BUSINESS AND TRANSACTIONS
INFORMATION MEMO
OCTOBER 19, 2023

Will National Banks Have to Pay Interest on Mortgage Escrow Accounts? Supreme Court to Decide

On Oct. 13, 2023 the U.S. Supreme Court granted certiorari in *Cantero v. Bank of America,* 49 F.4d 121 (2d Cir. 2022), allowing the Court to confront an unsettled issue of national concern: *whether laws governing mortgage escrow accounts, can be enforced against national banks.* Of course, the Supreme Court could adopt a holding that more broadly impacts the interplay between state consumer finance laws and national banks. Until the Supreme Court issues its decision, current Second Circuit precedent remains binding. That is, state banking regulations requiring banks to pay interest on mortgage escrow accounts do not apply to national banks where the mortgaged property is located in New York State.

Certiorari was granted following a split in authority between two circuits of the U.S. Courts of Appeals. The Second Circuit, in *Cantero*, concluded that national banks were not required to comply with New York law requiring banks to pay consumers interest on mortgage escrow accounts. The Second Circuit's ruling was in direct conflict with the Ninth Circuit's decisions in *Lusnak v. Bank of America*, and *Flagstar Bank v. Kivett*. In both *Lusnak* and *Flagstar*, the Ninth Circuit held that California financial consumer laws requiring banks to pay consumers on mortgage escrows apply to national banks.

New York Mortgage Escrow Law

Traditionally, lenders have required certain borrowers to escrow sufficient funds to cover both property taxes and home-insurance payments during the term of a loan. Over time, some banks began requiring escrow amounts that were disproportionate to the funds needed to cover taxes and insurance. From the perspective of state regulators, this amounted to an interest free deposit with or loan to the bank. In response, several states began passing laws requiring that lenders pay interest on the funds held in escrow accounts.

New York state law requires banks to pay consumers interest on mortgage escrow accounts. New York's General Obligations Law 5-601 states in relevant part:

> "Any mortgage investing institution which maintains an escrow account pursuant to any agreement executed in connection with a mortgage on any one to six family residence occupied by the owner or on any property owned by a cooperative apartment corporation . . . and located in this state shall, for each quarterly period in which such escrow account is established, ***credit the same with dividends or interest at a rate of not less than two per centum per year*** . . . ." NY Gen. Oblig. Law 5-601.

The *Cantero* Case

The plaintiff in *Cantero* sued Bank of America, a national bank, for violation of the Gen. Oblig. Law, after Bank of America failed to pay the 2% interest on plaintiff's mortgage escrow. Bank of America argued that it was not required to comply with state law because the National Bank Act preempted any New York law governing the issue. The Second Circuit held that "under ordinary preemption rules, GOL § 5-601 is preempted." The appellate court reasoned that the decision to pay interest was operational and part of the national bank's banking power granted by the federal government.

The Second Circuit cited its previous decision in *Flagg v. Yonkers Sav. and Loan Ass'n,* reached the same result with respect to federal savings institutions based on rulemaking by the Office of Thrift Supervision which previously regulated federal savings and loan associations. The Second Circuit performed a further analysis under the Dodd-Frank Act which it determined applied to some, but not all, of the putative class representatives suing Bank of America. There it reasoned that even though Dodd-Frank specifically required national banks to comply with state escrow interest laws in connection with subprime loans, Congress did not mean to waive preemption of state law in this area generally.

Historically Preemption has Protected National Banks

This issue in *Cantero* and *Lusnak* is whether state mortgage escrow interest laws can be enforced against national banks or whether those federally chartered entities are exempt from compliance with state law. More than 200 years ago the Supreme Court, relying on the Constitution's Supremacy Clause, held that states cannot use their laws to impede the federal government's valid exercise of its powers. The question was first resolved in 1819 when the State of Maryland attempted to tax the Second Bank of the United States. The Supreme Court, in *McCulloch v. Maryland*, addressed a political dispute over the limits of federal power. Maryland was opposed to the operation of a federally chartered bank within its borders and sought to tax it in protest it as federal government overreach. The Court found that the federal government had the right and power to establish a national bank under the Necessary and Proper Clause, and that the states did not have the power to tax the federal government. In holding that Maryland's attempt to tax a national bank was unconstitutional, Chief Justice Marshall famously noted that "the power to tax involves the power to destroy."

Since the *McCulloch* decision in 1819, Congress has attempted to strike a balance between state rights and the laws governing national banks. For example, Congress passed the National Bank Act in 1864 that allowed banks to choose whether to be formed under a national or state charter. Based on their choice, a bank's operations were governed by either state or federal law. Complicating matters, in 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, an act that required the Comptroller of the Currency, the regulator of national banks, to comply with certain rules in determining whether to preempt state consumer financial laws.

Clarification is Coming

By granting certiorari last week in *Cantero*, the Supreme Court can now clarify whether state consumer finance laws imposing interest payments on mortgage escrows apply to national banks. Until that decision is reached, however, the Second Circuit's holding in *Cantero* remains binding in New York; NY Gen. Oblig. Law § 5-601 does not currently apply to national banks.

If you have any questions about any of the information contained in this memo, please contact Dori Bailey, Curtis Johnson, Robert Kirchner, any attorney in Bond's business and transactions practice or the Bond attorney with whom you are regularly in contact.

**Special thanks to Associate Trainee Connor Johnson for his assistance in the preparation of this memo. Connor is not yet admitted to practice law.*

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