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PREEMPTION UNDER THE HOME OWNERS LOAN ACT

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I. Background: Constitutional and Statutory Basis for Preemption--The Framework of Analysis

A. Constitutional Basis.

The doctrine of federal preemption is derived from the Supremacy Clause of the U.S. Constitution, which makes federal law supreme and requires state authorities to be bound by such law, "any thing in the Constitution or law of any state to the contrary notwithstanding. *U.S. Const*., Art. VI, c1.2. In determining whether a state statute is preempted by federal law, the Supreme Court has instructed that "our sole task is to ascertain the intent of Congress." *California Federal Savings and Loan Association v. Guerra*, 479 U.S. 272, 280 (1987). If the investigation determines that Congress did indeed intend to preempt state law, any state law which purports to regulate the area occupied by federal law is preempted.

B. Three Types of Federal Preemption

1. **Express.** Congress may preempt state law by expressly stating its intent. *See*, *e.g.*, *Jones v. Rath Packing Co*., 430 U.S. 519, 525 (1977).

2. **"Field."** Congressional intent may be inferred in a particular area, *see California Federal*, 479 U.S. at 280. "Implied" includes statutes in which "the scheme of federal regulation is sufficiently comprehensive to make reasonable the inference that Congress 'left no room' for supplementary state regulation." *Rice v. Santa Fe Elevator Corp*., 331 U.S. 218, 230 (1947). In this latter situation, Congressional intent to preempt state law results from the fact that Congress has "occupied the field" available to state regulation.

3. **"Conflict."** Federal law preempts state law even where there is no express or implied intent of Congress to preempt state regulation, if

the state law conflicts with federal law. This conflict can result from the fact that state regulation makes compliance with the federal law a "physical impossibility," *Florida Lime and Avocado Growers. Inc. v. Paul*, 373 U.S. 132, 142-43 (1963) or where the state law stands "as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941). *See also Barnett Bank v. Nelson*, 517 U.S. 25 (1996).

C. Overview of HOLA Preemption.

With respect to federal associations, the Home Owners Loan Act, ("HOLA"), provides for the chartering and regulation of such institutions and has been regarded as "occupying the field" with respect to their operations and activities. This view was first stated in *California v. Coast Federal Savings and Loan Association*, 98 F. Supp. 311 (S.D. Cal. 1951). It was discussed favorably by the United States Supreme Court in *Fidelity Federal Savings and Loan Association v. de la Cuesta*, 458 U.S. 141 (1982) (*"de la Cuesta"*) but not relied on in the holding. OTS regulations and staff interpretations incorporate this view.

D. A Note about National Bank Preemption.

The National Bank Act ("NB Act") is structured differently from HOLA and provides a basis only for "conflict" preemption. Nevertheless, it appears that the Comptroller of the Currency ("OCC") in recent years has minimized the practical difference through adoption of rules that address more comprehensively the scope of the NB Act. Through adoption of such rules, including one describing the scope of NB Act preemption, the OCC has established an express basis for preempting any state law that would impinge upon the business of national banks and thus has made express the "field" it believes is occupied by the NB Act.

E. Applicable state law and role of state courts

1. **State laws not subject to preemption**. The federal agencies recognize that HOLA and the NB Act govern the conduct of banking activities and other activities provided federal banking institutions under their charters, but do not totally displace all state law. As reflected in the *Gibson v. World Savings* case, below, while state "consumer protection" laws that address banking operations tend to be preempted, federal institutions may be successfully sued under state unfair and deceptive practices laws, fair lending laws, or other provisions that may reach conduct regarded as egregious. The boundaries between appropriate banking practices, operations, and charges and those that are regarded as excessive, unscrupulous, or

deceptive are now being tested, for example, as states pass predatory lending statutes. See the OTS preemption opinions concerning 2002 enactments by Georgia and New York, below.

2. **Role of state courts**. Further, as a number of California cases illustrate, state courts may not adopt an "occupy the field" analysis of HOLA or may find the field smaller than the OTS would draw it. These courts may uphold state action unless it specifically conflicts with an applicable federal statute or regulation. *See, e.g., Fenning v. Glenfed,* 40 Cal App 4th 1285 (1995), *People ex rel Sepulveda v. Highland FS&L*, 14 Cal App. 4th 1692 (1993), *Siegel v. American S&L,* 210 Cap App 3d 953 (1989).

II. The Scope of The Home Owners Loan Act

A. General OTS Powers. HOLA provides the authority for the creation and regulation of federal savings associations, the establishment of the OTS, and also invests power in the Director of the OTS to carry out the responsibilities of the Director of the office. 12 U.S.C. § 1462a(b)(2). Pursuant to HOLA, the Director of OTS is required to "provide for the examination, safe and sound operation, and regulation of savings associations." 12 U.S.C. § 1463(a)(1). The statute expressly empowers the Director to issue regulations to carry out the duties of his office, and specifically empowers him to provide for the charter, organization, incorporation, examination, operation and regulation of federal associations. 12 U.S.C. § 1464(a)(1).

In addition to establishing the OTS and empowering the Director of the OTS to regulate the operations of federal savings associations, HOLA includes provisions concerning charter, governance, operations, affiliations, supervision and customer relations.

B. OTS "Occupation of the Field." While Congressional intent to preempt state law is not expressly stated in HOLA, the regulatory scheme created by HOLA nonetheless appears to be comprehensive with respect to federal savings associations and thus supports the view that HOLA should be read to "occupy the field," thereby preempting all state regulation of federal savings associations' charter activities.

1. **Seminal Case.** In *California v. Coast Federal Savings and Loan Association*, 98 F. Supp. 311 (S.D. Cal. 1951), the seminal case which involved state laws purporting to regulate federal savings associations chartered pursuant to HOLA, the court examined HOLA and the regulations promulgated by the FHLBB, and noted the "cradle to grave" regulatory regime created by HOLA and

FHLBB regulations. *Id.* at 316. The court concluded that HOLA and the federal regulations occupy the field, stating that "not only does the Act of Congress which authorizes the creation, operation and supervision of federal savings and loan associations . . . embrace the entire field, but the comprehensive rules and regulations adopted by the Board clearly meet the test of covering the subject matter of the statute." *Id.* at 318. The Court concluded by holding that the state statute was invalid as applied to the defendant.

2. The U.S. Supreme Court's View

a) Illustrative of the Supreme Court's approach to HOLA is *Fidelity Federal Savings and Loan Association v. de la Cuesta*, 458 U.S. 141, (1982), in which the Court reviewed the preemptive effect of a federal regulation concerning due-on-sale clauses in loans made by federal savings associations. The Court held that a California limitation on the enforcement of due-on-sale clauses to circumstances where the lender's security was impaired was invalid. 458 U.S. at 162. The Court found that the regulation, whose preemptive intent was clarified in the preamble to the final regulation, preempted the conflicting state law. The Court stated that where Congress has delegated discretionary power to an administrator the preemptive power of his regulations are subject only to the scope of his statutory authority. Thus, the federal regulations have the same preemptive power of statute. *Id.* at 153-154.

b) In considering the preemptive effect of the HOLA, the Court in its the holding stopped short of relying on field preemption. Nevertheless, it stated that HOLA contains "broad language" with no express limits on the authority of the FHLBB "to regulate the lending practices of federal savings and loans." In reaching this decision, the Court examined the issue of whether the FHLBB's preemptive regulation exceeded its authority, and found that the "language and history of the HOLA convince us that Congress delegated to the Board ample authority to regulate the lending practices of federal savings and loans so as to further the Act's purposes." The Court found that the due-on-sale regulation was consistent with the "principal purposes" of HOLA – the question to ensure that federal savings and loans "would remain financially sound institutions able to supply financing for home construction and purchase." *Id.* at 168.

C. Preemption By Regulation

1. **General OTS rules**. Like its predecessor, the OTS has used its rulemaking authority to promulgated a relatively comprehensive set of regulations implementing HOLA, including the regulations of savings accounts, investments, real estate lending practices, other loans, investments, and the operations of thrift offices. These regulations clearly preempt conflicting state laws and as a result in many cases OTS does not need to rely upon a "field" preemption approach. Nevertheless, OTS has included a catchall statement of its intent to occupy the field in its rules.

2. **OTS Preemption Rules**

   a) In 12 C.F.R. § 545.1, OTS states the general rule that a federal savings association "may exercise all authority granted it by [HOLA] and its charter and bylaws, whether or not implemented specifically by Office regulations, subject to the limitations and interpretations contained in this part."

   b) Section 545.2 states that the OTS part 545 regulations were issued under "the plenary and exclusive authority of the [OTS] to regulate all aspects of the operations of Federal savings associations, as set forth in section 5(a) of the Act. This exercise of the Office's authority is preemptive of any state law purporting to address the subject of the operations of a Federal savings association."

   c) A further rule in §560.2 concerning "applicability of law" specifically addresses the operations and lending activities of federal thrifts. Under the heading "occupation of field," the rule states that under sections 4(a) and 5(a) of HOLA, OTS is "authorized to promulgate regulations that preempt state laws affecting the operations of federal savings associations when deemed appropriate to facilitate the safe and sound operation of federal savings associations, to enable federal savings associations to conduct their operations in accordance with the best practices of thrift institutions in the United States, or to further other purposes of the HOLA. To enhance safety and soundness and to enable federal savings associations to conduct their operations in accordance with best practices (by efficiently delivering low-cost credit to the public free from undue regulatory duplication and burden), OTS hereby occupies the entire field of lending regulation for federal savings associations. OTS intends to give federal savings associations maximum flexibility to exercise their lending powers in accordance with a uniform federal scheme of regulation. Accordingly, federal

savings associations may extend credit as authorized under federal law, including this part, without regard to state laws purporting to regulate or otherwise affect their credit activities, except to the extent provided in paragraph (c) of this section or §560.110 of this part [concerning usury, see below]. For purposes of this section, 'state law' includes any state statute, regulation, ruling, order or judicial decision."

d) The rule then provides "illustrative examples" of the types of state laws preempted by this paragraph. These include requirements concerning:

(1) Licensing, registration, filings, or reports by creditors;

(2) Private mortgage insurance, insurance for other collateral, or other credit enhancements;

(3) Loan-to-value ratios;

(4) The terms of credit, including amortization, deferral and capitalization of interest, and adjustments to the interest rate, balance, payments due, or term to maturity of the loan, including loan calls;

(5) Loan-related fees, e.g., initial charges, late charges, prepayment penalties, servicing fees, and overlimit fees;

(6) Escrow and similar accounts;

(7) Security property;

(8) Access to and use of credit reports;

(9) Disclosure and advertising, including statements, information, or other content required in credit application forms, solicitations, billing statements, contracts, or other credit-related documents, or requirements to supply copies of credit reports;

(10) Processing, origination, servicing, sale or purchase of, or investment or participation in, mortgages;

(11) Disbursements and repayments;

(12) Usury and interest rate ceilings to the extent provided in 12 U.S.C. 1735f-7a and 12 U.S.C. 1463(g) and OTS rules in part 590 and §560.110 ; and

(13) Due-on-sale clauses.

e) In subparagraph 560.2(c), the following types of state laws are not preempted. ("to the extent that they only incidentally affect the lending operations of Federal savings associations"):

(1) Contract and commercial law;

(2) Real property law;

(3) Homestead laws specified in 12 U.S.C. 1462a(f);

(4) Tort law;

(5) Criminal law; and

(6) "Any other law" that OTS, upon review, finds:

(a) Furthers a "vital state interest" and

(b) Either has only an "incidental effect on lending operations" or is "not otherwise contrary to the purposes" of this rule.

D. Usury and Most Favored Lender Status. 12 U.S.C. 1463(g) provides express federal preemption for federal thrifts to override state usury laws and is parallel to the NB Act provision, 12 U.S.C. § 85, that provides both for "most favored lender" status for NBs and interstate export of uniform interest rates, as construed in the landmark *Marquette National Bank v. First of Omaha* case. OTS rule § 560.110 implements this statute and describes "most favored lender usury preemption".

1. It defines "interest" to include "any payment compensating a creditor or prospective creditor for an extension of credit, making available of a line of credit, or any default or breach by a borrower of a condition upon which credit was extended."

2. The rule provides that "interest" includes periodic interest rates, late fees, not sufficient funds (NSF) fees, overlimit fees, annual fees, cash advance fees, and membership fees, but does not "ordinarily" include appraisal fees, premiums and commissions attributable to insurance guaranteeing repayment of any extension of credit, finders' fees, fees for document preparation or notarization, or fees incurred to obtain credit reports.

3. It states the "most favored lender" rule that a "savings association located in a state may charge interest at the maximum rate permitted to any state-chartered or licensed lending institution by the law of that state. If state law permits different interest charges on specified classes of loans, a federal savings association making such loans is subject only to the provisions of state law relating to that class of loans that are material to the determination of the permitted interest."

4. It further states that a federal savings association may, for example, lawfully charge the highest rate permitted to a state-licensed small loan company (without being so licensed), subject to state law limitations on the size of loans made by such companies.

5. Finally, the rule addresses the interplay of federal and state definitions of interest, noting that the federal definition does not change how interest is defined by states "solely for purposes of state law." It gives the example of late fees, stating that if state law permits its most favored lender to charge late fees, then a federal association located in that state may charge late fees to its intrastate customers even though state law may not define such fees as "interest." The association may also charge late fees to its interstate customers because the fees are "interest" under the federal definition and an allowable charge under home state law. "However, the late fees would not be treated as interest for purposes of evaluating compliance with state usury limitations because state law excludes late fees when calculating the maximum interest that lending institutions may charge under those limitations."

E. Recent Examples of OTS Preemption Interpretations

1. 2002 Georgia Fair Lending Act ("GFLA") – P –2003-1 (January 21, 2003)

a) These GFLA restrictions impose different requirements depending upon whether a loan is a “home loan,” a “covered home loan,” or a “high-cost home loan." Restrictions on the terms of credit and loan-related fees are placed on all “home loans," including prohibiting the financing of credit insurance, debt cancellation coverage, or suspension coverage, and limiting late fees and payoff statement fees. “Covered home loans” are subject to further restrictions including the number of times a loan may be refinanced and the circumstances in which a refinancing may occur. “High-cost home loans” are subject to all of these restrictions and a number of other disclosure requirements and restrictions on the terms of credit and loan-related fees. For these loans, the creditor must disclose that the loan is "high-cost," and borrowers must attend loan counseling before the loan may be made. The sweeping nature of this statute has generated sufficient market uncertainty that FNMA and FHLMC will not acquire loans subject to GFLA and the rating agencies have stated they cannot rate mortgage securities including such loans.

b) In finding these provisions preempted the OTS made the following points:

(1) GFLA provisions purporting to regulate the terms of credit, loan-related fees, disclosures, or the ability of a creditor to originate or refinance a loan, are preempted by federal law from applying to federal savings associations because uniform federal scheme occupies the field of regulation for lending activities. The comprehensiveness of the HOLA language demonstrates that "Congress intended the federal scheme to be exclusive, leaving no room for state regulation, conflicting or complementary." GFLA imposes a number of specific restrictions and requirements on home loans and would regulate areas covered by regulation 560.2. It therefore "does not apply" to federal savings associations' home lending.

(2) However, OTS only found certain parts of the GFLA provisions preempted. In a footnote the opinion states: "As per telephone discussions between you and OTS staff, however, this opinion does not address certain specific provisions within those sections: GFLA 5 7-6A-5(11)-(13), which imposes certain requirements for foreclosures on high-cost home loans and GFLA 5 7-6A-5(6), which pertains to the ability of borrowers to assert claims or defenses in court."

(3) This opinion further states that, to the extent that the Association conducts its lending operations through an operating subsidiary, federal law preempts application of the same GFLA provisions to the operating subsidiary as are preempted for the Association.

(4) Finally, the opinion addresses whether the Association or its operating subsidiary may fund loans in the Association's or the operating subsidiary's name arranged by independent mortgage brokers where the loan terms do not comply with GFLA. Noting that OTS regulations specifically preempt state laws purporting to impose requirements on federal savings associations regarding processing and origination of mortgages, the opinion concludes that GFLA would not restrict the Association or the operating subsidiary from funding loans in its own name, as long as the loan documents evidence that the Association or the operating subsidiary is the lender.

2. 2002 New York Predatory Lending Law.

a) In Opinion P-2003-2, issued January 30, 2003, the OTS Chief Counsel addressed a New York law due to take effect in April 2003 that imposes a range of requirements on "high-cost home loans," including terms of credit, loan-related fees, disclosure and advertising, origination, refinancing, and servicing. The statute also provides a "multi-faceted compliance scheme," authorizing the state Attorney General, Superintendent of banks, or "any party to a high-cost home loan" to enforce the law through litigation.

b) Citing the statutory and regulatory provisions supporting its "field" preemption approach, the opinion finds that the New York law attempts to regulate areas covered by § 560.2 and is thus preempted.

c) Parallel to the Georgia opinion, this opinion notes that Congress gave "OTS, not the States, the task of determining the best practices for thrift institutions and creating nationally uniform rules." However, unlike the opinion issued a week earlier this document gives more detail about the consumer protections provided by the OTS regime: safety and soundness and consumer protection examinations, a toll-free consumer hotline for complaints and questions, and OTS authority to require institutions to take corrective action if a violation is found of federal consumer laws or regulations, which are enumerated. It concludes this discussion by quoting from the preamble to its 1996 rulemaking when it adopted its preemption rules: Uniformity "furthers both the 'best practices' and safety and soundness objectives of the HOLA by enabling federal thrifts to deliver low-cost credit to the public free from undue regulatory duplication and burden."

d) It also found the various compliance provisions, including the threat of litigation and foreclosure rules, preempted, because they would have the effect of compelling a federal thrift to comply with preempted provisions concerning lending.

F. A State Court Concurs: *Lopez v. World Savings*, 105 Cal. App. 4th 729 (No. A095666, January 23, 2003)

In *Lopez*, the court reviewed the imposition of a $10 fax charge by a federal savings association in conjunction with the pay-off of a borrower's loan, a charge that would not have been permissible under state law. The court held that even though the OTS had not adopted a rule specifically permitting such a charge, the allegation that it was

impermissible under the state unfair competition law ("UCL") was preempted under 12 C.F.R. § 560.2. The court distinguished the *Gibson* case, *infra*, on the ground that it dealt with the obligations of the parties to a contract and not, as in *Lopez,* with lending activities of federal associations.

III. State Limits on Preemption: *Gibson v. World Savings,* Cal. App. 4th E029823 (slip op. Nov. 27, 2002)

A. Plaintiffs sued this federal association in California state court alleging that the association had, *inter alia*, violated the UCL by purchasing replacement hazard insurance ("forced order insurance" ["FOI"]) at rates much higher than the borrower's prior policies. They alleged that the federal thrift benefited by charging the borrowers the full price of the more expensive policy, which included both the cost of the insurance as well as administrative services arising from the insurer's charges for monitoring the association's entire portfolio, which included loans to which the FOI program did not apply.

B. World, supported by an amicus brief by the OTS, countered that its FOI program and charges were permissible under its federal charter and that because HOLA occupies the field with respect to its lending and related activities, the California UCL claims are preempted. The court rejected the preemption claim because claims under HOLA and Section 545.2 of the OTS regulation do not preempt claims under the UCL The court summarized its conclusion quoting a prior case: State law cannot tell the bank "how its can or cannot operate, but it can insist that, however the Bank chooses to operate, it do so free from fraud and other deceptive business practices." Slip op. at 19.

C. The court stated that historic state police powers are not superseded by federal law unless it is the "clear and manifest purpose of Congress" and that regulation of banks to protect consumers is an historic police power. World thus must bear the burden of overcoming a presumption against preemption. *Id.* at 13.

D. In assessing the plaintiffs' claim that World's FOI practices were fraudulent because they misrepresented the costs of the replacement insurance, the court stated that a contracting party must act reasonably to mitigate damages of the other party's breaches (*i.e.,* failure of the borrower to maintain required insurance coverage), that the lender has a duty not to misrepresent material facts and to refrain from unfair and deceptive practices, and that HOLA does not preempt these duties and contractual principles. Moreover, the state law rules were not directed at regulating federal savings institutions and any effect on bank lending activities was incidental, not material. *Id.* at. 14-15.

E. The Court supported its conclusion by reference to the preamble to the final OTS preemption regulation adopted in 1996. That states that section 560.2(c) of the rule intends to "preserve the traditional infrastructure of basic state laws that undergird commercial transactions," which prevents states from using laws that "look like traditional property, contract, tort or commercial laws, but in reality are aimed" at regulating lender activities. The Court found the UCL one of these traditional state laws and not directed at regulating banking activities.

F. World has appealed this case to the California Supreme Court.