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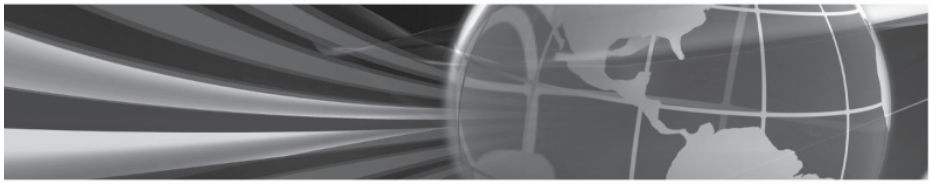
ALERT: Financial Institutions



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Supreme Court Holds National Bank Act Preempts State's Regulation of Mortgage Lending Subsidiary of National Bank

On April 17, 2007, the United States Supreme Court, in a 5 to 3 vote, affirmed the opinion of the U.S. Court of Appeals for the Sixth Circuit, holding that the State of Michigan may not require the operating mortgage lending subsidiary of a national bank to register and comply with state mortgage lending laws.

On April 17, the U.S. Supreme Court affirmed the opinion of the U.S. Court of Appeals for the Sixth Circuit, holding that the State of Michigan may not require the operating mortgage lending subsidiary of a national bank to register and comply with state mortgage lending laws.

In *Watters v. Wachovia Bank, N.A.*, the Court concluded that federal law shields national banks and their operating subsidiaries from "unduly burdensome and duplicative" state regulation. The Court distinguished operating subsidiaries of national banks, which may engage solely in activities the bank itself can conduct, from other types of affiliates authorized to engage in nonbanking financial activities that are subject to state regulation. Conducting business through operating subsidiaries, the Court opined, has long been recognized as part of a national bank's "incidental power" in carrying on the business of banking under the National Banking Act, 12 U.S.C. § 1 *et seq*. (the "Act"). The Act, and the Office of Comptroller of Currency ("OCC") regulations promulgated under it, specifically authorize national banks to engage in real estate lending. Accordingly, the Court concluded, states may not significantly burden national banks or their operating subsidiaries engaged in such activity. Further, states may not examine and inspect operating subsidiaries of national banks, as this "visitorial" control is exclusively vested in the OCC.

The *Watters* case was initiated in 2003, when Wachovia's mortgage lending business, in reliance on the OCC rules, advised the Michigan Office of Financial and Insurance Services that it was surrendering its state lending registration because it had become an operating subsidiary of Wachovia Bank, a national bank. Linda Watters, Commissioner of the state regulatory agency, responded, advising the company that it would no longer be authorized to make mortgages in the state. Wachovia sued.

Before *Watters*, the Court had not taken a preemption case involving national banks for years. The Court's decision affirms the decisions of four federal appeals courts on preemption issues. However, the three-justice dissent leaves room for argument that the case does not decide the matter once and for all as many had hoped.

State regulators and consumer advocates claim state regulation of the mortgage industry focuses on consumer protection, and the Court's decision in *Watters* impinges on this area of traditional state control. In its press release, the OCC expressed its pleasure with the Court's decision. As a result of the Court's decision, many believe mortgage companies seeking to avoid the patchwork of state legislation will seek out national bank parents. However, the Court's decision comes at the same time that the collapse of the subprime mortgage industry is causing Congress to consider national standards for all types of mortgage lenders, as Congressman Barney Frank (Chairman of the House Financial Services Committee) alluded to shortly after the Court issued the *Watters* decision. The decision may also encourage federal legislation to clarify the extent of the OCC's preemptory powers, especially in connection with consumer protection issues.

Although the *Watters* decision applies squarely to the operating subsidiaries of national banks, the decision should apply with equal force to the operating subsidiaries of federal savings banks regulated by the Office of Thrift Supervision.

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