Tucker Ellis | LLP

CLIENT ALERT

OCC RULE PROVIDES LOAN TRANSFEREES WITH PROTECTION FROM USURY LAWS

JUNE 2020

By a rule it adopted on May 29, 2020, the Office of the Comptroller of the Currency ("OCC") attempts to resolve a national dispute about the legality of interest rates on loans after the loans are sold by a national bank or a federal savings association. The new rule provides simply, "Interest on a loan that is permissible under [federal law] shall not be affected by the sale, assignment, or other transfer of the loan." The rule is an effort to reverse the effect of the Second Circuit's 2015 ruling in *Madden v. Midland Funding, LLC*. There, the court held that entities other than national banks are not entitled to protection under the National Bank Act from state-law usury claims merely because they are assignees of a national bank. The *Madden* case put a chill on non-banks' willingness to buy some loans and thereby put a chill on banks' origination of loans that might be sold to non-banks.

The controversy is a result of the fact that, in some states, the laws limiting interest rates, i.e., usury laws, allow different maximum rates depending on how the lender is licensed. For example, a state-chartered bank may be allowed to charge a higher interest rate than another type of lender. (See the Appendix for some state-specific examples.)

Federal law does not directly set interest rates that federally chartered banks and thrifts are allowed to charge. Instead, federal law allows the federal institution to charge interest "at the rate allowed by the laws of the State, Territory, or District where the bank is located … and no more, except that where by the laws of any State a different rate is limited for banks organized under State laws, the rate so limited shall be allowed …." This section makes it legal for a national bank or federal thrift to charge higher interest rates than might be permissible to lenders that are not banks.

The new rule addresses the uncertainty of what happens when a loan made by a national bank at a rate permitted to it is transferred to an entity that does not enjoy the same special interest rate treatment. For many years, the courts have applied the "valid-when-made doctrine," which provides that if the interest rate was legal in the context that the loan was made, the interest rate remains legal even if the loan is transferred to an entity that could not legally charge that rate if it made the original loan.

The "valid-when-made doctrine" was thrown into controversy by the *Madden* case. In that case, a national bank had originated credit card loans that were subsequently sold to a debt collection firm after the borrowers defaulted. The debt collection firm was not a national bank or affiliated with one, and the national banks that had previously held the loans no longer had any interest in them. The court held that the collection firm could not rely on the federal law that allowed the interest rate when a national bank originated the loans.

The banking industry asserts that the effect of the *Madden* case has been to curtail some forms of lending because of the uncertainty as to the value of loans that an originating bank needs or wants to transfer. The OCC's response is an attempt to overturn *Madden* by federal regulation. Critics of the OCC's action attack it on two fronts – authority and policy. Many commenters believe that the OCC has exceeded its authority by adopting the rule. Some commenters also believe that the rule is bad policy, regardless of whether the OCC has the appropriate authority. One policy argument is that the rule will facilitate "rent-a-charter" practices, where a business that is not a national bank will arrange with a national bank to originate loans and transfer them to the non-bank business, thereby allowing a non-bank business to charge higher interest rates than it is otherwise allowed. Attorneys general in more than 20 jurisdictions opposed adoption of the rule. The OCC maintains that it has consistently opposed predatory lending; however, it does not believe the concern about rent-a-charter practices outweighs the harm done by the uncertainty created by the *Madden* case. An existing body of law determines who is a "true lender," and the OCC does not intend its new rule to eliminate that analysis. So, arguably, there is still a tool to combat rent-a-charter abuses.

Although the *Madden* decision interpreted law that applies only to national banks, similar federal laws applicable to federal savings associations, state-chartered banks, and U.S. branches of foreign banks have been interpreted in a manner similar to that law. As a result, *Madden* has caused uncertainty as to the effect of transfers of loans by those institutions. As the chartering body and primary federal regulator of national banks and federal savings associations, the OCC has authority over only those institutions. The Federal Deposit Insurance Corporation has proposed similar rulemaking that would apply to state-chartered banks and FDIC-insured branches of foreign banks, but that rulemaking has not yet been made final.

Unfortunately, if uncertainty is a fundamental enemy of commerce, the OCC's adoption of the new rule only does so much to improve the situation. Until the FDIC adopts a final rule, only national banks and federal savings associations are covered by the federal rulemaking. Moreover, it is likely that opponents of the OCC and FDIC rules, or a borrower or class of borrowers, will bring legal action to declare the rules invalid. Until a court definitively holds the rules valid or invalid, there is still a cloud of uncertainty over this landscape.

ADDITIONAL INFORMATION

For more information, please contact:

- **Kristen A. Baracy** | 213.430.3603 | kristen.baracy@tuckerellis.com
- **Michael E. Elliott** | 216.696.2877 | michael.elliott@tuckerellis.com
- **Natalie L. Fine** | 312.256.9411 | natalie.fine@tuckerellis.com
- **Jayne E. Juvan** | 216.696.5677 | jayne.juvan@tuckerellis.com
- **Adam J. Kase** | 312.256.9409 | adam.kase@tuckerellis.com
- **Eugene M. Killeen** | 216.696.3984 | eugene.killeen@tuckerellis.com
- **Lauren E. Lipsyc** | 216.696.3859 | lauren.lipsyc@tuckerellis.com
- **Robert M. Loesch** | 216.696.5916 | robert.loesch@tuckerellis.com
- **Bartly J. Loethen** | 312.256.9408 | bartly.loethen@tuckerellis.com
- **Paul J. Malie** | 216.696.3466 | paul.malie@tuckerellis.com
- **Arthur E. Mertes** | 312.256.9407 | arthur.mertes@tuckerellis.com
- **Glenn E. Morrical** | 216.696.3431 | glenn.morrical@tuckerellis.com
- **Brian M. O'Neill** | 216.696.5590 | brian.oneill@tuckerellis.com
- **Thomas W. Ostrowski** | 216.696.5572 | thomas.ostrowski@tuckerellis.com
- **Thomas R. Peppard, Jr.** | 216.696.5267 | thomas.peppard@tuckerellis.com
- **Keith H. Raker** | 216.696.2468 | keith.raker@tuckerellis.com
- **Dana S. Rogers** | 216.696.4112 | dana.rogers@tuckerellis.com
- **Jennifer L. Roth** | 216.696.3782 | jennifer.roth@tuckerellis.com
- **Daniel L. Schiau II** | 216.696.3892 | daniel.schiau@tuckerellis.com
- **Christina Suh** | 216.696.2487 | christina.suh@tuckerellis.com
- **John C. (Chaz) Weber** | 216.696.4887 | chaz.weber@tuckerellis.com

Appendix

State-Specific Examples of Effect of Bank Status Under Usury Laws

California

In California, the general limit on interest rates is 10% per year on a loan in writing primarily for personal, family, or household purposes. For all non-consumer loans in writing, the interest rate is the higher of 10% or 5% over the amount charged by the Federal Reserve Bank of San Francisco on advances to member banks on the 25th day of the month before the loan is issued. For loan contracts not in writing, the maximum interest rate is 7%. Many banks, credit unions, and savings and loan associations are not subject to such interest rate limitations.

California enacted the Fair Access to Credit Act effective January 1, 2020 to combat predatory lending practices (such as payday lending) by imposing on non-bank lenders a 36% interest rate cap (plus the federal funds rate) on installment loans with a principal amount of $2,500 or more and less than $10,000, with a minimum 12-month loan term for such loans. Previously, there was no interest rate cap on loans over $2,500. The strength of the Fair Access to Credit Act to combat predatory lending may be undermined by the "rent-a-bank" arrangements as highlighted above in this Client Alert.

Illinois

In Illinois, the general maximum rate of interest on loans is 5% per year, but parties may contractually agree in writing on a maximum rate of 9%. There are several exceptions. For example, state banks, certain out-of-state bank branches, certain savings banks, and certain savings associations may contract with borrowers for any interest rate. There is also no maximum rate for loans made by any lender to a corporation, merchandise wholesaler and retailer, business association, and several other entities specified under Illinois law, and there is a maximum interest rate of 6% for loans to active military personnel.

Under Illinois law, consumers enjoy a host of strong protections from payday loan industry practices. Most recently, Illinois enacted the Consumer Fairness Act effective January 1, 2020 to combat predatory lending practices on consumer debts of less than $25,000 following a court judgment. The new law caps post-judgment interest rates on qualifying consumer debts at 5%, down from 9%. The Act also shortens the statute of limitations on collecting post-judgment consumer debt from 26 years to 17 years.

New York

In New York, the civil law generally limits interest rates to 16% for loans that do not exceed $250,000, and it exempts loans over $250,000. The criminal law limits interest rates to 25% for loans that do not exceed $2.5 million.

There is no maximum interest rate for loans that exceed $2.5 million. Loans made to corporations may be exempt from the civil and criminal interest rate limits if the loan amount is at least $100,000 and the interest rate does not exceed eight percentage points over the prime rate on the date the interest is charged or accrued.

If the interest rate exceeds the limits of the civil law, then the loan is void, the lender forfeits rights to interest, and, under certain circumstances, the borrower may recover from the lender twice the amount of interest already paid. If the interest rate exceeds the limits of the criminal law, a non-bank lender may be prosecuted for committing a felony. The New York Court of Appeals, the highest court in New York, held in *Flushing National Bank v. Pinetop Building Corporation* that New York's criminal usury law "was not intended to cover loans by banks" and "the only penalty for any usurious loan by a banking institution is the forfeiture of interest." Therefore, banks are limited only by the 16% maximum interest rate on loans that do not exceed $250,000 imposed by civil law. Unlike other lenders, banks are not limited by the 25% maximum rate, applicable to loans between $250,000 and $2.5 million, imposed by criminal law.

Ohio

In Ohio, the general limit on interest rates is 8%, but it is subject to many exceptions such as loans in excess of $100,000, certain residential mortgage loans, and business loans; however, an Ohio-chartered bank is allowed to charge up to 25%, plus fees and charges in excess of that rate for things such as cash advance fees, charges for exceeding a designated credit limit, charges for late payments, charges for the return of a dishonored check or other payment instrument, guarantee fees, origination fees, processing fees, application fees, and prepayment fees. The Ohio statute on rates that can be charged by Ohio-chartered banks specifically identifies those rates as relevant for the federal statute discussed in this Client Alert. It is a felony to charge interest in excess of 25% per annum unless the rate is "otherwise authorized by law." Thus, the authority granted banks to charge fees in the nature of interest listed above even if in excess of 25% is an advantage to them that is not necessarily available to non-banks.