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Federal Circuit Court Finds National Bank Not Exempt from State Mortgage Escrow Interest Law

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A federal appeals court has held that a national bank must comply with a California law requiring mortgage lenders to pay interest on certain mortgage escrow accounts despite the strong arguments of the lender that such law is preempted as to national banks. This ruling is at odds with the position that most national banks and other federally-chartered financial institutions have taken regarding the preemption of state-law mortgage escrow interest requirements.

The opinion in the class-action lawsuit, *Lusnak v. Bank of America*, No. 14-56755, 2018 WL 1122298 (9th Cir. Mar. 2, 2018), was issued by the Ninth Circuit Federal Court of Appeals, a circuit court generally known for its consumer-friendly opinions. While the Ninth Circuit only has jurisdiction over certain parts of the western United States and the case is subject to appeal by the lender, this opinion is a potential concern for federally-chartered financial institutions that do not comply with state mortgage escrow interest laws.

In its opinion, the court examined whether, in light of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), the National Bank Act ("NBA") preempts California's mortgage escrow interest law. California's mortgage escrow interest law requires financial institutions to pay certain mortgage borrowers at least two percent simple annual interest on funds held in borrowers' escrow accounts for the payment of property taxes and insurance. The specific terms of the plaintiff-borrower's mortgage required the national bank to pay interest on escrow funds if required by federal law or state law that is not preempted. As a condition for obtaining the mortgage, the borrower was required to open a mortgage escrow account into which he would pay $250 per month.

The Ninth Circuit first examined how the passage of Dodd-Frank affected federal preemption of state laws affecting national banks. The court noted that, through this legislation, Congress sought to undo broad preemption determinations. The court cited the following provision of Dodd-Frank which amended the Truth in Lending Act:

If prescribed by applicable State or Federal law, each creditor shall pay interest to the consumer on the amount held in any impound, trust, or escrow account that is subject to this section in the manner as prescribed by that applicable State or Federal law.

In the context of the NBA, Dodd-Frank provides that state laws are preempted if they "prevent[ ] or significantly interfere[ ] with the exercise by the national bank of its powers." This standard is in line with the United States Supreme Court's holding in *Barnett Bank of Marion County, N.A. v. Nelson* (517 U.S. 25 (1996)), which held that states are not deprived of the power to regulate national banks where doing so does not prevent or significantly interfere with a national bank's exercise of its powers. The court also noted that since this issue involves a state consumer protection law, a field historically regulated by the states, a national bank would need to put forth compelling evidence of the intention to preempt.

The bank in the *Lusnak* case argued that the Office of the Comptroller of the Currency ("OCC") intended state mortgage escrow interest laws to be preempted under 12 C.F.R. § 34.4(a), which states that a "national bank may make real estate loans…without regard to state law limitations concerning…[e]scrow accounts…" The court did not find the OCC's pre-Dodd-Frank preemption rule persuasive and instead looked to 12 C.F.R. § 34.4(b), which says that state laws that are "made applicable by Federal law" are not inconsistent with the real estate lending powers of national banks. In its holding, the court concluded that Dodd-Frank's above-noted mortgage escrow interest provision is one such federal law.

Based on this analysis, the Ninth Circuit held that the California law is not preempted because it does not prevent or significantly interfere with the national bank's exercise of its powers. The case was remanded to the Federal District Court to determine damages arising from the violation of California's law, as well as the breach of contract regarding the mortgage interest escrow provision in the borrower's mortgage document. It is possible that this case may be appealed by the bank.

Approximately thirteen states have escrow interest laws similar to that of California. New York General Obligations Law § 5-601 states that any mortgage investing institution which maintains a mortgage escrow account on any one to six family residence occupied by the owner or on any property owned by a cooperative apartment corporation must, for each quarterly period in which such escrow account is established, provide a minimum rate of interest on such accounts at a rate of no less than two percent per year.

Recently, the New York State Department of Financial Services ("DFS") provided New York chartered institutions some relief from the requirement to pay a minimum two percent interest rate on mortgage escrow accounts (see our previous advisory on this topic here). On January 19, 2018, Maria T. Vullo, Superintendent of DFS, issued an Order under Section 12-a of the New York State Banking Law changing the standard for the interest rate that must be paid by mortgage investing institutions on escrow accounts. The Order sets the minimum rate of interest to be paid by New York-chartered banks, private bankers, trust companies, savings banks, savings and loan associations and credit unions on escrow accounts in connection with loans secured by mortgages during any calendar quarter at least equal to the *lesser of* two percent or the six-month yield on United States Treasury securities on the last business day of the immediately preceding calendar quarter.

Federal and state courts in New York have not opined recently on the specific issue of federal preemption of New York's mortgage escrow interest law. While the Ninth Circuit opinion is not binding with respect to New York's mortgage escrow law, this case may lead to other courts taking the same position. We will continue to monitor developments on this issue.

If you have any questions regarding this case or federal preemption issues for federally-chartered institutions in general, please feel free to contact Joseph D. Simon at (516) 357-3710 or via email at jsimon@cullenanddykman.com, or Diana R. Acosta at (516) 357-3739 or via email at dacosta@cullenanddykman.com.

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