

Federal Preemption of Real Estate Lending Activities of OTS Regulated Lenders

By John G. Hall

Federally chartered real estate lenders can be subject to conflicting state and federal regulations. But when do federal rules trump state requirements?

To a large extent, the law of real estate lending is the statutory and case law of the state in which the real property is situated or where the loan is originated. Nevertheless, when the lender is a federally chartered institution such as a national bank, federal savings bank or federal savings association, state law is frequently overridden and preempted by federal statutes or regulations. The area is a complex area of the law with many pitfalls. The purpose of this article is to familiarize the real estate professional with areas that

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have been the subject of some concern.

Constitutional And Statutory Provisions

Article VI Section 2 of the United States Constitution (the Supremacy Clause) provides:

Clause 2. Supreme Law of Land

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

In the area of real estate lending, the statutory scheme is embraced in two acts. Federal thrifts (federal savings associations and federal savings banks) are regulated by the Homeowners Loan Act. National Banks are regulated by the National Bank Act.

Pursuant to the federal statutory scheme, the Office of Thrift Supervision ("OTS") (formerly the Federal Home Loan Bank Board) has enacted regulations impacting on real estate lending. The OTS regulates federal savings banks and federal savings associations. Its regulations are set forth in 12 CFR Part 500 et seq. It has a number of specific regulations that deal with preemption:

1. 12 CFR Part 560 - dealing with lending and investment
2. 12 CFR Part 590 - dealing with preemption of state usury laws
3. 12 CFR Part 591 - dealing with preemption of state laws prohibiting due on sale laws

The Doctrine of Preemption

When Congress enacts legislation or a federal agency issues regulations pursuant to congressional enabling legislation, conflicting state legislation may be challenged via the Preemption Doctrine. The Doctrine establishes the rule that federal law overrides any inconsistent state law or regulation where there is an actual conflict between the two sets of legislation such that both cannot stand, e.g. where federal law prohibits an act that state law requires. Preemption can be either express or implied. Express preemption occurs when a federal statute specifically prohibits parallel state legislation in that field. Implied preemption occurs when a body of federal law in a particular field or area is so pervasive that it leaves no doubt that Congress intended to preempt state law (even though Congress has not specifically stated such in the statute).

Unfortunately, in actual practice, implied preemption seldom occurs in totally clear-cut circumstances. In addition, Congress seldom articulates a specific intent to totally preempt an entire field. In other cases Congress sometimes in legislation enacts a savings clause permitting concomitant state regulations.

The United States Supreme Court in *Pennsylvania v. Nelson*, enunciated a three prong test to ascertain implied preemption parameters:

1. Pervasiveness of the federal regulatory scheme
2. Federal occupation of the field as necessitated by the need for national uniformity
3. Danger of conflict between state laws and the administration of the federal program

In areas where state law has not been preempted, federal courts will apply state law.

The Director of the OTS is authorized by federal statute to provide for the organization, incorporation, examination, operation and regulation of associations (including federal savings banks and federal savings associations) "under such regulations as the Director may provide." Pursuant to such statutory

authority regulations were enacted by the Director of the OTS which provide in 12 CFR Section 560.2 (a) and (c) as follows:

Sec. 560.2 Applicability of Law.

(a) Occupation of field. Pursuant to sections 4(a) and 5(a) of the HO LA, 12 U.S.C. 1463 (a), 1464 (a), OTS is authorized to promulgate regulations that preempt state laws affecting the operations of federal savings associations when deemed appropriate to facilitate the safe and sound operation of federal savings associations to enable federal savings associations to conduct their operation in accordance with the best practices of thrift institutions in the United States, or to further other purposes of the HO LA. To enhance safety and soundness and to enable federal savings associations to conduct their operations in accordance with best practices (by efficiently delivering low-cost credit to the public free from undue regulatory duplication and burden), OTS *hereby occupies the entire field of lending regulation for federal savings associations.* (emphasis added). OTS intends to give federal savings associations maximum flexibility to exercise their lending powers in accordance with a uniform federal scheme of regulation. Accordingly, federal savings associations may extend credit as authorized under federal law, including this part, without regard to state laws purporting to regulate or otherwise affect their credit activities, except to the extent provided in paragraph (c) of this section or Sec. 560.110 of this part (dealing with usury), (explanation added). For purposes of this section, "state law" includes any state statute, regulation, ruling, order or judicial decision...

(c) State laws that are not preempted. State laws of the following types are not preempted to the extent that they only incidentally affect the lending operations of Federal savings associations or are otherwise consistent with the purposes of paragraph (a) of this

1. Contract and commercial law;
2. Real property law;
3. Homestead laws specified in 12 U.S.C. 1462a(f);
4. Tort Law;
5. Criminal Law; and
6. Any other law that OTS, upon review, finds:
 - i. Furthers a vital state interest; and
 - ii) either has only an incidental effect on lending operations or is not otherwise contrary

to the purposes expressed in paragraph (a) of this section.

It thus appears that the Director of OTS clearly intended to exempt federal savings associations from the applicability of state law for many real estate lending issues such as prepayment or late charges to the issue of whether or not OTS regulations could preempt state statutes. The United States Supreme Court has held that they can.

Although some states have attempted to take a different posture (e.g., the New Jersey Licensed Lender Act provides that the doctrine of preemption applies to federal institutions but not to their operating subsidiaries) the OTS, in an opinion of Chief Counsel dated August 19, 1997, has taken the position that state laws that purport to regulate the activities of federal savings associations' operating subsidiaries are preempted by federal law to the same extent that federal law preempts the state law application to a federal savings association itself.

Preemption And Prepayment Charges

Under New York General Obligations Law Section 5-501(3), prepayment must be permitted if the premises consist of a one to six family residence and the interest rate is over 6%. If prepayment is made after one year it must be permitted without penalty. If prepaid within one year such a prepayment penalty as is set forth in the loan contract may be collected.

Federal regulations in 12 CFR Section 560.34 applying to federal thrifts state:

Any prepayment on a real estate loan must be applied directly to reduce the principal balance on the loan unless the loan contract or the borrower specifies otherwise. Subject to the terms of the loan contract, a Federal savings association may impose a fee for any prepayment of a loan.

Turning to the Preemption Doctrine, the issue is whether in imposing a prepayment charge in its loan documents a federal association must comply with state law or may go beyond state law. If the association in its written contract complies with the state law, state law would not be in conflict with its federal regulation. It would, however, limit the amount of prepayment that could be changed by a federal association. In the one federal case, which addressed the issue, *Meyers v. Beverly Hills Federal Savings and Loan Assoc.*³, the U.S. Circuit Court of Appeals for the Ninth Circuit affirmed the lower court's decision and held that "federal law preempts the field of prepayment of real estate loans to federally chartered savings and loan associations". There plaintiffs

brought suit against federally chartered banks in California and sought a declaratory judgment that the bank's prepayment penalty was void as it was inconsistent with the California state statute. The court held the prepayment penalty valid and stated that any state law in the area is inapplicable to federal savings and loan associations operating within the state. This premise has been confirmed by the OTS, which monitors federally chartered banks, in its opinion dated July 13, 1993. The opinion states "that the exercise of the office's authority is preemptive of any state law purporting to address the subject of the operations of a Federal savings association. Thus, a federally chartered savings association, is exempt from N.Y. General Obligations Law Section 5-501 by 12 CFR Section 560.34, which allows the bank to impose a prepayment penalty charge."

It thus appears that both the court and the OTS as stated in its letter of July 13, 1993, clearly feel that the area of prepayment penalties has been completely preempted by the federal regulation.

Preemption And Late Charges

Section 254-b(1) of the Real Property Law of the State of New York limits the amount of late charges. That statute provides:

If a bond or note, or the mortgage on real property, heretofore or hereafter made, improved by a one to six family residence occupied by the owner, securing the payment of same or a note representing a loan for the purpose of financing the purchase of an ownership interest in, a proprietary lease from, a corporation or partnership formed for the purpose of the cooperative ownership of residential real estate, contains a provision whereby the mortgagor or lender retains the right to collect a late charge on any installment which has become due and remains unpaid, such charge on any such delinquent installment, regardless of the period it remains in default, shall not exceed and shall only be enforced to the extent of two percent of such delinquent installment; provided, however, that no charge shall be imposed on any installment paid within fifteen days after the due date. No such late charge shall be deducted from any regular installment payment by the mortgagor or borrower, but shall be separately charged and collected by the mortgagee or lender. In the absence of a specific provision in a bond, note or mortgage no late charge on any delinquent installment shall be assessed or collected. The term "installment" shall include amounts representing interest, amortization of principal and payments in respect of insurance premiums, taxes and utility charges.

es if the bond, note or mortgage provides for collection thereof by the mortgagee.

Late charges may be imposed by a federally chartered thrift in accordance with 12 CFR Section 560.33, which provides:

A Federal savings association may include in a home loan contract a provision authorizing the imposition of a late charge with respect to the payment of any delinquent periodic payment. With respect to any loan made after July 31, 1976, on the security of a home occupied or to be occupied by the borrower, no late charge, regardless of form, shall be assessed or collected by a Federal savings association, unless any billing, coupon or notice the Federal savings association may provide regarding installment payments due on the loan discloses the date after which the charge may be assessed. A federal savings association may not impose a late charge more than one time for late payment of the same installment, and any installment payment made by the borrower shall be applied to the longest outstanding installment due. A Federal savings association shall not assess a late charge as to any payment received by it within fifteen days after the due date of such payment. No form of such late charge permitted by this paragraph shall be considered as interest to the Federal savings association and the Federal savings association shall not deduct late charges from the regular periodic installment payments on the loan, but must collect them as such from the borrower.

Although the section provides no specific limit on late charges the OTS has taken the position that a late charge cannot exceed 5 percent of the amount of an overdue payment.

Again, considering the Preemption Doctrine, 12 CFR Section 560.33 is not necessarily in conflict with Section 254(b) of the New York Real Property Law but could be harmonized with it, i.e. a late charge could be charged but only insofar as it complied with New York Law, i.e. at 2 percent and not 5 percent. However, if the federal government intended to completely occupy the field section, Section 254(b)(1) of the New York Real Property Law would be preempted.

No cases have been found dealing with the preemption issue insofar as it relates to late charges. Nevertheless the Director of the OTS as stated earlier appears to have totally preempted the area.

Lenders Obligation To Pay ¼ Percent Mortgage Tax

Section 253(1) (a) of the New York Tax Law imposes an additional ¼ percent mortgage tax to be paid by the mortgagee where the property consists of a one

to six family structure with separate cooking facilities for each unit and the mortgagee is not a natural person. The statute also provides that this tax may not be passed through to the borrower.

In *Dime Savings Bank F.S.B. v. State of New York*, the New York Appellate Division Second Department in a 3-2 decision held that the anti-pass through provision was preempted by federal regulations. A federally chartered lender could therefore pass-through the ¼ percent to the borrower.

Dime's victory however was somewhat a pyrrhic victory. Although Dime won the right to pass the tax along to the borrower, competitively it could not do so because its borrowers would end up paying a ¼ percent more in closing costs than they would at another lender which could not avail itself of preemption.

Prohibition Of Due On Sale Clauses

The United States Supreme Court upheld the validity of the exercise of a due on sale clause by a federal thrift despite a California statute prohibiting it in *Fidelity Federal v. de la Cuesta*. The courts of New York have upheld the validity of a due on sale clause where there was not a resulting prepayment charge. In *First Federal Savings & Loan Association of Rochester v. Jenkins*⁶ the court held that there was not a conflict with N.Y. Real Property Law Section 254(a) which recognizes the validity of a due on transfer but prohibits the levying of a prepayment charge when the due on transfer provision is implemented.

Indeed the decision parallels the present OTS regulation which provides in 12 CFR Section 591.5(b)(2) that:

"a lender shall not impose a prepayment penalty or equivalent fee when the lender or party acting on behalf of the lender

(i) declares by written notice that the loan is due pursuant to a due on sale clause...."

Escrow Accounts For Real Estate Taxes

The New York State Legislature in 1989 enacted Title 3-A of the Real Property Tax Law (Sections 953 to 959), regulating tax escrow accounts. The law is applicable to "mortgage investing institutions" which by definition include federal savings banks and federal savings and loan associations (these are now known as federal savings associations although the New York statute has not been amended). Although this area is a fairly clear cut area of preemp-

tion, it is clear that the New York Legislature is trying to thwart preemption in this area.

In its opinion letter of January 3, 1991, the OTS held that New York Real Property Tax Law Section 953 et seq. were clearly preempted insofar as they:

1. Required the payment of interest on mortgage escrow accounts
2. Prohibited the charging of fees on escrow accounts
3. Required that the lender provide to the borrower periodic written statements disclosing specified information about the status of the escrow account

A similar determination had been previously made in *First Federal Savings and Loan Association v. Greenwald*, with respect to a Massachusetts statute.

Payoff Statement Fax Charges

Section 274 (a) of the New York State Real Property Law requires that under designated circumstances, the mortgagee of certain residential real property deliver within 30 days "mortgage-related" documents defined to include a loan payoff statement. Section 274(a) (2) also prohibits the mortgagee from charging borrowers for the mortgage related documents pursuant to an initial request, but a mortgagee "may charge not more than twenty dollars or such amount as may be fixed by the banking board, for each subsequent payoff statement provided.

Although on its face, the statute is not entirely clear that it would bar charging for the service of faxing a payoff statement to the borrower, the Appellate Division Second Department held in *Negrin v. Norwest Mortgage, Inc.* that a claim for charging for a payoff statement did state a cause of action.

When an inquiry was made as to whether this statute would be applicable to a federally chartered institution, the OTS in a letter of its Chief Counsel, Carolyn J. Buck, dated April 21, 2000, stated in part:

"OTS regulations are clear that federal law preempts state laws that restrict loan related fees. Section 560.2(b)(5) expressly provides that state laws purporting to impose requirements regarding loan related fees are preempted....[a] charge for faxing loan payoff statements at the borrowers request, is a loan related fee...therefore under Section 560.2(b)(5) [of 12CFR], to the extent Section 274(a)(2) would prohibit [the lender] from charging a borrower for faxing

a loan payoff statement requested by the borrower, Section 274(a)(2) does not apply...."

Parenthetically it should be noted that the statute by its terms in defining "Banking Organization" states that it shall include any institution chartered or licensed by the United States.... This obviously would be of no effect if the statute is preempted.

Preemption Of State Usury Statutes

Although General Obligations Law Section 5-501 and Banking Law Section 14-a set the maximum rate of interest in New York at 16 percent, federal law exempts certain lenders from this limit. Pursuant to 12 U.S.C. 1735(f)1-5 and 7, qualified creditors are exempt from the New York Usury Law. Qualified creditors include:

1. a party which is insured by a Federal agency
2. a party which is regulated by a Federal agency
3. a party which makes or invests in residential real estate loans aggregating more than \$1 million a year and is a regular extender of 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.

OTS has enacted regulations dealing with the preemption of State Usury Laws in 12 CFR Part 590.

How Far Can The Preemption Envelope Be Pushed ?

Recent litigation in other states has begun to push the preemption doctrine to new limits. In 1982 the Alternative Mortgage Transactions Parity Act, 12 U.S.C. Section 380, et seq. was enacted to extend the rights of non-federally chartered housing creditors (such as mortgage companies) to make alternative mortgage loans provided they were in accord with Federal Regulations.

The Office of Thrift Supervision in response to the statute then enacted Regulation 12 CFR Section 560-220 which provides as follows:

Section 560-220 Alternative Mortgage Parity Act.

Pursuant to 12 U.S.C. 3803, housing creditors that are not commercial banks, credit unions, or Federal savings associations may make alternative mortgage transactions as defined by that section and further defined and described by applicable regulations identified in this section, notwithstanding any state

constitution, law, or regulation. In accordance with section 807(b) of Public Law 97-320, 12 U.S.C. 3801 note, Section 560.33, 560.34, 560.35 and 560.210 of this part are identified as appropriate and applicable to the exercise of this authority and all regulations not so identified are deemed inappropriate and inapplicable. Housing creditors engaged in credit sales should read the term "loan" as "credit sale" wherever applicable.

It identified Section 560.33 (late charges); Section 560.34 (prepayment charges) and Section 560.35 and 560.210 (both dealing with adjustable rate loan terms) as portions of the regulations applicable to non-federally chartered lenders.

As a result both in Virginia, in *National Home Equity Mortgage Association v. face*, and in New Jersey, in *Shinn v. Encore Mortgage Services*, attacks on state prepayment statutes were upheld and non-federally chartered lenders were permitted to impose prepayment charges on adjustable rate loans despite state statutes to the contrary. The New Jersey decision is currently being appealed.

Neither of these decisions would be applicable in New York because New York opted out of the Alternative Mortgage Transactions Parity Act. Nevertheless, a New York attorney may deal with an out of state mortgage company (either licensed or unlicensed in New York) which wrongfully attempts to apply the doctrine of preemption in these areas.

Additional Preemption Issues In Other States

There are a number of other preemption issues that arise in various states. For example, New Jersey by

statute N.J.S.A. 46:10A-6 sought to regulate the amount of legal fees that a lender could pass on to a borrower. The Supreme Court of New Jersey held in *Turner v. First Union National Bank*,¹¹ that where a lender was a federally chartered institution the state statute was preempted and the fees could be passed along.

In addition, title agents must be licensed in New Jersey. N.J.S.A. 17:46B-30.1 specifically prohibits a bank, trust company or other lending institution from being licensed to sell title insurance or otherwise act as agent for the sale of title insurance. The United States District Court for New Jersey held in *Valley National Bank v. La Vecchia*, that where a national bank is regulated by the Office of the Comptroller of the Currency and not by the OTS, the statute is preempted by Section 92 of the National Bank Act. B

Notes

1. 350 U.S. 497 (1956).
2. *Fidelity Federal S&L v. de la Cuesta*, 458 U.S. 141, 151 (1982).
3. 499 F.2d 1145 (1974).
4. 174AD2d173 (2nd Dept.-1992).
5. *Supra*.
6. 109Misc2d715d981). 7. 591 F2d417(1979-1stCir.).
8. 263AD2d39 (2nd Dept.); 700NY S2d 184 (1999).
9. 64 F.Supp 2d584 (E.D.VA.-1999); *Aff'd*. 239 F.3d 633 (4th dr.).
10. *Civ. Action 99-577'3* (JEI) - Di'st.qfNJ - 2000).
11. 162 N.J. 75,740 A 2d 1081 (1999).
12. 59 F.Supp 2d 432 (Dist. NJ.-1999).