Continuing Challenges to Interstate Lending by Depository Institutions

*By Darrell L. Dreher and Deborah Freye**

INTRODUCTION

In 1978, the Supreme Court in the landmark decision of *Marquette National Bank v. First of Omaha Service Corp.*[1] resolved the longstanding debate as to whether a national bank could charge interest in interstate transactions based upon the rates authorized by the laws of the state in which the bank's home office was located.[2] The Supreme Court unequivocally held that under the National Bank Act,[3] a national bank could charge an interest rate authorized in the bank's home state in interstate lending transactions with residents of other states.[4] This power has not been directly challenged since that decision, and today it is an accepted legal premise that a national bank can "export" the interest rates of its home state in interstate lending transactions. In 1980, Congress passed the Depository Institutions Deregulation and Monetary Control Act (DIDMCA),[5] in which it extended this right to other depository institutions, including federal savings and loans, savings banks, and credit unions, as well as state-chartered banks, savings and loans, credit unions and industrial loan companies holding federal deposit insurance.[6] The purpose of DIDMCA was clearly stated in the legislative enactment: to give these depository institutions the same right to "export" interest rates as was available to national banks.[7] The power to export interest rates by all types of federally insured depository institutions also has not been challenged and remains an accepted tenet in interstate lending.

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1. 439 U.S. 299 (1978).
2. *Id.* at 301.
3. 12 U.S.C. § 85 (2000).
4. *Marquette Nat'l Bank*, 439 U.S. at 307-19.
5. Pub. L. No. 96-221, 94 Stat. 142 (1980).
6. *Id.*; 12 U.S.C. §§ 1463(g), 1785, 1813, 1831d(a).
7. 12 U.S.C. § 1831d(a) (containing "rate allowed by the laws of the State . . . where the bank is located" language and "[i]n order to prevent discrimination against state-chartered insured banks" language); *see also id.* §§ 1730g, 1785, 1813 (2001).

SCOPE OF "INTEREST"

In the late 1980s and the early 1990s, numerous challenges were raised in plaintiffs' class action cases regarding the scope of the meaning of the word "interest" in the National Bank Act and DIDMCA.[8] Some depository institutions had taken the position that the term "interest" included not just the simple numerical rate but rather included other monetary returns to the lender in the form of various fees such as late fees and returned check fees. This continuing litigation began badly for the depository institutions in 1991 when the U.S. District Court for the District of Massachusetts decided a case against Greenwood Trust Company, holding that other credit terms apart from interest rates, such as late fees, were not included in the term "interest" and thus were not controlled by DIDMCA.[9] The U.S. Court of Appeals for the First Circuit thereafter reversed the district court, defining the term "interest" to include late fees.[10] Nevertheless, the *Greenwood Trust* case spawned numerous additional lawsuits alleging that various types of fees had been overcharged by depository institutions that had been relying upon the fee authority of their home state. This litigation was ultimately resolved in 1996 when the Supreme Court decided in *Smiley v. Citibank (South Dakota), N.A.*[11] that late fees and other types of fees that constitute additional return to the lender also constitute "interest."[12] The *Smiley* Court relied heavily upon a then recently promulgated regulation of the Office of the Comptroller of the Currency (OCC) defining the term "interest" to include "any payment compensating a creditor or prospective creditor for an extension of credit, making available of a line of credit, or any default or breach by a borrower of a condition upon which credit was extended."[13] The Federal Deposit Insurance Corporation (FDIC) and the Office of Thrift Supervision (OTS) followed with similar interpretations defining many types of fees as interest for purposes of interest rate exportation.[14]

8. *See* Jeffrey I. Langer, *The Scope of Exportation: Some Unresolved Issues After* Smiley v. Citibank, 52 BUS. LAW. 1065 (1997); Darrell L. Dreher, Hugh M. Hayden, & Michael C. Tomkies, *Developments in the Interstate Delivery of Consumer Financial Services*, 50 BUS. LAW. 1093 (1995); Darrell L. Dreher, Hugh M. Hayden, & Michael C. Tomkies, *Developments in the Interstate Delivery of Consumer Financial Services: Location, Fees and Common Law*, 49 BUS. LAW. 1325 (1994); Darrell L. Dreher & Michael C. Tomkies, *Interstate Delivery of Consumer Financial Services: Credit Card Issuers Win Decisions in* Greenwood Trust *and Related Cases*, 48 BUS. LAW. 1097 (1993); Darrell L. Dreher & Michael C. Tomkies, *Interstate Delivery of Consumer Financial Services:* Greenwood Trust *Decision Rendered*, 47 BUS. LAW. 1251 (1992); Harvey N. Bock, Darrell L. Dreher, & Michael C. Tomkies, *Developments in the Interstate Delivery of Consumer Financial Services*, 46 BUS. LAW. 1223 (1991); Jeffrey I. Langer & Jeffrey B. Wood, *A Comparison of the Most Favored Lender and Exportation Rights of National Banks, FSLIC-Insured Savings Institutions, and FDIC-Insured State Banks*, 42 CONSUMER FIN. L.Q. REP. 4 (1988).

9. Greenwood Trust Co. v. Massachusetts, 776 F. Supp. 21, 25-39 (D. Mass. 1991), *rev'd*, 971 F.2d 818 (1st Cir. 1992).

10. Greenwood Trust Co. v. Massachusetts, 971 F.2d 818, 830-831 (1st Cir. 1992).

11. 517 U.S. 735 (1996).

12. *Id.* at 745-47.

13. 12 C.F.R. § 7.4001(a) (2000).

14. *See* 12 C.F.R. § 560.110(a); FDIC General Counsel's Op. No. 10; Interest Charges Under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. 19,258, 19,259 (Apr. 17, 1998).

CURRENT ISSUES

If counsel for depository institutions had assumed that the *Marquette* and *Smiley* cases resolved the right of depository institutions to engage in interstate lending without further challenges to the right to charge their home state rates and fees, they were wrong. Today the challenges continue in the form of plaintiffs' class actions and state regulators' attempts to enforce state interest and fee limitations without regard to federal preemption. Plaintiffs' class actions are currently attacking exportation rights in interstate lending transactions by alleging: (i) that someone other than the depository institution is the actual lender in the transaction; (ii) that the depository institution is not a bank under the federal statutes; (iii) that methods of applying payments result in overcharges; and (iv) that agents of the depository institution violated a state requirement thus impacting upon the loan transaction of the depository institution. State regulators are also attacking interstate lending by depository institutions by: (i) adopting regulatory positions that prohibit agents of depository institutions from assisting in transactions that do not fully comply with the state statutes; (ii) recharacterizing transactions to find that other entities are in fact the actual lenders in the transaction; and (iii) adopting interpretations that are inconsistent with federal preemption.

Thus, depository institutions today face attacks on their interstate lending practices from two directions: litigation and state regulators. Federal regulatory agencies have responded with expanded regulations and interpretations further clarifying the scope of federal preemption in interstate lending, but this does not seem to have alleviated the flurry of lawsuits or the continuing regulatory pronouncements from state regulators, seeking to narrow the federal preemption rights of depository institutions. The basic goal in many of the class actions is to side-step the bank's right to export the interest rates and fees of its home state, thereby creating numerous rate and fee overcharges under various state laws with resulting penalties, damages, and attorneys' fees recoveries. The purpose of state regulators apparently is to retain maximum local control over consumer protection issues, but the result is often just the opposite as increasingly stringent enforcement positions often result in further preemptive pronouncements by federal regulators and litigation that, to date, has generally upheld federal preemption rights.

The following cases illustrate the scope of this battle, though they are by no means an exhaustive list of the lawsuits and regulatory pronouncements affecting interstate lending by depository institutions.

CLASS ACTION LITIGATION

TRUE CREDITOR ISSUE

In *Matheis v. The May Department Stores Co.*,[15] the plaintiffs brought consolidated Missouri state law usury class action claims against The May Department

15. Nos. 4:98CV01722 RWS, 4:98CV1739 RWS, 1999 U.S. Dist. LEXIS 21917 (E.D. Mo. May 21, 1999), *rev'd sub nom.* Krispin v. May Dep't Stores Co., 218 F.3d 919, 921 (8th Cir. 2000).

Stores Company ("May"). May originally issued credit cards to the plaintiffs and was the creditor in the original cardholder agreements with the plaintiffs. The cardholder agreements allowed unilateral modification by May with at least fifteen days' notice to cardholders. Shortly after the establishment of May National Bank ("Bank"), a wholly-owned subsidiary of May created to handle May's credit card operations, May sent an "IMPORTANT NOTICE" to its cardholders, providing that "[e]ffective immediately, credit is being extended by the May National Bank of Arizona" and stating that late fees would now be "up to $12.00, or as allowed by law."[16] Subsequent notices provided that late fees would be "$15, or as allowed by law. This varies from state to state."[17] There was little additional information and the notices did not purport to change any other terms of the agreement. The Bank thereafter sold its credit card receivables on a daily basis to May. The plaintiffs claimed that under state usury laws, applicable to the original issuer May, they were charged usurious late fees after the substitution of the Bank as the issuer, and that the National Bank Act did not apply because the party collecting the late fees was really May, not the Bank. The district court held that because credit was originated by the Bank, the National Bank Act controlled; thus, the plaintiffs' state law usury claims were preempted.[18] The district court also looked to the law of the Bank's home state, Arizona, to determine the late fees the Bank could assess.[19] On appeal, the U.S. Court of Appeals for the Eighth Circuit agreed with the district court, holding that the state law usury claim implicated the National Bank Act and that the Bank was the real party in interest.[20] The Eighth Circuit noted that the Bank, not May, issued the credit on a continuing basis, processed and serviced the accounts and set the terms of credit.[21] The Eighth Circuit remanded the case so that the plaintiffs could argue violations of the National Bank Act and for consideration of state law contract issues, including the issue of inadequate notice of a change in terms, an issue the court raised in a footnote.[22] This decision is important to the credit industry because it establishes that the sale of receivables by a creditor does not change the debtor-creditor relationship, nor the law applicable to that relationship. The Eighth Circuit noted, however, the existence of state contract law issues.[23] If the defendants failed to contractually effect a change of applicable law in the cardholder agreements, then the law applicable to the original creditor, May, rather than the Bank, would remain applicable, i.e., not the Bank's home state law.

Several separate but nearly identical suits have been filed around the country against ACE Cash Express, Inc., the owner, operator and franchiser of stores that

16. *Krispin*, 218 F.3d at 921.
17. *Id.*
18. *Matheis*, 1999 U.S. Dist. LEXIS 21917, at *11.
19. *Id.* at *11-*12.
20. *Krispin*, 218 F.3d at 924.
21. *Id.*
22. *Id.* at 924 n.2, 925.
23. *Id.* at 925.

offer "payday" or deferred presentment loans on behalf of a national bank.[24] In a representative suit, *Long v. ACE Cash Express, Inc.*,[25] the plaintiff filed a putative class action suit alleging that ACE entered into usurious and misleading lending contracts under Florida state law by feigning the use of Goleta National Bank as the creditor when ACE was the actual owner of the loans in order to avoid the Florida usury statutes. The plaintiff alleged that ACE and Goleta entered into a master loan agreement whereby ACE would offer bank loans designating Goleta as the lender through ACE's retail sites in Florida. Under the agreement, ACE purchased from Goleta all of the loans made on the previous day, and ACE then received "substantially" all of the interest and the risk. The loans are accessed in this case through debit cards that could be used at various ATM machines. The plaintiff claimed that the real purpose of the agreement was to allow ACE to evade state usury laws by allowing ACE to utilize Goleta's name and national bank standing, but because the loans were actually made by ACE, state laws and not the National Bank Act were applicable. ACE removed the case to the U.S. District Court for the Middle District of Florida on the theory that the plaintiff failed to name an indispensable party, Goleta, whose loans are governed by the National Bank Act, which preempts all state usury claims. The federal district court held, however, that whether ACE was the proper party named in the suit was not the question at issue.[26] The district court remanded the case, holding simply that the National Bank Act did not apply to ACE because ACE is not a national bank, and thus the National Bank Act cannot preempt the plaintiff's state law claims and there is no federal jurisdiction.[27] The allegations in this case raise the issue of whether the lender named in the loan contracts is the true creditor or whether another entity, such as a servicer or a purchaser of a participation interest (in this case ACE is both), can be found to be the creditor. In order to so find, the court would have to ignore the clear contractual relationships and recharacterize the transactions to fit the plaintiff's theory. Such a recharacterization would result in complete contract reformation and changes of parties, accounting and audit anomalies and serious bank regulatory issues. The court would be entering a legal quagmire.

In a similar case, *Phanco v. Dollar Financial Group, Inc.*,[28] the plaintiff brought a putative class action suit alleging that Eagle National Bank ("Bank"), designated

24. *See* Complaint, Hudson v. ACE Cash Express, Inc., No. IP01-C-1336-H/G (S.D. Ind. filed Sept. 11, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law); Complaint, Purdie v. ACE Cash Express, Inc., No. 301-CV1754-X (N.D. Tex. filed Sept. 6, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law); Complaint, Johnson v. ACE Cash Express, Inc., No. 01-CV-2299 (D. Md. filed Aug. 2, 2001) (voluntarily dismissed by plaintiffs) (on file with *The Business Lawyer*, University of Maryland School of Law); Complaint, Long v. ACE Cash Express, Inc., No. 3:00-CV-1306-J-25TJC (M.D. Fla. filed Nov. 1, 2000) (removed from state court) (on file with *The Business Lawyer*, University of Maryland School of Law); Complaint, Brown v. ACE Cash Express, Inc., No. 24-C-01-004036 (Cir. Ct. Md. filed Aug. 20, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law).

25. Complaint, *Long*, No. 3:00-CV-1306-J-25TJC.

26. Order, Long v. ACE Cash Express, Inc., No. 3:00-CV-1306-J-25TJC, at 2 (M.D. Fla. June 18, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law).

27. *Id.* slip op. at 2-3.

28. No. CV 99-1281 GHK (RZx) (C.D. Cal. Nov. 22, 2000) (on file with *The Business Lawyer*, University of Maryland School of Law).

as the lender in his "payday loan" transaction documents, was not the actual lender, but merely lent its name to Dollar Financial Group, Inc. and its affiliates, the corporations that allegedly made the "payday loans." The plaintiff claimed that this fiction allowed the corporations to avoid various state laws that either expressly prohibited short-term loans made by "deferred deposit" check cashing or imposed limitations with which the corporation would have had to comply if it was the lender. The plaintiff based his claim on allegations that: (i) the Bank did not meet prospective borrowers; (ii) the Bank did not review or approve borrowers' credentials; (iii) the Bank did not make credit decisions; (iv) the Bank did not advance funds; (v) the Bank did not bear risk of non-payment; (vi) the Bank did not own any of the accounts into which borrowers' checks were deposited; and (vii) the Bank had no knowledge of the loans made. Your authors understand that the defendant in this case disputes the facts as alleged by the plaintiff. Nevertheless, a settlement was reached in this suit, although the details of the settlement were not reported in the final order.[29]

BUSINESS OF RECEIVING DEPOSITS

In *Heaton v. Monogram Credit Card Bank of Georgia*,[30] a credit card customer brought a state court class action suit against Monogram Credit Card Bank of Georgia ("Bank"), the card issuer, for allegedly charging late fees in excess of the limit allowed under the Louisiana Consumer Credit Law. After the Bank removed the case to federal court, however, the district court remanded the case back to state court because it found that the Bank, a Georgia credit card bank, was not a "state bank" under the Federal Deposit Insurance Act because it was not engaged in the business of receiving deposits from its customers.[31] Accordingly, the district court found no federal question jurisdiction and no federal preemption.[32] While *Heaton* was on appeal to the Fifth Circuit, the FDIC published General Counsel's Opinion No. 12,[33] which interpreted the requirement in section 5 of the Federal Deposit Insurance Act that an applicant for deposit insurance must be "engaged in the business of receiving deposits other than trust funds."[34] The General Counsel's opinion states that the statutory requirement of being "'engaged in the business of receiving deposits other than trust funds' is satisfied by the continuous maintenance of one or more non-trust deposits in the aggregate amount of $500,000."[35] The opinion states that the FDIC will determine on a case-by-case basis whether the holding of non-trust deposits in amounts less than $500,000

29. *Id.*

30. 231 F.3d 994 (5th Cir. 2000), *cert. denied*, 533 U.S. 915 (2001).

31. Heaton v. Monogram Credit Card Bank of Ga., No. Civ. A. 98-1823, 1999 WL 1789422, at *1 (E.D. La. Nov. 22, 1999), *appeal dismissed*, 231 F.3d 994 (5th Cir. 2000), *cert. denied*, 533 U.S. 915 (2001).

32. *Id.*

33. FDIC General Counsel's Op. No. 12, Engaged in the Business of Receiving Deposits Other Than Trust Funds, 65 Fed. Reg. 14,568 (Mar. 17, 2000).

34. *Id.*; 12 U.S.C. § 1815(a)(1) (2000).

35. FDIC General Counsel's Op. No. 12, 65 Fed. Reg. at 14,572.

meets the definition.[36] The source of the deposit funds is not considered relevant.[37] The FDIC has now converted the General Counsel's opinion into a regulation.[38] Although the General Counsel's opinion specifically disapproved of the district court's analysis in the *Heaton* case, the U.S. Court of Appeals for the Fifth Circuit did not reach the substance of this case on appeal, holding that the district court order finding that the court lacked subject matter jurisdiction and remanding to state court was "not reviewable on appeal or otherwise."[39] The U.S. Supreme Court denied the Bank's petition for writ of certiorari to review the Fifth Circuit's procedural ruling.[40] The Fifth Circuit did reinstate the Truth in Lending Act (TILA)[41] claim that the district court had allowed the plaintiffs to dismiss on remand, noting that the Bank would have immediate grounds to once again remove the case to federal court.[42] Shortly after the Fifth Circuit's remand, the plaintiffs amended their petition to delete the Truth in Lending claim and the Bank removed the case again to federal court. In district court again, the FDIC moved to intervene in the suit and the plaintiffs moved to remand the case to state court. The district court remanded the case again, holding that the Bank was not "engaged in the business of receiving deposits" and even if the Bank were a state bank, complete preemption did not apply, and that therefore the district court lacked subject matter jurisdiction over the case and that the FDIC's motion to intervene was moot.[43] The FDIC has appealed from the decision to the Fifth Circuit. The allegations in *Heaton* represent another attempt to attack a bank's ability to export rates and fees by questioning the bank's status as an insured state bank under the federal law authorizing exportation. In order to adopt the plaintiffs' theory, however, a court will have to overcome the FDIC's longstanding position and interpretations of the act it is charged with interpreting and, specifically, overturn the FDIC's determination to grant deposit insurance to the Bank thirteen plus years ago. The court also would have to overcome strong Supreme Court precedent granting the federal banking agencies substantial deference in their interpretations of such statutes.[44]

Herren v. Monogram Credit Card Bank of Georgia[45] is a case similar to *Heaton*. In *Herren*, the original plaintiff brought a putative class action suit against Monogram ("Bank") in Arkansas state court, alleging that the Bank charged usurious interest

36. *Id.*

37. *Id.*

38. FDIC Final Rule, Engaged in the Business of Receiving Deposits Other Than Trust Funds, 66 Fed. Reg. 54,645 (Oct. 30, 2001).

39. Heaton v. Monogram Credit Card Bank of Ga., 231 F.3d 994, 997, 998, 1000 (5th Cir. 2000) (citing 28 U.S.C. § 1447(d)).

40. Monogram Credit Card Bank of Ga. v. Heaton, 533 U.S. 915 (2001).

41. 15 U.S.C. §§ 1601-1666j (2000).

42. Heaton v. Monogram Credit Card Bank of Ga., 231 F.3d at 1000.

43. Heaton v. Monogram Credit Card Bank of Ga., No. Civ. A. 98-1823, 2001 WL 15635, at *2-*4 (E.D. La. Jan. 5, 2001); Heaton v. Monogram Credit Card Bank of Ga., No. Civ. A. 98-1823, 2001 WL 125346, at *1 (E.D. La. Feb. 14, 2001).

44. *See* Smiley v. Citibank, 517 U.S. 735, 739-44 (1996).

45. Motion to Dismiss for Lack of Subject Matter Jurisdiction, Monogram Credit Card Bank of Ga. v. Herren, No. 5:01 CV00264WRW (E.D. Ark. filed Sept. 18, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law).

in excess of the interest rates allowed by the Arkansas Constitution. The plaintiff explicitly stated in her complaint that the Bank "is not engaged in the business of receiving deposits from customers" and "is not a state bank as defined by the [FDIC]," that she was asserting no federal claims, and that her state law claims were not preempted by federal law.[46] The plaintiff, however, subsequently filed a voluntary nonsuit of the action, resulting in a dismissal of the suit without prejudice. In response, the Bank brought an action in the U.S. District Court for the Eastern District of Arkansas for a declaratory judgment on the issue of whether the Bank's interest charges are subject to Arkansas law or whether Arkansas law is completely preempted by federal law. The Bank argued that as a federally insured state bank located in Georgia, it is permitted to charge interest allowed by Georgia law and any contrary Arkansas law is preempted. Since Herren dismissed her action without prejudice and threatened to refile the action, the Bank argued, the controversy remained actual, concrete and specific and appropriate for a declaratory judgment. However, Herren filed a Motion to Dismiss for Lack of Subject Matter Jurisdiction, arguing that the only actual controversy pending is in Louisiana (referring to the *Heaton* case) and "this suit is an effort by [the Bank] to have the Court second guess the State and Federal judges in Louisiana."[47] No decision had been reported in this case at the time of this writing.

Application of Payments

In *Priore v. World Financial Network National Bank*,[48] the plaintiffs commenced a putative class action suit in the U.S. District Court for the Southern District of Florida against World Financial Network National Bank ("Bank"), a national bank that issued credit cards to the plaintiffs, and against the Bank's affiliated processor. The plaintiffs alleged that the Bank and its affiliate failed to credit customers' accounts on the day payments were received, which allegedly resulted in the imposition of excessive finance charges and late fees, and that the Bank imposed excessive finance charges and penalties on customers for failure to conform to payment procedures set forth in billing statements. The plaintiffs claimed that these acts violated the federal Fair Credit Billing Act, the federal Truth in Lending Act and the Florida Consumer Collection Practices Act. The plaintiffs further alleged that, in violating such statutes, the Bank engaged in unfair and deceptive trade practices and breached contracts between the parties. The Bank's Motion to Dismiss argued that only the National Bank Act and the Bank's home state's law apply to claims of excessive interest charges arising from the timing of crediting payments to the plaintiffs' accounts. Thus, with the Bank located in Ohio, the

46. Class Action Complaint, Herren v. Monogram Credit Card Bank of Ga., No. CIV-2001-65-1, at 3 (Cir. Ct. Ark. filed July 2001) (on file with *The Business Lawyer*, University of Maryland School of Law).

47. Motion to Dismiss for Lack of Subject Matter Jurisdiction, *Herren*, No. 5:01 CV00264WRW, at 6.

48. Defendants' Alternative Motion to Dismiss, Priore v. World Fin. Network Nat'l Bank, No. 00-4373-CIV-HUCK (S.D. Fla. filed Feb. 9, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law).

interest and method of calculating such interest permitted in Ohio would be the standard under which the Bank would be required to operate in interstate lending transactions.[49] The plaintiffs, of course, are trying to avoid the application of federal and Ohio law by alleging violations of the state law of the residence of the class action representatives. Because the putative class is nationwide, the plaintiffs appear to be arguing that the laws of every state other than the Bank's home state and federal law apply. At this writing, the court had not yet ruled on the Bank's Motion to Dismiss.

In a similar case, *Mangone v. First USA Bank, N.A.*,[50] defendants First USA Bank, N.A. and Bank One Corp. settled with the class action plaintiffs without admitting liability. The plaintiffs held credit cards issued by First USA Bank and alleged various state and federal law violations, including violations of the Illinois Consumer Fraud and Deceptive Practices Act and the federal Truth in Lending Act, relating to payment crediting practices on payments received through the mail. Under the settlement, the defendants will establish a multipayment credit pool of approximately $700,000, a late fee pool of up to $28.7 million and a reprice credits pool of up to $3.8 million, to be paid to eligible class members who submit valid proof of claims. In addition, finance charge credits of $0.38 will be made to eligible current and former card members. The defendants will also contribute a maximum of $100,000 to consumer education from any undistributed finance charge credits. Finally, the defendants agreed not to oppose class counsel's application for up to $3 million in attorneys' fees and $100,000 in actual expenses.

Claims Based on Agency Relationships

Similar claims alleging violations of state lending laws have been made in class action suits against the lender, the assignee/holder, and the securitization trusts that hold mortgage loans originated by FDIC-insured state banks. In both *Davis v. Community Bank of Northern Virginia*[51] and *Avila v. Community Bank of Northern Virginia*,[52] the plaintiffs alleged that Community Bank of Northern Virginia ("Bank") funded, then immediately sold their mortgage loans that were originated by the Bank's affiliated brokers. The plaintiffs stated that they were charged interest rates, fees and costs that were in excess of the legal amounts under state lending laws. The plaintiffs in *Davis* claimed specifically that because the Bank originated loans through unlicensed brokers and charged interest rates and fees that were therefore illegal, the notes and mortgages were void or voidable. The complaints take the implicit position that the loans are subject to state law and

49. *Id.* at 3, 5 (citing Marquette Nat'l Bank v. First of Omaha Serv. Corp., 439 U.S. 299, 308 (1978)).

50. Class Action Settlement Agreement, Mangone v. First USA Bank, N.A., No. 00-881-MJR (S.D. Ill. Feb. 2, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law).

51. Amended Complaint in Class Action, Davis v. Cmty. Bank of N. Va., No. GD-01-8643 (Ct. C.P. Allegheny County, Pa. filed May 1, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law).

52. Petition, Avila v. Cmty. Bank of N. Va., No. 01CV215815 (Cir. Ct. Mo. filed June 27, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law).

that federal preemption is not available because the lender, a FDIC-insured state bank, is merely a "quasi" originator of the loans. The plaintiffs in these cases also try to avoid the application of the Bank's home state and federal law exportation rights by alleging violations of state law by loan brokers and ignoring the exportation rights of the Bank. At the time of this writing, no decision had been reported in either *Davis* or *Avila.*

The class actions noted herein have a common thread. They attempt to find state law violations of interest and fee restrictions by avoiding application of the federal law exportation rights of depository institutions engaging in interstate lending, using various theories. It remains to be seen whether the courts will be receptive to such theories, in the face of strong federal preemption authority.

STATE REGULATORS' ACTIONS AND FEDERAL AGENCY REACTIONS

INDIRECT ATTACKS ON AGENTS OF BANKS

Seeking confirmation that a state lending law would not regulate a national bank's lending program, National City Bank ("Bank"), a national bank located in Ohio, requested a declaratory ruling from the Michigan Department of Consumer and Industry Services, Financial Institutions Bureau regarding the applicability of the Michigan Motor Vehicle Sales Finance Act ("Act")[53] to the Bank's direct lending program in Michigan. Under the program, dealers serve as agents of the Bank in soliciting consumers to obtain loans to finance the purchase of motor vehicles. In comparing the Bank's direct loans and other installment sale contracts, the Bureau found that the main difference between the Bank's transactions and other installment sale contract transactions was that in a typical installment sale contract transaction, the dealer is the creditor and then assigns its interest in the contract to the assignee, while the Bank transaction does not require an assignment.[54] The Bureau concluded, however, that, based on the similarities between the two transactions, the Bank loans were in fact "installment sale contracts."[55] The Bureau found that the fee that the dealer received from the Bank for assistance with the loan was in no significant aspect different from the payment a dealer received when an installment contract was assigned.[56] The Bureau concluded:

> that where an entity has engaged an agent to facilitate the making of an installment sales contract, the agent must not only be licensed under the Act, but must ensure that the transaction is conducted in full compliance with all terms of the Act. Where such agent has either facilitated the making of an installment sale contract on behalf of an unlicensed entity, or, regardless of whether the entity is licensed, if the transaction does not comply with

53. MICH. COMP. LAWS §§ 492.101-.141 (West 1998 & Supp. 2001).

54. *In re* Martin (Michigan Financial Institutions Bureau Jan. 1, 2000), *available at* http://www.cis.state.mi.us/ofis/statutes/ord_rulng/declrtry/dr010100.asp.

55. *Id.*

56. *Id.*

> the Act, that agent will be subject to an administrative enforcement action as well as any applicable criminal sanction.[57]

Thus, the vehicle dealer in the Bank transaction must be licensed and is liable for any compliance failure. This ruling could result in dealers being unwilling to act as a bank's agent on direct loans. Consequently, a request was then made to the OCC by two national banks for a preemption determination.[58] In response, the OCC concluded that the Act is preempted to the extent that it limits a national bank's motor vehicle financing arrangements.[59] The OCC found that the Michigan Financial Institutions Bureau's interpretation of the Act's definition of "installment sales contracts" as including bank-originated loans conflicts with federal law and significantly interferes with a bank's ability to exercise its lending authority.[60] The OCC stated that the Act interfered with a bank's ability to lend by: (i) prohibiting a bank from using automobile dealers as agents to originate bank loans in conflict with section 24 (Seventh) of the National Bank Act;[61] (ii) preventing a bank from exercising its power under section 85 of the National Bank Act[62] to charge the interest rate permitted by the bank's home state; and (iii) purporting to require a national bank to obtain state approval or a license to engage in lending in conflict with the OCC's exclusive visitorial powers over national banks.[63] Although the OCC pronouncement appears to have effectively halted the Michigan effort to indirectly regulate direct loans by national banks, several other states have now commenced similar efforts.

RECHARACTERIZATION OF TRANSACTIONS

In *In re ACE Cash Express, Inc.*,[64] the Ohio Department of Commerce, Superintendent of the Division of Financial Institutions ("Division") charged ACE Cash Express, Inc. (ACE), a non-bank agent of a national bank, with violations of a state lending law on the theory that the nonbank entity, rather than the bank, was the lender.[65] ACE is an originator and servicer of loans made by a national bank located in California. The bank relies on federal and California law to set the interest rates and fees charged in its loans to Ohio borrowers. The loans are generally secured by a paycheck to be deposited by the borrower at a future date. The national bank sells a participation interest in the loans to ACE. The administrative action alleged that ACE, and not the national bank, was the lender and therefore general state lending laws apply to the transactions. Although ACE

57. *Id.*
58. OCC Notice of Request for Preemption Determination, 65 Fed. Reg. 63,917 (Oct. 25, 2000).
59. OCC Preemption Determination, 66 Fed. Reg. 28,593, 28,596 (May 23, 2001).
60. *Id.* at 28,595.
61. 12 U.S.C. § 24 (2000).
62. *Id.* § 85.
63. OCC Preemption Determination, 66 Fed. Reg. at 28,596.
64. *In re* ACE Cash Express, Inc., No. 01-SL-01 (State of Ohio, Department of Commerce, Division of Financial Institutions July 16, 2001) (finding violation of Small Loan Act) (on file with *The Business Lawyer*, University of Maryland School of Law).
65. *Id.* at 2.

claimed that its agreement with the bank exempts it from state regulation, the Division alleged that ACE was engaging in business in violation of the Ohio lending law by lending money without a license. ACE requested a formal administrative hearing on the Division's findings, but regardless of the outcome of the hearing, the courts will probably have to resolve this issue. Similar regulatory actions have been commenced by regulators in Colorado and Maryland against ACE.[66] In Colorado, the Attorney General and the Administrator of the Colorado Consumer Credit Code ("Code") filed suit in state court to enforce compliance with the Code, alleging that, without the required state license, ACE regularly engaged in the making or offering, arranging or acting as agent for a third party, of "payday" loans and regularly engaged in the taking of assignments of and undertaking direct collection of payments from or enforcement of rights against consumers arising from such loans. There was no direct mention of the national bank or the arrangement between ACE and the national bank in the complaint.[67] ACE subsequently removed the action to federal court on the basis of federal question jurisdiction, arguing that the plaintiffs' claims were completely preempted by the National Bank Act.[68] The OCC filed a brief as *amicus curiae* in support of the plaintiffs' motion to remand,[69] arguing that "ACE is not a national bank," nor do the plaintiffs' claims against ACE arise under the National Bank Act or other federal law. The OCC stated that the "hypothetical conflict between federal and state law does not give this court federal question jurisdiction under the doctrine of complete preemption."[70] No final decision had been reported at the time of this writing.

In Maryland, there is an additional matter at issue. The Maryland regulators claim that a new "secured" transaction set up by ACE is an attempt to circumvent a new Maryland state law, which prohibits credit services businesses from acting as agents for out-of-state lenders to facilitate unsecured closed-end loans at rates of interest in excess of the Maryland limit. As with the Colorado matter, no final decision had been reported in the Maryland matter at the time of this writing.[71]

The common element in these regulatory actions is an attempted avoidance by the states of any direct regulation of the national bank. By alleging only that the non-bank agent of the bank is violating state law, those states have attempted to

66. *See* Complaint, Colorado v. ACE Cash Express, Inc., No. 01-CV-1576 (D. Colo. filed Aug. 10, 2001) (removed from state court) (on file with *The Business Lawyer*, University of Maryland School of Law); Order to Show Cause, *In re* ACE Cash Express, Inc. (Maryland Commissioner of Financial Regulation, Maryland Department of Labor, Licensing and Regulation July 5, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law).

67. Complaint, Colorado v. ACE Cash Express, Inc., No. 01-CV-1576.

68. Notice of Removal, Colorado v. ACE Cash Express, Inc., No. 01-CV-1576 (D. Colo. filed Aug. 10, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law).

69. *See* Plaintiffs' Motion to Remand, Colorado v. ACE Cash Express, Inc., No. 01-CV-1576 (D. Colo. filed Sept. 6, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law).

70. OCC Amicus Curiae Brief, Colorado v. ACE Cash Express, Inc., No. 01-CV-1576, at 2 (D. Colo. filed Sept. 27, 2001) (on file with *The Business Lawyer*, University of Maryland School of Law).

71. Order to Show Cause, *In re* ACE Cash Express, Inc. (Maryland Commissioner of Financial Regulation, Maryland Department of Labor, Licensing and Regulation July 5, 2001).

recharacterize the loan transactions in ways that de-emphasize the role of the bank in advancing funds to and contracting with the borrowers. Such a recharacterization triggers significant contract reformation, accounting, auditing and bank regulatory issues that the courts will have to confront if they are inclined to recognize such arguments.

IGNORING FEDERAL PREEMPTION

Taking a similar stance in terms of seeking to avoid federal law, the State of Virginia announced in an official newsletter its position that the federal Alternative Mortgage Transaction Parity Act ("Parity Act")[72] did not preempt a Virginia statute limiting prepayment penalties. In response, a trade association representing non-federally chartered housing creditors commenced *National Home Equity Mortgage Ass'n v. Face*,[73] seeking a declaratory judgment and an injunction prohibiting Virginia from enforcing Virginia's prepayment penalty provisions for loans made under the Parity Act. The U.S. District Court for the Eastern District of Virginia granted the plaintiff's motions.[74] On appeal, the Fourth Circuit Court of Appeals affirmed the district court decision, pointing out that the Parity Act states that a non-federally chartered housing creditor may make an alternative mortgage transaction pursuant to applicable federal regulations "notwithstanding any State constitution, law, or regulation" and that the OTS does regulate prepayment fees as part of the alternative mortgage transaction regulations.[75] Thus, housing creditors in Virginia can elect to have their alternative mortgage transactions governed by federal law under the Parity Act and when they do, the Parity Act and its regulations preempt Virginia's statutory requirements, including its limits on prepayment penalties.[76] Thus, a federal appellate court decision was required to ensure that a creditor could avail itself of federal preemption of certain aspects of state law.

In another example, the OTS approved an application to designate Westcorp Financial Services, Inc. (now WFS Financial Inc.), as an operating subsidiary of Western Financial Bank, a federal savings bank. WFS then wrote to the state of Wisconsin to register its objection to being required to obtain licenses and to register under state law. An official from the state responded that "the Division of Banking [ ] does not recognize or give deference to assertions that the Office of Thrift Supervision [ ] has preempted State regulation of sales finance company activity conducted by subsidiaries of federally-chartered thrift institutions."[77] In *WFS Financial Inc. v. Dean*, WFS then brought an action in the U.S. District Court for the Western District of Wisconsin for declaratory and injunctive relief, seeking a determination that it was not subject to Wisconsin state laws regulating lending

72. *See* 12 U.S.C. §§ 3801-3806 (2000); *see generally* Scott D. Samlin, *AMTPA—The Federal Alternative Mortgage Transaction Parity Act (Parity or Parody?)*, 54 CONSUMER FIN. L.Q. REP. 129 (2000).

73. 64 F. Supp. 2d 584 (E.D. Va. 1999), *aff'd*, 239 F.3d 633 (4th Cir. 2001).

74. *Face*, 239 F.3d at 636.

75. *Id.* at 637-38 (quoting 12 U.S.C. § 3803(c)).

76. *Id.* at 640.

77. WFS Fin. Inc. v. Dean, 79 F. Supp. 2d 1024, 1025-26 (W.D. Wis. 1999) (alterations in original).

activities because it is an operating subsidiary of a federal savings bank to which the OTS extended the benefits of the federal preemption enjoyed by federal savings banks. In particular, WFS objected to Wisconsin laws that required WFS to obtain state licenses and to register as a "sales finance company." The district court concluded that the OTS acted non-arbitrarily and well within its delegated authority to advance the purposes of the Home Owners' Loan Act of 1933[78] when it promulgated the regulations allowing federal savings and loan associations to acquire and operate subsidiaries that would be regulated by the OTS in the same manner as their parent organizations and equally exempt from state regulation.[79] Thus, the state may not enforce any regulations against operating subsidiaries that the state cannot enforce against federal savings and loan associations.[80] Again, it took a federal court decision to ensure a creditor's rights to federal preemption.

Consequently, federal banking regulators have stepped up their pronouncements to clarify the scope of federal preemption in banking regulation. The OCC has revised section 7.4000[81] of the OCC rules to clarify the extent of the OCC's visitorial powers under 12 U.S.C. section 484 and other federal statutes.[82] Section 7.4000 codifies the definition of visitorial powers and illustrates what visitorial powers include by providing a non-exclusive list of these powers, including: (i) examination of a bank; (ii) inspection of a bank's books and records; (iii) regulation and supervision of activities authorized or permitted under federal banking law; and (iv) enforcing compliance with any applicable federal or state laws concerning those activities.[83] Section 7.4000 states that only the OCC or an authorized representative of the OCC may exercise visitorial powers with respect to national banks, except as provided in paragraph (b) of section 7.4000.[84] "State officials may not exercise visitorial powers with respect to national banks, such as conducting examinations, inspecting or requiring the production of books or records of national banks, or prosecuting enforcement actions, except in limited circumstances authorized by federal law."[85] The OCC has also issued a final rule governing investment securities, bank activities and operations, and leasing.[86] A new section, section 7.4006, provides that state laws apply to a national bank operating subsidiary to the same extent that those laws apply to the parent national bank.[87] This provision gives national bank operating subsidiaries the same exportation powers as are available to the national bank parent and is comparable to the OTS regulation that was tested in *WFS Financial Inc. v. Dean*.

78. 12 U.S.C. §§ 1461-1470 (2000).
79. *WFS Fin. Inc.*, 79 F. Supp. 2d at 1024.
80. *Id.* at 1025, 1028.
81. 12 C.F.R. § 7.4000 (2001).
82. OCC Final Rule, Investment Securities; Rules, Policies, and Procedures for Corporate Activities; Bank Activities and Operations, 64 Fed. Reg. 60,092, 60,094 (Nov. 4, 1999).
83. 12 C.F.R. § 7.4000(a)(2)(i)-(iv).
84. *Id.* § 7.4000.
85. *Id.*
86. OCC Final Rule, Investment Securities; Bank Activities and Operations; Leasing, 66 Fed. Reg. 34,784 (July 2, 2001).
87. *Id.* at 34,788.

Thus, some state regulators have been active in challenging federal preemption of state regulation of lending activities notwithstanding clear pronouncements by the courts and continuing federal regulatory responses to clarify the scope of that preemption. In one case, such a challenge resulted in the state regulator being required to pay the attorneys' fees and costs of the bank under 42 U.S.C. sections 1983 and 1988 for deprivation of the bank's constitutional rights under color of state law.[88]

CONCLUSION

The battle lines with respect to federal preemption appear to be well established, but the theories used in the contests continue to change. In 2001, the plaintiffs' class action bar and certain state regulators continued to attack the rights of depository institutions to use federal law in their interstate lending transactions. The depository institutions continued to fight back in court and the federal banking regulators continued to clarify and restate their regulatory positions. Will the war ever end? Unfortunately, it will probably continue as long as plaintiffs' lawyers envision the possibility of large recoveries and state regulators perceive their turfs to be unduly restricted by federal preemption of state laws.

88. *See* Order, Ass'n of Banks in Ins., Inc. v. Duryee, No. C2-98-1120, at 17 (S.D. Ohio filed Feb. 9, 2000) (on file with *The Business Lawyer*, University of Maryland School of Law).