Message from the Chair

To the Members of the Committee on Banking Law:

As I come to the end of my three years as Chair of the Banking Law Committee with the Annual Meeting in New York on August 9 and 10, some of the people to whom I owe the greatest debt of gratitude are Ray Natter, Peter Heyward, Charlotte Bahin, Tom Vartanian and Travis Nelson. These are the editors who for the past three years have written the articles that made the Banking Law Committee Journal (formerly, the Quarterly Newsletter) an integral part of and a tradition within the Committee. For some of you who cannot attend the meetings regularly, this is your most constant tangible link to the Committee. Of course, special thanks goes to Chris Bellini, a master at encouraging, pleading, cajoling (and, I believe, bribing) the editors to produce the fine articles you receive.

All Committee members should make a habit of reviewing the current and now extensive set of prior articles on our website. These articles provide examples of the blending of legal expertise and practical experience that make the Committee very useful for lawyers who represent financial institutions, trade associations, and government regulatory agencies. Hopefully, this Journal will be the initial step you take in your use of the Committee as well as be helpful in acquiring practical insights in how to understand and address the legal, policy and compliance issues with which you are dealing.

Please also feel free to contribute to this initiative and tradition, including by providing your opinion or analysis on current topical issues. Write a short article for the next edition and send it to any of the editors listed here. You will be speaking to the 1600 members of the Committee. Also, feel free to contact Chris Bellini at cbellini@gibsondunn.com or at our meetings if you want to discuss a proposed article or have other material suitable to be posted on our website for our members.

Remember, the Annual Meeting is upon us, and you have just until July 25 to preregister for the reception at the New York Federal Reserve Bank and the Committee dinner.

Jim Scott
Chair, Committee on Banking Law
scottj@citigroup.com

Featured Articles

Financial Institution Reform Initiative: OTS Proposal
Charlotte M. Bahin

There is little debate that, given a choice, the current regulatory structure of the financial services industry would be organized differently. Whether it is the regulation of the banking, securities, insurance or other financial services companies, the existing framework is the result of events of the past and not a
A comprehensive organizational plan. With some regularity, every few years, a proposal to reorganize the regulation of financial services companies is drafted. Sometimes the suggestions are borne from a crisis; while other times they are promoted as a means to avert a future crisis or to streamline the existing structure.

The latest version of a plan to modernize the financial services regulatory structure was issued by the Department of Treasury in March 2008 as a Blueprint for Modernized Financial Regulatory Structure. Even though the timing of the release of the document coincided with the collapse of Bear Stearns and the escalating mortgage crisis, Treasury staff had been working on the document for a year or more, during which time there had been numerous meetings and an advanced notice of proposed rulemaking. While a number of the suggestions appeared to respond to these events, in fact, the plan is much broader in scope.

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Peter Heyward


To the extent that its title implies startling new insights or daring solutions to the problems confronting the financial sector, Credit Squeeze may disappoint some readers: I suspect that there is little here that will surprise expert observers of these matters (a category that does not include this reviewer). But the paper's authors probably did not intend such an implication in any event. They readily acknowledge that their paper is a "work in progress," a sensible caveat in view of the frequency and force of the shocks that continue to rock the financial system. The paper contains a wealth of information about the origins of the current turmoil in our financial markets, offering thoughtful conclusions, debunking a few misconceptions, and making some interesting proposals for reforms. Moreover, it is richly annotated with interesting graphics and references to academic studies and other materials. Many readers should find it useful - as I did - to have such a large amount of data and wide range of possible policy responses addressed in a single document.

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The Subprime Mortgage Meltdown: New Role for the FHA

Raymond Natter

The United States faces one of the most severe financial challenges since the Great Depression. As a result of a spectacular bubble in housing prices, fed by easy credit and lax underwriting standards, Americans today are facing the prospect of millions of home foreclosures. Concerned that these foreclosures could have a serious negative impact on our financial
institutions and our economy in general, the Administration and both Houses of Congress have come forward with plans to enhance the ability of the Federal Housing Administration (FHA) to assist home owners by permitting many of them to refinance out of higher cost, often variable rate loans, and into FHA insured mortgages.

While the concept behind all of these plans is very similar, the details vary enough that the legislation has been stalled in Congress for many months. This situation changed dramatically when the Secretary of the Treasury and the Chairman of the Federal Reserve Board urged Congress to grant the Treasury authority to lend to and if necessary, invest in the equity securities of Fannie Mae and Freddie Mac. As a result of this unusual request, it now appears that Congress will probably enact comprehensive mortgage and housing related legislation before the August recess.

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Issues in Subprime Litigation: Removal Despite Lack of Federal Claims
Travis P. Nelson

Introduction

As the subprime meltdown continues to evolve, we are seeing attorneys for aggrieved consumers file individual and class action lawsuits alleging a variety of novel and not-so-novel theories as to why their clients are not liable for delinquent or defaulted mortgages. Increasingly, in order to get what they perceive as a more favorable forum, consumers are pleading what would otherwise be causes of action under the Truth in Lending Act (TILA), Real Estate Settlement Procedures Act (RESPA), or Fair Debt Collections Practices Act (FDCPA), as state causes of action ranging from breach of contract, to violation of state substantive disclosure or lending laws, to state unfair or deceptive acts or practices (UDAP) laws. The goal of proceeding under state claims is often to either seek state law remedies, or to retain jurisdiction in more favorable state courts. Notwithstanding these creative measures (“artful pleading”), there remain valid approaches that bank counsel can take to get the case removed to a more favorable federal court.

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An Overview of the Identity Theft Red Flags and Address Discrepancies under the Fair and Accurate Credit Transactions Act of 2003 Final Rules
Andrea J. Shaw

Introduction

The purpose of this article is to provide an overview of the requirements of the Identity Theft Red Flags and Address Discrepancies under the Fair and Accurate Credit Transactions Act of 2003 Final Rules (the "Final Rules"). The Final Rules are already effective; however, the mandatory compliance date is November 1, 2008. The Final Rules are accompanied by Interagency Guidelines on Identity Theft Detection, Prevention and Mitigation (the "Guidelines"), which further illustrate the Program (as defined below) requirements. The Final Rules mandate that financial institutions and creditors consider the
Guidelines and include in their Programs those that are appropriate.

This article is organized in a functional manner, rather than in sequential order of the Final Rules. Citations refer to the Federal Deposit Insurance Corporation (“FDIC”) version of the Final Rules whenever possible. The Final Rules apply to “financial institutions and creditors” but for ease of reading this article uses the term “financial institutions” when referring to both financial institutions and creditors.

Assault on the Shrine: the Demise and Possible Revival of the Attorney-Client Privilege

Thomas P. Vartanian, Michael R. Bromwich and Karen S. Bloom

Recent Congressional testimony summarized the results of the federal government's sustained assault on the attorney-client privilege over the past decade:

"We are forced to practice in a world where we cannot expect that any privilege will be respected by government investigators. The government now expects a waiver as an inherent right."

These sentiments reflect growing concern over the Department of Justice’s (“DOJ’s”) policies governing the role of attorney-client privilege and work product protection in federal prosecutions of business corporations. The DOJ policies, contained in a December 2006 Memorandum issued by then-Deputy Attorney General Paul McNulty (“the McNulty memo”), have been the subject of much recent debate and have generated calls for reform from, among others, Congress, former prosecutors, and corporate executives and lawyers. What began as a trickle of criticism is now more aptly characterized as a flood, placing DOJ on the defensive.

More...
Financial Institution Reform Initiative: OTS Proposal

by

Charlotte M. Bahin

Office of Thrift Supervision

There is little debate that, given a choice, the current regulatory structure of the financial services industry would be organized differently. Whether it is the regulation of the banking, securities, insurance or other financial services companies, the existing framework is the result of events of the past and not a comprehensive organizational plan. With some regularity, every few years, a proposal to reorganize the regulation of financial services companies is drafted. Sometimes the suggestions are borne from a crisis; while other times they are promoted as a means to avert a future crisis or to streamline the existing structure.

The latest version of a plan to modernize the financial services regulatory structure was issued by the Department of Treasury in March 2008 as a Blueprint for Modernized Financial Regulatory Structure. Even though the timing of the release of the document coincided with the collapse of Bear Stearns and the escalating mortgage crisis, Treasury staff had been working on the document for a year or more, during which time there had been numerous meetings and an advanced notice of proposed rulemaking. While a number of the suggestions appeared to respond to these events, in fact, the plan is much broader in scope.

The Treasury Blueprint contains short term, medium term and long term suggested changes to the regulatory structure. Many of the changes make sense when taken out of the context of the regulatory structure as it has evolved. The document contains sweeping suggestions that address all areas of financial services regulation. This article looks at one of the short term objectives and one of the intermediate term changes and addresses how the goals of one of the underlying suggestions can be accomplished but not necessarily the way described by the Treasury. An alternative proposal would replace the elements of the short term objective to form a Mortgage Origination Commission (MOC) and the intermediate goal of eliminating the Office of Thrift Supervision (OTS) and instead create a federal regulatory oversight for mortgage companies by expanding the OTS’s authority.

In recognition that the regulation and supervision of mortgage companies should be reviewed, one of the short term objectives of the report is to establish a MOC, the members of which would be the principals of the federal banking agencies, or their designees. Generally, the idea for the MOC is a good one and bears a resemblance to the Federal Financial Institution Examination Council. The ultimate result would be to have federal oversight over the mortgage origination and mortgage brokerage business. Any form of federal oversight of the mortgage origination industry would move in the direction of achieving an important goal – the establishment of a level playing field for all mortgage lenders.

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1 The views expressed are those of the author and do not necessarily reflect those of the Office of Thrift Supervision.
One of the intermediate objectives identified in the report would be the elimination of the OTS and combination of the agency’s functions with those of the Office of the Comptroller of the Currency. Among the reasons stated for this change is that the purpose for which the predecessor of the OTS was established is no longer applicable.

An alternative to this idea would be to build on the strengths of OTS and to expand its regulatory reach to entities in the mortgage arena that do not currently have a federal supervisor. The Federal Home Loan Bank System, of which the Federal Home Loan Bank Board was a part, was formed in the 1930’s to provide a source of stable financing for mortgage loans. The proposal builds on OTS’s expertise to use resources already available rather than creating a new entity or framework for regulating mortgage companies and mortgage brokers. Instead of eliminating the agency, as Treasury suggests, OTS would evolve as a federal regulator of the mortgage origination business, in a role similar to the one it had at its inception.

**OTS Proposal**

The OTS has developed an alternative proposal for providing federal oversight of independent mortgage companies and mortgage brokers. The proposal involves the development of a partnership with the OTS and the state regulatory authorities that license and supervise independent mortgage companies and mortgage brokers. This partnership would draw on the expertise that the OTS and its predecessor have developed in regulating and supervising mortgage lenders over the past seventy five years, while working with state regulators.

This new regulatory structure for mortgage companies would be housed in a new division of OTS that would regulate and supervise the companies in cooperation with their state regulators. There are successful and longstanding models for this type of collaboration. The OTS has worked for almost 20 years with the state regulators for state savings associations and has had information sharing agreements with the state insurance authorities. Further, the states have agreements with the FDIC and with the Federal Reserve to jointly supervise state chartered nonmember and member banks. Examination protocols would be developed jointly for both consumer protection and prudential regulation.

The state authorities would continue to charter mortgage companies and a federal mortgage company charter would not be created. The National Mortgage Licensing System (NMLS) that has been developed by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators would be a mechanism for the licensing and registration of mortgage companies and the individuals that work for them in those states that have adopted the NMLS. The development of the NMLS provides a uniform application process by which mortgage lenders will supply background information and a data base is created of each of the licensed companies or individuals.
Those mortgage companies that are affiliated with insured depository lenders would continue to be examined by the primary federal regulator of the depository institution. All mortgage companies would be subject to the same requirements. For a number of years, insured depository institutions engaged in mortgage originations have sought requirements and regulations that are enforced against all lenders offering the same products.

The other element of this proposal would be the licensing and registration of individual mortgage brokers. Through the use of the NMLS, the varying requirements of the different states would be minimized. However, the OTS proposal would go further. The licensing and registration of mortgage brokers is an important element in bringing some parity to the supervision of mortgage brokers, but other factors include establishing a meaningful bond or capital requirement and addressing some of the compensation issues that have driven the actions of mortgage brokers in the recent past. As part of the licensing requirement, brokers would have to meet specific education and testing thresholds. The application also would require the submission of personal and financial background information, including a fingerprint check.

The proposal appears to be simple, but there are a number of questions that arise and complications to be addressed in advance of the finalization of any plan. To achieve the basic change, the Home Owners’ Loan Act would need to be amended to authorize the OTS to supervise mortgage companies. OTS also would have to work with the individual states to coordinate examinations and requirements as well as protocols for mortgage companies. In addition, the logistics of supervising individual mortgage brokers, even on a back up basis, are difficult. Finally, ancillary changes, including amendments to the consumer protection regulations and requirements, would be made to accommodate a revised structure. The consumer protection requirements in each state would have to be addressed in order to achieve the result desired – a level playing field for all mortgage originators.

Federal oversight of the mortgage origination process and mortgage lenders is likely and the OTS suggests that rather than creating a new entity, it makes more sense to use the current framework to take advantage of an existing infrastructure and expertise to reach that goal.

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To the extent that its title implies startling new insights or daring solutions to the problems confronting the financial sector, Credit Squeeze may disappoint some readers: I suspect that there is little here that will surprise expert observers of these matters (a category that does not include this reviewer). But the paper’s authors probably did not intend such an implication in any event. They readily acknowledge that their paper is a “work in progress,” a sensible caveat in view of the frequency and force of the shocks that continue to rock the financial system. The paper contains a wealth of information about the origins of the current turmoil in our financial markets, offering thoughtful conclusions, debunking a few misconceptions, and making some interesting proposals for reforms. Moreover, it is richly annotated with interesting graphics and references to academic studies and other materials. Many readers should find it useful – as I did – to have such a large amount of data and wide range of possible policy responses addressed in a single document.

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1 The author is a partner in the Financial Services Group of Venable LLP in Washington. The views expressed in this article do not necessarily reflect those of other Venable lawyers or the firm’s clients.
2 In addition to the paper’s authors, other participants in the forum were FDIC Chairman Sheila Bair, who delivered opening remarks; FDIC Chief Economist Richard Brown; Keith Ernst, Senior Policy Counsel of the Center for Responsible Lending; and Sebastian Mallaby, Director of the Center for Geoeconomic Studies and Senior Fellow for International Economics, Council on Foreign Relations, a Washington Post columnist. A transcript of the forum is available on the Brookings website.
Litan, Baily and Elmendorf bring impressive credentials to the task of analyzing the financial crisis. Litan has been a frequent speaker and writer on issues affecting financial institutions, including, among many other publications, “What Should Banks Do?”, published by Brookings in 1987, which considered the “narrow bank” and other proposals for balancing the benefits and risks of federal bank insurance and product diversification. He has been affiliated with Brookings for many years and also serves as vice president of Research and Policy at the Kauffman Foundation. Litan has a distinguished record of public service, having served on the staff of the Council of Economic Advisers (1977-79), as Deputy Assistant Attorney General in the Antitrust Division of the Justice Department (1993-95), and Associate Director of the Office and Management and Budget (1995-96).

Brookings Senior Fellow Martin Baily, an MIT-trained economist, has also served in Democratic administrations. He was the chairman of the Council of Economic Advisers during President Clinton’s second term (1999–2001) and served as one of the council’s three members from 1994 to 1996. Doug Elmendorf's federal posts have included the serving on the Federal Reserve Board staff, U.S. Treasury Department, Council of Economic Advisors, and Congressional Budget Office, focuses his research on macroeconomics and fiscal policy.

**Origins of the Crisis**

The first of Credit Squeeze’s three main sections is devoted to The Origins of the Crisis. It consists largely of a review of the usually-cited culprits, including the widely held view that housing prices would always rise; a shift in the composition of mortgage lending from prime to subprime beginning in 2004; the erosion of underwriting standards in the “underwrite to distribute” model of mortgage origination, in which fraud and deception by mortgage originators and borrowers alike played an “important” but hard-to-quantify role; over-reliance on rating agencies, which failed to do their jobs properly due to conflicts of interest and faulty financial models; financial institutions’ failure to follow their own risk management policies; and continuing low interest rates, due largely to the abundance of foreign capital pouring into the United States. The authors note that, as of May 2008, $260 billion of losses had been taken world-wide as a result of the mortgage problems. It is sobering that they cite studies projecting...
total losses of more than twice that amount, in a range between $565 billion and $600 billion, although they allow that these predictions may be overly pessimistic.

Litan, Baily and Elmendorf deserve credit for providing a balanced analysis of the causes of the current crisis, yet their somewhat detached, academic tone also has a sort of leveling effect, conveying the impression at times that all the factors they describe had equal weight in bringing us to our current situation. In fact, I do not believe this to be the authors’ view. They are very critical of the credit rating agencies, and their analysis of the agencies’ role in bringing about the crisis is persuasive.

Another interesting portion of the discussion places a significant amount of the blame on regulatory failures – and in particular inaction by the Federal Reserve – with the honorable exception of late Federal Reserve Governor Edward M. Gramlich, whose prescient warnings of the dangers of declining lending standards were largely unheeded when there was still time to do something about them. In singling out the Fed, Credit Squeeze refers not to the central bank’s low-interest rate policy following the 2001 recession, which the authors generally absolve of responsibility as a contributing factor, but rather its failure to use its considerable influence to head off the mortgage lending problems which were becoming apparent as early as 2005: “Despite the limitations of its authority, the Federal Reserve should have done much more to slow or stop the erosion of mortgage lending standards ... The Federal Reserve had the stature to change things and to influence state regulators. Appropriate warnings given privately or publicly could have significantly reduced the amount of bad lending even in markets where the Fed had no direct legal authority.”

The authors raise the question why Federal and state regulators did not do more, and suggest that an undiscriminating belief that less regulation is always better, and that free markets can take care of any problem, played a part. (It seems to me that more might be said about the role of free market ideologues--including some prominent members of the regulatory community itself--in bringing our free market economy to its knees.) But the authors make clear that they are not against all deregulation, just dumb deregulation: “We need to get rid of bad regulation

3 Credit Squeeze at 41-42.
that stifles competition and inhibits innovation, but we need to improve regulation where it can make markets work better and avoid crises.”

The importance of crafting reasonable regulations that do not hobble the innovativeness and dynamism of U.S. financial markets is a consistent theme of Credit Squeeze, and Litan, Baily and Elmendorf take pains to defend their regulatory proposals against the criticisms that they evidently anticipate on this score. Given the questionable social value of some recent financial engineering, the authors are perhaps overly concerned about the dangers of stifling financial innovation by over-regulation.

**Short-Term Policies to Resolve the Credit Squeeze**

The second section of Credit Squeeze, and the shortest, reviews the measures that have already been taken to address the financial crisis. The authors generally approve of the policy responses thus far: the fiscal stimulus (“timely, targeted, and temporary”), the Fed’s “aggressive” reductions of the federal funds rate and expansion of discount window lending, and the “rescue” of Bear Stearns. While acknowledging the moral hazard in protecting Bear’s counterparties from losses, they deem it a price worth paying, given the risk that allowing Bear to fail would trigger a run on other investment banks that are similarly dependent on short-term funding. In a fascinating comparison with regulators’ “hands-off” reaction when Drexel Burnham failed in 1990, Litan, Baily and Elmendorf point out the enormous growth between 1990 and today in securities repo credit, both in absolute terms and in comparison with bank deposits. Citing an entry in the *The Wall Street Journal*’s blog of March 17, they claim that when Drexel failed, such credit amounted to $372 billion, equivalent to 13 percent in federally insured bank deposits, whereas today securities repos amount to $2.6 trillion, equivalent to 60 percent of total bank deposits. Because two thirds of repo loans must be rolled each day, the authors conclude that the Fed “understandably feared a ‘run’ on the repo market had it not intervened to provide liquidity to Bear Stearns, much as it fears a run on ‘bank deposits’ in the event of a failure of a large commercial bank.”

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4 Id.
5 Credit Squeeze, 69-70 n. 31.
6 Id.
To be sure, *Credit Squeeze* does not approve of everything that policy makers have done to address the credit crisis, and they offer various recommendations for additional steps to be taken in the near term, some of which are already being pursued. They urge active consideration of contingency plans for Fannie Mae and Freddie Mac but, in disagreement among themselves, do not make a recommendation as to the course that should be followed. Instead, they content themselves with a discussion of the pros and cons of three options: largely retaining the status quo; full privatization; and nationalization. Litan advocates the adoption of a prompt corrective action regime for the GSEs (PCA is a feature of the GSE reform bills passed by both House and Senate).

The authors also support more aggressive measures to address mortgage foreclosures. Among their recommendations are legislation to confirm that mortgage servicers’ fiduciary duties are owed to mortgage pool owners as a whole, rather than to any particular tranche of ownership, thereby giving servicers greater latitude to modify the underlying mortgages. They also reluctantly support “limited” bankruptcy reform to allow some “strip-downs” of mortgage debt (recognizing the negative impact that even limited steps in this direction could have on the cost and availability of mortgage credit for low-income families); and expanding eligibility for FHA-guaranteed loans to refinance existing mortgages, as both Senator Chris Dodd and Congressman Barney Frank have proposed.

**Long-Term Reforms to Improve the Financial System**

It is difficult to do justice in this brief review to the third section of *Credit Squeeze*, which contains a detailed discussion of the authors’ various long-term proposals for reform of the financial system. In their public presentation of their paper on May 16, Litan, Baily and Elmendorf identified three broad themes:

- Financial institutions should be more transparent.
- Financial institutions should be less leveraged and more liquid.
- Financial institutions should be supervised more effectively.

Regarding mortgage origination, they believe that transparency would be advanced by adoption of simpler disclosure and mandatory *pre*-mortgage counseling for subprime borrowers. They strongly endorse adoption of a one-page disclosure form very like the one proposed by
Alex Pollock, an experienced banker and former President of the Federal Home Loan Bank of Chicago who has been a Resident Fellow at the American Enterprise Institute since 2004. The form is accessible on AEI’s web site at http://www.aei.org/scholars/scholarID.88/scholar.asp.

Some of the suggestions regarding mortgage origination go beyond improving transparency and amount to substantive regulation of the types of mortgages that can be offered. They propose as one option offering a standardized mortgage form from which borrowers could opt-out. They oppose prohibiting all prepayment penalties, but are inclined to support banning yield spread premiums. With some apparent ambivalence, they also endorse a “suitability” requirement for mortgages, but would soften the blow by limiting enforcement authority to regulators or other public agencies. The authors also generally support the Federal Reserve’s strengthening of HOEPA and other mortgage protections (not yet finalized in May) and Treasury’s proposal to establish a Federal mortgage origination commission to oversee state regulation of mortgage originators. To solve problems with the “originate to distribute” model of mortgage origination, Credit Squeeze suggests consideration of requiring originators to retain some portion of the assets on their own books, as well as improving transparency in the rating process.

Several startling suggestions in the paper relate to addressing what the authors perceive as shortcomings in current bank capital requirements. They reiterate the by-now common criticisms of the Basel II regime’s reliance on rating agencies and banks’ internal risk models, on the grounds that these have been thoroughly discredited in the run-up to the current crisis. They also criticize Basel II’s lack of capital requirements for ostensibly off-balance sheet securitization vehicles, and the failure to address bank liquidity. Litan (but not his co-authors) goes so far as to suggest eliminating the risk categories altogether, in favor of a simple leverage ratio. All agree that bank regulators should pay more attention to rapid asset growth as a harbinger of problems, and recommend that banks be required to issue subordinated debt to enhance market discipline of bank risk-taking. In a portion of the paper that is oddly reminiscent of neocon screeds against multilateralism in U.S. foreign policy, Litan, Baily and Elmendorf
urge U.S. regulators “seek, but not wait for, international cooperation” in making necessary improvements to bank capital regulation.⁷

As to regulatory restructuring for more effective supervision, they are for it. But as Litan said in the public symposium, moving the regulatory boxes around is a long-term project, and “it’s a lot more important what goes inside the boxes than where the boxes are.”

* * *

Peter Heyward welcomes comments and questions about this article. He can be reached at peheyward@venable.com.

⁷ Credit Squeeze at 141.
The Subprime Mortgage Meltdown: New Role for the FHA

By Raymond Natter¹

The United States faces one of the most severe financial challenges since the Great Depression. As a result of a spectacular bubble in housing prices, fed by easy credit and lax underwriting standards, Americans today are facing the prospect of millions of home foreclosures. Concerned that these foreclosures could have a serious negative impact on our financial institutions and our economy in general, the Administration and both Houses of Congress have come forward with plans to enhance the ability of the Federal Housing Administration (FHA) to assist home owners by permitting many of them to refinance out of higher cost, often variable rate loans, and into FHA insured mortgages.

While the concept behind all of these plans is very similar, the details vary enough that the legislation has been stalled in Congress for many months. This situation changed dramatically when the Secretary of the Treasury and the Chairman of the Federal Reserve Board urged Congress to grant the Treasury authority to lend to and if necessary, invest in the equity securities of Fannie Mae and Freddie Mac. As a result of this unusual request, it now appears that Congress will probably enact comprehensive mortgage and housing related legislation before the August recess.

At this time, no one know which version of the FHA refinancing bill will become law, or whether some compromise between the two bills will be adopted. However, the following comparison shows the issues in which the House and Senate agree and disagree, along with the provisions the Administration suggested could be accomplished without legislation. This comparison should provide a useful guide to understanding what is before the Congress and the nature of what is likely to result later this summer.

## Comparison of FHA Refinancing Proposals of Subprime Mortgages

<table>
<thead>
<tr>
<th>Subject</th>
<th>House Passed</th>
<th>Senate Passed</th>
<th>Administration’s Proposal Expansion of FHA Secure&lt;sup&gt;2&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short Title</td>
<td>FHA Housing Stabilization and Homeownership Retention Act of 2008</td>
<td>HOPE for Homeowners Act of 2008</td>
<td>FHA Secure</td>
</tr>
<tr>
<td>New FHA Program</td>
<td>FHA shall insure mortgages on 1-4 family residences that are made to refinance “eligible” mortgages.</td>
<td>FHA is authorized to insure loans that refinance “eligible” mortgages.</td>
<td>FHA Secure is discretionary.</td>
</tr>
<tr>
<td>Oversight</td>
<td>“Oversight Board” (OB) composed of Secretaries of HUD and Treasury and Chair of the Federal Reserve. OB is to establish details of the program requirements and standards.</td>
<td>Board of the HOPE for Homeowners Program: Secretaries of HUD and Treasury and Chairs of the FDIC and the Federal Reserve. Board is to establish requirements and standards and prescribe necessary regulations.</td>
<td>Secretary of HUD.</td>
</tr>
<tr>
<td>Insurance Fund</td>
<td>The bill creates a Special Risk Insurance Fund.</td>
<td>The bill establishes the HOPE Fund.</td>
<td>No new insurance fund.</td>
</tr>
<tr>
<td>New Disclosures Required 3 Days Before Closing</td>
<td>Three days before closing on the refinancing loan, the lender must provide detailed disclosures to the borrower, e.g., total amount of loan, LTV, maturity date, amount of the exit premium, borrower’s income.</td>
<td>New disclosures required at least 7 days before closing. If disclosures have to be modified, corrected information must be provided at least 3 days before closing.</td>
<td>No new disclosures.</td>
</tr>
</tbody>
</table>

<sup>2</sup> As described by the Department of HUD.
<table>
<thead>
<tr>
<th>Subject</th>
<th>House Passed</th>
<th>Senate Passed</th>
<th>Administration’s Proposal Expansion of FHA Secure²</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduction in Principal and Other Terms</td>
<td>The new loan must “substantially reduce” the amount of indebtedness owed on existing mortgages; and Must meaningfully reduce the amount of the debt service, through reduction of principal, APR, or changes in the term of the loan (or any combination). The new loan to value ratio (LTV) may not exceed 90% of the appraised value of the property. The 90% limit must also include: (i) the initial 3% FHA premium; and (ii) closing costs up to 2% of the amount of the loan.</td>
<td>The principal obligation cannot exceed the reasonable ability of the borrower to repay under standards developed by the Board; and In no case may the refinanced loan have an LTV that exceeds 90% of the appraised value of the property (after including the initial FHA premium as part of the debt but not closing costs).</td>
<td>Write down of current loan to 97% of current appraised value for borrowers with no more than 2 delinquencies in the past year. Write down of current loan to 90% of appraised value for borrower with 3 delinquencies in the past year.</td>
</tr>
<tr>
<td>Existing Loan</td>
<td>Adjustable or Fixed</td>
<td>Adjustable or Fixed</td>
<td>Adjustable Rate Loan Only</td>
</tr>
<tr>
<td>FHA premiums and other fees in connection with New Loan</td>
<td>All initial fees, appraisal fees, inspections, and closing costs up to 2% of loan, and an initial 3% FHA premium are paid through the proceeds of the refinanced loan. Annual FHA premium thereafter is 1.5% of remaining insured balance. <strong>HUD</strong> is to establish reasonable limitations on origination fees, and ensure that the APR will be commensurate with market rates.</td>
<td>The initial 3% FHA premium is paid from the proceeds of the loan. Annual FHA premium thereafter is 1.5% of remaining insured balance. The <strong>Board</strong> is to establish reasonable limitations on origination fees, and ensure that the APR will be commensurate with market rates.</td>
<td>Borrowers will have to pay upfront and annual premiums. FHA will be updating its pricing policies for these premiums. New premiums will be determined upon the individual borrower’s credit risk profile.</td>
</tr>
<tr>
<td>Loan Amount</td>
<td>The refinanced loan may be up to $729,000 for the life of the program.</td>
<td>The refinanced loan may be up to $550,440.</td>
<td>Loan limit is $729,000 until December 31, 2008, unless further extended by law.</td>
</tr>
<tr>
<td>Documentation</td>
<td>The lender must document and verify income through income tax returns for prior two tax years and other methods as prescribed by the <strong>OB</strong>.</td>
<td>Same.</td>
<td>Documentation required under current FHA standards.</td>
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<tr>
<td>Fixed Rate, 30 Year Term</td>
<td>The new loan must have a fixed APR.</td>
<td>New loan must have a fixed APR and a maturity of at least 30 years from start of loan amortization.</td>
<td>Other options are available.</td>
</tr>
<tr>
<td>Underwriting Criteria</td>
<td>The OB to establish flexible underwriting criteria designed to ensure that the borrower would have a “reasonable expectation” of paying the loan. Criteria may not result in denying insurance to a borrower solely on the basis of: (i) current FICO scores; (ii) delinquency or default under the prior loan; or (iii) bankruptcy filing. Criteria must permit a total debt to income (DTI) ratio of 43%. The OB may permit a DTI ratio of 50% if the borrower can make payments on existing mortgage in the amount that would be due under the new FHA insured loan, for a six month period. The existing mortgage holder is directed to exercise forbearance during this “trial” period. In addition, the OB may alter the DTI ratio for a class of borrowers, as the Board considers appropriate. If borrower is in bankruptcy, DTI includes the amount of monthly payments due under a confirmed bankruptcy plan, but is not recurring debts that have been discharged.</td>
<td>The Board is authorized to establish underwriting standards.</td>
<td>Lenders will be required to use underwriting standards that ensure borrowers have the capacity to repay their mortgages. Borrowers must have a “reasonable credit history; employment history; and fully document and verify their incomes.” Under this program, DTI ratio limit is 43%, but could be higher with compensating factors.</td>
</tr>
<tr>
<td>Lack of Capacity to Pay</td>
<td>As of March 1, 2008, the borrower must have had a total mortgage DTI ratio of more than 35%.</td>
<td>As of March 31, 2008, the borrower must have had a total mortgage DTI ratio of more than 31%, or higher ratio as the Board may require.</td>
<td>Only borrowers who are delinquent on subprime ARM loans. Borrowers with more than 3 delinquencies may not participate.</td>
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<tr>
<td>Intentional Default</td>
<td>The borrower must certify that he or she did not intentionally default.</td>
<td>The borrower must certify that he or she did not intentionally default on the mortgage, or any other debt. Certification must also contain a statement that a false statement may result in a fine or imprisonment, or both.</td>
<td>No similar provision.</td>
</tr>
<tr>
<td>Owner-Occupied</td>
<td>The home must be owner-occupied and must be the principal residence of the borrower. Borrower may not have an ownership interest in another residence, unless OB creates an exception for a “partial ownership” interest.</td>
<td>The borrower must provide documentation to the FHA to prove that the loan is primary residence, occupied by the borrower, and is the only residence in which the borrower has any present ownership interest.</td>
<td>Owner-occupied principal residence.</td>
</tr>
<tr>
<td>Fraud Conviction</td>
<td>The borrower must not have had a conviction for mortgage fraud in the prior 7 years. Borrower must certify that he or she did not provide materially false information in obtaining the loan.</td>
<td>The borrower must not have a conviction for fraud under any Federal or State law. No time restricted.</td>
<td>No similar provision.</td>
</tr>
<tr>
<td>No Fraud in Obtaining Existing Loan</td>
<td>Borrower must certify that he or she did not knowingly, or willfully and with actual knowledge, furnish material information that was false in obtaining existing loan.</td>
<td>No similar provision.</td>
<td>No similar provision.</td>
</tr>
<tr>
<td>Fraud in Obtaining FHA Loan</td>
<td>Borrower must certify that he or she will repay the FHA loan for any benefit received if he or she made misrepresentations.</td>
<td>Same.</td>
<td>No similar provision.</td>
</tr>
<tr>
<td>FHA Premiums</td>
<td>Initial premium of up to 3%. Annual premium of up to 1.5% of remaining insured balance.</td>
<td>Same.</td>
<td>Initial premium of 2.5%. Annual premium of .55%.</td>
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<tr>
<td>Prepayment Penalties</td>
<td>Mortgage creditors must agree to waive all prepayment penalties and default/delinquency fees.</td>
<td>Same.</td>
<td>No similar requirement.</td>
</tr>
<tr>
<td>Loan Proceeds as Payment in Full</td>
<td>Existing mortgage holders must agree to accept the proceeds of the new loan as payment in full.</td>
<td>Same.</td>
<td>Existing mortgage holders can recapture write down through subordinate loans.</td>
</tr>
<tr>
<td>Treatment of Second Lien Holders</td>
<td>OB is to facilitate agreement among lien holders. The OB is to establish either a formula for a fixed payment to second lien holders or a formula to provide second lien holders a portion of net equity realized when the house is sold or refinanced. In no case can the formula provide a second lien holder more than 1 percent of the current appraised value if the value of the property is less than the amount of the first mortgage. The program is voluntary.</td>
<td>The Secretary of HUD may take actions to facilitate agreement among mortgage holders, subject to standards established by the Board to allow junior lien holders to share in future appreciation. This is a voluntary program.</td>
<td>Existing mortgage holders can recapture write down through subordinate loans.</td>
</tr>
<tr>
<td>Source of Funds to Pay Second Lien Holder</td>
<td>Any amount paid to the second lien holder in connection with this program must come from the holder of the existing mortgage or from participation in the realization of net equity.</td>
<td>No similar provision.</td>
<td>No similar provision.</td>
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| Subject                     | House Passed                                                                                                                                                                                                 | Senate Passed                                                                                                                                                                                                 | Administration’s Proposal Expansion of FHA Secure
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<td>Imposition of an Exit Fee</td>
<td>Proceeds from the sale, refinancing or other disposition of the property remaining after satisfaction of the FHA insured loan (“net proceeds”) are subject to an “exit premium.” The premium will be at least 3% of the principal amount of the FHA insured loan, and could be higher, based on a formula that relates the share going to the FHA with the period in which the insured loan has been in existence. During the first year, 100%. During the second year, 80%. During the third year, 60%. After the third year and thereafter, 50%. The exit fees are to be reduced by the amount of insurance fees paid prior to the sale, refinancing or other disposition.</td>
<td>Any “equity” created from the sale, disposition or refinancing of the property is subject to sharing with the FHA.³ This “equity” is divided between the FHA and the borrower pursuant to a schedule: During the first year, 100% to the FHA. During the second year, 90%. During the third year, 80%. During the fourth year, 70%. During the fifth year, 60%. After 5 years, 50%. In addition, upon the sale or disposition of the property, the FHA and borrower are each entitled to “50 percent of any appreciation in value of the appraised value of such property that has occurred since the date that such mortgage was insured.”⁴</td>
<td>None.</td>
</tr>
<tr>
<td>Prohibition on New Second Loans</td>
<td>During the first 5 years after the refinancing, the OB shall prohibit second liens, except if necessary to ensure appropriate maintenance.</td>
<td>During the first 5 years, the borrower may not obtain a new second mortgage. No exceptions authorized.</td>
<td>Second mortgages are permitted.</td>
</tr>
<tr>
<td>Appraiser Independence</td>
<td>Appraisers must meet the competency requirements of the Uniform Standards of Professional Appraisal Practice, and the appraisal must be conducted in accordance with the appraisal requirements for federally related mortgage transactions. No lender or other interested party may improperly influence the appraisal. Exception permits</td>
<td>Same, except does not include provisions specifically allowing the lender to provide additional data, ask for better explanation, or correct errors. In addition, the appraiser must be licensed or certified under State law or nationally recognized professional appraisal organization, and have demonstrated verifiable education in the</td>
<td>No similar provision.</td>
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³ It is not clear how to compute “equity.”
⁴ This may be a drafting error.
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<td>lender to ask appraiser to consider additional data, provide further details or explanations, and correct errors.</td>
<td>appraisal requirements established by the FHA. Parties interested in the loan may not improperly influence the appraisal.</td>
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</tr>
<tr>
<td>Standards to Protect Against Adverse Selection</td>
<td>The Oversight Board shall establish standards and policies to require the underwriter to provide reps and warranties on compliance with all underwriting and appraisal standards.</td>
<td>Same, and in addition, the FHA may not pay insurance benefits to a lender who violates reps and warranties, or in any case in which the borrower fails to make the first payment on the mortgage. The Board may establish other standards to protect against adverse selection, and may require “higher risk” borrowers to demonstrate payment performance for a reasonable time prior to being insured.</td>
<td>FHA may require similar reps and warranties.</td>
</tr>
<tr>
<td>Auction and Bulk Refi Mechanism</td>
<td>The Fed, in consultation with the OB, to study the need for, and efficiency of, an auction or bulk refinancing mechanism. Report is due 60 days after the enactment.</td>
<td>The Board shall study the need and efficacy of an auction or bulk refinancing mechanism. A report is due within 60 days.</td>
<td>No similar provision.</td>
</tr>
<tr>
<td>Aggregate Cap</td>
<td>Insurance for up to $300 billion of new refi loans.</td>
<td>Same.</td>
<td>Program assumes using existing $185 billion insurance authority.</td>
</tr>
<tr>
<td>Experts and Consultants</td>
<td>FHA may contract with private parties to develop underwriting criteria, pricing standards, quality review and other duties.</td>
<td>Same, and also provides that the Board may contract for services of experts and consultants as the Board considers appropriate.</td>
<td>Government agencies generally have authority to contract for experts and consultants.</td>
</tr>
<tr>
<td>Monitoring and Reports</td>
<td>HUD will monitor independent quality reviews to determine compliance with all requirements and status of insured loans, including rates of delinquencies. Various reports must be made to Congress.</td>
<td>Independent quality reviews not mandated, but the Board is required to make monthly reports on status of the program.</td>
<td>FHA provides annual credit report to Congress. HUD I.G. conducts annual audit.</td>
</tr>
<tr>
<td>I.G.</td>
<td>The I.G. must conduct an annual audit and report.</td>
<td>No similar provision.</td>
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<tr>
<td>GNMA</td>
<td>The Secretary to ensure that GNMA will guarantee securities backed by insured refinanced mortgages.</td>
<td>Same.</td>
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<tr>
<td>Sunset</td>
<td>This authority terminates 2 years after enactment, except Secretary may authorize up to 4 six-month extensions.</td>
<td>FHA may not insure mortgages under this program before October 1, 2008 or after September 30, 2011.</td>
<td></td>
</tr>
<tr>
<td>Duty of Servicers</td>
<td>Absent contractual provisions to the contrary, a servicer owes a duty to maximize return to the securitization vehicle for the benefit of all investors and not to any individual party or group. A servicer shall be deemed to be acting in the best interests of the securitization vehicle and in the best interests of investors if the servicer modifies the loan, enters into a workout plan, or engages in other types of loss mitigation efforts, such as a short sale. Absent contractual provisions to the contrary, a servicer is not liable to any party for entering into a qualified loan workout plan.</td>
<td>Similar, but: (i) Adds this to the Truth-in-Lending Act; (ii) provides that the servicer owes a duty to investors, not to the securitization vehicle; (iii) does not override provisions of an “investment” contract; (iv) limits safe harbor to modifications involving owner occupied properties; (v) limits safe harbor to modifications in which the anticipated recovery under the modification exceeds, on a net present value basis, the anticipated recovery through foreclosure; and (vi) does not provide any specific immunity from liability.</td>
<td></td>
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<tr>
<td>Funding</td>
<td>Appropriations.</td>
<td>Establishes HOPE Bonds and HOPE Trust Fund. The Treasury is to issue bonds (HOPE bonds) to provide necessary subsidy to the FHA for loans guaranteed under the program and other costs to the Government. The GSEs are to pay for the costs of borrowing by diverting contributions from the Affordable Housing Fund to a Housing Trust Fund, on a declining basis. Amounts collected in excess of the funds needed for the HOPE program will be used to reduce the national debt.</td>
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<td>Authorizations</td>
<td>Appropriations authorized of $230 million for counseling services and $150 million for contracting and additional FHA personnel. Of the $230 million, at least $34.5 million is for counseling organizations providing loss mitigation information in low- and moderate-income neighborhoods; $35 million for the Neighborhood Reinvestment Corporation to make grants to counseling organizations; at least $21 million to hire lawyers to assist homeowners; and at least $20 million to assist veterans returning from active duty. At least $4.6 million must be used to identify and notify homeowners who are eligible to participate in the program.</td>
<td>Appropriates $180 million for counseling and related services.</td>
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<tr>
<td>Grants Authorized</td>
<td>Authorizes $45 million per year for three years to provide grants to States and non-profit organizations providing homeownership and rental counseling.</td>
<td>Appropriates $3.92 billion to assist States and local governments in the redevelopment of abandoned and foreclosed upon homes.</td>
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<tr>
<td>FBI Authorization</td>
<td>Appropriations of $31.25 million are authorized per year for three years to hire additional FBI agents and prosecutors for mortgage fraud, and $.75 million for an interagency task force.</td>
<td>No similar provision.</td>
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<tr>
<td>Office of Housing Counseling, Public Outreach</td>
<td>An Office of Housing Counseling is established in the Department of HUD. The Office is to conduct research, grant administration, public outreach, and policy development related to housing counseling. An advisory committee is also established to assist the Department. The Office will establish materials, certify software, and conduct nationwide media campaigns. Appropriations are authorized of $3 million per year for three years.</td>
<td>No similar provision, but bill requires the Secretary of HUD to conduct a public outreach to ensure homeowners and lenders are aware of the FHA refi program. As noted, appropriates funds for homeownership counseling services.</td>
<td></td>
</tr>
<tr>
<td>Fair Value Accounting</td>
<td>The SEC, in consultation with the Fed, to conduct a study of fair value accounting applicable to financial institutions. A report is required 90 days after enactment.</td>
<td>No similar provision.</td>
<td></td>
</tr>
<tr>
<td>Study of Root Causes of Defaults</td>
<td>The Secretary of HUD to study the root causes of default and foreclosure using as much empirical data as possible. The study will look at the role of escrow accounts to avoid foreclosures.</td>
<td>No similar provision.</td>
<td></td>
</tr>
<tr>
<td>GAO Study</td>
<td>The GAO to study the effects of a tightening credit market on first time homebuyers. The study is to include an analysis of financial literacy outreach efforts.</td>
<td>No similar provision.</td>
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<tr>
<td>HUD Certified Counselors</td>
<td>An organization may not receive assistance for counseling unless it is HUD certified or uses HUD certified counselors.</td>
<td>No similar provision.</td>
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<tr>
<td>Mortgage Booklet</td>
<td>The Secretary of HUD is to prepare a real estate settlement booklet at least once every 5 years.</td>
<td>No similar provision.</td>
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July 11, 2008
Introduction

As the subprime meltdown continues to evolve, we are seeing attorneys for aggrieved consumers file individual and class action lawsuits alleging a variety of novel and not-so-novel theories as to why their clients are not liable for delinquent or defaulted mortgages. Increasingly, in order to get what they perceive as a more favorable forum, consumers are pleading what would otherwise be causes of action under the Truth in Lending Act (TILA), Real Estate Settlement Procedures Act (RESPA), or Fair Debt Collections Practices Act (FDCPA) as state causes of action ranging from breach of contract, to violation of state substantive disclosure or lending laws, to state unfair or deceptive acts or practices (UDAP) laws. The goal of proceeding under state claims is often to either seek state law remedies, or to retain jurisdiction in more favorable state courts. Notwithstanding these creative measures (“artful pleading”), there remain valid approaches that bank counsel can take to get the case removed to a more favorable federal court.

Overview of the Rule

Any civil action brought in state court may be removed by the defendant to the federal district court in the district where such action is pending, if the district court would have original jurisdiction over the matter. Where the defendant seeks removal based on federal question jurisdiction, the district court’s jurisdiction is: “all civil actions arising under the Constitution, laws, or treaties of the United States.”

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5 Examples of UDAP laws include California’s Cal. Bus. & Prof. Code § 17200 et seq., or Pennsylvania’s 73 P.S. § 201 et seq.


7 28 U.S.C. § 1331, 1441(b); Franchise Tax Bd. 463 U.S. at 8.
The challenge for bank counsel arises when the plaintiff does not plead any federal causes of action, and the complaint does not facially present a federal question. A plaintiff’s claims may nevertheless “arise under federal law,” for as the U.S. Supreme Court has long recognized, federal question jurisdiction also lies “over state-law claims that implicate significant federal issues.” A complaint characterized by “artful pleading,” the practice of carefully drafting a complaint so as to avoid removal, is one of those “less frequently encountered cases” in which federal jurisdiction is proper despite the plaintiff’s failure to plead federal causes of action. To assess whether federal question jurisdiction is proper requires the reviewing court to apply the Supreme Court’s *Grable* decision, where in 2005 “the Court clarified that the existence of a private cause of action is not the litmus test for the existence of a federal question, as many federal courts had previously held.” Rather, the proper test for exercising federal jurisdiction is whether “a state-law claim necessarily raises a stated federal issue, actually disputed and substantial, without disturbing any congressionally approved balance of federal and state judicial responsibilities.” Thus, the test under *Grable* is: “First the district courts should ask whether the ‘state-law claim necessarily raises a federal issue, [which is] actually disputed and substantial.’” “Second, courts must examine whether ‘the federal forum may entertain [the issue] without disturbing any congressionally approved balance of federal and state judicial responsibilities.’ “Despite this added clarity, the Supreme Court made clear that there is no bright-line rule for ascertaining whether a plaintiff’s state law claim gives rise to federal question jurisdiction.”

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8 “[E]ven if both federal and state law provide a remedy, the plaintiff can avoid federal jurisdiction by pleading solely state law claims – at the price, of course, of foregoing the federal remedies.” *Ball v. Argent Mortgage Company, LLC*, 2007 U.S. Dist. Lexis 16370 (S.D. Miss. 2007). See also *Avitts v. Amoco Prod. Co.*, 53 F.3d 690, 693 (5th Cir. 1995) (stating that “when both federal and state remedies are available, plaintiff’s election to proceed exclusively under state law does not give rise to federal jurisdiction.”).


10 *Id.*


12 *Id.*

13 *Chirik v. TD Banknorth, N.A.*, 2008 U.S. Dist. Lexis 3939, *9 (E.D. Pa. 2008). See also *Grable* at 313 (“It has become a constant refrain in such cases that federal jurisdiction demands not only a contested federal issue, but a *substantial* one, indicating a serious federal interest in claiming the advantages thought to be inherent in a federal forum.”).

14 *Id. See also Grable.* at 313 (“But even when the state action discloses a contested and substantial federal question, the exercise of federal jurisdiction is subject to a possible veto. For the federal issue will ultimately qualify for a federal forum only if federal jurisdiction is consistent with congressional judgment about the sound division of labor between state and federal courts governing the application of § 1331.”).

15 *Chirik* at *10.
In *Grable*, the Supreme Court addressed a case where a plaintiff filed a quiet title claim in state court under Michigan law, specifically Mich. Ct. Rule 3.411(b)(2)(c), in which the plaintiff premised its superior title claim on a failure by the IRS to give it adequate notice as defined by federal law.  

The Supreme Court affirmed that removal was proper and that the district court properly exercised federal question jurisdiction over Grable’s quiet title claim. First, the Court reasoned that the success of Grable’s suit turned directly on the “meaning of [a] federal statute [that was] actually in dispute.” Second, the Court observed that “the meaning of a federal tax provision is an important issue of federal law that sensibly belongs in federal court.” Third, the Court viewed the availability of a federal forum for both the government and private litigants as “valuable” because of the opportunity to appear “before judges used to federal tax matters.” And fourth, the Court believed that because it would be “the rare state title case that raises a contested matter of federal law,” exercising federal question jurisdiction in this instance will “portend only a microscopic effect on the federal-state division of labor.”

**Relevant Precedent**

Various federal district and appellate courts have applied *Grable* to removal actions where the complaint at issue pled only state law causes of action.

In *Pennsylvania Employees Benefit Trust Fund v. Eli Lilly & Co., Inc. et al.*, the state trust fund (the “Fund”) sued defendants for illegally promoting their respective drugs for non-medically accepted indications and non-medically necessary uses. The complaint alleged a series of claims arising under state law, specifically: failure to warn, negligence, breach of warranty, fraud and misrepresentation, misrepresentation under the Restatement of Torts, unjust enrichment, and violation of the Pennsylvania Unfair Trade Practices and Consumer Protection Law (“UTPCPL”). The defendants, in support of removal, argued that removal was proper because the marketing of prescription drugs is extensively regulated by the Food and Drug Administration and that resolution of the plaintiff’s claims necessarily turned on construction and application of federal law, namely, the federal Food Drug and Cosmetic Act (“FDCA”). The court held that remand was proper because: (1) unlike *Grable*, the case involved violations of Pennsylvania law that were fact-specific and not based on the meaning of a federal statute, and (2) the federal issues were not “substantial” because, among other reasons, “there is no meaningful indication that Congress intended to confer federal jurisdiction over state law causes of actions implicating the FDCA.” As to this latter point, the court noted:

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16 *Grable* at 314.
17 *Grable* at 315.
18 Id.
19 Id.
20 Id.
22 Id. at *22.
Considering the absence of a federal cause of action in FDCA, the Supreme Court held that “the Congressional determination that there should be no federal remedy for the violation of this federal statute is tantamount to a Congressional conclusion that the presence of a claimed violation of the statute as an element of a state cause of action is insufficiently ‘substantial’ to confer federal-question jurisdiction.” Due to the absence of any indication of congressional intent to confer federal jurisdiction over claims involving the FDCA, the Defendants also fail to demonstrate the requisite substantiality required by *Grable*.

In *Korensko v. Ed Murphy, et al.* a federal court addressed a motion for remand where one of the counts in the plaintiff’s complaint sought rescission of a contract between the parties because a condition precedent to the contract – “the disclosures required under federal law” – were allegedly never made. Specifically, the plaintiff alleged that defendants breached the contract because defendants failed to comply with the requirements of 49 U.S.C. § 32705 relating to the transfer of an automobile. The plaintiff argued that the case should be remanded because notwithstanding the allegation of violations of federal statutes, the central dispute “is squarely within the purview of state law.” In denying the motion for remand, the court held as to the first prong of *Grable*:

Plaintiff’s rescission claim is analogous to *Grable’s* quiet title claim, and it is therefore within the court’s federal question jurisdiction. Plaintiff’s rescission claim necessarily raises a federal issue – i.e., whether the Defendants satisfied the condition precedent to the contract becoming binding by making the disclosures required by federal law (that is, 49 U.S.C. § 32705). If not, Plaintiff is entitled to consider the contract void and recover his deposit. The outcome-determinative nature of this issue makes it “actually disputed and substantial” at this stage of the litigation.

As to the second prong of the *Grable* test, the court held:

Finally, the court’s exercise of jurisdiction over the Plaintiff’s rescission claim will not disturb the congressionally approved balance of federal and state judicial responsibilities, because unlike the federal statutes at issue in *Grable* and *Merrell Dow*, the federal odometer statute expressly authorizes a private cause of action

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23 Id., citing Merrell Dow Pharm. Inc. v. Thompson, 478 U.S. 804, 814 (1986). See also, Allen v. GSK, et al., 2008 U.S. Dist. Lexis 42491 (E.D. Pa. 2008) (A federal court in Pennsylvania similarly found that the marketing provisions of the FDCA are insufficient to constitute a substantial federal question for purposes of “arising under” federal question jurisdiction). In *Pennsylvania Employees Benefit Trust Fund v. Eli Lilly & Co.*, Inc., it is important to consider that while the unavailability of a federal cause of action seemed to heavily influence the court’s decision, were a federal cause of action present, the opposite holding would not necessarily have resulted.


25 *Id.* at 467.
against violators. Plaintiff presumably tried to avoid litigating this case in federal court by omitting 49 U.S.C. § 32710(b)’s express private cause of action from the complaint, but this exercise in artful pleading will not deny the defendants their right to a federal forum for this case.

In a federal banking case, *Chirik v. TD Banknorth*, the court addressed facts where the plaintiff attempted to rollover tax-qualified IRA funds into another eligible account, however the defendant bank misdirected the funds into an ordinary savings account that was not eligible for special tax treatment. The plaintiff alleged various state law claims, including breach of fiduciary duty, breach of contract, rescission, and negligence, and sought declaratory relief under the Pennsylvania Declaratory Judgment Act, specifically, to make certain declarations interpreting IRS procedures. The court found that the determination of IRS procedures as applied to the plaintiff’s claim constituted “an actual and substantial dispute over the meaning of federal law” because the plaintiff’s state law declaratory judgment claim required the reviewing court “to interpret multiple statutory and regulatory provisions of the [Internal Revenue Code] and ultimately determine whether they can be summarily dispensed with.” The court was also “satisfied that entertaining this action will not disturb any congressionally approved division of labor between state and federal courts,” because, among other reasons, the “failure to exercise jurisdiction over this matter is an invitation to state courts to issue declarations regarding federal tax law that could substantially upset and interfere with the federal government’s ability to uniformly resolve federal tax matters.”

In a pre-*Grable* case, *Smith v. Team Dodge-Kia*, a plaintiff asserted the following claims under Pennsylvania law: common law conversion, UCC violations, violations of the Pennsylvania Automotive Industry Trade Practices Act, violations of the Pennsylvania UTPCPL, common law negligence, common law fraud, and punitive damages. Although issued one day before the U.S. Supreme Court’s ruling in *Grable*, this case provided an analysis similar to that which is now available in prong one of *Grable*. In *Smith*, the court found that federal-question jurisdiction failed because on the face of the complaint the plaintiff’s claims were based on Pennsylvania state law, not federal law. Further, the defendant failed to adequately support its assertion that proving violations of federal law, namely TILA, was an essential element of the plaintiff’s claim. Conversely, according to the court, proving violations of TILA disclosure provisions would not be necessary for the plaintiff to prevail on her negligence claim because twenty-one other instances of negligent conduct were alleged in the complaint. This result in *Smith* is similar to the California Section 17200 case, discussed below (and decided post-

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26 See 49 U.S.C. § 32710(b) (2006); see also *Grable* at 318 (analogizing an express federal cause of action to a “welcome mat” to the federal courthouse).


28 Id. at *13.

29 Id. at *14-15.

Grable), in that TILA was not necessary to resolution of the claim because factually there were other non-federal issues that would resolve the claim. Were the state law claims founded solely on a federal violations, the result would likely have been different.

In California v. H&R Block,\(^{31}\) the California Attorney General brought suit under California’s UDAP statute\(^{32}\) against H&R Block related to the defendant’s sale and marketing of Refund Anticipation Loans (“RAL”). The defendant argued that the Attorney General’s request for an order enjoining defendant from doing any of the acts set forth in the complaint necessarily raised substantial and disputed federal issues because a single violation of the TILA is among the many allegations on which the complaint predicates its Section 17200 UDAP cause of action. The court granted the motion to remand, stating: “The AG’s allegation that Block has violated the TILA does not form an ‘essential part’ of the AG’s Section 17200 cause of action against Block. Rather, it is but one of eight basic predicate violations (many containing sub-violations) on which the AG bases its Section 17200 cause of action. If the AG successfully proves any one of these predicate acts it will prevail on its Section 17200 cause of action.”\(^{33}\) In other words, the possibility that TILA may have been violated was but one possible theory under which a court could have found Section 17200 liability. Therefore, because the Section 17200 claim could have proceeded without TILA, the federal question was not essential to resolving the dispute. A similar result was reached in Cortazar v. Wells Fargo & Co., et al.,\(^{34}\) where the plaintiffs alleged Section 17200 violations based on violations of TILA, RESPA, the Home Owners Equity Protection Act (HOEPA), the Home Equity Loan Consumer Protection Act (HELCPA), and violations of California Finance Code § 4970 et seq. The court determined that liability under Section 17200 could attach independent of the federal statutes because the claim was supported by an independent state law theory.\(^{35}\)

In King v. Provident Bank,\(^{36}\) a plaintiff brought suit against a defendant bank relating to a mortgage loan dispute where the plaintiff claimed fraudulent misrepresentation, unconscionability, unjust enrichment, and negligent hiring and retention, among other causes of action. The defendants sought removal on the basis that TILA and Reg. Z\(^{37}\) determined the adequacy of representations regarding home mortgages in the plaintiff’s state. Additionally, the

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\(^{32}\) Cal. Bus. & Prof. Code § 17200 et seq.

\(^{33}\) H&R Block at *12.

\(^{34}\) 2004 U.S. Dist. Lexis 30215 (N.D. Cal. 2004).

\(^{35}\) Id. See also, Howell v. Grant Holding, Inc., et al., 2004 U.S. Dist. Lexis 9400 (D. Minn. 2004) (“It is axiomatic, as here, that when a claim can be supported by alternative and independent theories – one of which is a state law theory and one of which is a federal law theory – federal question jurisdiction does not attach because federal law is not a necessary element of the claim.”).

\(^{36}\) 428 F.Supp.2d 1226 (M.D. Ala. 2006).

\(^{37}\) 12 C.F.R. Pt. 226.
defendants claimed that RESPA and its implementing regulations determined the adequacy of representations regarding settlement costs for home mortgages. The defendants further asserted that the plaintiff’s state law causes of action gave the federal court jurisdiction because they required the court to determine whether the alleged misrepresentations and omissions violated TILA or RESPA. The plaintiff, however, denied asserting any federal causes of action and did not claim that the disclosures made in connection with the loan failed to comply with TILA or RESPA. The court held that remand was required because the plaintiff had asserted valid state law claims that would permit recovery even absent a TILA violation. Additionally, the court was persuaded by the plaintiff’s express disclaiming of the application of federal law or any remedies available under federal law.38

In Levett v. American International Group, Inc.,39 the plaintiff filed in state court claiming fraud, misrepresentations, concealment, negligent and wanton hiring, training, and supervision, and breach of fiduciary duty, all in connection with several loans to the plaintiff. In support of removal, the defendants argued that TILA, Reg. Z, and regulations promulgated by the Office of Thrift Supervision (“OTS”), were “sure to be disputed” in the case. They further asserted that their compliance with TILA and Reg. Z’s disclosure requirements was likely to arise throughout the litigation, especially with regard to negligence claims. The plaintiff responded that she had expressly repudiated any federal claims, relying instead exclusively on state-law claims that do not require proof of violation or an interpretation of federal law. In remanding the case, the court ruled that the assertion that TILA and Reg. Z issues are “surely” or “likely” to be disputed in the litigation is insufficient to present a federal question under the Grable standard. Of interest to the court was that the defendants were unable to point to a single case where TILA was found as a basis for federal jurisdiction when TILA was not invoked by the plaintiffs in the complaint.40 A similar result was reached in Ball v. Argent Mortgage Company,41 where the plaintiff explicitly disclaimed any claim under federal law and any federal remedy, and did not tie a state law claim to a federal standard. Consequently, the court found the plaintiff’s claims not to contain an “actually disputed and substantial” question of federal law, and even if it did, it would not have been “so important that it ‘sensibly belongs in federal court.’”42

38 Id. at 1230.
40 Id. at *14. See also, Anderson v. Household Fin. Corp. of Alabama, 900 F.Supp. 386, 389 (M.D. Ala. 1995) (remanding case because the causes of action were supported by state-law claims and the TILA was not essential to any of those theories); Easterling v. Gulf Guar Ins. Co., 60 F.Supp.2d 586 (S.D. Miss. 1999) (remanding case where “the Plaintiff had stated viable state law causes of action and if TILA had been invoked, it was only in an unsubstantial way.").
42 Id. at *11.
In *Leggette v. Washington Mutual Bank, F.A.*, a plaintiff brought a breach of mortgage action against the defendant, Washington Mutual (“WAMU”), in which the plaintiff alleged a breach of contract based on three grounds, each of which asserted a failure to comply with regulations promulgated by the Department of Housing and Urban Development (“HUD”), pursuant to the National Housing Act (“NHA”). In satisfying the first prong of *Grable*, the court determined that each ground of the plaintiff’s wrongful foreclosure claim necessarily turned on WAMU’s obligations under federal law, that the dispute between the parties “rests entirely on the correct interpretation of three federal regulations” related to mortgage lending, and that if WAMU violated the provisions of the federal regulations, it may have breached the contract. In short, federal issues were the only questions contested in the case. On this basis, the court found that the first prong of *Grable* was met. As to the second prong, the court noted that regulating foreclosure on real property has traditionally been the province of the states, and that “[e]xercising federal jurisdiction over home foreclosure disputes typically governed by private contract and state law portends a significant transfer of judicial responsibilities from state to federal courts.” On this basis, the court found that the case did not meet the second prong of the *Grable* removal test.

In a California district court case, *Moore v. Chase Bank*, decided post-*Grable* but not citing to it, a plaintiff filed a complaint alleging six causes of action in connection with a mortgage refinancing: declaratory judgment for violations of California Civil Code § 2924 (establishing protections and procedures for valid foreclosure sales), unfair business practices (§ 17200), fraud, unconscionability, breach of contract, and accounting. The plaintiff stated that the defendants “are subject to and must comply with the Federal Truth in Lending and with the Act’s corresponding Regulation Z.” The complaint also alleged that the defendants “are debt collectors as defined by 15 U.S.C. § 1692a(6), the Federal Fair Debt Collection Practices Act,” and that the defendants “were at all times alleged in [the] complaint required to comply with and [sic] the federal Real Estate Settlement Procedures Act (RESPA), 12 U.S.C. § 2601-2617[.]” The court noted: “In light of Plaintiff’s facial invocation of these federal-statute allegations, Plaintiff’s argument that he did not ‘raise any federal issues,’ . . . is plainly contradicted by his own Complaint.”

In addition, several of the plaintiff’s causes of action contained predicate federal statutory violations. For example, in the plaintiff’s second cause of action for unfair business practices, the plaintiff alleged: “Defendants . . . made the following untrue and misleading statements, and engaged in the following unfair business practices. . . . They failed to comply with the disclosure provisions of the Federal Truth in Lending Act. . . . They failed to comply with the disclosure provisions of the Homeowner Equity Protection Act, a part of the Truth in Lending Act.” Under this same cause of action, the plaintiff also alleged that various fees demanded by the defendants “are erroneous and fraudulent, and are based on fraudulent representations, violations of the Federal Truth in Lending Act, violations of HOEPA, and concealed excessive charges and fees.” In the plaintiff’s third cause of action for fraud, the plaintiff alleged: “Defendants . . . committed

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44 *Id.* at *14.
fraud in the following ways. . . . They failed [to] comply with the disclosure provisions of the Homeowner Equity Protection Act, a part of the Truth in Lending Act.” Thus, the court held, “although Plaintiff has pleaded California state-law causes of action, Plaintiff’s decision to include numerous allegations relating to underlying federal statutory violations brings his action within this Court’s jurisdiction.” Thus, the court noted in denying the motion to remand, the plaintiff’s “right to relief necessarily depends on resolution of a substantial question of federal law.”

To restate, the test under Grable as announced by federal courts is: “First the district courts should ask whether the ‘state-law claim necessarily raises a federal issue, [which is] actually disputed and substantial.’” “Second, courts must examine whether ‘the federal forum may entertain [the issue] without disturbing any congressionally approved balance of federal and state judicial responsibilities.’”

The U.S. Supreme Court’s rule in Grable, as applied by lower federal courts makes clear that a state law claim that turns on interpretation of a federal law will support federal question jurisdiction. The Korensko court’s holding is instructive that “the outcome-determinative nature of this issue makes it ‘actually disputed and substantial’ at this stage of the litigation.” Similar to the outcome-determinative nature of the contract remedies at issue in Korensko, a bank defending against an artfully pled complaint must consider whether the complaint would turn exclusively on interpretation of federal law, and thus the cause of action would support federal question jurisdiction. The ultimate question for the courts would therefore be whether the outcome of a plaintiff’s claim is necessarily and exclusively dependent upon violations or interpretations of federal law.

Summary

As Korensko illustrates, the propriety of removal of an artfully pleaded state law cause of action relying on a dispositive provision of federal law that itself contains a private right of action, and for which Congress has explicitly granted access to the federal courts, arguably warrants even greater willingness to remove than was granted in Grable, where the underlying federal statute lacked a private right of action. Even if the underlying federal laws do not provide for a private right of action and jurisdiction in the federal courts, the second prong of the Grable test might still be satisfied by arguing that the federal interest in uniform application of federal laws relating to mortgage lending, loan servicing, and debt collection justify removal to the federal courts. From a plaintiff’s perspective, the challenge will be to allege standards based in federal and state law. This may prove difficult as many state substantive laws either contain express exceptions for federally-chartered institutions, or are inapplicable through federal preemption. Finally, an open question remains as to what extent the courts will consider the current national nature of the mortgage foreclosure crisis in applying the second prong of Grable, where the intent of Congress is considered in examining the underlying federal statute, and where, in the current crisis, the uniform application of federal mortgage foreclosure statutes is (at least as a policy matter) paramount.

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An Overview of the Identity Theft Red Flags and Address Discrepancies under the Fair and Accurate Credit Transactions Act of 2003 Final Rules

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Introduction

The purpose of this article is to provide an overview of the requirements of the Identity Theft Red Flags and Address Discrepancies under the Fair and Accurate Credit Transactions Act of 2003 Final Rules (the “Final Rules”). The Final Rules are already effective; however, the mandatory compliance date is November 1, 2008. The Final Rules are accompanied by Interagency Guidelines on Identity Theft Detection, Prevention and Mitigation (the “Guidelines”), which further illustrate the Program (as defined below) requirements. The Final Rules mandate that financial institutions and creditors consider the Guidelines and include in their Programs those that are appropriate.1

This article is organized in a functional manner, rather than in sequential order of the Final Rules. Citations refer to the Federal Deposit Insurance Corporation (“FDIC”) version of the Final Rules whenever possible. The Final Rules apply to “financial institutions and creditors” but for ease of reading this article uses the term “financial institutions” when referring to both financial institutions and creditors.

Legislative Background

Congress passed the Fair and Accurate Credit Transaction Act (“FACTA”) in 2003. FACTA amended the preexisting Fair Credit Reporting Act (“FCRA”). FACTA included a provision mandating that the Federal Financial Institutions Examination Council and the Federal Trade Commission (together, the “Agencies”) develop regulations regarding the implementation of sections 114 and 315 of FCRA. Sections 114 and 315 focus on identity theft and address discrepancies.

The Program; Identifying, Detecting and Responding to Red Flags

Definitions

The following key definitions are found in section 90(b) of the Final Rules:

“Covered Account” means (i) an account that a financial institution offers or maintains, primarily for personal, family, or household purposes, that involves or is designed to permit multiple payments or transactions, such as a credit card account, mortgage loan, automobile loan, margin account, cell phone account, utility account, checking account, or savings account; and (ii) any other account that the financial institution offers or maintains for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution from identity theft, including financial, operational, compliance, reputation or litigation risks.2 The new definition of “covered account” is divided into two parts. The first part refers to consumer accounts that involve multiple payments or transactions. The second part of the definition refers to any other account that the financial institution offers or maintains for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution from identity theft, including financial, operational, compliance, reputation, or litigation risks. This reflects the “Agencies views that small business accounts or sole proprietorship accounts, may be vulnerable to identity theft, and therefore, should be considered for coverage by the Program.”3 As such, both consumer and business accounts are subject to the Final Rule.

“Customer” is similarly defined as it includes businesses. The Final Rules define “customer” as a person that has a Covered Account with the financial institution.4 Thus, an individual with a consumer account will always be a customer. However, a “customer” may also be a person that has another type of account for which the financial institution determines there is a reasonably foreseeable risk to its customers

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2 72 Fed Reg 63761 (9 November 2007).
3 72 Fed Reg 63721(9 November 2007).
4 72 Fed Reg 63761 (9 November 2007).
or its own safety and soundness from identity theft.\(^5\) Note, also, that “person” as defined by the FCRA includes business entities of all types.

“Red Flag” means a pattern, practice, or specific activity that indicates the possible existence of identity theft.\(^6\)

**The Program**

The Final Rules require the financial institution to implement a written identity theft prevention program (the “Program”).\(^7\) The Program must be designed to detect, prevent, and mitigate identity theft in connection with a Covered Account (at account opening and with respect to existing Covered Accounts). The size of the Program should be appropriate for the size and complexity of the financial institution.\(^8\) The Final Rules mandate that the Program have policies and procedures that:

- Identify Red Flags relevant to detecting possible risk of identity theft;
- Verify the identity of persons opening accounts;
- Detect Red Flags that are relevant in connection with opening an account or with existing accounts;
- Assess whether Red Flags detected are evidence of identity theft;
- Mitigate the risk of identity theft that is appropriate for the level of risk;
- Respond appropriately to any detected Red Flags;
- Ensure that the Program is updated periodically, to reflect changes in risks to customers and to the safety and soundness of the financial institution from identity theft;\(^9\)
- Train staff; and
- Oversee service provider arrangements.

**Identifying Red Flags**

The Final Rules state that one element of the Program must consist of identifying Red Flags, without any elaboration.\(^10\) The Guidelines in Appendix J of the Final Rules set forth the framework the financial institution should follow to meet this element of the Program.

The Guidelines state that financial institution should consider the following risk factors in identifying relevant Red Flags, as appropriate for the financial institution:

- The types of Covered Accounts the financial institution offers or maintains;
- The methods the financial institution provides to open its Covered Accounts;
- The methods the financial institution provides to access its Covered Accounts; and
- The financial institution’s previous experiences with identity theft.\(^11\)

Next, the Guidelines set forth possible sources of Red Flags in addition to those listed in Appendix J. These additional sources may include, without limitation:

- Incidents of identity theft that the financial institution has experienced;
- Methods of identity theft that the financial institution has identified that reflect changes in identity theft risks; and
- Applicable supervisory guidance.\(^12\)

Finally, the Guidelines set forth the following categories of Red Flags that the financial institution’s Program should include, as appropriate for the institution:

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\(^5\) 72 Fed Reg 63722 (9 November 2007).
\(^6\) 72 Fed Reg 63761 (9 November 2007).
\(^7\) 12 CFR 334.90 implements FCRA section 615(e)(1)(A).
\(^8\) Id.
\(^9\) Id.
\(^10\) 72 Fed Reg 63761 (9 November 2007), 12 CFR 33490(d)(1).
\(^11\) 72 Fed Reg 63761 (9 November 2007).
\(^12\) Id.
• Alerts, notifications, or other warnings received from consumer reporting agencies or service providers, such as fraud detection services;
• The presentation of suspicious documents;
• The presentation of suspicious personal identifying information, such as a suspicious address change;
• The unusual use of, or other suspicious activity related to, a Covered Account; and
• Notice from customers, victims of identity theft, law enforcement authorities, or other persons regarding possible identity theft in connection with Covered Accounts held by the financial institution.13

**Detecting Red Flags**

The Final Rules mandate that the Program implemented by each financial institution contain policies and procedures for detecting Red Flags. The Guidelines found in Appendix J provide further explanation of how each financial institution is required to comply with this provision. The Program should address the detection of Red Flags in connection with the opening of Covered Accounts and with respect to existing Covered Accounts by:

• Obtaining identifying information about, and verifying the identity of a person opening a Covered Account by, for example, using the policies and procedures regarding the identification and verification set forth in the financial institution’s Customer Identification Program (“CIP”); and
• Authenticating customers, monitoring transactions, and verifying the validity of change of address requests, in the case of existing Covered Accounts.

**Responding to Red Flags**

Once identified, the Final Rules state that the Program must address how the financial institution will respond appropriately to any detected Red Flags and mitigate identity theft.14 The corresponding Guidelines section is titled “Preventing and Mitigating Identity Theft”. The Guidelines indicate the financial institution should “appropriately respond” to detected Red Flags. In order for a response to be “appropriate” the financial institution should consider aggravating factors that may heighten the risk of identity theft, such as a data security incident that results in unauthorized access to a customer’s account records held by the financial institution, or notice that a customer has provided information related to a Covered Account held by the financial institution to someone fraudulently claiming to represent the financial institution or to a fraudulent website.15 Appropriate responses may include:

• Monitoring a Covered Account for evidence of identity theft;
• Contacting the customer, changing any passwords, security codes, or other security devices that permit access to a Covered Account;
• Reopening a Covered Account with a new account number;
• Not opening a new Covered Account;
• Closing an existing Covered Account;
• Not attempting to collect on a Covered Account;
• Not selling a Covered Account to a debt collector;
• Notifying law enforcement; or
• Determining that no response is warranted under the particular circumstances.16

**Updating the Program**

The Final Rules require financial institutions ensure that the Program is updated periodically to reflect changes in risks to customers and to the safety and soundness of the financial institution from

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13 72 Fed Reg 63762 (9 November 2007).
14 72 Fed Reg 63761 (9 November 2007), 12 CFR 334.90(d)(iii).
15 72 Fed Reg 63862 (9 November 2007).
identity theft. The Guidelines set forth a list of factors to assist the financial institution in determining when the program needs updating. The Guidelines provide that the following relevant factors should be considered:

- The experiences of the financial institution with identity theft;
- Changes in methods of identity theft;
- Changes in methods to detect, prevent and mitigate identity theft;
- Changes in the types of accounts the financial institution offers or maintains; and
- Changes in the business arrangement of the financial institution (such as a merger).

Program Administration

The final element of the Program discussed in the Final Rules is program administration. The board of directors or an appropriate committee of the board must approve the initial written Program. The Program must require that the board of directors or a board committee approve annual reports on compliance. On an ongoing basis, the Final Rules require the involvement of the board of directors, a board committee or a designated senior management level employee in the oversight, development, implementation and administration of the Program. However, in order to not impair the ability of the financial institution to update its Program in a timely manner, the Final Rules allow, at the discretion of the financial institution, for the board of directors, a board committee, or senior management to update the Program once it has received initial board approval.

The Guidelines require that the board of directors (or designated committee or member of senior management) receive a report on compliance at least annually by the financial institution in accordance with section 12 CFR 344.90. The report should address material matters related to the Program and evaluate issues such as:

- The effectiveness of the policies and procedures of the financial institution in addressing the risk of identity theft in connection with the opening of Covered Accounts or with respect to existing Covered Accounts; and
- Recommendations for material changes to the Program.

The financial institution’s employees are required to receive appropriate training with respect to the Program. There is no corresponding section in the Guidelines that addresses training of employees. Finally, the financial institution must exercise appropriate and effective oversight of service provider arrangements. The purpose of this final requirement is to make it clear that a financial institution may not evade its obligations to comply with any provisions of the Final Rules by outsourcing one or more activities.

Card Issuer Requirements

Additional or Replacement Cards

The Final Rules require credit or debit card issuers to resolve address discrepancies whenever they receive a request for an additional or replacement card. The definition of a “Card Issuer” is set forth in the FCRA. The act by a financial institution of issuing its own debit and credit cards is sufficient to meet the definition.

The following definitions apply only to this section of the Final Rules:

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20 72 Fed Reg 63762 (9 November 2007).
21 72 Fed Reg 63763 (9 November 2007).
22 72 Fed Reg 63731 (9 November 2007).
25 12 CFR 334.91 implements FCRA section 615(e)(1)(C).
“Cardholder” means a consumer who has been issued a credit or debit card.\textsuperscript{26} The preamble to the proposed rules provided that a Card Issuer could assess the validity of a “consumer” request for an additional or replacement card for an existing account by notifying the cardholder.\textsuperscript{27} Note, however, that the term “consumer” is defined by the FCRA simply as an “individual.” Therefore, the Final Rules apply to any individual requesting an additional or replacement card, including a card for business purposes.\textsuperscript{28} The Final Rules only apply to those types of cards that are covered by Regulation E. Therefore, gift cards and other prepaid card products are not covered by the Final Rules unless and until these types of cards are covered by an amendment to Regulation E. The Final Rules do apply to a recipient of a home equity loan, if the holder is able to access the proceeds of the loan with a credit or debit card.\textsuperscript{29}

“Clear and conspicuous” means reasonably understandable and designed to call attention to the nature and significance of the information presented.\textsuperscript{30}

\textit{Address Validation}

12 CFR 334.91(c) sets forth requirements regarding address validation. Under the Final Rules, for a Card Issuer that receives an address change notification within thirty (30) days of a request for an additional or replacement card, the Card Issuer should not issue the additional or replacement card until it has notified the Cardholder or has otherwise assessed the validity of the change of address.\textsuperscript{31} The Final Rules provide two options to comply with this provision. The first option is to notify the Cardholder at the Cardholder’s former address or by any other means of communication that the Card Issuer and the Cardholder have previously agreed to use. The notice must provide the Cardholder with a reasonable means of promptly reporting an incorrect address change. The second option is for the Card Issuer to “otherwise assess the validity of the change of address in accordance with the policies and procedures the card issuer has established to comply with this rule.”\textsuperscript{32} Any notice provided under this provision must be “clear and conspicuous,” therefore, it must be provided separately from the Card Issuer’s regular correspondence with the Cardholder.\textsuperscript{33}

\textit{Address Discrepancies}

\textit{Notice from Credit Reporting Agency}

The Final Rules set forth certain steps that a financial institution is required to take upon receipt of a notice from a credit reporting agency of an address discrepancy. This section of the Final Rules applies to the users of consumer reports.\textsuperscript{34}

The following definition applies only to this section of the Final Rules:

“Notice of address discrepancy” means as a notice sent to a user by a consumer reporting agency pursuant to 15 U.S.C. 1681c(h)(1) that informs the user of a substantial difference between the address for the consumer that the user provided to request the consumer report and the address(es) in the agency’s file for the consumer.\textsuperscript{35}

The FCRA and Final Rules leave the determination of what constitutes a “substantial difference” to the consumer reporting agency. When the financial institution receives a notice of an address discrepancy from a consumer reporting agency it must develop a reasonable belief that a consumer report relates to the consumer about whom it has requested the report. Written policies and procedures must be in

\textsuperscript{26} 72 Fed Reg 63761 (9 November 2007), 12 CFR 334.91(b)(1).
\textsuperscript{27} 72 Fed Reg 63733 (9 November 2007).
\textsuperscript{28} Id.
\textsuperscript{29} 72 Fed Reg 63734 (9 November 2007).
\textsuperscript{30} 72 Fed Reg 63761 (9 November 2007), 12 CFR 334.91(b)(2).
\textsuperscript{31} 72 Fed Reg 63734 (9 November 2007).
\textsuperscript{32} 72 Fed Reg 63762 (9 November 2007), 12 CFR 334.91(c) (1) and (2).
\textsuperscript{33} 72 Fed Reg 63735 (9 November 2007).
\textsuperscript{34} 12 CFR 334.82 implements FCRA section 605(h).
\textsuperscript{35} 72 Fed Reg 63760 (9 November 2007), 12 CFR 334.82(b).
place to facilitate this determination. Comments received in response to the proposed rule requested that this requirement be limited to situations in which the financial institution has established a continuing relationship with the consumer. However, the Final Rules reject this proposition, and the requirement applies to any notification from a consumer reporting agency regarding a substantial address discrepancy. The Final Rules specifically state that if the financial institution employs the policies and procedures regarding identification and verification set forth in the CIP rules it would satisfy the requirement to have policies and procedures to verify the identity of the customer. However, the CIP would need to be applied whenever the financial institution receives a notice of an address discrepancy. The commentary accompanying the Final Rules indicates that if the financial institution received a notice of address discrepancy in connection with a previously established account, the Agencies would not expect the financial institution to rely on the CIP rules a second time.

The Final Rules provide two examples of reasonable policies and procedures:

First, the financial institution may compare the information in the consumer report provided by the consumer reporting agency with information that the financial institution:

- Obtains and uses to verify the consumer’s identity in accordance with the requirements of the CIP rules; or
- Maintains in its own records, such as applications, change of address notifications, other customer account records, or retained CIP documentation; or
- Obtains from third party sources.

Second, the financial institution may verify the information in the consumer report provided by the consumer reporting agency directly with the consumer.

If the financial institution cannot establish a reasonable belief that the consumer report relates to the consumer about whom it requested the report, the Agencies expect that the financial institution will not use that report.

**Furnishing a Consumer’s Address to a Consumer Reporting Agency**

The Final Rules require, in certain circumstances, that financial institutions furnish consumer addresses to consumer reporting agencies. The Agencies believe that the FCRA, implemented by these provisions in the Final Rules, is intended to enhance the accuracy of information relating to consumers. The requirement to furnish consumer addresses only applies when the financial institution receives a notice of address discrepancy when dealing with a newly established account. The Final Rules require the financial institution to have reasonable policies and procedures for furnishing an address for the consumer.

As a precondition to providing an updated consumer address, the financial institution must reasonably confirm that the address is accurate. The Final Rules provide the following examples of methods that the financial institution may use satisfy this requirement:

- Verifying the address with the consumer about whom it has requested the report;
- Reviewing its own records to verify the address of the consumer;
- Verifying the address through third-party sources; or
- Using other reasonable means.

Provided that the financial institution has reasonably confirmed that the address is accurate, it must provide the address to the consumer reporting agency from which it received the notice of address discrepancy when the following circumstances are met:

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36 72 Fed Reg 63760 (9 November 2007), 12 CFR 334.82(c).
37 72 Fed Reg 63736 (9 November 2007).
39 72 Fed Reg 63737 (9 November 2007).
40 72 Fed Reg 63760 (9 November 2007), 12 CFR 334.82(c).
41 72 Fed Reg 63737 (9 November 2007).
42 72 Fed Reg 63738 (9 November 2007).
• The financial institution can form a reasonable belief that the consumer report relates to the
  consumer about whom the user requested the report;
• The financial institution establishes a continuing relationship with the consumer; and
• The financial institution regularly and in the ordinary course of business furnishes information
to the consumer reporting agency from which the notice of address discrepancy relating to the
  consumer was obtained.43

The financial institution must respond to the consumer reporting agency in the same time period in
which the financial institution regularly furnishes updates to the reporting agency and in which the financial
institutions establishes a continuing relationship with the consumer.44 In other words, the financial
institution will furnish the consumer’s updated address during the next regular report that the financial
institution provides to the reporting agency in question, after the financial institution has established the
required relationship with the consumer.

Conclusion

With the adoption of the Final Rules and the mandatory compliance date approaching, financial
institutions need to be actively developing their Program and the related policies and procedures required to
comply with the provisions of the Final Rules. A working group, drawing on expertise throughout the
organization, should be convened to identify and assess potential difficulties. For example, financial
institutions may find that their core system may not interface with the system used to order debit and credit
cards, leading to time intensive programming and/or the development of manual processes, which, if
unanticipated, may delay compliance.

43 72 Fed Reg 63760 (9 November 2007), 12 CFR 334.82(d).
44 72 Fed Reg 63761 (9 November 2007), 12 CFR 334.82(d)(3).
Assault on the Shrine: the Demise and Possible Revival of the Attorney-Client Privilege

by

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Recent Congressional testimony summarized the results of the federal government’s sustained assault on the attorney-client privilege over the past decade:

“We are forced to practice in a world where we cannot expect that any privilege will be respected by government investigators. The government now expects a waiver as an inherent right.”

These sentiments reflect growing concern over the Department of Justice’s (“DOJ’s”) policies governing the role of attorney-client privilege and work product protection in federal prosecutions of business corporations. The DOJ policies, contained in a December 2006 Memorandum issued by then-Deputy Attorney General Paul McNulty (“the McNulty memo”), have been the subject of much recent debate and have generated calls for reform from, among others, Congress, former prosecutors, and corporate executives and lawyers. What began as a trickle of criticism is now more aptly characterized as a flood, placing DOJ on the defensive.

The concerns with DOJ’s policies and practices in white-collar investigations have focused on two critical issues: whether a corporation will be seen as non-cooperative -- and therefore punished -- 1) if it does not waive the attorney-client privilege, and 2) if it indemnifies directors and officers and advances expenses to cover costs of representation in criminal investigations. While both of these issues are important, the focus of this article is on the attorney-client privilege.

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This article builds on our previous article and describes the developments that led to the McNulty memo, the McNulty memo’s key provisions, and responses and reactions to the McNulty memo since its issuance 18 months ago. It concludes with an analysis of recent proposals for reforming the DOJ policies governing the attorney-client privilege and work product protection.

What Led to the McNulty Memorandum?

Prior DOJ Policies

The McNulty memo was designed to remedy prior DOJ policies that had come under sustained attack for having, in the eyes of many, legitimized the right of prosecutors to demand waivers of attorney-client privilege and work product protections. The McNulty memo was the latest chapter in DOJ’s recent history of trying to provide guidance to its own personnel and to the corporate world concerning the standards that would determine whether to prosecute a company or other business organization. In 1999, DOJ for the first time listed factors that prosecutors should consider in deciding whether to charge a corporation.\(^5\) DOJ refined this charging policy in a January 20, 2003 memo issued by then-Deputy Attorney General Larry Thompson (“the Thompson memo”).\(^6\) This memo provided, among other things, that prosecutors “should consider the willingness of a corporation to waive” its attorney-client privilege and work product protections “in evaluating the corporation’s cooperation” with the government’s investigation.

“Culture of Waiver”

According to many, the Thompson Memo led to prosecutors over time coming to treat as routine the demand that corporations under investigation waive their privileges, or risk exposing their companies to costly indictments. For example, in a recent survey of over 1,200 in-house and outside corporate counsel, almost 75% of the respondents stated that they believed that, in the wake of the new government policy reflected in the Thompson Memo, a “culture of waiver” evolved in which governmental agencies believe that it is reasonable and appropriate for them to expect a company under investigation to broadly waive attorney-client or work product protections.\(^7\) Notably, this “culture of waiver” has extended beyond the Justice Department.

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\(^5\) This guidance is entitled “Federal Prosecution of Corporations” and is informally referred to as “the Holder Memorandum” after former Deputy Attorney General, Eric Holder, Jr. The memo lists various factors to be considered in making the corporate charging decision, including the corporation’s timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of attorney-client and work-product privileges. Memorandum from Eric H. Holder to Heads of Department Components and United States Attorneys, Federal Prosecution of Corporations (June 16, 1999), available at: http://www.usdoj.gov/criminal/fraud/docs/reports/1999/chargingcorps.html.


\(^7\) Letter from former senior Justice Department officials to Attorney General Alberto Gonzales (Sept. 5, 2006) (citing study available at http://www.acca.com/Surveys/attyclient2/pdf and noting that corporate counsel
November 2004, the U.S. Sentencing Commission added language to the Commentary to the Federal Sentencing Guidelines that authorized and encouraged prosecutors to seek privilege waivers as a condition for cooperation in cases involving companies and other organizations. Similarly, the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC), the Department of Housing and Urban Development (HUD), and other agencies also adopted similar privilege waiver policies.

This “culture of waiver” has very substantial costs for individual companies and for the entire system of criminal and regulatory investigations. When corporations decide to waive privileges in exchange for avoiding indictment, individual employees’ statements are in many cases turned over to the government. Although these employees never have the opportunity to assert their Fifth Amendment rights to the government, they risk prosecution for the statements they have made to the company’s lawyers. As a result, according to in-house counsel who have to deal with the fallout on a regular basis, employees are less likely to seek from corporate counsel “the advice that is crucial to maintaining law abiding businesses.”

Moreover, once a corporation waives privileges with respect to the government, the privileges will also arguably be waived with respect to potential third party litigation adversaries, exposing the corporation to potential, and probably costly, litigation. This is particularly relevant in the financial services area where typical enforcement matters may involve multiple bank regulatory agencies, the SEC, DOJ, and multiple class action and derivative lawsuits.

indicated that when prosecutors gave a reason for requesting a privilege waiver, the DOJ memos were among the reasons most frequently cited).


11 See White Testimony, supra note 2.

12 For this reason, the bank regulatory agencies obtained an attorney-client waiver exemption at 12 U.S.C. § 1828(x) which states: "The submission by any person of any information to any Federal banking agency, State bank supervisor, or foreign banking authority for any purpose in the course of any supervisory or regulatory process of such agency, supervisor, or authority shall not be construed as waiving, destroying, or otherwise affecting any privilege such person may claim with respect to such information under Federal or State law as to any person or entity other than such agency, supervisor, or authority."
As this “culture of waiver” developed and then accelerated in the post-Enron era, the American Bar Association (“ABA”) and other industry groups began challenging the Justice Department’s policies. The ABA formed a Task Force on Attorney-Client Privilege and a Coalition to Preserve the Attorney-Client Privilege, consisting of, among others, the U.S. Chamber of Commerce, the National Association of Criminal Defense Lawyers and the American Civil Liberties Union, was also formed.13 These groups gathered information to determine the pervasiveness of coercive waiver requests, issued statements criticizing the government policy, sent letters to the Attorney General, arranged for former DOJ officials to “decry[] DOJ waiver tactics as unnecessary and harmful to compliance” and lobbied Congress to “invalidate provisions of the Thompson Memorandum and similar policies at other federal agencies that prevent executives and employees from freely, candidly, and confidentially consulting their attorneys.”14

These sustained efforts at lobbying and persuasion had an impact. For example, on April 5, 2006, the Sentencing Commission voted unanimously to remove the privilege waiver language from the Sentencing Guidelines. DOJ, however, responded by merely instructing each U.S. Attorney and Component Head to adopt a “written waiver review process for” his district or component.15 This development was widely regarded as insufficient because rather than restricting all prosecutors’ ability to demand privilege waivers, it merely provided for different waiver policies being established throughout the country.16 Nor was there any method for assessing whether this new requirement was followed or how seriously it was taken. Defense lawyers and companies under investigation failed to notice any difference.  

Proposed Legislation

The criticisms of DOJ’s practice in this area culminated when, on December 7, 2006, shortly before the issuance of the McNulty memo, Senator Arlen Specter introduced the “Attorney Client Privilege Protection Act of 2006” in an attempt to legislate out of existence many of the Thompson Memo’s objectionable provisions. The proposed legislation would prohibit prosecutors from requesting privilege waivers and, among other things, from conditioning charging decisions on whether a corporation waives its privileges.17

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16 Letter from Former Senior Justice Department Officials to Alberto Gonzales, supra note 7.

The McNulty Memorandum

On December 12, 2006, DOJ issued the McNulty memo to address “concerns that [its] practices may be discouraging full and candid communications between corporate employees and legal counsel.” The new memo, which replaced the Thompson memo, recognized the “extremely important function” of the attorney-client privilege and work product protection, and stated that waiver of these protections was “not a prerequisite to a finding that a company has cooperated in the government’s investigation.” The memo provided that prosecutors may only request waivers of these protections “when there is a legitimate need” for the privileged information, and should seek the “least intrusive waiver necessary to conduct a complete and thorough investigation” and “follow a step-by-step approach to requesting information,” that involves obtaining specific authorizations to request privilege waivers.

The memo explained that prosecutors should first request “purely factual information” (called “Category I” information), and, only if the factual information provides an incomplete basis to conduct a thorough investigation, can consider requesting attorney-client communications or non-factual attorney-client work product (“Category II” information). The memo required that prior to requesting Category I information, prosecutors obtain written authorization from the local U.S. Attorney, who must in turn consult with the Assistant Attorney General for the Criminal Division. Prior to requesting Category II information, which should be sought only in “rare circumstances,” the U.S. Attorney must obtain written authorization from the Deputy Attorney General.

According to the memo, a corporation’s response to a request for waiver of Category I information may be considered in determining whether that corporation has cooperated in the government’s investigation, but a corporation’s declining to provide a waiver for Category II information cannot be considered against that corporation. In any event, the memo provided, prosecutors “may always favorably consider a corporation’s acquiescence to the government’s waiver request in determining whether the corporation has cooperated in the government investigation.”

Critiques of the McNulty Memorandum and its Implementation

From the outset, the McNulty Memo was widely criticized. The ABA, for example, complained that the new guidelines “fall far short of what is needed to prevent further erosion of fundamental attorney-client privilege, work product, and employee protections.” The core of the

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18 McNulty memo, supra note 3.

19 The memo explains that whether there is a “legitimate need” depends on: (1) the likelihood and degree to which the privileged information will benefit the government’s investigation; (2) whether the information sought can be obtained in a timely and complete fashion by using alternative means that do not require waiver; (3) the completeness of the voluntary disclosure already provided; and (4) collateral consequences to a corporation of the waiver.

20 Thomas P. Vartanian and Michael R. Bromwich, supra note 4.
criticism was that the memo continued to permit prosecutors to ask for waivers, to consider a company’s refusal to waive in various circumstances and to give “cooperation credit” to those companies that do waive their privileges. Moreover, because many federal enforcement officials rely almost exclusively on informal demands to coerce corporations to waive their privileges, many claim the memo’s restrictions on formal waiver demands would do little to restrain prosecutors’ routinely seeking and/or expecting privilege waivers.

The McNulty Memo’s Language

Criticisms have also been aimed at the specific language of some of the memo’s provisions. For example, some have challenged the memo’s description of Category I information as “purely factual,” noting that “in practice . . . the line between what is ‘purely factual’ and what contains attorney work product is rarely clear cut” and that what the memo alleges to be “purely factual” is material that is generally protected by the attorney-client and/or work product privileges. The “legitimate need” language has also been challenged, as the memo is unclear about when a prosecutor will have demonstrated such a need, and the “legitimate need” determination is made by prosecutors in their sole discretion without any third party review or appeal process.

Implementation of the McNulty Memo

In addition to criticizing the language of the memo’s provisions, many have condemned the memo’s efficacy, claiming that even its limited improvements are not being implemented. Anecdotal reports from corporate attorneys, including our own experiences, suggest that local prosecutors in many instances lack familiarity with and therefore ignore the memo’s requirement to seek authorization before requesting disclosures. Thus, many lawyers practicing in the area believe that the memo has not significantly reduced the incidence of coerced waivers or changed the culture of waiver that permeates actual practices around the country. Some reports suggest that in the wake of the McNulty memo, prosecutors have become even more abusive in their requests, threatening that companies that ask them to take a formal waiver request “up the ladder” will be particularly harshly treated. Numerous anecdotes about coercive prosecutor


22 White Testimony, supra note 2 (Mr. White also complained that the memo, by merely clarifying how privilege waivers should be sought, ratifies the premise that DOJ, as opposed to courts, has a right to determine when a corporate client’s privilege rights deserve protection. Mr. White believes that this alters the long-standing principle that courts should make this determination). Other structural concerns about the memo’s provisions include that it does not provide for legislative or judicial oversight over charging decisions, or even for these decisions to be reviewed in Washington by “main justice.” Id. (statement of Andrew Weissman, Jenner & Block, LLP).

23 Id.

24 Id. (statement of William M. Sullivan, Jr., Winston & Strawn, LLP).

25 White Testimony, supra note 2 at 8-9
conduct after the McNulty memo are included in the letter that E. Norman Veasey, the former
Chief Justice of the Delaware Supreme Court, sent to the Senate Judiciary Committee on
September 13, 2007.26

Recent Developments

This widespread criticism of the McNulty memo led to renewed attempts to legislate to
address DOJ’s privilege waiver policies.27 In July 2007, HR 3013 was introduced in the House
of Representatives. This bill is identical to the legislation that Senator Specter had introduced in
December 2006, and reintroduced in January 2007 after concluding that the McNulty Memo had
not provided sufficient protection of the attorney-client privilege so as to obviate the need for
legislation on this issue. These bills would prohibit federal agencies from pressuring companies
to waive their privileges and from giving cooperation credit for corporations’ taking punitive
actions against their employees. The House Bill passed in November 2007, and the Senate bill is
pending.

Within the past month, on June 20, 2008, 32 former United States Attorneys wrote to
Senate Judiciary Committee Chairman Patrick Leahy asking him to support this legislation.28
The former prosecutors stressed that the legislation was necessary because the McNulty memo
was inadequate to fix, “the widespread practice of requiring waiver [that] has led to the erosion
not only of the privilege itself, but also of the constitutional rights of employees who are caught
up, often tangentially, in business investigations.” They emphasized that the proposed
legislation is “consistent with good corporate governance” because strengthening the privilege
will encourage employees to cooperate with internal business investigations.

A few days later, Senator Specter introduced a slightly modified version of the
legislation, S.3217.29 On the same day, Senator Leahy warned the Justice Department that he

26 Letter from E. Norman Veasey to Senate Judiciary Committee (Sept. 13, 2007), available at:
http://www.abanet.org/poladv/priorities/privilegewaiver/acprivilege.html. Some of the conduct recounted in this
letter is particularly egregious. For example, when one corporation mentioned the process required by the McNulty
memo, the prosecutor responded, “I don’t give a flying --- about the policy.” See also White Testimony, supra note 2.

27 The Complaints also caused some government agencies to reverse their privilege waiver policies. For
example, in March 2007, the CFTC eliminated the privilege waiver language from its cooperation standards. The
CFTC’s new cooperation standards are available at:

28 Letter from former representatives of the Department of Justice, supra note 10.

29 According to Senator Specter’s floor statement, the “improvements” in the revised bill include extending
the ban on privilege waiver demands to include administrative proceedings and adjudications, and making clear that
the bill’s prohibition on informal privilege waiver demands is far from unprecedented. “Attorney-Client Privilege
Protection Act of 2008,” Floor Statement of the Honorable Arlen Specter (June 26, 2008), available at:
would focus on quick legislative action if the department failed to modify its policy by the time Congress returned from its July 4th recess on July 7.\textsuperscript{30}

\textbf{The Filip Letter}

As a direct result of this pressure, and in an effort to avert legislative action, on July 9, 2008, Deputy Attorney General Mark Filip sent a letter to Senators Leahy and Specter ("the Filip letter") about "certain changes to the Principles that the Department intends to make in the coming weeks to address issues you [the Senators] raised." In his testimony before the Senate Judiciary Committee the next day, Attorney General Michael Mukasey referred to this letter, saying that it addresses proposed changes that would replace the McNulty memo.\textsuperscript{31}

Mr. Filip’s letter proposes that (1) corporate cooperation should be measured by the extent to which a corporation discloses relevant facts and evidence, and not whether it waives privileges in making its disclosures; (2) federal prosecutors not demand in any case the disclosure of Category II information as a condition for cooperation credit; (3) federal prosecutors not consider whether a corporation has advanced attorney’s fees to its employees in evaluating cooperation; (4) federal prosecutors not consider whether a corporation has entered into a joint defense agreement in evaluating cooperation; and (5) federal prosecutors not consider whether a corporation has retained or sanctioned employees in evaluating cooperation.

These proposed changes address many of the central concerns about the McNulty memo, most notably in their restriction of waiver demands for Category II information and the inclusion of protection for joint defense agreements. However, these proposed changes are unlikely to fully satisfy critics of the McNulty memo, and therefore are unlikely to obviate the call for legislative action in this area, for the following reasons:

- Under the McNulty memo’s definition, “Category I information” could include information protected by the attorney-client privilege or work product doctrine. The proposed guidelines do not prohibit prosecutors from demanding disclosure of this type of privileged information.

- The new guidelines do not provide any oversight mechanism for reviewing prosecutors’ decisions on demanding waivers.


\textsuperscript{31} Pedro Ruz Gutierrez, \textit{AG Mukasey Hints at Revision of McNulty memo, Spars with Senators at Hearing}, Legal Times (July 10, 2008), available at: http://www.law.com/jsp/article.jsp?id=1202422864034&rss=newswire. This was a change from the Attorney General’s statement only a month earlier that, “We think and continue to think that the McNulty memo is working and has worked.” Joe Palazzolo, \textit{Former U.S. Attorneys Assail McNulty Memo}, Legal Times (June 23, 2008), available at: http://www.law.com/jsp/article.jsp?id=1202422462137.
Whereas the proposed legislation restricts all agents and attorneys of the United States from engaging in the restricted practices, the proposed DOJ guidance affects only DOJ prosecutors. While the Justice Department cannot mandate conduct by other agencies, those seeking to remedy the “culture of waiver” that was created by DOJ policies and that has, as noted above, permeated other agencies, may prefer a legislative remedy that extends beyond DOJ to other regulatory agencies.

**Conclusion**

Whether the proposed new DOJ guidance set forth in the Filip letter is sufficient to stave off legislative action will become clear in the near future. In any event, it is likely that, either through legislative action or internal DOJ revisions, the McNulty memo will not be the controlling authority on privilege waiver and related issues for much longer.

However, even if the McNulty memo is formally superseded, pressure for privilege waivers to gain cooperation credit for disclosing relevant information (which would still be permitted under the proposed DOJ guidelines) will remain part of the fabric of government investigations of corporations, at least to some extent, for the foreseeable future. The privilege waiver demands facilitated by the Thompson memo, and ameliorated only to some degree by the McNulty memo, have in recent years become embedded in the expectations, sometimes unstated, between prosecutors and white-collar defense lawyers. Neither the issuance of a new memo nor even the passage of legislation, will change those expectations overnight because the very same practices previously approved in writing may now instead be undertaken with an unreviewable wink and a nod rather than through explicit DOJ authorization. It will take a sustained period of time for the damage done to the attorney-client privilege to be fully repaired, but it is a project very much worth the time and the effort.