Interest Rate Regulation Developments: State Opt-Outs of Federal Preemption of Discount-Point Limitations on First Mortgage Loans

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INTRODUCTION

During the late 1970s, with double-digit inflation rates pushing interest rates to record highs, consumer borrowers in states with low usury ceilings often found it difficult to obtain credit.[1] To ease this "credit crunch" and ensure an increased and evenly spread flow of available mortgage funds, Congress enacted section 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDA).[2] Section 501 of the DIDA preempts state law limitations on interest rates and discount points for certain first mortgage credit transactions,[3] but affords states the opportunity to opt out of such federal preemption.[4] The precise action that a state must take to opt out of section 501's preemption of state laws limiting discount points is the pivotal issue in *Richardson v. Credit Depot Corp.*,[5] a class action currently underway in Ohio. In a three-sentence order filed on February 25, 1998, the trial court in *Richardson* granted the plaintiff's motion for partial summary judgment on the federal preemption issue, effectively holding that a mere technical, nonsubstantive amendment to a statute limiting discount points is sufficient to override federal preemption.[6]

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1. *See* S. REP. NO. 96-368, at 19 (1979), *reprinted in* 1980 U.S.C.C.A.N. 236, 254-55.
2. 12 U.S.C. § 1735f-7a (1994).
3. *See infra* notes 7-9 and accompanying text.
4. *See infra* notes 10-15 and accompanying text.
5. No. 315343 (Ohio Ct. C.P. Cuyahoga County filed Jun. 25, 1997. *Richardson* has been consolidated with *Hudak v. United Companies Lending Corp.*, No. 334659 (Ohio Ct. C.P. Cuyahoga County Jun. 26, 1997), for purposes of the discount points issue.
6. *Richardson*, No. 315343 (granting order for the plaintiff's motion for leave to file third amended complaint and the plaintiff's motion for partial summary judgment on issues of preemption, and denying the defendants', Aames Capital Corporation and Aames Home Loan of America, Inc., cross-motion for partial summary judgment). On June 25, 1998, the

This Article summarizes federal preemption of state laws under section 501 of the DIDA and examines the arguments made in the *Richardson* case.

FEDERAL PREEMPTION OF STATE LAWS UNDER SECTION 501 OF THE DIDA

Under section 501(a)(1) of the DIDA,[7] the provisions of the constitution or the laws of any state expressly limiting the rate or amount of interest, discount points, finance charges, or other charges that may be charged, taken, received, or reserved do not apply to any loan, mortgage, credit sale, or advance that is: (i) secured by a first lien on residential real property, on all stock allocated to a dwelling unit in a residential cooperative housing corporation, or on a residential manufactured home;[8] (ii) made after March 31, 1980; and (iii) described in section 527(b) of the National Housing Act (NHA).[9] Section 501(b) of the DIDA, however, includes two pro-

trial court granted the defendants' motion for summary judgment on statute of limitations grounds but denied the defendants' motion for reconsideration on the federal preemption issue, thus establishing the basis for appeals by both sides.

7. 12 U.S.C. § 1735f-7a(a)(1).

8. Under § 501(c) of the DIDA, federal preemption under section 501 of the DIDA applies to loans, mortgages, credit sales, or advances secured by a first lien on a residential manufactured home only if the terms and conditions relating to such transaction comply with the consumer protection provisions prescribed by the Federal Home Loan Bank Board (FHLBB) (now the Office of Thrift Supervision (OTS)). *See id.* § 1735f-7a(c). The consumer-protection provisions include restrictions with respect to balloon payments, prepayment penalties, late charges, and deferral fees. *See* 12 C.F.R. § 590.4 (1997).

9. Section 527(b) of the NHA defines the term "federally related mortgage loan." 12 U.S.C. 1735f-5(b). Under § 527(b), the term "federally related mortgage loan" means any loan that:

> (1) is secured by residential real property designed principally for the occupancy of one to four families; and
> (2)(A) is made in whole or in part by any lender the deposits or accounts of which are insured by any agency of the Federal Government, or is made in whole or in part by any lender that is itself regulated by any agency of the Federal Government; or
> (B) is made in whole or in part, or insured, guaranteed, supplemented, or assisted in any way, by the Secretary of Housing and Urban Development or any other officer or agency of the Federal Government or under or in connection with a housing or urban development program administered by the Secretary of Housing and Urban Development or a housing or related program administered by any other such officer or agency; or
> (C) is eligible for purchase by the Federal National Mortgage Association, the Government National Mortgage Association, or the Federal Home Loan Mortgage Corporation, or from any financial institution from which it could be purchased by the Federal Home Loan Mortgage Corporation; or
> (D) is made in whole or in part by any "creditor", as defined in section 1602(f) of Title 15 [section 103(f) of the federal Truth-in-Lending Act], who makes or invests in residential real estate loans aggregating more than $1,000,000 per year.

visions allowing a state to wholly or partially override such federal preemption.[10] First, under section 501(b)(2) of the DIDA, a state may opt out of all preemption (both interest rates and discount points) by adopting a law or passing a constitutional amendment explicitly stating that the state does not want section 501(a)(1) to apply.[11] Section 501(b)(2) requires any such legislation or constitutional amendment to have been adopted between April 1, 1980, and April 1, 1983.[12] Second, under section 501(b)(4) of the DIDA, a state may opt out of federal preemption on discount-point limitations only.[13] Specifically, section 501(b)(4) provides that "[a]t any time after March 31, 1980, any State may adopt a provision of law placing limitations on discount points or such other charges on any loan, mortgage, credit sale, or advance described in [section 501(a)(1)]."[14] In contrast to section 501(b)(2), section 501(b)(4) does not require a state explicitly to declare that it does not want section 501(a) to preempt state law limitations on discount points; it is unclear whether this omission was intentional or merely an oversight in drafting.[15] In addition, unlike section 501(b)(2), section 501(b)(4) does not require a state to act within any particular time period in order to opt out of federal preemption of discount-point limitations.

THE RICHARDSON *CASE: WHAT CONSTITUTES "ADOPTING" A PROVISION OF LAW LIMITING DISCOUNT POINTS?*

BACKGROUND

The plaintiffs in *Richardson* contended that merely amending a statute restricting discount points constitutes readoption of such statute sufficient

Id. Section 103(f) of the federal Truth-in-Lending Act defines "creditor" as:

> a person who both (1) regularly extends, whether in connection with loans, sales of property or services, or otherwise, consumer credit which is payable by agreement in more than four installments or for which the payment of a finance charge is or may be required, and (2) is the person to whom the debt arising from the consumer credit transaction is initially payable on the face of the evidence of indebtedness or, if there is no such evidence of indebtedness, by agreement.

15 U.S.C. § 1602(f). In addition, any person who originates two or more mortgages referred to in § 103(aa), *id.* § 1602(aa) (high-rate, high-fee mortgages), in any 12-month period or any person who originates one or more such mortgages through a mortgage broker is considered to be a creditor. *Id.* § 1602(f).

10. 12 U.S.C. § 1735f-7a(b).
11. *Id.* § 1735f-7a(b)(2).
12. *Id.*
13. *Id.* § 1735f-7a(b)(4).
14. *Id.*
15. Section 501(b)(4) was introduced as an amendment to the DIDA by Senator William Proxmire, who did not indicate why no express statement regarding the override of federal preemption was required. *See* 125 CONG. REC. 30,659 (1979) (statement of Sen. Proxmire).

to override federal preemption of state law limitations on discount points under section 501(b)(4) of the DIDA. In 1975, Ohio added section 1343.011 to its interest statute.[16] Under section 1343.011, except for certain loans insured or approved by the federal government or a federal instrumentality, no residential mortgage lender may receive either directly or indirectly from a seller or buyer of real estate any discount points in excess of two percent of the original principal amount of the residential mortgage.[17] With the enactment of section 501 of the DIDA, this provision was preempted with respect to first mortgage loans effective April 1, 1980.[18] In 1988, however, Ohio made certain minor technical amendments to section 1343.011 of the interest statute.[19] Specifically, the legislature: (i) moved a comma in the definition of "discount points" from outside to inside the closing quotation mark for stylistic reasons, (ii) changed "shall include" to "includes" in the definition of "residential mortgage," (iii) deleted the obsolete term "building and loan association" from the definition of "residential mortgage lender," and (iv) substituted "November 4, 1975" (the original effective date of section 1343.011) for "the effective date of this section" in subsection 1343.011(C), which limits prepayment penalties.[20] Subsection (B) of section 1343.011, the subsection limiting discount points, was left unchanged. The plaintiffs in *Richardson* argued that by amending section 1343.011 in 1988, the Ohio legislature "adopt[ed] a provision of law" after March 31, 1980, that placed limitations on discount points, thereby overriding federal preemption of discount-point restrictions under section 501(b)(4) of the DIDA. Because the trial court granted the plaintiff's motion for partial summary judgment on this issue,[21] the court evidently accepted the plaintiff's argument. Case law, the legislative history of the DIDA, and federal agency interpretations, however, all indicate that making unrelated amendments to a statute limiting discount points should not be sufficient to trigger section 501(b)(4) and override discount-point preemption.

CASE LAW

No published court decision appears to have addressed directly the issue of what action is necessary to opt out of federal preemption of discount-

16. Act of Aug. 5, 1975, § 1, 1975 Ohio Laws 2624, 2625-26 (codified as amended at OHIO REV. CODE ANN. § 1343.011 (Anderson 1993)).

17. OHIO REV. CODE ANN. § 1343.011(B).

18. *See supra* text accompanying notes 7-9.

19. Act of Apr. 19, 1988, § 1, 1988 Ohio Laws 4853, 4926-27 (codified as amended at OHIO REV. CODE ANN. § 1343.011).

20. *Id.*

21. *See supra* note 6 and accompanying text.

point limitations under section 501(b)(4) of the DIDA.[22] Nevertheless, the same issue was addressed under the NHA[23] in *Green v. Decatur Federal Savings & Loan Ass'n.*[24] In *Green*, the court interpreted former section 412 of the NHA,[25] which was enacted in 1974 and permitted interest on certain loans at a rate not exceeding five percent plus the federal discount rate.[26] Former section 412 specifically preempted any state constitutional or statutory provisions setting a lower maximum rate,[27] but accompanying legislation provided that a state could override such preemption by "enact[ing] a provision of law which prohibits the charging of interest at the rates provided [in the amended NHA]."[28] Like section 501(b)(4) of the DIDA, former section 412 of the NHA did not require a state to provide explicitly that it intended to override federal preemption. Before the passage of former section 412 of the NHA, section 57-101.1 of the Georgia interest statute limited interest rates on loans secured by real property to eight percent.[29] In 1975, after passage of former section 412 of the NHA, the Georgia legislature repealed and reenacted section 57-101.1 to add a subsection providing that intangible recording taxes would not be considered "interest."[30] The court in *Green* ruled that this reenactment was insufficient to override federal preemption under former section 412 of the NHA, holding that the reenactment was not an enactment of a new provision of law prohibiting interest rates above eight percent, but merely a continuation of previous law.[31] The court reasoned that:

22. The plaintiffs in *Richardson* cite three cases in support of the proposition that merely amending a statute limiting discount points is sufficient to override federal preemption under § 501(b)(4), but none of these cases so holds. In *Autrey v. United Companies Lending Corp.*, 872 F. Supp. 925 (S.D. Ala. 1995), the court ruled that Alabama's enactment of section 5-19-4(g) of the Alabama Code qualified for the § 501(b)(4) override exception. *Id.* at 928. Unlike Ohio, however, Alabama had specifically adopted a provision (enacted as a new provision in 1989), limiting discount points and limiting points charged on consumer credit transactions to five percent. *See* 1989 Ala. Acts 1074. In *Hardy v. Equisouth Financial Services Co.*, No. CV-93-A-1149-N, 1993 WL 764463 (M.D. Ala. Nov. 23, 1993), the court held that the defendant could not remove the case to federal court on the basis of a federal defense, including the defense of preemption. *Id.* at *3. In *Currie v. Diamond Mortgage Corp.*, 859 F.2d 1538 (7th Cir. 1988), the court ruled that § 4.1a of the Illinois General Interest Statute was preempted by federal law because Illinois had not passed a law after March 31, 1980, under either override provision of § 501 of the DIDA. *Id.* at 1542.

23. 12 U.S.C. §§ 1701-1750g (1994 & Supp. I 1996).

24. 238 S.E.2d 740 (Ga. Ct. App. 1977).

25. NHA, Pub. L. No. 93-501, § 412, 88 Stat. 1557, 1559 (1974) (repealed 1980).

26. NHA § 412(a), 88 Stat. at 1559.

27. Pub. L. No. 93-501, § 206, 88 Stat. at 1560 (uncodified section).

28. *Id.*

29. *Green*, 238 S.E.2d at 741.

30. Act of Mar. 19, 1975, § 1, 1975 Ga. Laws 153, 153 (repealed 1983); *see also Green*, 238 S.E. 2d at 741.

31. *Green*, 238 S.E.2d at 741.

> where one statute expressly declares that an existing statute is repealed, and, at the same time, reenacts its provisions, or declares that a portion of another statute is repealed and reenacts such portion thereof, the reenactment neutralizes the repeal, so far as the old law is continued in force. The old law operates without interruption, where the reenactment takes effect at the same time as the repeal.[32]

The rationale in *Green*, which involved the repeal and reenactment of a statute, should apply with even greater force to the situation in *Richardson*, as the Ohio Interest statute was not repealed and reenacted, but merely amended.[33]

LEGISLATIVE HISTORY

The legislative history of section 501(b)(4) of the DIDA likewise suggests that making unrelated amendments to a statute limiting discount points should not cause a state unintentionally to override federal preemption. When Senator Proxmire introduced the amendment to the DIDA to permit states to override federal discount-point preemption, he noted that "this amendment would provide authority to States, without time limitation, to *enact new laws* placing limitations on discount points and other charges in connection with a residential mortgage loan."[34] He further stated that "States should have flexibility to *enact new laws* placing limitations on discount points or such other charges, without any time limitation. My amendment [providing separate authority to override federal preemption of discount points] would provide this flexibility."[35] Senator Proxmire's remarks indicate that Congress intended that states be required to enact new legislation in order to override federal preemption of discount points. Making unrelated amendments to a statute limiting discount points (as Ohio did) is not to "enact new laws" as envisioned by the sponsor of current section 501(b)(4) of the DIDA and, therefore, should not be sufficient to override federal discount-point preemption.

FEDERAL AGENCY INTERPRETATION

Under section 501(f) of the DIDA, the FHLBB (now the OTS) is authorized to issue rules and regulations and publish interpretations governing the implementation of section 501.[36] In a 1981 opinion by General Counsel Thomas Vartanian (Vartanian Letter), the FHLBB analyzed a 1980 Michigan law and concluded that making an unrelated amendment to a state statute containing discount-point limitations was not sufficient

32. *Id.* at 741-42 (quoting Webb v. Echols, 88 S.E.2d 625, 627 (1955)).
33. *See supra* notes 19-20 and accompanying text.
34. *See* 125 CONG. REC. 30,659 (1979) (statement of Sen. Proxmire) (emphasis added).
35. *Id.* (emphasis added).
36. 12 U.S.C. § 1735f-7a(f) (1994).

to override federal preemption of discount points under section 501(b)(4).[37] Before section 501 of the DIDA was enacted, section 438.31c of the Michigan interest statute prohibited the assessment of discount points and also forbade lenders from requiring borrowers to maintain deposits other than escrow accounts in connection with loans secured by first mortgages on real estate.[38] Effective July 24, 1980 (following the passage of section 501 of the DIDA), Michigan amended its interest statute to authorize so-called pledged-account mortgages.[39] Because the Michigan Constitution does not permit the legislature to amend a statute merely by referring to the affected section, the legislature must repeal and reenact the entire section.[40] Accordingly, to amend the interest statute to authorize pledged-account mortgages, the legislature was required simultaneously to reenact its statutory prohibition against discount points. Nevertheless, the FHLBB opined that this pro forma reenactment of Michigan's discount-point prohibition did not override federal preemption of state limitations on discount points under section 501 of the DIDA.[41] The FHLBB noted that, although section 501(b)(4) does not require a state to provide explicitly that it does not want section 501(a) to preempt state law limitations on discount points (as section 501(b)(2) requires for completely overriding federal preemption), this lesser degree of specificity does not imply that a mere technical reenactment of such limitations will displace federal preemption.[42] The FHLBB observed that Senator Proxmire, who introduced the amendment adding section 501(b)(4) to the DIDA, intended his amendment to preserve the states' authority to place *new* restrictions on discount points.[43] Accordingly, the FHLBB reasoned that, because a reenactment of an existing statutory provision is merely a continuation of the law as it existed prior to the reenactment, the reenactment of the discount-point restriction under Michigan's interest statute was not a new legislative limitation sufficient to override federal preemption.[44] The FHLBB's interpretation should likewise apply to the situation in *Richardson*, where the

37. Opinion Letter from Thomas P. Vartanian, General Counsel, FHLBB, to Frank J. Kelley, Attorney General, State of Michigan 2 (June 18, 1981) [hereinafter Vartanian Letter] (on file with *The Business Lawyer*, University of Maryland School of Law). *But see* Opinion Letter from Milan C. Miskovsky, General Counsel, FHLBB (Mar. 17, 1980), *available in* WL, FFIN-OTS database, FHLBB 911 (opining that any "reenactment" of state usury ceilings would override federal preemption regardless of whether such override was expressly intended).

38. *See* Vartanian Letter, *supra* note 37, at 1; *see also* MICH. COMP. LAWS ANN. § 438.31c (West 1995).

39. 1980 Mich. Pub. Acts 238, § 1 (codified as amended at MICH. COMP. LAWS ANN. § 438.31c).

40. *See* Vartanian Letter, *supra* note 37, at 2.

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.*

Ohio Interest statute was not repealed and reenacted, but merely amended.[45]

At the request of Aames Financial Corporation, one of the defendants in *Richardson*, the OTS Chief Counsel recently issued an interpretation concerning the applicability of section 501(b)(4) of the DIDA to the 1988 amendments to the Ohio Interest statute.[46] The Chief Counsel concluded that the 1988 amendments did not constitute an opt out of the federal preemption of state discount-point restrictions under section 501(b)(4) of the DIDA.[47]

The Chief Counsel acknowledged that section 501(b)(4) does not specify the exact procedure by which a provision of law must be adopted to fall within the ambit of the section's opt-out authority.[48] Nevertheless, she noted that in the Vartanian Letter the FHLBB had observed that Senator Proxmire's remarks as part of the legislative history of the DIDA indicated that Congress had intended states to opt out under section 501(b)(4) by placing new restrictions on discount points.[49] Accordingly, in her view, to satisfy section 501(b)(4), the 1988 Ohio amendments must have been "equivalent to enactment of a new substantive law limiting discount points."[50]

To determine whether the 1988 amendments were equivalent to the passage of a new substantive law, the Chief Counsel examined evidence of the Ohio legislature's intent in enacting the amendments. She noted that under Ohio law, "[i]n enacting any legislation with the stated purpose of correcting nonsubstantive errors in the [Ohio] Revised Code, it is the intent of the general assembly not to make substantive changes in the law in effect on the date of such enactment."[51] The Chief Counsel further observed that the Ohio Legislative Service Commission described the 1988 amendments as "technical amendments" such that "when the bill becomes law, the legal effect of each section affected by the bill will be the same as it was before the bill became law."[52]

From this evidence of intent, the Chief Counsel concluded that there

45. *See supra* notes 19-20 and accompanying text.

46. Letter from Carolyn J. Buck, Chief Counsel, OTS (Aug. 25, 1997), *available in* WL, FFIN-OTS database, P-97-7 [hereinafter Buck Letter].

47. *Id.*

48. *Id.* at *3.

49. *Id.*

50. *Id.*

51. *Id.* (quoting OHIO REV. CODE ANN. § 1.30(A) (Anderson 1990)). Section 1.30(B) consists of a list of the "acts of the general assembly with the purpose described in [§ 1.30(A)]." OHIO REV. CODE ANN. § 1.30(B). In addition to amending § 1343.011, the 1988 amendments also amended § 1.30 to include a reference in subsection (B) to "House Bill No. 708 of the 117th General Assembly." Act of Apr. 19, 1988, § 1, 1988 Ohio Laws 4853, 4856 (codified at OHIO REV. CODE ANN. § 1.30(B)(15)).

52. Buck Letter, *supra* note 46 (quoting the Ohio Legislative Service Commission's summary of 1988 Ohio Sub. H.B. 708).

was no indication that the 1988 Ohio amendments were intended to address the issue of discount points or constitute an opt out of federal preemption under section 501 of the DIDA with respect to discount points.[53] She reasoned that, although section 501(b)(4) does not require a legislature to state explicitly that its intention is to opt out of the DIDA's preemption regarding discount points, a state's legislative action must limit discount points before such action may be found to have overridden the DIDA.[54]

CONCLUSION

Because the *Richardson* decision does not resolve all issues in the case, an interlocutory appeal may not be available solely on the federal preemption issue. The eventual outcome of an appeal could have a considerable impact on mortgage lenders nationwide. Because several states have made unrelated amendments to statutes limiting discount points since the enactment of section 501 of the DIDA, an ultimate plaintiff's victory in *Richardson* likely would (and the trial court's decision alone may) result in class actions being filed in several jurisdictions, potentially subjecting lenders to significant exposure. Thus, until the courts conclusively address what actions are necessary to override federal preemption of discount-point limitations under section 501(b)(4) of the DIDA, mortgage lenders and state legislators both should be aware that making any amendment to a statute restricting discount points, even an unrelated technical revision, risks unintentionally overriding federal preemption.

53. *Id.*
54. *Id.*