United States Supreme Court Asked to Resolve Circuit Split Over Whether Federally Chartered Banks Must Comply With State Laws Requiring Payment of Interest on Mortgage Escrows

March 16, 2023

Source: Saiber Real Estate & Corporate Law Alert

In *Cantero vs. Bank of America, N.A.*, mortgage borrowers are asking the Supreme Court of the United States to reverse a Second Circuit ruling that federally-chartered banks need not comply with state laws that require the banks to pay interest on mortgage escrow accounts. The Second Circuit ruling conflicts with the Ninth Circuit's decisions in *Lusnak v. Bank* of America from 2018, and, more recently, *Flagstar Bank v. Kivett* in 2022, both of which reached the opposite conclusion.

The gist of the dispute centers on the interplay between federal and state banking regulations governing mortgage escrow accounts. As many readers are aware, lenders commonly require that borrowers escrow a sufficient amount of funds to cover both property taxes and home-insurance payments during the loan term. In the past, some banks required escrow amounts that were grossly disproportionate to the funds needed to cover taxes and insurance. This amounted to an essentially interest free deposit with or loan to the bank. In response, some states passed laws requiring that lenders pay interest on the funds held in these escrow accounts. Thirteen states currently require some form of interest payment on mortgage escrows.

New York, the state at issue in *Cantero*, requires banks to pay 2% interest on escrowed funds. After Alex Cantero purchased his New York home and Bank of America failed to pay interest on his mortgage escrow, Mr. Cantero sued, claiming that the failure to pay interest violated New York law. Bank of America countered that the National Banking Act and the Dodd-Frank Act "preempted" New York law and that it was not required to comply with the state law. "Preemption" is a complicated legal doctrine that has its roots in the Constitution. Article 6 of the Constitution states that federal law is "the supreme law of the land . . . the laws of any State to the contrary notwithstanding." Thus, where state laws conflict with federal law, federal law will prevail over - - that is, preempt - - the state laws.

Federal preemption of state laws that affect national banks can be traced back to some of the earliest and most important Supreme Court opinions, such as *McCulloch v. Maryland* in 1819, where the Court held that Maryland's taxation of the national bank was unconstitutional. Over the ensuing course of our nation's history, Congress enacted a few important laws relating to national banks that are at issue in *Cantero*: (1) the National Banking Act in 1864 (NBA), which allowed banks to be formed under a federal or state charter and subject to federal or state law, respectively; (2) the Real Estate Settlement Procedures Act in 1974 (RESPA), which limits mortgage escrows to no more than what is sufficient to pay property taxes, insurance premiums,

and other charges; and (3) the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 (Dodd-Frank), enacted in the wake of the 2007-2008 Financial Crisis and Great Recession, which, in part, required national banks to comply with state consumer financial laws under certain circumstances. Even prior to the enactment of Dodd-Frank, the Supreme Court has explained that states retain some power to regulate national banks, except where such regulations prevent or significantly interfere with a national bank's exercise of its powers, in *Barnette Bank v. Nelson* decided in 1996.

In *Cantero*, the Second Circuit ruled that Bank of America was not required to comply with New York's law imposing a 2% interest payment on the escrow account. The Court reasoned that the creation and administration of mortgage escrows implicate one of a national bank's core powers under the NBA and related federal laws and that New York's interest payment law, if applied to a national bank, could infringe on that power and potentially "destroy" it. Under those circumstances, the Court held that federal law preempted New York law pursuant to traditional preemption analysis, as well as the Dodd-Frank standard for determining when state consumer financial laws apply.

The Second Circuit's opinion in *Cantero* directly conflicts with the Ninth Circuit's decisions in *Lusnak* and *Flagstar*, respectively, both of which held that California laws similar to New York's law imposing interest payments on mortgage escrows were consistent with the NBA and Dodd-Frank and do apply to national banks.

Mr. Cantero petitioned the Supreme Court to hear his case and reverse the Second Circuit on December 5, 2022. Bank of America responded on February 16, 2023. In its response, Bank of America argued that if the Court decides that the question presented warrants immediate review, then the Court should grant the petition in *Flagstar* instead of *Cantero* on the basis that the *Flagstar* case presents the preemption issue more broadly than *Cantero*. In *Flagstar*, the Ninth Circuit held that federal law did not preempt California's interest-on-escrow law for "all mortgage escrow accounts," regardless of whether they qualify as mandatory under Dodd-Frank. The *Flagstar* petition is scheduled to be considered at the Court's March 24, 2023 conference.

It is unclear if the Court will agree to take the issue up, and if it does, whether it will agree to hear the *Cantero* case or the *Flagstar* case to resolve the matter. In any event, the application of state financial consumer laws to national banks is a perennial issue of national concern, and the outcome of this dispute could have an impact on the interests of lenders, borrowers, the federal government, and state governments throughout the country.