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Legal Update

With this, the first edition of "Legal Update," the aim is to provide timely information useful to you in your current role. While there can be no pretense that in all cases information contained in these Updates will be the first summary you have seen of the developments reported here, the focus, will, however, be on imminent or recent rulings—whether judicial or administrative and whether of potential significance for the regulated community, antitrust developments, ethics, or a host of other important areas affecting your practice. This first article deals with a case presently pending at the U.S. Supreme Court which may have an important bearing on the ability of an agency to issue rules or regulations purporting to pre-empt state laws. Whether through my own firm or General Counsel on Demand (see accompanying brochure), you will find the bandwidth you need for any project or deal at reasonable cost. Your comments and critique are welcome at any time. Below is only a short recitation of the background and the parties' arguments; the Briefs filed with the Court should be consulted for a more fulsome articulation of their position. Thank you in advance for your thoughts.

IN *WATTERS*, U.S. SUPREME COURT SET TO RULE ON PRE-EMPTION — AGAIN

In ***Watters v. Wachovia Bank, N.A. et al.*** (Docket No. 05-1342), the U.S. Supreme Court is set to issue a ruling in the Spring, 2007 which may have a vital bearing on the ability of federal agencies to issue rules or regulations seeking to pre-empt state laws. Whether it is the authority of the Department of Homeland Security to issue chemical plant security regulations capable of pre-empting stringent state rules, such as New Jersey's, or EPA's ability to issue certain pre-emptive regulations governing state conduct in the regulation of pesticides, further litigation will most likely arise in this area over the next few years. At this point, and after *Bates v. Dow AgroSciences LLC* in the agrichemical arena**,** *Watters v. Wachovia Bank, N.A. et al*. is the next significant case likely to have an impact on this doctrine.

BACKGROUND

Dating back to 1863 when Congress first authorized the chartering of national banks, The National Bank Act (the "Act") was intended to address federal revenue needs by replacing notes issued by state-chartered banks with a new national currency linked to the purchase of federal bonds. The Act states that no national bank shall be subject to any "visitorial powers except as authorized by Federal law" and provides that a national banking association shall have the power through its board of directors and officers to exercise "all such incidental powers" necessary to carry on the business of banking. "Visitorial powers" include a state's examination of the bank's "manner of conducting business." Pursuant to that provision, in 1966 the Office of the Comptroller of the Currency (OCC) adopted a regulation which authorized national banks to establish operating subsidiaries. The OCC was silent on the issue of whether states would no longer be able to regulate state-chartered nonbank operating subsidiaries of national banks. In 2001 the OCC issued a regulation which provides that an operating subsidiary engages in activities "pursuant to the same authorization, terms and conditions that apply to the conduct of such activities by its parent national bank." The OCC has also issued regulations which provide that state licensing requirements do not apply to state-chartered operating subsidiaries. The OCC now asserts that the National Bank Act allows it to issue regulations extending to state-chartered, nonbank operating subsidiaries of national banks, thereby preempting state laws regulating them.

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Linda A. Watters is the Commissioner of the Michigan Office of Financial and Insurance Services (OFIS) charged with enforcing Michigan's Mortgage Brokers, Lenders, and Servicers Licensing Act ("MBLSLA") and the Secondary Mortgage Loan Act. Mortgage brokers, mortgage lenders, and mortgage servicers which are subsidiaries of depository financial institutions are required to register with OFIS if the depository financial institution does not maintain a main office or branch in Michigan. The State's licensing statutes give OFIS important authority to prevent fraud and dishonesty and enables the Office to suspend or revoke a licensee or registrant if OFIS finds there has been fraud, material misrepresentation, deceit, etc.

At the time of this action, Wachovia Mortgage Corporation ("Wachovia Mortgage") is a wholly-owned subsidiary of Wachovia Bank, N.A. ("Wachovia Bank") which in turn is a wholly-owned subsidiary of Wachovia Corporation, a publicly-traded financial services holding company. Wachovia Bank is national bank as defined in the federal statutes and has its main offices in Charlotte, North Carolina. It has no physical presence (including no branch offices) in Michigan. As a State-chartered, nonbank, operating subsidiary of Wachovia Bank, Wachovia Mortgage is organized under the laws of the State of North Carolina. Wachovia Mortgage holds a Certificate of Authority from the Michigan Corporation Division to transact business as a Foreign Profit Corporation in Michigan under Michigan's Business Corporation Act.

Between March 27, 1997 and January 1, 2003, however, and because it was then a wholly-owned subsidiary of Wachovia Corporation, a financial holding company which also owned Wachovia Bank, Wachovia Mortgage "registered" in Michigan to engage in the business of making first mortgage loans under Michigan's MBLSLA. That Act did not require Wachovia Mortgage to be "licensed." As a subsidiary of a depository institution (Wachovia Bank), Wachovia Mortgage is exempt under Michigan law from licensure and must only "register" with the Commissioner of OFIS. Wachovia Mortgage submitted a financial statement within 90 days of its fiscal end each year, paid an annual operating fee to renew registration, submitted an annual report to the State, and maintained documents for possible examination by State officials. By letter, dated April 3, 2003, Wachovia Mortgage notified OFIS that on January 1, 2003, it had become an operating subsidiary of Wachovia Bank and would therefore engage in mortgage lending and servicing activities in Michigan "as authorized by regulations of the OCC." As a result, it claimed exemption from State regulations and asserted that since Michigan's registration requirements do not apply to a national bank, they therefore cannot be applied to an operating subsidiary of one. OFIS, by letter, dated June 23, 2003, notified Wachovia Mortgage that without a State registration pursuant to MBLSLA, it would no longer be authorized to conduct its mortgage broker, lender and servicer activities in Michigan as of July 1, 2003, the date of expiration.

Respondents Wachovia Bank and Wachovia Mortgage proceeded to file a Complaint in Michigan's U.S. District Court for the Western District, seeking declaratory and injunctive relief prohibiting Commissioner Watters from enforcing Michigan's mortgage laws against Wachovia Mortgage and argued that Michigan's mortgage laws were preempted by the Act, as well as by regulations promulgated by the OCC. Michigan argued that the Act does not grant authority to the OCC to preempt State law through an administrative regulation granting to State-chartered nonbank operating subsidiaries all of the immunities from State oversight, just as they were federally-chartered national banks. Michigan also argued that the Act, as construed by the OCC violates the Tenth Amendment to the United States Constitution which states that "powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States . . . ."

The U.S. District Court held that the limitation on visitorial powers in the Act, were, indeed, extended by OCC's regulation to State-chartered nonbank operating subsidiaries of national banks and that the OCC's rule was entitled to deference under *Chevron USA, Inc. v. National Resources Defense Council*, 467 U.S. 837 (1984). The Sixth Circuit Court of Appeals affirmed and held in part that as "Congress has not spoken precisely on the issue", the regulations were within OCC's authority and were a reasonable interpretation of the Act. Michigan's Commissioner now appeals to the U.S. Supreme Court.

QUESTIONS PRESENTED

1. Whether regulations issued by the OCC preempt Michigan's laws governing mortgage lending in the case of a State-chartered nonbank operating subsidiary.

2. Whether OCC's regulation and supervision of a State-chartered nonbank operating subsidiary violates the Tenth Amendment to the United States Constitution by treating it as a national bank for purposes of federal preemption of State regulation.

ARGUMENTS

A. Petitioner's Arguments – The Commissioner contends that the Act preempts State authority only with respect to "national banks", not separate legal entities such as Wachovia Mortgage that are not themselves "national banks." According to Watters, the Act has a defined meaning which does not include operating subsidiaries. Specifically, "national banks" are defined as (i) a depository institution that has applied for and received a charter from the OCC to conduct banking, (ii) is eligible to become a Federal Reserve member bank, and (iii) is eligible to obtain federal deposit insurance from the Federal Deposit Insurance Corporation. The limitation on State powers only extends to "national banks" and does not extend to "affiliates". Citing other authority, the Commissioner points to the Alternative Mortgage Transaction Parity Act as evidence that Congress intended to preserve states' authority to regulate state-chartered nondepository lenders like Wachovia Mortgage. Nor can the "incidental powers" granted to national banks by the Act be understood to include the power to erase the legal distinction between "national banks" and their "affiliates". In contrast, the Commissioner argues that just as Wachovia Bank would not argue in favor of piercing the corporate veil of Wachovia Mortgage should Wachovia Bank learn that its subsidiary had engaged in mortgage fraud, breaches of fiduciary duty, or other acts, so the two entities cannot be construed as identical for preemption purposes.

Pointing to the presumption against preemption, the Commissioner argues that the Supreme Court has said that "Congressional intent to supersede state laws must be 'clear and manifest'." The issue here is whether states can regulate state-chartered nonbank operating subsidiaries of national banks. Historically, states have been the traditional regulators of state-chartered nonbank entities, as well as state-chartered lending institutions. Here, the OCC has asserted that its exclusive visitorial powers over national banks precludes states from enforcing their own consumer protection laws against national banks. Arguing that the OCC clearly does not have the same state interest in enforcing consumer protection laws, the Commissioner points to the Department of Housing and Urban Development and the Department of the Treasury as other Departments which have urged additional state action to combat predatory lending practices. Nor, according to Petitioner, is the deference to federal administrative agencies as was held in *Chevron* appropriate in this case. Agency rules preempting state laws are not entitled to *Chevron* deference since administrative agencies such as OCC have no institutional interest in taking state sovereignty concerns into account. A delegation of authority to promulgate standards does not include the authority to decide the pre-emptive scope of a federal statute. Lastly, the Commissioner stresses OCC's regulations violate the Tenth Amendment to the United States Constitution since that Amendment has been recognized as preventing certain federal intrusions upon states even where Congress is operating in a field otherwise within the scope of its Commerce Clause power.

B. Respondent's Arguments – Wachovia points not only to the Act's grant of "all such incidental powers as shall be necessary to carry on the business of banking," but also to the Gramm-Leach-Bliley Act which endorsed the principle that banking activities conducted through operating subsidiaries are subject "to the same terms and conditions that govern the conduct of such activities of national banks." Michigan laws are preempted because they require national banks to obtain the State's permission to engage in mortgage lending through an operating subsidiary, and condition the exercise of that power on submission to State supervision, examination, and enforcement authority. The "terms and conditions" that govern national bank activities include the requirement that such activities are subject to the OCC's exclusive "visitorial" authority and, as a result, only the OCC can examine, regulate, and supervise national banking activities. Michigan's laws are also preempted by several of OCC's notice and comment rules, no less than were the preemption the act of federal statutes.

Wachovia argues that the OCC only regulates national banking activities and not the corporate existence or corporate governance which are determined by the law of the chartering state. For 40 years, the Comptroller has recognized that the incidental powers of national banks include the power to carry out federally-authorized banking activities through an operating subsidiary. Indeed, the OCC has licensed nearly 500 operating subsidiaries that deal directly with consumers, as well as other subsidiaries that do not involve direct interactions with consumers. Since the Act gives "incidental powers" to national banks, Wachovia argues that the State cannot condition a national bank's exercise of those powers on the grant of State permission. Nor, Respondent argues in its Brief, can Michigan interfere with a national bank's decision to exercise its mortgage lending powers through the corporate structure of an operating subsidiary by subjecting the national bank to fragmented State and local mortgage-lending regulation and supervision. Requiring that an operating subsidiary obtain licenses from as many as 50 states, as well as city and county governments, is clearly not the same licensing "terms and conditions" as requiring a national bank to obtain a single license from the OCC. Wachovia argues that accepting Petitioner's argument would therefore allow states to apply their own substantive standards to national bank activities conducted through operating subsidiaries.

Michigan's laws conflict not only with OCC's operati

ng subsidiary regulation, but also with that Agency's real estate lending rules, both of which were promulgated by all the notice and comment procedures of the Administrative Procedure Act. These regulations are just as preemptive as federal statutes. Citing *Fid. Fed. Sav. & Loan Ass'n v. de la Cuesta,* 458 U.S. 141 (1982), Respondent points out that the Court held that a regulation of the Federal Home Loan Bank Board permitting federal savings and loan associations to include due-on-sale clauses in mortgage contracts preempted a state law prohibiting such clauses. Wachovia argues that the Court held that the relevant question is "whether the [agency] meant to pre-empt California's due-on-sale law, and, if so, whether that action is within the scope of the [agency's] delegated authority." In this case, Congress has, according to Wachovia, recognized the OCC's authority to preempt state law.

In addition, OCC is entitled to deference in its rulemaking since, according to the Brief, "the agency is likely to have a thorough understanding of its own regulation and its objectives and is uniquely qualified to comprehend the likely impact of state requirements", citing *Geier v. Am. Honda Motor Co.,* 529 U.S. 861 (2000). Since a ruling that a state law conflicts with federal law is a policy determination, Wachovia argues that under the rationale of *Chevron* such determinations should be made by a politically-responsible branch of the government. Nor is OCC's rulemaking violative of the Tenth Amendment since the regulation of mortgage lending and banking activities clearly is within Congress' Commerce Clause powers. ■

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