Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

Barnett Sivon & Natter P.C.
ATTORNEYS at LAW
WASHINGTON, DC

The Preemption Provisions in the Financial Reform Legislation: A Fair Compromise?[*][†]

Jim Sivon

June, 2010

During the past year, my law firm has provided legal advice to the banking industry on the preemption provisions in the consumer protection title of the financial reform bills pending in Congress. Based upon that experience, I would like to take this opportunity to review the impact of those provisions on the banking industry, the States, and consumers. I will focus my remarks on the Senate passed bill. As I review the impact of the preemption provisions, I invite you to consider whether or not the provisions represent a fair compromise between all interested parties. Let's start by looking at the impact of the provisions on the banking industry.

The Codification of the Barnett Bank Standard and the Limitations on the Application of that Standard

For banks, the most significant provision is the codification of the *Barnett Bank* case as the legal standard for preemption. A little background on that case: Barnett Bank was a national bank headquartered in Florida. It challenged a Florida statute that prohibited banks from selling insurance. Barnett Bank argued that the Florida law conflicted with a provision in the National Bank Act that permits national banks to sell insurance from offices located in small towns. Upon review, the Supreme Court agreed with the Bank. The Supreme Court held that the Florida law was preempted because it "stood as an obstacle" to the accomplishment of the provision in the National Bank Act authorizing national banks to sell insurance from small towns. The Court went on to note that State laws will not stand if they "prevent or significantly interfere" with the exercise of a national bank's powers, they "unlawfully encroach" on the rights and privileges of a

[*] The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[†] The article is based upon a presentation at the 2010 Summer National Meeting of the Republican Attorneys General Association, Colorado Springs, Colorado, June 7, 2010.

national bank, or they "interfere with or impair" a national bank's efficiency in performing authorized functions.

Codifying the *Barnett Bank* case as the legal standard for preemption in the financial reform bills was an evolutionary process. Initially, the Treasury Department proposed to eliminate the application of federal preemption entirely. The House Financial Services Committee rejected this recommendation. The Committee voted to permit preemption in those cases in which a State law "prevents or significantly interferes with" the ability of a national bank to engage in the business of banking. In other words, the Committee selected one of the phrases used by the Supreme Court in the *Barnett Bank* case as the statutory standard for preemption.

The standard was further modified on the House Floor by Representative Melissa Bean of Illinois. She amended the House bill to provide that a State law would be preempted if it "prevents, significantly interferes, *or materially impairs*" the ability of a national bank to engage in the business of banking. In a floor statement, Representative Bean explained that the shorthand expression of "prevents or significantly interferes" could be construed as narrowing the Constitutional standard for preemption recognized in the *Barnett Bank* case. She noted that she added the words "materially impairs" so that there would be no question that the preemption standard encompassed all of the standards described in the case.

The Senate took yet a further step in the codification of the *Barnett Bank* case as the standard for preemption. That bill provides that State laws will be preempted in accordance with the legal standard of the decision of the U.S. Supreme Court in the *Barnett Bank* case, and it includes a citation to the case. The Senate bill leaves no doubt that the legal standard for preemption is the entire *Barnett Bank* case.

For the banking industry, the codification of the *Barnett Bank* case as the standard for preemption came with a price. The Senate bill places several limitations on the application of the standard.

First, the standard is narrower than the existing OCC and OTS preemption regulations. The OCC preemption regulation applies to deposit and lending laws that "obstruct, impair or *condition*" the ability of a national bank to exercise authorized powers. The *Barnett Bank* case clearly applies to State laws that obstruct or impair authorized activities. However, State laws that merely condition those activities are not within the scope of the case. Moreover, the current OTS regulation provides for field preemption of all State deposit and lending laws — some of which may not violate the *Barnett Bank* standard.

Second, the Senate bill eliminates the application of preemption for operating subsidiaries of national banks and federal thrifts. In 2007, the U.S. Supreme Court ruled that federal preemption ran to operating subsidiaries of national banks. The bill overturns that decision.

Third, the Senate bill provides that any future preemption determinations by the OCC must be made on a "case-by-case" basis. In other words, the agency's preemption determinations must relate to a particular State law. This means, in my opinion, that the OCC cannot adopt a regulation that declares an entire area off limits for State regulation.

Fourth, in reviewing an OCC legal determination related to preemption, a court may not apply *Chevron* deference. Instead, the court must assess the validity of the OCC's decision based upon the thoroughness of the agency's consideration, the consistency of the determination with prior determinations, and other relevant factors. This is commonly called "*Skidmore*" deference, and it is narrower than *Chevron* deference.

Finally, the bill States that the OCC may not take actions that occupy the field in any area of State law. This limitation is more relevant for federal thrifts than national banks because, as I have mentioned, the existing OTS preemption regulation asserts that it occupies the field in deposit and lending areas.

There was yet another limitation contained in the Senate bill that was removed when the bill was debated in the Senate. Originally, the bill precluded the preemption of a State law unless the OCC or a court could find a pre-existing federal law that addressed — in a substantive manner — the subject area of the State law. This provision was designed to avoid a gap in consumer protection based upon a preemption determination. It was removed, by an amendment authored by Senator Carper of Delaware, on the grounds that the new federal consumer financial protection bureau will have the authority to address gaps in consumer protection.

In summary, the Senate bill codifies the *Barnett Bank* case as the standard for preemption, but subjects that standard to several limitations. Let's now turn to the States — what is the impact of the Senate bill on the States?

New Enforcement Powers for the States

In addition to the limitations on the application of the preemption standard, the Senate bill gives State Attorneys General new power to bring actions against national banks and federal thrifts. State AGs are given the authority to enforce regulations issued by the new federal consumer financial protection bureau. This is an expansion of existing AG enforcement authority.

Last year, the U.S. Supreme Court overturned an OCC regulation that limited the ability of State Attorneys General to enforce State law. The Court held that the OCC could not prevent a State AG from enforcing non-preempted State law. The Senate bill goes one step further; it gives State AGs the power to enforce federal rules issued by the federal consumer financial protection bureau.

The only limitation on this new authority is a requirement that, before bringing an action, an AG must notify the bureau, and the bureau has the right to intervene and remove actions to federal court.

The Senate bill includes two other features favorable to State interests. The bill makes it clear that — aside from preempted State laws — State laws that provide consumers greater protection than federal law are applicable to national banks and federal thrifts. The bill also creates a procedure for States to recommend additional consumer protections to the federal consumer financial protection bureau.

To recap for the States — in exchange for the codification of the *Barnett Bank* case as the legal standard for preemption, the bill imposes a variety of limitations on the application of that standard, and it gives State AGs new enforcement authority over federal consumer protection regulations. Now, what about consumers?

Benefits for Consumers

Consumers benefit in two ways. First, the codification of the *Barnett Bank* case as the preemption standard will permit national banks and federal thrifts to continue to offer uniform products and services to consumers, regardless of where they live. We live in a mobile society and consumers benefit from the ability to use interstate ATM networks, to engage in Internet banking, and to obtain standardized mortgage and other consumer loan products. The bill preserves this benefit for consumers.

Second, the preemption provisions are paired with the creation of a new federal consumer financial protection bureau. This new federal agency will have broad power to look after the interests of consumers. In fact, the authority of this new agency is virtually unlimited, and I do worry that an overly zealous regulator could pursue actions that reduce product and service choices for consumers.

A Fair Compromise?

Let's return to the question I posed at the outset of these remarks. Do these provisions represent a fair compromise between the interests of the banks, the States, and consumers? Personally, I believe so. Banks gain the *Barnett Bank* case as the legal standard for preemption. In exchange, States gain some limitations on the application of that standard, and State Attorneys General gain new enforcement powers over national banks that they did not have before. Consumers, in turn, retain the benefit of uniform products and services as a result of the preservation of the *Barnett Bank* standard; they gain a new federal consumer financial protection agency; and they gain State enforcement of the rules issued by that agency.

A Transitional Problem

Before I close, I would like to mention a *transitional* issue created by the Senate bill. Currently, the preemption provisions will go into effect when the authority over existing federal consumer protection laws is transferred from the federal banking agencies to the new federal consumer financial protection bureau. This will be several months after the date of enactment of the bill. At that time, some or all of the existing OCC and OTS preemption regulations will cease to be effective, and some State laws that have not applied to national banks and federal thrifts as a result of those regulations will suddenly apply to national banks and federal thrifts. For example, there could be some State disclosure laws that become applicable because they were preempted under the existing OCC and OTS rules rather than under the "case-by-case" procedure required in the bill. In other words, upon the effective date, we face a degree of uncertainty over what State laws apply to national banks and federal thrifts. This is a problem not only for banks and State authorities, but also for consumers.

To minimize confusion over what State laws do or do not apply to national banks and federal thrifts as of the effective date of the preemption provisions, I would hope that State authorities and the OCC could use the time before the effective date to address this issue and reach an understanding over what laws will and will not apply upon the effective date. Such understandings are not unique, and, in this case, could provide a real public service. Otherwise, upon the effective date, all parties — banks, States and consumers — will face a period of confusion and litigation, which would undermine what, otherwise, appears to be a fair legislative compromise.

Jim Sivon is a partner with the law firm of Barnett Sivon & Natter, P.C.