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Supreme Court Holds Federal Law Preempts State Regulation of National Bank Operating Subsidiaries

2007-04-17

On April 17, 2007, the Supreme Court handed down a long-awaited decision about national bank operating subsidiaries and state visitorial powers. *Watters v. Wachovia Bank, N.A.*, No. 05-1342. In a 5-3 opinion written by Justice Ginsburg, the Court held that state regulators may not require such operating subsidiaries to register with state agencies and submit to their supervision. Chief Justice Roberts and Justices Stevens and Scalia dissented; Justice Thomas did not participate. The majority opinion ruled: "[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."

Focus on National Bank Powers

The Supreme Court's grant of certiorari in *Watters* had attracted widespread attention because the Court decided to review the case even though every lower federal court to rule on the question had held unanimously in favor of federal preemption. Unlike most other federal courts, however, the Supreme Court majority analyzed the case through the lens of national banks' powers authorized by the National Bank Act (NBA), rather than focusing on the Act's visitorial powers provisions or deferring to the 2004 regulation issued by the Office of the Comptroller of the Currency (OCC) concerning application of state law to operating subsidiaries.

The majority opinion begins by recounting the NBA's vesting in national banks of enumerated and "incidental powers as shall be necessary to carry on the business of banking" under 12 U.S.C. § 24 Seventh, and the Court's repeated decisions holding that states may not prevent or significantly interfere with the banks' exercise of such powers. The Court emphasized that state laws subjecting national banks themselves to registration, inspection and enforcement would "surely interfere with the banks' federally authorized business" by requiring compliance with such regulations in every state in which a national bank operates.

The Court then turned to operating subsidiaries, which are authorized by the OCC only to engage in activities that are permitted for their national bank parents. The Court noted that Michigan did not dispute a 40-year-old OCC interpretation recognizing that a national bank's use of an operating subsidiary is itself an incidental power under 12 U.S.C. § 24 Seventh and is subject to supervision

by the OCC. The Court concluded that requiring compliance with a state supervisory regime would significantly burden mortgage lending when performed by an operating subsidiary, just as when such lending is performed by the parent national bank. The Court reviewed its national bank preemption precedents, emphasizing that such decisions "have focused on the exercise of a national bank's *powers*, not on its corporate structure" and that the Court has "never held that the preemptive reach of the NBA extends only to a national bank itself." Accordingly, the Court held that the Act directly prohibits states from significantly impairing or impeding national banks' mortgage lending through an operating subsidiary.

Many observers expected that the decision would address the degree of deference a court should give the OCC's regulations regarding preemption, which has been a matter of debate. Justice Stevens's dissent argued that the OCC's interpretation should not stand in the absence of legislation expressly immunizing operating subsidiaries from state regulation or expressly authorizing the OCC to preempt state laws that it determines interfere with national bank activities. The majority concluded, however, that arguments about deference to the OCC's regulations were an "academic question" in this case because the National Bank Act itself preempted the state laws

Other NBA Preemption Issues

Although *Watters* determined that visitorial powers preemption applies to national bank operating subsidiaries, other important issues were not addressed in the case and remain unresolved. For example, the Court did not address the language in 12 U.S.C. § 484(a) which provides exceptions to the general prohibition against state regulators' exercise of visitorial powers over national banks.

The Court also did not discuss in detail which substantive state regulations may apply to national banks, other than to note its precedents recognizing that, for example, national banks' "contracts" and "acquisition[s] and transfer[s] of property" are governed by and based on state law. The Court also noted that the parties did not dispute that state law will continue to govern operating subsidiaries' incorporation-related issues (such as formation, dissolution and internal governance). Nor did the Court provide much guidance on when substantive state laws sufficiently impede bank activities to trigger preemption. The Court's visitorial powers analysis focused on the burden and undue duplication imposed on national banks and their operating subsidiaries by multiple examination and enforcement regimes. Further, as discussed above, the Court did not reach the question of deference to agency preemption determinations.

Some of these issues may be addressed in other preemption cases pending before lower federal courts, such as *OCC v. Spitzer*. Moreover, in the coming weeks public debate may shift to matters concerning the federal banking regulators' oversight capacity. House Financial Services Chairman Barney Frank has long criticized the breadth of national banking preemption, and Senate Banking Chairman Christopher Dodd responded to *Watters* by promising to "look closely at the commitment displayed by federal banking regulators to upholding their safety and soundness duties and their equally important consumer protection and enforcement responsibilities."

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