<table>
<tr><td>IN THE UNITED STATES DISTRICT COURT
DISTRICT OF COLORADO
<hr>RENT-RITE SUPER KEGS WEST, LTD.,
Appellant,

v.

WORLD BUSINESS LENDERS, LLC
Appellee.</td><td>▲ COURT USE ONLY ▲</td></tr>
<tr><td>Adam J. Levitin
Agnes N. Williams Research Professor &
Professor of Law
Georgetown University Law Center
600 New Jersey Ave., NW
Hotung 6022
Washington, DC 20001
(202) 662-9234
adam.levitin@law.georgetown.edu</td><td>Case No. 1:19-cv-01552-REB

(Appeal from Bankruptcy Adversary Proceeding No. 18-1099-TBM)</td></tr>
<tr><td colspan="2">MOTION FOR LEAVE TO FILE AMICUS CURIAE BRIEF OF PROFESSOR ADAM J. LEVITIN IN SUPPORT OF APPELLANT</td></tr>
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DATED: September 19, 2019

Adam J. Levitin
Agnes N. Williams Research Professor &
Professor of Law
Georgetown University Law Center
600 New Jersey Ave., NW
Hotung 6022
Washington, DC 20001
(202) 662-9234
adam.levitin@law.georgetown.edu

Professor Adam J. Levitin, *pro se*, respectfully requests leave to submit the attached, conditionally filed*, amicus curiae* brief in support of the Appellant, Rent-Rite Super Kegs West, Ltd., and as grounds therefore states the following:

INTRODUCTION

On its face, the instant litigation is an unremarkable adversary proceeding in a small business bankruptcy, the ultimate outcome of which has no particular public policy significance. Yet this is no ordinary *business* bankruptcy appeal. This case involves the single most critical *consumer* credit regulation issue in the courts today—the vitality of a so-called "valid-when-made" doctrine, which purports to hold that a non-bank lender may ignore state usury laws for loans it purchases from a bank that is exempt from those laws.

If courts recognize a "valid-when-made" doctrine, high-cost non-bank lenders, such as payday lenders and predatory small business lenders, will be able to evade long-standing state interest rate limits[1] through "rent-a-bank" lending

[1] States have set interest rate limits since the founding of our nation. *See* AMERICANS FOR FAIRNESS IN LENDING, THE HISTORY OF USURY (citing *James M.*

schemes, in which a non-bank lender uses a complicit bank to originate loans, which are promptly sold to the non-bank lender. Payday lenders have long attempted to use rent-a-bank schemes, which regulators have historically shut down,[2] but these attempts are making a comeback. Colorado, in particular, has been active in attempting to prevent a new wave of rent-a-bank lending, and two high-profile cases bought by the Colorado Attorney General are pending. *See Meade, Uniform Consumer Credit Code Administrator v. Marlette Funding, LLC*, No. 17-30376 (Colo. Dist. Ct.); *Meade, Uniform Consumer Credit Code Administrator v. Avant of Colorado LLC*, No. 17-cv-30377 (Colo. Dist. Ct.).[3]

The unusual involvement of the Federal Deposit Insurance Corporation ("FDIC") and Office of the Comptroller of the Currency ("OCC") as *amici* in the appeal of an otherwise unexceptional small business bankruptcy adversary

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Ackerman, Interest Rates and the Law: A History of Usury, 1981 ARIZ. ST. L.J. 61 (1981)), https://bit.ly/2lSASjl.

[2] *See* NATIONAL CONSUMER LAW CENTER, CONSUMER CREDIT REGULATION § 9.6.1 (2D ED. 2015), *updated at* www.nclc.org/library; *see also* ID. §§ 3.4.3.3, 3.4.3a.

[3] Professor Levitin has previously submitted amicus briefs on the valid-when-made doctrine in both of these cases.

proceeding underscores the importance of the consumer credit policy issue implicated in this case. The FDIC and OCC allege that a purported "valid-when-made doctrine" is a longstanding, "cardinal rule" of banking law and incorporated into the federal statutes preempting state usury laws for bank. Yet the doctrine appears only in a handful of recent cases. With one exception, it cannot be found in caselaw predating the relevant statute, much less in treatises, or scholarly articles, and the Second Circuit rejected the doctrine in 2015 in *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015).

After the defendant in the *Madden* case unsuccessfully sought *certiorari* from the Supreme Court of the United States, 136 S. Ct. 2505 (2016), the financial services industry attempted to advance "*Madden*-fix" legislation in Congress. *See* H.R. 3299 (115th Cong.); S. 1642 (115th Cong.). Numerous state attorneys generals, led by the Colorado Attorney General,[4] and over 200 consumer, civil rights, faith

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[4] *See* Letter from Cynthia H. Coffman, Attorney General of Colorado, *et al*. to Hon. Mitch McConnell *et al.,* opposing H.R. 3299 and S. 1642 (June 27, 2018), https://bit.ly/2kCyjlp.

and other groups[5] voiced their opposition to the legislation, and Congress did not act to overturn the decision.

The OCC and FDIC are now intervening as *amici* in an obscure small business bankruptcy dispute to seek a favorable appellate decision on the valid-when-made doctrine that could ultimately produce a circuit split. Such a circuit split might entice the Supreme Court to grant *certiorari* and possibly overturn the Second Circuit's *Madden* decision. Simply put, this is a critical case for consumer credit policy.

In this amicus brief, Professor Levitin draws on his expertise in the history of negotiable instruments and usury regulation to address the spurious pedigree of the valid-when-made doctrine, which is a recent invention, rather than a fundamental part of American banking and negotiable instrument law.

INTEREST OF AMICUS CURIAE

Amicus curiae Adam Levitin is the Agnes N. Williams Research Professor and Professor of Law at Georgetown University Law Center in Washington, D.C. Professor Levitin's scholarship and teaching focuses on consumer finance regulation

[5] See letter from 202 state and national groups opposing H.R. 3299 (McHenry) and S. 1642 (Warner) (Nov. 29, 2017), https://bit.ly/2kNossK.

and commercial law, including the law of usury and the law of negotiable instruments. He has previously served on the Consumer Financial Protection Bureau's Consumer Advisory Board, as the Bruce W. Nichols Visiting Professor of Law at Harvard Law School, as the Scholar in Residence at the American Bankruptcy Institute, and as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP).

Professor Levitin has previously written about the origins of the "valid-when-made" doctrine and the effects of preemption of state consumer protection laws in rent-a-bank transactions. *See* Adam J. Levitin, *"Madden Fix" Bills Are a Recipe for Predatory Lending*, AMERICAN BANKER, Aug. 28, 2017 (valid-when-made doctrine); Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Markets Upstream*, 26 YALE J. REG. 145 (2009) (rent-a-bank transactions). He has also previously testified before Congress thirty times, including at a hearing specifically addressing the valid-when-made doctrine. Hearing Before the House Financial Services Committee, Subcommittee on Financial Institutions and Consumer Credit, *Examining Opportunities and Challenges in the Financial Technology ("Fintech") Marketplace*, Jan. 30, 2018 (testimony of Professor Adam J. Levitin). Professor Levitin has also previously filed amicus briefs on the valid-when-made doctrine in Colorado state court litigation brought by the Colorado Uniform Consumer Credit

Code Administrator against non-banks engaged in rent-a-bank transactions. Amicus Brief of Professor Adam J. Levitin in Support of Plaintiff, *Meade, Uniform Consumer Credit Code Administrator v. Marlette Funding, LLC*, No. 17-30376 (Colo. Dist. Ct.); Amicus Brief of Professor Adam J. Levitin in Support of Plaintiff, *Meade, Uniform Consumer Credit Code Administrator v. Avant of Colorado LLC*, No. 17-cv-30377 (Colo. Dist. Ct.).

Professor Levitin believes that his expertise regarding the history of usury regulation in the United States will be helpful to the court, particularly in light of the claims of Appellee and its amici that the “valid-when-made” doctrine is a longstanding, fundamental rule of US banking law.

DESIRABILITY OF AMICUS CURIAE BRIEF

As explained above, this case has potentially momentous implications for states’ ability to regulate consumer lending by non-banks. Given the importance of the alleged historicity of the valid-when-made doctrine for its applicability through incorporation in the Depository Institutions Deregulation and Monetary Control Act of 1980, an informed understanding of its supposed caselaw roots is critical for the Court’s evaluation. This is where Professor Levitin seeks to assist the Court.

The 18th century English and early 19th century American commercial law cases on which the "valid-when-made" doctrine claims to rest are extraordinarily difficult for modern readers to parse. These cases involve a set of financial instruments, transactions, doctrinal problems, procedural stances, and even terminology that have largely disappeared from commerce. Further obfuscating the meaning of these cases is the style of judicial writing. These are cases that only a commercial law professor with antiquarian inclinations could love. Professor Levitin believes that his familiarity with these cases, with historical negotiable instrument law, and as well as with the larger (and now obscure) doctrinal context of usury law in the 19th century would assist the court in evaluating the claims about the historicity of the "valid-when-made" doctrine and whether it is in fact part of the background to the Depository Institutions Deregulation and Monetary Control Act of 1980.

POSITION OF THE PARTIES

Professor Levitin has obtained the consent of the Appellant to the filing of an amicus brief. Professor Levitin has not received any response from Appellee in regard to his request for consent to file.

TIMELINESS OF THE AMICUS BRIEF

Professor Levitin recognizes that he is seeking to file the amicus brief after the ordinary deadline provided by Federal Rule of Bankruptcy Procedure 8017(a)(6). Rule 8017(a)(6) provides the district court with discretion to grant leave for later filing. *See also Wildearth Guardians v. Lane*, 2012 WL 10028647 (D.N.M. 2012) (noting federal courts' broad discretion to allow participation of an amicus and the lack of 10th Circuit precedent).

Professor Levitin requests leave for a late-filing of the amicus brief on the grounds that he was not aware of the litigation until the Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency filed their amicus brief in support of the Appellee on September 10, 2019.

As noted above, this case is of potentially significant importance for consumer credit regulation because of its implication for the "valid-when-made" doctrine. Yet because the doctrinal question arose in a small business bankruptcy case, it received no notice within the community of consumer credit scholars or consumer advocates, who had no reason to be aware of this particular case among the thousands being litigated in the federal courts. It is also unusual for the FDIC or OCC to file an amicus brief before a district court. The unusual context of the case is the reason that Professor Levitin was unaware of the case and thus unable to file a timely amicus brief. Upon learning of the case, Professor Levitin promptly prepared the conditionally filed brief and submitted this motion.

Additionally, upon learning of the case, Professor Levitin spoke with leadership at a number of national consumer advocacy groups, as well as with the offices of certain state banking regulators and attorneys general. All confirmed that this case had escaped the notice of all of them—including the Colorado Attorney General's office—because it arose in the context of an unexceptional small business bankruptcy. All were concerned at the possibility of a district court upholding a "valid-when-made" theory, but none believed that they would be able to respond quickly enough with their own late-filed amicus briefs, in part because of their own internal institutional processes for approving amicus filings.

Given the importance of the case to consumer credit regulatory policy and the absence of institutional amici to offset the presence of the FDIC and OCC, Professor Levitin believes that the assistance of an academic amicus in support of the Appellant, even in a late-filed brief, is important to ensure a fully briefed consideration of by the Court of the historicity of the "valid-when-made" doctrine.

WHEREFORE, Professor Levitin respectfully requests leave to file the brief submitted with this motion.

Respectfully submitted this 19th day of September 2018.

Adam J. Levitin
Agnes N. Williams Research Professor
&
Professor of Law
Georgetown University Law Center
600 New Jersey Ave., NW
Hotung 6022
Washington, DC 20001
(202) 662-9234
adam.levitin@law.georgetown.edu

CERTIFICATE OF SERVICE

This is to certify that a true and correct copy of the foregoing MOTION FOR LEAVE TO FILE AMICUS CURIAE BRIEF OF PROFESSOR ADAM J. LEVITIN IN SUPPORT OF APPELLANT was served by email upon the following this 19th day of September, 2019:

Patrick D. Vellone
Jennifer E. Schlatter
ALLEN VELLONE WOLF HELFRICH & FACTOR P.C.
1600 Stout Street, Suite 1100
Denver, CO 80202
Telephone: (303) 534-4499
E-mail: pvellone@allen-vellone.com
E-mail: jschlatter@allen-vellone.com
Attorneys for Appellant

I further certify that a true and correct copy of the foregoing MOTION FOR LEAVE TO FILE AMICUS CURIAE BRIEF OF PROFESSOR ADAM J. LEVITIN IN SUPPORT OF APPELLANT was served by Federal Express delivery upon the following, this 19th day of September, 2019:

Phillip J. Jones
WILLIAMS, TURN & HOLMES, P.C.
744 Horizon Court, Suite 115
Grand Junction, CO 81506
Telephone: (970) 242-6262
E-mail: pjones@wth-law.com

Attorney for Appellee

Professor Adam J. Levitin

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INTRODUCTION

On its face, the instant litigation is an unremarkable adversary proceeding in a small business's bankruptcy, the ultimate outcome of which has no particular public policy significance. Yet this is no ordinary bankruptcy appeal. Although this is a *business* bankruptcy case, it involves the most critical *consumer* credit regulation issue in the courts today—the vitality of a so-called "valid-when-made" doctrine. That doctrine purports to hold that a non-bank lender may ignore state usury laws for loans it purchases from a bank that is exempt from those laws.

The vitality of a "valid-when-made" doctrine is a question of whether federal preemption of state usury laws for banks under the Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDA") or under the National Bank Act of 1864 ("NBA") is assignable to non-bank lenders that are not covered by those statutes. That is, is federal preemption a feature of a loan that travels with it like a warranty, or is it a non-transferrable privilege, personal to the federally-regulated bank? Thus, when a bank that is not subject to a state's usury law by virtue of federal preemption assigns a loan to a non-bank, may the non-bank also shelter in federal preemption despite not being subject to the federal bank regulation regime?

The stakes are significant for consumer credit regulation. Since colonial times, states have had usury laws to protect their citizens. While a wave of deregulation starting in 1978 exempted banks from state usury laws, states retain authority over non-bank lenders. If courts recognize a "valid-when-made" doctrine, high-cost non-bank lenders, such as payday lenders and predatory small business lenders, will be able to evade state usury laws through "rent-a-bank" lending schemes, in which a non-bank lender uses a complicit bank to originate loans, which are promptly sold to the non-bank lender. As a court recently observed:

> If [the statute] indeed gave [assignees] a preemption defense for any loan that originated with a federal savings bank, then homeowners would be deprived of state law protections based solely on their original lender and [assignees] would be allowed to engag[e] in the otherwise illegal conduct.

McShannock v. JP Morgan Chase Bank, N.A., 354 F.Supp.3d 1063, 1077 (N.D. Cal. 2018) (internal quotations omitted) (holding that preemption under the Home Owners Loan Act of 1933 was not assignable). Payday lenders have long attempted to use rent-a-bank schemes, which regulators have historically shut down,[1] but these attempts are making a comeback.

In this case, the record is not developed, but there are indicia of rent-a-bank lending as a Colorado small business obtained a 120% interest rate loan from a tiny

[1] *SEE* NAT'L CONSUMER L. CTR., CONSUMER CREDIT REGULATION § 9.6.1 (2d ed. 2015), *updated at* www.nclc.org/library; *see also ID.* §§ 3.4.3.3, 3.4.3a.

Wisconsin community bank that then transferred the loan to Appellee, World Business Lenders, LLC ("Appellee"), a subprime small business lending specialist firm based in New Jersey. *See* Zeke Faux, *Wall Street Finds New Subprime With 125% Business Loans*, BLOOMBERG.COM, May 22, 2014, *at* http://www.bloomberg.com/news/2014-05-22/wall-street-finds-new-subprime-with-125-business-loans.html (discussing Appellee's predatory business practices) (included as Appendix A).

INTEREST OF AMICUS

Amicus curiae Adam Levitin is the Agnes N. Williams Research Professor and Professor of Law at Georgetown University Law Center. Professor Levitin's scholarship focuses on consumer finance regulation and commercial law, including the law of usury and the law of negotiable instruments. He has previously served on the Consumer Financial Protection Bureau's Consumer Advisory Board and as the Bruce W. Nichols Visiting Professor of Law at Harvard Law School.

Professor Levitin has previously written about the origins of the "valid-when-made" doctrine and the effects of preemption of state consumer protection laws in rent-a-bank transactions. *See* Adam J. Levitin, *"Madden Fix" Bills Are a Recipe for Predatory Lending*, AMERICAN BANKER, Aug. 28, 2017 (valid-when-made doctrine); Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Markets*

Upstream, 26 YALE J. ON REG. 145 (2009) (rent-a-bank transactions). He has also testified before Congress regarding the "valid-when-made" doctrine. Hearing Before the House Financial Services Committee, Subcommittee on Financial Institutions and Consumer Credit, *Examining Opportunities and Challenges in the Financial Technology ("Fintech") Marketplace*, Jan. 30, 2018. Professor Levitin has also filed amicus briefs on the "valid-when-made" doctrine in litigation brought by the Colorado Attorney General against non-banks engaged in rent-a-bank transactions. Amicus Brief of Professor Adam J. Levitin in Support of Plaintiff, *Meade v. Marlette Funding, LLC*, No. 17-30376 (Colo. Dist. Ct.); Amicus Brief of Professor Adam J. Levitin in Support of Plaintiff, *Meade v. Avant of Colorado LLC*, No. 17-cv-30377 (Colo. Dist. Ct.).

Professor Levitin's interest in this litigation is in ensuring a proper understanding of usury laws and their relationship to the so-called "valid-when-made" doctrine. Professor Levitin takes no position on other issues in this litigation.

Professor Levitin has authored and funded this brief entirely himself. He has no financial stake in the litigation.

ARGUMENT

The Bankruptcy Court held that "the long-established 'valid-when-made' rule answers the question" of:

> whether a promissory note originated by a state bank with a non-usurious interest rate under DIDA section 1831 somehow can be transformed into a usurious promissory note by virtue of assignment to a non-bank entity.

Op. at 21. Likewise, Appellee and its *Amici*, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency (together "*Amici*"), point to this "longstanding" doctrine as a basis for affirming the bankruptcy court. Appellee's Br. at 1-2; Amici Br. at 3. *Amici* refer to the "valid-when-made" doctrine as a "well-established and widely-accepted rule," Amici Br. at 10, and claim that the Supreme Court described it as a "'cardinal rule' of American law." *Id.* Moreover, according to the Bankruptcy Court, the valid-when-made doctrine's "long-accepted principles were inherently incorporated into the NBA and, later, the DIDA." Op. at 21.

Yet if the law were in fact so "well-settled" on this point, as *Amici* claim, it begs the question why two federal bank regulators would bother filing a joint amicus brief in the district court in a small business bankruptcy appeal to which no regulated bank is a party? The presence of the *Amici* underscores that the law is hardly well-settled—and indeed, the Second Circuit has rejected the valid-when-made argument, *Madden v. Midland Funding, LLC*, 786 F.3d 246, 250-53 (2d Cir. 2015) (holding that National Bank Act preemption does not apply to a debt buyer from a national bank)—but that they would like it to be.

Appellee and *Amici* present three arguments in support of the valid-when-made principle. First, they argue that DIDA preemption is assignable under the common law of contracts. Second, they claim that "valid-when-made" is a "longstanding" doctrine and "well-settled" law that was part of the common law background to the NBA and DIDA (which is modeled on the NBA) and thus incorporated in those statutes. Therefore, Appellee and *Amici* argue, a non-bank purchaser of a loan originated by a bank also purchases DIDA preemption of state usury laws. Third, they argue that irrespective of the historical roots of valid-when-made, the principle is inherent within DIDA section 1831d, 12 U.S.C. § 1831d.

All three of these arguments are wrong. DIDA preemption is not a contract right that can be freely assigned. It is not alienable property, but is a privilege personal to a bank that comes as part of a bundle of a detailed regulatory scheme.

Likewise, the supposed historical roots of "valid-when-made" are spurious. With one exception, nothing approaching the claimed "valid-when-made" doctrine is to be found in cases, treatises, or scholarly articles that pre-date DIDA's 1980 preemption provision, much less the 1864 NBA, such that this supposedly longstanding doctrine is not even mentioned by name prior to 2015, when it suddenly appeared as part of unsuccessful *amicus curiae* briefing by financial institution trade associations in support of the defendant debt buyer in the *Madden* litigation.

No pre-1864 case deals with a "valid-when-made" situation, and only a single pre-1980 case cited by *Amici* deals with a transactional situation even remotely similar to the "valid-when-made" issue. *Amici* rely entirely and improperly on out-of-context and even misleadingly edited quotations from older cases to support the doctrine's claimed antiquity. At best the doctrine is "valid-when-made-up," and even the handful of post-1980 cases consistent with the doctrine are readily distinguishable from the instant litigation and some also include an exception for loans intended for assignment *ab initio*.

Similarly, there is nothing in DIDA section 1831d that compels "valid-when-made." The power of banks to assign their loans does not inherently include the power to assign federal preemption to non-bank entities. Contrary to *Amici*'s hyperbolic claims, declining to create a "valid-when-made" doctrine (with a falsified historical pedigree) will not prevent banks from selling loans in the secondary market. Instead, as the Second Circuit rightly recognized in *Madden v. Midland Funding, LLC*, 786 F.3d at 251, applying state usury laws to non-bank assignees will merely reduce the price at which banks are able to sell a subset of usurious loans.

Whether a "valid-when-made" doctrine *should* exist is a policy question properly reserved for the legislature, not the courts, and bills seeking to enact have failed to advance in Congress.

A. The Common Law of Assignments Is Irrelevant Because DIDA Preemption Is Not an Assignable Right Under a Contract

Amici argue that under the common law of contracts, the assignee takes all of the rights of the assignor. Amici Br. at 14-16. That is true, subject to an important limitation: an assignee takes all of the rights of the assignor *under the contract. See* Restatement (2d) of the Law, Contracts, § 317(2) ("A *contractual* right can be assigned….") (emphasis added). It is self-evident that an assignee does not assume the assignor's other rights extraneous to the contract, such as rights under licenses or from status. For example, if I sell my car, the buyer gets whatever rights are appurtenant to the car, but does not also get my driver's license or the benefits of my American Automobile Association membership , much less my parental or spousal rights.

This limitation underscores *Amici's* misconceptualization of what DIDA preemption is. Preemption is not a right *under the contract* that can be assigned. It is not an alienable property right or a characteristic of the loan that travels with the note. Instead, DIDA preemption is a personal and non-transferrable privilege that is part of a legal scheme that applies only to banks. Indeed, DIDA preemption does not void state usury laws—state usury laws remains valid and in effect for nondepositories. Instead, DIDA preemption merely allows an insured depository to export the usury cap of its home state into other states. DIDA preemption is part of a bundle of regulatory benefits and burdens specific to banks; allowing it to be assigned to a non-bank would result in a regulatory vacuum in which the non-bank would be exempt from state law, but also not subject to federal regulation. *See Levitin, Hydraulic Regulation*, *supra* at 188-89.

B. "Valid-When-Made" Is Not Incorporated in the NBA or DIDA Because It Is a Modern Invention Lacking Historical Roots

1. "Valid-When-Made" Responds to a Problem That Could Not Exist Prior to the NBA

Amici argue that "valid-when-made" is incorporate in DIDA because it was part of the common law background to section 85 of the NBA, 12 U.S.C. § 85, on which DIDA section 1831d is patterned. *See* Amici Br. at 5-6. Collectively, the Bankruptcy Court, the Appellee, and especially *Amici* cite to numerous cases that pre-date DIDA's enactment in 1980 and also to five cases that pre-date the NBA's enactment in 1864. Significantly, neither the Bankruptcy Court opinion, nor the briefing by the Appellee or *Amici* actually discusses the context or substance of a single pre-DIDA opinion. Instead, in every instance, they rely on selective snippets of decontextualized and even edited language that supposedly establishes "valid-when-made" as a "cardinal rule" of banking law. When one examines the actual cases, however, it becomes apparent that nothing remotely approaching a "valid-when-made" doctrine existed prior to DIDA, much less the NBA.

As an initial matter, the doctrine could not possibly have existed prior to the enactment of the NBA in 1864 because there was no situation in which it could have arisen. Prior to the NBA, state usury laws applied to all entities equally, with choice of law rules limited by an anti-evasion principle. *Miller v. Tiffany*, 68 U.S. 298, 308 (1864). Therefore, it was not possible prior to 1864 for a loan to be non-usurious in the hands of a bank, yet be usurious in the hands of a non-bank assignee merely by virtue of an assignment. This means that all of the *ante-bellum* cases on which the Appellee and *Amici* rely have nothing to do with the issue in this case. Accordingly, the "valid-when-made" doctrine could not be background law against which the NBA was enacted, and thus it could not have been incorporated into DIDA.

2. The Bankruptcy Court, Appellee, and Amici Rely on Decontextualized Language from Pre-DIDA Cases that Have No Connection to "Valid-When-Made"

An examination of the pre-DIDA cases cited by the Bankruptcy Court, Appellee, and *Amici* shows that with one exception, *Strike v. Trans-West Discount Corp.*, 92 Cal.App.3d 735, 745 (Cal. Ct. App. 4th Dist. 1979), none of them are dealing with anything remotely related to "valid-when-made" in the sense of assignment of a loan from a bank to a non-bank having no impact on the application of usury laws. *Strike* was decided as a matter of the California Constitution and expressly carves out an exception for loans intended to be assigned *ab initio*, as may well be the case in this litigation. *Id.* (citing *Calimpco, Inc. v. Warden*, 100 Cal. App. 2d 429, 446-447 (Cal. Ct. App. 1st Dist. 1950) ("If [an assignee cannot be held liable for accepting usurious interest], the statutes on usury might as well be abolished. All a lender would have to do would be to obtain a contract from a borrower providing for usurious interests…and then assign his contract and the contract would no longer be usurious.")). *See also Miller v. Tiffany*, 68 U.S. at 308 (contractual choice of law provisions for usury are enforceable, but when done with intent to evade the law, law of the contract location applies).

It is hardly support for "valid-when-made" being part of the pre-DIDA, much less pre-NBA, common law.

Other than *Strike*, the pre-DIDA cases address three issue patterns:

(1) the effect of the exercise of a payment option by the borrower on the usurious status of a loan (*i.e.*, where there is no assignment of the loan involved);

(2) the effect of a discounted assignment, where the question is whether the discount in the assignment may be treated as imputed interest on the note; or

(3) the effect of a valid assignment on a usurious loan (*i.e.*, the inverse transaction from that at issue).

Thus, the evidence Appellee and *Amici* adduce of the historical roots of the doctrine is limited to a set of selective, decontextualized, and even misleading quotations from cases that have nothing to do with the doctrine as they describe it. The doctrine's historical pedigree is thus entirely invented by shoehorning selective and decontextualized quotations from older cases to serve a modern deregulatory policy agenda. Indeed, even the handful of post-DIDA cases that are consistent with the doctrine are almost all pyramided on a single decision's selective and out-of-context language from a 19th century Supreme Court case.

a. Cases Regarding Effect of Debtor's Payment Option

Many of the cases cited in support of "valid-when-made" fit the "option" pattern.[2] Sometimes the option in these cases is prepayment, sometimes it is late

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[2] *See Tate* v. *Wellings*, 100 Eng. Rep. 716, 721 (K.B. 1790) (Buller, J.), (effect on usury calculation of loan of stock that was repayable in stock or cash at the borrower's option); *Unity Plan Finance Co. v. Green*, 155 So. 900, 905 (La. 1934) (effect on the calculation of the interest rate on the acceleration of the debt upon the debtor's failure to timely pay); *State v. J. C. Penney Co.*, 179 N.W.2d 641, 645 (Wis.

payment, and sometimes it is the form of payment. These cases generally do not even involve assignments of the loan. In all these cases, the idea that the calculation of the interest rate on a loan for usury purposes should not be determined based on the debtor's exercise of an option has nothing to do with "valid-when-made" in the sense of whether an assignment of the loan affects what state's usury law applies to the creditor.

1970) (language cited by *Amici* is actually from a block quotation from *Zang v. Schumann*, 262 Wis. 570, 577-579 (Wisc. 1952) (effect of borrower exercising option to pay extra premium to be relieved from a lease)); *First Nat'l Bank v. Danek*, 556 P.2d 31, 34 (N.M. 1976) (whether value of a non-optional discounted stock sale accompanying the loan should be included in the interest for the loan); *FDIC v. Tito Castro Constr.*, 548 F. Supp. 1224, 1227 (D.P.R. 1982) ("it was only as a consequence of defendant's election to delay in repaying the principal amount of those [demand] notes that an effective rate of interest in excess of the Puerto Rico statutory ceiling may have resulted."); *Rangen, Inc. v. Valley Trout Farms, Inc.*, 658 P.2d 955, 959 (Id. 1983) (effect on usury calculation of a fee for late payment option); *Saul v. Midlantic Nat'l Bank*, 572 A.2d 650, 658 (N.J. App. Div. 1990) (effect on usury calculation borrower's optional prepayments).

Unfortunately, in an attempt to pressgang inapposite precedent for support from option cases, *Amici* engage in misleading edits of quotations. For example, *Amici* represent *Hoffman v. Key Federal Sav. and Loan Ass'n*, 416 A.2d 1265, 1269 (Md. 1979) as standing for:

> "[t]he virtually universal rule is that a contract legal at its inception will not be rendered usurious" by subsequent acts.

Amici Br.at 12-13. But what *Hoffman* actually says is that:

> "[t]he virtually universal rule is that a contract legal at its inception will not be rendered usurious ***by voluntary prepayment***."

416 A.2d 1265, 1269 (emphasis added).

Similarly, *Amici* cite *Southwest Concrete Products. v. Gosh Construction Corp.*, 51 Cal.3d 701, 708 (1990) for the proposition that:

> "a transaction that was not usurious at its inception cannot become usurious by virtue of" a later act.

Amici Br.at 13, n.9. The full quotation from *Southwest Concrete Products,* however is that:

> "a transaction that was not usurious at its inception cannot become usurious by virtue of **the debtor's voluntary default.**"

Southwest Concrete Prods. v. Gosh Construction Corp., 51 Cal.3d 701, 708 (Cal. 1990) (emphasis added). Rather than expressing support for the idea that an assignment of a loan has no effect on what state's usury law applies, *Hoffman* and

Southwest Concrete Products merely state that the debtor's exercise of a payment option does not affect the rate on the loan for usury calculations. *Amici*'s editing and paraphrasing of the quotations, however, misleadingly portrays these cases as supporting "valid-when-made."

b. Cases Regarding the Effect of Usury in a Second, Subsequent Transaction on the First Transaction

The second common fact pattern in the cases relied upon for support of "valid-when-made" is the question of whether when there were two transactions, usury in transaction #2 could be imputed to transaction #1. As with the option cases, the issue here has nothing to do with the question of what jurisdiction's usury law applies to the note, but merely about whether rate on the note exceeds the usury cap.

Several of the cases cited in support of "valid-when-made" deal with the two-transaction scenario, particularly the impact of discounting of notes and bills. To understand these cases, it is important to recognize that in the 19th century a robust secondary market in bill and notes, which were frequently sold at a discount from their face amount The discount from face can be conceived as interest because the obligor on the note would owe the face amount irrespective of the discount to the purchaser. For example, if a $120 note were purchased for $100, the purchaser would have a right to collect the full face amount of $120. Economically, however, the transaction is equivalent to the purchaser having made a $100 loan and received $20 in interest. Indeed, this concept is still regularly applied today in the tax and bankruptcy law, where "original issue discount" on bonds is treated as imputed interest. *See, e.g.*, Treas. Reg. § 1.61-7(c); *In re Chateaugay Corp.*, 961 F.2d 378 (2d Cir. 1992); *Matter of Pengo Indus. Inc.*, 962 F.2d 543 (5th Cir. 1992).

Critically, the discounted sale issue does not give rise to the evasion of state usury laws like the "valid-when-made" doctrine. When a note is sold with a discounted sale, the borrower continues to pay interest to the purchaser at the contract rate, which would have been legal had the purchaser made the loan itself. The usury question only arises from the imputed interest in the discount. "Valid-when-made" deals with a situation in which the loan would have been illegal had the assignee made it directly. The "valid-when-made" would allow non-bank lenders to do indirectly what they cannot do directly.

Thus, *Amici* cite *Tuttle v. Clark*, 4 Conn. 153 (1822), which involved whether a discounted sale of a note would be treated as a sale or a loan. 4 Conn. at 156 (reporter's description). *Tuttle*'s holding—that the note "not being usurious in its original concoction, did not become so, by the subsequent [discounted] sale to the plaintiffs", 4 Conn. at 157—has nothing to do with the question of whether a non-bank may piggyback on the unique exemption of banks from state usury laws. The case is wholly inapposite for the proposition for which *Amici* cite it.

Similarly, *Gaither v. Farmers' & Mechanics' Bank of Georgetown*, 26 U.S. (1 Pet.) 37 (1828) involved a non-usurious note that was pledged by the payee as collateral for an unrelated, usurious loan. 26 U.S. (1 Pet.) at 41. The Supreme Court observed that:

> [T]he rule cannot be doubted, that if the note free from usury, in its origin, no *subsequent* <u>*usurious*</u> *transactions respecting it*, can affect it with the taint of usury.

Id. at 43 (emphasis added). The point here is that usury in transaction #2 does not impute usury to unconnected transaction #1. *Gaither* had nothing to do with the supposed "valid-when-made" doctrine that a "promissory note originated by a state bank with a non-usurious interest rate under DIDA section 1831" cannot "be transformed into a usurious promissory note by virtue of assignment to a non-bank entity". Op. at 21. Again, as in *Tuttle,* the interest charged on transaction #1 continued to be charged at a rate that would have been legal had the assignee made the loan directly, whereas the current case involves a loan that would have been illegal for the assignee to make directly.

Likewise, *Nichols v. Fearson*, 32 U.S. (7 Pet.) 103 (1833), involved a discounted sale of a note indorsed by the defendant. 32 U.S. at 103. When the defendant indorsed the note, the defendant became jointly liable for the full face amount of the note, just as if it were the maker of the note. *See* UCC § 3-415(a). The Supreme Court held that the usurious discounting did not void the original note, *id.* at 110, 112, observing that among the:

> cardinal rules of the doctrine of usury …[is] that a contract which in its inception is unaffected by usury can never be invalidated by any *subsequent* ***usurious*** *transaction*.

Id. at 109 (emphasis added). *See also id.* at 106 ("the rule of law is everywhere acknowledged that a contract free from usury in its inception shall not be invalidated by any *subsequent* ***usurious*** *transactions upon it*.") (emphasis added). Again, the point is that usury in transaction #2 does not affect transaction #1. *Nichols* has nothing to do with the present question of whether a bank can transfer its statutory preemption privilege to an assignee to allow the assignee to purchase and enforce a loan that the assignee could not legally make itself.

The same pattern appears in a more recent case, *Concord Realty v. Cont'l Funding*, 776 P.2d 1114, 1120 (Colo. 1989), which addressed whether the interest rate should be calculated based on the contract rate or on the imputed rate of interest from a foreclosure sale bid. The language quote by the *Amici,* "the usurious nature of a transaction must be determined from its inception" merely refers to the timing of the calculation of the interest rate, not the question of what law applies, which is the issue in this case.

c. Cases Regarding the Effect of a Subsequent Valid Transaction on Prior Usury

The third common fact pattern in the cases relied upon for support of "valid-when-made" is the about the effect of a later valid transaction on a loan that is usurious *ab initio. See Highway Equip. & Supply Co. v. Jones*, 153 N.W.2d 859, 863 (Neb. 1967) (issue of whether initial usury was purged by assignment); *Coral Gables First Nat. Bank v. Constructors of Fla., Inc.*, 119 So. 2d 741, 746 (Fla. Dist. Ct. App. 1960) (effect of renewal of a usurious loan on non-usurious terms); *Waggener v. Holt Chew Motor Co.*, 274 P.2d 968, 971 (Colo. 1954) (lender's acquisition of required license after making loan at rate above that allowed for unlicensed lenders does not cure violation).

Also in this pattern is *Watkins v. Taylor*, 16 Va. 424, 436 (Va. 1811) (effect of payment by surety on surety's subrogation claim on usurious contract). Shockingly, *Amici* fail to note that the language they quote from *Watkins* is from the *dissent*, not the majority opinion. Given that the subrogated surety was ultimately subject to the usury defense, *Watkins* tells us nothing about the existence of a "valid-when-made" doctrine, but again shows *Amici* playing fast-and-loose in their presentation of the law.

2. The "Valid-When-Made" Doctrine Is Entirely Absent from Historical Usury and Banking Law Treatises

If the "valid-when-made" doctrine were a "cardinal rule" of banking law, founded on Supreme Court opinions, one would expect it to regularly appear in 19^{th} and 20^{th} century usury and banking law treatises. Yet the doctrine is entirely unknown to historical treatise writers. Nothing even approaching the "valid-when-made" doctrine in which the assignment of a loan from an originator to an assignee subject to a different state usury law appears in any 19^{th} or 20^{th} century usury treatise. No prior reference to "valid-when-made" can be found in *any* banking or usury treatise.

Amici cite to language from 1838 edition of Blackstone's Commentaries on the Laws of England for support: "'[t]he usury must be part of the contract in its inception' for a contract to be deemed usurious." Amici Br. at 10. The quoted language is not from Blackstone himself, but from an annotator's footnote. It too, however, does not support the "valid-when-made" doctrine. The footnote cites two English cases, *Lowes v. Mazzaredo*, 1 Stark 385 (Assizes at Nisi Prius 1816) (usurious discounting of a non-usurious bill of exchange—pattern #2), and *Lowe v.*

Waller, 2 Dougl. 736 (King's Bench 1781) (good faith assignee of a usurious bill of exchange is subject to the defense of usury—pattern #3 of loan usurious *ab initio*), both of which are uninformative about the "valid-when-made" doctrine.

Similarly, *Amici* cite the 2018 edition of the *American Jurisprudence (2d)* treatise on Interest and Usury. Amici Br. at 10 (citing 44B Am. Jur. 2d Interest and Usury § 65 (2018)). That treatise too also never refers to "valid-when-made" and note one of the cases it cites in support of the language quoted by *Amici*—that the "usurious nature of a transaction is [determined] at the inception of the transaction" and that "usury therefore must exist at the inception of the contract"—deals with the question of whether an assignment affects the usurious status of a loan. The cases cited by *American Jurisprudence (2d)* are all in either payment option cases (the first pattern) or usury in separate, subsequent transactions (the second pattern).

3. Only a Single Pre-DIDA Case That Supports "Valid-When-Made"

There is only one pre-DIDA decision that is consistent with a "valid-when-made" doctrine. *Strike v. Trans-West Discount Corp.*, 92 Cal.App.3d at 745 (Cal. Ct. App. 4th Dist. 1979). The presence of a single pre-DIDA decision embracing valid-when-made suggests that it is unlikely that the doctrine is incorporated in DIDA.

Strike, notably, does not mention any such doctrine, even though *Strike* dealt with a situation similar to the instant case—a loan was assigned from a bank (exempt from California usury law by the California constitution) to a non-bank that was normally subject to California usury law. The California Court of Appeals held that the transfer of the loan did not change its status vis-à-vis the usury laws, but suggested that the outcome would be different if the loan had been intended for assignment *ab initio*. *Id.* This is a sensible position that ensures the liquidity of bank loans, but also prevents abuse of federal preemption through rent-a-bank arrangements and the like. *Strike* is the only pre-DIDA case that fits with "valid-when-made," and there is no evidence that Congress intended to incorporate its rule into DIDA, but if *Strike* was incorporated, that incorporation would also include the exception for loans intended for assignment *ab initio*.

4. Post-DIDA Cases All Stand on a Misreading of ***Nichols v. Fearson***

A handful of post-1980 cases arguably support the doctrine, although they were obviously not incorporated into DIDA because they post-date the statute. These post-1980 cases are in a line founded on a misinterpretation of the same decontextualized quotation from *Nichols v. Fearson*, 32 U.S. (7 Pet.) 103 (1833), upon which the Bankruptcy Court opinion, Appellee, and *Amici* rely. Thus, *Munoz v. Pipestone Financial, LLC*, 513 F.Supp.2d 1076 (D. Minn. 2007) cites to *Phipps* *v. FDIC*, 417 F.3d 1006 (8th Cir. 2005), which in turn relies with no original analysis on *Krispin v. May Dep't Stores Co*., 218 F.3d 919 (8th Cir. 2000), which in turn relies on *FDIC v. Lattimore Land Corp.*, 656 F.2d 139, 148-49, n.17 (5th Cir. 1981). An examination of *Lattimore Land Corp.* and *Krispin* show that neither is applicable to the instant case.

The holding in *Lattimore Land Corp.* was supported by two citations with no original analysis. One citation was to *Nichols v. Fearson* and the other to *Huntsman v. Longwell*, 4 F.2d 105 (5th Cir. 1925). *Huntsman*, unlike *Lattimore*, was not an assignment case, and properly relied *Nichols* as support for the idea that imputed interest from transaction #2 cannot be bundled with interest from transaction #1 to result in a combined interest rate that violates the usury cap. 4.F.2d at 106.

Lattimore, however, misread *Hunstman* and *Nichols* (as did subsequent courts, including the Bankruptcy Court in this case). These courts take the Jovian language from *Nichols* that among the "cardinal rules" of usury is that:

> a contract which in its inception is unaffected by usury can never be invalidated by any subsequent usurious transaction

32 U.S. at 109, and omit the penultimate word, so that it reads:

> a contract which in its inception is unaffected by usury can never be invalidated by any subsequent … transaction.

Indeed, *Huntsman* itself, in paraphrasing *Nichols* omitted the penultimate word. 4 F.2d at 106. By ignoring the word "usurious," courts have misread *Nichols* as standing for a broader proposition than it does. *Nichols* is a holding about the effect of a usurious discounting, nothing more. Hence the Supreme Court referred to "any subsequent ***usurious*** transaction," not merely "any subsequent transaction." The entire line of modern "valid-when-made" cases all stands on this misreading of *Nichols*.[3]

There is only one pre-DIDA decision, *Strike,* 92 Cal.App.3d. at 745 (Cal. Ct. App. 4th Dist. 1979), that is consistent with a "valid-when-made" doctrine. The presence of a single pre-DIDA decision embracing "valid-when-made" makes it unlikely that the doctrine is incorporated in DIDA, but if *Strike* was incorporated,

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[3] *Krispin v. May Dep't Stores* can also be distinguished from the instant case because it involved a transfer between a bank and its parent corporation (a department store), not a transfer between two unaffiliated parties. The continued affiliation between the bank and the debt buyer and the bank's continued involvement in the loan was the key factor in *Krispin.* 218 F.3d at 924. No such corporate nexus exists in this case.

that incorporation would also include its exception for loans intended for assignment *ab initio*.

Because the "valid-when-made" doctrine did not exist at the time of DIDA's enactment, it could not have been incorporated in DIDA, and the doctrine's current vitality is far from a "well-settled" matter, as it was rejected by the Second Circuit in 2015. *Madden*, 786 F.3d at 250-53.

C. "Valid When Made" Is Not an Inherent Implication of DIDA section 1831d

Amici further argue that irrespective of historical roots, "valid-when-made" is an inherent implication of section 1831d of DIDA. Amici Br. at 16-20. No one questions the power of banks to assign their loans. But it does not follow that the authority to assign loans also means the authority to assign federal preemption to non-bank entities that are not subject to the same extensive regulatory scheme as banks with the effect of also immunizing the non-banks from state laws. It is absurd to suggest that an inherent implication of section 1831d—part of a *federal bank* regulation law—is that *non-banks* should be exempt from *state* regulation.

Amici contend, however, that absent "valid-when-made" it would be "uneconomic" and "disastrous in terms of bank operations" because banks could not sell loans in the secondary market. Amici Br. at 17. Similarly, the Bankruptcy Court claimed that "[a]ny contrary legal standard would interfere with the proper functioning of state banks". Op. at 22.

There is no evidence in the record to support the Bankruptcy Court's conclusion, which is a matter of supposition about financial markets that goes beyond the proper scope of any judicial notice. In any event, this hyperbolic conjecture is demonstrably wrong; the ability of banks to sell loans in the secondary market does not depend on the vitality of "valid-when-made." Nothing in the *Madden* position prevents banks from selling loans.

First, the principal secondary market in the United States is the market for mortgages. State usury laws are preempted for most mortgages, regardless of the entity that holds them. 12 U.S.C. §§ 1735f-7, 1735f-7a. Indeed, the broad express preemption for mortgages suggests that Congress did not intend such broad preemption for other types of loans.

Second, there are over 5,300 FDIC insured banks, all of which benefit from DIDA preemption. FDIC Statistics on Depository Institutions, 2d Quarter 2019. Even without a "valid-when-made" doctrine, there is a sizeable potential secondary market for non-mortgage loans that is unaffected by state usury laws.

Third, most bank loans are made at non-usurious rates—nothing like the 120.86% rate in this case. "Valid-when-made" is not necessary for a secondary market in non-usurious loans, and indeed, non-banks regularly sell their non-usurious loans without incident.

Fourth, even usurious loans can still be sold absent "valid-when-made" because usury laws are not self-executing and are unlikely to be invoked absent a default on the loan. A robust "grey" market exists in "stale" debts, which are unenforceable because they are beyond the statute of limitations. *See, e.g.*, Andrew Martin, *Old Debts That Won't Die,* N.Y. TIMES, July 30, 2010, at B1. There is no reason to believe that a "grey" market would not also persist in usurious debts without "valid-when-made."

The only consequence of rejecting the spurious "valid-when-made" doctrine would be to decrease the price at which bank could sell *usurious* loans. DIDA, however, is not a price guaranty for banks' sale of usurious loans. As the Second Circuit observed in *Madden*, application of state usury laws to the assignee of a national bank might "decrease the amount a national bank could charge for its consumer debt in certain states," but that possible outcome would not "significantly interfere with the exercise of a national bank power." 786 F.3d at 251. So too, a lower price for usurious loans would not be a significant impairment of banks' powers, much less a conflict with section 1831d of DIDA, particularly in light of presumption against preemption in areas of traditional state regulation, such as consumer protection law. *Vien-Phuong Thi Ho v. Recontrust Co., NA*, 840 F.3d 618, 625 (9th Cir. 2016).

D. The Court Should Clearly State that It Is Not Addressing Whether Appellee Was the "True Lender" or Whether the *Ab Initio* Exception to "Valid-When-Made" Is Applicable

There are three doctrinal paths by which Appellee could be subject to Colorado's usury law. First, Appellee could be liable if the Court follows *Madden* and holds that DIDA preemption does not immunize non-bank assignees of banks. Second, the Appellee could be liable if it is found to be the "true lender" on the loan, meaning that the involvement of Lake Mills Bank in the loan was so *de minimis* that it should be disregarded. And third, Appellee could be liable if the Court holds that it falls under the exception to "valid-when-made" for loans intended for assignment *ab initio. See Strike,* 92 Cal.App.3d at 745; *Lattimore*, 656 F.2d at 148 n.15.

Only the first of these three paths has been briefed in this appeal and has a factual record sufficient for judgment. It is important that the Court not rule more broadly than necessary in this case. Irrespective of the outcome, the Court should make clear that it is not addressing the two paths to liability that are not before it. In particular, the Court should make clear that it is not addressing whether Appellee was the "true lender;" that issue has not been raised. If Appellee is the "true lender," then the Wisconsin choice-of-law provision would be void because it was selected for purposes of evading the Colorado usury laws. *Miller v. Tiffany*, 68 U.S. 298, 308 (1864).

Likewise, if the Court does embrace "valid-when-made," it should clearly enunciate the *ab initio* exception and remand the case for fact-finding about the circumstances of the assignment of the loan from Lake Mills Bank to World Business Lenders. It is not clear if the loan was always intended for assignment, but the known facts suggest that the loan might have been originated for assignment as part of a rent-a-bank transaction: a Colorado entity obtained a small business loan at 120.86% interest from a tiny Wisconsin community bank, which assigned the loan to World Business Lenders, a subprime small business lender whose website states that its loans are currently offered through a bank.

CONCLUSION

There was no "valid-when-made" doctrine prior to either the NBA or DIDA. The doctrine is a modern invention based on a misreading of *Nichols v. Fearson.* The doctrine is not implicit in the common law of assignments or in DIDA section 1831d. The doctrine is not valid, but made up. Whether such a doctrine should exist is properly the province of Congress, not the courts, and Congress has thus far declined to advance bills that would enact a "valid-when-made" doctrine.

Respectfully submitted this 19th day of September, 2019.

Adam J. Levitin
Agnes N. Williams Research Professor
&
Professor of Law
Georgetown University Law Center
600 New Jersey Ave., NW
Hotung 6022
Washington, DC 20001
(202) 662-9234
adam.levitin@law.georgetown.edu

CERTIFICATE OF SERVICE

I certify that a true and correct copy of the foregoing AMICUS CURIAE BRIEF OF PROFESSOR ADAM J. LEVITIN IN SUPPORT OF APPELLANT was served by email upon the following, this 19th day of September, 2019:

Patrick D. Vellone
Jennifer E. Schlatter
Allen Vellone Wolf Helfrich & Factor P.C.
1600 Stout Street, Suite 1100
Denver, CO 80202
Telephone: (303) 534-4499
E-mail: pvellone@allen-vellone.com
E-mail: jschlatter@allen-vellone.com
Attorneys for Appellant

I further certify that a true and correct copy of the foregoing AMICUS CURIAE BRIEF OF PROFESSOR ADAM J. LEVITIN IN SUPPORT OF APPELLANT was served by Federal Express delivery upon the following, this 19th day of September, 2019:

Phillip J. Jones
Williams, Turn & Holmes, P.C.
744 Horizon Court, Suite 115
Grand Junction, CO 81506
Telephone: (970) 242-6262
E-mail: pjones@wth-law.com

Attorney for Appellee

Professor Adam J. Levitin

CERTIFICATE OF COMPLIANCE

I certify that this amicus curiae brief complies with the type-volume limitation of Federal Rule of Bankruptcy Procedure 8017(a)(5) (and 8015(a)(7)(B)) because it contains 6,496 words, excluding the parts of the brief exempted by Federal Rule of Bankruptcy Procedure 8015(g).

Dated this 19th day of September, 2019.

Professor Adam J. Levitin

APPENDIX A

http://www.bloomberg.com/news/2014-05-22/wall-street-finds-new-subprime-with-125-business-loans.html

Bloomberg

Wall Street Finds New Subprime With 125% Business Loans

Zeke Faux

May 22, 2014, 12:00 AM EDT

Doug Naidus made his fortune selling a mortgage company to Deutsche Bank AG months before the U.S. housing market collapsed. Now he's found a way to profit from loans to business owners with bad credit.

From an office near New York's Times Square, people trained by a veteran of Jordan Belfort's boiler room call truckers, contractors and florists across the country pitching loans with annual interest rates as high as 125 percent, according to more than two dozen former employees and clients. When borrowers can't pay, Naidus's World Business Lenders LLC seizes their vehicles and assets, sometimes sending them into bankruptcy.

Naidus isn't the only one turning to subprime business lending. Mortgage brokers and former stock salesmen looking for new ways to make fast profits are pushing the loans, which aren't covered by federal consumer safeguards. Goldman Sachs Group Inc. (GS) and Google Inc. are among those financing his competitors, which charge similar rates.
"This is the new predatory lending," said Mark Pinsky, president of Opportunity Finance Network, a group of lenders that help the poor. "And the predators, just as they did in the mortgage market, have gotten increasingly aggressive."

Subprime business lending -- the industry prefers to be called "alternative" -- has swelled to more than $3 billion a year, estimates Marc Glazer, who has researched his competitors as head of Business Financial Services Inc., a lender in Coral Springs, Florida. That's twice the volume of small loans guaranteed by the Small Business Administration.

`Main Street'

Naidus, 48, chief executive officer of World Business Lenders, declined to be interviewed. Marcia Horowitz, a spokeswoman at public relations firm Rubenstein Associates Inc., said the company explains loan terms in plain English and takes steps to ensure that borrowers understand.

"World Business Lenders' sales and marketing techniques, as well as the interest rates it charges and the default rates it experiences, are generally consistent with those throughout the industry," Andy Occhino, general counsel for the company, wrote in a May 21 letter. "In serving the underserved small-business community along Main Street USA, World Business Lenders complies with all applicable laws and endeavors to ensure a positive experience for its customers."

Hurricane Damage

Maher and Tamer Kasem, a father and son who sell cigarettes and cosmetics to corner stores in Brooklyn and Philadelphia, are typical customers. They borrowed from World Business Lenders in December to keep their company afloat after being rejected by a bank and turned down for a hurricane-recovery loan.
A saleswoman initially talked about an unsecured $45,000 loan, they said. They had fallen further behind on bills by the time they received the final terms to borrow $12,500. The money, plus almost $1,000 in fees, was to be repaid over six months with $144.73 deducted from their bank account each business day, according to a contract they provided. That worked out to a total of $18,236 or an annualized rate, inclusive of fees, of about 110 percent.

Tamer and his mother Lamis said they signed personal guarantees that they would repay the money even if the business went bust, and the family put up a vacant lot as collateral.

"I was just wanting to get money to survive my business any way," Maher Kasem, 57, said in an interview at his office in the Bensonhurst section of Brooklyn, where he keeps boxes of fruit-flavored cigars and makeup ruined in Hurricane Sandy stacked on the crumbling tile floor. "They're slick."
World Business Lenders sued the Kasems and obtained a judgment for $22,828, which included a $3,879 prepayment fee. The firm hasn't yet foreclosed on the property, Kasem said.

Packaging Loans

Horowitz, the spokeswoman for World Business Lenders, said the company works with borrowers to avoid defaults.

“If the default cannot be cured, World Business Lenders enforces its rights under the loan documents, including the recovery of the pledged collateral,” she said.

Wall Street banks are helping the industry expand by lending originators money. They’re starting to package the loans into securities that can be sold to investors, just as they did for subprime-mortgage lenders.

OnDeck Capital Inc., a lender with funding from Google’s venture-capital arm and PayPal Inc. co-founder Peter Thiel, sold $175 million of notes backed by business debt last month in a deal put together by Deutsche Bank. Interest rates on the loans ranged from 29 percent to 134 percent, according to a report from credit rater DBRS Ltd., which labeled most of the deal investment grade.

Representatives for Thiel, Google Ventures and Goldman Sachs, which lends money to OnDeck, declined to comment.

‘Your Choice’

“While I am not real thrilled about some of the prices being charged, in some cases businesses need to get something done in a hurry and it makes sense,” said William Dennis, who directs the research foundation at the National Federation of Independent Business. “It may not be the world’s best choice, but at least it’s your choice.”

Brokers are popping up around the country to originate loans on behalf of lenders including OnDeck and World Business Lenders. The companies pay fees to the brokers of about $6,000 for finding people willing to take a $50,000 loan, according to current and former brokers, most of whom asked not to be identified to preserve their job prospects.

Some stock brokers have jumped to business loans after getting kicked out of the securities industry by regulators.

‘Absolutely Crazy’

“Our industry is absolutely crazy,” said Steven Delgado, who left World Business Lenders last year to become an independent loan broker. “There’s lots of people who’ve been banned from brokerage. There’s no license you need to file for. It’s pretty much unregulated.”

David Glass, 39, was still on probation for insider trading when he co-founded Yellowstone Capital LLC, a New York-based brokerage and lender that originated $200 million in loans last year, including for OnDeck.
He said he learned to sell in the 1990s at Sterling Foster & Co., a Long Island firm where he got his friend a job interview that inspired “Boiler Room,” a movie that portrayed a college dropout’s foray into high-pressure stock sales. Glass said he coached actor Vin Diesel on cold-calling for the film. “A natural,” Glass said.
Glass said it’s a lot easier to persuade someone to take money than to spend it buying stock.

“The guys I worked with then were incredible sales guys,” Glass said. “I don’t really feel like we’re selling now because everyone we’re calling is an inbound phone call or they’ve filled out a form on the Internet.”

Breeding Money

Jonathan Cutler, a spokesman for New York-based OnDeck, said Yellowstone and World Business Lenders have originated less than 1 percent of the company’s loans this year. OnDeck drops brokers who charge upfront fees or send a lot of deals that go bad, he said. OnDeck also doesn’t require collateral.

“OnDeck customers are experienced, savvy people,” said Andrea Gellert, senior vice president of marketing for the company. “Since entering the market, OnDeck has brought down pricing significantly.”

Since Aristotle condemned the “breeding of money” as the worst way to make it around 350 B.C., societies have both enacted laws against usury and devised ways to work around them. New York State instituted a 25 percent interest-rate cap after a 1965 investigation found the Genovese crime family backing a Fifth Avenue business lender that charged 5 percent a week.
Usury Laws

Some loan companies avoid state usury laws by partnering with banks based in Utah, which doesn't cap rates. Others say "cash advances," repaid by collecting a share of businesses' credit-card sales, aren't loans. World Business Lenders lends in only about half of U.S. states and won't make loans in New York, according to its website. The loan to the Kasems was made in Pennsylvania, where they also do business.

"It's kind of the Wild West right now," said Nick Bourke, who studies small loans for the Pew Charitable Trusts, a research and policy group. "Online lending is raising lots of legal questions about which state law governs."

Naidus, described by colleagues as the best salesman they'd ever met, turned the brokerage he founded after graduating from Syracuse University in 1987 into one of the biggest mortgage originators in the nation. He took MortgageIT Holdings Inc. public and then arranged to sell it to Deutsche Bank in 2007 for $429 million. During the sale process, Naidus made at least $12 million selling his shares and options, and the bank agreed to hire him for $17 million in pay and guaranteed bonuses over two years, according to public filings.

MortgageIT Settlements

Even as MortgageIT's loans went bad during the financial crisis, Naidus earned the trust of top Deutsche Bank executives. He became global head of mortgages and helped start a home-loan joint venture in Saudi Arabia.

Like other banks that bought mortgage originators, Deutsche Bank ended up bearing the cost of allegedly fraudulent loans that helped fuel the housing bubble. The Frankfurt-based lender paid $202 million in 2012 and admitted MortgageIT arranged for government insurance on ineligible loans that soured.

Deutsche Bank also paid $12 million to settle U.S. allegations that the originator imposed higher fees and interest rates on black and Hispanic applicants. It denied those claims. Naidus wasn't a defendant in any of the cases.

Naidus made colleagues at Deutsche Bank aware of his wealth, one former co-worker said. He invited his bosses to play golf at the Bridge, a country club near his summer house in the Hamptons. The club cost $750,000 to join, the Wall Street Journal reported in 2007. He also owned a duplex on the Upper East Side of Manhattan that he bought for $6.2 million in 2005, real estate records show.

Sharia Lending

Naidus founded World Business Lenders in April 2011, according to a regulatory filing. He rented the 29th floor of an office tower on West 45th Street and began reassembling his lieutenants from the mortgage company. Naidus left Deutsche Bank the following year, said Renee Calabro, a spokeswoman for the bank in New York.

The business plan sounded promising, ex-employees said. Naidus said they'd build the largest small-business lender in the country and share the wealth when he took it public. He also created a company called Palm National Partners that would make loans to Muslims structured to avoid the sharia ban on charging interest.

"We are already helping so many entrepreneurs to realize their dreams," Naidus said in an undated video that was posted on World Business Lenders' website. "I can relate to every one of our customers because I am the prototype of our customer."

'Who Cares?'

World Business Lenders put up job listings seeking former brokers, and they came. A February orientation schedule provided by a former employee shows that training is run by Bryan Herman, who got his start under Stratton Oakmont Inc.'s Belfort, the con man portrayed in "The Wolf of Wall Street." Herman later ran his own boiler room in the 1990s and avoided jail by informing on other brokers when he was charged with fraud in 1998, court records show. Another salesman was released from prison in 2010 after serving about a year for penny-stock fraud.

Herman has paid for his crimes, according to his lawyer, Marty Kaplan.

"It's really like saying Bill Clinton smoked dope in college," Kaplan said. "Who cares?"

Cold-callers said they typically got paid a draw of $1,300 a month against commission. Four former employees said Naidus impressed them during job interviews with his success and intensity. He'd meet them in his office, which he decorated with a photo of himself striking a martial-arts pose with a sword, shirtless. One ex-colleague said Naidus liked to discuss his street-fighting skills. He looked like action star Jean-Claude Van Damme, another said.

'Money Factors'

Salespeople said they were told to refer to “short-term capital” instead of loans and “money factors” instead of interest rates. Eight of them said they talked business owners into applying by saying they’d offer a good rate after reviewing bank statements.

World Business Lenders charged most people 125 percent annualized interest rates on six-month loans regardless of their situation, five former employees said. The borrowers often put up cars, houses or even livestock worth at least twice as much as the loan. About one in five were going bust as of last year, two people with knowledge of the matter said. One said that 9 percent of the loans made this year have already defaulted.

“The sweet spot is someone who can limp along well enough for six months but probably isn’t going to be around much longer,” Opportunity Finance Network’s Pinsky said. “They’re in the business of helping these businesses fail.”

Sushi Lunches

Naidus took the top three salespeople at World Business Lenders to lunch each month, often choosing sushi, former colleagues said. The successful ones were given the preferred leads, people who had called in about loans. Those who didn’t close deals survived on $1 pizza slices for a month or two until they were fired.

Former employees said finding qualified borrowers willing to pay their rates proved more difficult than Naidus made it sound. Six said they questioned whether their business was legal. Two others said they wondered why the company seized cars that weren’t worth enough to cover the repo man’s fee.

“You know payday loans?” said Aleena Skinner, who worked for World Business Lenders for a few months in 2012 and is now a saleswoman for a copy-machine company. “I don’t really feel like high-interest loans are in anybody’s best interest.”

World Business Lenders makes $1 million to $3 million a month in loans and was running at a loss as of last year because so many borrowers weren’t paying, one former executive said. Naidus once joked that the business would be better off if it paid salesmen in repossessed Pontiacs, the person said.

Pizza Oven

Naidus's investors include Fahad Abdullah Al Rajhi, the son of one of the billionaire founders of Saudi Arabia's Al Rajhi Bank. Al Rajhi invested in Palm, the sharia-compliant part of the business, and brought in the Muslim scholar who blessed its practices, according to former employees.

Instead of lending, Palm buys an asset, such as a refrigerator or a pizza oven, and then leases it to the business owner. Other than that, the terms were the same. Finding Muslims to take the loans was hard, the ex-employees said. Messages left for Al Rajhi with his family's bank weren't returned.

Palm and World Business Lenders are legally separate entities and operate at arm's length, Horowitz said. Palm complies with all laws and isn't associated with the Al Rajhi family's bank, she said.

Tow Truck

Nick Frederick, 38, a tow-truck driver in Sykesville, Maryland, said the Islamic lender solicited him by e-mail and phone last year when he needed $15,000 to buy a trailer. The six-month "asset sale and lease" cost the equivalent of an annualized 96 percent interest rate, according to Frederick's contract. Frederick said a saleswoman assured him she would lower the rate in a few months and hire him to tow other people's cars.
"They were real friendly at first," he said. "I should have known better because it sounded too good to be true."

Frederick said he struggled to make the daily $166.98 payments when one of his trucks broke down, so he borrowed from his grandmother to pay off the contract early. Palm wouldn't accept his money, he said. Then without warning, he said, the company took his truck, along with a license-plate scanner and a laptop.

"I'm real close to going out of business because they're jerking me around," Frederick said. "Alls I want out of the deal is I want my property out of it, and I want my damn truck back."

To contact the reporter on this story: Zeke Faux in New York at zfaux@bloomberg.net
To contact the editors responsible for this story: Peter Eichenbaum
at peichenbaum@bloomberg.net Robert Friedman, David Scheer