On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) into law. As the battle now looms over the selection of the new head of the Consumer Financial Protection Bureau (“CFPB”) established by the legislation, the focus is turning to how the Dodd-Frank Act will effect change across the financial sector.

One of the areas in which the law is changing significantly is federal preemption. In an update to our June 2 alert, we assess how the Dodd-Frank Act changes existing preemption standards and examine some of the areas of greatest concern to banks and federal thrifts as they face a new era of consumer protection regulation and enforcement.

Existing law

The past two decades have seen a major expansion of federal preemption of state law in the banking sector. For federal savings associations (thrifts), courts have interpreted the Home Owners’ Loan Act (“HOLA”) and regulations issued by the Office of Thrift Supervision (“OTS”) as extending “field preemption” to federal thrifts. As a result, the vast majority of actions against federal thrifts have been preempted.

Over the same period, national banks have benefited from a gradual expansion of preemption supported both by courts and Congress, leading to what many consider de facto field preemption for national banks. The recent trend began in 1994 when Congress passed the Riegle-Neal Interstate Banking and Branching Efficiency Act, dramatically expanding the scale of banking by allowing national banks to establish branches across state lines. An Office of the Comptroller of the Currency (“OCC”) interpretive letter issued shortly after its passage asserted that Riegle-Neal gave national banks the power to export the interest rates of both the state where the bank was headquartered and the state in which a branch was located, allowing banks to take advantage of the most favorable interest rates (known as the “most favored lender doctrine”). The most favored lender doctrine has become one of the hallmarks of federal preemption in this area.

Two years later, in 1996, the Supreme Court invalidated a state insurance law that prohibited national banks from selling insurance in small towns in Florida, holding it was preempted by a federal law permitting national banks to sell insurance in towns with populations of not more than 5,000 people. The Court held that a state law that “prevents or significantly interferes” with a national bank’s exercise of its powers is preempted. Barnett Bank of Marion, N.A. v. Nelson, 517 U.S. 25. The Barnett Bank

Even without a conflict between federal and state law or an express provision for preemption, the courts will infer an intention to preempt state law if the federal regulatory scheme is so pervasive as to “occupy the field” in that area of the law, i.e., to warrant an inference that Congress did not intend the states to supplement it. Gade v. National Solid Wastes Mgmt. Ass’n, 505 U.S. 88, 98 (1992).
Bank case set a new standard for preemption decisions and provided the OCC with the basis for a vast expansion of preemption law for national banks.

In 2004, the OCC issued two sweeping rules—a preemption regulation providing that national banks and their operating subsidiaries were not subject to state laws that “obstruct, impair or condition” a bank’s exercise of its federally authorized powers to make loans or take deposits—and a visitorial powers regulation that restricted the authority of states to examine and supervise national banks, making such examination and supervision the exclusive province of the OCC. The OCC regulations also specifically listed types of state laws that are and are not preempted under federal law.

The OCC regulations were widely criticized by consumer groups and state attorneys general as they led to an era in which national banks enjoyed what many consider de facto field preemption.

Changes to existing law

The Dodd-Frank Act will change the preemption landscape in several ways. First, for both national banks and federal thrifts, state consumer financial laws will be preempted only if (1) they discriminate against national banks; (2) a given law “prevents or significantly interferes with the exercise by the national bank of its powers,” as stated in the Barnett Bank case; or (3) the state law is preempted by another federal law. State laws rarely discriminate against national banks, so the relevant inquiry will most often be whether state laws prevent or interfere with a national bank’s powers or whether an existing federal law covers the subject.

The change is most significant for federal thrifts, which will no longer enjoy the broad field preemption under existing law. While the bill also arguably weakens the preemption standards for national banks, the practical effect is still unclear. For the past 14 years, courts have interpreted the Barnett Bank standard to preempt the majority of state laws aimed at regulating national banks’ activities. The new law codifies the Barnett Bank standard and national banks will continue to rely on this largely favorable precedent.

The Dodd-Frank Act also provides that courts and the OCC must make preemption determinations on a case-by-case basis with respect to particular state laws and can no longer rely on blanket preemption determinations like the OCC’s 2004 regulations. Furthermore, the standard for judicial review of OCC rulings will change under the new law. Previously, courts accorded a high level of deference to OCC rulings under the Chevron v. National Resources Defense Council case, which held that courts must defer to an agency’s reasonable construction of statutes administered by that agency. Under the Dodd-Frank Act, however, courts must now apply the standard from Skidmore v. Swift & Co., assessing the thoroughness of the OCC’s consideration, the validity of the OCC’s reasoning, the consistency with other determinations made by the OCC, and any other factors that the court finds persuasive and relevant to its decision. The Dodd-Frank Act also specifically reverses the preemption effect of the National Bank Act (the “NBA”) and HOLA with respect to operating subsidiaries, affiliates, and agents of national banks and federal thrifts.

Apart from these changes, it is not clear that the new law itself will do much to change the analysis as to whether a particular state law is preempted. Courts and the OCC will continue to analyze preemption questions in light of Barnett Bank and its progeny. However, because the OCC and courts can no longer rely on the sweeping 2004 regulations and must make preemption decisions on a case-by-case basis, significant litigation may ensue focusing on whether particular state consumer financial laws prevent or significantly interfere with a bank’s powers. The regulations to be written by the CFPB are also expected to be a source of substantial litigation.
Concerns for banks

How the “new rules” for federal preemption alter the legal landscape for national banks remains to be seen. While much remains uncertain about its impact, it is clear that the Dodd-Frank Act opens the way to increased scrutiny of national banks and thrifts by states and local authorities. Section 1042 provides that state attorneys general are authorized to enforce the new law as well as regulations issued by the CFPB. The law makes clear that state laws that provide greater protection than federal law are not necessarily preempted. It also upholds the Supreme Court’s decision in Cuomo v. Clearing House Assn. allowing states to sue national banks and federal thrifts to enforce non-preempted state laws. This may result in more activity from state Attorneys General and a dramatic increase in enforcement actions by state agencies.

Many banks are concerned that, as a result of the loss of field preemption, they will be subject to a patchwork of diverse state regulations that will increase the costs of doing business and engender waves of litigation. Some of the biggest areas of concern are:

- **Unfair and deceptive acts and practices.** In recent years regulators have increased scrutiny of “unfair and deceptive acts and practices” (“UDAP”). UDAP is also likely to be a focus of the CFPB, which is specifically authorized to protect consumers from “unfair,” “deceptive,” and “abusive” acts and practices. UDAP is particularly daunting for financial institutions because its scope is so broad. These vague and subjective standards potentially reach all kinds of bank services and products, including marketing and advertising, product design, mortgage and consumer lending, security, and deposit-taking. In addition, every state has its own UDAP law, often described as “mini-FTC Acts.” In the wake of the OCC’s expansive 2004 regulations, many courts determined that state UDAP laws were preempted by the NBA and OCC regulations with respect to a wide variety of activities, such as failure to disclose check card, overdraft, underwriting, and services fees; inadequate disclosure of adjustable rate mortgage terms; limits on pre-payment penalties; inflated appraisals; false advertising; and countless others. However, in 2008, in Jefferson v. Chase Home Finance, the Northern District of California allowed plaintiff to proceed with claims that a bank had violated the state’s Unfair Competition Law by misrepresenting the way in which it processed additional mortgage payments so as to violate its contract with the borrower. In refusing to bar the action on the grounds of preemption, the court reasoned that the bank’s alleged unfair practice involved obligations that apply to all businesses and only incidentally affected banking and lending. In light of the increased emphasis on state attorney general powers to bring action to enforce non-preempted state laws, there may well be an increase in this type of litigation.

- **Predatory lending:** Given its significant role in the latest financial crisis, predatory lending will be a primary focus of the CFPB. In the past, states have been preempted from regulating mortgage lenders with regard to the types of risky credit features for mortgage loans that played a key role in the crisis, including balloon payments, negative amortization, variable rates, interest only loans, and other non-traditional terms. States may seek to use their authority to bring enforcement actions in these areas.

- **Operating subsidiaries/agents.** The Dodd-Frank Act explicitly overrules a substantial body of case law, including the recent Supreme Court decision in Watters v. Wachovia, in providing that operating subsidiaries, affiliates, and agents of national banks and thrifts will now be subject to state law. This major shift requires banks to reevaluate the activities they
conduct through subsidiaries and choose between acquiring their subsidiaries, moving certain operations out of their subsidiaries, or complying with diverse sets of state and local laws. The change is likely to significantly alter national banks’ ability to make available certain types of products, such as residential loans, which may result in these costs ultimately being passed on to consumers.

- **Timing.** Under the Dodd-Frank Act, the preemption provisions go into effect only when the authority over existing federal consumer protection laws is transferred to the new CFPB, which is expected to happen between six and 18 months after enactment (the Treasury Secretary must fix the designated transfer date within 60 days after enactment). As a result, a period of great uncertainty as to what state laws apply to national banks and federal thrifts may generate confusion and inconsistent rulings in the courts.

Aside from these major changes and areas of concern, at least two aspects of the new law can be considered genuinely good news for banks. First, the law expressly provides that banks will maintain their ability to charge interest at the rate allowed by the laws of the state in which they are located (known as “most favored lender authority”). Under the definition of “interest” in the applicable OCC and OTS regulations, this provision would include not only interest on loans, but other types of fees connected with the extension of credit such as late fees, insufficient fund fees, over limit fees, annual fees, cash advance fees, and membership fees. This aspect of the Dodd-Frank Act will be critical to national banks seeking to offer a variety of consumer and loan products across multiple jurisdictions. Second, the new preemption standards will not apply to any contract entered into by national banks prior to enactment. This provision should preempt the applicability of state laws to contracts entered with consumers prior to the new law’s enactment such as credit and ATM card agreements, deposit accounts, and similar contracts.

For further information, please contact your Nixon Peabody attorney or:

- Karl D. Belgum at 415-984-8409 or kbelgum@nixonpeabody.com
- Krista P. Bell at 415-984-8451 or kpbell@nixonpeabody.com
- Raymond J. Gustini at 202-585-8725 or rgustini@nixonpeabody.com
- Vernon Johnson at 202-585-8401 or vjohnson@nixonpeabody.com
- Christopher M. Mason at 212-940-3017 or cmason@nixonpeabody.com
- Paulette Morgan at 212-940-3703 or pmorgan@nixonpeabody.com
- Carolyn G. Nussbaum at 585-263-1558 or cnussbaum@nixonpeabody.com
- W. Scott O’Connell at 617-345-1150 or soconnell@nixonpeabody.com
- George J. Skelly at 617-345-1000 or gskelly@nixonpeabody.com
- Todd C. Toral at 415-984-8206 or ttoral@nixonpeabody.com