WINSTON & STRAWN LLP

CLIENT ALERT

Supreme Court Clarifies Standard for Preemption of State Laws Regulating National Banks

JUNE 4, 2024

KEY TAKEAWAYS

- The Supreme Court unanimously vacated a Second Circuit decision holding that a New York statute requiring banks to pay interest on mortgage escrow accounts was preempted by federal banking law.
- The Court held that a state law is preempted only if it "prevents or significantly interferes with" a national bank's exercise of its powers. Courts must undertake "a practical assessment of the nature and degree of the interference caused by a state law," based on a case-by-case "nuanced comparative analysis" of the Court's prior preemption cases.
- The Supreme Court did not decide whether New York's escrow-interest law is preempted, instead remanding for the lower court to make that determination under the correct legal standard. The Supreme Court's rejection of categorical preemption tests and refusal to provide a bright-line rule is likely to create significant uncertainty and foster further litigation over the application of state consumer-protection laws to the operations of national banks.

SUMMARY

The Supreme Court issued a unanimous decision in *Cantero v. Bank of America, N.A.* that could have a significant impact on the ability of national banks to assert federal preemption defenses against state efforts to enforce consumer-protection laws. *Cantero* clarifies the standard for determining when state laws that regulate national banks are preempted by federal law.

BACKGROUND

The United States has both federal and state banking systems. Federally chartered "national banks," which are primarily subject to federal oversight and regulation, coexist and compete with state-chartered banks that are subject to additional state oversight and regulation. The National Bank Act of 1863 grants national banks various enumerated powers they need to organize and operate. It also authorizes them to exercise "all such incidental powers as shall be necessary to carry on the business of banking." As relevant to *Cantero*, the Act expressly gives national banks the power to administer home mortgage loans.

The vast majority of home mortgages require escrow accounts, which banks use to pay borrowers' insurance premiums and property taxes. This benefits both the borrower (by simplifying expenses and budgeting) and the bank (by ensuring insurance and tax bills are timely paid). To protect borrowers and curb "abusive practices," in 1974 Congress passed the Real Estate Settlement Procedures Act (RESPA), which extensively regulates national banks' operation of escrow accounts. RESPA requires national banks to return leftover funds to borrowers promptly, and to provide borrowers with notifications and account statements. It also caps the amount of money national banks can require borrowers to deposit. But RESPA does *not* require national banks to pay interest to borrowers on their escrow accounts. In contrast, thirteen states have statutes purporting to require national banks to pay interest on escrow accounts.

At issue in *Cantero* was a New York statute requiring banks to pay borrowers at least 2% a year on their escrow balance. In 2010 and 2016, several plaintiffs brought putative class action suits against Bank of America over its refusal to pay interest on their escrow accounts. Bank of America contended that the New York law was preempted by the National Bank Act. The U.S. District Court for the Eastern District of New York sided with the plaintiffs, concluding that nothing in the National Bank Act or other federal law preempted the New York statute. The Second Circuit reversed, holding that federal law preempts any state law that "purports to exercise control over a federally granted banking power," regardless of "the magnitude of its effects." This created a circuit split, as the Ninth Circuit had previously held that a similar California escrow-interest statute was not preempted. The Supreme Court granted certiorari.

THE SUPREME COURT HOLDS THAT A STATE LAW IS PREEMPTED ONLY IF IT "PREVENTS OR SIGNIFICANTLY INTERFERES" WITH A NATIONAL BANK'S EXERCISE OF ITS POWERS.

Writing for a unanimous Court, Justice Kavanaugh began his analysis with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which Congress passed in the wake of the 2008 financial crisis. Dodd-Frank established the controlling legal standard for when a "State consumer financial law," like New York's escrow-interest law, is preempted with respect to national banks. Dodd-Frank made clear that not all state laws regulating national banks are preempted. Instead, it provided that the National Bank Act preempts a state law "only if" the state law (i) discriminates against national banks as compared to state banks or (ii) "**prevents or significantly interferes** with the exercise by the national bank of its powers," as determined "in accordance with the legal standard for preemption in the decision of the Supreme Court of the United States in *Barnett Bank of Marion County, N. A. v. Nelson, Florida Insurance Commissioner, et al*., 517 U.S. 25 (1996)." In other words, Dodd-Frank expressly incorporated the Supreme Court's 1996 *Barnett Bank* decision as providing the legal standard for determining whether a state law is preempted on the ground that it "prevents or significantly interferes" with a national bank's exercise of its powers.

THE PREEMPTION ANALYSIS MUST ANALYZE THE SUPREME COURT'S PRECEDENTS AS SET FORTH IN *BARNETT BANK*.

Cantero explains that in *Barnett Bank*, the Supreme Court did not purport to establish a clear line to demarcate when a state law "significantly interfere[s] with the national bank's exercise of its powers." Instead, the Court analyzed several of its own precedents, comparing cases where it found state laws were preempted with other cases where state laws were not preempted. Accordingly, courts addressing preemption questions "must do as *Barnett Bank* did and likewise take account of those prior decisions of this Court and similar precedents."

In *Barnett Bank*, the Court held that a Florida statute prohibiting banks from selling insurance was preempted because it "significantly interfered" with a federal statute that expressly authorized banks to sell insurance. Because federal law "explicitly grant[ed] a national bank an authorization, permission, or power" with "no indication that Congress intended to subject that power to local restriction," the Court concluded state law could not limit national banks' ability to sell insurance. But the Court added that its ruling did not "deprive States of the power to regulate national banks, where (unlike here) doing so does not prevent or significantly interfere with the national bank's exercise of its powers."

Barnett Bank looked to a "paradigmatic example of significant interference" in the Supreme Court's 1954 decision in *Franklin National Bank of Franklin Square* v. *New York*. In that case, a New York law prohibited most banks from using the word "savings" in their advertising or business. The Court determined that law "significantly interfered" with the banks' power to receive savings deposits because they could not effectively advertise "using the commonly understood description which Congress has specifically selected" to describe their activities. *Barnett Bank* concluded that the Florida insurance law in its case interfered with national banks' power in a way "quite similar" to the savings-deposit law in *Franklin*, and thus was preempted for the same reason.

Barnett Bank also pointed to a second example of "significant interference" in the Court's 1982 decision in *Fidelity Federal Savings & Loan Association* v. *De la Cuesta*. In that case, the Court held that a California law limiting "due on sale" clauses in contracts for federal savings and loan associations was preempted because federal law expressly allowed such clauses.

Cantero holds that "for purposes of applying Dodd-Frank's preemption standard, *Franklin*, *Fidelity*, and *Barnett Bank* together illustrate the kinds of state laws that significantly interfere with the exercise of a national bank power and thus are preempted."

COURTS MUST MAKE A "PRACTICAL ASSESSMENT OF THE NATURE AND DEGREE OF THE INTERFERENCE" CAUSED BY THE STATE LAW.

Cantero holds that *Barnett Bank* and the older precedents considered therein – as expressly incorporated into Dodd-Frank's statutory preemption standard – provides the standard by which courts must determine whether a state law regulating national banks falls on the permissible or preempted side of the significant-interference line. In applying the *Barnett Bank* standard, a court must make "**a practical assessment of the nature and degree of the interference**" caused by the relevant state law. If the state law prevents or significantly interferes with the national bank's exercise of its powers, and its interference is akin to the interference in cases like *Franklin*, *Fidelity*, and *Barnett Bank* itself, then the state law is preempted.

THE SUPREME COURT REJECTS "CATEGORICAL TESTS" AND DECLINES TO FORMULATE A BRIGHT-LINE RULE.

The Supreme Court determined that the Second Circuit erred in analyzing New York's escrow-interest law because it failed to conduct the "nuanced comparative analysis" required by the *Barnett Bank*/Dodd-Frank standard. Instead, the Second Circuit erroneously applied "a categorical test that would preempt virtually all state laws that regulate national banks." By contrast, the plaintiffs' proposed standard "would yank the preemption standard to the opposite extreme, and would preempt virtually no nondiscriminatory state laws that apply to both state and national banks." The Court appreciated both parties' desire "for a clearer preemption line one way or the other" but concluded that was not what Congress intended when it expressly incorporated the *Barnett Bank* standard into the statute. *Barnett Bank* "sought to carefully account for and navigate this Court's prior bank preemption cases." Future courts analyzing bank-preemption issues must do likewise.

WHAT THIS MEANS

The Supreme Court's rejection of categorical preemption tests is likely to create significant uncertainty and foster further litigation over the application of state consumer-protection laws to the operations of national banks.

As a result, states are likely to take a more aggressive approach in seeking to enforce consumer-protection laws and other regulations against national banks, and it could be significantly more difficult for banks to oppose such measures as categorically preempted. National banks will need to carefully consider their exposure to a multiplicity of differing state laws not only regulating mortgage-escrow interest but also potentially extending to other operations, like ATM fees and credit card rewards.

7 Min Read

Authors

Linda Coberly

Mike Gaddis

Related Topics

The Supreme Court of the United States

Preemption

Related Capabilities

Appellate & Critical Motions

Financial Services Litigation

Related Professionals

Linda Coberly

Mike Gaddis