Watters v. Wachovia Bank, N.A.

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Summary

In *Watters v. Wachovia Bank*, the Supreme Court, in a 5-3 decision, ruled that Michigan mortgage lending requirements do not apply to a state-chartered operating subsidiary of a national bank. The decision was based on the Court's interpretation of various provisions of the National Bank Act, including provisions granting national banks the power to make real estate loans; the "incidental powers" clause, under which national banks have been authorized by the Office of the Comptroller of the Currency (OCC), the regulator of national banks, to conduct banking activities in operating subsidiaries; and a provision granting the OCC exclusive "visitorial" powers over national banks. This report summarizes the rulings in the case and potential implications. This report will not be updated.

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Background[1]

Watters v. Wachovia Bank[2] involves a challenge to a regulation promulgated by the federal agency that charters and regulates national banks, the Office of the Comptroller of the Currency (OCC). OCC's authority has been upheld both by the lower courts[3] in this case and by three other federal appellate courts.[4] The regulation, 12 C.F.R. § 7.4006 (§ 7.4006), reads, in pertinent part: "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." The lower courts have held § 7.4006 preempts the application of the Michigan Mortgage Brokers, Lenders, and Services Licensing Act,[5] to Wachovia Mortgage Corporation ("Wachovia Mortgage"), a state-chartered subsidiary of Wachovia Bank (Wachovia or the Bank), a national bank. The Michigan law requires state registration of mortgage brokers, imposes fees and various standards upon them, and authorizes state regulators to investigate consumer complaints not being pursued by federal regulators.

The OCC relies primarily on two provisions to promulgate its regulation: 12 U.S.C. § 24 Seventh (§ 24) and 12 U.S.C. § 484(a), both of which are part of the National Bank Act (NBA). Section 24 authorizes national banks to exercise, "all such incidental powers as shall be necessary to carry on the business of banking." Section 484(a) specifies that "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 exercised by Congress...." In the banking context, visitorial powers involve the authority to "visit" a bank and examine its activities and observance of laws and regulations, including the examination of records. By promulgating its regulation, the OCC has determined that the creation of subsidiaries is an "incidental power" of national banks and that visitorial powers are exclusively allocated to the OCC with respect to subsidiaries as well as to national banks.

District Court

The district court ruled the Michigan law inapplicable to state-chartered operating subsidiaries of national banks by holding that the OCC had authority to preempt state law under the NBA. It used a rationale called the *Chevron* test to review the OCC's interpretation of its authority.[6] The test has two components or prongs: (1) If Congress has directly spoken on the precise question at issue and its intent is clear and unambiguous, courts must defer to that interpretation of the law. (2) If the meaning or intent of a statute is silent or ambiguous, courts must give deference to the agency's interpretation of the law if it is based on a permissible and reasonable construction.

Concluding that Congress has not spoken on the precise question in this case, the court used the second prong of the *Chevron* test and deferred to the OCC's interpretation of its "broad and

[1] This report was originally prepared on August 1, 2006, by Aaron Droller, who was then a Law Clerk in the American Law Division.

[2] (No. 05-1342) 550 U.S. ___ (2007).

[3] *Wachovia Bank v. Watters*, 334 F.Supp. 2d 957 (W.D. Mich. August 30, 2004); *Wachovia Bank, N.A. v. Watters*, 431 F.3d 556 (6th Cir. 2005).

[4] *Wachovia Bank, N.A. v. Burke*, 414 F.3d 305 (2d Cir. 2005); *Wells Fargo Bank, N.A. v. Boutris*, 419 F.3d 949 (9th Cir. 2005); and, *National City Bank of Indiana v. Turnbaugh*, 463 F. 3d 325 (4th Cir. 2006).

[5] MCL 493.51 *et seq*; MCL 445.1661.

[6] *See Chevron U.S.A. v. National Resources Defense Council*, 467 U.S. 837 (1984).

pervasive"[7] authority to regulate national banks and their subsidiaries. It found that under the NBA, the OCC has exclusive visitorial authority over national banks, including their duly authorized operating subsidiaries. Since the Michigan law conflicted with the federal regulation, the court permitted federal preemption of state law.[8] The district court also held that the OCC had not violated the Tenth Amendment to the U.S. Constitution.[9] While the Commissioner of the Michigan Office of Insurance and Financial Services (Commissioner) suggested that § 7.4006 federalized a state corporation by converting it into an instrumentality of federal law, the court dismissed this claim by asserting that Congress had authority to regulate national banks under the Commerce Clause and, thus, there was no violation of the Tenth Amendment.[10]

Appellate Court

The United States Court of Appeals for the Sixth Circuit affirmed the judgment of the district court by holding that the NBA authorized the OCC to issue regulations covering both national banks and their subsidiaries pursuant to congressional authorization of "incidental powers" to national banks.[11] The Commissioner contended that the OCC, without adequate statutory authorization, expanded the definition of "national banks" to include "operating subsidiaries."[12] The appellate court, however, deferred to the OCC under *Chevron* and held that "incidental powers" included the authority to conduct business through an operating subsidiary, and that the exclusive visitorial powers of national banks trumped any state authority to examine their operating subsidiaries.[13] The court also affirmed the district court's ruling on Tenth Amendment implications.

Supreme Court Decision

The Supreme Court, in a 5-3 decision, ruled that NBA preempts state regulation of the mortgage lending activities of national bank operating subsidiaries. The majority opinion was written by Justice Ginsburg, joined by Justices Kennedy, Souter, Breyer, and Alito.[14] It holds that: "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."[15] The basic premise of the opinion is that, under the NBA's real estate lending and incidental powers clauses, Congress gave national banks the power to conduct real estate lending activities in operating subsidiaries and that grants of

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[7] *Wachovia Bank v. Watters*, 334 F. Supp. 2d at 964.

[8] *See* CRS Report RL32197, *Preemption of State Law for National Banks and Their Subsidiaries by the Office of the Comptroller of the Currency*, by (name redacted).

[9] United States Constitution, Amendment X reads, "The powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people."

[10] For scope and purpose of this amendment, see Johnny Killian *et al., United States Constitution: Analysis and Interpretation*, 1611-1612 (2004 ed.).

[11] *Wachovia Bank, N.A. v. Watters*, 431 F.3d 556 (6th Cir. December 19, 2005).

[12] In this argument, the Commissioner relied on: *ACLU v. FCC*, 823 F.2d 1554 (D.C. Cir. 1987); *Board of Governors of the Federal Reserve System v. Dimension Financial Corp*, 474 U.S. 361 (1986); *Minnesota v. Fleet Mortgage Corp*, 181 F.Supp.2d 995 (D.Minn. 2001).

[13] *Wachovia Bank*, 431 F.3d at 561.

[14] Justice Thomas did not take part in the consideration or decision of the case.

[15] *Watters v. Wachovia Bank, N.A.*, slip op., at 16.

authority to national banks generally preempt state law. The Court relied on the express language of the visitorial powers clause, providing exclusive authority to OCC to examine and regulate national banks, as indicative of congressional intent to protect the national banking system from intrusive or inconsistent state laws. It reviewed a long line of cases, beginning with *McCullough v. Maryland*,[16] that have held the federal bank system generally immune to state laws negatively affecting operations. The Court emphasized the reach of the NBA's preemptive effect by characterizing earlier decisions with respect to how they defined the test for determining whether a state law was preempted by the NBA. It spoke of federal law as shielding national banks "from unduly burdensome and duplicative regulation"[17] and national banks as being "subject to state laws of general application in their daily business to the extent such laws do not conflict with the letter or the general purposes of the NBA. "[18] It emphasized that the standard the Court applied to preempt state law in *Barnett Bank of Marion County, N.A. v. Nelson*[19] extends to powers of the national bank regulator, OCC, and to powers exercised under the incidental powers clause:

> States are permitted to regulate the activities of national banks where doing so does not prevent or significantly interfere with the national bank's or the national bank regulator's exercise of its powers. But when state prescriptions significantly impair the exercise of authority, enumerated or incidental under the NBA, the State's regulations must give way.[20]

The Court noted that operating subsidiaries have been authorized since 1966; are generally subject to the same regulatory oversight as their parent national banks; are not treated as separate economic enterprises by OCC; and have not been distinguished from national banks by the Court in earlier cases testing the preemptive effect of national bank powers.[21] In terms of the Court's analysis, the focus was on "the exercise of a national bank's *powers*, not its corporate structure."[22]

The Court found no Tenth Amendment issue and expeditiously rejected any concern that the issue that had been central in the lower courts, preemption by regulation, was implicated. Both the trial court and the court of appeals decisions looked at the question of whether, in the absence of clear statutory delegation to an administrative agency, the authority to determine the preemptive effect of a statute is a judicial prerogative. The Supreme Court, however, dismissed the issue as "an academic question" and "beside the point.[23] The NBA, according to the Court, "is ... properly read by OCC to protect from state hindrance a national bank's engagement in the 'business of banking' whether conducted by the bank itself or by an operating subsidiary, empowered to do only what the bank can do."[24] Essentially, the Court's reliance on statutory preemption eliminated the need for a *Chevron* analysis of whether courts should defer to OCC's preemption regulation.

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[16] 17 U.S. (4 Wheat. 316) (1819).

[17] *Waters v. Wachovia Bank, N.A.*, No. 05-1342 , slip op., at 9.

[18] Id., slip op., at 9.

[19] 517 U.S. 25, 32 (1996) (upholding national bank sales of insurance from offices in small towns despite a conflicting state statute).

[20] *Watters v. Wachovia Bank, N.A.*, slip op., at 7.

[21] Id., at 11-13. *Barnett Bank of Marion County v. Nelson* , 517 U.S. 25 (1996) involved an insurance operating subsidiary of a national bank; *Clarke v. Securities Industry Assn.*, 479 U.S. 388 (1987), a discount brokerage operating subsidiary.

[22] Id., at 13 (emphasis in original).

[23] Id., at 13.

[24] Id.

A strong dissenting opinion, written by Justice Stevens, joined by Chief Justice Roberts and Justice Scalia, emphasized the absence of clear statutory language stating that national bank operating subsidiaries need not comply with state laws regulating mortgage brokers. It noted that the Supreme Court decisions, even those upholding the preemptive effect of various powers granted to national banks carefully recognized that a wide range of national bank operations are committed to state oversight:

> Until today, we have remained faithful to the principle that nondiscriminatory laws of general application that do not 'forbid' or 'impair significantly' national bank activities should not be preempted.
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> *****
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> Congress has consistently recognized that state law must usually govern the activities of both national and state banks for the dual banking system to operate effectively.[25]

It also noted that national bank subsidiaries have not been directly authorized by Congress and found congressional acquiescence in OCC's "expansive interpretation of its authority ... a plainly insufficient basis for finding preemption."[26]

Possible Implications

This decision is likely to be viewed favorably not only by national banks, but also by some others in the banking industry as a clarification of distinctions between federal and state bank charters.[27] On the other hand, consumer advocates may find only minimal solace in the fact that the decision actually involves only one state's laws covering licensing and reporting requirements of a mortgage broker subsidiary of a national bank.

Although all state laws regulating the terms and conditions of loans were not actually before the Court, OCC regulations are broadly written to preempt state laws on virtually every aspect of the core banking business: real estate lending, deposit-taking, and non-real estate lending.[28] Moreover, there are regulations extending the preemptive effect to national bank operating subsidiaries[29] and covering all state laws that "obstruct, impair, or condition a national bank's ability to fully exercise its powers to conduct activities under Federal law."[30] The dissent included a prediction of the potential effect this decision might have on the applicability of state consumer protection laws:

> ... the Court's eagerness to infuse congressional silence with preemptive force threatens the vitality of most state laws as applied to national banks—a result at odds with the long and unbroken history of dual state and federal authority over national banks, not to mention our federal system of government. It is especially troubling that the Court so blithely preempts

[25] *Watters v. Wachovia Bank, N.A.*, Stevens J., dissenting, slip op., at 3-4.

[26] Id., slip op. at 10.

[27] *See* R. Christian Bruce, "Questions Raised About OCC Preemption As Justices Eye Case on Bank Subsidiaries," 87 *BNA Banking Report* 202 (July 31, 2006).

[28] 12 C.F.R. §§ 34.4, 7.4007, and 7.4008.

[29] 12 C.F.R.§ 7.4006.

[30] 12 C.F.R. § 7.4009.

> Michigan laws designed to protect consumers. Consumer protection is quintessentially a 'field which the States have traditionally occupied.'[31]

Considering the size[32] of the national bank subsidiary presence in the real estate lending business, the impact of this decision is likely to increase the calls for federal legislation.[33] States and some Members of Congress have been expressing the view that preemption of state banking laws will disturb the delicate balance of the dual banking system, particularly with respect to the dilution of consumer protection laws.[34] Preemption of state consumer protection laws, including the increasing number of predatory lending laws, carries with it various implications in terms that may garner attention from legislators.

Among the issues that might be raised in legislative oversight are (1) the competitive edge preemption gives to national banks over state-chartered banks which must comply with state laws; (2) the extent of the gap left by the possibility that state consumer protection laws would no longer cover national banks; (3) the sufficiency of OCC's consumer protection enforcement regime and personnel to replace the enforcement activities of 50 state attorneys general and administrative agencies policing; and (4) the extent to which OCC's expertise is adequate to the task of licensing and regulating the array of national bank subsidiaries.

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[31] *Watters v. Wachovia Bank, N.A.*, Stevens J., dissenting, slip op. at 15.

[32] "At the end of March [2007], there were 1,786 national banks, controlling nearly $7 trillion in assets, or about 70 percent of the commercial banking industry's assets. About 10 percent of those banks have state-incorporated banking subsidiaries." Robert Barnes and Dina ElBoghdady, "High Court Sides With Banks on Mortgage Rules; States Can't Regulate Loan Subsidiaries," *Washington Post*, B-1, col. 1 (April 18, 2007).

[33] *See* CRS Report RL33879, *Housing Issues in the 110th Congress*, coordinated by (name redacted).

[34] *See* CRS Report RS22057, *Preemption of State Law for National Banks and Their Subsidiaries by Regulations Issued by the Office of the Comptroller of the Currency: A Sketch*, by (name redacted).

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