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**MEMORANDUM**

April 17, 2007

To Our Clients and Friends

Re: Supreme Court Decision in *Watters v. Wachovia Bank*

The U.S. Supreme Court today, by a vote of 5 to 3, held in *Watters v. Wachovia Bank, N.A.* that federal law, not state law, controls the regulation of lending activities by national banks even when the activity is carried out in the bank's operating subsidiary. The opinion, authored by Justice Ginsburg,<sup>1</sup> holds:

Where a national bank engages in real estate lending through an operating subsidiary, the subsidiary is subject only to the same terms and conditions as those that would govern the bank itself--that is, federal regulation under the National Bank Act. Though state law...governs matters pertaining to an operating subsidiary's incorporation, state regulators cannot interfere with the "business of banking" by subjecting national banks or their [federal]-licensed subsidiaries to rival oversight regimes."

Because the principles of federal preemption apply to a nonbank subsidiary of a national bank, a nonbank subsidiary of a national bank will not be subject to state laws that would be preempted had the subsidiary been a national bank.

**SUMMARY OF THE DECISION**

Wachovia Bank conducts its real estate lending business through a wholly-owned operating subsidiary. Michigan law exempts banks from state mortgage lending regulation but requires their subsidiaries to register and submit to state supervision. Although Wachovia's subsidiary initially complied with Michigan's requirements, it subsequently terminated its registration. Michigan advised Wachovia it would no longer

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<sup>1</sup> Ginsburg's opinion was joined in by Justices Alito, Breyer, Kennedy and Souter. Justice Stevens dissented, and was joined by Chief Justice Roberts and Justice Scalia. Justice Thomas did not take part in the case.

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be authorized to engage in mortgage lending in Michigan. Wachovia prevailed in the lower courts.

The Supreme Court held that Wachovia's mortgage business, whether conducted by the bank itself or through the bank's operating subsidiary, is subject to supervision by the Office of the Comptroller of the Currency ("OCC"), and not to state licensing, reporting, and examination. The Court indicated that the National Bank Act ("NBA") vests in national banks enumerated powers and all "necessary" incidental powers. To prevent inconsistent or intrusive state regulation, the NBA provides that "[n]o national bank shall be subject to any visitatorial powers except as authorized by Federal law ... ." Federally chartered banks are subject to state laws of general application in their daily business to the extent such laws do not conflict with the letter or purposes of the NBA. But when state laws significantly impair the exercise of authority, the state must give way.

The OCC has recognized national banks' "incidental" authority to do business through operating subsidiaries. The OCC licenses and oversees national bank operating subsidiaries just as it does national banks. Just as duplicative state examination, supervision, and regulation would significantly burden national banks' mortgage lending, so too those state controls would interfere with that same activity when engaged in by a national bank's operating subsidiary. The Court stated that it has never held that the NBA's preemptive reach extends only to a national bank itself; instead, the Court indicated that it has focused on the exercise of a national bank's powers, not on its corporate structure, in analyzing whether state law hampers the federally permitted activities of a national bank. Security against significant interference by state regulators is a characteristic condition of "the business of banking" conducted by national banks. That security should adhere whether the business is conducted by the bank itself or by an OCC-licensed operating subsidiary.

The Court also rejected the argument that federal regulation of national bank subsidiaries violated the Tenth Amendment. The Court concluded that "[b]ecause regulation of national bank operations is Congress' prerogative under the Commerce and Necessary and Proper Clauses, the Tenth Amendment holds no sway in this case."

A copy of the Court's opinion can be found on our web site at [http://www.schwartzandballen.com/whats\\_new.html](http://www.schwartzandballen.com/whats_new.html).

If you have any questions, please call Gilbert Schwartz, Robert Ballen, Tom Fox or Heidi Wicker at (202) 776-0700.