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Foreclosing on the Federal Power Grab: Dodd-Frank, Preemption, and the State Role in Mortgage Servicing Regulation

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Foreclosing on the Federal Power Grab: Dodd-Frank, Preemption, and the State Role in Mortgage Servicing Regulation

*Kurt Eggert**

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INTRODUCTION

It is telling, but perhaps unsurprising that the legal and regulatory structures that helped cause the subprime mortgage crisis are also making it more difficult to address the resulting flood of mortgage defaults and foreclosures. Securitization lowered underwriting standards by allowing mortgage lenders to sell poorly underwritten loans, leaving investors to deal with the ensuing defaults. Securitization also is making it more difficult to resolve these problem loans, as they were stranded in securitized loan pools, and their resolution is often stymied by servicers' self-interest and unwillingness to spend the resources to modify the loans. Similarly, the deregulatory fever which swept Washington during the Bush Administration made it easier for lenders to reduce their underwriting standards without adequately informing investors.¹ As foreclosures mounted and servicers responded with robo-signing of foreclosure documents and other abusive practices, regulators seemed almost mystified as to who regulated mortgage servicers and how servicers should be regulated. When Congress passed the Home Affordable Modification Program (HAMP), there was so little expertise in regulating servicers among the federal agencies that the job of overseeing HAMP was passed to Fannie Mae and Freddie Mac, who have proven largely unable, and to a great extent even unwilling to rein in servicer misconduct.² And so deregulation not only led to the creation of risky loans, it hampered the ability of the federal government to create effective programs to reduce the harm caused by those loans to borrowers, investors, and the public.

A third cause of the mortgage meltdown that has also interfered with cleaning up the resulting foreclosure crisis is federal preemption of state laws. During the subprime boom ending in 2007, federal banking agencies insisted that their regulations preempted the state initiatives that could have slowed predatory lending and the creation of risky home loans. States attempted to curb predatory lending through a variety of state laws.³ In response, the federally regulated banking

¹ For a discussion of how securitization allowed lenders to reduce underwriting standards without adequate disclosure to investors, see Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 CONN. L. REV. 1257 (2009).

² See CONG. OVERSIGHT PANEL, 111TH CONG., DECEMBER OVERSIGHT REPORT 82 (2010), available at <http://cybercemetery.unt.edu/archive/cop/20110402010243/http://cop.senate.gov/documents/cop-121410-report.pdf>.

³ For a discussion of the various state statutes directed at halting such predatory lending, see Jessica Fogel, *State Consumer Protection Statutes: An Alternative Approach*

industry sought protection from state regulation by requesting that federal regulators determine that those state laws were preempted and so could be ignored by federally regulated banks and thrifts. Not coincidentally, federally regulated banks and thrifts have seen higher default rates in their mortgages than state regulated banks and thrifts, with lenders regulated by the federal Office of Thrift Supervision (OTS) among the worst offenders. Moreover, states were tempted to loosen their own regulations, or face losing their state banks to a more permissive federal charter.

Just as preemption by federal regulatory agencies helped cause the mortgage meltdown, preemption has been a barrier to state efforts to address the meltdown. Mortgage servicers that are federally regulated banks or their subsidiaries have claimed that they are free from state regulation, whether in the form of state regulators seeking to examine their practices, or state laws and regulations aimed at inducing servicers to modify loans where appropriate.⁴ Instead, these mortgage servicers have regularly argued that only federal regulation applies to them. Federal regulation of servicers has been weak and sparse, with few carrots and almost no sticks, and federal regulators have until recently had an almost entirely hands-off attitude toward the servicers. As a result, federally-regulated servicers have engaged in significant misbehavior, including the infamous “robo-signing” scandals, where servicer employees were certifying the debt and defaults for borrowers in notarized statements without personal knowledge of those debts or whether borrowers were even in default.⁵ On too many occasions, servicers have attempted to foreclose on homes even when it appears that neither they nor the trust they represent possess the note that would allow such foreclosure.⁶ And servicers have regularly piled excessive or unfounded fees on borrowers, at times pushing borrowers into foreclosure with such fees alone.

At the same time, servicers have failed to modify loans where appropriate, and have foreclosed even when a loan modification might have been best for both the borrower and the investors that hold the loans. By attempting to shield

to *Solving the Problem of Predatory Mortgage Lending*, 28 SEATTLE U. L. REV. 435, 451–53 (2005).

⁴ See *infra*, Section VI.

⁵ See Lorraine Woellert, ‘Robo-signing’ Penalties Expected Soon, BOSTON GLOBE, Feb. 24, 2011, at 11.

⁶ See Gretchen Morgenson, *Guess What Got Lost in the Pool*, N.Y. TIMES, Mar. 1, 2009, at BU1.

themselves with preemption from state regulation, and through the dearth of effective federal regulation, mortgage servicers have been acting as a law unto themselves, to the detriment of both the borrowers they collect from and the investors whom they are supposed to serve.

While there is only limited information regarding the servicing practices of non-federally regulated servicers, it appears that state community banks have avoided at least the worst practices of federally-regulated servicers so far. When the FDIC examined these state-regulated servicers, it did not find evidence of robo-signing or any other serious problems that have appeared industry-wide or that would warrant the FDIC taking formal enforcement action against these much smaller servicers.⁷ Furthermore, a recent Treasury Department analysis of mortgage servicers revealed that the three worst offenders were all national banks.

The new Dodd-Frank Act was drafted with recognition of the abuses of preemption in the mortgage industry. The Consumer Financial Protection Act of 2010, which is Title X of Dodd-Frank, calls for a rollback of preemption and for greater state action to prevent future servicing abuses by federally regulated banks and thrifts.⁸ The exact contours of this new law of preemption in the banking industry are not clear because Dodd-Frank leaves much of its specific effects to regulations not yet drafted by the respective federal agencies. Moreover, the OTS will disappear and be subsumed into the Office of the Comptroller of the Currency (OCC). A new regulator will appear—the Consumer Financial Protection Bureau (CFPB)—beginning in July, 2011, with the inevitable lag time in any regulations it might enact.⁹ With the creation of the CFPB, new turf battles may arise, with the OCC and the CFPB battling to provide mortgage servicer regulations that may defend consumers against banks, or vice-versa.

⁷ See Carrie Bay, *FDIC Releases Report Detailing Findings of Foreclosure Investigation*, DSNEWS (May 4, 2011), <http://www.dsnews.com/articles/fdic-releases-report-detailing-findings-of-foreclosure-investigation-2011-05-04> (explaining that in a 2011 FDIC report, the FDIC has to date failed to uncover any evidence of ‘robo-signing’ or other problems with state non-member banks which would call for disciplinary action to be taken).

⁸ See generally Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

⁹ Lewis S. Wiener & Evan J. Taylor, *The Consumer Financial Protection Bureau*, SUTHERLAND (Mar. 8, 2011), http://www.sutherland.com/files/News/cce089c9-6087-4cf6-9b87-0094eef8b957/Presentation/NewsAttachment/d7939b30-458d-4ccf-bda2-e3db48c38a97/ACC_Financial_Services_-_CFPB_Legal_Alert_-_March_2011.pdf.

Federal agencies have, after what appears to be a pro forma investigation of mortgage abuses, issued a report admitting the existence of those abuses and outlined a plan to correct them. However, the plan appears at first blush to be a weak one, with mortgage servicers ordered to correct their own policies and procedures and internal controls, and to hire their own monitor, with the approval of federal regulators, and then report back with what they have done.¹⁰ The federal regulators appear to be punting the regulation of mortgage servicers to outside firms chosen and hired by the servicers themselves.

This article is an attempt to show what went wrong in the previous regulation of mortgage servicing (or lack thereof), and to map the new preemption terrain for mortgage servicing, providing some guideposts on what the new post-Dodd-Frank preemption landscape will look like and where the boundaries for state action might lie. States should not wait for the federal agencies to act. Instead, states should move now to regulate mortgage servicers to deter the abuses servicers have been committing and to encourage appropriate loan modifications that benefit both borrower and investor alike. With the new rules of preemption, states should step boldly into what, even with recent federal action, mostly still is a void: the regulation of mortgage servicing.

I. THE FAILURES OF MORTGAGE SERVICING

Though the abuses and failures of mortgage servicers have long been detailed,¹¹ it was as if they were discovered anew, first by Congress and the news media, and then belatedly by federal regulators in the fall of 2010. The many failures of mortgage servicers suddenly became a hot topic, both in Congress and in the news.¹² Journalists reported nationwide evidence of “robo-

¹⁰ See *Regulatory Actions Related to Foreclosure Activities by Large Servicers and Practical Implications for Community Banks*, FDIC, <http://www.fdic.gov/regulations/examinations/supervisory/insights/sise11/foreclosure.html> (last visited May 19, 2011).

¹¹ See generally Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POLY DEBATE 753, 753–84 (2004), available at <http://ssrn.com/abstract=992095> (discussing abusive behavior of residential mortgage servicers towards borrowers).

¹² Congress has defined a “servicer” as “the person responsible for servicing of a loan (including the person who makes or holds a loan if such person also services the loan).” 12 U.S.C.A. § 2605(i)(2) (2011). On the other hand, “servicing” is “receiving any scheduled periodic payments from a borrower pursuant to the terms of any loan . . . and making the payments of principal and interest and such other payments with respect to the amounts received from the borrower as may be required pursuant to the terms of the loan.” 12 U.S.C.A. § 2605(i)(3) (2011).

signing,” by mortgage servicers seeking to foreclose on homes.¹³ One court has defined a “robo-signer” as “a person who quickly signs hundreds or thousands of foreclosure documents in a month, despite swearing that he or she has personally reviewed the mortgage documents and has not done so.”¹⁴ One bank admitted to false attestations on 55,000 affidavits.¹⁵ A bank employee who said that she signed up to 8000 affidavits and other foreclosure-related documents a month admitted that she normally did not read any of them.¹⁶ Another servicer employee, this one a supervisor in charge of signing affidavits, stated that she did not know what conditions justified foreclosure, that she could not even define the meaning of necessary terms like “promissory note,” and stated, “I don’t know the ins and outs of the loan, I just sign documents.”¹⁷ The practice of robo-signing appeared so wide-spread that many of the nation’s largest mortgage servicers declared moratoriums on foreclosures, either nationally or at least in states that require judicial foreclosure while they investigated their own practices.¹⁸

Robo-signing constitutes fraud on the court if the resulting affidavits are submitted as evidence. By using robo-signers, banks and servicers can foreclose on borrowers while hiding from courts the flaws or gaps in their loan records regarding mortgage payments or loan modifications, or concealing whether they are missing the loan documents demonstrating whether they even have the right to foreclose. Sadly, servicers have found that some attorneys have been all too willing to play “hide the ball” with courts to obtain foreclosure orders without valid evidence. In one case, a court noted that the legal representation of servicers in foreclosure actions had devolved into a “corrosive ‘assembly line’ culture of practicing law” and wondered “what kind of culture

¹³ See, e.g., Gretchen Morgenson, *Banks’ Flawed Paperwork Throws Some Foreclosures Into Chaos*, N.Y. TIMES, Oct. 3, 2010, at A1; David Streitfeld, *3rd Lender Will Freeze Foreclosures in the Courts*, N.Y. TIMES, Oct. 2, 2010, at B1.

¹⁴ *Onewest Bank, F.S.B. v. Drayton*, 910 N.Y.S. 2d 857, 859 (Sup. Ct. 2010). In *Drayton* the court dismissed a foreclosure action without prejudice upon request of plaintiff, with the court noting that the case involved a servicer employee who, in a deposition in another action, had “admitted that she: is a ‘robo-signer’ who executes about 750 mortgage documents a week, without a notary public present; does not spend more than 30 seconds signing each document; [and] does not read the documents before signing them . . .” *Id.*

¹⁵ Jeff Horwitz, *Wells Joins Robo Club, in its Way*, AM. BANKER, Oct. 29, 2010, at 1.

¹⁶ Jenifer B. McKim, *Lenders on Autopilot: Using Robo-Signers to Process Thousands of Foreclosures Opens Banks Up to Legal Risks*, BOSTON GLOBE, Nov. 2, 2010, at 7.

¹⁷ Michelle Conlin, *Robo-Signers: Mortgage Experience Not Necessary*, ASSOCIATED PRESS, Oct. 12, 2010.

¹⁸ Nelson D. Schwartz, *Foreclosures Had Errors, Bank Finds*, N.Y. TIMES, Oct. 25, 2010, at B1.

condones its lawyers lying to the court and then retreating to the office hoping that the Court will forget about the whole matter?”¹⁹ The Florida Attorney General’s office has been investigating claims that foreclosure attorneys in that state have been “fabricating and/or presenting false and misleading documents in foreclosure cases,” and reached a \$2 million settlement with one prominent firm based on such claims.²⁰ Even foreclosure attorneys who otherwise might attempt to follow the rules of court are at times being pushed by their servicer clients to engage in mindless, automated court filings, unable to verify if the information contained in their filings is even true because the attorneys are being directed solely by computer software that spits out what documents and claims to file. One court found that a bank servicing its own loans used mortgage servicing software that

manages, without human interaction, the relationship between [the bank] and its attorneys in the collection of delinquent mortgage loans through automated responses to certain queues” and that the software program “is the mortgage banking industry’s most widely used servicing system with more than 50% of all mortgages in the United States serviced on it.”²¹

The court seemed astounded to learn that the “entire process occurs without any communication between counsel and the client and for the most part, without any legal judgment by an attorney.”²²

Some argue that a larger problem for mortgage servicers is that often neither they nor the trusts for which they work actually hold some of the notes on which they are attempting to foreclose.²³ There is significant anecdotal evidence that, on a wide scale basis, notes were not validly transferred to the trusts for which servicers work.²⁴

¹⁹ *In re Parsley*, 384 B.R. 138, 183–84 (Bankr. S.D. Tex. 2008).

²⁰ David McLaughlin, *Florida Settles with Law Firm in Foreclosure Investigation*, BLOOMBERG (Mar. 25, 2011), <http://www.bloomberg.com/news/2011-03-25/florida-law-firm-to-pay-2-million-over-state-foreclosure-investigation.html>.

²¹ *In re Taylor*, 407 B.R. 618, 624 & n.9 (Bankr. E.D. Pa. 2009).

²² *Id.* at 637.

²³ Brady Dennis & Ariana Eunjung Cha, *In Foreclosure Controversy, Problems Run Deeper than Flawed Paperwork*, WASH. POST (Oct. 7, 2010), <http://www.washingtonpost.com/wp-dyn/content/article/2010/10/06/AR2010100607227.html?sid=ST2010100607251>.

²⁴ See Morgenson, *supra* note 6, at BU1. See also Dale A. Whitman, *How Negotiability Has Fouled Up the Secondary Mortgage Market, And What to Do About It*, 37 PEPP. L. REV. 737, 758 (2010) (“While delivery of the note might seem a simple matter of compliance, experience during the past several years has shown that, probably in countless thousands of cases, promissory notes were never delivered to secondary market investors or securitizers, and, in many cases, cannot presently be located at all. The issue

Consumer advocates complain that robo-signing is just the tip of the iceberg, and that servicers mistreat borrowers much more broadly by charging excessive or inappropriate fees, forcing borrowers to purchase high-cost insurance even though they already have insurance in place, and foreclosing without good cause or when both borrowers and the investors who own the loan would benefit from the borrower obtaining a loan modification.²⁵ Mortgage servicers can profit greatly from late fees and other charges when borrowers are in default, and industry insiders and other critics have long charged that mortgage servicers withhold some loan modifications that might help investors and borrowers alike so that the servicers can collect greater fees.²⁶ Another reason servicers have been slow to modify loans is that loan modification is a labor-intensive process, requiring the servicer in essence to re-underwrite the loan to determine how much the borrower can afford.²⁷ By hiring too little staff to engage in the many appropriate loan modifications requested, servicers can save large sums, as much as \$20 billion by one leaked confidential estimate.²⁸ The existence and nature of loan modifications is a crucial determinant in whether borrowers who go into default are able to save their homes from foreclosure.²⁹ However, the pace of loan

is extremely widespread, and, in many cases, appears to have been the result of a conscious policy on the part of mortgage sellers to retain, rather than transfer, the notes representing the loans they were selling.”).

²⁵ See *Problems in Mortgage Servicing from Modification to Foreclosure: Hearing Before the U.S. S. Comm. on Banking, Hous. & Urban Affairs*, 111th Cong. 1–5 (2010) (testimony of Diane E. Thompson, National Consumer Law Center), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=c1fac0f6-5ac5-4ae5-85cc-e2220255dfd9. See also *Robo-Signing, Chain of Title, Loss Mitigation, and Other Issues in Mortgage Servicing: Hearings Before the H. Fin. Servs. Comm., Subcomm. on Hous. and Cmty. Opportunity*, 111th Cong. 15 (2010) (testimony of Prof. Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center), available at <http://financialservices.house.gov/Media/file/hearings/111/Levitin111810.pdf>; *HAMP, Servicer Abuses, and Foreclosure Prevention Strategies: Hearings Before the Cong. Oversight Panel*, 111th Cong. 1–3 (2010) (testimony of Julia Gordon, Center for Responsible Lending), available at <http://cop.senate.gov/documents/testimony-102710-gordon.pdf>.

²⁶ Peter S. Goodman, *Late-Fee Profits May Trump Plan to Modify Loans*, N.Y. TIMES, July 30, 2009, at A1.

²⁷ See Kurt Eggert, *Comment on Michael A. Stegman et al.’s “Preventive Servicing Is Good for Business and Affordable Homeownership Policy”: What Prevents Loan Modifications?*, 18 HOUSING POL’Y DEBATE 279, 285 (2007).

²⁸ See CONSUMER FIN. PROT. BUREAU, PERSPECTIVES ON SETTLEMENT ALTERNATIVE IN MORTGAGE SERVICING (2011), available at http://www.huffingtonpost.com/2011/03/28/big-banks-save-billions-homeowners-suffer_n_841712.html.

²⁹ See Sumit Agarwal et al., *Market-Based Loss Mitigation Practices for Troubled Mortgages Following the Financial Crisis* 5 (Fisher Coll. of Bus., Working Paper No. 2010-03-019, 2010), available at <http://ssrn.com/abstract=1690627> (“In particular, greater

modifications has been glacial, with a recent report that “80% of all non-performing private-label mortgages have not been modified after twelve months.”³⁰ Securitized loans in default are significantly less likely to be modified than loans held in portfolio by a financial institution, showing that servicers are not modifying loans as they would if they owned the loans themselves.³¹ The Federal Trade Commission (FTC) recently obtained a settlement for \$108 million from two servicer units of Countrywide, now owned by Bank of America. The FTC chairman noted that Countrywide had marked up some fees more than 400% and stated that “[t]he record-keeping of Countrywide was abysmal. . . . Most frat houses have better record-keeping than Countrywide.”³²

Worse yet, this pattern of abusive behavior, along with an inadequate federal response, is not new, as even early in the last decade, servicers had perfected the art of using unfair practices to squeeze fees out of borrowers.³³ For years, courts have found that servicers attempted to foreclose even when it appears that no foreclosure was justified. In the 2002 case, *In re Gorshtein*, the court sanctioned servicers who falsely claimed borrowers were in default, saying that its decision was “provoked by an apparently increasing number of motions in this Court to vacate the automatic stay filed by secured creditors often based upon attorney affidavits certifying material post-petition defaults where, in fact, there were no material defaults by the debtors.”³⁴

Sadly, such cases continue unabated. In August 2010, a court noted how a servicer, through a combination of

reductions in loan interest rates (or monthly payments) are associated with sizable declines in redefault rates. As an illustration, a reduction of 1% point in the interest rate is associated with a 3.9% point drop in six-month redefault rate.”)

³⁰ See Brian Collins, *It's Hard Out There for a Mortgage Servicer...*, MORTGAGE SERVICING NEWS, Jan. 2011, at 6 (citing data from the Amherst Securities Group).

³¹ Sumit Agarwal, et al., *The Role of Securitization in Mortgage Renegotiation* 1–4 (Charles A. Dice Ctr., Working Paper No. 2011-2, 2011), available at <http://ssrn.com/abstract=1739915>. The authors argue “that the rate of loan modification, which constitutes the lion’s share (over 75%) of private renegotiation actions, is also significantly higher for portfolio loans. Specifically, portfolio-held loans are 4.2 to 5.8 percentage points (34% to 51% in relative terms) more likely to be modified.” *Id.* at 4.

³² Corbett B. Daly, *B of A's Countrywide Settles with FTC for \$108 Million*, REUTERS (June 7, 2010), <http://www.reuters.com/article/2010/06/07/us-countrywide-ftc-idUSTRE6563DT20100607>.

³³ Fairbanks Capital was likely the most notorious mortgage servicer in the years following the turn of the century, and settled an action with the Federal Trade Commission for \$40 million. For a discussion of the Fairbanks matter and further evidence of servicing abuse in the era before the mortgage meltdown, see Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POL’Y DEBATE 753, 761–67 (2004), available at <http://ssrn.com/abstract=992095>.

³⁴ *In re Gorshtein*, 285 B.R. 118, 120 (Bankr. S.D.N.Y. 2002).

inappropriate fees and the servicer's own incompetence, attempted to foreclose on two borrowers who had paid their loan like "clockwork."³⁵ The court stated that the servicer's conduct

represents the most callous and egregious effort to collect an indebtedness that was never owed that this court has been called upon to review. Succinctly stated, [the servicer's] incompetent servicing tactics converted a loan transaction that was being paid like 'clockwork' to a loan that was virtually impossible to pay, particularly for modest income borrowers.³⁶

A study of servicer claims in bankruptcy court found that "[a] majority of mortgage companies' proofs of claim lack the documentation necessary to establish a valid debt. Fees and charges on bankruptcy claims often are identified poorly and sometimes do not appear to be legally permissible."³⁷ These are filings in bankruptcy court, where a servicer is perhaps most likely to dot i's and cross t's, given the bankruptcy court's oversight. A recent survey of consumer attorneys indicates that a large percentage of the borrowers they represent have had foreclosure proceedings initiated either due to "improper fees or payment processing" or while the borrower is "awaiting a loan modification."³⁸ The U.S. Trustee's office has been investigating bankruptcy filings by mortgage servicers and has reportedly discovered error rates among those filings that "might be ten times higher" than the one percent error rate claimed by mortgage servicers in Senate testimony.³⁹ One servicer/bank claimed the borrower owed over \$50,000, but when the trustee "asked for documentation, the amount dropped to \$3,156."⁴⁰ According to the U.S. Trustee director, the flaws in the servicers' processes "undermine the integrity of the bankruptcy system. Many homeowners have been harmed," by such bad practices as submitting inaccurate statements or attempting to foreclose even

³⁵ *In re Cothorn*, 442 B.R. 494, 496–97, 499 (Bankr. N.D. Miss. 2010).

³⁶ *Id.* at 499. In *Cothorn*, the servicer first wrongly concluded that the borrowers' house was uninsured and so bought force-placed insurance. *Id.* at 496–97. Even when it realized its mistake, the servicer placed the borrowers' payments into a suspense account rather than fixing the problem and in the end tried to collect fees totaling roughly \$15,000, made up of attorney's fees, foreclosure fees, and other charges. The court stated that "[t]here is no doubt that the unrelenting actions of [the servicer] drove the Cothorns into bankruptcy." *Id.* at 499.

³⁷ Katherine M. Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEX. L. REV. 121, 124 (2008).

³⁸ *Servicers Continue to Wrongfully Initiate Foreclosures*, NAT'L ASS'N OF CONSUMER ADVOC. & THE NAT'L CONSUMER L. CTR. (Dec. 15, 2010), http://www.naca.net/_assets/shared/634280136429845000.pdf.

³⁹ See Gretchen Morgenson, *A Low Bid for Fixing a Big Mess*, N.Y. TIMES, May 14, 2011, at BU1, available at www.nytimes.com/2011/05/15/business/15gret.html.

⁴⁰ *Id.*

when borrowers are making proper payments on trial loan modifications.⁴¹

Faced with widespread evidence of servicer malfeasance, fifty state Attorneys General banded together to investigate the robo-signing problem and then expanded this investigation to include problems in the servicing industry more generally.⁴² Federal banking regulators, long too silent and passive regarding mortgage servicing, responded by asking servicers “to conduct self-assessments of their foreclosure management processes and correct any deficiencies,” but also began their own investigation of mortgage servicers.⁴³ They have reported significant problems in the servicing industry, noting “critical deficiencies and shortcomings in foreclosure governance processes, foreclosure document preparation processes, and oversight and monitoring of third party law firms and vendors” which resulted in “violations of state and local foreclosure laws . . . and have had an adverse affect [sic] on the functioning of the mortgage markets and the U.S. economy as a whole.”⁴⁴

The federal interagency review of the fourteen top servicers included eight national banks regulated by the OCC, four thrifts regulated by the OTS, and two other financial institutions regulated by the Federal Reserve’s Board of Governors.⁴⁵ The reviewers found “widespread unsafe or unsound operational practices, including missing documents, execution of documents by unauthorized persons, failure to notarize documents in accordance with local law, inaccurate affidavits, and affidavits signed by persons lacking sufficient knowledge of the underlying mortgage loan transactions.”⁴⁶ The review demonstrated that federal regulators had woefully failed to deter misconduct by mortgage servicers.

⁴¹ *Id.*

⁴² See, e.g., *Miller Says Foreclosure Investigation is Broad-Based*, DES MOINES SUNDAY REG., Dec. 12, 2010, at 1D.

⁴³ U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-11-433, MORTGAGE FORECLOSURES: DOCUMENTATION PROBLEMS REVEAL NEED FOR ONGOING REGULATORY OVERSIGHT 25 (2011) [hereinafter GAO DOCUMENTATION PROBLEMS REPORT], available at <http://www.gao.gov/new.items/d11433.pdf>.

⁴⁴ *Testimony of John Walsh Acting Comptroller of the Currency: Hearings Before the U.S. S. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. 15 (2011), (testimony of John Walsh, Acting Comptroller of the Currency), available at <http://www.occ.treas.gov/news-issuances/congressional-testimony/2011/pub-test-2011-19-written.pdf>.

⁴⁵ See FED. DEPOSIT INS. CORP., REGULATORY ACTIONS RELATED TO FORECLOSURE ACTIVITIES BY LARGE SERVICERS AND PRACTICAL IMPLICATIONS FOR COMMUNITY BANKS 3 (2011), available at http://www.fdic.gov/regulations/examinations/supervisory/insights/sise11/SI_SE2011.pdf.

⁴⁶ *Id.* at 4.

A recent report by the Treasury Department confirms that large national banks are the worst offenders when it comes to mortgage servicing. Of the mortgage servicers featured in the report, only three will have their servicer incentives withheld, because they needed substantial improvement and had no mitigating factors sufficient to justify the disbursement of those payments.⁴⁷ All three are the servicing arms of national banks regulated by the OCC.⁴⁸

By comparison, the FDIC's investigation found much better behavior by state-supervised servicers. The FDIC investigated state banks that are not members of the Federal Reserve System to see if they engaged in "robo-signing" or the other deficient practices found by the interagency review of the fourteen largest federally regulated servicers. The FDIC reported that it did not find "serious industry wide problems among state nonmember banks," and that "[t]o date, the review has not identified 'robo-signing' or any other deficiencies that would warrant formal enforcement actions."⁴⁹ In other words, the most egregious servicer problems seem concentrated among federally rather than state-regulated mortgage servicers.

While the states' Attorneys General and federal agencies report that they are finding significant evidence of widespread servicer misconduct, they appear to disagree on what punishment mortgage servicers should receive for their misconduct. The regulatory agency most concerned with consumer protection, the "newly created Consumer Financial Protection Bureau[,] is pushing for \$20 billion or more in penalties, backed up by the attorneys general and the Federal Deposit Insurance Corporation . . ."⁵⁰ The traditional federal bank regulators, the OCC, and the Federal Reserve Board, reportedly claim that few borrowers were victims of wrongful foreclosures, and so the fines should be much smaller.⁵¹ And so it is possible that even after this apparently widespread misconduct by servicers, they may receive the proverbial slap on the wrist.

⁴⁷ See U.S. DEPT OF THE TREASURY, MAKING HOME AFFORDABLE REPORT AND SERVICER ASSESSMENTS FOR FIRST QUARTER 2011, at 16 (2011), available at <http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/April%202011%20MHA%20Report%20FINAL.PDF>.

⁴⁸ *Id.*

⁴⁹ *Id.* at 5–6.

⁵⁰ Nelson D. Schwartz & David Streitfeld, *Officials Disagree on Penalties for Mortgage Mess*, N.Y. TIMES, Mar. 3, 2011, at B1.

⁵¹ *Id.* at B1.

In the midst of this servicer misconduct, the mortgage crisis continues. One Federal Reserve governor recently noted that foreclosures had rocketed from about one million in 2006 to 2.8 million in 2009, estimated that the final tallies in 2010 would be about 2.25 million foreclosures, and predicted another two million in 2012, with foreclosure levels thereafter expected to “remain extremely high by historical standards.”⁵² Roughly a third of the approximately two million homes that were in foreclosure sit vacant.⁵³ As of the end of 2010, “almost 5 million mortgage loans [were] 90 days or more past due or in foreclosure.”⁵⁴ Adding to the foreclosure risk are the number of American homeowners with negative equity in their homes, with an estimated 15.7 million homeowners “underwater” at the end of 2010, up nearly two million from just three months before and representing twenty-seven percent of all single-family dwellings with a mortgage.⁵⁵ While foreclosures declined somewhat in November of 2010, this decline “likely is due to voluntary foreclosure suspensions put in place in the fall of 2010 in response to the documentation irregularities situation” rather than to any decline in defaults or greater loan modification efforts.⁵⁶

The primary federal response to the foreclosure crisis has been the Making Home Affordable (MHA) program, announced in February 2009 and initially intended to “help as many as 3 to 4 million financially struggling homeowners avoid foreclosure by modifying loans”⁵⁷ The primary component of MHA is the Home Affordable Modification Program. While HAMP was initially designed to modify a million loans per year from its start in 2009, as of November 2010, it had produced fewer than 550,000 permanent loan modifications.⁵⁸

⁵² *Statement by Elizabeth A. Duke: Hearings Before the H. Fin. Servs. Subcomm. On Hous. and Comty. Opportunity*, 111th Cong. 5 (2010) (testimony of Elizabeth A. Duke, Governor of the Federal Reserve Board), available at www.federalreserve.gov/newsevents/testimony/duke20101118a.htm.

⁵³ See Schwartz & Streitfeld, *supra* note 50.

⁵⁴ See *Statement by Elizabeth Duke*, *supra* note 52, at 5.

⁵⁵ See John Gittelsohn, *Negative Home Equity Rises*, ST. LOUIS POST-DISPATCH, Feb. 10, 2011, at A8.

⁵⁶ See CONG. OVERSIGHT PANEL, 112TH CONG., MARCH OVERSIGHT REPORT 88–89 (2011), available at <http://cop.senate.gov/reports/>.

⁵⁷ *Home Affordable Modification Program: Overview*, THE DEPARTMENT OF THE TREASURY, <https://www.hmpadmin.com/portal/programs/hamp.jsp> (last visited May 11, 2011).

⁵⁸ *Making Home Affordable Program*, THE DEPARTMENT OF THE TREASURY, <http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/Nov%202010%20MHA%20Report.pdf> (last visited May 11, 2011).

II. THE LACK OF EFFECTIVE FEDERAL REGULATION OF MORTGAGE SERVICING

For too long, mortgage servicing has been relatively unregulated, with no one agency given the task of overseeing servicing and preventing abuses by servicers and no national standards for servicer regulation. Federal regulation of mortgage servicing has been, in the words of the Government Accountability Office (GAO) “limited and fragmented.”⁵⁹ Federal law provides little protection for borrowers from abusive servicing. Even federal regulators have bemoaned the lack of national servicing standards and the need to develop them.⁶⁰ While some have been arguing for national mortgage standards for years, those calls have recently grown louder, and for good reason, given servicer misbehavior.⁶¹

The primary federal law governing servicing is the Real Estate Settlement Procedures Act (RESPA), which is designed to inform borrowers when the servicing rights to their mortgage have been transferred, to give them some disclosure of how that transfer will affect them, and to provide some protection from late fees during transfer.⁶² In addition, RESPA was intended to prevent kickbacks and referral fees that can drive up the cost of settlement services.⁶³ Furthermore, RESPA allows borrowers to seek some information regarding their loan’s payment history and current status and requires servicers to respond to those requests as well as requests that errors in the account be corrected. While RESPA can be useful for borrowers, its usefulness is relatively limited as to protection from abusive servicers and does not reach many of the current issues embroiling the servicing industry.⁶⁴

⁵⁹ GAO DOCUMENTATION PROBLEMS REPORT, *supra* note 43, at 14.

⁶⁰ GAO DOCUMENTATION PROBLEMS REPORT, *supra* note 43, at 54.

⁶¹ See Alan Zibel, *Regulators Urged to Devise National Loan Servicing Standards*, WALL ST. J. BLOG (Dec. 21, 2010, 10:35 AM), <http://blogs.wsj.com/developments/2010/12/21/regulators-urged-to-devise-national-loan-servicing-standards/> (reporting on a letter signed by a group of academics, analysts, and investors urging the establishment of a set of national standards for mortgage servicing).

⁶² See 12 U.S.C. § 2601(a)–(b) (2006).

⁶³ See Patricia Quinn Robertson, *Kickbacks, RESPA and the Title Insurance Industry: How to Get a Foot in the (Courthouse) Door*, 36 REAL EST. L.J. 270, 270 (2007) (“Goals of RESPA include the provision of ‘more effective advance disclosure to home buyers and sellers of settlement costs’ and ‘elimination of kickbacks or referral fees that tend to increase unnecessarily the costs of certain settlement services.’” (quoting 12 U.S.C. § 2601(b)(1)–(2) (2000)).

⁶⁴ See Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. (2011) (forthcoming 2011) (manuscript at 7–8), available at <http://ssrn.com/abstract=1324023> (noting the lack of rights RESPA grants to borrowers).

Other federal laws regulating servicers also do little to quell abusive practices by servicers. Until recently, the Truth in Lending Act (TILA) affected servicers little. It was amended in 2009, however, to provide servicers some safe harbor from liability to investors should servicers enter into loan modifications with borrowers. The goal was to lessen the effect of “tranche warfare,” whereby some investors could claim that their individual interests were harmed by a loan modification, even if the modification helped investors as a whole.⁶⁵ While this amendment gives servicers protection against some claims as they modify loans, it does not give borrowers more leverage in obtaining such loan modifications. Recent changes to Regulation Z implementing TILA require prompt crediting of mortgage loan payments and forbid charging late fees on unpaid late fees.⁶⁶

While the existing statutory framework provides little protection for borrowers from the improper fees, shoddy paperwork, and unnecessary foreclosures that have marred the mortgage servicing industry, some federal agencies have the power to sanction servicers for such practices and have on occasion used that power. For example, the Federal Trade Commission has reached significant settlements with mortgage servicers accused of abusive treatment of borrowers, including a 2003 settlement with Fairbanks Capital providing a \$40 million fund for injured borrowers, which included a set of “best practice[s] guidelines for mortgage servicing,”⁶⁷ a 2007 modification of that settlement with additional guidelines,⁶⁸ a 2008 settlement for \$28 million with Bear Stearns and its servicers that included the establishment of a data integrity system,⁶⁹ and a settlement for \$108 million with Countrywide’s

⁶⁵ See Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, 123 Stat. 1638 (2009). For a discussion of this point, see Levitin & Twomey, *supra* note 64 (manuscript at 56). “Tranche warfare” is the battle between different classes (or “tranches”) of investors who may have conflicting interests regarding whether a servicer modifies or forecloses on a loan. For a description of tranche warfare, see Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 560–62 (2002).

⁶⁶ See 12 C.F.R. § 226.36(c)(ii) (2008); Truth in Lending, 73 Fed. Reg. 44, 522 (July 30, 2008).

⁶⁷ For a discussion of Fairbanks’ actions and the FTC litigation against Fairbanks, see Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POL’Y DEBATE 753, 761–67 (2004), available at <http://ssrn.com/abstract=992095>.

⁶⁸ See Press Release, Federal Trade Commission, FTC, Subprime Mortgage Servicer Agree to Modified Settlement (Aug. 2, 2007), available at <http://www.ftc.gov/opa/2007/08/sps.shtm> (announcing the modification of a settlement between the FTC and Fairbanks Capital which provides additional benefits to consumers).

⁶⁹ See Press Release, Federal Trade Commission, Bear Stearns and EMC Mortgage to Pay \$28 Million to Settle FTC Charges of Unlawful Mortgage Servicing and Debt Collection Practices (Sept. 9, 2008), available at <http://www.ftc.gov/opa/2008/09/emc.shtm>

loan servicing operation, which the FTC had accused of inflating loan fees.⁷⁰ While such actions are helpful and clearly necessary, the FTC's actions have been too limited to have a significant effect on the servicing industry. Furthermore, the FTC's authority does not extend to depository institutions themselves.⁷¹

Other federal agencies or quasi-federal organizations have the authority to regulate servicing organizations but so far have focused more on the safety and soundness of their regulated institutions or on their own pecuniary gain than on preventing servicer misbehavior that primarily damages borrowers.⁷² According to a recent GAO report, "federal banking regulators have not regularly examined servicers' foreclosure practices on a loan-level basis. Instead, previous federal regulatory examinations of mortgage servicers have focused on loan modifications or on the income banks earn from servicing loans."⁷³

At a December 2010 Senate hearing, officials from the OCC, the United States Department of the Treasury (Treasury), and the Federal Housing Finance Agency, as well as a governor of the Board of Governors of the Federal Reserve System, all testified about problems in the mortgage and servicing industry.⁷⁴ By and large, they acknowledged that they had some authority over mortgage servicing, that there was a significant problem with mortgage servicing, and that they were currently investigating the scope of the problem and hoped to have some idea soon how widespread the problem was and what they could and should do about it.⁷⁵

It is telling that to a great extent this widespread servicer abuse appears to have come as some surprise to these agencies,

(announcing settlement between FTC, Bear Stearns, and EMC Mortgage which requires the installation of a data integrity program).

⁷⁰ See Press Release, Federal Trade Commission, Countrywide Will Pay \$108 Million for Overcharging Struggling Homeowners: Loan Servicer Inflated Fees, Mishandled Loans of Borrowers in Bankruptcy (June 7, 2010), available at <http://www.ftc.gov/opa/2010/06/countrywide.shtm> (announcing \$108 million settlement due to Countrywide's deceptive loan collection practices).

⁷¹ See 15 U.S.C. §§ 41, 45(a)(2) & 58 (2006).

⁷² See Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 92-93 (2008).

⁷³ GAO DOCUMENTATION PROBLEMS REPORT, *supra* note 43, at 17.

⁷⁴ For the written testimony of these federal regulators, as well as an archived webcast of their oral testimony, see *Problems in Mortgage Servicing from Modification to Foreclosure, Part II, U.S. S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. (2010), http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=ea6d7672-f492-4b1f-be71-b0b658b48bef.

⁷⁵ *Id.*

despite their power to investigate and regulate servicers. John Walsh, Acting Comptroller of the Currency noted:

The OCC supervises all national banks and their operating subsidiaries, including their mortgage servicing operations. The servicing portfolios of the eight largest national bank mortgage servicers account for approximately 63 percent of all mortgages outstanding in the United States—nearly 33.3 million loans totaling almost \$5.8 trillion in principal balances as of June 30, 2010.⁷⁶

The OCC is “the primary regulator for banks that service 78.3 percent of loans serviced by the top 25 servicers.”⁷⁷ With such broad supervisory powers over such a significant segment of the servicing industry, the OCC should have been in a position to monitor ongoing servicer behavior, to detect servicer misbehavior as it happened, and to administer timely corrective measures, including real sanctions for servicer misbehavior.

Unfortunately, however, the OCC appears to have had far greater interest in preserving the powers of its client banks than in protecting the borrowers/consumers affected by the servicing operations of those banks. First of all, its primary mission is protecting the safety and soundness of its regulated financial institutions, and when the banks’ soundness seems threatened by consumer protection, the OCC perpetually seems to opt against consumer protection.⁷⁸ Also, as much as ninety-five percent of the OCC’s income comes from the banks that it regulates, giving it a financial incentive to protect its client banks.⁷⁹ The OCC receives no Congressional funding, and so depends on fees from banks, such as examination or application fees.⁸⁰

It appears that only recently has the OCC made any significant investigation into foreclosure misconduct by servicers. The OCC has acknowledged that until recently, it paid scant attention to servicers’ foreclosure activities, abusive or not: “We looked at the final stage of the process and thought of it as one

⁷⁶ *Id.* (testimony of John Walsh, Acting Comptroller of the Currency).

⁷⁷ GAO DOCUMENTATION PROBLEMS REPORT, *supra* note 43, at 17.

⁷⁸ See Arthur E. Wilmarth, Jr., *Written Testimony on the Credit Card Industry Before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services, April 26, 2007* 13–20 (The George Washington Univ. Law Sch. Pub. Law and Legal Theory Working Paper No. 517, 2007), available at <http://ssrn.com/abstract=1729840> (noting how rarely the OCC has sanctioned any national bank for a consumer protection violation, especially when compared to state banking regulators).

⁷⁹ See Bar-Gill & Warren, *supra* note 72, at 93.

⁸⁰ See *About the OCC*, OFFICE OF THE COMPTROLLER OF THE CURRENCY, <http://www.occ.gov/about/index-about.html> (last visited Apr. 13, 2011).

that would be governed by standards and procedures in internal controls,” the OCC chief counsel stated.⁸¹ A GAO report on the servicers and foreclosures noted, “[a]lthough various federal agencies have authority to oversee most mortgage servicers, past oversight of their foreclosure activities has been limited, in part because banking regulators did not consider these practices as posing a high risk to banks’ safety and soundness”⁸²

After the robo-signing affair reached the news, the OCC and other federal agencies with banking oversight announced with great fanfare an investigation into the practices of their regulated servicers. They claimed that they sent teams of investigators to pour over the books of the servicers and review their practices, and issued a report that showed that their investigators had discovered “significant problems in foreclosure processing at the servicers” though also that “borrowers subject to foreclosure in the reviewed files were seriously delinquent on their loans.”⁸³

This report itself disclosed how minimal the inspection of servicers by the federal agencies was, however. The investigation seemed to rely primarily on servicers’ self-assessment, as examiners reviewed only “approximately 2,800 borrower foreclosure files” from the two year period ending in December 2010, or about 200 files at each of the fourteen servicers.⁸⁴ Even the federal examiners noted that this was “a relatively small number of foreclosure files given the volume of recent foreclosures processed by these servicers”⁸⁵ The reviewers did not examine the “entire cycle of the borrowers’ loans or potential mortgage-servicing issues outside of the foreclosure process,” and so would have missed foreclosures caused by earlier servicer errors.⁸⁶ The report acknowledges that “examiners may not have uncovered cases of misapplied payments or unreasonable fees, particularly when these actions occurred prior to the default,” leaving one to wonder what the examiners were looking for if not those basic elements of servicer

⁸¹ Zachary A. Goldfarb, *Regulators Lagged in Foreclosure Oversight*, WASH. POST, Nov. 8, 2010, at A1.

⁸² GAO DOCUMENTATION PROBLEMS REPORT, *supra* note 43.

⁸³ FEDERAL RESERVE SYSTEM, OFFICE OF THE COMPTROLLER OF THE CURRENCY & OFFICE OF THRIFT SUPERVISION, *Interagency Review of Foreclosure Policies and Practices*, 1, 3 (Apr. 2011), available at www.federalreserve.gov/boarddocs/rptcongress/interagency_review_foreclosures_20110413.pdf [hereinafter INTERAGENCY REVIEW].

⁸⁴ INTERAGENCY REVIEW, *supra* note 83, at 1.

⁸⁵ GAO DOCUMENTATION PROBLEMS REPORT, *supra* note 43, at 25.

⁸⁶ INTERAGENCY REVIEW, *supra* note 83, at 3.

abuse.⁸⁷ The FDIC, in a follow-up report, noted how minimal the interagency examination of servicers was, stating that the examination “did not review allegations of improper servicing or loss mitigation, such as misapplied payments, unreasonable fees, inappropriate force-placing of insurance, failure to consider adequately a borrower for loan modification, or requiring a borrower to be delinquent to qualify for a loan modification.”⁸⁸

After this minimal investigation, the federal agencies decreed a minimal enforcement action against the servicers, requiring them mostly to “[r]etain an independent firm to conduct a review of residential foreclosure actions that were pending” during the same time period as the federal agencies’ review “to determine any financial injury to borrowers caused by errors” by the servicers’ misbehavior “and to remediate, as appropriate . . .”⁸⁹ Servicers are also required to hire a firm to conduct risk assessment for the servicers. In other words, the federal agencies punted their investigation and oversight role to a firm to be hired by each servicer, leaving open the possibility, if not likelihood, that servicers will choose oversight firms that signal a willingness to protect the interests of the servicer itself, rather than the borrowers. Worse yet, the “independent reviews” will not be made public, according to the OCC, so that the public cannot determine whether the reviews have any validity.⁹⁰

The remainder of the agencies’ enforcement order is akin to ordering the servicers to come up with better policies and get back to the agencies to let the agencies know what the servicers had done, with little indication what will happen if the servicers’ proposed changes do not meet federal approval. Worse yet, federal regulators have not indicated any intention to increase their oversight of servicers following this review. As noted by a GAO report, “[a]lthough regulators have taken enforcement actions against servicers, they have not identified specifically

⁸⁷ *Id.*

⁸⁸ Federal Deposit Insurance Corporation, *Regulatory Actions Related to Foreclosure Activities by Large Servicers and Practical Implications for Community Banks*, SUPERVISORY INSIGHTS, May 2011, at 4, available at http://www.fdic.gov/regulations/examinations/supervisory/insights/sise11/SI_SE2011.pdf.

⁸⁹ FEDERAL RESERVE SYSTEM ET AL., INTERAGENCY REVIEW OF FORECLOSURE POLICIES AND PRACTICES 13 (Apr. 2011), available at www.federalreserve.gov/boarddocs/rptcongress/interagency_review_foreclosures_20110413.pdf.

⁹⁰ Jon Prior, *Independent Reviews in Mortgage Servicer Consent Orders to Stay Sealed*, HOUSINGWIRE, May 13, 2011, <http://www.housingwire.com/2011/05/13/independent-reviews-in-mortgage-servicer-consent-orders-to-stay-sealed>.

how they will change the extent and frequency of future oversight of servicers going forward.”⁹¹

Given the lackadaisical attitude that the OCC and other federal regulators have demonstrated toward servicer misbehavior, it is reasonable to worry that the OCC and others are using their purported investigation of, and enforcement action against, servicers merely as a way to stall for time, and will not take meaningful action to deter and punish servicer misbehavior. Instead, the OCC and other federal regulators may well still be acting primarily to protect bank/servicers’ financial soundness and their own turf as banking regulators, to the detriment of homeowners and borrowers.

Another part of the mortgage servicing problem is the role of Fannie Mae and Freddie Mac in overseeing servicers, and their self-interest in performing those roles. Fannie and Freddie, quasi-governmental bodies with their own pecuniary interests at stake, have been given much of the task of regulating servicer conduct, both directly for the loans they have purchased or guaranteed, and through the HAMP program.⁹² Treasury granted Fannie and Freddie this power by entering into contracts with them to oversee HAMP.⁹³ Under those contracts, Fannie Mae was designated as the point of contact for servicers that participate in HAMP, not only to pay them for their HAMP modifications, but also to instruct them how loans should be modified.⁹⁴ Fannie Mae was also supposed to “help design and execute a program that implements standardized, streamlined mortgage modifications for all types of servicers, regardless of the risk holder . . . and that lowers monthly payments for qualified borrowers.”⁹⁵

Freddie Mac, on the other hand, was hired by Treasury to be its program compliance agent, to examine and investigate mortgage servicers to ensure that servicers comply with the

⁹¹ GAO DOCUMENTATION PROBLEMS REPORT, *supra* note 43, at 31.

⁹² See Henry E. Hildebrand III, *HAMP and Your Chapter 13 Practice*, 29 AM. BANKR. INST. J. 12, 74 n.8 (2010) (“Loans that are owned or guaranteed by Fannie Mae and Freddie Mac must be examined for HAMP modification. Loans that are owned by others are encouraged to participate by contract.”).

⁹³ See Theresa R. DiVenti, *Fannie Mae and Freddie Mac: Past, Present, and Future*, 11 CITYSCAPE: J. OF POL’Y DEV. & RES. 231, 232 (2009).

⁹⁴ U.S. DEP’T OF THE TREASURY, FINANCIAL AGENCY AGREEMENT FOR A HOMEOWNERSHIP PRESERVATION PROGRAM UNDER THE EMERGENCY STABILIZATION ACT OF 2008, EXHIBIT A 1–2 (2009), available at http://www.treasury.gov/initiatives/financial-stability/about/procurement/faa/Financial_Agency_Agreements/Fannie%20Mae%20FAA%20021809.pdf.

⁹⁵ *Id.* at 1.

published rules of HAMP and to report to Treasury the results of its investigations.⁹⁶ Freddie Mac was given the authority to conduct on-site audits of servicers and, in consultation with Treasury, require certain corrective measures by servicers, such as suspending foreclosures. Treasury, through the actions of its MHA Compliance Committee, could impose penalties on servicers that fail to comply with their HAMP obligations, such as withholding or requiring repayment of incentive payments.⁹⁷ Treasury has failed to use this power to any significant extent, however. According to the Congressional Oversight Panel's December 2010 report, "Treasury has seemed reluctant to do more than vaguely threaten the potential for clawbacks of HAMP payments. Despite rampant anecdotal stories of servicer errors, to date, no servicer has experienced a clawback or other financial repercussion."⁹⁸ The Treasury Department recently announced that the three worst offending mortgage servicers would suffer some financial repercussion, though it is not clear how significant these penalties will be. After finding that four of the nation's largest servicers were in need of substantial improvement to conform to HAMP guidelines, Treasury announced, "[b]eginning this month, Treasury will withhold servicer incentives owed to three of the four servicers requiring substantial improvement until those servicers make certain identified improvements."⁹⁹ Thus, even though Treasury's report indicates that the largest servicers needed significant improvement, its only punishment was to withhold some payments until that improvement occurs, when presumably the servicers will be made whole.¹⁰⁰

It has become apparent that Fannie and Freddie performed their oversight function poorly, likely in large part because their own financial interests conflict with regulating servicer behavior to protect borrowers from abusive practices. The Congressional Oversight Panel (Panel) has noted Fannie and Freddie's self-

⁹⁶ See U.S. DEPT OF THE TREASURY, FINANCIAL AGENCY AGREEMENT FOR A HOMEOWNERSHIP PRESERVATION PROGRAM UNDER THE EMERGENCY STABILIZATION ACT OF 2008, EXHIBIT A 1-2 (2009), available at http://www.treasury.gov/initiatives/financial-stability/about/procurement/faa/Financial_Agency_Agreements/freddie%20mac%20financial%20agency%20agreement.pdf.

⁹⁷ See CONG. OVERSIGHT PANEL, 111TH CONG., DECEMBER OVERSIGHT REPORT 50 (2010), available at <http://cybercemetery.unt.edu/archive/cop/20110402010243/http://cop.senate.gov/documents/cop-121410-report.pdf>.

⁹⁸ *Id.* at 50.

⁹⁹ See U.S. DEPT OF THE TREASURY, MAKING HOME AFFORDABLE REPORT AND SERVICER ASSESSMENTS FOR FIRST QUARTER 2011, at 16 (2011), available at <http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/April%202011%20MHA%20Report%20FINAL.PDF>.

¹⁰⁰ *Id.*

interest in overseeing HAMP, and how that self-interest may limit Freddie's willingness to engage in aggressive oversight of mortgage servicers. Regarding Freddie Mac, the Panel reported:

In response to revelations that servicers have been using "robo-signers" to submit false affidavits in thousands of foreclosure cases, Freddie Mac noted that . . . [t]rying to enforce Freddie Mac contractual rights, however, "may negatively impact our relationships with these seller/servicers, some of which are among our largest sources of mortgage loans."¹⁰¹

Also weakening the oversight of mortgage servicers has been the voluntary nature of this HAMP oversight. While it is not clear what the servicers' rights are, some have been concerned that if Treasury through Fannie and Freddie were to crack down on servicer behavior, then servicers would attempt to leave the HAMP program to avoid sanction.¹⁰² As a result of this lack of oversight, servicers often have acted as if they were free to violate or simply ignore the HAMP guidelines intended to promote loan modifications.¹⁰³

Because of the great weakness of the current regulation of mortgage servicers, it seems clear that a new system of national mortgage servicer regulation is in order to provide a floor of regulation below which servicers cannot go. A natural agency to draft such regulations would be the new Consumer Financial Protection Bureau, to be established as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. While this Bureau is now ramping up, however, it is not clear how soon it will be in a position to draft national servicing regulations and to enforce them once it officially opens for business in July 2011.

III. FEDERAL PREEMPTION OF STATE REGULATION

While states wait for federal action on mortgage servicer regulation, they could take action on their own. However, to a great extent, state servicer regulation has been hampered by the

¹⁰¹ See DECEMBER OVERSIGHT REPORT, *supra* note 97, at 82. The Panel added that "[t]he Panel condemns this sentiment. If Freddie Mac is hesitant to jeopardize their relationships with servicers to enforce their rights in their own book of business, it is reasonable to worry that they may be similarly unwilling to risk these relationships on Treasury's behalf by aggressively overseeing HAMP servicers." *Id.*

¹⁰² See *id.* at 51, 87 n.330.

¹⁰³ See *Problems in Mortgage Servicing From Modification to Foreclosure: Hearing Before the U.S. S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. 3 (2010) (testimony of Diane E. Thompson), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=c1fac0f6-5ac5-4ae5-85cc-e2220255dfd9 ("Advocates continue to report that borrowers are denied improperly for HAMP, that servicers solicit opt-outs from HAMP, and that some servicers persistently disregard HAMP applications.").

fact that many of the largest mortgage servicers are parts of federally regulated financial institutions and have been able to claim that state regulation over them is preempted.¹⁰⁴ Preemption of state law by federal law or regulation comes in many varieties, with the touchstone of all forms being the purpose of Congress.¹⁰⁵ Preemption doctrine has a long and tortured history, with courts and academics grappling with its challenges more or less successfully through the years.¹⁰⁶ Generally, preemption analysis starts with the “assumption that the historic police powers of the States [are] not to be superseded by the [federal law] unless that was the clear and manifest purpose of Congress.”¹⁰⁷ Preemption can be expressly stated or implied by statute.¹⁰⁸ Preemption implied by statute can either be through conflict preemption, where state law conflicts with federal law, or field preemption, “where Congress has legislated so comprehensively in a field that it must have intended national uniformity of regulation, and, therefore, its legislation displaces all state regulation” without regard to whether there is a specific conflict with federal law.¹⁰⁹ Another way of describing field preemption is that state law is preempted “where the scheme of federal regulation is so pervasive as to make reasonable the inference that there is no room for state action.”¹¹⁰

Conflict preemption has two distinct types: (1) direct conflict preemption, where state and federal law directly contradict each other such that it would be impossible to comply with both; and

¹⁰⁴ The OCC oversees over sixty percent of mortgage servicing. See *Problems in Mortgage Servicing From Modification to Foreclosure, Part II: Hearing Before the U.S. S. Comm. On Banking, Hous., & Urban Affairs*, 111th Cong. 13 (2010) (testimony of John Walsh, Acting Comptroller of the Currency), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=c1fac0f6-5ac5-4ae5-85cc-e2220255dfd9.

¹⁰⁵ See *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 494 (1996) (“[T]he purpose of Congress is the ultimate touchstone’ in every pre-emption case.” (quoting *Cipollone v. Liggett Grp.*, 505 U.S. 504, 516 (1992))).

¹⁰⁶ For useful articles on the history and development of preemption doctrine, see Mary J. Davis, *The Battle over Implied Preemption: Products Liability and the FDA*, 48 B.C. L. REV. 1089 (2007); Viet D. Dinh, *Reassessing the Law of Preemption*, 88 GEO. L.J. 2085, 2112–17 (2000); Karen A. Jordan, *The Shifting Preemption Paradigm: Conceptual and Interpretive Issues*, 51 VAND. L. REV. 1149 (1998); Caleb Nelson, *Preemption*, 86 VA. L. REV. 225, 298 (2000).

¹⁰⁷ *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1946). See also *Jones v. Rath Packing Co.*, 430 U.S. 519, 525–604 (1977) (“[W]e start with the assumption that the historic police powers of the States were not to be superseded by [federal law] unless that was the clear and manifest purpose of Congress.” (quoting *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1946))).

¹⁰⁸ See Mary J. Davis, *The “New” Presumption Against Preemption*, 61 HASTINGS L.J. 1217, 1220–21 (2010).

¹⁰⁹ *Id.* at 1221.

¹¹⁰ *Conference of Fed. Sav. & Loan Ass’ns v. Stein*, 604 F.2d 1256, 1260 (9th Cir. 1979) (citing *Ray v. Atlantic Richfield Co.*, 435 U.S. 151, 157 (1978)).

(2) preemption where the state law is “an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.”¹¹¹ Direct conflict preemption, where it is impossible to comply with both federal and state law, is a rarity, however.¹¹² Therefore, courts attempting to apply conflict preemption typically grapple with the issue of whether state law or regulation is a sufficient obstacle to federal law or regulation that it should be preempted.

In addition to preemption through federal statute, state law can also be preempted by the action of federal regulatory agencies.¹¹³ “Federal regulations have no less pre-emptive effect than federal statutes.”¹¹⁴ Also, agencies may attempt to preempt state law either through express statements of preemption or by enacting regulations that conflict with existing state law.¹¹⁵ If the scheme of agency regulation of an area is so pervasive as to leave no room for state action, then field preemption is implied.¹¹⁶ However, it would upset the balance of federalism to assume blanket preemption simply because of extensive regulation of an area.¹¹⁷ Because Congressional purpose is the touchstone of preemption, agency power to preempt must come from Congress, which may grant agencies preemption power either directly, stating that agencies have the power to make preemption declarations, or indirectly, giving agencies the power to take actions which, through their conflict with state law, preempt those laws.¹¹⁸

A crucial question, and one subject to much current debate, is whether and how much deference courts should give to agency declarations and decisions regarding the preemptive effects of

¹¹¹ *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941).

¹¹² See Davis, *supra* note 106, at 1244.

¹¹³ See William Funk, *Judicial Deference and Regulatory Preemption by Federal Agencies*, 84 TUL. L. REV. 1233, 1235–36 (2010). Recognition of agencies’ preemptive effect on state law goes back, some argue, at least to *Gibbons v. Ogden*, 22 U.S. 1 (9 Wheat.) (1824). See Funk, at 1234–35.

¹¹⁴ *Fidelity Fed. Sav. & Loan Ass’ns. v. De la Cuesta*, 458 U.S. 141, 153 (1982).

¹¹⁵ See Funk, *supra* note 113, at 1235.

¹¹⁶ *Rice Bank of Am. v. City & Cnty. of S.F.*, 309 F.3d 551, 558 (9th Cir. 2002) (citing *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947)).

¹¹⁷ See John P.C. Duncan, *The Course of Federal Pre-emption of State Banking Law*, 18 ANN. REV. BANKING L. 221, 317–18 (1999) (“To infer pre-emption whenever an agency deals with a problem comprehensively is virtually tantamount to saying that whenever a federal agency decides to step into a field, its regulations will be exclusive. Such a rule, of course, would be inconsistent with the federal-state balance embodied in our Supremacy Clause jurisprudence.”).

¹¹⁸ See Funk, *supra* note 113, at 1235–36 (explaining how agency regulations may expressly preempt state law or may have the effect of doing so).

their actions.¹¹⁹ Agencies that seek the greatest latitude in preempting state law would prefer that their preemption decisions be given *Chevron* deference, a standard which requires greater administrative procedure to establish a regulation, but provides an agency with greater deference to its determination, so long as it is reasonable.¹²⁰ A lesser standard is *Skidmore* deference, which requires less daunting administrative procedure to establish a regulation, but leaves greater discretion to courts to determine preemption.¹²¹ Some academic commentators have urged against granting federal agencies *Chevron* deference regarding their preemption determinations, arguing, among other things, that federal agencies lack expertise on the effects of preemption, or that agencies lack sufficient political accountability in their consideration of states' interests.¹²² Others have urged courts to take a "hard look" at agency declarations of preemption not grounded in express powers granted by Congress.¹²³

In the 2009 case, *Wyeth v. Levine*, the Supreme Court indicated that in determining whether state law conflicts with federal regulation, courts should not defer "to an agency's *conclusion* that state law is pre-empted" but instead should attend to the agency's explanation of any such conflict.¹²⁴ The Court noted that, absent delegation of preemption powers by Congress, federal agencies possess no inherent "authority to pronounce on pre-emption," though they do "have a unique understanding of the statutes they administer and an attendant

¹¹⁹ See, e.g., Nina A. Mendelson, *A Presumption Against Agency Preemption*, 102 NW. U. L. REV. 695, 699, 702–03 (2008) (arguing that federal agencies are poorly suited to make preemption decisions, given their "particular stake in validating their own policy decisions," their lack of stake in protecting state autonomy, and the likelihood that agencies would extend preemption of state law far beyond that intended by Congress).

¹²⁰ See Brian Galle & Mark Seidenfeld, *Administrative Law's Federalism: Preemption, Delegation, and Agencies at the Edge of Federal Power*, 57 DUKE L.J. 1933, 1998 & n.268 (2008) (explaining that agency decisions made after formal procedures, such as notice and comment, will receive great deference by the courts).

¹²¹ See *Skidmore v. Swift & Co.*, 323 U.S. 134, 164 (1944). For a discussion of *Skidmore* deference, see Galle & Seidenfeld, *supra* note 120, at 1998 & n.268.

¹²² See, e.g., Nina A. Mendelson, *Chevron and Preemption*, 102 MICH. L. REV. 737, 758–98 (2004) (arguing against *Chevron* deference for agency preemption determinations given their lack of expertise regarding the effects of such preemption, and discussing alternative theories regarding agency political accountability).

¹²³ Karen A. Jordan, *Opening the Door to "Hard-Look" Review of Agency Preemption*, 31 W. NEW ENG. L. REV. 353, 359 (2009). The author argues that while appearing deferential to agency preemption decisions, the Supreme Court in *United States v. Shimer*, 367 U.S. 374 (1961), was actually mandating "a hard-look review [that] requires a court to search for the rationale and reasoning underlying the agency's decision." See *id.* at 361.

¹²⁴ *Wyeth v. Levine*, 129 S. Ct. 1187, 1201 (2009).

ability to make informed determinations about how state requirements may pose an ‘obstacle to the accomplishment and execution of the full purposes and objectives of Congress.’”¹²⁵ How much deference to grant agency claims of preemption has become a crucial issue in the banking industry, because federal banking regulators have made extensive claims that their regulation preempts the powers of the states to govern banks’ activities.

A The Previous Co-Existence of State and Federal Regulation of National Banks and Thrifts

Many statutes come into play in the effect of federal preemption on the banking industry.¹²⁶ Two sets of statutes and regulators are central to the federal preemption for national banks and thrifts: (1) the National Bank Act (NBA), which charters national banks that are overseen by the Office of the Comptroller of the Currency; and (2) the Home Owners Loan Act (HOLA), which charters Federal Savings associations (also known as “thrifts”), that are currently supervised by the Office of Thrift Supervision.¹²⁷

For many decades since the enactment of the NBA in 1863–1864 and HOLA in 1933, these statutes were construed to recognize the importance of the dual federal and state banking system, as well as the extensive role that state law plays in the operation even of federally regulated banks and thrifts.¹²⁸ Both the courts and Congress were concerned about preserving the “competitive equality” of the dual state and federal banking system and so strove to keep them on at least somewhat equal

¹²⁵ *Id.* (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)).

¹²⁶ Among the federal statutes with the most significant preemptive effect in the mortgage industry are: the National Bank Act of 1864, 12 U.S.C. §§ 21–216 (2006); Home Owners’ Loan Act, 12 U.S.C. §§ 1461–70 (2006); Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. § 1735f (2006); National Credit Union Administration, 12 U.S.C. § 1757 (2006); and the Alternative Mortgage Transactions Parity Act, 12 U.S.C. §§ 3801–06 (2006). For a more complete description of various federal laws preempting state law in the mortgage and banking industry, see ELIZABETH RENUART & KATHLEEN E. KEEST, *THE COST OF CREDIT: REGULATION, PREEMPTION, AND INDUSTRY ABUSES* 53–55 (4th ed. 2009).

¹²⁷ In addition, there is the Federal Credit Union Act (FCUA) providing for credit unions supervised by the National Credit Union Administration (NCUA). However, as credit unions do not loom large in the mortgage meltdown or its aftermath, the NCUA will be little discussed herein.

¹²⁸ For an extensive discussion of the history of preemption in the banking industry, see generally Arthur E. Wilmarth, Jr., *The OCC’s Preemption Rules Exceed the Agency’s Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225 (2004).

footing.¹²⁹ On the other hand, national banks and thrifts and federal regulators have vociferously argued that because the federal government has always played a significant role in the regulation of the banking industry, and a dominant one for national banks, there should be no presumption against preemption of state law as to national banks.¹³⁰

Notably, NBA and HOLA are virtually silent regarding whether they preempt state law. The NBA has only one direct assertion of preemption in its text, which is the provision that national banks can abide by either state usury limits or, alternatively, a federal one.¹³¹ The Supreme Court has never held that the NBA occupies the field of law generally regarding regulation of national banks, even though it does occupy the field regarding usury claims.¹³²

The Supreme Court commented on the great role state law plays in governing national banks in 1869, stating that national banks:

are subject to the laws of the State, and are governed in their daily course of business far more by the laws of the State than of the nation. All their contracts are governed and construed by State laws. Their acquisition and transfer of property, their right to collect their debts, and their liability to be sued for debts, are all based on State law. It is only when the State law incapacitates the [national] banks from discharging their duties to the [federal] government that it becomes unconstitutional.¹³³

Traditionally, therefore, national banks' "right to collect their debts," which is the core of servicing, is "based on State law."

Decades later, the Court reemphasized the role state law plays in regulating national banks and rejected the idea of field preemption by federal regulation in *St. Louis v. Missouri*.¹³⁴ In 1978, however, the Court extended the reach of the NBA's usury

¹²⁹ Duncan, *supra* note 117, at 222 ("Competitive equality' became shorthand in the courts for the complex state-federal balances created by federal banking statutes.").

¹³⁰ See *United States v. Locke*, 529 U.S. 89, 108 (2000).

¹³¹ See Lauren K. Saunders, *Restore the States' Traditional Role as "First Responder,"* NATIONAL CONSUMER LAW CENTER, at 4–5 (Sept. 2009), <http://www.nclc.org/images/pdf/preemption/restore-the-role-of-states-2009.pdf>.

¹³² See Duncan, *supra* note 117, at 223. See also RENUART & KEEST, *supra* note 126, at 84 & nn.273–74 (citing *Jefferson v. Chase Home Fin.*, No. C 06-6510 THE, 2008 WL 1883484 (N.D. Cal. Apr. 29, 2008), for the proposition that the NBA does not occupy the field of banking, and *Beneficial Nat'l Bank v. Anderson*, 539 U.S. 1 (2003), which applies express preemption language to usury claims).

¹³³ See *Nat'l Bank v. Kentucky*, 76 U.S. (9 Wall.) 353, 362 (1869).

¹³⁴ See *St. Louis v. Missouri*, 263 U.S. 640, 656–61 (1924).

preemption by holding that national banks had “most favored lender” status in their respective home states and decreed that national banks could export their own home states’ usury limits to other states in which they do business.¹³⁵

In 1994, Congress appeared to attempt to rein in preemption claims by the OCC when, during the enactment of the Riegle-Neal Act, it directed the OCC, as well as courts, to try to harmonize state and federal law where possible, rather than finding preemption-causing conflict, noting that the OCC should not decide that a state law is preempted unless “the legal basis is compelling and the Federal policy interest is clear.”¹³⁶ Since preemption is based on and reflects Congressional intent, clear direction such as this should be a guidepost to limit the extent of preemption caused by OCC regulations.

In 1996, the Supreme Court issued its decision in *Barnett Bank of Marion County v. Nelson*, which laid out the Court’s view of the preemption effects of federal banking law.¹³⁷ In *Barnett*, a national bank sued Florida’s Department of Insurance, seeking to enjoin it from enforcing a state statute that prohibited some banks from selling many varieties of insurance, arguing that this statute was preempted by a 1916 federal statute that provided that banks may sell insurance in certain instances.¹³⁸ The Supreme Court held that because the federal law granted national banks a power, in this case to sell insurance, that grant of power preempted a state law that would deny such power.¹³⁹ However, the Court noted that national banks are still subject to state regulation and provided a standard by which to determine whether state law should be preempted by the NBA and OCC regulation:

In defining the pre-emptive scope of statutes and regulations granting a power to national banks, these cases take the view that normally Congress would not want States to forbid, or to impair significantly, the exercise of a power that Congress explicitly granted. To say this is not to deprive States of the power to regulate national banks, where

¹³⁵ See *Marquette Nat’l Bank v. First Omaha Serv. Corp.*, 439 U.S. 299, 314 & n.26 (1978).

¹³⁶ H.R. REP. NO. 103-651, at 53–55 (1994) (Conf. Rep.), reprinted in 1994 U.S.C.C.A.N. 2074.

¹³⁷ See *Barnett Bank of Marion Cnty. v. Nelson*, 517 U.S. 25, 27–28 (1996).

¹³⁸ See *id.* at 28–29. The federal statute in question was the Act of Sept. 7, 1916 (Federal Statute). See 12 U.S.C. § 92 (2006).

¹³⁹ See *Barnett*, 517 U.S. at 37 (“[W]e conclude that the Federal Statute means to grant small town national banks authority to sell insurance, whether or not a State grants its own state banks or national banks similar approval.”).

(unlike here) doing so does not prevent or significantly interfere with the national bank's exercise of its powers.¹⁴⁰

This case therefore lays out what the Supreme Court, in 1996, viewed as the appropriate preemption standard for state regulation of national banks. States do have the power to regulate national banks so long as their regulation does not “prevent or significantly interfere with the national bank's . . . powers” or does not “forbid or . . . impair significantly, the exercise of a power that Congress [has] explicitly granted.”¹⁴¹ Congress explicitly adopted the *Barnett* standard by citing it in subsequent legislation.¹⁴²

Like the NBA, HOLA, which governs thrifts, has only very limited preemption language, also specifying that thrifts can choose between state and federal usury limits, and specifying the federal thrift usury limit.¹⁴³ Because HOLA and the NBA have such limited preemption language, courts have generally applied the narrower “conflict” preemption analysis to determine if state laws purporting to regulate national banks and thrifts were preempted, rather than the broader field preemption.¹⁴⁴ For example, in the 1986 case *Departamento de Asuntos del Consumidor(DACO) v. Oriental Federal Saving Bank*, a federal district court employed a conflict preemption analysis in finding that local law setting interest rate maximums for retail installment contracts was not preempted, and in doing so rejected the argument that HOLA necessarily preempted local law by occupying the field.¹⁴⁵ That court stated that, despite the fact that HOLA grants the thrift regulator broad powers, which it has used to issue “detailed regulations covering all aspects of every federal savings and loan association ‘from its cradle to its

¹⁴⁰ See *id.* at 33.

¹⁴¹ *Id.*

¹⁴² The Gramm-Leach-Bliley Act of 1999 limits the states' ability to restrict depository institutions or their affiliates from engaging “in any insurance sales, solicitation, or crossmarketing activity” and expressly states that this limitation is in “accordance with the legal standards for preemption set forth in the decision of the Supreme Court of the United States in *Barnett Bank of Marion County . . .*” 15 U.S.C. § 6701(d)(2)(A) (2006).

¹⁴³ See 12 U.S.C. § 1463 (2006). For a discussion of this point see Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Markets Upstream*, 26 YALE J. ON REG. 143, 167 (2009) (noting that except as to national thrifts, HOLA contains no explicit language preempting state law).

¹⁴⁴ In 1982, in finding “an actual conflict between federal and state law,” the Supreme Court held that it “need not decide whether the HOLA or the Board's regulations occupy the . . . entire field of federal savings and loan regulation.” *Fidelity Fed. Sav. & Loan Ass'n v. De la Cuesta*, 458 U.S. 141, 159 n.14 (1982).

¹⁴⁵ *Departamento de Asuntos del Consumidor (DACO) v. Oriental Fed. Sav.*, 648 F. Supp. 1194, 1197 (D.P.R. 1986).

grave,' . . . most courts have been unwilling to blanketly declare that Congress has occupied the entire field of federal savings and loan association regulation."¹⁴⁶ Another court in 1982 opined in discussing HOLA and its accompanying regulations: "The fact that federal statutes or regulations covering some aspects of a regulated area are, by necessity, complex and detailed, does not imply that Congress intended to occupy the entire field to the exclusion of state law."¹⁴⁷

B. Federal Regulators Move to Preempt State Regulation of Nation Banks and Thrifts

During the 1980s, as federal "regulatory zeal" declined and states stepped up their regulatory efforts, preemption, which had been a backwater of American law, suddenly gained new importance.¹⁴⁸ Various industries sought to stifle state regulation by seeking federal preemption, so as to trump state action with federal inaction in regulation.¹⁴⁹ In the banking industry, banks and thrifts increasingly sought protection from state regulation by appealing to federal regulators to assert greater preemptive powers.¹⁵⁰

The OTS struck first in 1996 by issuing regulations claiming that it had the authority to occupy the field regarding any regulation of federal thrifts.¹⁵¹ Its regulation stated, "[p]ursuant to sections 4(a) and 5(a) of the HOLA, 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 OTS hereby occupies the entire field of lending regulation for federal savings associations."¹⁵² The regulation provides specific illustrations of state law that is preempted, and includes: "Processing, origination, *servicing*, sale or purchase of, or

¹⁴⁶ *Id.* (quoting *Cal. v. Coast Fed. Sav. & Loan Ass'n*, 98 F. Supp. 311, 316 (S.D. Cal. 1951)).

¹⁴⁷ *Morse v. Mutual Fed. Sav. & Loan Ass'n of Whitman*, 536 F. Supp. 1271, 1280 (D. Mass. 1982).

¹⁴⁸ Susan Bartlett Foote, *Administrative Preemption: An Experiment in Regulatory Federalism*, 70 VA. L. REV. 1429, 1430–31 (1984).

¹⁴⁹ *Id.* ("Until recently, administrative preemption provisions attracted little political, judicial, or scholarly attention. . . . In the last few years, however, the federal government has declined in regulatory zeal, and states and localities have become more protective. Faced with stricter state laws varying from state to state, businesses have begun to lobby for uniform federal regulations that would preempt more protective state laws." (footnotes omitted)).

¹⁵⁰ See Julia Patterson Forrester, *Still Mortgaging the American Dream: Predatory Lending, Preemption, and Federally Supported Lenders*, 74 U. CIN. L. REV. 1303, 1309 (2006).

¹⁵¹ 12 C.F.R. § 560.2 (2011).

¹⁵² 12 C.F.R. § 560.2(a) (2010) (original version at 12 C.F.R. § 560.2(a) (1997)).

investment or participation in, mortgages.”¹⁵³ Therefore, with a single regulation, the OTS claimed to eliminate any state power to regulate thrifts engaged not only in lending, but also in servicing loans on behalf of others.

The OTS did note some exceptions to its claimed field preemption in this regulation, preserving state contract law, real property law, tort and criminal law, and any law that “[f]urther[s] a vital state interest,” among others, but only “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 section.”¹⁵⁴ The OTS made clear that these exceptions to preemption were meant merely to “preserve the traditional infrastructure of basic state laws that undergird commercial transactions, not to open the door to state regulation of lending by federal savings associations.”¹⁵⁵ Furthermore, any exception is “intended to be interpreted narrowly. Any doubt should be resolved in favor of preemption.”¹⁵⁶

The OTS based its field preemption claim on two sections of federal statute, “sections 4(a) and 5(a) of the HOLA, 12 U.S.C. 1463(a), 1464(a).”¹⁵⁷ However, these sections are essentially silent as to any explicit Congressional purpose to grant the OTS the power to preempt. 12 U.S.C. § 1463(a) provides that the OTS, through its director, can issue regulations.¹⁵⁸ 12 U.S.C. § 1464(a) provides that the Director of the OTS can, under regulations the Director prescribes, “provide for the organization, incorporation, examination, operation, and regulation of [Federal savings] associations” and to issue charters for them.¹⁵⁹ Neither provides any expression that Congress’ purpose was to have the OTS occupy the field regarding regulation of thrifts, unless one

¹⁵³ 12 C.F.R. § 560.2(b)(10) (emphasis added).

¹⁵⁴ 12 C.F.R. § 560.2(c). The OTS gave courts instructions on how to apply the preemption doctrine in section 560.2, stating that “[w]hen analyzing the status of state laws under § 560.2, the first step will be to determine whether the type of law in question is listed in paragraph (b). If so, the analysis will end there; the law is preempted. If the law is not covered by paragraph (b), the next question is whether the law affects lending. If it does, then, in accordance with paragraph (a), the presumption arises that the law is preempted. This presumption can be reversed only if the law can clearly be shown to fit within the confines of paragraph (c). For these purposes, paragraph (c) is intended to be interpreted narrowly. Any doubt should be resolved in favor of preemption.” Lending and Investment, 61 Fed. Reg. 50,951, 50,966–67 (Sept. 30, 1996).

¹⁵⁵ Lending and Investment, 61 Fed. Reg. at 50,966.

¹⁵⁶ *Id.* at 50,966–67.

¹⁵⁷ 12 C.F.R. § 560.2(a).

¹⁵⁸ 12 U.S.C. § 1463(a) (2006).

¹⁵⁹ 12 U.S.C. § 1464(a).

takes the position that anytime Congress allows a federal agency to draft regulations, its purpose is to have that agency occupy the field, or that federal agencies directed to regulate an area can merely announce that their regulations occupy the field for that area.

The OTS, somewhat disingenuously, stated in its announcement of the regulations that its preemption regulation did not constitute a change in the law, but merely a clearer restatement of it, arguing that the regulation merely

restates long-standing preemption principles applicable to federal savings associations, as reflected in earlier regulations, court cases, and numerous legal opinions issued by OTS and the Federal Home Loan Bank Board (FHLBB), OTS's predecessor agency. OTS still intends to occupy the field of lending regulation for federal savings associations.¹⁶⁰

After the OTS issued regulations purportedly preempting the field of thrift regulation, it was perhaps nearly inevitable that the OCC would do the same for the regulation of national banks. While thrifts and national banks might appear to be different types of entities, in fact the OTS and the OCC were in competition, both with each other and with state regulators, over subject financial institutions.¹⁶¹ Should the OTS be free to provide its member thrifts freedom from state regulation and the OCC not, then banks would be tempted to switch from being either state chartered institutions or national banks to being national thrifts in order to reduce their regulatory burden, thus starting a "race to the bottom" to see which regulator would mandate the fewest consumer protections and other regulations.¹⁶² Like that of OTS, the budget of the OCC depended largely on fees from the financial institutions it regulated, giving the agencies an incentive to maintain or increase the number of institutions they regulated, and making preemption a valuable tool to lure those institutions away from state charters.¹⁶³ Without broad preemption powers, the OCC was no doubt concerned that not only could it not lure banks away from state charters, but that the OTS might lure them into becoming thrifts. The OCC was constrained by the fact that the Supreme Court had, in 1996, stated the standards for preemption governing national banks in the *Barnett* case, and Congress had

¹⁶⁰ Lending and Investment, 61 Fed. Reg. at 50,952.

¹⁶¹ Duncan, *supra* note 117, at 318.

¹⁶² *Id.*

¹⁶³ Patricia A. McCoy et al., *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1349 (2009).

subsequently expressed approval of those standards, as noted above.¹⁶⁴ However, the OCC brushed such concerns aside.¹⁶⁵

In 2003, the OCC fired a salvo against state regulation of national banks, issuing a preemption order finding that the Georgia Fair Lending Act, designed to deter predatory lending, did not apply to national banks.¹⁶⁶ In 2004, the OCC moved to preempt state regulation more universally and issued regulations purporting to preempt state law generally in the business of banking for national banks, including for deposit-taking and lending, either with or without mortgages.¹⁶⁷ The OCC's regulation went far beyond the existing *Barnett* standard, whereby state law was preempted as to national banks only to the extent it would "forbid, or to impair significantly" or "prevent or significantly interfere with the national bank's exercise of its powers."¹⁶⁸ Instead, the OCC regulation declared any state law that would "obstruct, impair, or condition, a national bank's ability to fully exercise" its powers as a national bank was preempted.¹⁶⁹ This "obstruct, impair, or condition" is a broader standard than *Barnett's* "forbid, or to impair significantly" or "prevent or significantly impair" standard, in that the impairment no longer has to be significant. Even state regulation that did not forbid, prevent or significantly impair a national bank's exercise of its powers would be preempted if state law merely "conditioned" the use of those powers, which is vague and broad language. The OCC regulations further widened their preemptive effect by mandating that only a specific set of state laws could apply to national banks, and even then only those that had a mere "incidental" effect on national banks' powers, which the regulation preamble defines as those that "form the legal infrastructure that makes it practicable" for national banks to exist and conduct business and "do not attempt to regulate the manner or content of" the business of banking authorized for national banks.¹⁷⁰

¹⁶⁴ *Barnett Bank of Marion Cnty., N.A. v. Nelson*, Fla. Ins. Comm'y, 517 U.S. 25, 33 (1996); 12 C.F.R. § 560.2(a) (2010) (original version at 12 C.F.R. § 560.2(a) (1997)).

¹⁶⁵ Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904, 1904 (Jan. 13, 2004).

¹⁶⁶ Preemption Determination and Order, 68 Fed. Reg. 46,264, 46,264 (Aug. 5, 2003).

¹⁶⁷ Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. at 1904; 12 C.F.R. §§ 7.4007–09 (2010). For a discussion of this preemption order, see Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 TEMP. L. REV. 1, 70–71 (2005).

¹⁶⁸ *Barnett*, 517 U.S. at 33.

¹⁶⁹ 12 C.F.R. §§ 7.4007, 7.4009.

¹⁷⁰ Bank Activities and Operations, 69 Fed. Reg. 1912 (Jan. 13, 2004); 12 C.F.R. §§ 7.4007(c), 7.4008(e), 7.4009(c), 34.4(b).

The OCC regulations further limited state action by claiming that the OCC has exclusive visitorial powers not only over national banks, but also over their operating subsidiaries.¹⁷¹ Worse yet, even if a state law is not preempted and does apply to a national bank, the states themselves cannot enforce that law against the national banks, according to OCC's regulations.¹⁷² At most, a state can sue the national bank for declaratory relief, seeking a judgment that the state law does apply to national banks and is not preempted. However, only the OCC, according to its regulations, could then enforce applicable state law, so that the OCC could pick and choose which state law to apply, even among those that are not preempted.¹⁷³

The OCC expanded its powers of preemption in an advisory letter by arguing that not only are national banks protected from state regulation, even their local non-national bank agents are protected from state licensing requirements when they are acting in ways related to the national banks' powers as such.¹⁷⁴

The reaction against the OCC's preemption expansion was swift and initially futile. All fifty Attorneys General sent a letter opposing the increased federal preemption of state law for national banks, and they were joined by academics and consumer advocates.¹⁷⁵ Unfortunately, they were not immediately joined by the courts, by and large. In the case *Watters v. Wachovia Bank*, the Supreme Court appeared to condone the OCC's expansion of its powers of preemption, agreeing with the OCC that the NBA's preemption extended even to operating

¹⁷¹ Travis P. Nelson, *Preemption Under Title X of the Dodd-Frank Act*, BANKING LAW COMMITTEE JOURNAL, Oct. 2010, at 5, available at <http://apps.americanbar.org/buslaw/committees/CL130000pub/newsletter/201010/nelson.pdf>.

¹⁷² Bank Activities and Operations, 69 Fed. Reg. 1895, 1897; 12 C.F.R. § 7.4000 ("The provisions of any State law to which a branch of a national bank is subject under this paragraph shall be forced, with respect to such branch, by the Comptroller of the Currency.").

¹⁷³ Bank Activities and Operations, 69 Fed. Reg. at 1899–900. For a discussion of this point, see Wilmarth, *supra* note 128, at 228.

¹⁷⁴ Letter from John E. Bowman, Chief Counsel, Office of Thrift Supervision, Authority of a Federal Savings Association to Perform Banking Activities through Agents Without Regard to State Licensing Requirements, P-2004-7 (Oct. 25, 2004), available at http://www.ots.treas.gov/_files/560404.pdf. For a discussion of this, and the argument that preemption protection for non-national banks leads to additional predatory behavior, see Christopher L. Peterson, *Preemption, Agency Cost Theory, and Predatory Lending by Banking Agents: Are Federal Regulators Biting Off More Than They Can Chew?*, 56 AM. U. L. REV. 515, 543 (2007).

¹⁷⁵ See discussion of the opposition in Peterson, *supra* note 174, at 70–71. For an opposition letter from multiple consumer advocacy groups, see Letter to the Office of the Comptroller of the Currency, (Oct. 6, 2003), available at <http://www.responsiblelending.org/media-center/press-releases/archives/CRL-OCCsignon100603.pdf>.

subsidiaries of national banks as well as to the banks themselves.¹⁷⁶ The Supreme Court stated that national banks have “the power to engage in real estate lending through an operating subsidiary” and that this power of the national banks “cannot be significantly impaired or impeded by state law.”¹⁷⁷

The *Watters* case is interesting both for what it added to the OCC’s preemptive powers and for what it withheld. On the one hand, its extension of federal preemption to the operating subsidiaries of national banks, even if those subsidiaries were state-chartered, handed national banks and their subsidiaries an enormous victory against state regulation.¹⁷⁸ At the same time, however, the Court failed to adopt the OCC regulations’ more expansive preemption language, and instead cited *Barnett* as finding preemption where “state prescriptions significantly impair” the authority “enumerated or incidental under the NBA.”¹⁷⁹ Also, the Court did not rule on the issue of whether the OCC had the power to declare the preemptive effects of its action or seek judicial deference for its preemption declarations.¹⁸⁰ While noting that the OCC had, by regulation, claimed to limit the application of state law to national bank operating subsidiaries only to the same extent such laws applied to national banks, the Court did not decide what level of deference to give those regulations, as its decision was based on the NBA itself.¹⁸¹

The OCC’s and OTS’s efforts to lure financial institutions to their charters through preemption appeared to be successful. Engel and McCoy noted, “[a]lthough landing Countrywide was a huge coup for OTS, the OCC was the biggest beneficiary of charter shopping after 2003,” and also quoted the Comptroller as crowing within months of adopting the preemption rule, “the past several months have seen some notable movements of state banks into the national system.”¹⁸² The market shares of their regulated institutions grew as well. “Depository institutions and their subsidiaries and affiliates accounted for about half of nonprime loans originated in 2004 and 2005, 54% in 2006, and 79% in 2007.”¹⁸³ Worse yet is the likelihood that the threat of

¹⁷⁶ *Watters v. Wachovia Bank, N.A.*, 550 U.S. 1, 18 (2007).

¹⁷⁷ *Id.* at 21.

¹⁷⁸ *Id.* at 18.

¹⁷⁹ *Id.* at 12.

¹⁸⁰ *Id.* at 20.

¹⁸¹ *Id.* at 20–21.

¹⁸² KATHLEEN C. ENGEL & PATRICIA A. MCCOY, *THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS* 160–61 (2011).

¹⁸³ Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial*

losing financial institutions to a federal charter encouraged states to reduce the regulatory burden on their state-chartered institutions.

During the Bush era, both the OCC and the OTS were preempting state law regarding lending practices, not only to lure banks and thrifts to their charters, but also in order to reduce the total regulatory burden on banks and thrifts, based on the belief that the markets should broadly be left to regulate themselves.¹⁸⁴ The OTS was especially brazen in its lack of regulation for its member thrifts, and laid off sixty-nine thrift examiners, while its director claimed his goal “was ‘to allow thrifts to operate with a wide breadth of freedom from regulatory intrusion’” and showed up with a chainsaw at a conference set up to proclaim a reduction of red-tape and regulation.¹⁸⁵ Countrywide switched from a bank to a thrift charter specifically to take advantage of the fact that the OTS was more restrained than the OCC in the application of its guidelines governing alternative mortgage products.¹⁸⁶

Federal regulators have since claimed that preempting state regulation did not cause the influx of default-prone loans that came after the OCC’s 2004 preemption regulation.¹⁸⁷ However, a review of default rates from 2006 to 2008 among depository institutions shows that federally regulated banks and thrifts had significantly higher default rates than those regulated by the states, with federal thrifts by far the worst.¹⁸⁸ As noted by Engel and McCoy, “the best loan performance was at state bank and thrifts, which were subject to both state and federal regulation and did not enjoy preemption.”¹⁸⁹

As a result of the federal preemption of state regulation of national banks and thrifts, those banks and thrifts

Conglomerates and the Origins of the Subprime Financial Crisis, 41 CONN. L. REV. 963, 1018–19 (2009).

¹⁸⁴ See McCoy, *supra* note 163, at 1349 (stating “[c]oncomitantly, OCC regulators and their federal bank regulator counterparts were true believers in the ability of market structures and new instruments to contain risk. When market innovations could contain risk, the thinking went, why have government regulation?”).

¹⁸⁵ ENGEL & MCCOY, *supra* note 182, at 175.

¹⁸⁶ Barbara A. Rehm, *Countrywide to Drop Bank Charter in Favor of OTS*, AM. BANKER, Nov. 10, 2006, at 1.

¹⁸⁷ See, e.g., John C. Dugan, Comptroller of the Currency, Remarks Before Women in Hous. & Fin., Washington, DC (Sept. 24, 2009), available at <http://www.occ.gov/news-issuances/speeches/2009/pub-speech-2009-112.pdf>. Dugan stated, “[i]t is widely recognized that the worst subprime loans that have caused the most foreclosures were originated by nonbank lenders and brokers regulated exclusively by the states.” *Id.*

¹⁸⁸ ENGEL & MCCOY, *supra* note 182, at 163.

¹⁸⁹ *Id.*

understandably became less willing to cooperate with state regulators attempting to resolve consumer complaints. State officials reported a noticeable effect from the preemptive strike by federal regulators, diminishing state consumer protection efforts.¹⁹⁰ Although this perception was not universal, many felt that national banks were less cooperative with state officials and less concerned about consumer complaints.¹⁹¹ While state officials stated that they had been able, before the assertion of preemption, to informally resolve customer complaints efficiently, once the OCC announced its intent to preempt state regulation, some state agents felt that national banks became significantly less cooperative.¹⁹²

Worse yet, the OCC and OTS were not themselves engaging in significant enforcement action for violations of consumer protection by their regulated institutions. The OCC provided little public evidence that it was sanctioning national banks for consumer protection violations. As Professor Arthur E. Wilmarth, Jr. noted:

The OCC's record is similarly undistinguished with respect to consumer enforcement actions taken against national banks for violations of consumer protection laws. Since January 1, 1995, the OCC has taken only thirteen public enforcement actions against national banks for violations of consumer lending laws. With two exceptions, all of those actions were taken against small national banks.¹⁹³

IV. PREEMPTION AND SERVICER REGULATION

At the very beginning of the mortgage crisis, it was clear that federal preemption of state law would reduce the states' abilities to investigate or regulate the way national banks serviced loans. In 2007, a group of state bank regulators, concerned that borrowers were being foreclosed upon unnecessarily, requested information from the biggest national banks regarding their foreclosure operations. When two banks refused to cooperate, the state bank examiners sent a letter to the OCC, requesting its aid. Rather than helping, the OCC

¹⁹⁰ U.S. GOV'T ACCOUNTABILITY OFFICE, OCC PREEMPTION RULES: OCC SHOULD FURTHER CLARIFY THE APPLICABILITY OF STATE CONSUMER PROTECTION LAWS TO NATIONAL BANKS, GAO-06-387, at 17 (2006), *available at* <http://www.gao.gov/new.items/d06387.pdf>.

¹⁹¹ *Id.*

¹⁹² *Id.* at 17–21.

¹⁹³ Wilmarth, *supra* note 78, at 14 (noting how rarely the OCC has sanctioned any national bank for a consumer protection violation, especially when compared to state banking regulators).

insisted that national banks should respond only to inquiries from federal officials, claiming that it was going to collect the information itself and did not want to risk “confusing matters.”¹⁹⁴ Rather than “scrutinize the foreclosure operations” of the large national banks, however, the OCC reportedly merely relied on the banks’ own internal assessments of their procedures.¹⁹⁵ As foreclosures mounted and state attorneys tried to investigate the causes of the dramatic increase in foreclosures, large servicers regulated by the OCC reportedly refused even to turn over basic servicing data, citing federal preemption.¹⁹⁶

Federal preemption for national banks is especially significant in the servicing industry because, as previously noted, residential mortgage servicing is dominated by the servicing arms of national banks and thrifts.¹⁹⁷ The four largest servicers are the servicing arms of Bank of America, Wells Fargo, Chase, and CitiMortgage, which between them service over fifty-six percent of the market.¹⁹⁸ Because many of the largest mortgage servicers are the parts of federally regulated financial institutions, the expansion of OTS and OCC preemption and the extension of preemption to the subsidiaries of national banks and thrifts has provided servicers protection from state regulation. Both the OTS and the OCC regulations specifically purport to preempt all state regulation of mortgage servicing by national banks and thrifts. The OTS regulations list, as examples of

the types of state laws preempted by paragraph (a) of this section . . . state laws purporting to impose requirements regarding . . .

(5) Loan-related fees, including without limitation, initial charges, late charges, prepayment penalties, servicing fees, and overlimit fees;

(6) Escrow accounts, impound accounts, and similar accounts;

. . . .

(10) Processing, origination, servicing, sale or purchase of, or investment or participation in, mortgages.¹⁹⁹

¹⁹⁴ A description of this episode can be found in Zachary A. Goldfarb, *Regulators Lagged in Foreclosure Oversight*, WASH. POST, Nov. 8 2010, at A1.

¹⁹⁵ *Id.*

¹⁹⁶ Press Release, Office of Sen. Hillary R. Clinton, Sens. Clinton, Bayh Call on Administration, Mortgage Services to Cooperate with State’s Efforts to Address Mortgage, Foreclosure Crisis (Apr. 30, 2008), available at 2008 WLNR 8047227.

¹⁹⁷ Wilmarth, *supra* note 78, at 2.

¹⁹⁸ *Firms Ranked by Number of Loans Serviced at 9/30*, MORTGAGE SERVICING NEWS, Feb. 2011, at 1.

¹⁹⁹ 12 C.F.R. § 560.2(b) (2010).

The OCC regulations also expressly purport to preempt state regulation of mortgage servicing, stating that “[s]pecifically, a national bank may make real estate loans under 12 U.S.C. § 371 and § 34.3, without regard to state law limitations concerning: . . . (10) Processing, origination, servicing, sale or purchase of, or investment or participation in, mortgages.”²⁰⁰

The federal preemption of state law governing mortgage servicing provided a challenge to courts: while the OTS and OCC seemed to indicate a desire to occupy the field of regulating mortgage servicing, clearly the states had to play some role in providing the legal structure undergirding mortgage servicer behavior. For example, the law governing mortgage foreclosure is primarily a state creation, with some states mandating judicial procedure and others allowing for non-judicial foreclosures.²⁰¹ Given that a foreclosure is one of the most extreme steps taken by servicers, federal regulators can hardly be said to occupy all mortgage servicing regulation if they have not regulated how federally regulated servicers foreclose.²⁰²

Mortgage servicers also needed other forms of state law to apply to their mortgages and loans, including state negotiable instrument law and contract law.²⁰³ Mortgage servicers clearly should not be exempt from criminal law and general tort law, providing liability for torts such as deception.²⁰⁴ Therefore, contract, tort, and real property law were listed as examples of the kinds of law NOT preempted by the OTS’s and OCC’s regulation.²⁰⁵ The challenge for courts attempting to honor the preemption regulations regarding mortgage servicing has been trying to distinguish between permissible state regulation of

²⁰⁰ 12 C.F.R. § 34.4(a).

²⁰¹ Grant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act*, 53 DUKE L.J. 1399, 1403 (2004) (stating that “[m]ortgage foreclosure law is in a state of pronounced disarray. A sizeable number of states mandate judicial foreclosure, while others authorize a nonjudicial ‘power of sale’ foreclosure proceeding. Additionally, many states impose a variety of postforeclosure restrictions, including statutory redemption and limitations on deficiency judgments, whereas others provide no such protections for debtors.”). See also Debra Pogrud Stark, *Foreclosing on the American Dream: An Evaluation of State and Federal Foreclosure Laws*, 51 OKLA. L. REV. 229, 230–31 (1998) (describing the interplay between state and federal laws concerning foreclosure).

²⁰² Stark, *supra* note 201, at 230–32.

²⁰³ *Gibson v. World Sav. & Loan Ass’n*, 128 Cal. Rptr. 2d 19, 28 (Cal. Ct. App. 2002) (noting that HOLA does not preempt “duties to comply with contracts and the laws governing them and to refrain from misrepresentation.”).

²⁰⁴ See *Martinez v. Wells Fargo Home Mortg., Inc.*, 598 F.3d 549, 555–57 (9th Cir. 2010) (stating that “various district courts have held that the [National Bank] Act does not preempt a claim of express deception asserted under state law.”).

²⁰⁵ 12 C.F.R. §§ 560.2(c), 34.4(b) (2010).

foreclosures and tort law on the one hand, and what those regulations list as impermissible state regulation of servicing on the other.

In a 2007 case, Judge Posner attempted to define the demarcation between the arguably preempted regulation of servicing and non-preempted tort and contract law. He noted that a borrower should be free to sue a servicer for breach of contract or for fraud, given the OTS's inability to adjudicate disputes between borrower and servicer, finding that the application of state tort or contract law "would complement rather than substitute for the federal regulatory scheme."²⁰⁶ The task of a court, therefore, is to determine which state regulation governs lenders and servicers as such, and so would be preempted as to federally regulated institutions, and which regulation is merely part of the general law of the state. The essential question is "which claims fall on the regulatory side of the ledger and which, for want of a better term, fall on the common law side."²⁰⁷

Courts have struggled, with inconsistent results, to determine what state law constitutes "regulating servicing" and is therefore deemed preempted by OCC and OTS regulation, and what is merely the general law of the state. One court went so far as to state that any state claim against a federally-chartered thrift involving improprieties in foreclosures would be preempted because such claims would necessarily involve servicing, etc. of the loan, though claims that the servicer misled the borrower as regarding a loan modification were not preempted.²⁰⁸ Another court reached the opposite result on such deception, finding that all state claims based on a servicer's misrepresentations about loan modifications were preempted because loan modifications are an element of servicing.²⁰⁹ General consumer protection laws seem to be part of the general law of the state, however, and

²⁰⁶ *In re Ocwen Loan Servicing, LLC Mortg. Servicing Litig.*, 491 F.3d 638, 643–44 (7th Cir. 2007).

²⁰⁷ *Id.* at 644. In that case, the court found that, due to the vagueness of the complaint, "the case is largely unripe for a determination of preemption." *Id.* at 648.

²⁰⁸ *Ahmed v. Wells Fargo Bank & Co.*, No. 4:11cv00436, 2011 WL 1751415, at *3–4 (N.D. Cal. May 9, 2011). The court ruled that claims based on allegations that "defendants falsely represented that plaintiff's loan would be modified and that the foreclosure sale had been cancelled" were not preempted, however, because they "arise from a more 'general duty not to misrepresent material facts,' and therefore [do] not necessarily regulate lending activity." *Id.* at *4 (quoting *Becker v. Wells Fargo Bank, N.A.*, No. 2:10cv02799, 2011 WL 1103439, at *8–9 (E.D. Cal. March 22, 2011)).

²⁰⁹ *Wittenberg v. First Indep. Mortg. Co.*, No. 3:10cv00058, 2011 WL 1357483, at *14 (N.D. W. Va. April 11, 2011).

some courts have for that reason held them not to be preempted.²¹⁰

Courts have likewise ruled inconsistently on whether state restraint against unfair business practices should be preempted as to federally regulated servicers. In a case where borrowers alleged that servicers “routinely refused to discuss good faith modifications” regarding their loans, the court determined that, to the extent such actions constituted a violation of California’s Unfair Competition Law, any claim based on that violation was preempted by the OTS’s regulations.²¹¹ Similarly, where a loan servicer was alleged to have engaged in unfair practices by using inadequate property valuation methods to evaluate short sales and unfair practices in making offers to postpone foreclosures, the court found that simply because those activities “relate entirely” to the defendant’s “processing, origination, servicing, sale or purchase of, or investment or participation in, mortgages,” the claims were preempted.²¹²

By comparison, in a case where borrowers alleged unfair business practices in overcharging for force-placed insurance, the court found that California’s Unfair Competition Law was not preempted, because it was a general business law, and even though the subject matter concerned the servicing of loans, the specific claims, that the defendants had made misrepresentations and engaged in deceptive conduct, were not specific to lending.²¹³

Courts have similarly considered whether unfair competition laws are preempted by the National Bank Act as to servicers regulated by the OCC.²¹⁴ In one case, a borrower alleged that his

²¹⁰ See, for example, *Smith v. BAC Home Loans Servicing, LP*, No. 2:10-cv-00354, 2011 WL 843937, at *10 (S.D. W. Va. 2011), where the court states, “[i]nstead, I look to the intent of Congress, as best demonstrated by the text of the NBA, and conclude that there is no significant federal regulatory objective at play that would merit displacing the generally applicable state consumer-protection claims presented in the Complaint.”

²¹¹ *Biggins v. Wells Fargo & Co.*, 266 F.R.D. 399, 417 (N.D. Cal. 2009). See also *In re Ocwen*, where the court found that a claim against a servicer pursuant to New Mexico’s Unfair Trade Practices Act was preempted because it claimed “a gross disparity between the value received by the [class] members [in New Mexico] and the price paid,” a charge that clearly is preempted.” *In re Ocwen*, 491 F.3d at 647.

²¹² *Grant v. Aurora Loan Servs., Inc.*, 736 F. Supp. 2d 1257, 1275 (C.D. Cal. 2010).

²¹³ *Gibson v. World Sav. & Loan Ass’n*, 128 Cal. Rptr. 2d 19, 29–30 (Cal. Ct. App. 2002). See also *Binetti v. Wash. Mut. Bank*, 446 F. Supp. 2d 217, 221 (S.D.N.Y. 2006) (holding that because the effect on national thrifts was only an incidental part of the state’s unfair competition law, that state law was not preempted even as to claims regarding federally regulated thrifts).

²¹⁴ *Wells v. Chase Home Fin., LLC*, No. C10-5001RJB, 2010 WL 4858252, at *10 (W.D. Wash. 2010), wherein the court found that claims under the Washington Consumer Protection Act were not preempted even though they concerned misrepresentations regarding foreclosures and borrowers’ requests for loan modifications.

servicer had made misrepresentations about whether mortgage prepayments would be applied to principal or held in suspense accounts.²¹⁵ The court found that because the borrower relied on a general Unfair Competition Law (UCL) rather than a state law “specifically directed at banking or lending,” the borrower’s claim was not preempted even though it went directly to how the servicer serviced the loan.²¹⁶

In other cases, where borrowers claimed that a servicer committed an unfair or deceptive act in violation of the state’s Unfair and Deceptive Practices Act (UDAP) law, courts have held that because the act consisted of mortgage servicing, the state UDAP law was preempted even though it was a general business law not specifically directed toward servicers.²¹⁷ In a California case, a court found that an unfair business practices claim was preempted, stating “each of Plaintiffs’ claims specifically challenge the processing of Plaintiffs’ loan modification application and servicing of Plaintiffs’ mortgage, and fall within the specific types of preempted state laws listed in § 560.2(b)(4) & (10). Accordingly, each of Plaintiffs’ claims are preempted by HOLA.”²¹⁸ Courts have tried to explain these contradictory results by arguing that when it comes to general statutes such as UDAP, the question is not whether the statute will be generally preempted, but rather whether as applied, the statute would impose requirements on lending or servicing and so should be preempted.²¹⁹

In a recent case, the court applied a different standard to judge whether state law was preempted, looking not at whether the state law was a general one but rather at whether there was an applicable federal claim that would preempt the state claim.²²⁰ In that case, a borrower sued a servicer, alleging that the servicer had told him not to make his mortgage payments so that the borrower could become eligible for the HAMP program,

²¹⁵ Jefferson v. Chase Home Fin., No. C 06-6510 TEH, 2008 WL 1883484, at *1 (N.D. Cal. 2008).

²¹⁶ *Id.* at *13–14.

²¹⁷ James J. Pulliam, *Good Cop, Bad Cop: Market Competitors, UDAP Consumer Protection Laws, and the U.S. Mortgage Crisis*, 43 LOY. L. REV. 1251, 1251 (2010).

²¹⁸ Zarif v. Wells Fargo Bank, NA, No. 10CV2688-WQH-WVG, 2011 WL 1085660, at *3 (S.D. Cal. 2011).

²¹⁹ Casey v. Fed. Deposit Ins. Corp., 583 F.3d 586, 593–94 (8th Cir. 2009); Boursiquot v. Citibank F.S.B., 323 F. Supp. 2d 350 (D. Conn. 2004); Moskowitz v. Wash. Mut. Bank, 329 Ill. App. 3d 144, 263 Ill. Dec. 502, 768 N.E.2d 262 (2002); McCurry v. Chevy Chase Bank, F.S.B., 144 Wash. App. 900, 193 P.3d 155 (Wash. Ct. App. 2008); Silvas v. E*Trade Mortgage Corp., 514 F.3d 1001 (9th Cir. 2008).

²²⁰ Bennett v. Bank of America, No. 3:11cv00003, 2011 WL 1814963, at *2 (E.D. Va.).

then foreclosed on his house based on non-payment of the loan.²²¹ When the borrower brought state law claims for breach of contract, fraud, and trespass, the bank/servicer responded by claiming that those state law claims were preempted.²²² The court, however, held that the claims were not preempted because there was no corresponding federal claim that the borrower could bring, noting that “Congress has not provided an alternative claim governing the allegations [the borrower] raises,” and therefore neither federal law nor regulation preempted the state claims.²²³

V. THE STATES JUMP IN

States have recently taken more aggressive steps to rein in mortgage servicer abuse and to attempt to induce servicers to make loan modifications that benefit both the borrower and the investor.²²⁴ However, their efforts have at times been met with a preemption defense. For example, in 2008, California passed Senate Bill 1137, also known as the “Perata Mortgage Relief Bill,” which requires, among other things, that in order to file a notice of default to start a foreclosure, a servicer or lender must follow a proscribed process of notification, meeting, and consultation with the borrower, to determine whether the servicer/lender and borrower can resolve the default without foreclosure.²²⁵ The idea is to spur direct discussion between the parties for an exploration of alternatives to foreclosure.²²⁶ This requirement is now incorporated in section 2923.5 of the California Civil Code, part of the state’s statutory framework for foreclosures.²²⁷

While section 2923.5 seems to be a minor requirement, merely requiring notice and discussion, but not mandating any loan modifications, federally regulated servicers have challenged it by claiming that it is preempted, at least as to federally regulated thrifts.²²⁸ Some courts have rejected this preemption argument, finding that section 2923.5 requires so little of lenders

²²¹ *Id.* at *1.

²²² *Id.* at *1, *3.

²²³ *Id.* at *5.

²²⁴ *Problems in Mortgage Servicing From Modification to Foreclosure Part II: Hearing Before S. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. (2010) (statement of Kurt Eggert, Professor, Chap. Univ. Sch. of Law).

²²⁵ CAL. CIV. CODE § 2923.5 (2010).

²²⁶ CAL. CIV. CODE § 2923.5(f) (2010).

²²⁷ CAL. CIV. CODE § 2923.5 (2010).

²²⁸ *Murillo v. Aurora Loan Servs., LLC*, No. C 09-00503 JW, 2009 WL 2160579, at *4 (N.D. Cal. July 17, 2009).

and servicers that it is not preempted by federal law.²²⁹ For example, in *Mabry v. Superior Court*, the court found that section 2923.5, at least narrowly construed, did not step over the line that separates the permitted state regulation of foreclosure from the state regulation of loan servicing, which would be preempted as to financial institutions regulated by the OTS.²³⁰ *Mabry* has been cited with approval by several other courts.²³¹

Another federal court ruled that because section 2923.5 “imposes a state law mandate about what information must be given to borrowers, and includes a strict time frame for doing so” and other states do not have such requirements, section 2923.5 “concerns the processing and servicing of Plaintiffs’ mortgage and is preempted by HOLA.”²³² Other federal courts have followed suit,²³³ and have even gone so far as to assert that despite the contrary opinions of California courts, “it is evident that the overwhelming weight of authority has held that a claim under § 2923.5 is preempted by HOLA.”²³⁴

Other states have taken more aggressive measures to regulate servicers. Numerous states currently have often competing legislative proposals for servicer regulation. “To date, lawmakers in 41 jurisdictions and the District of Columbia have

²²⁹ *Mabry v. Superior Court*, 110 Cal. Rptr. 3d 201, 218 (2010).

²³⁰ *Id.* at 218–19 (“Finally, to the degree that the ‘assessment’ or ‘exploration’ requirements impose, in practice, burdens on federal savings banks that might arguably push the statute out of the permissible category of state foreclosure law and into the federally preempted category of loan servicing or loan making, *evidence* of such a burden is necessary before the argument can be persuasive. For the time being, and certainly on this record, we cannot say that section 2923.5, narrowly construed, strays over the line.”).

²³¹ *Wienke v. Indymac Bank FSB*, No. CV 10-4082 NJV, 2011 WL 871749, at *5 (N.D. Cal. Mar. 14, 2011); *Paik v. Wells Fargo Bank, N.A.*, No. C 10-04016 WHA, 2011 WL 109482, at *3 (N.D. Cal. Jan. 13, 2011); *Aguilera v. Hilltop Lending Corp.*, No. C 10-0184 JL, 2010 WL 3340566, at *4 (N.D. Cal. Aug. 25, 2010); *Kariguddaiah v. Wells Fargo Bank, N.A.*, No. C 09-5716 MHP, 2010 WL 2650492, at *6 (N.D. Cal. July 1, 2010).

²³² *Odinma v. Aurora Loan Servs.*, No. C-09-4674 EDL, 2010 WL 1199886, at *8 (N.D. Cal. Mar. 23, 2010).

²³³ See *Giordano v. Wachovia Mortg., FSB*, No. 5:1-cv-04661-JF, 2010 WL 5148428, at *3–5 (N.D. Cal. Dec. 14, 2010); *Taguinod v. World Sav. Bank, FSB*, No. CV 10-7864-SVW (RZx), 2010 WL 5185845, at *2–3 (C.D. Cal. Dec. 2, 2010); *Ngoc Nguyen v. Wells Fargo Bank, N.A.*, No. C-10-4081-EDL, 2010 WL 4348127, at *10 (N.D. Cal. Oct. 27, 2010); *Pinales v. Quality Loan Serv. Corp.*, No. 09cv1884 L(AJB), 2010 WL 3749427, at *3 (S.D. Cal. Sept. 22, 2010); *Gonzalez v. Alliance Bancorp*, No. C 10-00805 RS, 2010 WL 1575963, at *5 (N.D. Cal. Apr. 19, 2010); *Parcray v. Shea Mortg., Inc.*, No. CV-F-09-1942 OWW/GSA, 2010 WL 1659369, at *8 (E.D. Cal. Apr. 23, 2010); *Murillo v. Aurora Loan Servs., LLC*, No. C 09-00503 JW, 2009 WL 2160579, at *4 (N.D. Cal. July 17, 2009); *Murillo v. Lehman Bros. Bank FSB*, No. C 09-00500 JW, 2009 WL 2160578, at *5 (N.D. Cal. July 17, 2009).

²³⁴ *Beall v. Quality Loan Serv. Corp.*, No. 10-CV-1900-IEG (WVG), 2011 WL 1044148, at *8 (S.D. Cal. Mar. 21, 2011) (quoting *Taguinod v. World Sav. Bank, FSB*, No. CV 10-7864-SVW (RZx), 2010 WL 5185845, at *7 (C.D. Cal. Dec. 2, 2010)).

introduced legislation regarding foreclosures.”²³⁵ New York’s Superintendent of Banks issued perhaps the most stringent state mortgage servicing regulations in October 2010, requiring servicers to pursue suitable loan modifications and imposing a “duty of good faith and fair dealing in [the servicer’s] communications, transactions, and course of dealings with each borrower”²³⁶ The regulations limit what fees servicers can charge and requires them to have “adequate staffing, written procedures, resources and facilities to provide timely and appropriate responses to borrower inquiries and complaints regarding available loss mitigation options”²³⁷ Servicers must provide timely responses to loan modification requests, and where they deny them, must provide the reasons for such denial.²³⁸ They must also provide a process by which borrowers “may escalate disagreements to a supervisory level where a separate review of the borrower’s eligibility or qualification for a loss mitigation option can be performed” and provide “special escalation contacts” for use by housing counselors, attorneys and government agents.²³⁹ The regulations also allow the state to require servicers to provide detailed reports of their modification attempts and success.²⁴⁰

Nevada responded to the high rates of foreclosure by requiring mortgage servicers to engage in mediation with borrowers who request it. The borrower and the lender/beneficiary split the cost of paying the mediator and the lender/beneficiary must be represented at the mediation by someone with the authority to modify the loan at issue.²⁴¹ The parties are required to submit a proposal to “resolve the foreclosure” and financial information that would allow the evaluation of those proposals, and the lender/beneficiary has to submit evidence of possession of the note and deed of trust along with assignments of the note and deed of trust, as well as the “evaluative methodology” used to evaluate the request for a loan modification.²⁴² Many different types of foreclosure mediation

²³⁵ NATIONAL CONFERENCE OF STATE LEGISLATURES, FORECLOSURES 2011 LEGISLATION, <http://www.ncsl.org/?tabid=22116>.

²³⁶ N.Y. COMP. CODES R. & REGS. tit. 3, § 419.2 (effective May 2, 2011).

²³⁷ *Id.* at §§ 419.10–419.11.

²³⁸ *Id.* at § 419.11(d).

²³⁹ *Id.* at § 419.11(g).

²⁴⁰ *Id.* at § 419.12.

²⁴¹ NEV. FORECLOSURE MEDIATION R. 10(1)(A), *available at* http://www.nevadajudiciary.us/images/foreclosure/adkt435_amendedrules.pdf.

²⁴² NEV. FORECLOSURE MEDIATION R. 11, *available at* http://www.nevadajudiciary.us/images/foreclosure/adkt435_amendedrules.pdf.

programs have sprung up, some at the state level, others mandated by individual court systems.²⁴³

Utah changed its foreclosure laws to require foreclosures to be conducted by an in-state attorney or title company. One large bank responded by refusing to follow the law, based on the claim that its status as a national bank gave it immunity from this aspect of state foreclosure law, reportedly arguing, “[a]s a national bank, [its] authority to act as trustee is derived from federal law (the National Bank Act).”²⁴⁴

One potentially productive step that the states have taken is the joint action by fifty Attorneys General to investigate mortgage servicer abuse and demand change, beginning in October 2010.²⁴⁵ That investigation was reportedly quite limited, perhaps from fears that the federally regulated mortgage servicers would claim preemption and refuse to cooperate.²⁴⁶ According to one news report after the coalition had already sent part of a settlement offer, “no witnesses had been interviewed and . . . the coalition had sent out just one request for documents—and it has not yet been answered.”²⁴⁷ The coalition of Attorneys General reportedly have been negotiating with the large banks/servicers to settle claims of widespread improper foreclosures, with at least some Attorneys General initially pushing for a large fund to provide principal reductions for borrowers as well as a set of rules that servicers must follow, while banks are suggesting a much smaller settlement fund, no mandated principal reductions and fewer rule changes. The parties are also bargaining over how much the banks who are the largest servicers should pay to settle with the Attorneys General. At least some of the Attorneys General are reportedly asking for \$20 billion and the banks are reportedly offering \$5 billion, with the money either going in large part to principal reductions for borrowers, under the Attorney General proposal or to repay borrowers “previously wronged in the foreclosure process and

²⁴³ Shana H. Khader, *Mediating Mediations: Protecting the Homeowner's Right to Self-Determination in Foreclosure Mediation Programs*, 44 COLUM. J.L. & SOC. PROBS. 109, 111 (2010).

²⁴⁴ Tom Harvey, *Bank Defies Utah Law on Foreclosures*, THE SALT LAKE TRIBUNE, May 12, 2011, at A6.

²⁴⁵ Ariana Eunjung Cha & Dina Elboghdady, *States to Initiate Joint Foreclosure Probe*, WASH. POST, Oct. 13, 2010, at A13.

²⁴⁶ Gretchen Morgenson, *Swift Deals May Not Be Sound Ones*, N.Y. TIMES, Mar. 12, 2011, at BU1.

²⁴⁷ *Id.*

provide transition assistance for borrowers who are ousted from their homes” under the banks’ counteroffer.²⁴⁸

VI. THE DODD-FRANK ACT AND ITS EFFECT ON PREEMPTION

Given the recent record of abusive behavior by mortgage servicers and also the harm caused by federal preemption of state law governing mortgage lending, it is no surprise that when Congress decided to reform the financial services industry, it included not only some mortgage servicer reform, but also a roll-back of the preemption effects of OCC and OTS regulation.²⁴⁹ The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) includes Title X, which is separately referred to as the Consumer Financial Protection Act of 2010 (the CFP Act).²⁵⁰ The Act contains some direct reforms of mortgage servicing. It mandates the use of escrow accounts in certain circumstances and requires disclosure for consumers who waive such accounts.²⁵¹ It imposes new duties on mortgage servicers regarding qualified written requests and responses to borrowers, force-placed insurance, and refunds of escrow funds.²⁵² It requires prompt crediting of loan payments as well as prompt responses to loan payoff requests.²⁵³ And it requires greater transparency in the calculations underlying servicer decisions in the HAMP program.²⁵⁴

More importantly, at least in terms of this article, Dodd-Frank significantly limits federal preemption of state consumer financial laws, even as to national banks and thrifts, and in many ways signals an explicit return to the law as it stood in the mid-1990s before the OTS and OCC made their preemption power grabs.²⁵⁵

²⁴⁸ Nathan Koppel, *Banks Willing to Pay \$5 Billion to Settle Mortgage Mess*, L. BLOG OF THE WALL ST. J. (May 11, 2011, 10:04 AM), <http://blogs.wsj.com/law/2011/05/11/banks-willing-to-pay-5-billion-to-settle-mortgage-mess/>.

²⁴⁹ LAUREN SAUNDERS, NATIONAL CONSUMER LAW CENTER, *THE ROLE OF THE STATES UNDER THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010*, at 2 (2010), available at <http://www.nclc.org/images/pdf/legislation/dodd-frank-role-of-the-states.pdf>.

²⁵⁰ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). Title X of Dodd-Frank states, “This title may be cited as the ‘Consumer Financial Protection Act of 2010.’” *Id.* at § 1001.

²⁵¹ *Id.* at §§ 1461–62.

²⁵² *Id.* at § 1463.

²⁵³ *Id.* at § 1464.

²⁵⁴ *Id.* at § 1482.

²⁵⁵ See Saunders, *supra* note 131, at 5–6. See also Michael Hamburger, *The Dodd-Frank Act and Federal Preemption of State Consumer Protection Laws*, 128 BANKING L.J. 9, 11–12 (2011).

Dodd-Frank and the CFP Act constitute a dramatic change in the preemption landscape. Gone are the ideas that the federal banking agencies are the sole regulators of banks and thrifts, and that banks and thrifts can virtually ignore state regulation. Congressional intent is the touchstone for preemption, and Dodd-Frank shows irrefutable Congressional intent to limit and roll back federal preemption of state consumer finance law.²⁵⁶ The CFP Act's subtitle on preemption is called "Preservation of State Law."²⁵⁷ The subtitle reasserts the traditional role that states have played in regulating the financial industry, including national banks and thrifts.

Dodd-Frank, drafted in an era when federal preemption of state law looms large as an issue, contains specific and extensive language regarding its own preemptive effect and the preemptive effect of other federal regulations. Dodd-Frank affects federal preemption in four significant ways. First, the CFP Act states explicitly what its own preemption effect is.²⁵⁸ Second, Dodd-Frank explicitly limits federal preemption of state law by the law governing national banks and thrifts and regulations made pursuant to that law.²⁵⁹ Third, Dodd-Frank transfers responsibility for much federal financial consumer protection (depending on the size of the financial institution) to the new Consumer Financial Protection Bureau (CFPB), which is much more constrained in how it can preempt state law.²⁶⁰ Lastly, Dodd-Frank spells out non-preempted powers of states' Attorneys General to enforce state and federal law.²⁶¹

The CFP Act explicitly limits the preemptive power of the CFP Act itself, and therefore, presumably any regulations issued pursuant to that Act.²⁶² The CFP Act rules out field preemption and limits its preemptive effect to conflict preemption, stating it has preemptive effect only "to the extent that any such provision of law is inconsistent with the provisions of this title, and then only to the extent of the inconsistency."²⁶³ Moreover, the CFP Act also protects states' power to provide greater consumer protection

²⁵⁶ *Id.* at §§ 1041–43.

²⁵⁷ Subtitle D of the Dodd-Frank Wall Street Reform and Consumer Financial Protection Act.

²⁵⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act, §§ 1044–45.

²⁵⁹ *Id.* at § 1043.

²⁶⁰ *Id.* at § 1041.

²⁶¹ *Id.* at § 1042. For good descriptions of the changes to preemption made by the Dodd-Frank Act, see Saunders, *supra* note 131, at 5–6; Hamburger, *supra* note 255, at 11–12.

²⁶² *Id.* at § 1044.

²⁶³ Dodd-Frank § 1041(a)(1).

than its own terms without state regulation necessarily being considered in preemptive conflict with the CFP Act, so that its federal consumer protection constitutes a floor rather than a ceiling.²⁶⁴

In addition to abolishing the OTS, Dodd-Frank creates the Consumer Financial Protection Bureau (CFPB), which will have the power “under Federal consumer financial law to administer, enforce, and otherwise implement the provisions of Federal consumer financial law,” and to “prescribe rules and issue orders and guidance . . . to administer and carry out the purposes and objectives of the Federal consumer financial laws, and to prevent evasions thereof.”²⁶⁵ This rulemaking authority gives the CFPB broad powers, since the “Federal consumer financial laws” it oversees include not only the CFP Act, but also broad swaths of the consumer law affecting borrowers, such as the Fair Debt Collection Practices Act, the Home Ownership and Equity Protection Act of 1994, and the Real Estate Settlement Procedures Act of 1974.²⁶⁶ Moreover, the consumer financial protection functions of the Federal Reserve Board of Governors, the OCC, and the OTS are all largely transferred to the CFPB, with other regulators retaining examination and enforcement powers for smaller financial institutions.²⁶⁷ This transfer of much of the consumer protection function will make it more difficult for the OCC to argue that consumer protection provisions of state law are preempted by OCC regulation.

Next, Dodd-Frank reverses the field preemption claims of OTS regulation and the effective field preemption of OCC regulation,²⁶⁸ and instead provides that state consumer financial laws are preempted by national banks, thrift laws, and regulations only in three circumstances: (1) if the state consumer financial law would have a “discriminatory effect on national banks” compared to state chartered banks, (2) if “in accordance with the legal standard for preemption in the decision of the Supreme Court of the United States in *Barnett Bank* . . . the State consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers,” and if (3)

²⁶⁴ *Id.* at § 1041(a)(2) (“For purposes of this subsection, a statute, regulation, order, or interpretation in effect in any State is not inconsistent with the provisions of this title if the protection that such statute, regulation, order, or interpretation affords to consumers is greater than the protection provided under this title.”).

²⁶⁵ *Id.* at § 1022(a)–(b).

²⁶⁶ *Id.* at § 1002(12).

²⁶⁷ *Id.* at § 1061(b).

²⁶⁸ *Id.* at § 1044(a).

“the State consumer financial law is preempted by a provision of Federal law other than this title.”²⁶⁹ State laws regulating residential mortgage servicers should necessarily be “state consumer financial laws” given the definition of that term in Dodd-Frank.²⁷⁰

Both the text of Dodd-Frank itself and its legislative history signal the return to the *Barnett* “prevent or significantly interfere” standard. Not only does the text directly cite the *Barnett* standard, but Dodd-Frank was specifically amended to include that standard, as a colloquy on the record between Senator Dodd and the senator who proposed the amendment shortly before passage of Dodd-Frank makes clear.²⁷¹ Moreover, Congress rejected efforts to substitute the *Barnett* standard with the more wide-ranging preemption standard that would have preempted any state law that merely “hampered” or “impaired” a bank’s powers under the National Bank Act.²⁷²

Dodd-Frank not only rolls back the preemption standard, it also makes it much more onerous and difficult for the Comptroller of the Currency to claim extensive powers of preemption over state consumer financial law, setting up a series of hurdles that the OCC must clear to preempt state law. Dodd-Frank mandates that preemption determinations “may be made by a court, or by regulation or order of the Comptroller of the Currency on a case-by-case basis, in accordance with applicable law.”²⁷³ Thus, the statute explicitly provides courts with the power to make preemption determinations and limits the

²⁶⁹ *Id.*

²⁷⁰ According to Dodd-Frank, “The term ‘State consumer financial law’ means a State law that does not directly or indirectly discriminate against national banks and that directly and specifically regulates the manner, content, or terms and conditions of any financial transaction (as may be authorized for national banks to engage in), or any account related thereto, with respect to a consumer.” *Id.* at § 5136C(a)(2).

²⁷¹ See 156 CONG. REC. S5902 (July 15, 2010), in which after Senator Carper notes with pleasure that his amendment regarding preemption standards was retained “with only minor modifications” by the conference committee, and that his reading of the then current language “indicates that the conference report still maintains the *Barnett* standard for determining when a State law is preempted,” Senator Dodd replies that Senator Carper is correct and “[t]hat is why the conference report specifically cites the *Barnett* . . . case. There should be no doubt that the legislation codifies the preemption standard stated by the U.S. Supreme Court in that case.” See discussion of this point in Hamburger, *supra* note 255, at 11–12.

²⁷² As noted by Lauren Saunders, “Congress did not adopt an amendment by Rep. Bean that would have preempted a state law that ‘impairs, or hampers’ the business of banking. Amendment 141 to H.R. 4173 at 6 (Offered by Rep. Bean Dec. 9, 2009).” LAUREN SAUNDERS, NATIONAL CONSUMER LAW CENTER, THE ROLE OF THE STATES UNDER THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010 6 (2010), available at: <http://www.nclc.org/images/pdf/legislation/dodd-frank-role-of-the-states.pdf>.

²⁷³ Dodd-Frank § 1044(a).

Comptroller of the Currency to making case-by-case determinations, rather than engaging in blanket preemption determinations as the OCC and OTS had previously done. Even if the Comptroller determines that one state's law is substantially similar to another state's law that the Comptroller has already decided is preempted, the Comptroller must consult with the newly established Bureau of Consumer Financial Protection to seek its views regarding whether to extend such preemption to the additional state's law.²⁷⁴

The CFP Act forces the Comptroller of the Currency to make the preemption determination personally, and can no longer delegate such determinations to a subordinate, such as the OCC's chief counsel, who had written a series of interpretive letters stating that various state laws were preempted.²⁷⁵ Furthermore, no preemption finding of the Comptroller shall be valid "unless substantial evidence, made on the record of the proceeding, supports the specific finding."²⁷⁶ Rather than merely issuing preemption determinations based on its own judgment, the OCC is required to hold some sort of proceeding, keep a record, and admit "substantial evidence" supporting each such determination.²⁷⁷

Dodd-Frank also changes the standard of deference courts apply to any OCC determination of preemption.²⁷⁸ Rather than the deferential *Chevron* standard, asking if there is a rational basis for the agency's determination, instead, a court reviewing an OCC finding of preemption is directed to assess "the validity of such determinations, depending upon the thoroughness evident in the consideration of the agency, the validity of the reasoning of the agency, the consistency with other valid determinations made by the agency, and other factors which the court finds persuasive and relevant to its decision."²⁷⁹ In essence, this directs courts to use the less deferential *Skidmore* standard in determining what weight to give agency determinations of the preemption of its regulations.²⁸⁰ Dodd-Frank overrules the

²⁷⁴ *Id.*

²⁷⁵ *Id.*

²⁷⁶ *Id.*

²⁷⁷ *Id.*

²⁷⁸ DAVID H. CARPENTER, CONG. RESEARCH SERV., R41338 THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: TITLE X, THE CONSUMER FINANCIAL PROTECTION BUREAU 14–15 (2010).

²⁷⁹ Dodd-Frank, § 1044(a).

²⁸⁰ In *Skidmore* deference, the deference a court grants an agency's decision "will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it

primary holding of the *Watters* case by mandating that state law apply to subsidiaries of national banks to the same extent such law would apply to other business entities subject to state law, unless the subsidiaries are also national banks.²⁸¹

Dodd-Frank also protects the powers of states, through their Attorneys General, to enforce applicable state laws even against national banks and thrifts, explicitly codifying the Supreme Court's decision in *Cuomo v. Clearing House Assn.*²⁸² In other words, the OCC's visitorial powers to supervise national banks and thrifts cannot be seen as preempting the power of states' Attorneys General to sue those financial institutions and seek discovery during such litigation. Furthermore, state Attorneys General can sue national banks and thrifts to enforce regulations made by the CFPB pursuant to the Act.²⁸³ The power of private parties to enforce applicable state and federal law is also explicitly protected.²⁸⁴

The CFP Act does provide a protection from the new preemption rules for any contract entered into before its enactment, with the idea that national banks and thrifts should not immediately have all existing contracts overturned based on the new preemption rules.²⁸⁵ However, it is difficult to see how such a grandfather clause can be applied to mortgage servicers, where these consumer contracts can last for thirty years. Such a rule might leave states free to regulate servicers, but only as to newer loans, which seems to be an unworkable system, and one unintended in the drafting of Dodd-Frank. Much of the state regulation of servicers would affect their operations as a whole, rather than address specific loans. And it would make little sense to have the borrowers who need servicer regulation the most, those who were the victims of the subprime boom and meltdown, be given fewer protections from servicer abuse than newer borrowers. Also, if the grandfathering of contracts

power to persuade, if lacking power to control." *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944). See discussion of this point in Saunders, *supra* note 131, at 7. For a discussion of the difference between the *Chevron* and *Skidmore* standards, and questions regarding the evolution of the *Skidmore* standard, see generally Jim Rossi, *Respecting Deference: Conceptualizing Skidmore Within the Architecture of Chevron*, 42 WM. & MARY L. REV. 1105 (2001); Kristin E. Hickman & Matthew D. Krueger, *In Search of the Modern Skidmore Standard*, 107 COLUM. L. REV. 1235 (2007).

²⁸¹ Dodd-Frank § 1044(a).

²⁸² *Id.* at § 1047(a) (stating that its announced rule is "[i]n accordance with the decision of the Supreme Court of the United States in *Cuomo v. Clearing House Assn.*, L. C. (129 S. Ct. 2710 (2009))").

²⁸³ *Id.* at § 1042(a).

²⁸⁴ *Id.* at § 1047(a).

²⁸⁵ *Id.* at § 1043.

included the servicing of contracts, servicers would be loath to modify existing loans for fear of losing their grandfathered preemption protection.

The OCC has responded to the preemption changes in Dodd-Frank by acknowledging that the preemption landscape has changed, while at the same time attempting, it seems, to minimize those changes.²⁸⁶ In an interpretive letter, the OCC's Acting Comptroller stated that the OCC planned to rescind its regulations extending preemption to bank subsidiaries. The Acting Comptroller disingenuously claims that the OCC's regulations purporting to preempt any state law that would "obstruct, impair, or condition" national bank powers were merely "the OCC's effort to distill principles from *Barnett* and cases cited in *Barnett* into an abbreviated regulatory standard," even though the regulations clearly were designed to expand preemption far beyond the *Barnett* standard.²⁸⁷ However, according to the letter, the OCC plans to remove the "obstruct, impair, or condition" standard from its regulations in order to conform to *Barnett*. However, the OCC appears ready to fight a rear-guard action to preserve its expanded preemption claims, arguing that Dodd-Frank's requirement that the Comptroller make preemption determinations on a case-by-case basis should not be applied retroactively so as to "overturn existing precedent and regulations," an argument that seems designed to defend as much as possible the OCC's pre-Dodd-Frank regulation.²⁸⁸

The OCC has followed up with a Notice of Proposed Rulemaking (NPR) that attempts to resist some of the preemption changes mandated by Dodd-Frank.²⁸⁹ The OCC admits in its commentary to the NPR that its regulation claiming preemption for any state law that would "obstruct, impair, or condition" is no longer valid and must be withdrawn.²⁹⁰ At the same time, the OCC makes the odd claim that existing court precedent based on the withdrawn language is still valid because "[t]his language was drawn from an amalgam of prior precedents To the extent any existing precedent cited those terms in our regulations, that precedent remains valid, since the

²⁸⁶ Letter from John Walsh, Acting Comptroller of the Currency, to Sen. Thomas R. Carper (May 12, 2011), *available at* http://www.aba.com/aba/documents/press/OCC_preemption_ltrtoSenCarper051211.pdf.

²⁸⁷ *Id.*

²⁸⁸ *Id.*

²⁸⁹ See Notice of Proposed Rulemaking, 76 Fed. Reg. 30557 (proposed May 26, 2011) (to be codified at 12 C.F.R. Pts. 4, 5, 7, 8, 28, & 34), *available at* <http://www.occ.treas.gov/news-issuances/news-releases/2011/nr-occ-2011-62a.pdf>.

²⁹⁰ *Id.* at 30563.

regulations were premised on principles drawn from the Barnett case.”²⁹¹ In other words, the OCC is attempting to preserve its discredited preemption rule by insisting that the precedent it created is still valid. The OCC should have made a sweeping re-write of its preemption regulations and revisit its previous preemption claims, pursuant to the new marching orders under Dodd-Frank. However, its NPR does not contain such a widespread re-write, and instead appears to constitute a claim that Dodd-Frank did little to alter the preemption landscape for federal bank and thrift regulation. The OCC will not give ground easily on preemption, it appears, even in the face of Dodd-Frank.

CONCLUSION

It is clear that Dodd-Frank is designed to be a dramatic curb on the power of federal agencies, and specifically the OCC, to preempt state law even when it comes to national banks. By rolling preemption back to the *Barnett* standard, Dodd-Frank undoes the OCC’s and the OTS’s efforts to obtain *Chevron* deference for their insistence that their regulations occupy the field or virtually occupy the field regarding their regulated financial institutions.

The question remains, however, what the states can do with this regained power. While preemption has been rolled back, it has not been eliminated. Tellingly, the OCC retains visitorial power, by far the greatest regulatory power, because visitorial power allows the OCC to demand to see the banks’ books without having to file a lawsuit to do so.²⁹² At the same time, much that had been preempted should now be fair game again. To the extent that states are enforcing the kind of existing best practices and servicing standards that are already contemplated in the FTC’s settlements with rogue servicers or in HAMP, it is hard to see how banks or the OCC can claim that such state regulation would “prevent or significantly interfere” with a national banks’ exercise of its powers, under the *Barnett* standard for preemption.²⁹³ Similarly, given the longstanding state regulation of debt collection and foreclosure, the two most important duties of a mortgage servicer, it is difficult to see how, absent aggressive OCC and OTS preemption regulations, a court would conclude that servicer regulation was preempted. Now that the financial

²⁹¹ *Id.*

²⁹² *Id.* at § 1047(a); *Cuomo v. Clearing House Assn., L.L.C.*, 129 S. Ct. 2710, 2716–17 (2009).

²⁹³ *Barnett Bank of Marion Cnty., N.A. v. Nelson*, Fla. Ins. Comm’r, 517 U.S. 25, 33 (1996).

consumer protection aspects of OCC and OTS regulation have by and large been transferred away from them, their powers to preempt state consumer protection in the area of mortgage servicing should be minimal. State officials should find national banks and thrifts much more willing to cooperate with them, even if informally, for fear that a state Attorney General might bring suit.

Given the lack of federal standards, and the go-ahead from Dodd-Frank, the best strategy by states could well be to plow forward with effective servicer regulation. While we are in the midst of a mortgage foreclosure crisis, this is no time for continued dithering and half measures. States should assert their right to control their own foreclosure processes, and to demand whatever steps they deem appropriate in those processes, including mediation. States should enact best practices standards for mortgage servicers in the state, and argue that such best practices standards should not be preempted because they should not, under the *Barnett* standard, “prevent or significantly interfere with the national bank’s exercise of its powers.”²⁹⁴

It will take federal regulators some time to prepare the regulations called for under Dodd-Frank. It will take courts longer to determine the contours of the new banking law preemption rules. However, given that the mortgage crisis is ongoing, states, especially those that are bearing the brunt of that crisis, should act now.

²⁹⁴ *Id.*