

Ninth Circuit Limits Scope of Mortgage Litigation by Clarifying Preemptive Reach of Home Owners Loan Act

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A decision by the U.S. Court of Appeals for the Ninth Circuit limits the scope of litigation stemming from the mortgage crisis.

In the wake of the mortgage crisis, lawsuits related to mortgages are flooding the courts.¹ A decision earlier this year by the U.S. Court of Appeals for the Ninth Circuit may limit the scope of that litigation. In *Silvas v. E*Trade Mortgage Corporation*,² the court clarified when state law claims against federal savings associations are preempted by the Home Owners Loan Act³ (“HOLA”) and regulations promulgated under that statute by the Office of Thrift Supervision (“OTS”). Early indications suggest that the approach adopted by the Ninth Circuit for analyzing preemption questions will limit the extent to which litigants can bring state common law and statutory claims against federal savings associations for their activities in the mortgage market.

Silvas v. E*Trade Mortgage Corp.

In the *Silvas* case, the plaintiffs had applied to refinance their mortgage through E*Trade Mortgage Corp., and as part of the process they paid E*Trade a \$400.00 fee

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to lock in an interest rate.⁴ One month later, the plaintiffs exercised their right to rescind the mortgage, but E*Trade did not refund their lock-in fee. E*Trade had said in its Web site, advertisements, and customer disclosures that the fee was not refundable.⁵

The plaintiffs sued in a purported class action and claimed that the Truth In Lending Act⁶ requires that lock-in fees be refunded if a consumer elects to rescind a mortgage within the time permitted. The plaintiffs alleged that E*Trade’s practice of telling customers that the fees were not refundable constituted violations of California’s False Advertising and Unfair Competition laws.⁷

E*Trade moved to dismiss the complaint on the ground that the plaintiffs’ claims were preempted by HOLA and by the OTS preemption regulation, 12 C.F.R. § 560.2. Section 560.2(a) states that the OTS “hereby occupies the field of lending regulation for federal savings associations.” The district court granted E*Trade’s motion and dismissed the complaint. The plaintiffs appealed, and the question before the Ninth Circuit was how to construe the preemptive reach of HOLA and § 560.2.

HOLA was the federal government’s response to the national mortgage crisis of an earlier era. A prod-

uct of the Great Depression, HOLA was enacted in 1933 “to provide emergency relief with respect to home mortgage indebtedness at a time when as many as half of all home loans in the country were in default.”⁸ The law aimed to restore public confidence by creating a nationwide system of federal savings and loan associations that would be centrally regulated according to nationwide best practices.⁹

As the central regulator under the modern HOLA scheme, the OTS issued regulations that were a “radical and comprehensive response to the inadequacies of the existing state system” and that are “so pervasive as to leave no room for state regulatory control.”¹⁰ A cornerstone of that regulatory framework is 12 C.F.R. § 560.2, the OTS preemption regulation that was at issue in *Silvas*.

Paragraph (a) states the intent of the regulation to occupy “the field of lending regulation for federal savings associations.” Paragraph (b) of § 560.2 next provides a non-exclusive list of state laws that are preempted by the regulation. These include “state laws purporting to impose requirements regarding”, among other things, terms of credit; loan-related fees; access to and use of credit reports; disclosure and advertising; and the processing, origination, servicing, sale or purchase of, or investment or participation in, mortgages.¹¹

Paragraph (c) of § 560.2 then lists state laws that are not preempted “to the extent that they only incidentally affect the lending operations of Federal savings associations or are otherwise inconsistent with the purposes of [§ 560.2(a)].” These laws include contract and commercial law; real property law; tort law; and criminal law.¹²

Three Step Approach

In *Silvas*, the court adopted a three step approach for determining how to apply the provisions of § 560.2. “[T]he 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.”¹³ Second, “[i]f the law is not covered by paragraph (b), the next question is whether the law affects lending. If it does . . . the presumption arises that the law is preempted.”¹⁴ Finally, “[t]his 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.”¹⁵

The *Silvas* court used this approach and concluded that the plaintiff’s False Advertising and Unfair Competition law claims were preempted. The plaintiffs had based their claims on allegations that E*Trade included false information on its web site, advertising, and disclosures. Because the subject matter of the plaintiffs’ claims was listed in paragraph (b) of § 560.2 (specifically (b)(9), “disclosures and advertising”), the court held that “the preemption analysis ends” and the claims were preempted.¹⁶

The court rejected the plaintiffs’ argument that their state law claims were not preempted because they were founded on California contract, commercial and tort law—types of laws listed in paragraph (c) of § 560.2. The court explained that analysis under paragraph (c) is only triggered if the law is not covered by those listed paragraph (b). Therefore, the court said, “We do not reach the question of whether the law fits within the confines of paragraph (c) because Appellants’ claims are based on types of laws listed in paragraph (b) of § 560.2, specifically (b)(9) and (b)(5).”¹⁷

Earlier Cases

Prior to *Silvas*, a number of trial courts had adopted an approach to applying the OTS preemption regulation that was the inverse of the approach taken by the *Silvas* court. These courts analyzed whether the law at issue fit within one of the categories enumerated in paragraph (c) of § 560.2. If the law was one of general applicability, fit within one of the categories in § 560(c) (e.g., contract, commercial, or tort law), and did not appear to be an overt attempt by the state to regulate the operations of federal savings associations, then it was found not to be preempted.

In *Gibson v. World Savings and Loan Association*,¹⁸ for example, the court also had before it a claim based on California’s Unfair Competition Law. The plaintiffs in that case, whose mortgage was serviced by the defendant, alleged that the defendant charged them higher rates for replacement hazard insurance than was authorized in their deed of trust.¹⁹ The court said that paragraph (c) of § 560.2 was intended “to preserve the traditional infrastructure of basic state laws that undergird commercial transaction.”²⁰ The court then described plaintiffs’ claims as “predicated on the duties of a contracting party to comply with its contractual obligations[,] . . . on the duty not to misrepresent material facts, and on the duty to refrain from unfair or deceptive business practices.”²¹ The court held that the plaintiffs’ claims were not preempted by § 560.2 because “[t]he duties to comply with contracts and the laws governing them and to refrain from misrepresentation, together with the more general provisions of the [Unfair Competition Law], are principles of general application,” and they “are not designed to regulate lending[.]”²²

Application of *Silvas v. E*Trade*

The rule announced in *Silvas* is starting to be applied by trial courts, and it appears that the rule will limit the scope of claims against federal savings associations in mortgage litigation. On May 23, 2008, the U.S. District Court for the Central District of California applied *Silvas* to dismiss state law counterclaims brought by a mortgage originator against an investor in mortgage loans.²³ In that case the plaintiff, Aurora Loan Services LLC, brought breach of contract claims against NBGI,

Inc. after NBGI refused to repurchase certain non-conforming mortgage loans that NBGI had sold to Aurora and its parent, Lehman Brothers Bank, FSB. NBGI filed numerous counterclaims alleging, among other things, that Aurora and Lehman had violated California's False Advertising and Unfair Competition laws by engaging in misleading and fraudulent marketing and advertising to induce mortgage originators to sell mortgage loans to Lehman. Aurora responded by moving to dismiss NBGI's counterclaims based on § 560.2 preemption.

Citing cases like *Gibson v. World Savings and Loan Association*, NBGI argued that preemption under § 560.2 should be understood to apply only when state laws interfere with the lending and credit activities of a federal savings association and not with activities in the secondary mortgage market. The district court rejected that view and, applying *Silvas*, explained that while many of the examples of preempted laws in paragraph (b) of § 560.2 involve lending and credit activities between banks and borrowers, paragraph (b) also expressly references "a wide variety of activities in the secondary market."²⁴ Specifically, paragraph (b)(10) refers to "Processing, origination, servicing, sale or purchase or, or investment or participation in, mortgages." Because the plaintiffs' state law claims would impose requirements regarding a specific area listed in paragraph (b), the court held that those claims were preempted. The court said "it appears clear that permitting NBGI to pursue a state law claim based on its transactions with Lehman in the secondary market would directly contravene the express preemptive objective of the OTS regulation."²⁵

Conclusion

The *Aurora Loan Services LLC* case illustrates that after *Silvas*, federal savings associations involved in mortgage litigation should pay careful attention to whether claims against them can be categorized as falling within one of the categories in paragraph (b) of 12 C.F.R. § 560.2.²⁶ In particular, paragraph (b)(10), with its broad description of mortgage related activities—the "Processing, origination, servicing, sale or purchase of, or investment or participation in, mortgages"—should provide a broad and powerful preemption defense in future litigation.

¹ See generally Daniel Reiman & Susan Holik, "Impending Flood: Wave of Subprime Litigation Could Soak Business World Outside Mortgage Industry," *Miami Daily Bus. J.* (May 20, 2008); Press Release, "Subprime Mortgage Litigation Outpacing Savings-and-Loan Crisis of the Early 1990s, According to Navigant Consulting Study" (Feb. 14, 2008); Stacy Shapiro, "Domino Effect: Subprime Mortgage

Woes Raise Concerns For Insurers of Financial Institutions; Lawsuits May Generate D&O, Professional Liability Claims," *Bus. Ins.* (Aug. 27, 2007).

² *Silvas v. E*Trade Mortgage Corporation*, 514 F.3d 1001 (2008).

³ 12 U.S.C.A. §§ 1461 et seq.

⁴ *Silvas*, 514 F.3d at 1003.

⁵ *Id.*

⁶ 15 U.S.C.A. §§ 1601 et seq.

⁷ *Silvas*, 514 F.3d at 1003.

⁸ *Washington Mutual Bank, F.A. v. Superior Court of Los Angeles*, 95 Cal. App. 4th 606, 613, 115 Cal. Rptr. 2d 765, 770-71 (2002) (internal quotation marks omitted).

⁹ *Silvas*, 514 F.3d at 1004.

¹⁰ *Silvas*, 514 F.3d at 1004. The original body charged with administering HOLA was the Federal Home Loan Bank Board. In 1989, Congress abolished the Home Loan Bank Board, created the OTS, and gave the OTS the rights and duties under HOLA formerly held by the Bank Board. See *Washington Mutual Bank, F.A.*, 95 Cal. App. 4th at 613.

¹¹ 12 C.F.R. § 560.2(b)(1)-(13).

¹² 12 C.F.R. § 560.2(c).

¹³ *Silvas*, 514 F.3d at 1005.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.* at 1006.

¹⁷ *Id.*

¹⁸ *Gibson v. World Savings and Loan Association*, 103 Cal. App. 4th 1291 (2003).

¹⁹ *Id.* at 1294.

²⁰ *Id.* at 1303 (internal quotation marks omitted).

²¹ *Id.* at 1301.

²² *Id.* at 1303-04. Other cases have undertaken similar analysis. See, e.g., *Fenning v. Glenfed*, 40 Cal. App. 4th 1285, 1298, 47 Cal. Rptr. 2d 715 (1995) (holding that a lawsuit for "fraud, negligent misrepresentation" and "unfair and deceptive business practices" does not effectively regulate the operations of savings association and is not preempted); *People ex rel. Sepulveda v. Highland*, 14 Cal. App. 4th 1692, 19 Cal. Rptr. 2d 555 (1993) (holding that general claims of unfair business practices and fraud were not preempted).

²³ *Aurora Loan Services LLC v. NBGI, Inc.*, No. CV 07-6501 GAF (RCx) (C.D. Cal. May 23, 2008). The author and his firm represent Aurora Loan Services and Lehman Brothers Bank, FSB, in this case.

²⁴ *Id.* at 6-7.

²⁵ *Id.* at 7. The court also held that NBGI's claims for common law fraud, negligent misrepresentation, and intentional interference with prospective economic advantage were preempted. *Id.* at 8-10.

²⁶ See also *Buick v. World Savings Bank*, No. 2:07-CV-01447-MCE-KJM, 2008 WL 2413172, at *5-*8 (E.D. Cal. June 12, 2008) (citing *Silvas* and holding that claims of unfair business practices were preempted).