The Waters Case: U.S. Supreme Court Upholds Ability of National Bank Operating Subsidiaries to Preempt State Laws--What Does It Mean?

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The Watters Case: U.S. Supreme Court Upholds Ability of National Bank Operating Subsidiaries to Preempt State Law--What Does It Mean?

By Fred H. Miller, Meghan S. Musselman, and Alvin C. Harrell

I. The Watters Decision

On April 17, 2007 the United States Supreme Court decided Watters v. Wachovia Bank, N.A.,1 in which the Michigan Office of Insurance and Financial Services sought to exert state regulation over a Michigan-chartered operating subsidiary of Wachovia, a national bank. Wachovia argued that the Office of the Comptroller of the Currency (OCC) regulation at 12 C.F.R. section 7.4006, which provides that national bank operating subsidiaries have the benefit of federal preemption of state law to the same extent as their parent national banks, protected its operating subsidiary from state supervision. The Supreme Court held that the OCC, and not the individual states, has visitatorial power over national bank operating subsidiaries. The Court concluded that, in determining the preemptive reach of the National Bank Act (NBA), the proper focus is on a national bank's powers, not its corporate structure. Section 24(Seventh) of the NBA permits banks to conduct their business through operating subsidiaries and, therefore, the Court reasoned, the ability of a national bank to conduct the business of banking

free from state regulation extends to any business conducted through its operating subsidiaries. With respect to the OCC's operating subsidiary rule, the Court concluded that section 7.4006 merely confirms what the NBA already says.

The Court dismissed Michigan's argument that the states have visitatorial powers over a national bank's state-chartered operating subsidiaries. The state argued that section 484(a) of the NBA expressly exempts national banks from state supervision, but not their operating subsidiaries, and that section 481 of the NBA addresses affiliates but does not provide a similar exemption from state supervision. In response the Court noted that Congress enacted section 484 before operating subsidiaries were authorized by the OCC and, therefore, Congress could not have contemplated operating subsidiaries. Additionally, although operating subsidiaries are a type of affiliate, they are tightly tied to the parent bank because they can only engage in activities that the parent bank may engage in directly. The Court also dismissed Michigan's Tenth Amendment argument, finding that the U.S. Constitution delegates the power to regulate national bank operations to Congress pursuant to both the Commerce and the Necessary and Proper Clauses of the United States Constitution. Because the Tenth Amendment applies only to powers not otherwise delegated, it did not apply here.

Justice Ginsburg wrote for the majority, joined by Justices Kennedy, Souter, Breyer and Alito. Justice Stevens authored the dissent, joined by Chief Justice Roberts and Justice Scalia. Justice Thomas recused himself from this case.

II. Implications of Watters

A. Scope of this Analysis

In the Introduction to the 2007 Annual Survey of Consumer Financial Services Law in The Business Lawyer,2 written before the Watters case was decided, two of your authors joined Don Lampe in examining the potential implications of the Watters case,3 in the broader context of the relation between state and federal law. As noted above, the basic issue in Watters was whether a state can assert jurisdiction over a national bank operating subsidiary in connection with issues such as licensing, reporting, and visitatorial supervision. This, by itself, is a fairly narrow issue. Still, the Court's conclusion that the mortgage business, whether conducted by the bank or through a state-chartered operating subsidiary, by reason of the enumerated and necessary powers provisions of the NBA,4 is exclusively subject to OCC jurisdiction and supervision, and not to the licensing, reporting, and visitatorial regimes of the states in which the subsidiary in chartered and operates, is undoubtedly a landmark decision in terms of financial services

3. 127 S.E. 2d 559.
law and relations between the state and federal governments. But in some ways that is the easy issue. The purpose of this article is not to elaborate on the court’s treatment of that narrow issue, but rather to consider the implications of the standards the Court articulated for preemption of state law, in the context of broader issues such as those noted in the introduction to the 2007 Annual Survey.4

B. The Watters Standard

The Watters opinion emphasizes that the NBA vested in nationally-chartered banks certain enumerated powers, including all such incidental powers as are necessary to carry on the business of banking, and to prevent inconsistent or intrusive state regulation, and further provides that no national bank shall be subject to any vitiatorial powers except as authorized by federal law.5 This standard requires application of an "inconsistency" standard, now extended to operating subsidiaries as well. Those familiar with the federal Consumer Credit Protection Act6 are well aware that the concept of inconsistency does not have an inherent meaning outside of the context in which it is used.6 Of course, in many cases this standard will not pose undue difficulty. For example, since the NBA specifically authorizes nationally-chartered banks to engage in real estate lending,6 a state law denying a bank that power,5 or perhaps conditioning it in an overly burdensome way, or perhaps even duplicating the grant of power but in different words thus creating questions, is preempted.6 But still, this requires a sometimes laborious, and knowledgeable, case-by-case analysis, and perhaps litigation, as to otherwise routine matters.

This also raises other, more difficult questions, e.g., what broader meaning are we to ascribe to the word "inconsistent" in the Watters context, and further what does the term "intrusive" mean? Apparently, state usury laws are generally not such, as in essence they are applied through the NBA at 12 U.S.C. section 85.10 On the other hand, state law governs contracts made by national banks as well as the acquisition and transfer of property.11 State consumer protection laws on the whole seem to fall into the "intrusive" category,15 although as noted the nature of the analysis makes broad conclusions difficult.

The Watters Court also uses the standard of "significantly impair," and favorably cites Franklin Nat. Bank of Franklin Square v. New York,16 which struck down local restrictions because they "burdened"17 the exercise of a bank's incidental power. In Watters the Court also talks disapprovingly about state laws that "curtail or hinder" the bank or its operating subsidiary.18 It is not unique for the Court to send an unclear message, but the Watters opinion and the record it is based on are abysmal in this respect: surely the essential and foundational principles of federalism deserve better.

C. The Watters Dissent

The Watters decision, of course, was split, with Justices Stevens, Roberts, and Scalia dissenting, and there is reason to believe that Justice Thomas would have joined the dissent had he not recused himself. Thus, even the Court's unclear message is on thin ice.19 Then there is the
question of the precise scope of regulatory preemption by the OCC, which has asserted a very broad view of preemption power but has been careful in choosing its targets, apparently with the intent of pursuing an incremental approach. Because the Watters Court based its opinion on the statute, and the role of operating subsidiaries, it did not consider the extent of the authority of the OCC with regard to preemption—dismissing the assertion that the OCC went beyond its authority as "beside the point" and "academic." But the dissent discussed the issue and opined that Congress has not authorized an executive agency to broadly preempt state laws whenever it concludes that they interfere with national bank activities.

III. Conclusion

In conclusion, the Court may have bobbed the ball, but in defense it was dealing with a narrow issue governed by a statute that does not contemplate or answer the question presented. This is an issue that the courts should not have to deal with, except perhaps as to specifics at the fringes. Providing an appropriate broad rule for preemption is necessarily hard to do in a narrow Court opinion which must deal with ambiguous statutory language, and prior and not always consistently-phrased cases. Moreover, in these circumstances, even if a provided standard seems clear, it does not solve the difficult issue of its application in numerous scenarios, perhaps unless the rule truly embraces complete, or "field" preemption, which clearly is inappropriate in this context and itself presents enormous problems that have to date been kept largely from view. Add to this the split on the Court, and the vague terminology sprinkled throughout the Court's opinion, and one can conclude that Watters, while seminal to a degree and apparently resolving a narrow point, in other ways leaves the law murky than ever. But this may be little more than a reflection on the Court's inherent limitations when it comes to deciding broad policy matters.

Rather, the fault lies directly with Congress. If it is going to intrude into what used to be the exclusive province of the states, with respect to issues that have long been thought to be settled, it is incumbent on Congress, in light of the federal system, to competently address the preemption issue. Rather than addressing these questions in a way that resolves the fundamental issues at stake, Watters leaves us with many of the same generalizations and ambiguities, restated even more ambiguously by a sharply divided Court. Thus, your author's renewed the call made in the Introduction to the 2007 Annual Survey, for representatives of the states and Congress to coordinate in addressing the federalism issues in this area of law. In today's global economy, the financial markets require competent law-making in order for the United States to remain competitive; it is time for cooperative federalism to replace ambiguity coupled with incremental, unilateral preemption and the resultant uncertainty. The Supreme Court cannot do the job alone, and case law like Watters is obviously not the answer.

19. Id. at 454-455.
20. See 12 C.F.R. §§ 240.7-240.8, concerning state laws that obstruct, impair, or condition a national bank's ability to freely exercise its powers.
22. Dissent, 127 S. Ct. at 3557-58 and 1582-84.
23. In the context here, the experience goes back some 300 years to Witters, 127 S. Ct. at 1506—where, in most utilitarian terms, it is more complete but still extant back to the late 1960s, e.g., with the enactment of the Consumer Credit Protection Act, 15 U.S.C. § 1601 et seq.
24. To its credit, Congress attempted just that in the Consumer Credit Protection Act, see, e.g., 15 U.S.C. § 1601, 1569, 1670, 1681, 1681d, 1681m, 1681n, and 1681z(d), (e) and (f). It succeeded in that experience, and the law thus enacted in the area to ensure a sensible rule, and allow an agency, perhaps like the Federal Reserve Board which has a track record of coordinating with state laws to set payment system matters, as well as the Federal Reserve Act, authority to provide any necessary alternative. See, e.g., Regulation Z, 12 C.F.R. § 226.20.

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**Safeco v. Burr: Supreme Court Decides What “Willful” Violation Means Under the Fair Credit Reporting Act**

By Elizabeth M. Bohn

The Fair Credit Reporting Act (FCRA) requires users of consumer credit reports to give notice to any consumer subjected to "adverse action", based on...