Implications for Mortgage Lenders, Servicers, and Investors if the "Valid-When-Made" Rule is Overruled

Prepared by the Legal League 100
Special Initiatives Working Group
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Dear Colleagues,

The Legal League 100 (LL100) is the nation's premier collection of financial services law firms, organized to further its members' commitment to supporting the mortgage servicing industry through education, communication, and relationship development. The LL100's membership at large, council, and Special Initiatives Working Group (SIWG) work tirelessly to be a leading force for industry standards, education, and market research.

In advancement of this mission, this whitepaper from the LL100's SIWG provides information about the "Valid-When-Made" Rule, an important doctrine governing maximum interest rates in lending and foreclosure in all states. This paper discusses the history of the doctrine, the origin of the 2020 rules promulgated by the OCC and FDIC, the *Madden* decision as well as pending challenges to this Rule.

As the challenges to this doctrine could impact lending, the secondary market and future foreclosures, the SIWG's goal is that the following information will provide useful insights and assistance to the industry.

Sincerely,

Legal League 100's Special Initiatives Working Group

IMPLICATIONS FOR MORTGAGE LENDERS, SERVICERS, AND INVESTORS IF THE "VALID-WHEN-MADE" RULE IS OVERRULED.[1]

New rules promulgated by the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) in 2020 codified a doctrine known as the "Valid-When-Made" Rule. The new OCC and FDIC rules are under attack in the federal courts, with legal actions seeking to have the rules overturned. The potential effects of a successful challenge to these rules could have implications for lenders, servicers, investors, and law firms in the foreclosure area. They could also throw into question enforcement of interest rates and other terms on previously originated mortgages.

This article explores the history of the "Valid-When-Made" Rule, the important *Madden* decision, and the rules promulgated by the OCC and the FDIC, as well as the implications if this long-standing doctrine is eliminated.

I. HISTORY OF THE "VALID-WHEN-MADE" RULE

Analysis of the origins of the "valid-when-made" rule first requires a review of the subject of preemption under various federal statutes, including the National Bank Act (NBA),[2] the Home Owners' Loan Act (HOLA),[3] the Federal Deposit Insurance Act (FDIA),[4] and the federal Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDA). To promote lending and interstate banking, DIDA provided for preemption of certain state laws, including on matters related to usury:

[1]By Stephen M. Hladik, Esquire, Seth J. Greenhill, Esquire and David Friedman, Esquire.

[2]*See*, 12 U.S.C. § 85.

[3]*See*, 12 U.S.C. § 1463(g).

[4]*See*, 12 U.S.C. § 1831d(a).

Section 521 of DIDA provides in pertinent part:

> In order to prevent discrimination against State-chartered insured depository institutions … 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, or upon any note, bill of exchange, or other evidence of debt, interest … at the rate allowed by the laws of the State … where the bank is located. …
>
> 12 U.S.C. § 1831d(a).
>
> We [the FDIC] have stated consistently that section 521 was intended to give state-chartered FDIC-insured banks the same "most favored lender" status and right to export interest enjoyed by national banks under 12 U.S.C. 85 ("section 85"). *See, e.g.*, Letter from Frank L. Skillern, Jr., General Counsel, FDIC #81--3 [1988--89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,006 at 55,107 (February 2, 1981) (most favored lender); Letter from Kathy A. Johnson, Attorney, FDIC #81--7 [1988--89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,008 at 55,110 (March 17, 1981) (exportation). In our most recent interpretation, we concluded that **section 521 preempts the laws of an out-of-state borrower's home state, to the extent that such laws purport to restrict the interest or fees that are a component of interest or material to determination of interest** (Material Fees) that an FDIC-insured state bank is authorized to assess by its chartering state. *See* Letter from Douglas H. Jones, Deputy General Counsel, FDIC #92--47 [Current] Fed. Banking L. Rep. (CCH) ¶ 81,534 at 55,730--31 (July 8, 1992).[5]

To summarize, any bank created under federal law (i.e., a national bank, national association, etc.) or state-chartered bank insured by the FDIC may utilize the maximum interest provided for under the laws of their home state and "export" that rate to a borrower in a different state, even where that different state may, under its own state laws, have a lower cap on interest rates. This became known as the "Export Doctrine," which allowed lenders to use a uniform interest rate across all 50 states by exporting the maximum allowable interest rate from their home state.

If the interest rate was legally permissible at origination, the legal issue then becomes what happens when a lender *sells* or *assigns* a mortgage loan to another entity that does not have a banking charter at all. This is how the "valid-when-made" rule evolved. Essentially, if the loan and its interest rate were valid under the particular state law where the originator was located, that interest rate would remain valid when the loan transferred to a non-bank entity.

[5] https://www.fdic.gov/regulations/laws/rules/4000-8160.html

Essentially, a loan presumed to be valid at the time it was originated cannot transform into an invalid loan when the loan is sold to a different company. For example, the Pennsylvania Department of Banking succinctly stated, "Thus, the preemption of state usury law *attaches to the loan itself*, rather than just to a particular lender."[6] This acknowledgment by the Department of Banking is an acceptance of the "Valid-When-Made" Rule. This rule is a cornerstone of United States contract law. This basic principle has been acknowledged and validated by federal courts since at least the early 19th century. As observed by Judge Richard Posner "[o]nce assignors were authorized to charge interest, the common law kicked in and gave the assignees the same right, because the common law puts the assignee in the assignor's shoes, whatever the shoe size." *Olvera v. Blitt & Gaines, PC*, 431 F.3d 285, 289 (7th Cir. 2005).

There are numerous cases confirming that a non-usurious loan cannot be made usurious merely by an assignment of the debt. *See, e.g., Huntsman v. Longwell*, 4 F.2d 105 (5th Cir. 1925) (if, at the time of origination, a contract is unaffected by usury, it is not invalidated by a subsequent transaction); *Hirsch v. Smith*, 262 Wis. 75, 79, 53 N.W.2d 769, 771, 1952 Wisc. LEXIS 328, *7 ("it is an established rule that, if a contract for the loan of money is valid when made, it does not become void for usury"); *General Motors Acceptance Co. v. Weinrich*, 218 Mo. App. 68 (1924) (contract free from usurious taint will not be invalidated by any subsequent transaction). The Valid-When-Made Rule is an essential, universal principle of commercial dealing.

II. THE SECOND CIRCUIT'S OPINION IN THE *MADDEN* DECISION IMPACTED THE VALID-WHEN-MADE RULE.

The United States Court of Appeals for the Second Circuit (the Second Circuit) issued a decision in *Madden v. Midland Funding LLC*, 786 F.3d 246 (2d Cir. 2015) affecting this long-standing doctrine.[7] The Second Circuit, in reaching its holding, did not take into consideration the "Valid-When-Made Rule" and instead focused solely on a non-bank's relationship with the originating bank.

[7]A very good analysis of the *Madden* case and the lengthy history of federal preemption in the banking arena is contained in a Note appearing in the Columbia Law Review: "Interest Exportation and Preemption; *Madden's* Impact on National Banks, The Secondary Credit Market, and P2P Lending," by Michael Marvin, Vol. 116, No. 7, https://columbialawreview.org/content/interest-exportation-and-preemption-maddens-impact-on-national-banks-the-secondary-credit-market-and-p2p-lending/

See, also, "A Surge in Support for 'Valid When Made,'" by Dawn Causey, Thomas Pinder and Andrew Doersam, ABA Banking Journal, December 2019, https://bankingjournal.aba.com/2019/12/a-surge-of-support-for-valid-when-made/

As a direct result of this ruling, both the OCC and the FDIC issued Notices of Proposed Rulemaking which codified the "Valid-When-Made" Rule in the Code of Federal Regulations. In its November 2019 Notice, the OCC stated, "After considering the principles discussed below, the OCC has concluded that when a bank sells, assigns, or otherwise transfers a loan, interest permissible prior to the transfer continues to be permissible following the transfer. This proposed rule would codify this conclusion." *See*, Fed. Register, November 21, 2019, Volume 84, p. 64230, https://www.occ.gov/news-issuances/federal-register/2019/84fr64229.pdf.

By way of background, *Madden* was a class-action debt-collection case involving unsecured credit card debt issued by a national bank. Eventually, the national bank sold the unsecured debt to FIA Card Servicers, N.A. (FIA); the debt was again transferred to the named defendant, Midland Funding, LLC (Midland). *Id* at 248. Midland is not a national or state-chartered bank, and neither the national bank nor FIA retained any interest in the debt. Notwithstanding, the District Court found that Midland was "entitled to the protection" of the NBA. *Id*. Notably, the District Court's finding relied partly upon the "Valid-When-Made" doctrine, which was not considered on appeal.

Ultimately, the Second Circuit, in fact, found that Midland was not entitled to federal preemption. In so holding, the Second Circuit examined the relationship between Midland and its predecessors in interest to conclude, "in most cases in which [NBA] preemption has been applied to a non-national bank entity, the entity has exercised the powers of a national bank—*i.e.*, has acted on behalf of a national bank in carrying out the national bank's interest." *Id* at 251. However, the Second Circuit of Appeals did not discuss the applicability of the "Valid-When-Made" doctrine. The *Madden* decision does not square with the long-accepted view of preemption applying to the loan itself at the time of origination rather than the current owner of the loan.

As a result of *Madden*, the OCC and FDIC took the extraordinary step of incorporating the "Valid-When-Made" Rule into the Code of Federal Regulations. The OCC issued its Final Rule on May 29, 2020, and the new regulation is codified for national banks at 12 CFR § 7.4001(e) and a similar regulation for federal savings associations at 12 CFR § 160.10(a).

As noted earlier, there is pending federal litigation in the United States District Court for the Northern District of California which contends that the rule was improperly promulgated and is thus invalid. The two cases are *People of the State of California ex rel. Xavier Beccerra, et al., v. The Office of the Comptroller of the Currency, et al.*, Case No. 20-cv-5200 (the OCC Case) and *People of the State of California ex rel. Xavier Beccerra, et al., v. The Federal Deposit Insurance Corporation*, Case No. 20-5860 (the FDIC Case):

In these cases, various state attorneys general argue that:

> The Rule also contravenes the judgment of Congress, which limited the preemption of state interest-rate caps to FDIC banks in § 1831d and declined to extend that pre-emption to non-banks. The Non-bank Interest Provision impermissibly preempts state law by extending § 1831d's protection against state-law rate caps to *any* entity that purchases a loan from an FDIC Bank. This is contrary to Congress's clear and manifest intent and invades the traditional sovereign authority of state governments to protect consumers, busines owners, and the lending marketplace within their borders.[8]

Motions for summary judgment are currently pending on this legal issue of whether the OCC and/or the FDIC had the appropriate powers to promulgate these rules codifying the doctrine.

III. IMPLICATIONS FOR LENDERS, SERVICERS, AND LAW FIRMS

A significant impact will be created if this doctrine is overruled. Without the rule, and in consideration of the *Madden* decision, it is now going to be a circuit-by-circuit battle as to this doctrine, as well as a state-by-state fight.

In the current economic environment, interest rates are low, and many loans may not be near any state caps on rates, but there are certainly still outstanding loans that would be impacted. If (and when) interest rates go up, more loans may approach rate caps, and there is a potential logistical problem for lenders and servicers. If the *Madden* view becomes the prevailing view throughout the country, this would create problems with the secondary market in the sales of loans.[9]

Second, it also creates the confusion around servicing, in that every servicer taking on a new loan would now have to review the location of the originator, the domicile of the new owner of the loan, and whether the new owner of the loan is a national bank or an FDIC-insured institution, as well as the location by state of the borrower. If either the new owner of the loan or the borrower of the loan were in different states, a servicer would now have to review whether the state of the new owner or the state of the borrower have different caps on interest rates and whether the rate being charged is within or under those caps. Interest may have to be recalculated to account for a new potentially lower rate. Finally, this also creates issues under the federal Fair Debt Collection Practices Act if the servicer or a foreclosing lender seeks to charge interest at a rate that may no longer be enforceable.

[8]FDIC Case, complaint at paragraph 8, Case 4:20-cv-05860, Document 1.

[9]According to the Structured Finance Association, "If regulatory or legislative action does not clearly codify the 'Valid-When-Made' doctrine, then the Second Circuit's [Madden] decision will continue to unsettle credit markets, increase costs, decrease competition, chill efforts to expand access, and impact products and lending models." https://structuredfinance.org/wp-content/uploads/2019/08/Valid-When-Made_Structured-Finance-Association.pdf

Another important consideration of widespread acceptance of the *Madden* view is how this rule would impact enforcement of the loan instruments in state court foreclosure actions. In the judicial foreclosure state of Florida, for example, courts have held that a borrower can defend against foreclosure by proving violations of the statutes governing usury law. In Florida, a loan is usurious if the original principal balance is $500,000.00 or less with an interest rate of greater than 18%. If the *Madden* view becomes the standard, a Florida-based investor could be faced with a situation where they acquire a loan with an interest rate valid when made, but which is now considered a violation of the state's cap on allowable interest rates. In this scenario, a new owner may be forced to forfeit all interest charged on the loan.

There is also a situation where an interest rate could rise to the level of being considered criminal. A loan is criminally usurious in Florida when the interest rate is greater than 25% but less than 45%. While there are additional factors and requirements on top of a violation of the interest rate threshold, including a determination that the lender had a corrupt intent at the inception of the loan, the penalty for a criminally usurious loan is extreme. A court could find that a criminally usurious loan is completely unenforceable, leaving an investor with a non-performing loan without any recourse.

The *Madden* view also impacts bankruptcy cases. Oftentimes when a borrower files for bankruptcy, particularly a chapter 13, it is done so in order to try and save their residence. This is accomplished by filing a plan that proposes to "cure and pay" in accordance with 11 U.S.C. § 1322(b)(5). This allows the loan to de-accelerate and the borrower is able to cure the arrears without interest while maintaining the ongoing payments. In order to determine the correct arrearage amount, the borrower looks to the Proof of Claim that is filed by the creditor. A Proof of Claim is a snapshot of the loan as of the date of filing. This includes the computation of the arrearage amount, which is comprised of pre-petition interest charges. A Proof of Claim is also signed under penalty of perjury, where it is attested to that all of the information is true and accurate.

Where this could be problematic is a borrower objecting to the Proof of Claim that includes interest calculations that violate state usury laws. Not only would this create unnecessary litigation, but it would also require the creditor to re-calculate the pre-petition interest on the loan. It may also result in fees being awarded to borrower's counsel. This would create a potential servicing nightmare when loans are in bankruptcy.

The view espoused by proponents of the *Madden* decision upends the long-standing notion that parties to lending agreements (including assignees) can rely on the written terms as set forth in the instrument. If the *Madden* view prevails, that "certainty" of relying on the written terms of a loan document may no longer exist.

THE LEGAL LEAGUE 100

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