No. 15-610

IN THE
Supreme Court of the United States

MIDLAND FUNDING, LLC AND MIDLAND CREDIT MANAGEMENT, INC.,
Petitioners,

v.

SALIHA MADDEN,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF OF THE STRUCTURED FINANCE INDUSTRY GROUP, INC., AND THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF *AMICI CURIAE*[1]

The Structured Finance Industry Group, Inc. (SFIG) is a member-based trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFIG has over 300 members from all sectors of the securitization market, including investors, issuers, financial intermediaries, accounting, law, and technology firms, rating agencies, servicers, and trustees. SFIG's core mission is to support a robust and liquid securitization market, recognizing that securitization is an essential source of core funding for the real economy.

The Securities Industry and Financial Markets Association (SIFMA) is the voice of the U.S. securities industry, representing the broker-dealers, banks and asset managers whose 889,000 employees provide access to the capital markets, raising over $2.4 trillion for businesses and municipalities in the U.S., serving retail clients with over $16 trillion in assets and managing more than $62 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional

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[1] Pursuant to this Court's Rule 37.2(a), counsel of record for both parties have received timely notice of the intent to file this brief. Petitioners filed a letter of blanket consent to the filing of *amicus curiae* briefs and respondents separately consented to the filing of this *amicus curiae* brief. Pursuant to this Court's Rule 37.6, *amici* state that this brief was not authored in whole or in part by counsel for any party, and that no person or entity other than *amici* or their counsel made a monetary contribution intended to fund the preparation or submission of this brief.

member of the Global Financial Markets Association (GFMA).

Amici have an abiding interest in preserving a vibrant secondary loan market, which involves numerous types of securitization transactions and whole loan portfolio sales. As discussed further, *infra*, the Second Circuit's opinion threatens to upend and substantially impair the secondary loan market and, by extension, the securitizations that form a vital part of the nation's financial system. Amici also have a strong interest in the primary market of extending credit to borrowers; in the absence of a vibrant secondary market, the primary market will inevitably suffer as well.

INTRODUCTION

"Securitization"—the combining and reselling of financial assets, like debt—is essential to the function of the global financial system in the twenty-first century. Banks routinely serve as financial intermediaries in this system. They make loans to many borrowers, combine similar loans into packages, and then sell those packages of loans in the secondary market. By buying up these loans, investors in the secondary market instantly provide banks with liquidity, which allows banks to originate additional loans in the primary market and manage their balance sheets. It is a cornerstone of the secondary loan market that investors are able to charge borrowers the interest rate for which the loan originators lawfully contracted.

A uniform rule of usury law is that the *purchaser* of a loan is entitled to collect the same interest rate that the loan *originator* was permitted to charge. This rule is based on numerous state and federal case law precedents, including precedent of this Court, and

was well-established when Congress enacted the National Bank Act of 1864, 12 U.S.C. § 21 *et seq*. ("NBA").

In departing from that rule and long-established precedent interpreting it, and construing the NBA not to preempt the application of state usury law to sales of bank loans to non-banks, the Second Circuit's decision has substantially disrupted sales of loans into the secondary loan market, which includes not just credit card loans, as was the case in the matter before the Court, but also many other types of consumer and business loans, including student loans, automobile loans, and mortgage loans. The decision also creates unwarranted potential liability for market participants that have justifiably relied on previously well-established principles of preemption. The decision, if left standing, will reduce the availability of credit and hinder banks from acting as financial intermediaries, to the detriment of borrowers, banks, and the national economy.

The Second Circuit's decision has already impaired portions of the securitization markets and will further destabilize them if allowed to stand. Moody's Investors Service, one of the nation's premier credit rating agencies, recently warned investors that "[t]he ongoing *Madden* v. *Midland Funding, LLC* litigation poses risks to marketplace lenders and related ABS [asset-backed securitizations] by throwing into doubt the presumed legal benefits created by the lenders' use of third-party partner banks to originate loans." Moody's Investors Serv., *Viability of Current Marketplace Lending Model Depends on Ongoing Litigation, Including Possible Supreme Court Review* (Nov. 11, 2015).

Since the Second Circuit's decision, some secondary market investors have been reluctant (or, in some

cases, have refused) to purchase or finance loans made to consumers or small businesses located in the Second Circuit, or have been willing to purchase or finance only those loans made at rates lower than the state-specific usury limits. Aside from its impact in New York, Connecticut, and Vermont, the Second Circuit's decision has implications for other states outside the Second Circuit that also have or may adopt usury restrictions, as some nonbank lenders and loan purchasers are seeking to reduce the impact of the decision below by constructing various workarounds to the loss of a reliable rule of national preemption. Such workarounds can include excluding or minimizing the number of loans to residents of other states or of any one state. The inevitable result of attempting to reconcile national lending and investment platforms with a patchwork of state usury limits is to drive up the cost and limit the availability of credit to consumers and small businesses.

Such pernicious consequences are wholly unwarranted given that Congress long ago eliminated the ability to invoke state usury laws to interfere with the efficiency of a national approach to banking. State usury laws that otherwise might limit the interest rate that an investor buying a loan originated by a national bank are squarely preempted by 12 U.S.C. § 85. By preempting state usury laws, Congress chose long ago to preclude state law from disrupting the ability of national banks to serve the critical role of financial intermediaries in a national economy.

Until the decision below, no court had failed to apply the basic rule that usury is determined at the time of loan origination and that subsequent events, such as a bank's assignment of a valid loan to a non-bank, cannot render the loan usurious. Because the

implications of the Second Circuit's failure to enforce Section 85 involve significantly negative and needless economic consequences for consumers, lenders, and investors alike, the Court should grant the petition.

ARGUMENT

I. SECURITIZATION IS VITALLY IMPORTANT TO BANKS, BORROWERS, AND THE NATIONAL ECONOMY.

Before the advent of securitization, banks were largely "portfolio lenders."[2] They held most of the loans they originated, and funded those loans through deposits or other bank debt. Funding loans in this way, however, limited banks' ability to meet increased demand for credit. Portfolio lending also posed institutional risks to banks with portfolios that were not adequately diversified across geographic or other market sectors.

Securitization allows banks to address these limitations and risks by packaging loans or other receivables and selling them in the form of asset-backed securities. A bank that securitizes loans typically transfers them to a special purpose vehicle, which then issues securities to investors.

Securitizations first developed in the housing market. Securitizing mortgages enabled mortgage

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[2] For a discussion of the background of asset securitization, see Comptroller of the Currency, *Asset Securitization: Comptroller's Handbook* (Nov. 1997), http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/assetsec.pdf ("*Comptroller's Handbook*"). *See also* Bd. of Governors of the Fed. Reserve Sys., *Report to Congress on Risk Retention* (Oct. 2010), http://www.federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf ("*Board Report*").

lenders to replenish their capital for use in making new mortgages and thus keep pace with rising demand for new housing loans. Many investors were eager to purchase residential mortgage-backed securities in a secondary market. As securitizations grew more sophisticated, the secondary market quickly grew to include the securitization of automobile, credit card, and other loans.

The ability to securitize bank loans is fundamentally important to banks, borrowers, and the economy. Banks benefit substantially from securitization because the transactions allow banks to limit the credit and interest rate risk of holding a loan portfolio for many years, and to manage loss exposure as well as capital requirements. Securitization thus functions to "lower borrowing costs, release additional capital for expansion or reinvestment purposes, and improve asset/liability and credit risk management." *Comptroller's Handbook* at 4.

The economy, too, including consumer and business borrowers, benefits substantially from securitizations. The secondary market effectively decreases borrowing costs for consumers and businesses because it facilitates more lending; banks would originate fewer loans if they were required to conduct their lending business as portfolio lenders. As the capital available to support lending is reduced, the cost of borrowing increases. The secondary market also lowers risks to the Federal Deposit Insurance Corporation ("FDIC") from bank failures because it transfers ownership risks of the loans away from federally-insured banks to private investors that are not FDIC-insured. The benefits of lower interest rates, greater availability of credit, and lower-risk banks, in turn, improve the nation's economy.

Federal regulatory agencies have repeatedly recognized these benefits from securitizations to banks and borrowers. They were specifically identified in a 2010 report to Congress on the securitization market from the Board of Governors of the Federal Reserve System, see *Board Report* at 8–9, and subsequently described by the Office of the Comptroller of the Currency, the Federal Reserve, the FDIC, the Federal Housing Finance Agency, the Securities and Exchange Commission and the Department of Housing and Urban Development in recent rulemaking on the requirement that banks retain risk in securitization transactions. See 79 Fed. Reg. 77602, 77604 (Dec. 24, 2014), adopting final rule under Section 15G of the Exchange Act, 15 U.S.C. § 78o-11.

The confusion that the Second Circuit's decision causes for the securitization markets is not limited to national banks, but also affects other depository institutions. State banks, federal and state savings associations, and federal and state credit unions, all have authority to charge interest based on statutes that are modeled after Section 85. See 12 U.S.C §§ 1831d (state banks), 1463(g) (savings associations) & 1785(g) (credit unions); see also *Greenwood Trust Co.* v. *Massachusetts,* 971 F.2d 818, 827 (1st Cir. 1992) (state bank); *Gavey Props./762* v. *First Fin. Sav. & Loan Ass'n*, 845 F.2d 519, 521 (5th Cir. 1988) (savings association). Banks and other financial services companies provide loans to businesses of all sizes, residential and commercial real estate loans, credit card loans, auto loans, and other consumer loans. Thus, not only does the decision impair the ability of these institutions to sell loans in the secondary market, whether in securitizations or through whole loan sales, but, because of banks' central role in the

credit markets, "the impairment of banks' ability to extend credit . . . has the potential to hinder investment and adversely affect the overall economy," including small businesses and the labor markets. James McAndrews, Dir. of Research, Fed. Reserve Bank of N.Y., Remarks at the Economic Press Briefing on Student Loans, Fed. Reserve Bank of N.Y. *Credit Growth and Economic Activity after the Great Recession* (Apr. 16, 2015), https://www.newyorkfed.org/newsevents/speeches/2015/mca150416.html.

The reach of the decision below is not limited to sales of loans to unaffiliated debt buyers. Rather, its effects are already working mischief on the national credit and securitization markets and dampening secondary loan markets in general by compelling lenders to address the concerns of investors seeking to avoid securitizations that could implicate state usury limits, such as securitization pools containing loans to consumers and small businesses located in the Second Circuit. See, *e.g.*, Jayson Derrick, *Are Changes Coming to the P2P Lending Model?*, Benzinga (Sept. 29, 2015), http://www.benzinga.com/analyst-ratings/analyst-color/15/09/5873715/are-changes-coming-to-the-p2p-lending-model#/ixzz3r8dcHny5 (explaining that, because of the Second Circuit's decision here, leading financial institutions "have reportedly considered pulling loans within securitization pools to avoid interest rate usury issues[,] . . . [and] have also reportedly contemplated limiting exposure to loans originated in . . . states [in the Second Circuit]. And rating agencies . . . have recently cautioned investors over the same topic.").

Such costs created by the Second Circuit's decision make it more expensive for consumers and small businesses to obtain credit. Over time, these costs will reduce the availability of financing for lending to

consumers and small businesses in the Second Circuit and in other states vulnerable to a challenge like the one below, leading to significant effects throughout the securitization market. See Moody's Investors Serv., *Appeals Court Ruling Adds to Legal Uncertainty for ABS Backed by Bank-Originated Marketplace Lending Loans* (July 17, 2015) ("[T]he decision is likely to result in a reduction of bank sales of written-off loans to non-bank debt buyers, a credit negative particularly for credit card ABS transactions and for transactions such as student loan ABS that also employ this debt collection strategy."); see also Allison Bisbey, *Here's Something Else for Marketplace Lenders to Worry About: State Usury Laws*, Asset Securitization Report (July 21, 2015), http://www.structuredfinancenews.com/news/consumer_abs/heres-something-else-for-marketplace-lenders-to-worry-about-usury-laws-257347-1.html ("The Madden decision adds to the legal uncertainty for securitizations of marketplace loans."); John Browne, *Judiciary Lashes Peer Lending*, Trib Total Media, Sept. 5, 2015, http://triblive.com/business/brownebusiness/8995720-74/lending-peer-rates#axzz3tren3LFc ("[P]eer lending is in jeopardy because of [the decision below]."); Chris Bruce, *Loans in Flux as Appeals Court Rebuffs Midland Funding*, BNA's Banking Report (Aug. 24, 2015) ("New questions about the impact of [the Second Circuit's decision] arise almost daily."); Kevin Wack, *Debt-Sale Ruling Spooks Banks, Marketplace Lenders*, Am. Banker (July 27, 2015) ("The financial services industry is expressing alarm over a recent federal appeals court decision that threatens to curtail a key regulatory advantage held by depository institutions: their ability to sell off high interest-rate consumer loans to third parties [which] could have a short-term impact on the decision-making of investors in securitized consumer loans.").

The extraordinary size of the securitization market shows both the importance of securitization to banks and borrowers and the potential for harm. For example, although securitizations may involve originators other than banks, a leading rating agency estimates that in 2014 there were $178 billion in automobile loan securitizations, $135 billion in credit card securitizations, $216 billion in student loan securitizations and $136 billion in other consumer loan securitizations. See Moody's Investors Serv., *Securitization Provides Meaningful Funding to the US Economy* 4–5 (Mar. 11, 2015). Further, lenders have sold roughly $9 trillion of loans into outstanding securitizations. See Sec. Indus. & Fin. Mkts., *Research Quarterly; First Quarter 2015*, at 8–9 (2015), http://www.sifma.org/WorkArea/DownloadAsset.aspx?id=8589954778. Refusing to honor the National Bank Act's preemptive force thus has the potential, over time, to implicate and disrupt a vast portion of the national economy.

II. SECTION 85 PREEMPTS STATE USURY LAWS THAT PURPORT TO LIMIT INTEREST RATES THAT MAY BE COLLECTED ON NATIONAL BANK LOANS.

Federal law governs the interest rate for which a national bank can contract on loans. See 12 U.S.C. § 85 (allowing banks to charge "interest at the rate allowed by the laws of the State . . . where the bank is located"); *Smiley* v. *Citibank (S.D.), N.A.*, 517 U.S. 735, 737 (1996). As usury laws are solely matters of statute, *e.g.*, *Sci. Prods.* v. *Cyto Med. Lab., Inc.*, 457 F. Supp. 1373, 1375 (D. Conn. 1978), whether Section 85 continues to apply to a loan after it is sold by a national bank is a matter of federal statutory construction.

Courts must interpret Section 85 in accordance with both the "historical context" of the National Bank Act, 12 U.S.C. § 21 *et seq*. ("NBA"), and "the basic policy foundations of the statute." *Marquette Nat'l Bank of Minneapolis* v. *First of Omaha Serv. Corp.*, 439 U.S. 299, 313-14 (1978). The considerations that *Marquette* requires leave no doubt that, as a matter of federal law, Section 85 continues to apply to a national bank loan sold into the secondary market. Any state law that purports to prohibit the interest rate that federal law allows to be collected on that loan is preempted because it conflicts directly with federal law.

When Congress enacted the NBA in 1864, it already was well-established that loans that are valid under a usury law when made are not invalidated by a subsequent event. In 1828, the Court held that a non-usurious loan could not later be transformed into an invalid, usurious loan simply because it was sold. *Gaither* v. *Farmers & Mechs. Bank of Georgetown*, 26 U.S. (1. Pet.) 37, 43 (1828) ("[F]or the rule cannot be doubted, that if the note be free from usury, in its origin, no subsequent usurious transactions respecting it, can affect it with the taint of usury."). Then, in 1833, the Court observed that "the rule of law is every where acknowledged, that a contract, free from usury in its inception, shall not be invalidated by any subsequent usurious transactions upon it." *Nichols* v. *Fearson*, 32 U.S. (7 Pet.) 103, 106 (1833). This rule, the Court stated, was one of the "two cardinal rules in the doctrine of usury which we think must be regarded as the common place to which all reasoning and adjudication upon the subject should be referred." *Id.* at 109.

The *Nichols* Court's description of this precept as a "cardinal rule" was hardly overstated, as courts

throughout the Anglo-American judicial systems had long espoused the same view. See, *e.g.*, *Tuttle* v. *Clark*, 4 Conn. 153, 153 (1822) ("[I]t was an effective instrument in his hands, and not being usurious in its original concoction, it did not become so, by the subsequent sale to the plaintiffs."); *Watkins* v. *Taylor*, 16 Va. 424, 436 (1811) ("[I]f it was not usury *at the time* when the contract was entered into, no *after* circumstance can make it so; and any argument, therefore, drawn from after circumstances, would be improper." (footnote omitted)); *Tate* v. *Wellings* (1790) 100 Eng. Rep. 716, 721 (opinion of Buller, J.) ("Here the defence set up is that the contract itself was illegal; and in order to support it, it must be shewn that it was usurious at the time when it was entered into; for if the contract were legal at that time, no subsequent event can make it usurious.").

Treatises, too, have long reflected uniform adherence to this cardinal rule. Blackstone's treatise, in 1838, affirmed that "[t]he usury must be part of the contract in its inception." 1 William Blackstone, Commentaries 355, 379 n.32 (18th ed. 1838). Likewise, Webb's seminal treatise from 1899 observes that "it seems to be the well-settled doctrine both in England and in America . . . that a valid debt can never be avoided by any subsequent usurious contract." J. A. Webb, *A Treatise On the Law of Usury* § 306, at 345 (1899) (citing cases and authorities). A more recent treatise concludes that "[t]he usurious nature of a transaction is established at the inception of the transaction. The essential elements of usury therefore must exist at the inception of the contract. It is the agreement to exact and pay usurious interest, and not the performance of the agreement, which renders it usurious." 44B Am. Jur. 2d *Interest and Usury* § 82 (2015) (footnotes omitted).

Amici are not aware of any decision other than the Second Circuit's decision below that departs from this foundational precept. Courts instead hold that loans, after assignment, continue to be governed by the usury law that applied prior to the assignment. See, *e.g.*, *Olvera* v. *Blitt & Gaines, P.C.*, 431 F.3d 285 (7th Cir. 2005) (holding that the assignee has the same right to charge interest as the usury law permitted for assignor); *FDIC* v. *Lattimore Land Corp.*, 656 F.2d 139, 148–49 & nn.17, 18 (5th Cir. Unit B Sept. 1981) (citing *Nichols,* and stating "the non-usurious character of a note should not change when the note changes hands"); *Strike* v. *Trans-W. Disc. Corp.*, 155 Cal. Rptr. 132, 139 (Cal. Ct. App. 1979) (holding that the purchaser of a loan from a bank is exempt from usury law because the bank was exempt). It is thus fair to assume that Congress and the credit markets took this interpretation of Section 85 as a given. See *Astoria Fed. Sav. & Loan Ass'n* v. *Solimino*, 501 U.S. 104, 108 (1991) ("Congress is understood to legislate against a background of common-law adjudicatory principles. Thus, where a common-law principle is well established . . . the courts may take it as given that Congress has legislated with an expectation that the principle will apply except when a statutory purpose to the contrary is evident." (quotation and citations omitted)).

Imposing state usury laws on loans assigned to a non-bank would deprive bank assignors of the substantial value that Section 85 provides to them. That is because state usury laws vary widely, and consequences for violating those laws can be severe, including the loss of all interest and, in some cases, principal. See, *e.g.,* N.Y. Gen. Oblig. Law § 5-511; Conn. Gen. Stat. § 37-8. Thus, instead of simply looking at whether the originating bank complied

with Section 85, investors would need to evaluate the usury laws independently to determine which applied to that investor for every single loan included in the transaction. That is a hopelessly complex task, unworkable as a practical matter, not only because it involves evaluating a vast and heterogeneous portfolio of loans against the evolving laws of fifty states, but also because state usury laws vary widely from state to state, often setting different interest rate limits (including limits for periodic interest and for other interest charges) for different types of loans.

Given that the value of a loan that a bank originates includes the value for which the bank can sell that loan, such uncertainty over the future validity of the interest rate if the loan is sold thus severely compromises its value.

As the Fifth Circuit has explained, "Congress surely did not intend to disadvantage National banks" by denying them the protection of "one of the 'cardinal rules in the doctrine of usury.'" *Lattimore*, 656 F.2d at 149 nn.17, 18 (quoting *Nichols*, 32 U.S. (7 Pet.) at 109). Indeed, a rule that denies assignees the right to collect interest allowed assignors "would in effect prohibit—make uneconomic—the assignment or sale by banks of their commercial property to a secondary market [which] would be disastrous in terms of bank operations and not conformable to the public policy exempting banks in the first instance." *Strike*, 155 Cal. Rptr. at 139. Instead, "Congress intended [the NBA] to facilitate . . . a 'national banking system.'" *Marquette,* 439 U.S. at 314–15. Achieving that purpose requires faithful adherence to the cardinal rules of usury that underpin Section 85 and the preemption of conflicting state laws. This Court should grant certiorari to enforce Section 85 as Congress intended.

CONCLUSION

The Court should grant the petition for a writ of certiorari and reverse the judgment of the Second Circuit.

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