

FINANCIAL REFORM: THE SHIFTING PENDULUM OF PREEMPTION

PERSPECTIVE

By Richard Kellner and Evan Zucker

On Wednesday July 21, 2010, President Barack Obama signed into law the Dodd-Frank Act, also known as the Wall Street Reform and Consumer Protection Act. The mammoth new legislation is 2,319 pages long and covers everything from regulatory authority to reinsurance. For months, commentators have either heralded the legislation as a remedy to prevent future banking crises, or portrayed it as the harbinger of doom for the free market system. However, one aspect of the legislation is beyond dispute. The legislation will have a profound impact on banks' ability to use preemption as a defense to consumer based actions.

For the past dozen years, banks have often tried to use preemption as a shield against consumer based litigation relating to their banking practices. Preemption generally arises from the Supremacy Clause of the U.S. Constitution, which provides that "the laws of the United States...shall be the supreme Law of the Land." Under the Supremacy Clause, if there is an actual conflict, either explicit, implied or in application of a federal and a state law, the federal law will apply and the state law will be disregarded. Based on the comprehensive nature of certain federal regulations, banks have had some limited success in having state laws preempted by federal regulations. For example, in *Bank of America v. City and County of San Francisco*, 309 F.3d 551 (9th Cir. 2002), the court ruled that local ordinances that were violated by the bank's practices of charging ATM fees to non-depositor customers were preempted by banking regulations contained in the Home Owners Loan Act and the National Bank Act.

The passage of Dodd-Frank represents a major shift in the preemption pendulum toward consumers, by restricting banks' ability to use preemption as a defense to consumer litigation relating to banking practices. Under the Act, the standard that governs the situations in which state laws that affect banking transactions has been changed. Whether or not these changes will result in increased litigation remains to be seen.

The Office of the Comptroller of Currency as per the National Bank Act regulates National Banks. Prior to the Act, the Office of the Comptroller of Currency's standards resulted in the preemption of state laws affecting national banks when those laws obstructed or interfered with their banking practices.

However, under Section 1044 of the Dodd-Frank Act, state consumer financial laws are only preempted if its application "would have a discriminatory effect on national banks, in comparison with the effect of the law on a bank chartered by that State" and if the law "prevents or significantly interferes with the exercise by the national bank of its powers." The first clause is designed to ensure that states do not create obstacles for fair competition between national and state banks. The second clause will have the most profound affect on preemption law. On its face, this new standard will create a formidable obstacle for any bank that wants to argue that it is not bound by state consumer protection statutes due to preemption. Now, such banks will have to show not only that their banking activities will be obstructed or interfered with by the state law, but must further demonstrate the state law

"prevents or significantly interferes" with their banking practices. At a minimum, Dodd-Frank sends the unmistakable message to courts and regulators that Congress doesn't favor preemption in this area.

The Act has also changed the preemption standard for banks classified as savings and loans. Home Owners Loan Act sets the standard for governance of federal savings and loans or thrifts, which are carried out by the Office of Thrift Supervision. Prior to Dodd-Frank, the Office of Thrift Supervision promulgated explicit regulations indicating that it and the Home Owners Loan Act occupied the field of lending regulations for federal savings and loans. This type of preemption is known as "field preemption." Yet, even under the Home Owners Loan Act, the Office of Thrift Supervision enacted a "savings clause," which still allowed for state laws that only incidentally affected the lending operations of federal savings associations. Dodd-Frank has effectively expanded the "savings clause" far beyond the standard that previously permitted state regulations affecting the banking industry.

Dodd-Frank will also abolish the Office of Thrift Supervision, and transfer its authority to other banking regulatory agencies. Moreover, in Section 1046 of the Act, the bill specifically proclaims that Home Owners Loan Act does not, in fact, occupy the field in any area of law. This represents a monumental shift in banking law. This vital change also calls into question many of the other regulations handed down by the Office of Thrift Supervision, because when they overstepped their Congressional mandate by proclaiming "field preemption," challengers can now argue they did so in other areas as well.

Prior to Dodd-Frank, anyone seeking to assert a claim against a bank for fraud or other state law violations was forced to try to slot their claim into the narrow savings clause of the Home Owners Loan Act. Now, without field preemption, injured thrift customers can argue that as long as the provisions of the Home Owners Loan Act are not in conflict with state laws, these thrifts should have to play by state rules. While it is likely many of the regulators previously working for the Office of Thrift Supervision will transition to the Office of the Comptroller of Currency or the newly created Consumer Financial Protection Bureau, under the authority of the Federal Reserve, their outlook and regulatory culture should adjust with their new purpose and leadership.

To a great extent, judicial restriction of the preemption doctrine was already occurring prior to the passage of Dodd-Frank. In *Ayala v. World Savings Bank, FSB*, the 9th U.S. Circuit Court of Appeals concluded that field preemption, as asserted by the Office of Thrift Supervision, did not extend to "common law" causes of action such as the tort slander of title in *Ayala*. 616 F.Supp.2d 1007, 1014. Now, with the abolition of the Office of Thrift Supervision and the explicit statement that it had overstepped its authority when it proclaimed field preemption, as well as the lowering of the national bank preemption standard, Congress has signaled a fundamental shift in the way banks will be treated by state laws. This shift will likely be felt the most in states with strong consumer protection statutes like California and Massachusetts.

State consumer protection statutes give consumers the ability to combat deceptive, fraudulent and unfair practices. Consumers are too often blocked in court by preemption arguments, which force them to wait for the problem to get big enough or garner enough public attention for an attorney general or a banking regulator to take action. Now, it is likely that consumers will become further empowered with additional tools that will enable them to combat inequities in the ever-increasing complexities of the credit, lending, borrowing and securities markets.

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