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Federal Preemption of State Subprime Lending Laws

In the cascade of litigation arising from the subprime credit crisis, a crucial issue will be the interplay between state laws aimed at predatory lending practices and federal banking preemption doctrine.

This article examines in tandem two recent cases, the New York State Supreme Court ruling in *LaSalle Bank NA v. Shearon*,¹ applying New York State's High Cost Home Loan Law,² and the U.S. Court of Appeals for the Ninth Circuit opinion in *Rose v. Chase Bank USA NA*.³

LaSalle Bank highlights the potentially draconian consequences to a mortgage holder if a court finds that there has been a violation of the High Cost Home Loan Law, as interpreted by the court in that case. *Rose v. Chase*, and the Supreme Court authority on which it relies, highlights the defense of federal preemption that may be invoked by federally chartered banking institutions against state laws such as the High Cost Home Loan Law.

This article recommends caution to financial institutions holding subprime mortgage loans that are potentially subject to New York law, and outlines an argument for the preemption of the High Cost Home Loan Law as applied to federally chartered banking institutions.

The High Cost Home Loan Law imposes requirements on lenders aimed at "predatory lending" practices in covered high-cost mortgages, as defined by the statute.⁴ The statute defines "high cost home loans" as primary home loans with interest rates that exceed "eight percentage points over the yield on treasury securities with comparable periods of maturity" to the mortgage or loans with points and fees exceeding five percent, among other thresholds.⁵



'*LaSalle Bank v. Shearon*'

In *LaSalle Bank v. Shearon*, the court ruled on summary judgment that the loan in that case was void and unenforceable under the statute as interpreted by the court and awarded the debtor the return of all points, fees and payments on principal and interest, plus direct and consequential damages, in amounts to be determined at a hearing.⁶ *LaSalle Bank* highlights the potentially severe pitfalls that can arise in what would be an otherwise routine foreclosure action on a subprime loan. It signals a strong caution to institutions holding subprime loans to carefully review their mortgage files for state law compliance before pursuing litigation that could result in unexpected losses and additional liability.

Results like *LaSalle Bank*, if upheld and widely repeated, could worsen the financial crisis by converting defaulted mortgages into sources of unexpected damages liability, as well as total losses of principal and interest. Federal preemption doctrine could help mitigate this effect. Preemption was not raised in *LaSalle Bank*, perhaps because the loan had not originated with a federally chartered institution. However, *Rose v. Chase* and the Supreme Court authority on which it relies shows that the High Cost Home Loan Law should be deemed preempted by federal law as applied to loans made by a federally chartered bank and possibly loans purchased by a federally chartered institution as well.⁷

High Cost Home Loan Law

In *LaSalle Bank*, the plaintiff, a national bank, brought suit as a trustee and holder of a mortgage loan issued by a subprime lender, WMC Mortgage Corp. (WMC).⁸ The bank sought summary judgment on the loan and mortgage. Even without a cross-motion from the debtor, the court took the unusual step of not only denying the bank summary judgment, but granting the debtor summary judgment on his cross-claims for damages as well as his defenses.⁹ This appears to be the first published decision of its kind under the High Cost Home Loan Law, which was enacted on Oct. 3, 2002 (Section 6-1(1)(e) was amended in 2007). It covers high-cost home loans (as defined by the statute) applied for, on or after April 1, 2003.¹⁰

The court found violations of §6-1(2)(k) ("lending without due regard for repayment ability"), §6-1(2)(1)(ii) (counseling notice requirement) and §6-1(2)(m) (points and fees exceeding 3 percent of the principal).¹¹

- **First**, the court found that the loan was made "without due regard for repayment ability," as required by §6-1(2)(k). The borrower had claimed on his application a significantly greater income than was reported on his tax returns. Although stating that "this court will not condone fraud by the borrower," the court interpreted the statute to require that the ability to repay be "verified by detailed documentation of all sources of income and corroborated by independent verification."¹² Because the bank produced no evidence of the lender's due diligence efforts, the court found that the lender had intentionally failed in its obligations.

- **Second**, the court found that the terms of the loan violated the statutory limit that points and fees should not be more than 3 percent of the total principal (the court found that they were 5.4 percent).¹³

- **Third**, the court found that the lender

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entirely failed to provide the required "counseling notice," the text and timing of which is prescribed by the statute.

According to the court, because it found that violations of the statute were "intentional," the loan and mortgage were void and unenforceable under §6-1(10), "strip[ping] the lender from having any right to collect, receive or retain any principal, interest or other charges whatsoever with respect to the loan, as well as giving the borrower the ability to recover any payments made under the agreement."¹⁴ As a result, the debtor, who had purchased the property with "no money down," would receive title to the property gratis; an inequitable consequence that the court did not address.

In addition, the court interpreted the statute to allow direct and consequential damages against the plaintiff, an innocent trustee, for the conduct of the lender from whom the loan was acquired. There is strong argument that the statute does not authorize such third-party liability. The statute refers only to causes of action against "lenders" and "mortgage brokers."¹⁵ In a section concerning the liability of assignees seeking to enforce covered loans, it provides only that "a borrower may assert any claims in recoupment and defenses to payment...that the borrower could assert against the original lender of the loan."¹⁶ By strong implication, while the "recoupment" of payments may be permitted, other damages against an assignee are not authorized. Institutions holding acquired subprime loans should be alert to that limitation when defending claims under the statute.

'Rose v. Chase'

• **Federal Preemption of State Laws as Applied to National Banks.** Federal preemption is a defense available to federally chartered institutions against statutes such as the High Cost Home Loan Law. In *Rose v. Chase*, the Ninth Circuit held that provisions of California's Civil Code, which require certain disclosures in credit card "convenience checks," were preempted by the National Bank Act, 12 U.S.C. §24, which empowers national banks to "loan money on personal security."¹⁷ Relying primarily on the Supreme Court's decision in *Watters v. Wachovia Bank NA*,¹⁸ the Ninth Circuit found that the state disclosure requirements were preempted because they "significantly impair the exercise of the authority" of the national bank to lend money. The decision implies that virtually any state limitation on the authority of a federally chartered bank to lend money, not explicitly permitted by federal law, would be similarly struck down.

The holding in *Rose* applies with equal force to restrictions on mortgage lending, a power granted to national banks by 12 U.S.C. §371.¹⁹ As the Supreme Court stated in *Watters*, "state law may not significantly burden a national bank's own exercise of its real estate lending power, just as it may not curtail or hinder a national bank's efficient exercise of any other power, incidental or enumerated under the NBA."²⁰

This article cautions institutions holding subprime mortgage loans potentially subject to N.Y. law and argues for the preemption of the High Cost Home Loan Law as applied to federally chartered banking institutions.

Federal law may go further and preempt the application of state-law banking statutes to mortgage loans acquired by national banks from state-regulated lenders. Federal law empowers national banks not only to make mortgage loans, but also to "purchase or sell" such loans.²¹ When a national bank acquires a mortgage, the bank arguably remains protected by federal law, even if the mortgage originated with a lender governed by state law. The Supreme Court has stated that "[s]ecurity against significant interference by state regulators is a characteristic condition of the 'business of banking' conducted by national banks, and mortgage lending is one aspect of that business."²² Accordingly, as part of their "business of banking," national banks should be able to purchase mortgage loans free of state banking law restrictions that would otherwise apply.

There is a contrary argument that a loan governed by state law should be deemed taken subject to all state laws, even those that would not apply to the national bank had it originated the loan.²³ However, the imposition of vicarious liability for damages upon a national bank by operation of state banking law solely because of the purchase of a loan, as occurred in *LaSalle Bank*, is arguably another matter.

Allowing such damages actions would obviously discourage federally chartered institutions from acquiring distressed mortgages that originated with state-regulated lenders, a result that can only worsen the financial crisis arising from

mortgage defaults. Such vicarious liability would impose a significant burden on the bank's exercise of its power to purchase loans under 12 U.S.C. §371. Viewed in that light, there is a strong argument that if the statute is construed to allow damages liability to be imputed to an innocent loan purchaser, it would be preempted.

The aggressive assertion of federal preemption defenses could avoid results like *LaSalle Bank*, and mitigate the exposure of federally chartered financial institutions²⁴ holding subprime loans to unexpected and unnecessary loan losses and damages liability.



1. 850 NYS2d 871 (N.Y. Sup. Rich. Cty. Jan. 28, 2008) (J. Maltese, J.). The plaintiff has moved for reargument of the decision and the motion is scheduled to be heard May 2, 2008.

2. N.Y. Banking Law §6-1 (McKinney's 2004 & Supp. 2008).

3. 513 F.3d 1032, 1037-38 (9th Cir. Jan. 23, 2008).

4. N.Y. Banking Law §6-1(d)&(g).

5. In its motion for reargument, the plaintiff contends that the loan at issue does not fall within the definition of "high-cost" home loans under the statute. See Plaintiff's Memorandum of Law in Support of Motion for Reargument, dated March 13, 2008 ("Mem."), Index No. 100255/07, at 5-7.

6. 850 NYS2d at 878.

7. The statute applies on its face to all lenders, and does not exempt federal institutions. N.Y. Banking Law §6-1(i) & 590(f)&(e).

8. The case caption identifies LaSalle Bank NA "as Trustee for the MLMI Trust Series, 2006-WMC2."

9. 850 NYS2d at 877.

10. See NYL 2002, c. 626, §4 (regarding effective date) (McKinney's 2004 & Supp. 2008); N.Y. Banking Law §6-1(d)&(g) (defining high-cost home loans).

11. 850 NYS2d at 873-78.

12. 850 NYS2d at 873 & 875.

13. In its motion for reargument, the plaintiff contends that the court incorrectly calculated points and fees. Mem. at 7-9.

14. 850 NYS2d 878-79.

15. N.Y. Banking Law §6-1(i).

16. N.Y. Banking Law §6-1(13).

17. 513 F.3d at 1037-38 (citing 12 U.S.C. §24 (Seventh)).

18. 127 S.Ct. 1559 (2007); see also *Barnett Bank of Marion City, N.A. v. Nelson*, 517 U.S. 25 (1996) and *Franklin Nat. Bank of Franklin Square v. New York*, 347 U.S. 373 (1954).

19. In addition, the provision of the statute placing a 3 percent limit on points and fees may be preempted by the federal Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDMCA"). See 12 U.S.C. §1735f-7a(a)(1); *Wolfert v. Transamerica Home First Inc.*, 439 F.3d 165, 175 (2d Cir. 2006) (reverse mortgage may not be invalidated under state usury law); see also *Beneficial National Bank v. Anderson*, 539 U.S. 1, 10-11 (2003) (preemption of state law usury claims).

20. 127 S.Ct. at 1567-68 & 1772-73 (extending preemption to national bank subsidiaries).

21. 12 U.S.C. §371.

22. See *Watters*, 127 S.Ct. at 1571.

23. Cf. *Federal National Mortgage Assn. v. Lefkowitz*, 390 F.Supp. 1364, 1370 (S.D.N.Y. 1975) (FNMA acquires mortgages "accompanied by the appurtenances of state law" and such laws are not preempted because FNMA purchases the mortgage).

24. In addition to national banks, federal savings and loans and other federally chartered institutions are also protected by federal preemption doctrines. See, e.g., *State Farm Bank, F.S.B. v. Burke*, 445 F.2d 207, 219 (D. Conn. 2006) (state statutes purporting to govern federal savings bank preempted by the Home Owners Loan Act); *Mayor of the City of New York v. Council of the City of New York*, 4 Misc3d 151, 780 NYS2d 266 (N.Y. Sup. N.Y. Cty. 2004) (City predatory lending law preempted under various statutes).