

March 13, 2007

**Update II on Watters v. Wachovia**

**Peter Heyward  
Venable LLP<sup>1</sup>  
Washington, D.C.**

As most Banking Law Committee members are aware, Watters v. Wachovia pits Michigan's Commissioner of Insurance and Financial Services against Wachovia Bank and its mortgage lending subsidiary regarding the extent, if any, to which a State may regulate a national bank's operating subsidiary doing business within its borders. Michigan sought to apply laws requiring Wachovia's mortgage lending subsidiary, Wachovia Mortgage, to register as a mortgage lender and pay annual registration fees as a condition of doing business in the State; submit annual financial statements; and retain certain records for examination by the Commissioner. The Michigan laws would also permit the Commissioner to investigate a complaint against Wachovia Mortgage if it were not being pursued adequately by the Comptroller of the Currency.<sup>2</sup>

The District Court granted summary judgment to Wachovia when it challenged the application of these laws to Wachovia Mortgage,<sup>3</sup> holding that the State laws in question were preempted by regulations of the Comptroller of the Currency implementing the "incidental" powers of national banks under Section 24(7) of the National Bank Act and the Comptroller's exclusive visitorial authority with respect to

---

<sup>1</sup> The author is a partner in the Financial Services Group of Venable LLP, based in Washington, D.C. The opinions expressed in this article do not necessarily reflect the views of other partners or employees of Venable LLP, or of any of its clients.

<sup>2</sup> See MICH. COMP. LAWS § 445.1651 *et seq.*, MICH. COMP. LAWS § 493.51 *et seq.*

<sup>3</sup> Wachovia v. Watters, 334 F.Supp. 2d 957 (W.D. MI 2004).

national banks under 12 U.S.C. § 484(a).<sup>4</sup> The U.S. Court of Appeals for the Sixth Circuit affirmed.<sup>5</sup>

The case has attracted keen interest in the banking industry, while causing concern in some quarters, as a result of the Supreme Court's grant of *certiorari* in June 2006. In view of the unanimity of lower federal courts in finding State laws to be preempted in similar cases, the Court's action inevitably suggested that at least four Justices were inclined to reverse, creating a nightmare scenario in which national banks' operating subsidiaries might have to observe consumer protection laws and other legal requirements in every State in which they operate.

Developments in the last few months have not been reassuring for the partisans of preemption. In particular, the Justices' questions in the oral argument on November 29, and the fact that the Court has not issued a ruling since then,<sup>6</sup> can be interpreted as reinforcing the inference that a majority of the Court will hold that the OCC's exclusive visitorial authority over national banks, and the resulting broad preemption with respect to State regulations deemed visitorial in nature, does not extend to national banks'

---

<sup>4</sup> Section 484(a) provides:

No national bank shall be subject to any visitorial powers except as authorized by Federal law, vested in the courts of justice or such as shall be, or have been exercised or directed by Congress or by either House thereof or by any committee of Congress or of either House duly authorized.

An OCC regulation provides:

Unless otherwise provided by Federal law or OCC regulation, State laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank.

12 C.F.R. § 7.4006.

<sup>5</sup> Wachovia v. Watters, 431 F.3d 556 (6<sup>th</sup> Cir. 2005).

<sup>6</sup> Justice Thomas recused himself, leaving eight Justices to decide the case. Knowledgeable Court observers have indicated that a 4-4 affirmance or a ruling that *certiorari* should not have been granted in the first place (never very likely), would probably have been issued by now.

operating subsidiaries. Based on a review of the transcript, this article will offer some tentative predictions of the outcome.

“You are really trying to have your cake and eat it, too.”

It seems clear that Chief Justice Roberts and Justices Scalia and Stevens were inclined to reject the extension of the exclusive visitorial authority of the OCC to operating subsidiaries. Chief Justice Roberts was obviously troubled by the notion that a national bank could reap the benefits of operating through a State-incorporated mortgage lending subsidiary, while avoiding the burdens of State corporate status. When Justice Ginsburg suggested to Michigan’s counsel, John Blanchard, that he was advocating “the worst of all possible regulatory worlds, so that they’ve got two equally competent regulators, and they have to meet requirements of both,” Justice Roberts came to Mr. Blanchard's aid, interjecting: “And if they don’t want to, they don’t have to set up a separate subsidiary, right? They can do this business directly as a national bank and they’re not going to be subject to any visitation?”<sup>7</sup> Later, he observed to Wachovia’s counsel: “You are really trying to have your cake and eat it too . . . you want to be able to operate through a subsidiary and yet not be subject to the same rules that apply to other people.”<sup>8</sup>

Justice Scalia, too, made clear his reservations about Wachovia’s position, commenting to Wachovia’s counsel: “If you are an affiliate of a national bank, you have the same immunity that the national bank has. That’s not what the statute says.”<sup>9</sup> He

---

<sup>7</sup> Tr. at 13.

<sup>8</sup> Tr. at 30.

<sup>9</sup> Tr. at 32.

made much the same point in an exchange with the Assistant to the Solicitor General representing the United States, as amicus curiae, supporting Wachovia and the OCC rule: “What troubles me . . . is the core function of a banking regulatory agency is the visitation power, and the Banking Act makes it very clear there is visitation power to national banks and makes it very clear that there is not for subsidiaries. And here is a regulation which under the guise . . . of defining the powers of the national bank simply eliminates that distinction. And it seems to me that perhaps goes beyond what an agency regulation is allowed to do.”<sup>10</sup>

Justice Stevens was also openly skeptical of the bank’s position. Echoing a point made by the Chief Justice, he noted that Wachovia could operate through branches if it chose, but elected the operating subsidiary structure to obtain protection from liability or for other reasons.<sup>11</sup> Later, he pointedly asked the Assistant to the Solicitor General how many additional personnel the OCC had hired to handle the exclusive regulatory functions taken over from State supervisors as a result of its assertion of exclusive visitorial authority with respect to operating subsidiaries.<sup>12</sup>

From the questions at the argument, it is harder to find the two additional votes needed for reversal in Watters. But given that at least four Justices voted to grant *certiorari*, there must have been at least one Justice in addition to Justices Roberts, Scalia and Stevens who was similarly disposed. And, as noted above, if there were only four

---

<sup>10</sup> Tr. at 48.

<sup>11</sup> Tr. at 26-67.

<sup>12</sup> Tr. at 45. I note, also, that Justice Stevens was one of only two dissenters from the Supreme Court’s decision in Fidelity Federal Savings & Loan Association v. De La Cuesta, 458 U.S. 141 (1982), that lodestar of federal thrift preemption, holding that California’s restriction on the enforceability of mortgage due-on-sale clauses was preempted by a regulation of the Federal Home Loan Bank Board authorizing such clauses.

votes for reversal after oral argument, the Supreme Court might have been expected to issue its decision by now.<sup>13</sup> Therefore, it seems reasonable to assume that there are at least five votes for some decision on the merits. The two most likely additional votes for reversal may belong to Justices Breyer and Alito. This inference is based on the admittedly inconclusive evidence provided by their questions to the litigants, along with the fact that Justices Ginsburg, Souter and (to a somewhat lesser extent) Kennedy seemed inclined to side with Wachovia and the OCC.

Justice Breyer at first seemed to assume that Wachovia was asserting that Michigan's laws were preempted only under a "conflict" preemption theory,<sup>14</sup> suggesting that he was not disposed to agree with the broader visitorial, or "field" preemption, protection claimed by the bank based on OCC regulations. And, once it was established that the bank was indeed relying, at least in part, on conflict preemption, he did not seem to get the clear answer he was seeking from Wachovia's counsel as to what that conflict might be.<sup>15</sup>

Justice Alito, who said little during the oral argument, also seemed inclined to analyze the case in terms of conflict preemption rather than exclusive visitorial powers. His one question, addressed to Wachovia's counsel, asked for concrete examples of how Michigan's laws might "impair or impede the operations" of Wachovia Mortgage.<sup>16</sup> As with Justice Breyer, one may ascribe to him an inclination to vote against the broader claim of preemption asserted by Wachovia and the OCC because of his apparent interest

---

<sup>13</sup> It will be recalled that Justice Clarence Thomas has recused himself from the case.

<sup>14</sup> Tr. at 30-31.

<sup>15</sup> Tr. at 31.

<sup>16</sup> Tr. at 29.

in conflict preemption criteria and the lack of a clear response to his questions about the actual conflict between Michigan's laws and Wachovia Mortgage's operations.

“Can you think of any reason that Congress would have contemplated the scheme that you are defending?”

On the other side, Justices Ginsburg and Souter seemed sympathetic to the view that it would be inherently burdensome, and hence contrary to the federal scheme of national bank regulation, to impose even Michigan's relatively unintrusive regulatory scheme on Wachovia Mortgage. Justice Souter reinforced Justice Ginsburg's concern that subjecting an operating subsidiary to the jurisdiction of both the OCC and local authorities would be “the worst of all regulatory worlds.” He asked Michigan's counsel to “give me any reason to think that Congress would have contemplated this system of potentially more restrictive State legislation when a national bank in a given instance decides to . . . exercise its Federal banking power through a subsidiary rather than directly? Can you think of any reason that Congress would have contemplated the scheme that you are defending?”<sup>17</sup> He went on to note: “Regulation costs the entity something. It is a burden on them.”<sup>18</sup>

Justice Kennedy, for his part, seemed untroubled by the possible preemption of any Michigan laws purporting to regulate the bank-related activities carried on by Wachovia Mortgage. He seemed concerned only to establish that the OCC was not infringing on the State's right to regulate matters of corporate housekeeping and the like. After indicating that he would understand (and presumably agree with) Wachovia's taking the position that a Michigan law limiting the consumer lending activities of an

---

<sup>17</sup> Tr. at 23.

<sup>18</sup> Id.

operating subsidiary would be preempted, he asked Michigan's counsel whether Wachovia was making a broader claim: "But just to see if the corporation had a meeting that year, has duly elected its officers under State law, do the respondents take the position you have no authority to visit the corporation to determine that?"<sup>19</sup> Later, he observed: "This is just a standard preemption case. When the OCC has regulations that control, then the State has no authority to add to those regulations or to have contrary regulations. But if it's something that doesn't have to do with banking at all, then I suppose they would say . . . the State has authority to regulate."<sup>20</sup> Despite a later question to counsel for Wachovia hinting at a possible concern that only Congress could define the extent of field preemption of the kind asserted by Wachovia, Justice Kennedy seemed, on balance, to be leaning in favor of affirmance.

#### What Next?

Assuming that a majority of the Supreme Court holds that the exclusive visitorial provision of the National Bank Act does not accomplish field preemption and automatically shield a national bank's operating subsidiary from all State regulation, reversal of the decision below seems likely but is not inevitable. Even the Justices who were obviously skeptical of visitorial exclusivity with respect to operating subsidiaries seemed to recognize – indeed assumed – that State laws must yield to OCC rules to the extent that they actually prevent or stand as an obstacle to the federally authorized lending activities of a national bank's operating subsidiary. And none of the Justices seemed interested in establishing any sweeping principle of States' rights to regulate

---

<sup>19</sup> Tr. at 9.

<sup>20</sup> Tr. at 10.

State-chartered corporations without regard to federal rules, whether under the Tenth Amendment (which was not mentioned in the oral argument) or otherwise.

It therefore seems theoretically possible that the Court, having clarified the limited scope of the visitorial powers clause, will nevertheless (possibly through a majority comprised of different Justices) uphold the result below on the basis that the Michigan laws in question actually conflict with federal purposes to a sufficient extent to be preempted. Concededly, this result might seem at odds with the principle of not deciding questions unnecessarily: Why should the Court reach out to define the scope of the visitorial authority if the lower court's decision should be upheld on other grounds?

Alternatively, the Court might conclude that Michigan's laws do not conflict with the federal scheme, or might remand the case with a direction to develop a fuller record as to whether a conflict exists.

If either of the latter two alternatives comes to pass, national banks that wish to conduct mortgage lending or other consumer lending programs nationwide through operating subsidiaries will face a far more complicated legal environment, in which State laws can not be brushed aside with impunity. National banks will have to weigh the advantages and disadvantages of complying with State requirements and, if the disadvantages seem too great, will need to assess the prospects and costs of a successful legal challenge. The alternative of rolling the lending operations back into the bank itself may not be practical. It is not necessarily a simple matter for a national bank to significantly restructure substantial consumer lending operations that had previously been conducted through an operating subsidiaries in reliance on the OCC's view of the law.

The implications for thrift institutions may be less dramatic. Long viewed as the beneficiaries of field preemption of state laws, federal savings institutions will not necessarily be affected by a decision limiting the scope of the national bank visitorial powers clause.

\* \* \*

*Peter Heyward would be pleased to respond to questions or comments about this article. He can be reached at [peheyward@venable.com](mailto:peheyward@venable.com).*