



# Title Topics



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## Supremes OK Prepayment Penalty AFFECTS “ALTERNATE MORTGAGE TRANSACTIONS”

**Last month** we told you about *Glukowsky v. Equity One, Inc.* (A-22-03) and the Supreme Court’s decision upholding prepayment penalties in certain situations. The decision in *Glukowsky* recognizes that Federal law trumps New Jersey state law limitations on the ability of lenders to charge prepayment penalties on certain types of loans made by state-chartered lenders. While at first appearing ominous, there is good news—the authority given to state-chartered lenders to charge prepayment penalties has been repealed because of their affect on low income and poorer credit risks.

Getting back to Mr. Glukowsky, we don’t know what his attorney or settlement agent told him about the terms of the loan at the closing table when Glukowsky obtained his mortgage from Equity One, but he sure acted surprised when he went to payoff the loan and found several thousand dollars added to the bottom line as a prepayment penalty.

Can’t be you say? That’s what Glukowsky thought too so he filed suit alleging the loan violated New Jersey’s Prepayment Penalty Law, N.J.S.A. 46:10B-2. Equity One moved to dismiss the complaint on the ground that New Jersey’s Prepayment Penalty Law was preempted by 12 C.F.R. § 560.220, the rule which barred enforcement of any state law that prohibited a state-chartered lending institution from charging a prepayment fee on an “Alternative Mortgage Transaction” (AMT). An AMT is usually found in the form of a balloon or adjustable rate mortgage.

Prior to the adoption of that Rule, state lenders, such as Equity One, were barred by state laws from collecting prepayment fees. “Federally related lenders,” however, could charge such fees pursuant to the Alternative Mortgage Transactions Parity Act, 12 U.S.C. §§ 3801-3805. The adoption of 12 C.F.R. § 560.220 placed state-chartered housing creditors on an equal footing with their federal counterparts by extending 12 C.F.R. § 560.34 to state lenders and preempting any state law that forbid charging a prepayment fee on an AMT.

At trial, the Law Division found that 12 C.F.R. § 560.220 barred enforcement of New Jersey’s Prepayment Penalty Law and dismissed the complaint on the basis of federal preemption. The Appellate Division reversed and held that the Office of Thrift Supervision (OTS) exceeded the scope of its authority under the Parity Act. *Glukowsky v. Equity One, Inc.*, 360 N.J. Super 1 (2003). The panel concluded that Congress did not intend the Parity Act to preempt state consumer protection laws that prohibited the imposition of prepayment fees on real estate transactions in general, and on AMTs in particular.

In reversing the Appellate Division the Court determined that the 1996 regulation of the federal Office of Thrift Supervision (OTS) that authorized state housing lenders to charge prepayment penalties in alternative mortgage transactions preempted the New Jersey Prepayment Law, which prohibited housing lenders from imposing such penalties. Here’s a synopsis of the Court’s thinking:

1. The Parity Act, designed to overhaul the residential mortgage market, allowed state-chartered lenders to offer AMTs if they agreed to operate in accordance with federal regulations. To achieve the goals of the Parity Act, the main goal being achieving parity between state- and federally-chartered housing creditors, rulemaking authority was granted first to the Federal Home Loan Bank Board (FHLBB) and then to OTS.

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**Vested Title Inc. 648 Newark Avenue Jersey City NJ 07306**  
**201-656-9220 800-637-0251 in NJ 201-656-4506 Fax**

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States were given the opportunity to opt-out of the Act's preemption provisions, but they had to certify their intention to do so within three years of its passage. Otherwise, states agreed to follow all applicable federal regulations, those in existence then and those to be adopted in the future. In 1996, OTS adopted 12 C.F.R. § 560.220, giving state-chartered housing lenders the same authority to impose prepayment penalties on AMTs already possessed by their federal counterparts under 12 C.F.R. § 560.34. By applying 12 C.F.R. § 560.34 to state lenders issuing AMTs, 12 C.F.R. § 560.220 clearly preempted enforcement of New Jersey's Prepayment Penalty Law. When OTS decided to regulate prepayment fees in 1996, it did so believing that Congress intended to remedy the disadvantage to state-chartered institutions that flowed from differing federal and state laws regulating AMTs. By 2002, however, OTS had knowledge that widespread use of prepayment penalties in sub-prime loans promoted predatory lending practices. The 1996 OTS regulation also had the unintended consequence of creating an incentive for state lenders to favor AMTs over traditional fixed-interest mortgages that still were subject to state prepayment penalty laws. In July 2003, OTS eliminated § 560.34 from the list of federal regulations applicable to state-chartered housing creditors. Nevertheless, OTS concluded in the 2002 Final Rule that the 1996 regulation was a permissible interpretation at the time.

2. OTS did not exceed the authority Congress delegated to it in the Parity Act. The Court accepted OTS's explanation that the 1996 rulemaking represented one permissible interpretation of the Parity Act. As the agency responsible for enforcing the Parity Act, OTS's interpretation of that Act is entitled to substantial deference.

3. The power of a federal statute to preempt a state law is derived from the Supremacy Clause of the US Constitution. A federal regulation will have preemptive effect provided the agency intended to preempt state law and acted within the scope of its authority. A court generally must defer to a regulatory agency's decision, unless the agency acts outside the scope of its authority or arbitrarily. Moreover, an agency's statutory interpretation is entitled to deference even when that agency has changed its interpretation over time. Final interpretation, however, is the prerogative of the courts, and there is no doubt that OTS intended its 1996 regulation to preempt states' prepayment penalty laws.

4. Regulatory law has elasticity that permits it to adapt to changing circumstances. "Real-world experience" has shown OTS that a regulation that appeared reasonable in 1996 is not necessary to achieve the paramount objectives of the Parity Act in 2003.

5. In deciding whether OTS exceeded the scope of its authority in promulgating 12 C.F.R. § 560.220, we give due consideration to the interpretation of the Parity Act by the federal courts. Federal courts uniformly have concluded that the Parity Act allowed federal agencies to promulgate regulations preempting state laws governing prepayment penalties. Those federal court decisions, while not binding on New Jersey courts, are entitled to respectful consideration in the interests of judicial comity. Judicial comity helps to ensure uniformity and discourage forum shopping. Moreover, OTS's opinion is entitled to great weight and is a substantial factor in our interpretation. We cannot conclude, based on the language of the Parity Act or its legislative history, that Congress would not have sanctioned OTS's interpretation of the Act, and therefore cannot declare invalid OTS's decision to adopt the 1996 regulation.

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### How to Contact Us:

**Vested Title Inc.**  
**648 Newark Avenue**  
**P.O. Box 6453**  
**Jersey City, NJ 07306**

**201-656-9220 201-656-4506 Fax**  
**800-637-0251 in New Jersey**

**On the Web at**

**www.vestedtitle.com      vti@vested.com**

**Susan L. Kruger, President**  
**Stephen M. Flatow, Vice President & Counsel**  
**Paul D. Kruger, Vice President & Manager**  
**Vincent Bellucci, Jr., Vice President-Marketing**  
**Diane R. Menard, Vice President-Sales**  
**Jackie Stevens - Sales**  
**Susan Ann Ryan - Sales**  
**Karen Miller - Policy Supervisor**  
**Paula Tamburo - Title Officer**