Consumer Finance Monitor (Season 6, Episode 51): What the Recent Developments in Federal Preemption for National and State Banks Mean for Bank and Nonbank Consumer Financial Services Providers

Speakers: Alan Kaplinsky, John Culhane, Reid Herlihy, Ron Vaske, and Mindy Harris

Alan Kaplinsky:

Welcome to the award-winning Consumer Finance Monitor podcast where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. This is a weekly show brought to you by the Consumer Financial Services Group at the Ballard Spahr Law Firm. I'm your host, Alan Kaplinsky, the foreign practice group leader for twenty-five years, and now Senior Counsel of the Consumer Financial Services Group at Ballard Spahr. And I'll be moderating today's program.

For those of you who want even more information, don't forget about our blog, ConsumerFinanceMonitor.com. We've hosted our blog since 2011, so there is a lot of relevant industry content there, including a lot of information about the topic we'll be discussing today. We also regularly host webinars on subjects of interest to those in the industry. So to subscribe to our blog or to get on the list for our webinars, please visit us at BallardSpahr.com. And if you like our podcast, please let us know about that. Leave us a review on Apple Podcasts, Google, or wherever you obtain your podcasts. Also, please let us know if you have ideas for other topics that we should consider covering or speakers that we should consider inviting as guests on our show.

I'm very excited and pleased to tell our listeners today that very recently our podcast show was ranked by Good to Be Social as the number one podcast among law firm podcast shows in the United States devoted exclusively to consumer financial services. Good to Be Social is a prominent law firm consulting firm owned by best lawyers. We're very gratified by this recognition from one of the country's leading social media consultants for law firms.

Today's episode is the repurposing of a webinar that we held on November 30 entitled Recent Important Developments in Federal Preemption for National and State Banks: What They Mean for Bank and Non-Bank Consumer Financial Services Providers.

Let me turn now to our program today. A series of recent important developments are creating big challenges for providers of consumer financial services that rely on federal preemption to charge customers uniform interest rates and fees on a nationwide basis. In addition to state legislative efforts to expand the reach of state law, the scope of federal preemption is under challenge in federal and state courts. While federal banking regulators have historically taken an expansive view of federal preemption, the traditional deference that courts have given to such interpretations could and will be, very soon revisited based on the outcome of a case soon to be decided by the US Supreme Court. Actually two cases, the Raymundo and the Relentless cases that I mentioned altogether.

So now what I would like to do, let me introduce all of our speakers. I almost neglected to do that. John Culhane. John I've practiced with longer than any of my other colleagues, decades literally. And John, people always want to know what John focuses on. The answer is he focuses on everything and anything pertained to consumer finance and he has what we all call encyclopedic knowledge of a lot of different areas. And the topic we're talking about today, namely National Federal Preemption and more specifically National Bank Act preemption is one of the areas, many areas in which he has a tremendous depth of knowledge.

Reid Herlihy, he is in our mortgage banking group. Reid has been following the case that's now pending before the Supreme Court that he's going to address in a moment, the Cantero versus Bank of America case where the Supreme Court recently granted cert on the question of whether the National Bank Act preempts state laws that require the payment of interest on

mortgage escrow accounts. And Reid has been following that issue very, very closely and he and John will be talking about that case.

And Ron Vaske in our Minnesota office is a partner in the firm and Ron is very, very much involved in bank model of partnerships or joint ventures. And of course there are enormous federal preemption and national, not so much national bank preemption because most of the, if not all of the partnerships are with state charter banks, but there are very serious preemption issues raised by those kinds of arrangements. And Ron's going to, among the other things say, bring us up to date on a very important opinion that came down from the California's Superior Court.

And finally, Mindy Harris and Mindy has been with us for a couple of years, maybe it's a little longer than that. And she came to us from after having worked at a consulting firm for several years as general counsel and then prior to that was general counsel to Nordstrom's credit card bank. And of course there are a lot of preemption issues that are implicated when you are giving legal counsel with respect to credit card banks and Mindy will be talking about that today.

So without further ado, I'm going to first turn it over to Reid and Reid is going to tell you about the very important Cantero v. Bank of America case.

Reid Herlihy:

Thank you Alan. Hi everybody. So I'm going to sort tee up our broader discussion today with kind of an overview of one of the primary events bringing us all together here and that's the Supreme Court granting cert in Cantero. I'm going to delve into kind of some of the competing arguments for and against preemption and the standards argued for in the split circuits and also in one of the meekest briefs filed for the petition for cert.

So last month the Supreme Court granted cert to hear Cantero on the issue of whether the National Bank Act preempts the New York law, requiring interest to be paid on, or to consumers on mortgage servicing escrow accounts. And I have the law copy there on the slide. It essentially is a 2% interest payment requirement for single-family owner-occupied properties in New York. And one thing agReid upon the standard for preemption here in Barnett Bank and as codified by the Dodd-Frank Act is whether the state law prevents or significantly interferes with the exercise by the National Bank of its powers.

So moving into Cantero, the Second Circuit held that thankfully that the National Bank Act preempts the New York law and in doing so, the court asserted that in applying the standards of Barnett Bank, a court must employ what it called long-established ordinary legal principles of preemption to that standard of whether the state law prevents or significantly interferes with the exercise by the bank of its powers.

So on review, the Second Circuit rejected the lower court's approach of really weighing on a case-by-case basis the impact or the degree of interference with the bank's exercise of its powers for purposes of applying the Barnett standard. Instead, using the standard they mentioned employing the long-established legal principles, the court cited the line of cases back to 1819 Supreme Court case of McCullough v. Maryland and held that it's not a question of how much a state law impacts the National Bank, but whether it purports to control the exercise of its enumerated and incidental powers, incidental to those enumerated powers, which just is not a question of degree. Or put differently by the court, it's the nature of the invasion into a national bank's operations, not the magnitude of its effects that determines whether the state law purports to exercise control over a federally granted banking power and is therefore preempted.

So with that standard, the Second Circuit held by, requiring a bank to pay its customers in order to exercise a banking power granted by the federal government and that power being the power to create and fund escrow accounts, the law would exert control over bank's exercise of that power and therefore it is preempted by the National Bank Act. Separately, the Second Circuit elaborated and stated that the enactment of Dodd-Frank had no effect on the National Bank Act's preemption standard as it simply codified a body of pre-existing case law.

So why the granting of cert? Well that decision constitutes a split with the Ninth Circuit in a line of cases really starting with the 2018 decision in Luznak v. Bank of America, which was more recently affirmed in the 2022 case in the Ninth Circuit of Kivett versus Flagstar Bank. And we note a petition for cert was also filed in Kivett and those cases similarly weigh whether California's 2% interest on escrow laws preempted by the National Bank Act.

So in Luznak, the Ninth Circuit, they took a more indirect approach. I mean they did an exploration of the impact of Dodd-Frank on National Bank Act preemption. They discussed some of the underlying motivations and need for the Dodd-Frank

Act. Assessed in more detail the impact of the OCC's preemption regulations. On that they said that Dodd-Frank did in fact alter the existing standard for National Bank Act preemption, but only to the extent it involves the process for the OCC's future preemption determinations which have to be on a case-by-case basis. And there are additional procedural steps, but they can see that those changes don't really have bearing here where the preemption determinations being made by the court and not the OCC.

Regarding the OCC's preemption regulation, they take a pretty dim view of any deference to be afforded to the OCC there. They apply Skidmore and held that under Skidmore that the OCC's preemption regs would've been entitled to little if any deference in light of Barnett and even before of the enactment of the Dodd-Frank Act. More specifically, the court stated that the regulation was the OCC's articulation of its legal analysis and while the OCC purported to adopt the supreme Court's articulation of the applicable preemption standards, it did so inaccurately.

But more directly to the question of whether California's interest on escrow law prevents or significantly interferes with the bank's powers. The Ninth Circuit kind of summarily just stated that it does not, it does not do so. And only elaborated to say that minor interference with federal objectives is not enough. They really just said the standard is whether the law prevents or significantly interferes with the bank's ability to exercise its powers. Applying that standard we hold the laws not preempted because it does not prevent or significantly interfere with Bank of America's exercise of its powers. And then they sort of following that they kind of just pivot to a different aspect of the Dodd-Frank Act which amended a separate provision in TILA that governs mortgage escrow accounts to further this argument.

So the amendment to TILA that they cite states that if prescribed by applicable state or federal law, each creditor shall pay interest to the consumer on the amounts held in escrow in the manner prescribed by that applicable state or federal law. And because of the existence of that provision, in again a separate section of the Dodd-Frank Act, the Ninth Circuit reasoned that Congress had expressed its view that such laws would not necessarily prevent or significantly interfere with the national bank's operations. Of course, as we know TILA applies to banks and non-banks, I'll leave it at that. But oddly the court then sort goes on to state that the term applicable is used there in the Truth and Lending Act, would appear to include any relevant or appropriate state laws that require creditors to pay interest on escrow funds. And further that the inclusion of the term applicable makes sense only because not all states have interest in escrow laws.

Again, sort of dismissing the possibility that a state interest in escrow law may not be applicable to perhaps the entire range of entities subject to TILA. We also note that some of those state interests on escrow laws expressly on their face exempt national banks because for instance, they are found in state mortgage licensing statutes that expressly exclude depositories. And then the rest of the decision points to the drop back of the 2008 mortgage crisis. And again, the modus of Dodd-Frank and at one point sort of oddly alluding to the role of mortgage servicing escrow accounts in the subprime mortgage crisis.

So that's what we have in the Ninth to sort of round out the circuit split. I did also want to briefly talk about an amicus brief filed by the DOJ and they did so at the invitation of the court just to sort of give you another perspective of the competing arguments here. The petition, sorry, the brief from Solicitor General Prelogar essentially said, "Certs shouldn't be granted because neither of the Second nor the Ninth got it right. And both cases are flawed vehicles for review."

In terms of the heart of their argument on preemption, the DOJ argued that the court has to make a practical assessment of the degree to which the state law will impede the exercise of a bank's powers. They say a court has to assess the law's likely practical effect on national bank's ability to exercise those powers. They really base that argument simply looking at the plain and ordinary definition of the terms significant and interfere. According to the DOJ, the Second Circuit's analysis is especially flawed because it implies that substantially all state consumer financial laws are going to be preempted and the categorical approach taken runs counter to the ordinary meaning of the term significantly interferes.

Regarding the Ninth Circuit, the DOJ also thinks they erred but this time not actually conducting that case specific degree of interference analysis. And as I said, they kind of pivot from that and instead make a purely legal determination based on a separate escrow provision in TILA. It also says both Flagstar and Cantero are flawed vehicles, but Flagstar is better than Cantero if they have to hear one of them. Of course, as we know the Supreme Court did grant cert and it did so for Cantero but not Flagstar. So here we are and that's the framework of the competing standards and arguments at issue for the petition for cert. And so now I'm going to go ahead and hand things off to John Culhane to sort of further explore some of the possible ramifications of these cases.

John Culhane:

Thanks Reid. So I think Reid has made it very clear that with the decisions in the Second and the Ninth Circuit and even with the Solicitor General's brief, we have teed up very differing views as to what the standard is for preemption, how it applies in this situation and what the results should be.

So one of the things we're concerned about here obviously is that this could very well, depending on how the decision comes down, this could very well kick off a wave of litigation over OCC preemption. So we thought it might be a good idea with that in mind, to kind of walk you back through what happened with the Dodd-Frank Act and how we got to where we are and the positions that the OCC has taken.

Right now the OCC's preemption rules are all set for the 12 CFR Part 7 Subpart D, well most of them are, and there are a group of them. There's one I haven't listed, I'll mention that in a second. But we have the rules around visitorial powers, which the OCC amended to reflect the decision in Cuomo v. Clearing House saying that states can sue national banks. And there were also changes that incorporated that in the law that resulted from Dodd-Frank. 7.401, the provisions around charging interest, defining what interest means very broadly, any payment compensating the bank for an extension of credit, including the most favored lender test, discussing the impact of state definitions of interest and how they apply with regard to interstate and interstate lending. There's a provision that deals with interest charged on loans to corporate borrowers where state law provides that corporate borrowers can't assert a defensive of usury and then tacked on at the end is the valid one made provision.

7.4002 is really all other non-interest charges and fees. And the OCC really provides for a lot of discretion on the part of national banks, basically saying that the fees that are going to be charged or business decisions to be made by the bank at its discretion and sort of making it clear that there's really not any room for state regulation in that space. 7.407 and 7.408 respectively deal with deposit taking and lending. And in each of these subsections of Part 7 we have provisions that state of general rule for preemption and provide a long list by category, not by specific state, of the kinds of laws that are preempted in this area. There's also another provision, Section 7.4010, which just says that the same rules apply for federal savings associations.

So what did Dodd-Frank do here? I think those of you who've been practicing in this area for a long time know that the Office of the Comptroller of Currency has traditionally been quite the supporter of preemption for national banks. Maybe not to the extent that the old Federal Home Loan Bank Board was for federal savings and loan associations, but very aggressive in asserting preemption. And Dodd-Frank changed all that and the questions really are how do those changes work?

Now as a result of language that appears in 12 U.S.C § 25b, state consumer financial laws, that's a defined term I'll come back to, our preempted only in three situations. If state law discriminates against national banks, that is there's a discriminatory effect on national banks compared to the effect on state chartered banks. The language at issue in Cantero, if state law prevents or significantly interferes with the exercise of national bank powers, that's specifically said to be the Barnett Bank standard and if a federal law other than the National Bank Act preempts state law. So there are modest preemption provisions in a number of the other federal consumer financial laws like the Truth and Lending Act, particularly in the credit card area. Fair Credit Reporting Act has preemption provisions, et cetera.

There are two important exceptions here and they're going to come into play as well. Preemption is preserved with respect to charging interest, although there's I guess a question as to how far that preservation goes. The statute specifically refers to Section 85 and seems to indicate that the Comptroller's interpretation of Section 85 asset forth in 7.4001 is preserved as well. So that's great exportation most favored lender fees deemed to be interest.

Arguably at least in terms of Dodd-Frank, the decisions in Marquette on rate exportation and Smiley on late fees being deemed to be interest, are preserved as well. And then there's a preservation of preemption for visitorial powers, although it's tweaked to reflect the Cuomo decision again allowing states to sue but not examine or conduct investigations of national banks.

So that's what the law says on its face. What does it mean? Well, as I mentioned, only state consumer financial laws may be preempted. There's no field preemption. That's a defined term. So in order to be preempted, this has to be a law that directly and specifically regulates the manner content or terms and conditions of any financial transaction or any account offered with

respect to a consumer. If it's not a state consumer financial law, then we're not dealing with these standards. But there are some specific rules here for how preemption decisions are supposed to be made.

Preemption decisions have to be made on a case-by-case basis. A determination concerning the impact of a state consumer financial law or the laws of any other states with substantially equivalent terms requires a case-by-case determination. We'll talk a little bit about that, a little bit more about that in a minute. And OCC decisions determinations here no longer get Chevron deference. They only get Skidmore deference. Reid alluded to that earlier.

Skidmore deference is a much lower standard of deference and basically requires the agency to make its case as to why its consideration should be controlling. And it does that through the thoroughness evident in its consideration of the issues, the validity of its reasoning, the consistency with other valid determinations that have previously been made and other factors that might be persuasive and relevant that it can present. But it doesn't simply get a free pass if it can say that a law provisions are silent or ambiguous.

Dodd-Frank also imposes a lot of procedural barriers on preemption determinations and those are going to be significant. Preemption decisions can't be delegated. They have to be made by the comptroller at the comptroller level. The comptroller is directed to consult with the Consumer Financial Protection Bureau whenever it's making one of these determinations and the determinations have to be made through formal proceedings. That seems to mean notice and comment under the Administrative Procedures Act or it's not defined. But the OCC must marshal substantial evidence in support of its determination and must make specific findings spelling out exactly what terms it believes are preempted and why. And then preemption determinations have to be published quarterly. They have to be reviewed at least once every five years and also the OCC has to report to Congress.

So Dodd-Frank laid all of this out and then the OCC went through a rulemaking process where it decided what it all meant. Started that process back in May of 2011, May 26 when it published its proposed rules and it published its final rules in the federal Register on July 21. And it looked at all of this and it made very few changes to its prior preemption rules, including importantly that the Dodd-Frank standard doesn't apply retroactively and that the standard is I think more like the Second Circuit viewed it, that it's really just a conflict preemption standard. It's the discussion of impairs or significantly interferes is just one of the ways there can be a conflict.

So any law that impedes a national bank in the exercise of its powers is preempted and that's the standard it applies. The revocation of Chevron deference doesn't apply retroactively, any of the actions and any of the regulations that it had in place prior to July 21 are not affected, and it can base its determinations on categories of state laws. And that's not field preemption, that's still conflict preemption.

Now significantly, the Solicitor General and the Department of the Treasury seemed to have raised concerns. Well, have raised concerns with the way the OCC views the law. During the comment period on the OCC's proposed rule at the 11th hour, there was a very substantial letter from the Department of the Treasury that disagReid significantly with the OCC's view of Dodd-Frank. Saying that the way it's proceeding, it's basically reading prevents or significantly impairs out of the law completely, that Dodd-Frank's changes don't just apply only prospectively, that they also apply retroactively and that it's improper to preempt broad categories of state law.

State laws have to be analyzed on a state-by-state basis. Maybe there's an exception where you can map state laws in one state to identical terms in another state, but you can't just lump all state laws in a particular category together. And as Reid mentioned, the Solicitor General's brief opposing the grant of certiorari disagReid with the position taken by the OCC. Interestingly, that brief doesn't even cite Chevron. So we've really got a lot of issues here that could give rise to further litigation depending on the decision in Cantero. So it remains to be seen where national bank preemption is going to go. Let me stop here and turn it over to Mindy and Ron to talk about state law issues and to start with opt-out.

Mindy Harris:

Thanks John. As John said, Ron Vasky and I are going to talk about interest rate, rate exportation and I'm sure everyone here is an avid student of rate exportation, but I did want to give you just a little bit of background to catch up on it. So on this slide you can see the basic federal laws that establish rate exportation in case anyone needs it. National Bank Act as John and Reid explored, that derives from civil war era legislation, it's been around a very long time and was enacted to avoid state laws

that would discriminate against national banks and John just very thoroughly explained the OCC's point of view and the Dodd-Frank carve out with respect to Section 85.

So national bank rate exportation power is very strong but it's not a panacea when it comes to challenges to rate exportation in some circumstances as we'll discuss later. State chartered banks rate exportation added in 1980 by virtue of the Depository institution's Deregulation and Monetary Control Act of 1980 DIDMCA. I guess that was before Congress was thinking of snappy acronyms for legislation, so we have to call it DIDMCA, to create competitive equality between state chartered banks and national banks. And Federal Savings Association and State Savings Association exportation rights also originally derived from DIDMCA, although as we'll discuss later, the DIDMCA amendment to the then National Housing Act was repealed and then replaced by FIREA and turned into a section of the Homeowners Loan Act and still provides rate exportation powers to federal savings associations and savings associations.

Credit unions, federally insured credit unions, also DIDMCA added Section 205 of the Federal Credit Union Act. Just as a side note, federally chartered credit unions are subject to an interest rate cap. Currently, it's 18% and does preempt state law. And so the effect is that state chartered federally insured credit unions exportation rights are sort of like state banks and federally chartered credit unions currently have the 18%.

And then just as a reminder, most fees by virtue of case law and the Comptroller's rule and the credit union rules generally are included as interest for purposes of rate exportation power. And again, a reminder that when we want to talk about bank, non-bank partnerships, you've got a bank that makes the loans and exports the rates permitted by its home state and the non-bank facilitates market services. The loans and the proliferation of financial technology, especially in the last I would say 10 years, and lack of traditional credit alternatives available to the unbanked population or underbanked population really created these opportunities to expand multi-state presence for banks. And the bank's ability to export charge uniform rates and fees across the country is what's really important in what fuels these partnerships.

Over the last, I would say 20 years and ramping up consistently over the last 10 years or so, there are these specific types of challenges to banks' rate exportation rights from both private plaintiffs and putative class actions and state attorneys general. And the categories of these challenges are, first the opt-out approach. Now we're going to discuss this in detail shortly with respect to state chartered banks, DIDMCA created an opt-out where states could opt out of state bank exportation rights. This one doesn't affect national banks, so Ron and I are going to jump to that topic shortly.

The second type of challenge is a true lender theory and that can be asserted even when it's a national bank that's the lender. This theory is asserted when there's a bank, non-bank partnership that creates the loans. And then the third kind of challenge to valid when made is to rate exportation is that if the loan is sold to a third party, sold into a securitization or sold to another kind of purchaser, that the rate exportation power does not survive. And that is contrary to what's called a valid when made principle. Ron and I are not going to be focusing on that, but I believe Alan is going to be speaking about some aspects of that issue and that litigation later on.

So let me hand it over to Ron for a moment to go into more detail about the Section 525 DIDMICA opt out.

Ron Vaske:

Thanks Mindy. I'll start out by with as Mindy discussed, Sections 521 through 523 of DIDMCA are intended to give state banks the same authority as national banks with respect to interest rate authority. And that's particularly with the respect to the right to export interest from their state to residents of another state. This parity was and still is controversial, particularly because of this exporting right that DIDMCA was adopted really in the wake of the Supreme Court's Marquette decision which created that right.

So given the controversy when Congress granted this parity, it also adopted a compromise that was Section 525 of DIDMCA. This gave states the right to override parity with respect to loans made in, and I stress that term made in, any state that adopts a law explicitly opting out of Sections 521 through 523. Now before getting too deep into Section 525, I think it's important to stress that this opt-out right applies only with respect to state chartered institutions. There's no similar opt-out right applicable to national banks. So Section 525 definitely limits the parity granted to state institutions really quite significantly.

Initially there were eight states, Colorado, Iowa, Maine, Massachusetts, Nebraska, North Carolina, Puerto Rico, and Wisconsin that adopted opt-out laws. All but Iowa and Puerto Rico have since repealed their opt-out legislation. For decades no one

really thought about opt-outs. Iowa and Puerto Rico weren't taking any formal action, although for years there had been rumblings about Iowa's position that it's opt-out defeated state bank's authority to export interest and loans made to Iowa residents. That has since changed. Iowa started enforcing its view with respect to its opt-out and there's been a drive by consumer groups to get additional states to adopt opt-out legislation. Mindy, we'll talk about this a little later.

One other issue pertaining to Section 525 that's interesting is that it was never formally codified. It was merely included as a statutory note under the code Section for 525. That's 12 U.S.C. 1730g which is the parity statute applicable to savings institutions. In FIREA in the '90s, Section 1730 was repealed, which has led many to argue that Section 525 itself was also repealed since it was nothing more than a note, a statutory note under the repealed statute. We're not going to get into that issue today and we'll assume Section 525 is still operative.

The repeal of Section 1730g also leads to the question of whether the opt-out right applies to savings associations at all. When Congress repealed Section 1730g it basically transferred its terms to a new statute under the Homeowners Loan Act. So Section 525 as it stands now give states the right to opt-out of Section 414 of the National Housing Act, which is a statute that no longer exists. It was repealed. It does not expressly give states the right to opt-out of the new statute under the Homeowners Loan Act.

So what does it mean when a state opts out? As I mentioned, the right to opt-out applies only to loans made in an opt-out state. So this begs the question, where is a loan made for purposes of Section 525? Not surprisingly, there's more than one view on this. On the one hand, the word made is the past participle form of the verb make. So you can argue that the plain text of Section 525 suggests emphasis on the party that makes the loan, that's the lender or the actions make as a verb the lender takes to make a loan.

Now the FEIC in the past at least has been supportive of this position. It proposed in 2005 regulations which would've clarified that a state's opt-out right only affects loans made by banks physically situated in an opt-out state. Problem is the FEIC never formally adopted this regulation. After publishing it, it received public comments and it ultimately withdrew it in 2010.

Also, in an analogous situation addressing where a loan is made in the case of banks with interstate branches, the FDIC issued General Counsel's Opinion 11 in 1998. GC-11 determined that the question of whether loans are made at the bank's main office or an interstate branch is answered primarily by looking at where certain non-ministerial lending functions are performed. Those functions are the decision to extend credit where the credit is extended from and where the funds are dispersed. In general, the state's law where the three non-ministerial functions are performed will apply. GC-11, the opinion that adopted this non-ministerial functions test, was based on legislative history included in the conference report for the Regal Meal Act in 1994, which is the law that allowed interstate branching itself. It's based on reasonable authority, not something that the FDIC or the OCC just pulled out of thin air.

On the other hand, some argue that Congress could not have intended such a result. As I mentioned previously, DIDMCA was opted in the wake of the Marquette decision which gave national banks the right to export interest rates. That was controversial. Sections 521 through 524 were enacted for the purpose of creating parity among federally insured banks, particularly with respect to the right to export interest. This was controversial and the whole point of Section 525 was a compromise to create a mechanism for preserving federalism that is the state's right to determine their own interest rates. Provenants of this view argue that Congress could not have intended such a narrow construction of Section 525 if its purpose was to create an exception to the Marquette exporting principle.

There's only one case that addresses this issue and that's Stoorman v. Greenwood Trust, a 1994 Colorado decision, Colorado Court of Appeals decision. Unfortunately, Stoorman doesn't really address the issue. It was decided on the basis of Colorado law, which at the time clearly provided that Colorado law, usury laws did not apply to loans made by out-of-state banks. Stoorman didn't have to get into the question of how to construe Section 525.

Although Stoorman may be important in that it also adopted in what is arguably just DIDMCA, the view that Section 525 was repealed, which I talked about, which would mean that the states no longer have the authority to opt out. Stoorman case didn't explain its rationale for this conclusion, presumably because it didn't have to since it decided the case based on Colorado law alone.

I'll turn it back to Mindy for discussion on state activity in the opt-out arena. Mindy?

Mindy Harris:

Thank you Ron. So bringing us down to the present, currently there are three states that have legislation in place opting out of Section 27. And those states are, and by the way, definition of state in DIDMCA includes Commonwealth of Puerto Rico. Those states are Iowa, Colorado, and Puerto Rico. As Ron mentioned, the Iowa opt-out has been in place since 1980 and it was just sitting there for decades. I recall being advised that it just wasn't something that people had to spend a whole lot of time or money worrying about. That was several decades ago.

Recently, Iowa, as Ron said, has started aggressively asserting an enforcement position, taking that latter position that Ron talked about, insisting that the opt-out prevents out-of-state state banks from exporting rates and fees into Iowa. And we're aware of at least three enforcement actions in the past I would say two and a half years, resulting in assurances of discontinuance with non-Iowa state chartered banks regarding installment loans made to Iowa residents at rates higher than what the Iowa consumer credit law permits. So Iowa is really being aggressive.

Now, interesting to point out, none of those actions involved credit card loans, they were all installment loans. And one of the reasons for that is that Iowa separately has carve-out subject to certain registration requirements that credit cards, general purpose credit cards, credit cards usable at 100 or more unrelated merchants, are not subject to those rate and fee limits of the Iowa state.

So that's where we were at the beginning of 2023. And then I would say, I think Ron will agree with me and others in the industry, really sort of unexpectedly, along came Colorado's opt-out legislation in 2023. As Ron said, Colorado originally opted out of Section 27 pursuant to Section 525 in 1981. Colorado repealed its opt out effective July 1st, 1994. So Colorado got rid of its opt out. And then in connection with a bill that also included some small dollar loan adjustments, it was signed into law in June 2023. It's effective July 1st, 2024.

Again, the Colorado law, it's unusual, it has some provisions in it that will make it difficult for people to understand exactly what they have to do. For example, it does, again, it has a carve out, carving general purpose credit cards as defined out of the Colorado Uniform Consumer credit code limits on fees and rates. But the way general purpose credit card is defined is ambiguous. It's based on a fee determination and you can't exactly tell what the language of the law is anticipating. It says in order to be a general purpose credit card among other things, you have to charge fees no greater than 15% of the available credit. But unlike Reg Z fee harvester rules, it doesn't tell you when you make that determination, which fees are included, and so hard to know how you're going to take advantage of that carve out. And of course, what about private label credit cards? Why should they be treated differently?

So there are suggestions that industry groups may be working to have Colorado clarify that carve out or make other adjustments to its law. And based on what we're hearing that may or may not happen because there's other concerns about that law in connection with what it might, if you open that law up, there might be other things that consumer advocates try to achieve.

So one of the big burning questions, and Ron please chime in on this one if you like, is are other states going to follow suit and adopt opt-out rules? And we sort of think that might happen based on our observations, our interactions, various sources. And I would go out there on a limb maybe and suggest that we might see legislation arising in some states including we are thinking maybe Oregon, California, Washington State, Minnesota, Washington DC. Ron, did you want to add any?

Ron Vaske:

The only thing... I don't think I have anything to add, I would just say we really think that's likely and this is going to be a trend that catches on.

Mindy Harris:

Yeah. So let me again turn it over to Ron for the next section, which is the other type of challenge we were going to talk about today. And that is the true lender theory.

Ron Vaske:

Thank you Mindy. Yeah, so true lender theory. What is the true lender theory? It is a theory that the non-bank partner, not the bank, in a partnership between the two is the true lender of loans. And this is based primarily on the predominant on which party holds the predominant economic interest in the loans and based on other more subjective factors as well. And as the argument goes, then the courts should elevate this substance over form, the form of the loan being that the bank is identified as the lender and therefore in that case the exportation rights don't apply. And any interest in fee restrictions that would apply to an unlicensed lender for a non-bank lender would be applicable. That there's been a lot of cases involving that. I'm going to talk about one in particular later on, but we've seen a lot of that challenging bank partnership structures.

This applies to not just state banks like the opt-out issue does, but it also applies to national banks. So it's generally a concern all around. These theories are asserted whether or not there's statutory support for it. But there are a number of states that have adopted recently and Mindy will talk about these so-called anti-evasion statutes that support this.

Mindy Harris:

Thank you Ron. So as Ron explained, we are seeing again in recent years mostly, although there are some old ones out there, states that have adopted statutes to help propel this true lender argument to defeat bank, non-bank, bank model partnerships to make loans. So the interesting thing here is that, as Ron pointed out, some of the litigation brought by AGs against bank, non-bank partnerships has been in states that have not adopted these statutes at all. But this is a list of states that we know that we're following now that have adopted specific statutes that list attributes such as predominant economic interest and then totality of the circumstances. And then they recite a lot of factors that can help a court maybe ultimately decide that the true lender in the case is really the Fintech partner and that therefore the bank partner's rate cannot be exported into that state.

So you can see this list of states here and interesting, these are not opt-out states. They're going after the bank Fintech partnership arrangement and not necessarily rate exportation by a bank by itself. Although we may see some overlap. The Georgia law is the oldest one that we know of. That was originally a payday loan that was targeting payday lending. But a putative class action was just filed this month against a bank and Fintech partner arrangement in federal court in Georgia claiming the Fintech is the true lender and using this statute as the basis for that litigation. And then as you see at the bottom of the slide, a Florida bill was just introduced again an anti-evasion bill. Many of these have the 2021, '22, '23 vintage laws have attributes of the Illinois law, which is very comprehensive and basically gives a court a lot to hang its hat on if it wants to find that the non-bank partner is the true lender.

So at that point I'd like to turn it over to Ron to talk about one specific litigation matter where a non-bank partner is fighting with the state authority, that state does not have an anti-evasion statute. So Ron, please go ahead.

Ron Vaske:

Thanks Mindy. I think probably the most important case involving the true lender theory that's out there, at least right now, is the Opportunity Financial versus the California Department of Financial Protection and Innovation. This has been going on for a while. It was originally OPFI sued the state seeking a declaratory judgment that its loans that are originated by FinWise Bank are not subject to the California usury laws that would otherwise apply if made by OPFI itself. That has brought about litigation including a move by the state to seek a preliminary injunction which would prevent OPFI from originating or facilitating these loans during the pendency of the litigation. And it is been quite a saga. OPFI argued among other things that the bank or that the DFPI was attempting to establish an underground regulation. As Mindy mentioned, there's no true lender statute in California.

Interesting development, recently October 30th and good for at least the clients that I work with, the California trial court rejected the DFPI's motion for a preliminary injunction. And this was based basically on it didn't buy the true lender theory. It applied the law really as written, did not elevate or elevate the substance argued by the DFPI over the form of the transaction and did not grant the preliminary injunction to the DFPI.

Importantly, with respect to that, it suggests and that one of the standards for the DFPI to prevail would've been that it was likely to prevail in the litigation. The court concludes that it's not likely to prevail, which of course we anticipate appeals. Maybe not from the injunction itself, but possibly. But if this case is decided against the DFPI, we're certain that it will be

appealed up to the California Supreme Court ultimately. And this could go further, it could go on to the US Supreme Court, but interesting case to watch.

With that, I will turn it over to Alan for a discussion of the potential Supreme Court override of Chevron. Alan?

Alan Kaplinsky:

An abbreviated discussion of Chevron, it's worth a lot of attention. So in 1984, the Chevron case came down and under the Chevron opinion, there is a two-step analysis that's used to determine if a court must defer to an agency's regulation that interprets the statute under which the agency's got statutory authority. So the step one, the court determines first whether the statute directly addresses the precise question before the court. If so, that's the end of the inquiry. You don't have to get to the issue of deference. If not because the statute either doesn't cover the issue or it's ambiguous, the court proceeds to step two. And the only determination it makes is whether the agency's interpretation is reasonable. If it determines that it's reasonable, the court doesn't do anything else. It exercises no independent judgment on the issue before the court.

So these are on this slide, the two cases where the Supreme Court is granted cert. These cases, one of them has been fully briefed. The Relentless case circuit granted at a later stage, but it involves essentially the same facts and the same law. It's being briefed right now. What creates the issue here, and this is really important, and that is there are a lot of opinions that have been issued by courts that have exclusively relied on Chevron deference in validating all kinds of agency regulations, including those issued by the OCC and the FDIC.

And so the question that I want to raise with all of you to make sure you have your antennae focused on this, when this case gets argued and decided, and that is, what happens if the Supreme Court overrules the Chevron deference framework, says that doesn't apply anymore. And does that get applied just prospectively or does it get applied retroactively to cases that the Supreme Court and other courts have already decided years ago? And one of those cases, Smiley v. Citibank, which is the seminal opinion where the Supreme Court concluded that a credit card late fee constituted interest within the meaning of Section 85 within the National Bank Act. And the court exclusively relied on Chevron deference and in particular relied on a regulation promulgated by the OCC while the Smiley case was pending, literally at the 11th hour, that had defined interests under Section 85 to include late fees.

So in these cases, suffice it to say, that generally when a court applies the rule of federal law to the parties in front of it, that rule will control interpretations of the federal law and has to be given full retroactive effect and all cases that are still open or on direct review. Now that doesn't apply to cases that are final like the Smiley v. Citibank case. There's the issue of a stare decisis, that is not likely to save prior decisions whose underpinnings have been eroded by subsequent developments of constitutional law.

Well, the Chevron doctrine, it's unclear whether it's a constitutional law issue or not that's embedded in the case. Some people argue that it does deal with the separation of judicial and executive powers, which is very much a constitutional issue. But others say it's just a procedural rule of convenience that has been adopted by the court in 1984. And which by the way, it very seldom follows itself, the justice ignored it. So Chevron v. Huson or Husson because that gives the court an opening to say that it will not apply an opinion, a new opinion retroactively if to do so it creates a hardship or if it would be unfair to some of the people who would be affected by the opinion. Hopefully that will be what the Supreme Court hangs its hat on. But we can't say for sure.

Just pointing out there's a six-year statute of limitations in the APA. There's another issue pending before the Supreme Court as to when the six-year statute of limitations begins to run. Does it run from when the regulation is finally issued or when an injury occurs to a party as a result of the regulation?

Final thing I want to say, I know Madden has been discussed earlier in this webinar, but that is another case where the Second Circuit relied... Well, the Second Circuit first said that the use of reprehension that a national bank has does not carry over to a debt buyer. The debt buyer is subject to state law. The OCC and the FDIC issued what we call the Madden Fix regulations to purport to overrule the Second Circuit opinion. And that got challenged by a number of state attorneys general claiming that they were incorrect interpretations. But the federal district court deferred to the OCC and the FDIC again, exclusively based on Chevron deference. And will that hold up if Chevron deference is overruled? I don't know.

So if we have about a minute left, I'll turn it over to just say a couple words about this licensing law problem.

John Culhane:

The only thing I'm going to say is that when we've seen states opt-out or assert that they've opted out, in some cases that assertion has been followed by claims that out-of-state, state charter banks have to obtain licenses. That Oregon has been most the one state that's noteworthy in this respect. And it's important to look at the state opt-out to make sure there really is an opt-out. And if there is, it's important to look and see what the lending loss still says because states sometimes enact opt-outs, but don't go back and change their lending laws and they will have left in place in some cases exemptions for out-of-state state chartered banks. So I'll stop there.

Alan Kaplinsky:

I want to thank all of our speakers today for doing a terrific job in explaining the very important developments that are occurring in this area of National Bank Act and state bank preemption of certain state laws. To make sure you don't miss our future episodes, please subscribe to our show on your favorite podcast platform, be it Apple Podcasts, Google, Spotify, or wherever you obtain your podcasts. And don't forget to check out our blog consumerfinancemonitor.com for daily insights about the consumer finance industry. And if you have any questions or suggestions for our show, please email us at podcast@BallardSpahr.com and stay tuned each Thursday for a new episode. Thank you very much for listening and have a good day.