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Federal Preemption of State Regulation of Banks—Current Developments

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Consumer Finance
MONTHLY BREAKFAST BRIEFING

Today's Discussion

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Today's Discussion

- Recent decisions regarding Federal Preemption of various state regulations
  - *Lusnak v. Bank of America*
  - Deference owed to OCC Regulations
- "True Lender" challenges in marketplace lender and other bank partnership arrangements
- "Valid when made" and the impact of *Madden*

“Pillars” of Preemption for Banks

- Visitorial Powers Preemption: State regulators may not exercise supervisory authority over federally-chartered banks and have limited authority to enforce their compliance with state law.
  - Federally-chartered banks (national banks and FSBs) only—no visitorial powers preemption for state banks.
  - Derived primarily from 12 U.S.C. §484 (national banks) and 12 U.S.C. §1465(c) (FSBs)
- Interest Rate Exportation: Authority of banks to charge “interest” at the rate allowed by the laws of the state where they are located.
  - All federally-chartered or federally-insured depository institutions have this authority.
- *Barnett*: Preemption of state laws that “prevent or significantly interfere with” a national bank’s or FSB’s exercise of its powers.
- Insurance Preemption: Special rules enacted by GLBA governing bank activities related to the “business of insurance.”
  - Generally doesn’t apply to state laws that purport to regulate a bank’s determination to require insurance as a loan condition—but would apply if the bank then markets certain insurance products.

Basic Preemption Framework

- Express Preemption Regarding Interest Rates
  - National Bank Act § 85
    - Permits national banks to "charge on any loan . . . Interest at the rate allowed by the laws of the State, Territory, or District where the bank is located . . ."
  - FDIA § 27(a)
    - Provides that any federally insured state-chartered bank "may, notwithstanding any State constitution or statute, which is hereby preempted for the purposes of this section, . . . charge on any loan interest . . . At the rate allowed by the laws of the State, territory or district where the bank is located. . .

Basic Preemption Framework

- Implied, or Conflict Preemption Under *Barnett Bank*
  - *Barnett Bank*, 517 U.S. 25
    - Absent express preemption, implied preemption may be found where:
    - (i) the federal statute creates a scheme of federal regulation "so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it."
    - (ii) federal law may be in "irreconcilable conflict" with state law, where compliance with both laws is a "physical impossibility," or where state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."
  - *Watters v. Wachovia Bank,* 550 U.S. 1 (extends to subsidiaries of National Banks; reversed by Dodd-Frank).

Basic Preemption Framework

- Dodd-Frank Section 1044 (12 USC § 25b)
  - State consumer financial laws are preempted only if
    - Application of a State consumer financial law would have a discriminatory effect on national banks (compared to state chartered banks)
    - In accordance with *Barnett* the state consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers; and any preemption determination under this subparagraph may be made by a Court or the OCC on a case-by-case basis
  - Standard of review for OCC preemption determination based on *Skidmore* standard (thoroughness, validity, and consistency).
  - OCC preemption determinations may only be made on a case-by-case basis and shall be based on substantial record evidence
  - Subsidiaries and affiliates: State consumer financial law applies to subsidiary, affiliates or agents to same extent as other persons

Barnett and the OCC Rules: Pre-*Barnett* Timeline

1819: *McCullough v. Maryland*

- Holds that a federally-chartered bank is immune from state taxation.
- “The power to tax is the power to destroy”—therefore, states are deprived of the power altogether.
- Decides this without inquiry into Congressional intent or whether the discrete tax at issue actually was likely to significantly interfere with (much less destroy) the bank.

1864: Congress enacts the National Bank Act.

- No provision expressly preempts state laws.
- The only provision that addresses state laws at all is Section 30 (today codified at 12 U.S.C. §85), which requires a national bank to follow the laws of the state where it is located.

1864-1996: Supreme Court (and lower courts) issue a broad range of opinions holding that various types of state laws do not (or do) apply to national banks.

Barnett and the OCC Rules (cont.)

1996: Supreme Court decides *Barnett Bank of Marion County v. Nelson*. In Barnett, the Court attempts to synthesize its NBA preemption jurisprudence.

- “Legislative grants of both enumerated and incidental "powers" to national banks historically have been interpreted as grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law.”
- “In defining the pre-emptive scope of statutes and regulations granting a power to national banks, these cases take the view that normally Congress would not want States to forbid, or to impair significantly, the exercise of a power that Congress explicitly granted.”
- States may regulate national banks only if “doing so does not prevent or significantly interfere with the national bank's exercise of its powers.”

2004: OCC issues rules that purport to interpret and apply the Supreme Court’s NBA preemption jurisprudence.

- The rules say that a state law is preempted if the state law “obstructs, impairs, or conditions” a national bank’s exercise of its powers.
- The rules also lists specific types of state laws preempted under this standard.
  - The list of preempted state laws was almost word-for-word identical to a similar list under OTS rules that purported to “occupy the field” of federal thrift lending regulation and then listed types of state laws that were preempted as a result.

Barnett and the OCC Rules (cont.)

2010: Congress passes the Dodd-Frank Act,

- Adds 12 U.S.C. § 25b to the NBA.
- Among other things, this new section (1) codifies the *Barnett* standard; (2) prohibits the OCC from issuing preemption determinations on anything other than a *case-by-case basis* (no rules declaring entire categories of state laws to be preempted); and (3) instructs courts to review OCC preemption determinations using mere *Skidmore* deference.

July 20, 2011: OCC reissues its 2004 preemption rules.

- It revises the "obstructs, impairs, or conditions," standard to track the Barnett standard as set forth in the statute.
- It reissues the list of preempted state laws without making any changes.

July 21, 2011: Dodd-Frank Act provisions that, inter alia, prohibit the OCC from issuing rules that preempt entire categories of state laws goes into effect.

Barnett and the OCC Rules (cont.)

2011-2018: Courts, through various methods, sidestep the question of whether OCC preemption rules are valid.

- In no decision involving facts that occurred after 12 U.S.C. § 25b took effect does the court base its determination solely based on deference to the OCC preemption rules.
- When concluding that the state law is preempted, courts typically performed a de novo Barnett analysis, and then more or less said "The OCC rules concur with our assessment."
- When a court held that a state law was not preempted under Barnett, the court generally would avoid addressing the validity of the rule by construing it narrowly.

2018: Ninth Circuit decides *Lusnak v. Bank of America*

- Declares that the OCC rules are entitled to "little, if any, deference."
- Technically dicta because the court ultimately based its decision on a narrow interpretation of the regulation– but expect district courts in the Ninth Circuit to regard it as binding.

Recent Decisions on State Law Preemption

- Debt Cancellation Cases
  - *Gordon v. Kohls Dept. Store*, 172 F. Supp. 3d 840 (E.D Pa. 2016)
    - Claim for breach of good faith and fair dealing and unjust enrichment related to debt cancellation program (and related fees) preempted against Capital One, but not against Kohls (which serviced the accounts) due to Dodd-Frank elimination of preemption for agents.
    - 12 C.F.R. § 37: National banks debt cancellation contracts are governed by this part, and not by State law. (Provides comprehensive regulatory framework).
  - Edwards v. Macys, 2016 U.S. Dist. LEXIS 31097 (S.D.N.Y. 2016)
    - Express preemption under Section 37; field preemption due to comprehensive regulatory scheme governing enrollment, eligibility, and fees.
    - Finds claims against Macys preempted too because plaintiff alleged that Macys was acting on behalf of Bank.

Recent Decisions on State Law Preemption

- Disclosures required in Collecting Debt or Modifying Loans
  - *Aguayo v. US Bank,* 653 F.3d 912 (9th Cir. 2011); 185 F. Supp. 3d 820 (S.D. Cal. 2016)
    - California Rees-Levering statute requiring certain notices in repossession process not preempted by 12 C.F.R. 7.4008 (permitting national banks to make non-mortgage loans without regard to state disclosure or advertising laws) because Rees-Levering deemed a debt collection law, not disclosure law.
    - On remand, fact that law would require bank to reinstate loan or give up deficiency payment does not significantly interfere with lending power.
  - *Jacobik v. Wells Fargo,* 2017 U.S. Dist. LEXIS 194529 (N.D. Cal. 2017)
    - Refusing to dismiss claim based on California HBOR based on preemption because NPV disclosure rules more like rules of general application
  - *Arriola v. Flagstar Bank,* 2016 U.S. Dist. LEXIS 49245 (C.D. Cal. 2016)
    - HBOR claim preempted by HOLA and OTS regulations related to servicing

Recent Decisions on State Law Preemption

- Late Fees and Overdraft Fees
  - *Powell v. Huntington Nat'l Bank,* 226 F. Supp. 3d 625 (S.D. WV 2016)
    - State law claim related to application of late fees not preempted by NBA § 85, even though *Smiley* deems late fees to be interest; Court finds that only claims related to the rate applied to the late fee is preempted.
    - But, state laws that would interfere with how the bank posts payments are preempted by the NBA (§ 24 (Seventh)) and OCC regulations 12 C.F.R. § 34.4.
  - *Walker v. People's United Bank,* 305 F. Supp. 3d 365 (D. Conn. 2018)
    - Denying motion to dismiss Connecticut CUTPA claims, finding they are not preempted under NBA where overdraft fees were charged based on a change of posting process compared to what was described to customers.

Recent Decisions on State Law Preemption

- *Lusnak v. Bank of America,* 883 F.3d 1185 (9th Cir. 2018)
  - Holds that Cal. Civ. Code § 2954.8 (requiring payment of interest on escrow accounts of at least 2% per annum) is not preempted by the NBA or 12 CFR § 34.4.
  - Finds that OCC regulations are only given *Skidmore* deference even before the Dodd-Frank Act was adopted; concludes that the OCC regulation (§34.4) is entitled to little if any deference.
  - No conflict preemption in light of Section 1639d(g)(3) of Dodd-Frank, which provides that "If prescribed by applicable State or Federal law, each creditor shall pay interest to the consumer on the amount that is held in any . . . Escrow account."
  - Holds that this reflects Congressional view that application of state laws does not interfere with National Bank's operations

Madden v. “True Lender” Issues

- True lender challenges argue that the bank isn’t the lender—so no preemption at all, end stop.
- Madden said that preemption for a bank-originated loan might not travel with the loan—i.e., assignees might be subject to state laws that were preempted for the bank originator.
- Often cases involve both a true lender challenge and a Madden challenge.
  - In most arrangements potentially vulnerable to a true lender challenge, the bank’s partner acquires the loan after origination and services it—in fact, these factors are probably essential conditions to a plausible true lender challenge.

True Lender Issues: Cases Finding Preemption

- *Krispin v. May Dep't Stores Co.*, 218 F.3d 919 (8th Cir. 2000)
  - "It makes sense to look to the originating entity (the bank), and not the ongoing assignee (the store), in determining whether the NBA applies."
- *Discover Bank v. Vaden*, 489 F.3d 594 (4th Cir. 2007), *rev'd on other grounds*, 556 U.S. 49 (2009)
  - Given facts showing that the bank is the "real party in interest, … the FDIA is implicated"
- *Sawyer v. Bill Me Later, Inc.*, 23 F. Supp. 3d 1359 (D. Utah 2014)
  - Bank true lender on facts, but "court would still be required to dismiss … claims as preempted by Section 27" even if it were not the true lender
- *Hudson v. Ace Cash Express, Inc.*, 2002 WL 1205060 (S.D. Ind. 2002)
  - The "lending arrangement is lawful under § 85 even if the purpose of the arrangement was to avoid application of state usury laws."

True Lender Issues: Cases Finding No Preemption

- *Meade v. Marlette Funding*, No. 17 CV 30376 (Colo. Dist. Ct. Aug. 13, 2018)
  - "While banks can certainly sell loans, they cannot sell interest exportation rights that are intended to circumvent state usury laws."
- *Eul v. Transworld Sys.*, 2017 WL 1178537 (N.D. Ill. 2017)
  - "assignees are *not* entitled to NBA preemption simply by virtue of the loan originating with a national bank"
  - "NBA preemption does not apply here" because "Plaintiffs have alleged that [the bank] was not in fact the true originator of their student loans"
- *CashCall, Inc. v. Morrisey*, 2014 WL 2404300 (W. Va. Sup. Ct. 2014)
  - "the 'predominant economic interest' test [is] the proper standard to determine the true lender"

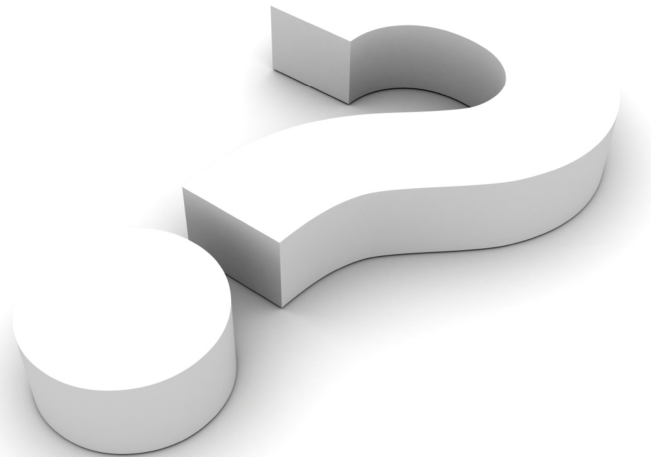
True Lender Issues: Factors Considered

- Extent to which bank retains on-going interest in loan
- Extent to which bank vs. non-bank controls origination process
- Extent to which bank vs. non-bank bears the costs of origination
- Extent to which non-bank raises the capital used to fund the loans
- Extent to which non-bank indemnifies bank
- Extent to which non-bank guarantees purchase of loans
- How long bank holds onto loans
- Whether bank services loans before loans are sold to non-bank

Loans Sold To Unaffiliated Non-Bank Entities

- *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015)
  - Usury claims not preempted by Section 85 "[b]ecause neither defendant is a national bank nor a subsidiary or agent of a national bank, or is otherwise acting on behalf of a national bank, and because application of the state law on which Madden's claims rely would not significantly interfere with any national bank's ability to exercise its powers under the NBA."
  - Allowing usury claims against non-bank assignees would "limit only activities of the third party which are otherwise subject to state control"

QUESTIONS?



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