

Update on Watters v. Wachovia

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The order of the United States Supreme Court granting certiorari in the case of *Watters v. Wachovia*, issued on June 19, 2006, has attracted considerable attention in the banking world, and for good reason. The case raises the question whether national banks' operating subsidiaries are shielded from state laws by the regulation of the Office of the Comptroller of the Currency declaring that "State laws apply to national bank operating subsidiaries to the same extent that those apply to the parent national bank" [i.e., hardly at all]. 12 C.F.R. § 7.4006.

As has been widely reported, this is the first national bank preemption case to be considered by the Supreme Court in almost a decade. Moreover, the granting of certiorari, despite the lack of conflict among the federal Courts of Appeal on the questions presented, has led to speculation that the Court may be about to end the OCC's long winning streak on preemption issues, either reversing the lower courts' determination that state laws generally do not apply to a national bank operating subsidiaries, or limiting the degree of deference due to the OCC when it issues preemptive regulations of the type at issue in this case.

Watters is scheduled for oral argument on November 29, and the possible implications of the Supreme Court's ultimate decision in the matter, whether it has been

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issued or not, will be the subject of a program at our Spring Meeting in March, jointly sponsored by the Banking and Consumer Financial Services Committees. A panel discussion on preemption is also on the agenda for the Banking Committee's Fall meeting next month.

For those readers who, like this writer, are not steeped in Supreme Court jurisprudence and have not been following the *Watters* case closely until now, I will try in this article to provide a primer on the dispute, including a summary of the proceedings below, a brief description of the questions on which certiorari was granted, and some thoughts about the strength of the parties' respective arguments.

The Proceedings Below

The *Watters* case arises from the mortgage lending operations in Michigan of Wachovia Mortgage Corporation ("Wachovia Mortgage"), a North Carolina corporation. Although Wachovia Bank has no physical presence in Michigan, Wachovia Mortgage (previously First Union Mortgage Corporation) had been licensed under Michigan's Mortgage Brokers, Lenders and Servicers Licensing Act when it was a bank holding company subsidiary. However, in April 2003, Wachovia Mortgage notified the Michigan authorities that it had become a wholly owned operating subsidiary of Wachovia Bank on January 1, 2003, and that it would be surrendering its Michigan lending registration. Michigan's Office of Insurance and Financial Services advised the company that, effective July 1, 2003, Wachovia Mortgage would no longer be authorized to make mortgage loans in Michigan and Wachovia Bank and Wachovia Mortgage brought suit in federal court seeking declaratory and injunctive relief to prevent the State from

attempting to interfere with the exclusive visitorial rights of the Comptroller of the Currency.

The district court ruled for Wachovia.² It reasoned that national banks are generally free from state visitorial powers under the National Bank Act,³ and that the Act also grants the OCC broad authority over national banks' operating subsidiaries. The court also noted that the OCC has promulgated regulations authorizing national banks to conduct bank-permissible activities through operating subsidiaries,⁴ subjecting operating subsidiaries to the OCC's visitorial authority to the same extent as their bank parents,⁵ and providing that operating subsidiaries are subject to state laws "to the same extent that those laws apply to the parent bank."⁶ Applying *Chevron* deference, the court rejected Michigan's argument that the promulgation of Section 7.4006 exceeded the OCC's authority. The court also gave short shrift to the State's contention that the OCC's regulation violated the Tenth Amendment to the U.S. Constitution by effectively converting state corporations like Wachovia Mortgage into instrumentalities of federal law, relying on Congress's authority under the Commerce Clause to regulate national banks. The United States Court of Appeals for the Sixth Circuit affirmed the decision following an essentially similar analysis of the issues.⁷

Watters is one of four cases raising the question of state regulatory authority over national banks' operating subsidiaries that have been working their way through the federal courts in the past two years, all of which have been decided in favor of national

² Wachovia Bank v. Watters, 334 F. Supp. 2d 957 (S.D. Mi. 2004).

³ 12 U.S.C. § 484(a).

⁴ 12 CFR § 5.34(e)(1).

⁵ 12 CFR § 5.34(e)(3).

⁶ 12 CFR § 7.4006.

⁷ Wachovia Bank, N.A. and Wachovia Mortgage Corporation v. Linda A. Watters, 431 F.3d 556 (6th Cir. 2005).

banks and their operating subsidiaries at both the district court and appellate levels: Wachovia Bank, N.A. v. Burke, 319 F.Supp.2d 275 (D. Conn. 2004), aff'd, 414 F.3d 305 (2d Cir. 2005), petition for cert. pending, No. 05-431 (applying *Chevron* deference and holding that Section 7.4006 prevents the Connecticut Department of Banking from requiring licensing of or otherwise regulating Wachovia Mortgage); Wells Fargo Bank v. Boutris, 265 F.Supp.2d 1162 (E.D. Cal. 2003), aff'd, 419 F.3d 949 (9th Cir. 2005) (holding that Section 7.4006 prevents the California Commissioner of Corporations from exercising visitorial authority over mortgage lending operating subsidiaries of Wells Fargo Bank and National City Bank of Indiana; that the State licensing of such subsidiaries was field-preempted by the OCC's own regulations with respect to national bank operating subsidiaries; but that California's restriction on the charging pre-recordation interest during certain periods was *not* preempted by the Depository Institutions Deregulation and Monetary Control Act of 1980); National City Bank v. Turnbaugh, 367 F.Supp.2d 805 (D.Md. 2005), aff'd, Nat'l City Bank v. Turnbaugh, 2006 U.S. App. LEXIS 20538 (4th Cir. 2006) (Section 7.4006 prevents Maryland Commissioner of Financial Regulation from exercising visitorial authority over, or enforcing Maryland restrictions on certain mortgage prepayment penalties against, operating subsidiaries of National City Bank).

Questions Presented and the Parties' Main Arguments

The Supreme Court granted certiorari with respect to both questions presented in Michigan's petition:

1. 12 USC § 484(a) of the National Bank Act limits visitorial powers over “national banks” except as authorized by federal law. National banks are defined and created under the National Bank Act. State-chartered nonbank operating subsidiaries of national banks are created under State

corporate law. The Comptroller of the Currency, by Rule 12 CFR 7.4006, made 12 USC § 484(a) equally applicable to State-chartered nonbank "operating subsidiaries" of national banks. Is the interpretation of the Comptroller of the Currency that 12 CFR 7.4006 preempts Michigan's laws regulating mortgage lending as applied to State chartered nonbank operating subsidiaries, entitled to judicial deference under *Chevron USA, Inc. v. Natural Resources Defense Council*?

2. A national bank has been declared to be a national corporation in *Guthrie v. Harkness*. 12 CFR 7.4006 treats a State-chartered nonbank operating subsidiary of a national bank as equivalent to a national bank and, thus, as a national corporation. The Tenth Amendment to the United States Constitution is violated to the extent a statute permits the conversion of State corporations into federal ones in contravention of the place of their creation. *Hopkins v. Federal Savings & Loan Ass'n v. Cleary*. Does 12 CFR 7.4006, by equating a State-chartered nonbank operating subsidiary with a national bank for purposes of federal preemption of State regulation, violate the Tenth Amendment to the United States Constitution?⁸

The larger portion of the State of Michigan's Brief on the merits, filed on September 1, 2006, develops the State's contention that 12 C.F.R. § 7.4006, to the extent it purports to prevent a state from exercising visitorial authority over a state-chartered operating subsidiary, is plainly inconsistent with 12 U.S.C. § 484(a), which refers only to the OCC's exclusive visitorial authority over "national banks." Michigan also contends that the lower courts improperly applied *Chevron* deference in upholding the Comptroller's regulation, arguing that such deference is inappropriate when an agency interprets its own regulation to preempt State law in areas of traditional State police power, namely regulation of state-chartered entities and consumer protection.

In a shorter portion of its brief, Michigan argues that Section 7.4006 violates the Tenth Amendment because it "impermissibly federalizes a State corporation." The State

⁸ The Tenth Amendment states: "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."

places considerable reliance on the Supreme Court's decision in Hopkins Federal Savings Loan Ass'n v. Cleary, 296 U.S. 315 (1935). In *Hopkins*, the Supreme Court ruled that Section 5 of the Home Owners' Loan Act, 12 U.S.C. § 1464, which permits a state-chartered thrift institution to convert to a federal charter, may not, in light of the Tenth Amendment, be applied to permit such a conversion over the objection of the chartering state (in this case, Wisconsin). The Court, in an opinion by Justice Cardozo, reasoned that the formation, existence and supervision of what it called "building and loan associations," including the manner and timing of their dissolution, were "matters of [the State's] government policy, which it would be an intrusion for another government to regulate by statute or decision, except when reasonably necessary for the fair and effective exercise of some other and cognate power explicitly conferred." 296 U.S. at 337. Michigan contends that the effect of Section 7.4006, barring states from exercising visitatorial authority over State-chartered corporations, is to similarly encroach on state functions in a manner prohibited by the Tenth Amendment to the Constitution.

As of this writing, Wachovia, having been granted an extension of time until November 3, has not yet filed its brief on the merits. But the main elements of its arguments presumably can be found in its Brief in Opposition to Michigan's petition and in the Brief for the United States as Amicus Curiae opposing the granting of certiorari in the similar *Burke v. Wachovia* case. The Brief for the United States makes the main argument succinctly:

In light of the unchallenged preemption of state laws with respect to a parent national bank, and the undisputed authority of a national bank to conduct its banking functions through an operating subsidiary, it follows that the Comptroller has authority to preempt the application of state laws to an operating subsidiary to the same extent that those laws would be preempted with respect to the parent national bank.

Brief for the United States as Amicus Curiae at 14, *Burke v. Wachovia Bank* (No. 05-431).

It seems likely that, when it is filed, Wachovia's Brief on the merits of the case will, in addition, describe fully all the horrible consequences that can be expected to ensue in the event national banks' operating subsidiaries should be forced to comply with local laws.

What Next?

It is understandable that the granting of certiorari on the two questions presented in *Watters* should have evoked serious concerns among national banks. Under Supreme Court Rule 10, a petition is granted "only for compelling reasons" and, of the reasons identified in the Rule for granting cert. in the absence of a disagreement among the courts of appeal, the only ones that seems to apply are:

a United States court of appeals has decided an important question of federal law that has not been, but should be, settled by this Court, or has decided an important federal question in a way that conflicts with relevant decisions of this Court.

Sup. Ct. R. 10.

Since the lower federal courts that considered *Watters* and the similar cases in other circuits seemed to have had little difficulty deciding in favor of national bank preemption, it is natural to infer that the Justices perceive a problem that needs correction and can be expected to reverse the Court of Appeals as to at least one of the questions presented (although it would not be unprecedented for the Court, having granted cert. despite the absence of a conflict among the circuits, to affirm).⁹

⁹ See, e.g. *Saenz v. Roe*, 526 U.S. 489, 498 (1999) (affirming a decision of the U.S. Court of Appeals decision enjoining implementation of California's durational residency requirement for certain welfare benefits).

It may be tempting, as well, to speculate that the presence of two new conservative Justices on the Supreme Court – Chief Justice Roberts and Justice Alito – will result in a tilt towards states' rights that makes a reversal in *Watters* more likely. However, it is questionable that Chief Justice Roberts and Justice Alito are more sensitive to federalism concerns than the Justices they replaced. A third member of the Court who might be expected to be generally sympathetic to states' rights – Justice Thomas - has apparently recused himself from the case.¹⁰ In any event, although states' rights were long associated with the legal apparatus of segregation, federalism issues are no longer so readily susceptible to analysis along lines of left versus right. They may arise now in the context of states' attempts to implement policies more "liberal" than those enshrined in Federal law, such as permitting medical use of marijuana, conferring a right to end one's life voluntarily with a doctor's assistance or, indeed, protecting state consumers from predation or other perceived abuses by national mortgage lenders.

To predict the outcome in *Watters*, it may be more useful to consider the legal merits of the parties' positions rather than the ideological composition of the Supreme Court. In this regard, whatever the wisdom of the broad preemption of state laws in favor of national banks' operating subsidiaries as a matter of policy, the legal arguments in its favor seem persuasive. Michigan's assertion that preemption in this case is barred by the Tenth Amendment seems particularly unconvincing. To paraphrase the United States' brief as *amicus* in *Burke v. Wachovia*, if a national bank may lawfully carry out certain functions through a state-chartered operating subsidiary, why should state laws not be

¹⁰ Justice Thomas took no part in the consideration or decision of the petition for certiorari in *Watters*. Since he also took no part in the Court's decision in *Wachovia v. Schmidt* (addressing the question of a national bank's citizenship for purposes of diversity jurisdiction), he apparently has recused himself from all cases involving Wachovia Bank.

preempted with respect to such a subsidiary to the same extent as with respect to its national bank parent? The *Hopkins Savings & Loan* case, on which the State places so much reliance in its brief, seems readily distinguishable. That case involved Wisconsin's assertion of an interest in its own continued jurisdiction over a specially chartered corporation that it had *itself* chartered. It is not self-evident that the State of Michigan has a similarly strong interest in the regulation of a corporation, such as Wachovia Mortgage, chartered by a *sister* state. Moreover, Justice Cardozo's opinion for the *Hopkins* court expressly indicated that the provision of HOLA that was in question did not implicate the Commerce Clause.¹¹ In contrast, both the District Court and the Court of Appeals in *Watters* found that Congress has assumed authority to regulate national banks under the Commerce Clause, a basis of authority undercutting the State's Tenth Amendment claim.¹² Therefore, if the Supreme Court decides that it is appropriate to correct in some fashion the legal approach followed by the lower federal courts in *Watters* and similar cases, it seems somewhat more likely that the Court will rule on the first question presented in Michigan's petition, regarding the degree of deference due to federal agencies when they preempt state laws, rather than invoking a sweeping right of the States, grounded in the Constitution, to regulate state corporations. A decision clarifying the appropriate degree of deference might even leave undisturbed the outcome below, while establishing a framework for more careful consideration of state concerns in future cases of this type.

¹¹ 296 U.S. at 338-9.

¹² 451 F.3d at 563; 334 F.Supp.2d at 966.