Financial Services Update

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OCC Clarifies Federal Preemption Of State Laws Relating to National Banks

On January 7, 2004, the Office of the Comptroller of the Currency (OCC) promulgated its final rule clarifying the application of state laws to national banks and their operating subsidiaries. This controversial rule, put out by the OCC last August for comment (generating approximately 2,600 comments) identifies the types of state laws relating to a national bank's lending and deposit-taking activities that are preempted, and those that continue to apply. Importantly, to counter criticism that the rule emasculates state and local initiatives to combat predatory lending, the OCC adopted additional anti-predatory lending standards applicable to a national bank's lending activities. The rule became effective on February 12, 2004.

The rule summarizes the rich history of the National Bank Act, the reasons for its adoption during the Civil War and the need for national uniformity. In adopting these regulations, the OCC declined to "occupy the field" as the OTS did in similar regulations relating to thrifts. Rather, the OCC relied on its authority under 12 USC § 93a and § 371 to issue the preempting regulations, so-called "statutory preemption."

What Is Preempted?

Deposits:

State laws that obstruct, impair or condition a national bank's ability to fully exercise its deposit-taking powers are preempted and not applicable to national banks.

Specifically, the rule preempts state law limitations relating to:

- abandoned and dormant accounts
- checking accounts
- disclosure requirements
- funds availability
- state licensing or registration requirements.

Non-Real Estate Loans:

State laws that obstruct, impair, or condition a national bank's ability to fully exercise its non-real estate lending powers are pre-

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Supreme Court to Tackle TILA Damages Cap

On January 20, 2004, the U.S. Supreme Court granted certiorari in a Truth in Lending Act (TILA) case, *Nigh v. Koons Buick Pontiac GMC*, 319 F.3d. 119 (4th Cir. 2003), to determine whether the TILA caps non-compensatory damages at $1,000 for most violations. The TILA requires most financial institutions and other grantors of consumer credit to provide meaningful disclosure of credit terms to consumers, and it allows consumers to recover actual damages as well as statutory damages for violations.

The TILA was amended in 1995. Before the amendment, the statutory damages provision read as follows:

> (a) . . . any [TILA violator] is liable to such person in an amount equal to the sum of —
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> (2)(A)(i) in the case of an individual action twice the amount of any finance charge in connection with the transaction, *or* (ii) in the case of an individual action relating to a consumer lease under part E of this subchapter, 25 per centum of the total amount of monthly payments under the lease, *except that liability under this*

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empted. Specifically, the rule preempts state laws relating to:

- licensing or registration
- insurance requirements
- loan to value ratios
- terms of credit
- escrow accounts
- security property
- credit reports
- disclosure or advertising
- interest rate on loans.

Real Estate Loans

State laws that obstruct, impair or condition a national bank's ability to fully exercise its right to exercise its federally authorized real estate activities are preempted. These include:

- licensing and registration
- requiring private mortgage or other types of insurance
- loan to value ratios
- terms of credit
- escrow accounts
- use of credit reports
- disclosure and advertising
- mortgage lending
- disbursement and repayments
- interest rates on loans
- due on sale clauses.

State laws that are not preempted are contracts, torts, criminal law, debt collection laws, real estate acquisition and transfer laws, taxation, and zoning and any other law the OCC determines is otherwise consistent with the powers of national banks.

To deal with predatory lending issues, the OCC prohibited a national bank from making a consumer loan based "predominantly" on a foreclosure or liquidation value of the loan's collateral without regard to a borrower's ability to repay the loan (excepting reverse mortgage loans). A bank is permitted to use any reasonable method to determine a borrower's ability to repay, including current and expected income or cash flows, other financial resources, current financial obligations, employment status, credit history or other factors.

The OCC reiterated its view that a bank is not permitted to engage in an unfair or deceptive trade practice within the meaning of section 5 of the FTC Act.

The regulations promulgated by the OCC reflect existing OCC policy and judicial interpretation. The rule is based on 140 years of court interpretation and the well-researched prefatory material lays out a strong basis to uphold the regulation.

However, Congressional and state reaction to the promulgation of the regulations has been intense. Already, New York Attorney General Eliot Spitzer has brought an action indirectly challenging the ability of the OCC to police operating subsidiaries of national banks engaging in predatory lending activities. It also seems likely that the Conference of State Bank Supervisors, the trade association for state bank regulators, will challenge the rule, since it questions the value of the state charter and the vitality of the dual banking system. Given the deference that courts have shown to the powers given to national banks as interpreted by the OCC, the battle will be a tough one for the state banks to win.

The development of the national banking system has almost always been shaped by our judicial system. The OCC's preemption regulation appears headed in that direction as well.

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Pepper Assists MBA-NJ in Oral Argument on Prepayment Penalty Case in NJ Supreme Court

The New Jersey Supreme Court heard oral argument on February 3, 2004 in *Glukowsky v. Equity One, Inc.*, an important case about prepayment penalties in alternative mortgage transactions. Pepper partner Dennis R. Casale and E. Robert Levy, executive director and general counsel of the Mortgage Bankers Association of New Jersey (MBA-NJ), represented MBA-NJ as *amicus curiae* in the Supreme Court.

The *Glukowsky* case involves the validity of the 1996 OTS regulation that expressly permitted state-licensed housing creditors to charge prepayment penalties in "alternative mortgage transactions" under the same terms and conditions as federal thrifts. This regulation was revised by the OTS, effective July 1, 2003, to eliminate that authority. The Supreme Court was hearing the case at the request of a lender, Equity One, Inc., because the New Jersey Appellate Division, unlike every other court that has previously considered the issue, held that the 1996 OTS regulation was invalid, and left open the issue of whether its decision should be applied retroactively to affect mortgages made and prepayment penalties collected from April 30, 1996 to July 1, 2003. (For more information, see our July 2003 *Financial Services Update*, available online at http://www.pepperlaw.com/pepper/publications_update.cfm?rid=377.0)

In addition to arguing that the 1996 regulation was valid, Equity One and the MBA-NJ, as *amicus curiae*, provided the court with information regarding the benefits prepayment penalty provisions provide for consumers seeking lower interest rates, and the economic utility of prepayment penalties in the mortgage market. MBA-NJ also updated the court on state and federal regulatory developments regarding prepayment penalties, and argued that regardless of the court's ultimate determination about the validity of the 1996 regulation, lenders and loan purchasers had the right to rely upon it and must not now be penalized for having done so. At the end of oral argument, the court reserved decision, as is customary.

What Financial Institutions Need to Know About the Servicemembers Civil Relief Act

On December 19, 2003, the Servicemembers Civil Relief Act (the SCRA) amended the prior Soldiers and Sailors Civil Relief Act of 1940 (the 1940 Act). The SCRA, which took effect immediately, modernizes the 1940 Act and gives active-duty servicemembers more protection from creditors, allowing them peace of mind to devote their full attention to their official military duties. Some of the changes that may affect financial institutions include:

1) **6 Percent Cap on Interest Rates; Forgiveness of Excess Interest.** The 6 percent cap on interest rates for obligations incurred by a servicemember was included in the 1940 Act, but the SCRA clarifies that any interest in excess of 6 percent that accrues during the period of active duty is forgiven (rather than deferred). Since the military has always interpreted the 6 percent cap to mean forgiveness of interest in excess of 6 percent during the period of active duty, this change should come as little surprise to lenders and creditors.

2) **Motor Vehicle Leases.** Under certain circumstances, servicemembers may now terminate leases for motor vehicles if entered into either before *or after commencement* of active duty if they are deployed for at least 180 days, or if they receive orders to move overseas in connection with a permanent change of duty station. The 1940 Act only allowed servicemembers to terminate residential leases that had been entered into before the commencement of active duty. This is perhaps the most important change for financial institutions and captive leasing companies, because many servicemembers lease their motor vehicles, and they may seek to terminate those leases to the detriment of the lessors.

3) **Availability of Non-Business Assets to Satisfy Obligation.** If a servicemember is personally liable on an obligation of that servicemember's trade or business, then only the assets of the servicemember held in connection with that trade or business are available to satisfy the obligation during active duty. Under the 1940 Act, servicemembers may stay execution of a judgment against them personally for up to 90 days after termination from active duty, so the issue of execution on an obligation for which a servicemember is personally liable does not often arise.

4) **Waivers.** Servicemembers may waive the protections of the SCRA in writing, but only after entering active duty.

A copy of the SCRA is available at http://thomas.loc.gov/home/c108bills.html (H.R. 100.ENR).

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> *subparagraph* shall not be less than $100 nor greater than $1,000.

15 U.S.C. §1640(a)(2)(A) (emphasis added). Courts interpreted this provision as capping statutory damages at $1,000 in individual actions, instead of permitting consumers to recover twice the finance charge even if that exceeded $1,000. *See, e.g., Mars v. Spartanburg Chrysler Plymouth*, 713 F.2d 65, 67 (4th Cir. 1983). In other words, the statutory cap was found to apply to both subsection 1640(a)(2)(A)(i) and subsection (ii).

The 1995 amendment added a third clause to section 1640(a)(2)(A), as follows:

> (a) . . . any [TILA violator] is liable to such person in an amount equal to the sum of –
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> (2)(A)(i) in the case of an individual action twice the amount of any finance charge in connection with the transaction, (ii) in the case of an individual action relating to a consumer lease under part E of this subchapter, 25 per centum of the total amount of monthly payments under the lease, except that liability under this subparagraph shall not be less than $100 nor greater than $1,000, *or (iii) in the case of an individual action relating to a credit transaction not under an open end credit plan that is secured by real property or a dwelling, not less than $200 or greater than $2,000.*

15 U.S.C. §1640(a)(2)(A) (emphasis added). In *Nigh*, the Fourth Circuit held that the addition of subparagraph (iii), without any other changes in the language of subparagraphs (i) and (ii), demonstrated that the $1,000 cap only applied to subparagraph (ii), not (i). Accordingly, the court upheld a TILA jury verdict of $24,192.80, which was awarded under subparagraph (i)

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Be Wary of Securities Laws in Sales-Leaseback Transactions

In its recent decision in *Securities and Exchange Commission v. Edwards*, 2004 U.S. Lexis 659, the U.S. Supreme Court held that a sale-leaseback transaction which guaranteed a fixed rate of return and was offered to a broad range of potential investors constituted an "investment contract." Investment contracts are encompassed within the broad definition of "securities" and are subject to federal securities law regulation.

The Supreme Court first addressed the question of what will constitute an "investment contract" in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). In *Howey*, the Supreme Court articulated certain criteria that should be considered in determining whether a particular scheme constitutes an investment contract. Those criteria include, in part, whether the transaction in question involves "an investment of money in a common enterprise with profits to come solely from the efforts of others." In *Howey*, the Supreme Court signaled that the definition intentionally "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of money of others on the promise of profits."

In *Edwards*, the Supreme Court further clarified the scope of the meaning of an

In structuring and documenting sale-leaseback transactions, the lessor and lessee should avoid entanglement with securities regulation.

"investment contract" to include sale-leasebacks of pay phones entered into with a broad range of investors. Charles Edwards and his company, ETS, sold pay phones to the public through independent distributors with the option of a site lease, a five-year leaseback and management agreement, and a buyback agreement. Investors were promised a 14 percent per year return under the leaseback and management agreement. None of the investors had any involvement with the installation, maintenance, repair or collection of revenue from the phones. The scheme was marketed as "an exciting business opportunity" which had "opened the door for profits for individual pay phone owners and operators."

After ETS filed for bankruptcy, the Securities and Exchange Commission filed suit in September 2000 alleging that the characteristics of the sale-leaseback transaction promoted by Edwards and ETS constituted an "investment contract" within the meaning of federal securities laws. The SEC alleged violations of the registration requirements and antifraud provisions of the Securities Act of 1933 and Rule 10b-5 of the Securities Exchange Act of 1934. The district court agreed with the SEC's claim, but the court of appeals reversed on two grounds. First, the appellate court contended that precedent required that to be an "investment contract," the scheme must either offer "capital appreciation or a participation in the earnings of the enterprise," excluding any scheme which offered a fixed rate of return, such as the Edwards scheme. Secondly, the appellate court held that the *Howey* requirement that the return on investment is "derived solely from the efforts of others" could not be met when the investor has a contractual right to the return represented by the fixed rate promised by ETS.

The Supreme Court reversed the appellate court on both grounds. The Court clarified its holding in *Howey* and

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and which represented twice the finance charge assessed in the transaction.

Judge Gregory's dissenting opinion in *Nigh* points out that the Seventh Circuit, the only other circuit to interpret the amended statute, has taken the opposite approach. *See Strange v. Monograph Credit Card Bank of Ga.*, 129 F.3d 943, 947 (7th Cir. 1997). According to the *Strange* court, "the 1995 amendment was designed simply to establish a more generous minimum and maximum for certain secured transactions, without changing the general rule on minimum and maximum damage awards for the other two parts of § 1640(a)(2)(A)."

The Supreme Court will likely hear argument regarding this circuit split in October. Should the Court uphold the *Nigh* decision, financial institutions and other lenders could face more significant liability in TILA cases than the previously imposed $1,000 limit.

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determined that "profits" which come "solely from the efforts of others" pursuant to an investment contract means profits that investors seek on investment, not profits of the scheme in which they invest. The return that an investor believes will be forthcoming is the indicative measure, not the amount of profit the scheme itself might generate. Further, the Court pointed out that investments that promise a fixed rate of return are arguably even more deserving of securities law regulation than their variable rate counterparts, because investments offering a fixed rate of return often are pitched as "low-risk" and, therefore, are more likely to attract more vulnerable, less sophisticated investors. Finally, the Supreme Court noted that "the fact that investors have bargained for a return on their investment does not mean that the return is not also expected to come from the efforts of others."

The Supreme Court held that where an investor is attracted solely by the prospect of a return on an investment and not motivated by the desire to use or consume the item purchased, the scheme will fall within the meaning of an investment contract and will be subject to regulation under the federal securities laws, regardless of whether the return on such investment is fixed or variable.

So what does all of this mean in the context of sale-leaseback transactions? Based on Supreme Court precedent, traditional commercial loans and, arguably, single-investor finance leases which resemble traditional commercial loans, are not regulated by the federal securities laws. However, in structuring and documenting sale-leaseback transactions, the lessor and lessee should be wary of securities issues. In the case where such a transaction may fall within the meaning of a security for federal securities laws purposes, the lessor and lessee should carefully analyze whether the transactions should be registered with the SEC or whether an exemption from registration, such as under Section 4(2) of the Securities Act of 1933, may apply.

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Pepper Lawyers to Speak at Seminar On U.S. and Foreign MBOs and LBOs

Pepper lawyer Neil Boyden Tanner is a course planner and partners Joan C. Arnold and Andrew J. Rudolph are on the faculty of a seminar that will analyze the latest developments in management buyouts and leveraged buyouts around the world. The seminar, titled "U.S. and Non-U.S. MBOs and LBOs: Which Model Works Best and When?" is slated for 9 a.m. to 5:30 p.m. on Thursday, May 20, 2004 at the Philadelphia Bar Association Conference Center, 1101 Market Street, Philadelphia, PA.

The seminar is sponsored by the International Association of Young Lawyers (Association Internationale de Jeunes Avocats) and is being held in conjunction with that organization's Executive Committee meeting in Philadelphia.

The seminar will provide an in-depth look at structuring issues (tax and corporate), new trends, financing alternatives, and management issues associated with MBOs and LBOs, while providing panel discussions comparing each of the topics in countries around the world.

Ms. Arnold will speak on the U.S. view of possible tax structures, partnerships and do's and don't's. Mr. Rudolph will moderate a panel discussion on various M&A, labor, employee benefits and tax aspects of transactions.

The seminar will be followed by a cocktail party at Pepper Hamilton's offices in Philadelphia.

The seminar is free to members of the International Association of Young Lawyers (AIJA) and $100 for non-members. The fee includes lunch and CLE credit in Pennsylvania or New York, as well as attendance at the cocktail party and an AIJA Commission meeting the following day. For more information, call 011-32-2-347-33-34 or e-mail adegimbe@aija.org.

Reading Room

All of Pepper's newsletters and other articles by our lawyers are available on our Web site, www.pepperlaw.com. Here is a sampling of recent articles of interest to financial institutions:

- Affordable Housing, Low Income Housing Tax Credits, Public Housing, Section 202 Elderly and Nonprofit Housing – *Housing Update*, January 2004
- *Financial Services Litigation and Class Action Report*, January 2004 (included articles on the Class Action Fairness Act, a Seventh Circuit ruling on punitive damages, amendments to the Fair Credit Reporting Act and amendments to the federal Rules of Civil Procedure)
- FACT Act Requires Creditors and CRAs to Help Protect Consumers Against Identity Theft – *Financial Services Update*, December 2003
- *Financial Services Update*, October 2003 (included articles on a Seventh Circuit ruling on "ordinary course" transactions, Pepper's role as independent examiner in the Spiegel, Inc. case, and shippers' bills of lading.

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