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alert

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Preemption Under Dodd-Frank

On July 15, 2010, the Senate approved the conference report for H.R. 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The House had approved the conference report on June 30. It is anticipated that President Obama will sign the Act into law the week of July 19. The Act includes a number of important provisions of interest, which we will address in a series of Alerts to our banking clients. This Alert discusses those provisions of the Act that significantly reduce the ability of federally chartered financial institutions to rely on federal preemption of state consumer finance laws. These entities will need to carefully consider whether they may now be required to comply with various state consumer finance laws.

Scope of Preemption

As an initial matter, the preemption provisions under the Act apply only to "state consumer financial laws." Accordingly, it appears that existing preemption standards under federal law will continue to apply to state laws that do not fit within the definition of "state consumer financial laws."

The Act defines a "state consumer financial law" as a law that does not directly or indirectly discriminate against national banks or federal thrifts and that directly and specifically regulates the manner, content or terms and conditions of any financial transaction, or related account, with respect to a consumer. This definition is very broad and somewhat ambiguous, and it will certainly take some time for the OCC (which will take over regulation and supervision of federal thrifts from the Office of Thrift Supervision) and courts to sort out which laws or types of laws are subject to preemption. For example, many states in the past have attempted to impose licensing rules on national banks and thrifts prior to engaging in certain types of transactions. If such state laws do not regulate the "manner, content or terms and conditions" of such transactions, then they arguably would not constitute a "state consumer financial law" and existing preemption standards would continue to apply. It is clear that the Act's heightened standards of preemption will likely not apply to a number of state laws intended to protect consumers.

Legal Standard

A "state consumer financial law" will be preempted only:

Related practice areas:

Financial Services Regulation

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- to the extent that such law would have a "discriminatory effect" on national banks or federal thrifts in comparison with the effect of the law on state banks;

- when the OCC by order or regulation, or a court, in accordance with the legal standard for preemption established by *Barnett Bank of Marion County, N.A. v. Nelson, Florida Insurance Commissioner, et al.,* 517 U.S. 25 (1996), determines on a "case-by-case basis" that the law "prevents or significantly interferes" with the exercise of any of the powers of a national bank or federal thrift; or

- if it is expressly preempted by a separate provision of federal law other than the Act.

Since state law typically is not discriminatory against national banks and thrifts and express preemption is rare, the focus of bankers should fall squarely on the second bullet point above. *Barnett* stands for the principle that state or local law applies to national banks in circumstances that do not alter, condition or interfere with a national bank's ability to exercise a power granted by federal law. However, some courts have interpreted *Barnett* in a relatively favorable manner for national banks. It will remain to be seen how the OCC and federal courts apply the principles of *Barnett* going forward.

Restrictions

In addition to the restrictions on preemption of state law above, the Act substantially curtails the ability of the OCC to strike down "state consumer financial laws."

As set forth above, the Act requires the OCC to make preemption determinations on a "case-by-case basis," defined as a determination by the OCC concerning the impact of a particular "state consumer financial law" on any national bank that is subject to the law, or the law of any other state with substantively equivalent terms. Accordingly, the OCC may not make a determination that multiple state laws are preempted unless it has determined that each of such laws has "substantively equivalent terms" to other state laws that have already been preempted.

Before making a determination that a state law is "substantively equivalent" to another state law that has been preempted, the OCC is required to consult with the newly created Bureau of Consumer Financial Protection and take its views into account.

Any court reviewing the OCC's determination will be able to assess the validity of such determination by considering the "thoroughness evident in the consideration of the [OCC], the consistency with other valid determinations made by the [OCC], and any other factors which the court finds persuasive and relevant." It is evident from the breadth of such language that Congress intends to subject any preemption determination by the OCC to close court scrutiny.

Other restrictions on the OCC's determinations regarding preemption include the following:

- Preemption restrictions must be made by the Comptroller and cannot be delegated.

- Preemption determinations are required to be supported by "substantial evidence" made on the record of the OCC proceeding and in accordance with the legal standards enumerated in *Barnett.*

- The Comptroller is required to periodically review, through notice and public comment, each preemption determination every five years and is further required to publish such notice in the Federal Register announcing the results of such review.

- The Comptroller is required to submit a formal report of each preemption reconsideration to Congress.

- On a quarterly basis, the OCC must publish a current list of all preemption determinations then in effect.

Miscellaneous

The Act reverses existing case law to eliminate preemption of state law with respect to operating subsidiaries and affiliates of federally chartered institutions. Accordingly, all state laws, including "state consumer financial laws," will apply to operating subsidiaries to the same extent as any other entity. National banks and thrifts should immediately consider whether existing operating subsidiaries now exposed to such laws should consolidate with the parent bank.

Although the Act is mostly full of bad news for national banks, one item of good news is that the Act appears to preserve the right of national banks to "export" interest rates under 12 U.S.C. 85. The definition of "interest" would appear to encompass many fees, including late fees, NSF fees, overlimit fees, annual fees and cash advance fees.

Effective Date

The provisions of the Act related to preemption will become effective on the "designated transfer date," which can be no earlier than six months and no later than 18 months after enactment of the Act.

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