

# PREEMPTION POST-WATTERS

**Robert M. Jaworski**

**ReedSmith**

---

The business of relationships.<sup>SM</sup>

# Overview

- General Principles of Federal Preemption
- *Watters* Re-Cap
- Post-*Watters* Case Law Developments
- What Lessons Can We Learn From These Cases?

# General Principles of Federal Preemption

- Rooted in Supremacy Clause of U.S. Constitution (Article VI)  
This Constitution, and the Laws of the United States which shall be made in pursuance thereof ... shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, anything in the Constitution or Laws of any State to the contrary notwithstanding.
- State laws may be preempted in three ways:
  1. Express Preemption – where federal law expressly states that state laws are preempted
  2. Field Preemption - where federal law regulates the field so pervasively that it is reasonable to conclude that Congress left no room for state regulation
  3. Conflict Preemption - where state law actually conflicts with the federal law

# General Principles of Federal Preemption

- Federal regulations generally have no less preemptive effect than federal statutes
- State laws preempted by federal regulations:
  - licensing and registration
  - terms of credit
  - permissible rates of interest
  - LTV limitations
  - escrow accounts
  - access to credit reports
  - disclosures and advertising
  - origination, processing, servicing, sale or purchase of mortgage loans
- State laws not preempted (provided they do not significantly interfere with the bank's deposit-taking or lending activities):
  - contracts
  - acquisition and transfer of property
  - taxation
  - zoning
  - crimes
  - torts
  - homestead rights

# Watters Re-Cap

## Who Was Involved?

- Wachovia Bank – a national bank
- Wachovia Mortgage Corporation (“WMC”)
  - corporation formed in the State of North Carolina
  - wholly-owned operating subsidiary (“Op Sub”) of Wachovia Bank
  - previously a wholly owned subsidiary of the bank holding company that owns Wachovia Bank and a registrant with the Michigan Office of Insurance & Financial Services (“OIFS”)
- Linda Watters – OIFS Commissioner
- OCC – Office of the Comptroller of the Currency, the regulator of national banks

# Watters Re-Cap

## What Precipitated The Lawsuit?

- Pending OCC regulation would declare that state laws apply to national bank Op Subs “to the same extent that those laws apply to the parent national bank.” 12 C.F.R. 7.4006.
- WMC notified OIFS it was going to surrender its registration.
- OIFS: “If you do, you will no longer be able to make mortgage loans in Michigan.”
- WMC sued Watters for declaratory judgment that MI law preempted as to WMC.

# **Watters Re-Cap**

## How Did The Case Get To The U.S. Supreme Court?

- District Court ruled in favor of WMC
- Sixth Circuit Court of Appeals affirmed
- MI asked the U.S. Supreme Court to review the Sixth Circuit's decision
- Surprise/Shock: U.S. Supreme Court grants MI's request (4 Justices needed to say "yes" before cert. could be granted)

# ***Watters* Re-Cap**

## What Issues Were Presented?

- Whether the OCC's Preemption Rule was entitled to *Chevron* deference\*
  - Whether the OCC Rule violated the Tenth Amendment
- \* Court instead analyzed whether the National Bank Act (“NBA”) itself preempted enforcement of the MI law against national bank Op-Subs.

# Watters Re-Cap

## What Did The Court Decide?

- VERY CLOSE (5-3)!
  - Majority: Ginsberg, Kennedy, Souter, Breyer, Alito
  - Dissent: Stevens, CJ Roberts, Scalia
  - Did Not Participate: Thomas
- NBA did preempt enforcement of the MI law against WMC
- OCC's preemption rule did not violate 10th Amendment

# Watters Re-Cap

## What Was Court's Rationale?

- NBA § 371 – authorizes national banks to engage in mortgage lending
- NBA § 484(a) – says that no national bank shall be subject to any “visitorial powers” except as authorized by federal law (which grants such powers exclusively to the OCC)
- NBA § 24 (Seventh) – gives national banks power to exercise all such incidental powers as needed to carry on the business of banking

# Watters Re-Cap

## What Was Court's Rationale? (Cont'd.)

- 1966 OCC regulation - “incidental powers” includes power to do business through Op-Sub
- 1999 GLBA:
  - National banks can create “financial subsidiaries” (“FSs”) to engage in activities not permitted to bank itself/subject to heightened scrutiny
  - FSs do NOT include Op Subs that engage solely in activities permitted to national banks and conduct activities subject to “same terms and conditions” that govern the bank
- Preemptive authority of national banks is a “term or condition”

# Watters Re-Cap

## Why Did Dissenters Disagree?

- Nothing in NBA says that national bank Op-Subs – creatures of state law – need not comply with non-discriminatory state laws so long as those laws do not forbid or significantly impair a national bank's activities
- § 484 only speaks of the national bank, not affiliates – even though Congress had ample opportunity to expand

# Watters Re-Cap

## What Does Decision Say That Can Be Used To Support Future Attempts to Expand Preemption?

- “We have never held that the preemptive reach of the NBA extends only to a national bank itself. Rather, in analyzing whether state law hampers the federally permitted activities of a national bank, we have focused on the exercise of a national bank’s *powers*, not on its corporate structure.” (Italics in original)
- But both majority and dissent focused most of their time discussing the history of national bank Op-Sub regulation and how Congress treated Op-Subs in NBA and GLBA

# Watters Re-Cap

## Does Decision Say Anything That Can Be Used To Limit Preemption?

- Dissenting Opinion calls into question the OCC's ability to preempt state law by regulation:

“When an agency purports to decide the scope of federal preemption, a healthy respect for state sovereignty calls for something less than *Chevron* deference.”

# Post-*Watters* Case Law Developments

- Push by states to enforce laws against 3rd parties doing business of national banks/federal thrifts as agent
- Push by states and private litigants to enforce state unfair and deceptive trade practice (“UDAP”) laws against national banks/federal thrifts
- Push by states to enforce state anti-discrimination laws against national banks/federal thrifts

# Post-*Watters* Case Law Developments

## 3rd-Party Agents

***SPGGC, LLC v. Ayotte***, 88 F. 3d 52 (1st Cir. May 30, 2007)

- NH law - illegal to sell gift cards that expire or impose administrative fees
- Held unenforceable against mall owner hired by national bank to market its gift cards in NH
- Otherwise, would significantly impair the bank's exercise of powers given by NBA:
  - power to issue gift cards with expiration dates and/or administrative fees
  - power to use 3rd-party agents to market gift cards in NH

# Post-*Watters* Case Law Developments

## 3rd-Party Agents

***SPGGC, LLC v. Blumenthal***, 505 F. 3d 183 (2nd Cir. Oct. 19, 2007)

- CT gift card law similar to NH law held enforceable against 3rd-party agent of national bank
- Key Difference: In NH, bank charged/collected fees and paid mall owner commissions for selling cards; in CT, mall owner charged/collected fees (bank earned VISA interchange fees)
- Mall owner: “We’re just like Op Sub under *Watters*.”  
Court: “You’re not Op Sub/*Watters* only deals with Op-Subs”
- Prohibition against expiration dates remanded - could directly infringe bank’s access to VISA payment network if allegation proven that VISA requires to prevent fraud

# Post-*Watters* Case Law Developments

## 3rd-Party Agents

***State Farm Bank, F.S.B. v. Reardon***, 2007 WL 2822793 (S.D. Ohio, Sept. 28, 2007)

- Exclusive agents of SF Insurance solicited for SF Bank/OH claimed Agents must be licensed as mortgage brokers/Court agreed
- No deference given to conflicting OTS Opinion: OTS rules extended preemption only to Op-Subs/further extension requires rulemaking
- *Watters* inapplicable/Court rejects “functional equivalent” argument, does not mention “powers” language

# Post-*Watters* Case Law Developments

## 3rd-Party Agents

### *State Farm Bank, F.S.B. v. Reardon* (Continued)

- But see *State Farm Bank, FSB v. Burke*, 445 F. Supp. 2d 207 (D. Ct. 2006)
  - OTS Opinion entitled to *Chevron* deference
  - Field Preemption important factor
  - SF Agents viewed as functional equivalent of Op Sub provided bank exercises sufficient control over them

# Post-*Watters* Case Law Developments

## 3rd-Party Agents

***Pacific Capital Bank v. Milgram***, No. 08-0223  
(FLW) (D.N.J. March 12, 2008)

- NJ criminal law - illegal if 3rd-party tax preparers offer, facilitate or make refund anticipation loans (“RALs”) with APRs above 30%
- Held preempted/would significantly interfere with the bank’s powers under the NBA to make RALs and to charge interest at home state (CA) rates
- Court accepts that services of experienced tax preparers “indispensable” for good faith and error free preparation of RALs

# Post-*Watters* Case Law Developments

## State UDAP Laws

***Rose v. Chase Bank USA, N.A.***, 513 F. 3d 1032  
(9th Cir., January 23, 2008)

- CA Unfair Competition Law (UCL) prohibits “unlawful,” “unfair” and “fraudulent” business practices and “deceptive or misleading advertising.” CA Convenience Check Law (CCL) prescribes “convenience check” disclosures.
- Plaintiff claims disclosures not given/violates UCL (law of general applicability).
- Claim dismissed as preempted/9th Circuit affirms
  - “[P]roper inquiry is whether the ‘legal duty that is the predicate of’ Plaintiffs’ state law claim falls within the preemptive power of the NBA or [the OCC’s] regulations.”
  - “Legal Duty” is in CCL, which is clearly preempted as to national bank.

# Post-*Watters* Case Law Developments

## State UDAP Laws

*Jefferson v. Chase Home Finance*, 2007 WL 4774410 (N.D. Cal., Dec. 14, 2007).

- Classic customer service snafu: Borrower remits additional mortgage payments that are not credited to principal, tries repeatedly to resolve, with only partial success, gets fed up and sues.
- Borrower asserts violation of CA Consumer Legal Remedies Act (CLRA) (misrepresenting/systematically breaching promises about crediting prepayments), and CA False Advertising Act (disseminating false or misleading statements about its services).
- Claims held not preempted.
  - “Duty to refrain from misrepresentation falls on all businesses. It does not target or regulate banking or lending, and it only incidentally affects the exercise of banks’ real estate lending powers.”
  - Inconsistent with goal of uniformity/what court finds “unfair” or “misleading” likely to differ from state to state.

# Post-*Watters* Case Law Developments

## State UDAP Laws

***Silvas v. E\*Trade Mortgage Corp.***, 2008 WL 239422 (9<sup>th</sup> Cir. Jan. 30, 2008).

- Borrower rescinded mortgage loan and lender (FSB Op-Sub) refused to refund lock-in fee.
- Too late to file claim under TILA, borrower claimed unlawful, unfair and deceptive conduct by bank in violation of UCL.
- Court affirmed dismissal
  - “[F]ield of lending regulation of federal savings associations is preempted .... Appellants were too late to sue under TILA. Their end run will not do.”
- In essence, borrower attempted to convert expired TILA claim into state law claim. Didn't work.

# Post-*Watters* Case Law Developments

## State UDAP Laws

*Montgomery v. Bank of America Corp.*, 515 F. Supp. 2d 1106 (C.D. Cal. Sept. 24, 2007)

- Claim that bank's failure to provide NSF/OD fee schedule at account opening was fraudulent, unfair and unlawful business practice under UCL and violation of CLRA.
- Dismissed as preempted
- In conflict with bank's powers under OCC regulation
  - to charge "non-interest charges and fees, including deposit account service charges" and
  - to exercise deposit-taking powers" without regard to state law limitations concerning ... [d]isclosure requirements."

# Post-*Watters* Case Law Developments

## Anti-Discrimination Laws

### Background

- OCC Interpretive Letter #998 (August 2004)
  - State anti-discrimination laws not preempted by OCC regulation, but subject to case-by-case analysis under “obstruct, impair, or condition” analysis.
- OTS Interpretive Letter (March 7, 2006) (Lending-Related Provisions in Code of Montgomery County, Maryland)
  - Provisions that prohibit specific lending practices preempted.
  - Other provisions may or may not be preempted but only OTS may enforce.

# Post-*Watters* Case Law Developments

## Anti-Discrimination Laws

***Clearing House Association, LLC v. Cuomo***, 510 F. 3d 105  
(2nd Cir., Dec. 4, 2007)

- NYAG finds HMDA data “troubling”, “requests” national banks and/or Op-Subs to produce mortgage lending data
- Banks and Clearing House Association (“CHA”), a consortium of national banks, get injunction based on preemption/affirmed on appeal (after *Watters*).
- Effort to obtain records was attempt to exercise “visitorial power” over national banks which, under applicable OCC regulation (afforded *Chevron* deference by court), could only be exercised by OCC.

# What Lessons Can We Learn From These Cases?

- If state law (even criminal) preempted as to national bank/federal thrift ⇒ preempted as to Op-Sub
- If state law as applied to 3rd party agent of national bank/federal thrift *prevents or significantly interferes with* bank/thrift's exercise of power granted by NBA/HOLA ⇒ probably preempted as to the third-party agent
- If state law as applied to 3rd-party agent of national bank/federal thrift only *incidentally interferes with* bank/thrift's exercise of its powers ⇒ may not be preempted

# What Lessons Can We Learn From These Cases?

- If state law UDAP claim based on violation of preempted “predicate” state law ⇒ UDAP claim also preempted.
- If state law UDAP claim based on actions that conflict with existing agreements entered into by national bank/federal thrift ⇒ UDAP claim may not be preempted
- If state law UDAP claim based on misrepresentations in advertisements/solicitations ⇒ UDAP claim probably preempted (unless perhaps if representations are inconsistent with terms of actual product or service offered)

# What Lessons Can We Learn From These Cases?

- If State anti-discrimination laws do not significantly interfere with a national bank/federal thrift's powers  
⇒ probably not preempted

But may only be enforced by OCC/OTS

# QUESTIONS

**Robert M. Jaworski, Esq.**

Reed Smith, LLP

136 Main Street, Suite 250

Princeton Forrestal Village

Princeton, NJ 08543-7839

609.520.6003/rjaworski@reedsmith.com

**ReedSmith**

The business of relationships.™