State-Chartered Banks in the Post-Watters Environment

By: Travis P. Nelson[1]

In *Watters v. Wachovia*,[2] the U.S. Supreme Court brought some measure of certainty to preemption issues relative to national bank operating subsidiaries, but has invited new and revived debate as to the application of federal preemption principles to the activities of state-chartered banks. This article will consider how *Watters* and other recent court decisions might resolve some issues, and raise new ones.

The Watters Revolution

On April 17, 2007, the U.S. Supreme Court issued its much-anticipated decision in *Watters*, holding that operating subsidiaries of national banks are entitled to the same preemption as their parent associations. The *Watters* decision will be studied as much for what it did not say in its analysis as for what it did in its ultimate outcome. A "home run" from the Office of the Comptroller of the Currency's (OCC) perspective would have entailed the Court declaring that the OCC regulation at issue – "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"[3] – is valid as preempting state regulation of operating subsidiaries of national banks. The OCC did not get its wish, as the Court described that issue as "an academic question" that need not be addressed. According to the Court, the rule does not provide a new substantive provision, but rather "clarifies and confirms what the National Bank Act already conveys: a national bank has the power to engage in real estate lending through an operating subsidiary, subject to the same terms and conditions that govern the national bank itself; that power cannot be significantly impaired or impeded by state law." Beyond the core holding of the Court, some practitioners view *Watters* as ending the practice of "per se" preemption regulations, absent clear Congressional directive, as exceeding agency authority. Unfortunately, however, as the *Watters* majority declined to address the validity of the OCC preemption regulation at issue in the case, referring to such a discussion as "an academic question," a definitive answer on this practice will have to wait for another day.

Preemption and the State Charter

In considering how *Watters* might affect state-chartered banks, it is important to consider and compare parallel or similar preemptive abilities of national banks. Though to a much lesser extent, state-chartered banks enjoy the benefits of preemption like their national bank cousins.

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[2] 550 U.S. _____, 127 S.Ct. 1559 (2007).

[3] *Id*, *citing* 12 C.F.R. § 7.4006.

This preemption lies in the ability to export interest rates, as provided in § 27(a) of the Federal Deposit Insurance Act ("FDIA"):

> In order to prevent discrimination against State-chartered insured depository institutions . . . with respect to interest rates . . . such State bank[s] . . . may, notwithstanding any State constitution or statute which is hereby preempted for the purposes of this section, take, receive, reserve, and charge on any loan or discount made, or upon any note, bill of exchange, or other evidence of debt, interest . . . at the rate allowed by the laws of the State . . . where the bank is located . . . .[4]

This language in the FDIA governing the exportation authority of state-chartered banks is strikingly similar to the comparable provision for national banks contained in the National Bank Act ("NBA"): "Any association may take, receive, reserve, and charge on any loan or discount made, or upon any notes, bills of exchange, or other evidences of debt, interest at the rate allowed by the laws of the State, Territory, or District where the bank is located . . . ."[5]

This similarity in the language of the FDIA and the NBA is not coincidental. "The historical record clearly requires a court to read the parallel provision of [the Depository Institutions Deregulation and Monetary Control Act of 1980 – "DIDMCA"] and [the NBA] in *pari materia*. It is, after all, a general rule that when Congress borrows language from one statute and incorporates it into a second statute, the language of the two acts should be interpreted in the same way."[6] The two federal appellate courts that have addressed this issue with regard to state-chartered banks have also held that § 27 completely preempts state law claims challenging the rates of interest charged by state-chartered, federally insured banks, relying on the principle of *pari materia* to find that Congress intended § 27 to completely displace contrary state laws in the area of interest rates.[7] The Fourth Circuit in *Vaden* relied on the legislative history of § 27, which "tells us that Congress intended 'to allow competitive equity among financial institutions, and reaffirm the principle that institutions offering similar products should be subject to similar rules,'" and that "[t]he FDIA was enacted in part 'to provide parity, or competitive equality, between national banks and State chartered depository institutions.'"[8]

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[4] 12 U.S.C. § 1831d.

[5] 12 U.S.C. § 85.

[6] *Greenwood Trust Co. v. Massachusetts*, 971 F.2d 818, 827 (1st Cir. 1992) (holding that § 27 preempted enforcement of state law that prohibited the imposition of late fees on credit cards issued by subsidiary of a state-chartered, federally insured bank). This is consistent with the interpretation of the FDIC. FDIC General Counsel's Opinion No. 10: Interest Charges under § 27 of the FDIC, 63 Fed. Reg. 19,258, 19,259 (Apr. 17, 1998).

[7] *See In re Community Bank of Northern Virginia*, 418 F.3d 277, 295-296 (3rd Cir. 2005); *Discover Bank v. Vaden*, 489 F.3d 594 (4th Cir. June 13, 2007).

[8] *Vaden*, 489 F.3d 594, *citing* 126 Cong. Rec. 6,908 (1980) (Statement of Sen. Bumpers), and 126 Cong. Rec. 6,900 (1980) (Statement of Sen. Proxmire).

The Ginsburg Approach

In two sentences, and without prodding from briefing counsel, Justice Ginsburg provides what practitioners widely regard as the crucial lesson to be learned from *Watters*: "We have never held that the preemptive reach of the [National Bank Act] 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."[9]

Justice Ginsburg's analytical approach may ultimately become the benchmark for analyzing the preemptive powers of financial institutions. The next round of financial institution preemption raises a question that *Watters* does not quite reach but for which an answer can be inferred: If preemption protects operating subsidiaries of national banks from state law interference, does it not also protect agents of national banks? This issue, like the issue in *Watters*, has undeniable implications for state-chartered banks.

In *SPGGC v. Ayotte*, the First Circuit addressed the question of whether states have the power to regulate the activities of national banks and federal savings associations that choose to carry out their activities through third-party agents.[10] Perhaps remembering the lesson from *Watters* as to reliance on preemption regulations, the *Ayotte* court looked to the NBA's language permitting national banks to use "duly authorized officers or agents" in the exercise of their incidental powers. Further, in rejecting the state's argument that the OCC preemption regulation is irrelevant as it covers banks and not third-parties, the *Ayotte* court followed the guidance of Justice Ginsburg, stating: "this analysis is too formalistic: the question here is not *whom* the New Hampshire statute regulates, but rather, against *what activity* it regulates."[11] In applying both the NBA and the Home Owners Loan Act ("HOLA" – governing federal savings associations), the *Ayotte* court held that national banks and federal savings associations may exercise their preemptive powers through agents free of state law restrictions. In other words, at least in the First Circuit, if a state law restriction would be preempted as applied to a national bank or federal savings association, then that law would be preempted as applied to agents of those institutions insofar as such agents are performing activities on behalf of their federally-chartered principals.[12]

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[9] *Watters* at 13 (emphasis in original)

[10] *SPGGC v. Ayotte*, 488 F.3d 525 (1st Cir. 2007).

[11] *Id.* (emphasis in original).

[12] The *Ayotte* court cited with approval a lower court decision that reached a similar result as to exclusive agents of federal savings associations. *State Farm Bank, F.S.B. v. Burke*, 445 F. Supp. 2d 207 (D. Conn. 2006). While *Ayotte* considered whether substantive state law provisions apply to agents, the *Burke* court addressed the question of whether exclusive agents were subject to licensure generally, without reaching the application of technical restrictions on licensees.

A federal district court in Ohio, in *State Farm Bank, F.S.B. v. Reardon*, reached a result contrary to *Ayotte* and *Burk*e, holding that exclusive agents of a federal savings association are subject to state mortgage broker laws notwithstanding the assertion of preemption by the OTS. In response to the attempts by John Reardon, Superintendent of the Ohio Division of Financial Institutions, to enforce state law against the exclusive agents of State Farm, the company argued that application of Ohio law to exclusive agents of a federal savings association is preempted by the Home Owners Loan Act (HOLA) and implementing regulations promulgated by the OTS. These regulations were evidenced by an OTS Chief Counsel opinion letter addressing the precise State Farm activities at issue. The court rejected State Farm's argument that the Ohio law is preempted. Under the facts and circumstances before the court, the court did acknowledge that the OTS might very well have preemptive authority in this matter, but even if it did, the exercise of such authority had not yet been properly established by the agency. The court rejected the validity of the OTS Chief Counsel opinion letter, holding that the letter attempted to change the law and the agency's existing policy but was not the product of notice-and-comment rulemaking under the Administrative Procedures Act, and therefore was not entitled to deference.[13] The court determined that the underlying statute and regulations provide no support for the proposition that non-employee third party exclusive agents are exempt from state regulations.

Most practitioners might have thought that under the above-quoted language from *Ayotte* and *Watters* that the Ohio court, even if it viewed the OTS State Farm Opinion Letter as flatly over-reaching, would have undertook an analysis like the *Ayotte* court and found a statutory basis for preemption. Instead, however, the Ohio court viewed the *Watters* holding as applying only to banks and their operating subsidiaries, and that absent a controlling regulation, there was no legal basis for preempting application of state law to agents. There are definite problems with this decision, for example, that it acknowledges the possibility that the OTS could promulgate a preemption regulation, while such practice is at least called into question by *Watters*, and that it declines to address application of *Ayotte*.

More recently, the Second Circuit issued its decision in *SPGGC v. Blumenthal*.[14] Similar to the First Circuit in *Ayotte*, this case examined the question of whether an agent of a national bank is entitled to preemption from state law in activities it performs for its national bank principal. At issue in *Blumenthal* were two provisions of the Connecticut law prohibiting gift cards that impose (1) inactivity or dormancy fees, and (2) an expiration date. Unlike the First Circuit, this court found that *Watters* should be limited to operating subsidiaries: "[W]e believe that it would be a mistake to read *Watters* so broadly as to obscure the unique role assigned to operating subsidiaries in the context of national banking regulation." Notably, however, even though the Second Circuit took a narrower view of *Watters* than the First Circuit, it did acknowledge that under the right circumstances an agent could be covered by the preemption afforded a national bank. The court distinguished its holding from that in *Ayotte* on the facts, focusing on the degree of agency and the extent to which the fees were determined by the

[13] This is contrasted with *Watters*, which viewed the OCC regulation as a mere confirmation of existing statutory law.

[14] *SPGGC v. Blumenthal*, 05-4711-cv (2nd Cir. Oct. 19, 2007).

national bank versus the non-bank third party. In the end, *Blumenthal* did not reject *Ayotte* and would probably have upheld *Burke*, which involved agents with very little discretionary authority independent of their federally-chartered principals.

State-Chartered Banks After Watters

As noted above, *Watters* has called into question the practice of agencies promulgating preemption regulations. This possible effect of *Watters* may extinguish the currently stalled FDIC preemption rulemaking. In 2005, the FDIC issued a notice of proposed rulemaking addressing, among other things, the preemption of state law as applied to state-chartered banks.[15] Specifically, the FDIC's proposed rule would provide parity of preemption for state-chartered banks with national banks, declaring that the law of a host state will not apply to the activities of a branch of an out-of-state state-chartered bank if such host state law would not apply to the activities of a branch of an out-of-state national bank.[16] Further, the FDIC proposed that an out-of-state state-chartered bank may engage in any activity in a host state that is permissible for either an out-of-state national bank, or a bank chartered by the host state.[17] Whether the FDIC has the legal authority to promulgate such a per se preemption regulation is debatable, however regardless of its legality, given the uncertainty on the practice raised by *Watters*, practitioners should look beyond the regulation for a statutory basis for such preemption.

An appropriate area to focus the comparison of national bank and state-chartered bank preemptive abilities is on interest rate exportation. Those who would attempt to restrict the scope and application of *Watters*, in addition to reading it as limited to operating subsidiaries as the *Blumenthal* court did, might also attempt to limit its holding to national banks, or at least national bank powers. Proponents of this view would argue that the legislative history and case law supporting parity between national banks and state-chartered banks focuses on the parity of § 85 of the NBA and § 27 of the FDIA, however the recent case law addressing national banks' use of operating subsidiaries or agents have based the preemptive benefits of operating subsidiaries and agents not on national banks' exportation authority under § 85, but rather on the powers of national banks as listed in § 24.[18] Arguably, under this approach, the ability of a national bank to export interest rates through operating subsidiaries and agents only exists through the national bank powers contained in § 24. Some might argue that this view is supported by Justice Ginsburg's emphasis on the word "powers" in her approach to preemption analysis: "[I]n 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

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[15] FDIC Notice of Proposed Rulemaking: Interstate Banking; Federal Interest Rate Authority, 70 Fed. Reg. 60019 (Oct. 14, 2005).

[16] *Id*. at 60031.

[17] *Id*.

[18] 12 U.S.C. § 24.

structure."[19] Under this view, because Congress did not federalize the *powers* of state-chartered banks, they do not enjoy the same powers as national banks, only the exportation ability.

This view would be incorrect because in drafting §27, Congress expected that the doctrine of *pari materia* would enable state-chartered banks to fully and completely step-into-the-shoes of national banks in every aspect of their exportation powers. Section 27 was enacted as part of the DIDMCA,[20] in which as discussed above, "Congress made a conscious choice to pattern section 1831d after section 85 to achieve competitive equality in the area of interest charges between state and national banks."[21] This notion that the word "powers" should control and demand a reference to § 24 at the exclusion of § 85, is overly literal, and ignores Justice Ginsburg's likely use of the word "powers" synonymously with "activities" that she uses in the preceding clause. The First Circuit obviously recognized this when it focused on the "activity" that is targeted. The point behind both *Watters* and *Ayotte* is that the preemption analysis must focus not on the identity of the party engaging in the conduct, but rather on whether the conduct itself is entitled to preemption.

The question then becomes: What is the extent of the "competitive equality" that Sen. Proxmire and his brethren intended DIDMCA to bring about? It seems counterintuitive to give state-chartered banks full "competitive equality" with their national bank counterparts in the area of interest rate exportation, and yet hamper such parity by withholding the parity of powers needed to achieve such equality. To illustrate, § 85 gives national banks the power to "take, receive, reserve, and charge" interest (as does § 27 for state-chartered banks), but nowhere in § 85 does the statute prescribe the means through which such interest may be taken, received, reserved or charged. The vehicles through which to engage in these activities, for example, through contracting for the interest,[22] or to sue for interest payments due,[23] or to collect interest through agents, all implementing powers under § 24,[24] all must be implied in § 85. Arguably then, in drafting § 27, Congress was doing so with a view not only toward § 85, but to § 24 as well insofar as Congress sought to provide parity for state-chartered banks in the power to implement interest rate exportation, or in the alternative, with a view toward typical state-chartered bank powers that tend to mirror that of national banks.[25] For a state to assert that while it cannot regulate an out-of-state state-chartered bank's ability to set interest rates in accordance

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[19] *Watters* at 13 (emphasis in original).

[20] Pub. L. 96-221, 94 Stat. 132 (1980).

[21] Notice of FDIC General Counsel's Opinion No. 11, 63 Fed. Reg. 27282, 27283 (May 18, 1998).

[22] 12 U.S.C. § 24(Third).

[23] 12 U.S.C. § 24(Fourth).

[24] 12 U.S.C. § 24(Seventh).

[25] For example, the Commonwealth of Pennsylvania allows its state-chartered banks to appoint agents, and to use such to engage in permissible banking activities, including activities permissible for national banks. 7 P.S. § 201.

with its home state law, or export such rates, but that it can regulate the corporate mechanisms of such exportation, would be to eviscerate the very parity that Congress sought. This cannot be the result that Congress intended.

Conclusion

The debate is surely far from over, and practitioners from Wall Street to Main Street are seeing a rise in state regulators and attorneys general, dismayed at their loss in *Watters*, attempting to circumvent preemption issues by bringing enforcement actions against those third parties with whom banks would attempt to partner. While both federally-chartered and state-chartered institutions are susceptible to litigation arising out of such state actions, state-chartered institutions currently are at a disadvantage as they have not enjoyed the recent string of appellate court victories as their federal cousins.