust Co.*, 971 F.2d at 827.

[11] 786 F.3d 246 (2d. Cir. 2015).

OCC Final Rule

To seek to address the uncertainty created by *Madden,* both the OCC (for national banks) and the FDIC (for state banks) published substantially similar proposed rules seeking to administratively affirm the valid when made doctrine.[12] The OCC finalized its rule on June 2, 2020.[13] In the Preamble to the OCC Final Rule, the OCC asserted that *Madden* did not foreclose its rulemaking, because the Second Circuit did not make a specific finding that Section 85's language unambiguously does not extend preemption to Fintech purchasers of bank loans. The OCC offered a number of additional arguments in support of its rulemaking:

- **Authority**. The OCC acknowledged that the comprehensive statutory scheme regarding interest permitted on national bank loans does not expressly address how the exercise of a national bank's authority to transfer a loan and assign the loan contract affects the interest term.[14] However, the OCC noted that, when Congress enacted the NBA, it understood that loan transfers were a fundamental aspect of the business of banking and that such transfers would play an important role in the national banking system. Therefore, the Final Rule asserts the OCC has the authority to interpret and resolve the ambiguity inherent in this aspect of the NBA through a rulemaking process.

- **Reasonable Interpretation**. The NBA provides national banks with enumerated powers, including the ability to lend money, and "all such incidental powers as shall be necessary to carry on the business of banking," including the authority to transfer loans[15] and make contracts.[16] Under common law, inherent in the power to make contracts is the right to assign some or all of the benefits of a contract to a third party. For banks to effectively exercise the power to assign a loan contract, the OCC asserted, a permissible interest rate must remain permissible and enforceable notwithstanding the assignment.

- **Safety and Soundness**. The OCC also stated it believes the reaffirmation of the valid when made doctrine in the Final Rule will promote safe and sound operations by

---

[12] OCC, Permissible Interest on Loans That Are Sold, Assigned, or Otherwise Transferred, 84 FR 64229 (Nov. 21, 2019); FDIC, Federal Interest Rate Authority, 84 Federal Register 66845 (December 6, 2020).

[13] OCC, 12 C.F.R. Parts 7 and 160, Final Rule Permissible Interest on Loans That Are Sold, Assigned, or Otherwise Transferred (June 2, 2020).

[14] "However, the comprehensive statutory scheme regarding interest permitted on national bank loans does not expressly address how the exercise of a national bank's authority to transfer a loan and assign the loan contract affects the interest term." OCC, Final Rule Permissible Interest on Loans That Are Sold, Assigned, or Otherwise Transferred, 84 Federal Register 33531 (June 2, 2020).

[15] 12 U.S.C. 24 (Seventh) and 371.

[16] 12 U.S.C. 24 (Third).

> ensuring that national banks of all sizes can continue to rely on loan transfers as a means to access alternative funding sources, manage concentrations, improve financial performance ratios and more efficiently meet customer needs.

The FDIC issued a substantially similar NPR that would clarify that interest rates that are permissible by a *state* bank before transfer continue to be permissible after the transfer. The FDIC has yet to finalize its rule.

Recent Colorado Decision

Shortly after the OCC Final Rule sought to resolve this issue with respect to national bank/Fintech relationships, some question about the valid when made doctrine was raised again by a Colorado court on June 9, 2020.[17] The Colorado state district court ruled that federal preemption from state interest rate caps for state banks does not extend to nonbank entities that purchase the loans.[18] Citing *Madden,* the court held that Section 27 of the FDIA—which, as noted above, authorizes state banks to charge interest at the rate permitted by the law of the state in which the national bank is located, regardless of interest rate restrictions by other states was clear in its exclusion of nonbanks and that any expansion of preemption to nonbanks would create an end run around state usury laws.

Notably, although the decision was issued a week after the OCC published its Final Rule, the court's opinion discusses only the proposed regulations of the OCC (as well as the still proposed FDIC rulemaking). The court disregarded both the OCC and FDIC proposed rules, noting that it "accepts that these federal agencies are entitled to some deference" but that "the rule proposals are not yet law and the Court is not obligated to follow their proposals."[19] Because the case involved a state bank, the OCC's finalization is not directly relevant to the case, and thus it is not certain how the court would have ruled if both the OCC and FDIC valid when made rules had been finalized. Nonetheless, the court's reference to only "some deference" to the banking agencies leaves some concern about whether the OCC Final Rule—and the forthcoming FDIC final rule—will eliminate further judicial questioning of the valid when made doctrine.

---

17 Debevoise & Plimpton LLC filed an amicus brief in support of the valid when made doctrine in this case. The amicus brief was filed in federal court prior to the case's remand to the Colorado state district court.

18 *Fulford v. Marlette Funding, LLC*, Colo. Dist. Ct., No. 2017CV30376, (June 9, 2020).

19 *Id.* at 9.

Upcoming "True Lender" Rulemaking

In a recent statement, Acting Comptroller Brooks announced that the OCC is preparing another proposal to address a related but distinct issue that was not addressed in the OCC Final Rule—who is the "true lender" in a bank/Fintech relationship. The "true lender" doctrine has been used by some courts to apply state usury or consumer protection laws to Fintech companies that have partnered with banks in issuing loans and retain a "predominant economic interest" in the loan.[20] These courts assert that, for purposes of preemption, the Fintech company rather than the bank should be deemed to have made the loan because, for instance, the bank is not sufficiently engaged in the lending program and does not receive the benefits or take the risks expected of a "true lender." The new OCC proposal is expected to establish sharper lines between bank-Fintech partnerships the OCC views as legitimate and so-called "rent-a-charter" arrangements in which online lenders purportedly use bank relationships to evade state interest rate caps.[21] Acting Comptroller Brooks stated the FDIC also is likely to join the OCC on this proposal. Notably, this forthcoming rulemaking can also be seen as an attempt to assuage some of the concerns expressed by the courts in *Madden* that the expansion of preemption to Fintech in rent-a-charter arrangements would create an end run around state usury laws.

* * *

Please do not hesitate to contact us with any questions.

---

[20] *See, e.g.*, *People ex rel. Spitzer v. Cty. Bank of Rehoboth Beach, Del.*, 846 N.Y.S.2d 436 (N.Y. App. Div. 2007).

[21] Online Lending Policy Institute, A conversation with Brian Brooks, Acting Comptroller of the Currency (June 11, 2020), description found here.

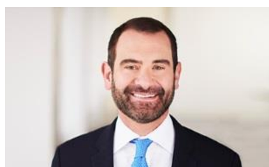
NEW YORK

Courtney M. Dankworth
cmdankwo@debevoise.com

Mary Beth Hogan
mbhogan@debevoise.com

Gregory J. Lyons
gjlyons@debevoise.com

Alison M. Hashmall
ahashmall@debevoise.com



David G. Sewell
dsewell@debevoise.com

Alexandra N. Mogul
anmogul@debevoise.com

Jason Samstein (Law Clerk)
jsamstei@debevoise.com