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Robert M. Jaworski on *Watters v. Wachovia Bank*

N.A., 127 S. Ct. 1559, 167 L. Ed. 2d 389 (2007)

This past April, the U.S. Supreme Court, in [*Watters v. Wachovia Bank, N.A.*, 127 S. Ct. 1559, 167 L. Ed. 2d 389 \(2007\)](#), rejected an attempt by the State of Michigan to enforce its mortgage lender registration requirements against an operating subsidiary of a national bank. This decision brought an end to the controversy over whether a state-chartered corporation formed by a national bank for the purpose of engaging in activities that the bank could have engaged in directly should be subject to state laws as are other state-chartered corporations.

The Facts. Wachovia Bank (“Bank”) is a national bank. Wachovia Mortgage Corp. (“WMC”) is a corporation organized in the State of North Carolina. WMC engages in the mortgage loan origination business in the State of Michigan from offices located outside Michigan. Before 2003, WMC was owned by the holding company that also owned the Bank. It was an affiliate, but not a subsidiary, of the Bank. As such, it was required to, and did, register with the Michigan Office of Insurance and Financial Services (“OIFS”) and submit to OIFS supervision (which entails paying the OIFS an annual operating fee, filing with the OIFS an annual report and opening its books and records to the OIFS for inspection).

In 2003, WMC, by means of a corporate reorganization, became a wholly-owned “operating subsidiary” of the Bank. It did so presumably to take advantage of a regulation adopted by the Office of the Comptroller of the Currency (“OCC”) in 2001 ([12 C.F.R. 7.4006](#)) which declared that “State laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank.” WMC thereupon notified the OIFS that it was surrendering its registration, to which the OIFS responded essentially by telling WMC that, if it did so, it could no longer make mortgage loans in Michigan. The Bank sued the OIFS Commissioner, Linda Watters, seeking a declaratory judgment that the Michigan law at issue was preempted as to WMC. The District Court granted summary judgment in favor of the Bank and the Sixth Circuit Court of Appeals affirmed (following similar decisions rendered by three other Circuit Courts). [*Wells Fargo Bank N.A. v. Boutris*, 419 F.3d 949 \(9th Cir. 2005\)](#); [*Wachovia Bank, N.A. v. Burke*, 414 F.3d 305 \(2d Cir. 2005\)](#); [*National City Bank v. Turnbaugh*, 463 F.3d 325 \(4th Cir. 2006\)](#).

LexisNexis® Expert Commentaries

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To the surprise—even shock—of virtually everyone, the U.S. Supreme Court granted certification, leading to industry (and OCC) fears that the Court might end a long string of preemption victories won by the OCC. These fears, however, did not materialize since the Court affirmed the Sixth Circuit’s decision. But it was very close. Three Justices, Roberts, Scalia and Stevens, dissented; Justice Thomas, who might well have joined the dissenters, recused himself; and one unknown Justice who joined in the vote to grant certification ended up siding with the majority.

How Did the Majority Reach Its Decision? The precise question presented to the Supreme Court for determination was whether the OCC’s preemptive regulation, [12 C.F.R. 7.4006](#), was entitled to [Chevron](#) deference. (There was an additional question presented as to whether the OCC’s regulation violated the 10th Amendment, which the Court, almost summarily, answered in the negative.) However, the Court did not answer this question, choosing instead to analyze whether the National Bank Act, [12 U.S.C. §§ 1 et seq.](#) (the “NBA”), itself preempted enforcement of state laws, like the Michigan law at issue, against national bank operating subsidiaries. After reciting that grants of powers to national banks have ordinarily been interpreted by the Court as “not normally limited by, but rather ordinarily pre-empting, contrary state law,” the Court then answered this question in the affirmative, finding sufficient preemptive authority in sections 24 (Seventh), 371 and 484(a) of the NBA.

[Section 371](#) authorizes national banks to engage in mortgage lending subject to OCC regulation; [section 484\(a\)](#) of the NBA says that “[n]o national bank shall be subject to any visitatorial powers except as authorized by federal law”; and [section 24 \(Seventh\)](#) gives national banks the power “to exercise...all such incidental powers as shall be necessary to carry on the business of banking.” The Court noted that the OCC recognized as early as 1966 that the incidental powers granted to national banks by § 24 (Seventh) included the authority of national banks to do business through operating subsidiaries, and that this was confirmed by Congress in 1999 when it enacted the Gramm-Leach-Bliley Act (“GLBA”).

The GLBA defined and regulated national bank “financial subsidiaries” (which are empowered to engage in a wider range of activities than their parent banks) and distinguished them from national bank “operating subsidiaries” (which the GLBA indicated may engage “solely in activities that national banks are permitted to engage in directly and are conducted subject to the same terms and conditions that govern the conduct of such activity by national banks”). The Court interpreted the phrase “subject to the same terms and conditions that govern the conduct of such activity by national banks” as ex-

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pressing a Congressional intent that “state laws [will only] apply to operating subsidiaries to the same extent as they apply to the parent national bank.”

Michigan had conceded that the NBA preempted enforcement of its law against the Bank itself. However, it argued that Congress’ grant in § 484(a) to the OCC of exclusive visitatorial powers over national banks *but not their affiliates* (which include by definition bank operating subsidiaries) signaled its intent not to extend preemption to such affiliates.

Responding to this argument, the Court observed that § 484(a) was enacted well before operating subsidiaries came into existence. In addition, the Court stated:

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.

This is a key sentence in the Court’s decision, and one that is likely to be cited, and in fact has already been cited, by national banks looking to extend their preemptive authority beyond current boundaries.

How Did the Dissent Differ In Its Analysis? The dissenting Justices took a dramatically different view of the issue than the majority. Their dissent first noted that nothing in the NBA says that national bank operating subsidiaries need not comply with non-discriminatory state laws regulating the activities of mortgage lenders and brokers so long as those laws do not forbid or significantly impair a national bank’s activities and that ordinarily such state laws are presumed not to be preempted. They also observed that the Court’s decision gives national banks a competitive advantage over state banks and thus runs counter to the policy of competitive equality that is “firmly embedded in the statutes governing the national banking system.”

With respect to the majority’s reliance on the GLBA, the dissent maintained that the GLBA did not grant any powers to operating subsidiaries. Rather, it overruled a 1996 OCC regulation permitting operating subsidiaries to undertake activities that the parent bank was not allowed to engage in directly. Nowhere did it say anything about preemption with respect to operating subsidiaries. In addition, the dissent contended that the “[s]ame terms and conditions” language in the GLBA from which the majority inferred a preemptive intent at most reflected an acknowledgment by Congress that operating subsidiaries are subject to the same federal oversight as the bank itself. “It has nothing

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Robert M. Jaworski on *Watters v. Wachovia Bank*

to do with preemption.” The dissent was of the view that non-encroachment of state regulation is not a “term or condition” of engagement in the business of banking.

The dissent also found no merit in the majority’s contention that the applicability of § 494(a) on its face only to banks did not signify an intent to exclude operating subsidiaries since it was enacted before operating subsidiaries came into existence. They pointed out that Congress, after inserting § 494(a) into the NBA, enacted numerous amendments to the NBA curtailing and expanding the ability of national banks to affiliate with other companies yet chose to leave the language in § 494(a) unchanged.

Finally, the dissenters expressed their view that the Michigan law at issue in the case did not, in any event, significantly impair the bank’s ability to carry out its banking functions through operating subsidiaries. As proof, they pointed to the fact that WMC had for several years (while a subsidiary of the holding company) complied with the Michigan law without any significant problems.

For the dissenters, the real question for determination was whether Congress delegated to the OCC the authority to preempt the nondiscriminatory laws of a state as they apply to operating subsidiaries of a national bank and whether that authority was properly exercised in this instance. Their answer to both questions was no. In this regard, the following statement in the dissent may prove significant in future cases in which agency regulations are being relied upon to preempt state laws: “When an agency purports to decide the scope of federal preemption, a healthy respect for state sovereignty calls for something less than *Chevron* deference.”

So What Does This Mean Going Forward? One might surmise that the Court’s decision would embolden the OCC to become even more aggressive on preemption. But it seems, at least for now, to have had the opposite result. Rather than becoming more aggressive on preemption, the OCC appears to be taking a more conciliatory stance, concentrating on working in a cooperative mode with state regulators, becoming more responsive to consumer complaints, etc. The OCC seems to realize that if it does not responsibly regulate its institutions, Congress could cut back on the preemptive authority granted to national banks by the NBA. However, it is also possible that the OCC is simply waiting for the dust to settle and/or for the right opportunity to arise before attempting to expand the boundaries of preemption even further.

One possible area of opportunity, which is already being addressed in the courts (with conflicting results), concerns whether state laws should apply to independent third par-

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ties when acting as agents for a national bank, when those same state laws would be preempted as to the bank itself. The argument in favor of preemption derives from the Court's statement in *Watters* that "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 in its corporate structure." On the other hand, the *Watters* decision did not say anything about independent third-parties acting as agents of a national bank and relied heavily upon Congress' recognition in the GLBA of the status of a national bank operating subsidiary as essentially equivalent to a department or division of the bank.

Another possible ramification of the *Watters* decision is that the dissent's belief in the inappropriateness of giving *Chevron* deference to agency preemption determinations may live to see another day, leading to closer scrutiny of such determinations and more problems for institutions wishing to do business on a uniform national basis.

In sum, it seems too early to tell whether the decision in *Watters* represents final victory for the proponents of preemption or just another successful battle in the continuing preemption struggle.

About the Author. Robert M. Jaworski is a partner in the Financial Services Regulatory Group of Reed Smith, LLP in Princeton, New Jersey and a former Deputy Commissioner of the New Jersey Department of Banking. He is also Co-Chair of the RESPA and Housing Finance Subcommittee of the American Bar Association's Consumer Financial Services Committee; the former Editor of Pratt's Mortgage Compliance letter, a national publication on mortgage compliance issues; and the Secretary of the Board of Directors of the New Jersey Bar Association's Banking Law Section. Mr. Jaworski provides federal and state compliance and regulatory advice to banks, mortgage lenders and other consumer financial services providers, and regularly assists Reed Smith litigators in defending financial institutions in individual and class actions. He has written on real estate topics for several LexisNexis publications, including Real Estate Financing (LexisNexis Matthew Bender), which features his Special Alert on *State Governmental Responses to Problems in the Subprime Mortgage Loan Origination Business*.