Message from the Chair

After a brief hiatus, we are pleased to announce the reconstituted Banking Law Committee Journal, under the leadership of Travis Nelson of Reed Smith LLP. In this edition of the Journal, we see an example of the expansive variety of backgrounds and practices of our Committee's members. Paul Belanger, Dawn Jetten, and Vladimir Shatiryan of Blake, Cassels & Graydon LLP in Toronto, Canada, provide helpful insights into cross-border lending by U.S. institutions into the Canadian market. Andrea Shaw of TD Bank, NA, and Adrianna DeRice of the University of Maine, both in Portland, ME, provide a witty and insightful commentary on the disparate impact analysis under the Equal Credit Opportunity Act. Robert Jaworski, of Reed Smith LLP in Princeton, NJ, offers his views on the application of the Sixth Circuit's decision in Carter v. Welles-Bowen, Inc. on HUD's affiliated business arrangement test. Elizabeth Bohn of Carlton Fields in Miami, FL, has provided a survey of recent CFPB's issues in the area of mortgage lending and servicing. Adam Hall of Crowe & Dunlevy in Oklahoma City, OK, offers advice on commercial transactions issues. Steve Harvey of Steve Harvey Law LLC and Seth Stern provide a very timely analysis of a March 21, 2014 decision from the D.C. Circuit that constitutes a significant victory for banks and credit unions. Valerie Hamm of The Hamm Law Group in Tampa, FL, offers her views on the FDIC's guidance issued last fall regarding D&O liability policies. Nancy Sparrow and Carolyn Payne from e-farmcredit.com in Louisville, KY point out some common pitfalls of the amended ECOA valuations rule. Finally, Stephen Hladik, Pamela Cunningham, and Gordon Miller, of Hladik, Onorato & Pearson, LLP, in North Wales, PA, discuss the potential liability of MERS for assignment of mortgage recording fees. This collection of authors, who come from throughout the U.S. and from Canada, who are in-house counsel as well as practitioners at a variety of firms from small boutique shops to among the largest international law firms, and who practice in a wide variety of areas of financial services law, truly show that the Banking Law Committee is a big tent that offers something for members of all backgrounds.

William F Kroener III
Chair, Banking Law Committee

Featured Articles

Sixth Circuit Invalidates HUD's Ten Factor Affiliated Business Arrangement Test
By Robert M. Jaworski

The U.S. Department of Housing and Urban Development ("HUD") recently suffered another setback in court with respect to its administration of the Real Estate Settlement Procedures Act ("RESPA"). RESPA broadly governs the residential real estate settlement services industry and, in particular, § 8 of RESPA prohibits the payment of incentives for the referral of settlement service business. A HUD interpretation of § 8 was recently discounted by the U.S. Supreme Court in the Quicken Loans case when the Court refused to give Chevron deference to HUD's position, expressed in a 2001 Statement...
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DC Circuit Sides with Federal Reserve Board on Meaning of Durbin Amendment to Dodd-Frank Act
By Stephen G. Harvey and Seth William Stern

On March 21, 2014, in a significant victory for banks and credit unions that issue debit cards and for the companies that own and operate debit card networks (i.e., Visa and MasterCard), the DC Circuit upheld the Federal Reserve Board's Regulation II, which implemented the Durbin Amendment to the Dodd-Frank Act by capping interchange fees for large issuers at 21 cents plus 5 basis points for fraud losses. It also requires banks to offer only two unaffiliated networks for processing debit card transactions.

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Disparate Impact - The Equivalent of the "Little Black Dress"
By Andrea Shaw and Adrianna DeRice

Let's face it: the "little black dress" is a staple in every woman's wardrobe. It's practically a uniform that is issued to you upon reaching adulthood. Disparate impact theory of discrimination has become the regulatory agencies' "little black dress." They all are aware of it and are wearing it at every opportunity. This article focuses on current trends in fair-lending enforcement, specifically in the context of disparate impact, or what we have come to think of as "the little black dress" of the fair-lending enforcement world. Although there are multiple theories federal and state regulatory agencies can use to combat discrimination, disparate impact is getting all the attention. This article provides an overview of the theory and insight on current enforcement trends by the Department of Justice ("DOJ") and the regulatory agencies that supervise financial institutions: the Consumer Financial Protection Bureau ("CFPB"), the Federal Deposit Insurance Corporation ("FDIC"), and the Office of the Comptroller of the Currency ("OCC") (collectively, the "Regulatory Agencies").

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Cross-Border Lending to Canada: Canadian Regulatory Considerations
By Paul Belanger, Dawn Jetten and Vladimir Shatiryan

Canada has a highly concentrated financial sector with six large Canadian domestic banks holding 93 percent of all bank assets - one of the highest concentration levels in G7 countries. Perhaps because of this, there is a growing interest by U.S. and other foreign lenders to participate in the Canadian financial sector. Currently, 24 foreign bank subsidiaries and 27 foreign bank branches operate in Canada with a total of Can$185.9 billion assets in Canada, compared to Can$3,663 billion held by Canadian domestic banks. Foreign banks also participate in the Canadian financial sector by making cross-border bilateral and syndicated commercial loans to Canadian borrowers without maintaining an authorized presence in Canada. These cross-border lending activities have become more prevalent since 2008 after the Government of Canada eliminated the withholding tax on arm's length outbound interest payments made by Canadian borrowers to non-resident lenders. The purpose of the elimination of the withholding
tax, as Canada's Department of Finance put it, was to "increase access to foreign capital markets and reduce costs for Canadians and Canadian businesses that borrow from foreign lenders."

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FDIC Issues Warning Over D&O Liability Policies and Civil Money Penalties
By Valerie J. Hamm

Concerned over a recent upswing in D&O policy exclusions and provisions negatively impacting insurance coverage, the Federal Deposit Insurance Corporation ("FDIC") recently released an Advisory Statement entitled "Director and Officer Liability Insurance Policies, Exclusions, and Indemnification for Civil Money Penalties" (FIL 47-2013, October 10, 2013). In the Advisory, the FDIC reminded insured depository institutions and their directors and officers that D&O liability insurance remains an important risk mitigation tool, and cautioned that exclusions contained in D&O policies could both impair the recruitment and retention of qualified management, and subject management to the very real possibility of personal liability for damages should they be sued. The FDIC also warned institutions and their management that insured depository institutions cannot purchase insurance to indemnify directors and officers against Civil Money Penalties ("CMPs"), even in the event the directors and officers reimburse the institution for the premiums used to purchase the coverage.

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Creditors Beware: Common Pitfalls of the Amended ECOA Valuations Rule
By Nancy J. Sparrow and Carolyn L. Payne

A common misconception of the tidal wave of new regulations that went into effect during January 2014 is that the rules only applied to consumer purpose loans. For a majority of the new rulemakings, the regulations promulgated by the Consumer Financial Protection Bureau ("CFPB") did in fact only impact loans made primarily for personal, family or household needs. However, amendments to the Equal Credit Opportunity Act's regulations regarding appraisals apply to both consumer and business purpose credit extensions. Additionally, the CFPB expanded the rule's applicability to now include credit unions, which used to be exempt from ECOA's appraisal requirements. This article examines the amended appraisal requirements and best practices for successful implementation of the amended rule.

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CFPB's Focus and Enforcement Activity: Mortgage Origination and Servicing
By Elizabeth Bohn

Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 20102 ("the Act") created and authorized the Consumer Financial Protection Bureau ("CFPB" or "the Bureau") to implement, examine for compliance with, and enforce "Federal consumer financial law." Under the Act, CFPB has regulatory, supervisory, and enforcement authority of depository institutions and credit unions with total assets of more than $10 billion, as well as certain nonbanks, regardless of size, including mortgage companies, originators, brokers, and servicers.

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A Case Study of the Enforceability of Yield Maintenance Clauses
By Adam C. Hall

http://apps.americanbar.org/buslaw/committees/CL130000pub/newsletter/201404/
With interest rates at historically low levels following the financial crisis of 2008, many commercial borrowers have challenged the enforceability of yield maintenance prepayment clauses contained in commercial real estate loan documentation. These challenges have given rise to a considerable amount of case law that is instructive as to what might constitute a properly drafted yield maintenance prepayment clause and whether a properly drafted yield maintenance prepayment clause is enforceable. This article provides a brief case study of the enforceability of yield maintenance prepayment clauses that are commonly found in commercial real estate loans.

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Is Mortgage Electronic Registration Systems, Inc. Liable for Assignment of Mortgage Recording Fees?
By Stephen M. Hladik, William E. Miller and Pamela L. Cunningham

In a battle playing out across the country in multiple forums, there is a debate about whether the Mortgage Electronic Registration Systems, Inc. or its parent corporation MERSCORP, Inc. (hereafter, MERS) is liable to the local county recorder of deeds offices for recording fees for assignments of mortgage. This article examines the types and locations of the cases, the status and the legal questions involved. The article also focuses on the matter currently pending in the United States District Court for the Eastern District of Pennsylvania where the Montgomery County Recorder of Deeds, Nancy J. Becker, has recently succeeded in obtaining class certification in her action against MERS.

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Sixth Circuit Invalidates HUD’s Ten Factor Affiliated Business Arrangement Test

By Robert M. Jaworski, Esq.

The U.S. Department of Housing and Urban Development ("HUD") recently suffered another setback in court with respect to its administration of the Real Estate Settlement Procedures Act ("RESPA"). RESPA broadly governs the residential real estate settlement services industry and, in particular, § 8 of RESPA prohibits the payment of incentives for the referral of settlement service business. A HUD interpretation of § 8 was recently discounted by the U.S. Supreme Court in the Quicken Loans case when the Court refused to give Chevron deference to HUD’s position, expressed in a 2001 Statement of Policy, that a fee need not be split or shared between two parties for § 8(b) of RESPA to be violated. Now comes the Sixth Circuit’s decision in Carter v. Welles-Bowen, Inc., decided November 27, 2013, in which the court refused to give deference to a 1996 HUD Statement of Policy concerning “affiliated business arrangements” ("AfBAs"). As in the Quicken Loans case, the Bureau of Consumer Financial Protection, which took over the administration of RESPA from HUD in 2011, was also a loser here, having unsuccessfully intervened in support of HUD’s position.

Section 8 of RESPA

Section 8(a) of RESPA prohibits a person from giving or receiving a “thing of value” pursuant to an agreement or understanding” that settlement service business will be referred. Section 8(b) prohibits the sharing or splitting of a fee for the rendering of a settlement service “other than for

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1  12 U.S.C. 2601 et seq.
3  No. 10-3922 (6th Cir. 2013).
services actually performed.” RESPA provides for both civil and criminal penalties for violations of § 8, and class actions are possible.

RESPA, however, exempts AfBAs from the prohibitions in § 8. An AfBA is defined in RESPA as essentially an arrangement in which a person who is in a position to refer settlement service business has an affiliate relationship with a settlement service provider. Despite that the affiliated person has an obvious financial incentive to refer business to the AfBA, § 8(c)(4) of RESPA states that nothing in § 8 shall be construed as prohibiting AfBAs so long as: (1) the referring person gives the consumer, at the time of the referral, a specific disclosure describing the nature of the relationship between the referring person and the AfBA, indicating that use of the AfBA is not required and including an estimate of the AfBA’s fee; (2) the consumer is not required to use the AfBA; and (3) the only thing of value received by the referring person from the AfBA is a return on ownership interest.

The 1996 HUD Statement of Policy

Regulation X⁴ was adopted by HUD to implement the provisions of RESPA, and § 15 of Regulation X⁵ essentially restates the statutory conditions under which a person may qualify for the AFBA exemption. Over the years, HUD issued few changes to Regulation X, choosing instead to use the “statement of policy” device to issue policy pronouncements, generally without adhering to notice and comment procedures that apply to rule changes. One such policy pronouncement was the 1996 HUD Statement of Policy on AfBAs (the “AfBA SOP”).⁶

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⁵ 12 CFR 1024.15.
In the AfBA SOP, HUD declared that for an AfBA created by two existing settlement service providers to be eligible for the exemption in RESPA § 8(c)(4), the AfBA, in addition to satisfying the three statutory conditions, must qualify as a “bona fide” settlement service provider. HUD then listed ten factors and four questions that it would consider in determining, for enforcement purposes, whether or not an AfBA is a bona fide provider. For example, the ten factors included such things as “Does the new entity perform all of the substantial services itself? Or does it contract out part of the work? If so, how much of the work is contracted out?” and “If the new entity contracts out some of its essential functions, does it contract services from an independent third party? Or are the services contracted from a parent, affiliated provider or an entity that helped create the controlled entity? If the new entity contracts out work to a parent, affiliated provider or an entity that helped create it, does the new entity provide any functions that are of value to the settlement process?”

HUD apparently believed that “sham” entities were created to circumvent the prohibitions in RESPA § 8 and justified its issuance of the AfBA SOP based on its general regulatory authority under RESPA.7

The Facts in Carter

Erick and Whitney Carter bought a home in 2005 through the Welles-Bowen real estate agency. They were referred by Welles-Bowen to WB Title for their title work. WB Title is an AfBA jointly owned by Welles-Bowen and Chicago Title Insurance Company (“Chicago Title”). WB Title performed some of the Carters’ title work itself but contracted most of it to Chicago Title.

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7 12 USC 2617(a) authorizes HUD “to prescribe such rules and regulations, to make such interpretations, and to grant such reasonable exemptions for classes of transactions, as may be necessary to achieve the purposes of this chapter.”
Relying on the AfBA SOP, the Carters sued claiming that the arrangement between Welles-Bowen, WB Title and Chicago Title was a sham designed to funnel referral fees from Chicago Title to Welles-Bowen in violation of Section 8(a). When the district court dismissed their complaint, the Carters appealed to the Sixth Circuit.

The Sixth Circuit’s Decision

In deciding whether or not the Carters’ complaint stated a viable cause of action, the Sixth Circuit refused to consider the various factors and questions laid out in the AfBA SOP. It did so for several reasons.

First, the court held that the AfBA SOP was not entitled to *Chevron* deference because *Chevron* “comes into play only when an agency offers a binding interpretation of a statute that it administers.” The court determined that the AfBA SOP did not constitute a “binding interpretation.” According to the words used in AfBA SOP itself, it merely informs the public that HUD plans to “consider” the factors listed in the AfBA SOP when determining whether to pursue RESPA enforcement cases. The court therefore characterized the AfBA SOP as merely “non-binding advice about [HUD’s] enforcement agenda, not a controlling interpretation of the statute.”

Second, citing prior Supreme Court precedent, the court determined that (i) an agency interpretation is entitled to receive *Chevron* deference only if “Congress delegated authority to the agency generally to make rules carrying the force of law, and … the agency interpretation claiming deference was promulgated in the exercise of that authority,” and (ii) since policy statements do not speak “with the force of law,” “interpretations contained in policy statements … do not warrant Chevron-style deference.”
Third, the court observed that RESPA is both civil and criminal statute and that “a bedrock principle of American law requires the government to give the people fair notice of what conduct it has made a crime.” Based on these observations, the Court held that it was precluded from “supplementing the safeguards expressed on the face of the statute with a multi-factor blend that the statute nowhere mentions.”

Expanding on this point, Judge Sutton, in a lengthy concurring opinion, discussed how the rule of lenity (a rule of statutory construction requiring that when courts interpret laws with criminal applications, they must resolve uncertainties in favor of the defendant) interacts with *Chevron* (which requires courts to give deference to reasonable agency interpretations of ambiguous statutes). Because the rule of lenity derives, in large measure, from a belief that only Congress has the power to make an action criminal, Judge Sutton opined that administrative agencies (which are part of the executive branch) as well as courts must apply the rule of lenity when interpreting statutes under their jurisdiction that criminalize conduct. He then concluded that the AfBA SOP is invalid since it impermissibly resolves ambiguities in the law against the defendant.

Fourth, the Court held that the AfBA SOP was not even entitled “to weight in proportion to its persuasiveness,” under *Skidmore v. Swift & Co., i.e.*, because the 10-factor test is presented in the AfBA SOP only as “guidelines that [HUD] intends to consider” and not as its definitive interpretation of the Act. Moreover, the imprecision of the AfBA SOP’s 10-factor test, the Court found, was not “compatible with the imperative to provide fair warning in the criminal context.”

Finally, the Court rejected plaintiffs’ argument that the reference in RESPA § 8(c)(4) itself to a “provider of settlement services” was intended to mean “bona fide provider of settlement
services.” The natural interpretation of “provider of settlement services,” the Court stated, was simply “one who provides settlement services,” which the plaintiffs had already conceded WB Title does. Additionally, the Court contrasted Congress’ use of the phrase “bona fide” in another exception to Section 8 (“the payment to any person of a bona fide salary or compensation or other payment for goods or facilities actually furnished or for services actually performed”) with its failure to include that phrase in Section 8(c)(4), finding that “[t]his disparity confirms that the latter exception does not call upon courts to conduct a freestanding inquiry into a provider’s bona fides unconnected to the safe harbor test already baked into the statute.”

Since the Carters conceded that WB Title satisfied the three conditions set forth in the statute to qualify for the safe harbor and performed at least some settlement services, the Court concluded that their complaint failed to state a cause of action for violation of Section 8 of RESPA and was therefore properly dismissed by the district court.

**What now?**

RESPA practitioners have long advised clients seeking to create an AfBA in conjunction with another settlement service provider to fulfill as many as possible of the ten factors listed in the 1996 SOP, and to ensure that the AfBA’s profit distributions do not raise any of the four questions raised in the AfBA SOP. In many cases, doing so resulted in duplication of effort and increased expense. If the Sixth Circuit’s decision is not appealed, settlement service providers doing business in the Sixth Circuit may be able to establish new AfBAs and/or revise how their existing AfBAs are structured and engage in business, without some of the complications necessitated by adherence to the AfBA SOP.

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8 12 USC 2607(c)(2).
It will be interesting to see where this case goes from here and whether its reasoning will be adopted by other courts around the country. Likewise, it will be interesting to see whether other courts, in deciding claims brought under RESPA § 8 which rely upon a HUD (or CFPB) interpretation of an ambiguous statutory provision, will adopt the reasoning in Judge Sutton’s concurring opinion.

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Robert M. Jaworski is a partner in the Financial Services Regulatory Group of Reed Smith, LLP in Princeton, New Jersey. He is a former Deputy Commissioner of the New Jersey Department of Banking, the immediate past Chair of the New Jersey Bar Association’s Banking Law Section, a former Co-Chair of the RESPA and Housing Finance Subcommittee of the American Bar Association’s Consumer Financial Services Committee and the former Editor of Pratt’s Mortgage Compliance letter, a national publication on mortgage compliance issues. Mr. Jaworski provides federal and state compliance and regulatory advice and assistance to banks, mortgage lenders and other consumer financial services providers and regularly assists Reed Smith litigators in defending financial institutions in individual and class actions. He is also a frequent speaker before financial institution groups and, has authored numerous articles on consumer financial services regulatory issues.

Mr. Jaworski would like to thank his partner, Leonard A. Bernstein, Esq., for his extremely valuable assistance in preparing this article.
On March 21, 2014, in a significant victory for banks and credit unions that issue debit cards and for the companies that own and operate debit card networks (i.e., Visa and MasterCard), the DC Circuit upheld the Federal Reserve Board’s Regulation II, which implemented the Durbin Amendment to the Dodd-Frank Act by capping interchange fees for large issuers at 21 cents plus 5 basis points for fraud losses. It also requires banks to offer only two unaffiliated networks for processing debit card transactions.

The decision represents a reversal of fortune for the retailers who challenged Regulation II and won in the trial court. In July 2013, federal district judge Richard Leon chastised the Fed for supposedly ignoring the clear intent of Congress, but the court of appeals in reversing Judge Leon laid the blame on Congress: “Congress put the Board, the district court, and us in a real bind. Perhaps unsurprising given that the Durbin Amendment was crafted in conference committee at the eleventh hour, its language is confusing and its structure convoluted.”

The DC Circuit decision upholding Regulation II, with the exception of one minor issue remanded to the Fed, resolves any uncertainty about Regulation II, barring review by the Supreme Court, which is unlikely.

Retailers have been fighting with card issuers and the Visa/MasterCard networks about fees on credit and debit card transactions for years. Sometimes called “swipe fees,” interchange fees...
fees compensate issuers for their role in processing transactions. The networks themselves charge separate fees as do the banks that accept the transactions for the retailers. But interchange fees are clearly the biggest. By 2009, interchange and network processing fees had reached, on average, 55.5 cents per transaction, including 44 cents of interchange fee. Congress stepped into this dispute in a big way with the Durbin Amendment to the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010.

The Durbin Amendment set standards and rules governing debit fees and transactions to issuers with assets exceeding $10 billion. Specifically, it directed the Federal Reserve Board to establish standards for determining whether debit card interchange transaction fees are “reasonable and proportional to the cost incurred by the issuer with respect to the transaction[s].” It required the Fed to consider incremental costs related to authorization, clearing, and settlement (“ACS”), and prohibited the consideration of issuer costs not specific to a particular transaction. It also instructed the Fed to prescribe rules related to maintaining network non-exclusivity for routing debit transactions, in order to ensure that issuers and networks do not restrict the number of payment card networks for processing transactions.

In 2011, the Federal Reserve Board promulgated Regulation II to implement the Durbin Amendment. Regulation II caps the interchange fee permitted by issuers in connection with debit card transactions at 21 cents per transaction, plus five basis points. In setting this cap, the Fed followed Durbin’s command to consider express incremental ACS costs and exclude costs

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3 Id. at 7.
6 Id. § 1693o-2(a)(2).
7 Id. § 1693o-2(a)(4)(A)-(B).
8 Id. § 1693o-2(b)(1)(A)-(B).
10 12 C.F.R. § 235.3(b).
not specific to a particular transaction, but it also included costs specific to a transaction on which the statute was otherwise silent. The Fed also provided issuers the option to receive up to an additional one-cent fraud prevention adjustment per transaction if they satisfied fraud-prevention standards.\textsuperscript{11}

Regulation II requires issuers to provide for network non-exclusivity by ensuring that at least two unaffiliated networks are available for each debit card transaction, but not necessarily two unaffiliated networks for each type of authorization method.\textsuperscript{12} For example, an issuer can comply with Regulation II by enabling a signature-based network and an unaffiliated PIN-based network for debit transactions, instead of two unaffiliated networks each with signature and PIN capabilities.

In November 2011, upset with the high interchange fee cap, a group of representing retailers (NACS, the National Retail Federation, the Food Marketing Institute, Miller Oil Co., Inc., Boscov’s Department Store, LLC, and the National Restaurant Association) filed suit against the Fed in U.S. District Court for the District of Columbia.\textsuperscript{13} The action, \textit{NACS v. Board of Governors of the Federal Reserve System}, assigned to Judge Richard J. Leon, claimed that the interchange fee and network non-exclusivity provisions of Regulation II were “arbitrary, capricious, an abuse of discretion, and otherwise not in accordance with the law.”\textsuperscript{14} This required analysis under the principles set forth in the Supreme Court’s decision in \textit{Chevron, U.S.A., Inc. v. Natural Resources Defense Council}.\textsuperscript{15}

In \textit{Chevron}, the high court held that any court reviewing agency action must first ask whether “the intent of Congress is clear” as to “the precise question at issue” by “employing

\begin{footnotesize}
\begin{tabular}{ll}
\textsuperscript{11} & Id. § 235.4(a). \\
\textsuperscript{12} & Id. § 235.7(a)(2). \\
\textsuperscript{14} & Id. at 96. \\
\textsuperscript{15} & 467 U.S. 837 (1984). \\
\end{tabular}
\end{footnotesize}
traditional tools of statutory construction.” If so, the agency must adhere to the express intent of Congress. But “if the statute is silent or ambiguous with respect to the specific issue,” the court must defer to any agency interpretation that is “based on a permissible construction of the statute,” so long as it is not “arbitrary, capricious, or manifestly contrary to the statute.”

Judge Leon granted the retailers’ motion for summary judgment on July 31, 2013. He held that the Durbin Amendment unambiguously directed the Fed to consider only incremental ACS costs in establishing the interchange fee cap, which would inevitably lead to a lower transaction fee cap. Relying upon a “Chevron Step One” analysis, he concluded that the Fed disregarded the intent of Congress, which did not empower it to “make policy judgments that would result in significantly higher interchange rates.” Judge Leon also found under “Chevron Step One” that the non-exclusivity provisions were inconsistent with the Durbin Amendment. He determined that the statute explicitly required at least two unaffiliated networks be available for each type of authentication used for debit transactions, rather than simply one each for PIN-based and signature-based transactions.

Judge Leon’s decision made news, not only because of the outcome, but also for the tone of chastisement he took with the Fed. For example, in his opinion he used the word “clearly” twenty times to describe the statutory intent. He also began his opinion by observing that “[a]ccording to the Board, [the statute contains] ambiguity that the Board has discretion to resolve. How convenient.”

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16 Id. at 842-43.
17 Id.
18 Id. at 843.
19 NACS, 958 F. Supp. 2d at 97.
20 Id. at 99-109.
21 Id. at 109.
22 Id. at 109-14.
23 Id.
24 Id. at 101.
In litigation, as in life, fate is a fickle friend. The U.S. Court of Appeals for the District of Columbia Circuit reversed Judge Leon’s grant of summary judgment on March 21, 2014. Judge David S. Tatel authored the opinion for the court, and consistent with comments and questions at oral argument, viewed this matter as a “Chevron Step Two” scenario. The court held, with only one minor exception, that the Fed had reasonably interpreted the Durbin Amendment, reversing Judge Leon’s decision, and upholding Regulation II in its present form. The minor exception concerns the division of transaction-monitoring costs between the interchange fees calculation and fraud-prevention adjustment. On this issue the court of appeals remanded to the Fed for further explanation.

In what may be the most interesting part of the decision, the court of appeals applied rules of grammar including punctuation to decide a key issue in the case. The statute commanded the Board not to consider “other costs incurred by an issuer which are not specific to a particular electronic debit transaction.” The issue was whether this clause should be read restrictively or descriptively. Read restrictively, as the Board read it, the clause defines the class of “other costs” issuers are precluded from recovering. Read descriptively, as the retailers urged, it would describe a characteristic of “other costs” without limiting the meaning of “other costs.” This would have greatly broadened the costs that the Board could not consider.

In deciding this issue, the court of appeals consulted leading style and writing manuals, including The Elements of Style by Strunk and White and The Chicago Manual of Style. The court noted that, while careful writers use that to restrict and which to describe, the distinction is considered by some (including Congress) a style preference with which used for both purposes. In contrast, the absence of a comma universally signals the restrictive. As the court noted, in

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26 Id. at 33.
response to the retailers’ suggestion that the court ignore the lack of a comma, “[t]he idea that we should entirely ignore punctuation would make English teachers cringe.” On that basis, the court adopted the Board’s interpretation of the statutory clause as restrictive.

The decision represents a clear victory, not just for English teachers, but also for the banks and credit unions that issue debit cards and for the Visa and MasterCard networks. Interchange fees will not be as high as they were in 2009, but they will not be as low as the retailers urged. It is possible, but unlikely, that the decision will be reviewed either by the en banc court of appeals or by the Supreme Court. At least for the moment, despite the cloudy language of the Durbin Amendment, for all parties impacted by Regulation II there appears to be clarity.

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28 NACS, No. 13-5270, slip op. at 20.
Disparate Impact – the Equivalent of the “Little Black Dress”

By Andrea Shaw, Esq. & Adrianna DeRice

INTRODUCTION

Let’s face it: the “little black dress” is a staple in every woman’s wardrobe. It’s practically a uniform that is issued to you upon reaching adulthood. Disparate impact theory of discrimination has become the regulatory agencies’ “little black dress.” They all are aware of it and are wearing it at every opportunity. This article focuses on current trends in fair-lending enforcement, specifically in the context of disparate impact, or what we have come to think of as “the little black dress” of the fair-lending enforcement world. Although there are multiple theories federal and state regulatory agencies can use to combat discrimination, disparate impact is getting all the attention. This article provides an overview of the theory and insight on current enforcement trends by the Department of Justice (“DOJ”) and the regulatory agencies that supervise financial institutions: the Consumer Financial Protection Bureau (“CFPB”), the Federal Deposit Insurance Corporation (“FDIC”), and the Office of the Comptroller of the Currency (“OCC”) (collectively, the “Regulatory Agencies”).

BACKGROUND

The History of “Disparate Impact”

The disparate impact doctrine, also referred to as the “effects test”\textsuperscript{2}, is triggered “when a lender applies a policy or practice equally to credit applicants, but the policy or practice has a disproportionate adverse impact on applicants from a group protected against discrimination.”\textsuperscript{3} The theory was introduced by the Supreme Court in the employment law context in the 1970s.\textsuperscript{4} In the landmark employment discrimination case of \textit{Griggs v. Duke Power Co.}, the Court admitted that it was facing a question of first impression\textsuperscript{5} and stated that Title VII of the Civil Rights Act of 1964 “proscribes not only overt discrimination but also practices that are fair in form, but discriminatory in operation.”\textsuperscript{6} Specifically, the unlawful employment practices statute provides that: “[i]t shall be an unlawful employment practice for an employer (1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual’s race, color, religion, sex, or national origin; or (2) to limit, segregate, or classify his employees or applicants for employment in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual’s race, color, religion, sex, or national origin.”\textsuperscript{7}

\textsuperscript{1} Andrea Shaw is counsel at TD Bank, NA America’s Most Convenient Bank\textsuperscript{®} and Adrianna DeRice is currently a third year student at the University of Maine School of Law and a JD Candidate for May 2014.


\textsuperscript{6} Id. at 431.

\textsuperscript{7} 42 U.S.C. § 2000e-2(a)(1)&(2) (emphasis added).
Statutes Used to Prevent Discrimination in Lending

The Regulatory Agencies prevent discrimination in lending primarily by enforcing two statutes: the Equal Credit Opportunity Act (“ECOA”) and the Fair Housing Act (“FHA”). We would be remiss if we did not point out that, unlike Title VII of the Civil Rights Act of 1964, the ECOA is noticeably missing language that goes beyond prohibiting overt discrimination. The applicable portion of the statute simply states that: “[i]t shall be unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction—(1) on the basis of race, color, religion, national origin, sex or marital status, or age (provided the applicant has the capacity to contract).”8 The FHA, on the other hand, offers a thorough description of prohibited acts that addresses more than just overt discrimination:

It shall be unlawful:

(a) To refuse to sell or rent after the making of a bona fide offer, or to refuse to negotiate for the sale or rental of, or otherwise make unavailable or deny, a dwelling to any person because of race, color, religion, sex, familial status, or national origin.

(b) To discriminate against any person in terms, conditions, or privileges of sale or rental of a dwelling, or in the provision of services or facilities in connection therewith, because of race, color, religion, sex, familial status, or national origin.

(c) To make, print, or publish, or cause to be made, printed or published any notice, statement, or advertisement, with respect to the sale or rental of a dwelling that indicates any preference, limitation, or discrimination based on race, color, religion, sex, handicap, familial status, or national origin, or an intention to make any such preference, limitation or discrimination.

(d) To represent to any person because of race, color, religion, sex, handicap, familial status, or national origin that any dwelling is not available for inspection, sale, or rental when such dwelling is in fact so available.

(e) For profit, to induce or attempt to induce any person to sell or rent any dwelling by representations regarding the entry or prospective entry into the neighborhood of a person or persons of a particular race, color, religion, sex, handicap, familial status, or national origin.9

Evolution of “Disparate Impact” Law

Despite the fact that the ECOA does not include disparate impact language found in Title VII of the Civil Rights Act of 1964, in 1994, the Interagency Task Force on Fair Lending (consisting of the Department of Housing and Urban Development, the DOJ, the OCC, the Board of Governors of the Federal Reserve System, the FDIC, the Federal Housing Board, the Federal Trade Commission, and the National Credit Union Administration) issued a Policy Statement on Discrimination in Lending (“Policy Statement”).10 The Policy Statement listed evidence of

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9 42 U.S.C. § 3604(a)-(e).
disparate treatment and evidence of disparate impact, along with overt evidence of
discrimination as the three methods of proving lending discrimination under the ECOA and
FHA.\textsuperscript{11} According to the Policy Statement, disparate treatment occurs “when a lender treats
applicants differently based on one of the prohibited factors.”\textsuperscript{12} The prohibited factors include
race, national origin, religion, sex and familial status.\textsuperscript{13} Disparate impact occurs when “a lender
applies a practice uniformly to all applicants but the practice has a discriminatory effect on a
prohibited basis and is not justified by business necessity.”\textsuperscript{14} Though the CFPB was not yet
established at the time the Policy Statement was released, a CFPB Bulletin that was published in
2012 expressed the bureau’s agreement with the methods of proving lending discrimination
outlined in the Policy Statement.\textsuperscript{15} The CFPB supported its adoption of the disparate impact
doctrine under the ECOA by pointing out that the legislative history of the ECOA indicates that
Congress intended the concept of an “effects test” as described by the Supreme Court in the
employment law context, “to be applicable to a creditor’s determination of creditworthiness.”\textsuperscript{16}

In a final rule issued by HUD in 2013, the agency formalized its long standing view that
the FHA “is violated by facially neutral practices that have an unjustified discriminatory effect
on the basis of a protected characteristic, regardless of intent.”\textsuperscript{17}

Additionally, in 2013 the Supreme Court granted certiorari\textsuperscript{18} to review the question of:
“whether disparate impact claims are cognizable under the Fair Housing Act.”\textsuperscript{19} This was the
second time this Supreme Court was prepared to decide on the issue\textsuperscript{20} and also the second time
the case settled prior to arguing in front of the justices.\textsuperscript{21} Since the Supreme Court has shown its
interest in the topic, hopefully, this issue will eventually be heard and the questions relating to
the applicability of disparate impact will be answered, at least in the context of the FHA. If the
Supreme Court decides disparate impact is available under FHA it still leaves the question open
under the ECOA given the different language in the underlying statute.

\textbf{DISCUSSION}

\textsuperscript{11} Policy Statement on Discrimination in Lending, 59 Fed. Reg. at 18268.
\textsuperscript{12} Id.
\textsuperscript{13} Id. at 18266.
\textsuperscript{14} Id. at 18268.
\textsuperscript{15} CFPB Bulletin No. 2012-04 (Apr. 18, 2012)
\textsuperscript{16} 12 C.F.R. § 1002.6
\textsuperscript{17} Implementation of the Fair Housing Act’s Discriminatory Effects Standard, 78 Fed. Reg. 11460, 11460-11461
(Feb. 15, 2013).
\textsuperscript{19} Township of Mount Holly v. Mount Holly Gardens Citizens, Petition for Writ of Certiorari (June 11, 2012).
Citizens-in-Action-Petition.pdf
\textsuperscript{20} Supreme Court Agrees Again to Decide Critical Disparate Impact Questions under the Fair Housing Act (June 17,
2013) http://www.ballardspahr.com/alertspublications/legalalerts/2013-06-17-supreme-court-agrees-again-to-
\textsuperscript{21} New Fair Housing Case Settled, (Nov. 13, 2013) http://www.scotusblog.com/2013/11/new-fair-housing-case-
settled/.
The DOJ is authorized to investigate and file fair lending lawsuits under the ECOA or the FHA.\textsuperscript{22} Pursuant to the ECOA, the bank regulatory agencies are required to refer any patterns and practices of discrimination to the DOJ.\textsuperscript{23} The DOJ then evaluates the referral to determine whether to file suit or return the alleged violation to the referring regulatory agency to proceed with administrative enforcement.\textsuperscript{24}

The DOJ’s Fair Lending Unit in the Civil Rights Division’s Housing and Civil Enforcement Section was established in 2010 by the Attorney General in response to President Obama’s concern with fair lending after the financial crisis.\textsuperscript{25} The Attorney General’s 2012 ECOA Report to Congress highlights the scrutiny on fair lending enforcement since the establishment of the DOJ’s Fair Lending Unit: “[i]n 2011, the Division’s investment in fair came to fruition, producing record-breaking cases in collaboration with other government agencies and other offices within the Department of Justice. In 2012, the Division obtained a record 11 lending settlements that will provide more than $265 million in monetary relief to individual victims and communities harmed by illegal lending practices.”\textsuperscript{26}

Lessons can be learned by the banking and lending industries by paying close attention to the cases brought by the DOJ’s Fair Lending Unit. Many of the cases have similar fact patterns and the enhanced scrutiny on the disparate impact to consumers has created common themes. By understanding the recurring scenarios, lending institutions can proactively evaluate their own practices to avoid practices that result in disparate impact discrimination, and thus the next headline.

(a) Acquiring Portfolios:

In \textit{CFPB \& United States v. National City Bank}, a case brought jointly by the CFPB and the DOJ under the ECOA and FHA in December 2013, the defendant bank originated more than one million home loans in the U.S. through its retail lenders from 2002 to 2008.\textsuperscript{27} Of those mortgages, approximately 36,000 were to African-American borrowers and approximately 34,000 were to Hispanic borrowers.\textsuperscript{28} Additionally, the bank originated more than 600,000 loans in the U.S. through wholesale lending with mortgage brokers from 2003 to 2008.\textsuperscript{29} Of those mortgages, approximately 25,000 were to African-American borrowers and approximately 49,000 were to Hispanic borrowers.\textsuperscript{30} Allegedly, African-American and Hispanic borrowers

\textsuperscript{22} Policy Statement on Discrimination in Lending, 59 Fed. Reg. at 18273.
\textsuperscript{23} See 15 U.S.C. § 1691e(g) (“The agencies . . . shall refer the matter to the Attorney General whenever the agency has reason to believe that 1 or more creditors has engaged in a practice of discouraging or denying applications for credit in violation of section 1691(a) of this title”).
\textsuperscript{24} Attorney General’s 2010 Annual Report to Congress, p. 6.
\textsuperscript{26} Id.
\textsuperscript{28} Id.
\textsuperscript{29} Id.
\textsuperscript{30} Id.
paid more for their home loans than non-Hispanic white borrowers. 31 The plaintiffs allege that the higher prices were not based on the borrowers’ creditworthiness or other risk-related criteria, but rather on their race or national origin. 32

Compensation structures that financially incentivized loan officers to charge overages, a fee charged to borrowers who are over the par rate, and diminish underages, a price adjustment that reduces the par rate of loans, led to the discrimination against African-American and Hispanic borrowers. 33 When PNC acquired National City Bank, it ceased the practice of using third-party mortgage brokers. In addition, PNC did not adopt National City Bank’s origination policies and procedures. 34

The CFPB and DOJ jointly submitted a consent order that was adopted by the U.S. District Court for the Western District of Pennsylvania in January 2014. 35 The consent order required PNC to establish a settlement fund in the amount of $35 million to compensate impacted borrowers. 36

In United States v. Chevy Chase Bank, the DOJ brought an action under the ECOA and FHA to remedy alleged discrimination by Chevy Chase Bank based on race and national origin. 37 The lawsuit originated from a referral by the OCC in 2010 and the DOJ filed the complaint in the U.S. District Court for the Eastern District of Virginia in September of 2013. 38 The OCC began investigating Chevy Chase Bank when it was purchased by Capital One in early 2009 and evidence of discrimination came to light. 39 From 2006 to 2009, Chevy Chase Bank, through its subsidiary retail mortgage companies, originated between 4,000 and 6,500 home loans per year. 40 Additionally, during 2006 and 2007, Chevy Chase Bank originated between 5,000 and 6,000 loans nationwide through wholesale mortgage brokers. 41

The government alleged that Chevy Chase Bank’s compensation structure encouraged loan officers to charge overages and diminish underages and, as a result, African-American and Hispanic borrowers paid higher interest rates and increased fees and costs for their mortgages than non-Hispanic white borrowers. 42 The complaint further alleged that the decision on the part of the loan officers to charge higher rates and increase fees and costs was not based on the borrowers’ creditworthiness or other risk-related criteria, but rather on their race or national origin. 43 The settlement agreement, which was approved by the court in October 2013, required

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31 Id.
32 Id.
33 Id. at p. 2.
34 Id. at p. 2.
36 Id. at p. 3.
38 Id. at pp. 1-4.
39 Id. at p. 4.
40 Id. at p. 1.
41 Id. at p. 2.
42 Id.
43 Id.
Capital One, as successor-in-interest, to establish an account with $2.85 million to compensate victims of Chevy Chase Bank’s alleged discrimination. After acquiring Chevy Chase Bank, Capital One voluntarily refunded 279 Chevy Chase Bank borrowers to compensate for overcharges and claims to have eliminated all discriminatory practices.

Lessons Learned: financial institutions that acquire portfolios must include in due diligence evaluating and assessing fair lending issues. Although not discussed in either settlement agreement, the agencies did not issue civil monetary penalties. The absence of civil monetary penalties in these two cases seems to send the subtle message to financial institutions to review newly acquired portfolios and to address any fair lending concerns thoroughly and swiftly to avoid additional costs. Additionally, a lesson for all financial institutions, whether acquiring portfolios or not, is to avoid discretionary pricing as these practices subject banks to heightened scrutiny and are frowned upon by regulators.

(b) Small Community Banks:

In United States v. Fort Davis State Bank, referred to the DOJ by the FDIC and filed in the U.S. District Court for the Western District of Texas in December 2013, the defendant bank allegedly charged Hispanic borrowers higher interest rates on unsecured consumer loans than non-Hispanic white borrowers. The consent order was approved in January 2014 and required Fort Davis State Bank to make changes to its pricing policies and procedures and to deposit $159,000 into an escrow account to compensate victims of discrimination. In United States v. Community State Bank, also referred to the DOJ by the FDIC, the complaint was filed in the U.S. District Court for the Eastern District of Michigan in January 2013. Community State Bank allegedly violated the FHA and ECOA when it “served the credit needs of the residents of predominantly white neighborhoods in the Saginaw and Flint metropolitan areas to a significantly greater extent than it served the credit needs of majority African-American neighborhoods.” Specifically, the complaint alleged that Community State Bank engaged

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47 At the close of 2013, Fort Davis State Bank held $68,155,000 in assets. See http://www2.fdic.gov/IDASP/main.asp (Apr. 7, 2014).
51 At the time the consent order was approved, Community State Bank held just shy of $196,000,000 in assets. See http://www2.fdic.gov/IDASP/main.asp (Apr. 7, 2014).
discriminatory racial redlining practices by avoiding servicing neighborhoods with substantial African-American populations.\textsuperscript{53}

The consent order, approved in March 2013, required Community State Bank to serve a lending area as specified by the FDIC, expand by opening a new branch within a census tract made up of a majority of African-American populations in Saginaw, and invest $165,000 in advertising, community development, and credit extension programs geared towards residents of African-American communities.\textsuperscript{54} Lessons Learned: banks of all sizes, including small community banks, should be on notice that the DOJ and financial regulatory agencies are scrutinizing lending practices for discrimination. All banks should be aware that all prudential regulators are actively making fair lending enforcement referrals to the DOJ.

CONCLUSION

Just like the “little black dress” that has been a fashion staple for years, the Regulatory Agencies’ utilization of disparate impact theory as an enforcement tool is not likely to go away anytime soon. Financial institutions need to be aware of the shift in regulatory scrutiny in this area since the creation of both the CFPB and the DOJ’s Fair Lending Enforcement Unit. Although the statutes underlying the enforcement actions have not changed, the resources dedicated to identifying disparate impact in lending have increased greatly. In addition to the lessons identified above (need for strong due diligence pre-acquisition, strong portfolio monitoring, and swift corrections post–acquisition, regardless of the size of the financial institution) financial institutions need to increase their internal resources (both in terms of preventing concerns by more effort dedicated to spotting potential issues when creating or changing lending products and in post change monitoring) dedicated to these issues in order to keep pace with the increased resources and scrutiny from the Regulatory Agencies. What do you wear with your “little black dress”? We recommend anything but an enforcement action!


\textsuperscript{54} \textit{Id.} at pp. 5-14.
Cross-Border Lending to Canada: Canadian regulatory considerations

Paul Belanger, Dawn Jetten & Vladimir Shatiryan
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Canada has a highly concentrated financial sector with six large Canadian domestic banks holding 93 percent of all bank assets - one of the highest concentration levels in G7 countries. Perhaps because of this, there is a growing interest by U.S. and other foreign lenders to participate in the Canadian financial sector. Currently, 24 foreign bank subsidiaries and 27 foreign bank branches operate in Canada with a total of Can$185.9 billion assets in Canada, compared to Can$3,663 billion held by Canadian domestic banks. Foreign banks also participate in the Canadian financial sector by making cross-border bilateral and syndicated commercial loans to Canadian borrowers without maintaining an authorized presence in Canada. These cross-border lending activities have become more prevalent since 2008 after the Government of Canada eliminated the withholding tax on arm's length outbound interest payments made by Canadian borrowers to non-resident lenders. The purpose of the elimination of the withholding tax, as Canada’s Department of Finance put it, was to “increase access to foreign capital markets and reduce costs for Canadians and Canadian businesses that borrow from foreign lenders.”

Although this tax disincentive was eliminated, foreign banks without an authorized presence in Canada continue to face a broad legislative prohibition under the Bank Act (Canada) against carrying on business in Canada. As a result, such foreign banks are required to structure their lending activities with residents of Canada cross-border, by maintaining minimal “touch points” with Canada to ensure that they do not carry on business in Canada contrary to the Bank Act.

The discord between the policy reasons underlying the elimination of withholding tax in 2008 and the Bank Act prohibition against foreign banks carrying on business in Canada without an authorized presence reflects a long-standing policy tension in Canada between increasing

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The views expressed in this article are entirely those of the authors and do not reflect the opinions of Blake, Cassels & Graydon LLP or any of its clients.


3 Ibid, at 30, 38.


5 SC 1991, c 46 [Bank Act].
competition in Canada’s financial sector on the one hand, and maintaining a level playing field between Canadian and foreign banks on the other.

The Bank Act Prohibition

Subsection 510(1) of the Bank Act includes the following broad prohibition:

Prohibited activities

510. (1) Except as permitted by this Part [XII], a foreign bank or an entity associated with a foreign bank shall not

(a) in Canada, engage in or carry on

(i) any business that a bank is permitted to engage in or carry on under this Act, or

(ii) any other business;

(b) maintain a branch in Canada for any purpose.

The effect of paragraphs 510(1)(a) and (b) is that a foreign bank or an entity associated with a foreign bank (as discussed below) is not permitted to engage in or carry on any business in Canada or maintain a branch in Canada, except as permitted by Part XII of the Bank Act. Part XII permits a foreign bank to establish a subsidiary or branch in Canada with the approval of the Minister of Finance, subject to satisfying applicable legislative and regulatory requirements.

The Bank Act prohibition is broadly drafted; however, it expressly applies to activities that are carried on “in Canada”. As a result, a distinction has been drawn between engaging in Canada in an activity (which is prohibited by subsection 510(1) of the Bank Act) and engaging in the same activity from outside Canada cross-border with residents of Canada (which is permitted). This distinction has been accepted by the Office of the Superintendent of Financial Institutions (“OSFI”) – Canada’s main banking regulator – in a variety of different circumstances. A number of OSFI rulings address this issue and provide guidance as to what factors are relevant, although each situation is dependent on the facts. Further, OSFI rulings have confirmed that some activity in Canada by or on behalf of the foreign bank is acceptable; provided that such activity is ancillary to the main business activity of the foreign bank undertaken from outside Canada. OSFI rulings also indicate that policy concerns may impact OSFI’s determination whether cross-border dealings with Canadians constitute the carrying on of business in Canada. Specifically, there is a heightened sensitivity in respect of transactions that include cross-border deposit

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6 There are also other prohibitions that apply to the activities and investments of a foreign bank in Canada.
7 Certain other exceptions under Part XII apply which, for the most part, are not relevant in connection with cross-border loans.
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taking. In addition, consumer lending programs generally have more connecting factors to Canada and raise consumer protection issues and, as a result, can be more difficult to structure across the border without contravening the Bank Act.

Who is Subject to the Prohibition?

The Bank Act prohibition applies to foreign banks and certain entities associated with foreign banks. For the purposes of this prohibition, the following entities are considered foreign banks:

a. an entity that is a bank according to the laws of the jurisdiction of its incorporation or any jurisdiction in which it carries on business;

b. an entity that is regulated as a bank or as a deposit-taking institution according to the laws of the jurisdiction of its incorporation or any jurisdiction in which it carries on business; or

c. an entity that engages in the business of providing financial services and employs, the word “bank” or “banking” or any corresponding words in other languages to identify or describe its business.\(^8\)

The definition of an entity associated with a foreign bank is more complex. It is defined to include entities that control or are controlled by a foreign bank and entities that are controlled by the same person as the foreign bank.\(^9\) There are, however, important carve-outs from this broad definition for the purposes of the subsection 510(1) prohibition, some of which are tied to materiality thresholds established under the Bank Act.\(^10\) This is an area where care needs to be taken to consider whether a non-bank entity in a corporate group that includes a foreign bank is an “entity associated with a foreign bank” subject to the Bank Act prohibition before that entity carries on business in Canada.

The Bank Act prohibition also extends to the activities in Canada carried out by an agent or nominee of a foreign bank or an entity associated with a foreign bank.\(^11\) As a result, the foreign bank or the entity associated with the foreign bank cannot circumvent the Bank Act prohibition by enlisting agents or nominees in Canada and carrying out the prohibited activity through them. The term “agent” in this context refers to a common law relationship of agency, while the term

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\(^8\) Bank Act, supra note 5 at s 508(1)(a).

\(^9\) Bank Act, supra note 5 at s 507(2).

\(^10\) Bank Act, supra note 5 at ss 508(1)(b) and 508(2).

\(^11\) Bank Act, supra note 5 ss 510(2)-(3).
“nominee” does not have an established meaning in the jurisprudence and is open to broader interpretation.

If a lender is not a foreign bank or an entity associated with a foreign bank within the meaning of the Bank Act, then the lender would not be subject to the Bank Act prohibition, although certain licensing requirements under Canada’s provincial laws may apply.

**Relevant Considerations**

A number of considerations have emerged from OSFI rulings and caselaw that help determine whether a cross-border activity of a foreign bank or an entity associated with a foreign bank constitutes the carrying on of business in Canada contrary to the Bank Act. As previously noted, this determination is highly fact-specific and often a single connecting factor (or its absence) is not by itself dispositive of the issue. Rather, the considerations set out below outline the factors that OSFI will likely consider in determining if a foreign bank or an entity associated with a foreign bank is carrying on business in Canada in contravention of the Bank Act. For ease of reference, we use the term foreign bank to refer both to foreign banks and entities associated with foreign banks in the discussion below.

**Office or Employees in Canada:** Maintaining a place of business or establishment in Canada, such as an office that is regularly used for an extended period of time by a foreign bank’s employees or nominees or agents is a significant adverse factor in the carrying on business determination. Maintaining an office in Canada will also likely contravene the prohibition against opening a branch in Canada (other than an authorized branch), which is specifically prohibited by paragraphs 510(1)(a) and(b) of the Bank Act.

**Trips to Canada by Foreign Bank’s Employees:** Regular extended visits to Canada by the employees of a foreign bank are also an adverse factor. However, limited visits to Canada to conduct due diligence, audits and inspections or visits occasioned by realization situations are likely to be permitted. Even limited visits, however, when combined with other significant connecting factors may result in a carrying on business determination. Visits for the purpose of the solicitation of business are particularly sensitive, and call for careful analysis in light of any other expected commitments to Canada.

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13 *Club Resorts Ltd v Van Breda* 2012 SCC 17 at para 87, [2012] 1 SCR 572 [*Van Breda*].

Contract Formation and Negotiations: OSFI will consider where the material business contracts are negotiated and executed. Material contracts will include loan documents, such as commitment letters, terms sheets, credit agreements, and security documents, as well as service agreements that a foreign bank enters into with Canadian service providers in certain permitted circumstances. Negotiations that take place in person in Canada will have a significant adverse impact on the carrying on business determination. Therefore, all material negotiations should be conducted by persons located outside of Canada at the times they are negotiating, such as by telephone or by electronic means of communication. Although the foreign bank may engage local Canadian legal counsel to assist with the cross-border transaction, the foreign bank should be careful not to delegate material decision-making authority on business matters to the Canadian counsel. This is to ensure that the Canadian counsel is not viewed as an agent or nominee negotiating in Canada on behalf of the foreign bank. In addition, because the common law rules of contract formation applicable in Canada consider a contract to be executed in the jurisdiction where it was last signed, the foreign bank should ensure that it signs all agreements outside Canada and, if the counterparty signs in Canada, the foreign bank should sign last. This may be difficult to accomplish in the era of email exchanges of PDF signature pages.

Servicing Contracts: OSFI has accepted that foreign banks may utilize services in Canada in connection with cross-border loans if the services are incidental to the lending otherwise carried on from outside Canada. This can be explained in two ways. First, the activity carried out in Canada by the local service provider is such that even if undertaken by the foreign bank, the activity would not amount to carrying on business in Canada. Second, in some cases, OSFI has recognized that because the services carried out in Canada by the local service providers are incidental in nature, the service providers are not considered as agents or nominees of the foreign bank. In such cases, in order for a servicing arrangement to be permitted, it should be carried out by independent Canadian service providers that are not affiliated with the foreign bank and do not work exclusively for the foreign bank. Other permitted services could include valuation services, receivership services and legal services. OSFI rulings also indicate that the use of Canadian service providers for certain aspects of loan servicing or enforcement alone would not be considered carrying on business in Canada. Further, the services provided by an independent


18 OSFI Ruling 2004-06, ibid.
Canadian agent bank on a syndicated loan should fall within this category of permitted services, although this issue has not been specifically considered in OSFI rulings.

**Bank Accounts:** Maintaining bank accounts in Canada to advance loans and receive loan repayments is a significant factor in the carrying on business determination. To reduce the impact of this factor, foreign banks can ensure that loan advances and repayments are effected outside of Canada or through wire payments. Where this is not possible or impractical, such as when the loan is funded in Canadian currency, the foreign bank may consider using flow-through correspondent banking accounts, which will ensure that the foreign bank does not maintain general use accounts in Canada.

**Advertising:** Although Canadian courts have held that advertising in Canada does not by itself amount to carrying on business in Canada,19 advertising specifically directed at residents of Canada is a factor that OSFI will likely consider in the carrying on business determination. Therefore, while having a Website that is accessible from Canada is unlikely to influence a carrying on business determination, advertising or solicitation carried out specifically targeting Canadian borrowers will be a relevant factor.

Where a foreign bank engages in other type of cross-border activities, such as deposit-taking, trade finance or securities trading, other factual, policy and legal considerations may apply in determining whether the activity would be permitted.

**Penalties for Contravention**

The *Bank Act* and the *Office of the Superintendent of Financial Institutions Act* (Canada)20 provide for criminal and administrative penalties for contravening the *Bank Act* prohibition. The administrative penalties are up to Can$ 500,000,21 while criminal penalties on indictment can be as high as Can$ 5 million.22 However, criminal and administrative penalties are rarely imposed. Where a potential violation of subsection 510(1) of the *Bank Act* comes to the attention of OSFI, OSFI normally first requests the foreign bank to explain how its activities do not result in a violation. In the course of discussing such explanation, OSFI might identify particular aspects of the activity that should be changed. Alternatively, OSFI may conclude that the cross-border program as a whole is in breach of subsection 510(1) of the *Bank Act* and must be discontinued if it cannot be remedied by eliminating only some of the connecting points with Canada.

19 *Van Breda*, supra note 13 at para 87.

20 RSC 1985, c 18 (3rd Supp), Part I.

21 *Ibid* at s 28(1).

22 *Bank Act*, supra note 5 at s 980.
OSFI Ruling Process

Contravening the *Bank Act* prohibition may have a significant disruptive effect on a foreign bank’s cross-border lending activities in Canada. OSFI is generally open to discussions with foreign banks on whether a proposed cross-border lending program will be permitted under the *Bank Act*. Foreign banks may also formally request a ruling from OSFI on the proposed program. Although it would be unusual to request a ruling in respect of straightforward commercial loans made to borrowers in Canada and many situations can be addressed by Canadian legal advisors, foreign banks that wish to consider more complex cross-border programs may initiate discussions with OSFI and potentially request a formal ruling on the proposed plan.
FDIC Issues Warning Over D&O Liability Policies and Civil Money Penalties
by Valerie J. Hamm

Concerned over a recent upswing in D&O policy exclusions and provisions negatively impacting insurance coverage, the Federal Deposit Insurance Corporation (“FDIC”) recently released an Advisory Statement entitled “Director and Officer Liability Insurance Policies, Exclusions, and Indemnification for Civil Money Penalties” (FIL 47-2013, October 10, 2013). In the Advisory, the FDIC reminded insured depository institutions and their directors and officers that D&O liability insurance remains an important risk mitigation tool, and cautioned that exclusions contained in D&O policies could both impair the recruitment and retention of qualified management, and subject management to the very real possibility of personal liability for damages should they be sued. The FDIC also warned institutions and their management that insured depository institutions cannot purchase insurance to indemnify directors and officers against Civil Money Penalties (“CMPS”), even in the event the directors and officers reimburse the institution for the premiums used to purchase the coverage.

The FDIC did not cite an exclusion, provision or term in D&O policies that it finds particularly nettlesome, but two types of exclusions – the “insured v. insured” exclusion and the “regulatory” exclusion – are most likely the focus of the FDIC’s attention. The insured v. insured exclusion precludes coverage for losses arising from an intracorporate lawsuit among directors, officers or entities insured under the same policy, while the regulatory exclusion denies coverage for suits against an institution’s directors and officers brought by governmental, quasi-governmental, or self-regulatory agencies. This article will briefly examine the history of the insured v. insured and regulatory exclusions, as well as two recent cases that illustrate the deleterious effect these exclusions can have on D&O insurance coverage. Finally, the article will address the FDIC’s stricture regarding indemnification by insured depository institutions of directors and officers for CMPS.

Insured v. Insured Exclusion

Insurance companies first used the insured v. insured exclusion in the late 1980s to prevent collusion among insured institutions, directors and officers seeking to obtain first party coverage under D&O policies. Insurers objected to what they perceived as backdoor attempts by D&O policy holders to obtain coverage by having an institution sue its own directors and officers to recover losses caused by those directors and officers. For example, in *Nat’l Union Fire Ins. v. Seafirst Corp.*, 662 F.Supp. 36 (W.D. Wash. 1986), Seafirst Corporation (“Seafirst”) sued several of its directors and officers under a D&O policy after the company suffered disastrous losses resulting from loan participations entered into by Seafirst’s energy lending department. Seafirst’s insurer, National Union Fire Insurance, denied coverage, asserting that the D&O policy at issue was never intended to cover losses arising from a suit between two insureds (Seafirst and its own management), and filed a separate suit against Seafirst alleging

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2 See generally 12 U.S.C. 1786(k)(2) and 1818(i)(2).
bad faith, negligent misrepresentation, collusion, and a declaration that there was no coverage under the policy for the directors and officers. The district court held that neither public policy nor the express terms of the D&O policy prohibited coverage.

After Seafirst and similar cases were decided in favor of coverage, insurers began issuing D&O policies containing an exclusion prohibiting coverage for claims made against an insured brought by another insured (i.e., insured v. insured). Most courts have since interpreted the insured v. insured exclusion to preclude coverage only where there was evidence of collusion among the policy holders, and not where federal banking agencies are involved. However, in St. Paul Mercury Insurance Company v. Miller, et al., 2013 WL 4482520 (N.D. Ga. Aug. 19, 2013), the U.S. District Court for the Northern District of Georgia granted a motion for summary judgment filed by the plaintiff, St. Paul Mercury Insurance Company (“St. Paul”), determining that there was no coverage under the D&O policy at issue due to the insured vs. insured exclusion.

The case arose from the failure of Community Bank & Trust of Cornelia, Georgia (“CB&T”), a state-chartered community bank. The FDIC sued two former officers of CB&T, alleging the officers had acted improperly by approving risky loans. St. Paul agreed to provide, under reservation of rights, the cost of defending the officers. Nonetheless, St. Paul later filed a declaratory action naming the former officers and the FDIC as defendants, and sought a determination that the D&O policy’s insured vs. insured exclusion abrogated coverage for the FDIC’s claims.

The language in the exclusion provided that St. Paul would:

“not be liable for Loss on account of any Claim made against any Insured... brought or maintained by or behalf of any insured or Company in any capacity....” (emphasis added).

The court held this provision barring coverage, noting that FIRREA specifies that the FDIC “steps into the shoes” of a failed financial institution when it acts as its receiver. Notably, the court rejected prevailing case law (including that of its sister court in the Northern District of Georgia) which found that when acting as receiver, the FDIC sues not only “on behalf of” a failed institution, but also “on behalf of” itself, third party creditors, depositors, and to replenish the federal Depository Insurance Fund as well. Instead, the court in St. Paul Mercury focused


4 See, e.g., Am. Cas. Co. of Reading, Pa. v. Sentry Fed. Sav. Bank, 867 F.Supp. 50, 60, (“Most courts agree . . . that the obvious intent behind the ‘insured v. insured’ exclusion is to protect [the insurer] from collusive suits among [the entity] and its directors and officers. Such a concern is not implicated here where the [the regulator] is an adverse party, not in collusion with the directors and officers”) (internal citations omitted).


on the plain language of the insured v. insured exclusions in the cases cited by the FDIC as the “majority view,” and found that none of those cases involved the same policy language at issue in *St. Paul Mercury*. The court noted that the regulatory exclusions in those cases merely precluded coverage for claims brought “by” an insured and made no mention of claims brought “on behalf of” an insured as in *St. Paul Mercury*. The court further reasoned that “not applying the exclusion in this context would have the effect of reading the phrase, ‘on behalf of,’ out of the policy in contravention of the rule that requires this court to construe a contract ‘in whole and in every part.’” The case is currently on appeal to the U.S. Court of Appeals for the Eleventh Circuit.8

**Regulatory Exclusion**

In reaction to the wave of S&L failures (again in the late 1980s), insurers similarly began to issue D&O policies containing a second type of exclusion, the regulatory exclusion. This exclusion was initially attacked by banking regulators on public policy grounds, but these attempts were largely unsuccessful.9 Although the prevalence of D&O policies containing the regulatory exclusion steadily decreased as the S&L crisis waned,10 with the advent of the economic crash of 2008, insurers again began to issue policies featuring this exclusion.

In *Reis et al. v. Federal Insurance Co.*, No. CV 11-09835 RSWL (C.D. Cal. July 12, 2013). The plaintiffs were former directors and officers of Alliance Bank of Culver City, California (“Alliance”), a state-chartered commercial bank that failed in February, 2009. The FDIC as receiver for Alliance presented a claim for damages to the plaintiffs who, in turn, demanded coverage from their insurer, Federal Insurance Company (“Federal”). The FDIC later sued Alliance’s former directors and officers in December, 2012, alleging negligence, gross negligence, and breach of fiduciary duty. When Federal declined coverage and refused to advance the costs of defending the FDIC’s claims, the directors and officers sued Federal for declaratory relief, breach of contract and breach of the implied covenant of good faith and fair dealing.

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7 2013 WL 442520 at *4-5.
The D&O policy at issue in *Reis* contained a multi-year policy endorsement which allowed Federal, upon the occurrence of certain triggering events, to impose additional terms and conditions on coverage to take effect at the end of the policy year. Federal opted to add the regulatory exclusion only days\(^\text{11}\) after the plaintiffs notified it of circumstances\(^\text{12}\) triggering Federal’s right to modify the policy.

The court examined the rather unambiguous language of the new regulatory exclusion, which read:

“[A]s respects the Directors & Officers Liability overage Section(s) of this policy, the Company shall not be liable for Loss on account of any Claim by, on behalf of, or at the behest of . . . [the] Federal Deposit Insurance Corporation . . . in any capacity whatsoever.”

The court held that this exclusion quite clearly negated coverage. The court further noted that the exclusion was added the year before the FDIC’s 2009 claim against Alliance’s former directors and officers, and therefore took effect before the FDIC’s claim was made. The court also rejected the plaintiffs’ claim for breach of the implied warranty of good faith and fair dealing, stating “[Federal] was merely acting within its rights when, in response to the occurrence of said transactions and events, it issued the Regulatory Exclusion Endorsement, effective at the end of the 2007-2008 Policy year, and subsequently denied Plaintiffs coverage pursuant to the endorsement.”

**Traps for the Unwary**

The recent holdings in *Reis* and *St. Paul Mercury* illustrate the pitfalls that can occur when management fails to fully grasp the possible limitations of its D&O policy. Undoubtedly, “exclusion creep” will continue to be an issue as insurers draft exclusions and limitations further narrowing the scope of director and officer indemnification. Management – particularly that of troubled institutions – must therefore be proactive in evaluating coverage, or else risk having their personal assets seized in order to satisfy a judgment of liability.

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\(^{11}\) The regulatory exclusion was made effective as of October 17, 2008, which was the end of the 2007-2008 policy year and the beginning of the 2009-2009 policy year.

\(^{12}\) The court did not elucidate on what events triggered Federal’s right to modify the policy; however, it is noteworthy that after the conclusion of a joint examination by the FDIC and the California Department of Financial Institutions (“CDFI”), Alliance entered into a Consent Agreement with the FDIC and the CDFI on October 10, 2008. *See Order to Cease and Desist*, FDIC Docket 08-265b. The FDIC’s Material Loss Review of Community Bank & Trust, Cornelia, Georgia also noted that management received a composite rating of “4” in the October, 2008 joint examination. *See FDIC Office of Inspector General, Office of Material Loss Reviews, Report No. MLR-10-046, September, 2010*. Moreover, Alliance’s parent holding company entered into a Written Agreement (also on October 10, 2008) with the San Francisco Federal Reserve Bank, requiring the company to adopt a capital maintenance plan and obtain a capital infusion. *See Written Agreement by and between Alliance Bancshares California and Federal Reserve Bank of San Francisco*, Federal Reserve Docket No. 08-040-WA/RB-HC.
What steps should prudent management take when considering the purchase or renewal of a D&O policy? According to the FDIC, directors and officers of insured depository institutions should pose the following questions:

- What protections do I want from my institution’s D&O policy?
- What exclusions exist in my institution’s policy?
- Are any of these exclusions new, and if so, will they change my coverage?
- What is my potential personal exposure resulting from each policy exclusion?

Of course, it is also recommended that management itself closely inspect the policy, and consult a knowledgeable insurance broker and attorney who can answer any questions or concerns management may have.

### Prohibition on Indemnification of Civil Money Penalties

The FDIC Advisory also cautioned institutions that they are prohibited from obtaining insurance to be used to pay civil money penalties (“CMPs”) imposed against an institution-affiliated party (“IAP”) by a federal banking agency. CMPs may be assessed against an IAP such as a director or officer in response to a violation of a law or regulation, the commission of unsafe or unsound banking practices, a breach of fiduciary duty, or for engaging in willful misconduct. Penalties may be stiff—a federal banking agency may assess CMPs ranging from $5,000 to $25,000 per day, depending on the violation, and “knowing” violations may bring a penalty of up to $1 million per day against officers and directors.

The FDIC further noted in the Advisory that there is no exception to the prohibition against obtaining insurance to indemnify IAPs, even for cases in which the IAP reimburses the institution or its holding company for the cost of CMP indemnification coverage. In fact, an institution found to have improperly indemnified an IAP may itself commit a violation.

The Advisory was distinctly silent on whether it is permissible for a director or officer to purchase his or her own personal umbrella policy which may offer indemnity coverage for CMPs. Nevertheless, this is undoubtedly a thorny area, and institutions and their management would be wise to consult an experienced banking lawyer when evaluating any policy which purports to offer coverage for CMPs.

### Conclusion

Generally, an IAP is a director, officer, employee or controlling shareholder of an insured depository institution, or a person who participates in the conduct of the affairs of such an institution as determined by a federal banking agency. Under certain circumstances, an independent contractor such as an attorney, appraiser or accountant may likewise be deemed an IAP. See 12 U.S.C. §1813(u).


See 12 C.F.R. §359.3
From January 1, 2007 through March 1, 2014, 497 banks failed.\textsuperscript{17} As the FDIC continues to work through its backlog of failed bank cases (and as the three-year statute of limitations draws nearer for each case), we can expect to see more lawsuits filed against directors and officers of these institutions. It may be too late for them to adjust their insurance coverage, but the directors and officers of those institutions still standing would be wise to conduct a comprehensive review of their D&O policies in order to obtain the broadest possible coverage—just in case. \textit{Praemonitus, praemunitus}.\textsuperscript{18}

\textsuperscript{17} Source: www.fdic.gov. Last accessed March 12, 2014.

\textsuperscript{18} Loosely translated: “forewarned is forearmed.”
CREDITORS BE AWARE: COMMON PITFALLS OF THE AMENDED ECOA VALUATIONS RULE

Nancy J. Sparrow
Carolyn L. Payne

INTRODUCTION

A common misconception of the tidal wave of new regulations that went into effect during January 2014 is that the rules only applied to consumer purpose loans. For a majority of the new rulemakings, the regulations promulgated by the Consumer Financial Protection Bureau (“CFPB”) did in fact only impact loans made primarily for personal, family or household needs. However, amendments to the Equal Credit Opportunity Act’s regulations regarding appraisals apply to both consumer and business purpose credit extensions. Additionally, the CFPB expanded the rule’s applicability to now include credit unions, which used to be exempt from ECOA’s appraisal requirements. This article examines the amended appraisal requirements and best practices for successful implementation of the amended rule.

DISCUSSION

The Equal Credit Opportunity Act (“ECOA”) and its implementing regulations, commonly known as “Reg B”, apply to any “oral or written request for an extension of credit

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6 12 C.F.R. § 1002.01 et seq.
that is made in accordance with procedures used by a creditor for the type of credit requested.”

ECOA generally prohibits creditors from discriminating against applicants based on marital status, among other prohibited factors. Reg B requires, in part, that creditors provide copies of appraisals to applicants developed in connection with an application for credit. In 2013, the CFPB issued a final rule, effective January 18, 2014, which expanded the appraisal delivery requirements under Regulation B referred to as the “ECOA Valuations Rule”. On its face, the rule seems fairly simple and straightforward, nevertheless, there are several important nuances to be aware of during the loan origination process.

In a nutshell, the new ECOA Valuations Rule requires creditors to provide loan applicants with free copies of all appraisals or other written valuations and requires creditors to notify applicants that copies of the same will be provided promptly upon completion or no later than three business days prior to loan consummation or account opening if secured by a first lien on a dwelling. The new rule has two main components. First, an early disclosure regarding the appraisal must be provided within three business days of application. This early notice provides an applicant with information about the right to receive a copy of all written valuations as well as the right to obtain a separate written valuation for the applicant’s benefit and at the applicant’s own cost. Although an applicant has the right to a free copy of any appraisal or other written valuation used in connection with the application, a creditor may charge a reasonable fee for the actual cost. Second, the final version of the appraisal or written valuation must be delivered to the applicant promptly upon completion or within three business days prior to loan

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7 12 C.F.R. § 1002.2(f).
10 Id.
11 12 C.F.R. § 1002.14(a).
consummation or accounting opening (for open-end credit), unless a waiver is provided to allow for delivery at consummation or account opening or within thirty days if the application is denied or withdrawn. The rule applies to all creditors and all applications for credit, regardless of purpose, that are secured by a first lien on a dwelling. The fact that the rule applies to both consumer and business purpose extensions of credit can be especially treacherous for creditors, since the broad applicability crosses many types of loan products. The rule specifically defines the term “dwelling” as a residential structure with one to four units, regardless of whether or not it is attached to real property and it includes individual condos or coop units as well as mobile or manufactured homes.

For the first time, a creditor is required to provide an applicant a written notice within three business days of an application for credit secured by a first lien on a dwelling, regardless of purpose. This disclosure requirement outside of the early disclosures required under the Real Estate Settlement Procedures Act (“RESPA”) and the Truth in Lending Act (“TILA”) signals a significant shift in industry practice. All applications for credit to be secured by a first lien on a dwelling require that the creditor mail or deliver within three business days of application, a written notice that explains an applicant’s right to receive copies of any appraisals or other written valuations developed in connection with the application. The only exception is a renewal, which does not require the appraisal disclosure if a new appraisal is not performed in connection with the transaction. The CFPB has provided sample language that a creditor may

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13 *Id.*
14 *Id.*
15 12 C.F.R. § 1002.14(b)(2).
20 Official Interpretation to 12 C.F.R. § 1002.14(a)(1), Comment 2.
use on its notice which states that the creditor may order and charge for an appraisal and that the creditor is required to provide a copy of the appraisal even if the loan does not close.\textsuperscript{21} The sample notice language also informs the applicant of the right to order an additional appraisal for the applicant’s own use at its own cost.\textsuperscript{22} The sample language states as follows: “We may order an appraisal to determine the property’s value and charge you for this appraisal. We will promptly give you a copy of any appraisal, even if your loan does not close. You can pay for an additional appraisal for your own use at your own cost.”\textsuperscript{23}

The amended rule also expanded the examples of appraisal or other written valuation to include not only reports prepared by an appraiser or internal staff, but automated valuation models and broker price opinions.\textsuperscript{24} Likewise, not all documents that state a value are considered an appraisal or other written valuation under the rule. Specifically, internal documents that merely restate a value, publically available governmental agency statements of value, manufactured homes invoices, property inspections and appraisal reviews that do not state an opinion of value are not considered appraisals or written valuations.\textsuperscript{25}

Prior to the new rule, creditors were required to provide the appraisal either as a routine practice on all extensions of credit or upon the applicant’s request; however, the creditor could charge for that appraisal prior to providing a copy of the same.\textsuperscript{26} In addition, if not delivered

\textsuperscript{21} Appendix C to Part 1002- Sample Notification Form C-9.
\textsuperscript{22} Id.
\textsuperscript{23} Id.
\textsuperscript{24} Official Interpretations to 12 C.F.R. § 1002.14(b)(3), Comment 1.
\textsuperscript{25} Official Interpretations to 12 C.F.R. § 1002.14(b)(3), Comment 3.
routinely on all loans, the applicant had to request a copy within 90 days of receiving notice of action on the application or withdrawal.\textsuperscript{27}

Now, under the amended ECOA Valuations Rule, a creditor must provide the applicant with a copy of any valuation performed on the property promptly upon completion or at least three business days before consummation for closed-end credit or account opening for open-end credit, whichever comes first, regardless of whether or not the applicant has paid for it.\textsuperscript{28} If the application for credit is denied, the creditor must provide the appraisal promptly upon completion unless the applicant waived the deadline.\textsuperscript{29} The final rule does not prohibit a creditor from charging an applicant for the appraisal.\textsuperscript{30} In fact, the sample notice informs the applicant of the creditor’s right to charge for the appraisal.\textsuperscript{31} However, the practical implications of trying to collect an appraisal fee after the appraisal has already been provided to the applicant could prove difficult; especially if the application is denied. Thus, creditors have been forced to re-evaluate when an appraisal fee should be collected during the origination process.

In addition, official interpretations of the rule specifically define what it means to “provide” the appraisal stating that “[f]or purposes of this timing requirement, ‘provide’ means ‘deliver’”.\textsuperscript{32} The appraisal or other written evaluation are deemed “provided” three business days after mailing or delivering the same to the applicant’s last known address or documentation of actual receipt by the applicant, whichever comes first.\textsuperscript{33} Finally, both the initial notice and the appraisal copy may be provided in electronic format as long as they are in compliance with the
consumer consent and other provisions of the E-Sign Act.\textsuperscript{34} The addition of the availability of electronic delivery allows more flexibility to creditors and is in line with other lending regulations that allow for electronic delivery of documents, such as TILA and RESPA.

Under the E-Sign Act, in order to establish consumer consent for purposes of the ECOA Valuations Rule, prior to the applicant’s consent, the creditor must provide a clear and conspicuous statement that contains the following information: (1) informs the applicant of the right to have the notice and/or appraisal in a non-electronic format; (2) the right to withdraw the consent and any consequences related to the withdrawal, if any; (3) the scope for which the consent applies; (4) the procedures to withdraw consent, update electronic contact information, or obtain a paper copy and any applicable fee, if any.\textsuperscript{35} In addition, the creditor must also provide a statement of the hardware and software requirements to access and retain the electronic records and provide a method of consent that demonstrates that the applicant can access the notice and/or appraisal in electronic form.\textsuperscript{36} Lastly, if there is any change to the hardware and/or software requirements that could impact the applicant’s access to the notice or appraisal after consent is demonstrated, the creditor must re-send the hardware and software requirements, again obtain consent in a method that demonstrates that the applicant can access the documents in electronic form, and inform the applicant of the right to withdraw consent without any conditions or consequences.\textsuperscript{37}

The amended rule provides for a waiver of the pre-consummation or account opening delivery of the appraisal or other written valuation. Applicants may waive their right to receive a copy of the appraisal or other written valuation promptly upon completion or within three

\textsuperscript{34} 12 C.F.R. 1002.14(a)(5) and 15 U.S.C. § 7001 et seq.
business days of loan consummation or account opening under certain conditions.\textsuperscript{38} The waiver must be obtained by the creditor at least three business days prior to consummation or account opening unless it is a waiver that relates only to clerical changes from an already provided appraisal.\textsuperscript{39} The applicant may consent to the waiver verbally or in writing.\textsuperscript{40} After the waiver is provided, if the application for credit is not consummated or opened, the creditor has up to thirty days to provide the appraisal.\textsuperscript{41} While a creditor has flexibility in determining whether or not waivers will be offered to applicants, it makes sense to attempt to at least obtain a waiver relating to clerical changes from an already provided appraisal. Otherwise, creditors could face delayed closings if minor changes are made to the final appraisal. Without the clerical changes waiver, creditors are required to provide the latest version of the final appraisal to the applicant at least three business days before consummation or accounting opening.

Compliance with the notice requirements early in the application process and delivery of the appraisal prior to or at closing are important new steps in the loan origination process. Under ECOA, if a creditor fails to follow the requirements set forth above with regard to the notice and delivery of a copy of the appraisal or other written valuation, it is subject to civil liability for actual and punitive damages in individual or class actions (subject to certain limitations) together with costs and reasonable attorney’s fees.\textsuperscript{42} The time period in which an action may be brought was extended from two years from date of occurrence to five years when Regulation B was redesignated under the CFPB in December 2011 pursuant to requirements under the Dodd-Frank

\textsuperscript{38} 12 C.F.R. § 1002.14(a)(1).
\textsuperscript{39} Id.
\textsuperscript{40} Official Interpretations of 12 C.F.R. § 1002.14(a)(1), Comment 6.
\textsuperscript{41} 12 C.F.R. § 1002.14(a)(1).
\textsuperscript{42} 12 C.F.R. § 1002.16(b).
Act.\textsuperscript{43} Given the potential liability exposure and increase in time that an action may be brought, it is important to make sure that creditors have the tools in place to ensure compliance.

Based on the significant impact of the amended ECOA Valuations Rule on the loan origination process and the potential liability exposure if not followed, creditors must take steps to ensure employees understand the requirements of the amended rule. The practical impact of the ECOA Valuations Rule is that creditors need to ensure that their processes, guidelines, systems, procedures, software and other aspects of business operations insure that any time an appraisal or valuation is conducted or obtained for a credit/loan application secured by a first lien on a dwelling, the applicant is provided both notice of a right to a copy of the appraisal or other written valuation and the actual copy itself, promptly upon completion or at least within three business days of loan consummation or account opening. Along with training, operating procedures should be amended to address the new early disclosure requirement on all loans secured by a first lien on a dwelling. Next, appraisal delivery requirements should be outlined, with documentation of delivery in compliance with the rule. With the mandatory appraisal delivery requirement, creditors should also determine when the appraisal fee should be collected in the loan origination process. Finally, if delivery is achieved through electronic methods, creditors must verify that consent is obtained in a way that is compliant with the E-Sign Act.

CONCLUSION

Recent amendments to the ECOA Valuations Rule have forced creditors to re-evaluate the appraisal process on all loans secured by a first lien on a dwelling, regardless of purpose. The new early notice requirement and required delivery of the final appraisal prior to

\textsuperscript{43} 12 C.F.R. § 1002.16(b)(2) and Equal Credit Opportunity Act (Regulation B) 76 Fed. Reg. 79442 (December 21, 2011)(to be codified at 12 C.F.R. pt. 1002).
consummation or account opening regardless of receipt of payment are significant changes to the loan origination process. In order to achieve compliance with the amended rule, creditors should establish standardized procedures and train staff to be aware of new requirements and how they impact the creditor’s loan-making process. Lastly, creditors should consult with legal counsel to fully understand their obligations under the new rule and to help devise policies and procedures to ensure compliance with the revised rule.
A Review and Analysis of the CFPB’s Focus and Enforcement Activity related to Mortgage Origination and Servicing

By: Elizabeth Bohn

Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Act) created and authorized the Consumer Financial Protection Bureau (CFPB or the Bureau) to implement, examine for compliance with, and enforce “Federal consumer financial law.” Under the Act, CFPB has regulatory, supervisory, and enforcement authority of depository institutions and credit unions with total assets of more than $10 billion, as well as certain nonbanks, regardless of size, including mortgage companies, originators, brokers, and servicers.

The CFPB’s authority to implement and enforce “Federal consumer financial law” includes Title X (also known as the Consumer Financial Protection Act or CFPA), which prohibits “unfair, deceptive, or abusive acts and practices” (UDAAP) in connection with offering consumer financial products and services, as well as other enumerated statutes and implementing regulations covering consumer financial products and services. The statutes which the Bureau is authorized to implement and enforce include, but are not limited to, the following statutes regulating aspects of mortgage origination and/or servicing, and their implementing regulations:

- Alternative Mortgage Transaction Parity Act (12 U.S.C. 3801 et seq.);
- Equal Credit Opportunity Act (15 U.S.C. 1691 et seq.);
- Fair Credit Reporting Act (15 U.S.C. 1681 et seq.), excluding 1681m(e) and 1681w;
- Home Ownership and Equity Protection Act of 1994 (15 U.S.C. 1601 note);
- Truth in Lending Act (15 U.S.C. 1601 et seq.);

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1 Ms. Bohn is a Shareholder in the Miami office of Carlton Fields Jorden Burt, P.A. The article discusses activity through March 31, 2014.
Discussion

From its inception, the CFPB has prioritized and focused on mortgage origination and servicing issues, which it views as having contributed to the financial crisis, through new rule making, supervision, and enforcement. This article will examine the CFPB complaint gathering, regulatory and enforcement activity related to mortgage lending and servicing.

(a) Consumer Complaints

In 2012, the CFPB’s complaint portal, an integral part of its data gathering functions began accepting consumer complaints relating to mortgages. The CFPB analyzes consumer complaints, forwards them to the subject entities for response and monitors those responses. On a macro scale, the Bureau analyzes the number and nature of complaints filed against specific entities in deciding when investigation for violation of consumer financial protection laws is warranted. According to the Bureau’s Consumer Response Annual Report for 2013, mortgages were the most complained about product in 2013, accounting for 60,000 complaints, 37% of overall complaints. Most of the mortgage complaints related to consumers’ inability to pay as agreed, including loan modification, collection and foreclosure issues.\(^7\)

In its winter 2013 Supervisory Highlights issued in January of 2014,\(^8\) the Bureau also identified mortgage servicing issues uncovered through its 2013 supervisory activities. Although the issues identified in the report occurred before new mortgage rules went into effect, the Bureau found violations of the CFPA’s ban on unfair, abusive or deceptive acts and practices.\(^9\) Examples of practices it found to be unfair or deceptive in violation of the CFPA included:

- failure of servicers to honor loan modifications after servicing transfers;
- requiring borrowers to waive existing claims in connection with loan modification agreements under broad waiver clauses unrelated to individual circumstances;
- misrepresentations to consumers of bi-weekly mortgage payment plan benefits;
- failing to provide correct information to credit reporting agencies by misreporting short sales as foreclosures, thus negatively impacting consumers’ credit.

The report further stated that CFPB examiners imposed remedial measures and that it has opened investigations for potential enforcement actions. Allegations made in the consent judgment entered against Ocwen Financial Corporation for UDAAP violations,\(^10\) discussed at further at page 9, \textit{infra}, echo many of the servicing issues identified by the Bureau in the Supervisory Highlights.

(b) Rulemaking

By now, the banking industry is well aware of the new mortgage related rules issued in 2012 and 2013 which went into effect in January 2014 and additional rules which are pending.

\(^7\) \url{http://files.consumerfinance.gov/f/201403_cfpb_consumer-response-annual-report-complaints.pdf}.
\(^8\) \url{http://files.consumerfinance.gov/f/201401_cfpb_supervision-highlights.pdf}.
\(^9\) Id.
\(^10\) \url{http://files.consumerfinance.gov/f/201312_cfpb_consent-order_ocwen.pdf}. 
Detailed analysis of the new rules is beyond the scope of this article, but an overview is worthy of mention as the rules were drafted at least in part based on the Bureau’s analysis of consumer complaints and information acquired through supervisory and investigatory activity. Furthermore, based on the CFPB’s enforcement activity of existing rules to date, vigorous enforcement of the new rules must be expected.

New mortgage-related rules include, among others:

**Mortgage Servicing Rules.**\(^{11}\) New mortgage servicing rules which went into effect in January amend Regulation Z (“Reg. Z”), which implements Truth in Lending Act (“TILA”), and Regulation X (“Reg. X”), which implements Real Estate Settlement Procedures Act (“RESPA”). The amendments to Reg. Z require mortgage payments to be credited the date of receipt, accurate payoff balances to be provided within seven days of request, and 210 days advance notice of interest rate adjustments.\(^{12}\) They also prescribe content for rate adjustment notices, and content, delivery and frequency of periodic billing statements. Amendments to Reg. X require servicers to promptly contact delinquent borrowers and offer loss mitigation options and refrain from foreclosure during evaluation for loss mitigation options.\(^{13}\) They also add requirements for responding to consumer requests for information, resolving errors, record retention, servicing transfers, and force placement of hazard insurance.

**Ability to Repay/Qualified Mortgage Rule.**\(^{14}\) Requires financial institutions to make a reasonable good faith determination that a consumer has a reasonable ability to repay the loan, considering factors such as the consumer’s income or assets and employment status, the mortgage loan payment and other ongoing expenses related to the mortgage or property. A presumption of compliance with the rule applies to “Qualified Mortgages,” i.e., those which meet certain underwriting criteria, including eligibility for purchase by a GSE and absence of risky features such as allowing interest only payments, negative amortization, or balloon payments.

**Loan Originator Rule.**\(^{15}\) Prohibits compensation to a loan originator based on the terms of the loan transaction, or a “proxy” for the terms of the transaction. Thus, any rate or cost of a loan which is a term of transaction cannot be the basis for compensation. Under the proxy analysis, pricing of a transaction may relate not only to the terms of the loan, but also on whether the originator has discretion to steer the consumer toward a product with different terms. Also requires individual loan officers, mortgage brokers, and creditors to be “qualified” and, “registered” or “licensed” to the extent required under State and Federal law and imposes duties on loan originator organizations to make sure that their individual loan originators are licensed or registered under the Safe Act.

**Integrated Loan Disclosures.**\(^{16}\) This rule, which takes effect on August 1, 2015, integrates home mortgage disclosures required by TILA and RESPA. The new rule requires two new forms to replace the existing TILA disclosure form and RESPA (HUD) statement: the Loan

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Estimate form, to be provided within three days of a mortgage application and the Closing Disclosure, which must be provided three days before closing a home mortgage.

**Home Mortgage Disclosure Act.** The CFPB is preparing to issue new rules which will require disclosure of far more information to regulators, including additional pricing and underwriting information. It has already issued guidance highlighting requirement of accurate collection and reporting of mortgage data, and begun enforcement actions.

**Home Ownership and Equity Protection Act (HOEPA) Rule.** Requires additional disclosures and protection for consumers for “high-cost” mortgages. Consumer purchase money mortgages, refinances, closed-end equity loans, and open-ended credit plans secured by the consumer’s principal dwelling are subject to the Rule. An analysis of the APR, points and fees, and pre-payment penalties is required to determine whether the transaction is subject to the HOEPA high-cost mortgage requirements.

(c) **Supervision and Examination**

The CFPB’s Supervision and Examination Manual details how supervised entities are examined for compliance with federal consumer financial laws. Additional updated examination procedures have also been issued as new mortgage related rules have taken effect including the following:

- January 10, 2014 – Mortgage Origination examination procedures;
- January 10, 2014 – Mortgage Servicing examination procedures;
- November 27, 2013 – RESPA procedures – home ownership and equity protection (January 2014) and mortgage servicing requirements (January 2014);
- November 27, 2013 – TILA procedures – Higher-Priced Mortgage Loan Appraisals (January 2014), Escrow Accounts (June 1, 2013), Loan Originator Compensation (January 2014), Ability-to-Repay/Qualified Mortgages (January 2014), High-Cost Mortgages (January 2014), and Mortgage Servicing Requirements (January 2014);
- October 9, 2013 – HMDA resubmission schedule and guidelines;
- July 19, 2013 – ECOA baseline review procedures;

(d) **Interagency Cooperation**


18 12 C.F.R. 1024 and 2026, RIN 3170– AA12, 78 FR 6855.
20 12 U.S.C. 5495 directs the Bureau to “coordinate with the Commission, the Commodity Futures Trading Commission, the Federal Trade Commission, and other Federal agencies and State regulators, as appropriate, to
Evidence of interagency information sharing and cooperation appears in the regulations themselves, in administrative complaints and litigation, and in enforcement orders entered jointly with other agencies based on interagency investigations. 21 Entities subject to CFPB supervision should assume that the CFPB has access to information obtained by other agencies which relate to the CFPB’s enforcement authority. Supervised entities should also expect that the CFPB will share information it obtains through its investigations with law enforcement authorities, including state Attorney Generals and the Department of Justice, when it finds evidence of violations of consumer financial protection law which may be subject to criminal prosecution, such as fair lending violations.

(e) Enforcement Activity

In fulfilling its mandate to enforce federal consumer financial law, the CFPB is authorized to conduct hearings and administrative proceedings, including special cease and desist proceedings, or bring litigation in federal courts. 22 Its administrative proceedings have typically been based on violations uncovered in compliance examinations or investigations, often initiated as the result of consumer complaints and conducted jointly with other agencies. 23

The administrative proceedings have typically resulted in consent orders in which the defendant acknowledges the violations charged. The consent orders have also generally included:

- ongoing cease and desist provisions;
- future compliance, monitoring, auditing, record-keeping, and reporting requirements;
- implementation of detailed compliance plans;
- requirements of executive officer and board involvement in compliance;
- refunds, remediation and/or disgorgement; and
- assessment of civil penalties.

In addition to the administrative proceedings, the Bureau has brought actions in federal district courts with other agencies relating to mortgage insurance issued by captive reinsurers, RESPA violations, unfair, deceptive or abusive acts or practices, loan originator compensation, mortgage servicing and ECOA violations, all discussed below.

The Bureau also has an agreement with the National Association of Attorneys General to share investigatory information, coordinate enforcement activities and route complaints between

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21 These two consent orders were entered in 2012 actions jointly filed by the CFPB and FDIC against American Express and Discover Bank, respectively: http://files.consumerfinance.gov/f/201210_cfpb_001_Amex_Consent_Order.pdf; http://files.consumerfinance.gov/f/201209_cfpb_0005_001_Consent_Order.pdf.


23 See footnote 21, supra.
the CFPB and the state attorneys general. The Bureau and state attorneys general have jointly filed lawsuits for violations of consumer protection law.

The Bureau opened its complaint portal in 2011 by first accepting complaints about credit card products. Its first five administrative proceedings, brought in 2012, all involved credit cards and resulted from investigations apparently initiated as a result of consumer complaints. As the CFPB complaint portal did not begin accepting mortgage complaints until 2012, the first mortgage enforcement proceedings were not brought until 2013. Below are summarized the enforcement actions which relate to aspects mortgage origination or servicing through administrative proceedings and litigation.

(f) **2012 Enforcement Activity.**

**Debt Collection Practices.**

The Fair Debt Collections Act (“FDCPA”) prohibits third party debt collectors and debt buyers who acquire and collect delinquent debt from engaging in unfair, deceptive or abusive practices in collecting consumer debt. In 2012, the CFPB, FDIC, OCC and Federal Reserve Board obtained consent orders against three subsidiaries of American Express for deceptive debt collection practices. The FDCPA did not apply because the subject debt was not collected by third parties. However, the agencies found that companies deceived consumers regarding benefits to paying off old credit card debt in violation of the CFPA prohibition on deceptive practices. The companies were ordered to refund $85 million to approximately 250,000 customers for several illegal card practices, including deceptive debt collection. Although mortgage debt was not involved, the basis for the findings in the orders might also apply to mortgage debt collection.

The CFPB also filed an amicus brief in an FDCPA suit against a company collecting mortgage debt in which the consumers claimed to have received harassing and threatening phone calls to induce them to pay mortgage debt to avoid foreclosure. The district court rejected the consumers’ claims on grounds that because the company was also pursuing foreclosure, the challenged practices related to enforcement of a security interest, which does not qualify as “debt collection” under the FDCPA. By its amicus brief, the Bureau persuaded the 11th Circuit to reverse and adopt the Bureau’s position that companies collecting mortgage debt and pursuing foreclosure actions could still qualify as debt collectors.

(g) **2013 Enforcement Activity.**

(1) **RESPA violations – kickbacks for mortgage referrals.**

Section 8(a) of RESPA prohibits giving a "fee, kickback, or thing of value" in exchange for a referral of business related to a real-estate-settlement service. Under RESPA's

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implementing regulations, "[w]hen a thing of value is ... connected in any way with the volume
or value of the business referred," it is evidence that it was given "for the referral of business." 29

In CFPB v. Paul Taylor, et al., 30 the CFPB’s first 2013 administrative proceeding, it
found a residential real estate developer violated RESPA by accepting “fee[s], kickback[s], or
thing[s] of value” in connection with a mortgage servicing joint venture, Stratford Mortgage
Servicing created by the developer with a bank. Under the arrangement, the developer received
payments based on his interest in Stratford in exchange for referrals of customers for mortgage
loans and other real estate settlement services involving federally related mortgage loans.

Prior to the CFPB’s action against the developer, Stratford was dissolved and the FDIC
imposed a civil money penalty on the bank based on its determination that “the Bank violated
[RESPA] by creating and operating a company that was used by [the Bank] as a conduit for
paying unlawful referral fees ... for the referral of mortgage loan customers to the Bank.”
Stratford was the company “used as a conduit for paying unlawful referral fees” and Taylor was
the recipient of those fees. The order is silent as to the amount of the FDIC civil penalty, but the
developer was ordered to disgorge more than $118,000.00 in fees received from the banks which
were found to be kickbacks for referring mortgage origination business, and prohibited from
engaging in future real estate settlement services, including mortgage origination.

(2) RESPA violations – kickbacks through captive reinsurance.

In April 2013, the CFPB filed lawsuits in the Southern District of Florida resulting in
consent judgments assessing over $15 million in civil penalties against four national mortgage
insurers. The CFPB alleged that the insurers received insurance business in exchange for
kickbacks to the lenders in violation of RESPA and the CFPA. 31 The kickbacks were allegedly
provided to the lenders through the purchase by the defendants of reinsurance from the lenders’
captive reinsurers that was essentially worthless.

Specifically, the Bureau asserted that in order to capture a portion of lucrative insurance
premiums, the lenders set up the captive reinsurers and entered into reinsurance arrangements by
which the defendants ceded back a portion of the premiums to the captive subsidiaries. The
CFPB alleged that the ceded payments to the captive reinsurers did not correspond to the portion
of the insurance risk transferred, and that the payments were thus in effect prohibited kickbacks
to the lenders in exchange for the referral of insurance business to the mortgage insurers in
violation of RESPA and the CFPA.

These orders indicate that arrangements between lenders and insurers for reinsurance
through captive reinsurers may not pass CFPB scrutiny, unless the reinsurance has actual value
and the reinsurance premiums correspond to the actual risk reinsured.

(3) RESPA violations – kickbacks to law firm.

In October 2013, the CFPB filed suit in a Kentucky District Court against Borders &
Borders, a Kentucky law firm, for allegedly paying illegal kickbacks for real estate settlement

\[29\] 12 C.F.R. § 1024.14(e).
\[31\] http://files.consumerfinance.gov/f/201304_cfpb_Doc5_Genworth-Final-Order.pdf,
http://files.consumerfinance.gov/f/201304_cfpb_Doc5_MGIC-Final-Order.pdf,
http://files.consumerfinance.gov/f/201304_cfpb_Doc5_Radian-Final-Order.pdf,
referrals through a network of shell companies. The lawsuit alleges that the firm and its principals violated RESPA by operating a network of affiliated companies to pay kickbacks for referrals of mortgage settlement business. When a real estate or mortgage broker with a preexisting arrangement referred a homebuyer to the firm for closing or other settlement services, the firm would arrange for the title insurance to be issued by the corresponding joint venture and the profits split between the joint venture’s owners, i.e., the law firm’s principals and the referring real estate or mortgage broker. The CFPB alleges that the profit sharing arrangement disguised illegal kickbacks, and seeks disgorgement of fees received by the firm for closing services provided to consumers referred by the referring brokerages as well as injunctive relief.

In announcing the lawsuit, the Bureau stated that it would “continue to enforce RESPA’s anti-kickback provisions to protect consumers and honest businesses and deter individuals from engaging in illegal activity.”

(4) HMDA reporting violations.

In consent orders entered in administrative proceedings brought against Washington Federal and Mortgage Master, Inc., the CFPB found, based upon its examinations and sampling of Home Mortgage Disclosure Act (“HMDA”) data, that the mortgage lenders violated HMDA reporting requirements and that their compliance management systems did not maintain procedures reasonably adapted to avoid errors in their HMDA data reporting.

The Washington Federal Consent Order states that as part of its supervision and examination of the bank for HMDA compliance, the CFPB conducted a data integrity review of a sample of its HMDA reporting data and found a 38% error rate. In addition to correcting the data, the Consent Order required Washington Federal to cease and desist violating the law, submit a comprehensive written compliance plan to the CFPB for approval, to include, inter alia, reporting requirements, regular testing of data integrity, and training on HMDA requirements. A $34,000.00 civil penalty was also assessed.

Unlike Washington Federal, Mortgage Master was not an insured depository institution, and the Massachusetts banking regulators had previously found excessive error rates in its HMDA reporting for 2007, 2009 and 2010. The CFPB began a data integrity review in 2012 that found that Mortgage Master’s error rate violated CFPB thresholds. The Mortgage Master Consent Order contained provisions similar to those in the Washington Federal order, but also assessed civil penalties of $425,000 by reason of the current and past violations.

5. Fair Lending/ECOA pricing violations

The CFPB has emphasized preventing and addressing discrimination in loan pricing. In a December 20, 2013 consent order, the CFPB ordered Ally Bank, an indirect auto lender, to pay approximately $80 million in refunds and $18 million in penalties for an alleged pattern of discrimination against minorities in setting interest rates. The CFPB and DOJ used a proxy based analysis in finding the alleged pattern of discrimination in the Ally Bank case. Their

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34 Washington Federal is an insured depository institution with assets exceeding $10 billion.
methodology employed combined geographic and name-based probabilities, based on census bureau data. The joint race and national origin probabilities were then used in the CFPB and DOJ models to estimate disparities in dealer markup on the basis of race or national origin.

Only three days after entry of the Ally Bank Order, the DOJ and CFPB jointly filed a complaint and proposed consent order against National City Bank in a Pennsylvania District Court requiring PNC Bank, as successor to National City Bank, to establish a $35 million settlement fund for African-American borrowers allegedly affected by discriminatory mortgage loan pricing. The agencies allege that National City Bank’s discretionary pricing and compensation policies caused the discriminatory pricing differences. Specifically, National City Bank gave its loan officers and brokers the discretion to set borrowers’ rates and fees, and then compensated the officers and brokers from extra costs paid by consumers. The complaint alleges African-American and Hispanic borrowers paid higher costs because of this discriminatory pricing and compensation scheme.

(6) UDAAP in Mortgage Servicing

On December 16, 2013, the CFPB and 49 state attorneys general filed a consent judgment in the District of Columbia against Ocwen Financial Corporation and Ocwen Loan Servicing, the nation’s largest non-bank mortgage servicer (“Ocwen”). According to the CFPB, Ocwen engaged in “systemic misconduct” in mortgage servicing which allegedly pushed consumers into foreclosure. Ocwen was ordered to provide $2 billion in principal reduction to underwater borrowers and refund $127 million to borrowers already foreclosed upon. The CFPB and Attorneys Generals specifically found that the company violated the CFPA’s UDAAP prohibitions when it:

- failed to timely and accurately apply payments made by borrowers;
- failed to maintain accurate account statements;
- charged borrowers unauthorized fees for default-related services;
- imposed force-placed insurance on consumers when it knew or should have known that they already had adequate home-insurance coverage;
- provided false or misleading information in response to consumer complaints;
- failed to provide accurate information about loan modifications and other loss mitigation services;
- failed to properly process borrowers’ applications and calculate their eligibility for loan

39 An act or practice is “unfair” under the CFPA if it (1) causes or is likely to cause substantial injury to consumers; (2) such injury is not reasonably avoidable by consumers; and (3) such injury is not outweighed by countervailing benefits to consumers or to competition. 12 U.S.C. § 5531(c). An act or practice may be considered "deceptive" under the CFPA if the act or practice (1) misleads or is likely to mislead the consumer; (2) the consumer's interpretation of the act or practice is reasonable under the circumstances; and (3) the misleading act or practice is material. This is the FTC definition of deception, http://www.ftc.gov/ftc-policy-statement-on-deception, which is incorporated in the CFPB Supervision and Examination Manual: http://files.consumerfinance.gov/f/201210_cfpb_supervision-and-examination-manual-v2.pdf.
modifications and provided false or misleading reasons for denying loan modifications;
- failed to honor previously agreed upon trial modifications with prior servicers;
- deceptively sought to collect payments under the mortgage’s original unmodified terms
  after the consumer had already begun a loan modification with the prior servicer;
- engaged in illegal foreclosure practices and mishandling foreclosures by providing false
  or misleading information to consumers about the status of foreclosure proceedings
  where the borrower was in good faith actively pursuing a loss mitigation alternative also
  offered by Ocwen, and robo-signing foreclosure documents, including preparing,
  executing, notarizing, and filing affidavits in foreclosure proceedings with courts and
  government agencies without verifying the information.

As mentioned in the CFPB’s Winter Supervisory highlights discussed above, at page 2,
Ocwen’s mortgage servicing errors occurred before the new mortgage servicing regulations went
into effect, but were still found to be in violation of the Act’s UDAAP prohibitions.

(h) 2014 Enforcement Activity through March 31st

A consent order issued in CFPB v. Fidelity Mortgage Corporation and Mark Figert, the
Bureau’s first administrative action of 2014, adjudicated violations of RESPA’s prohibition on
giving "fee, kickback, or thing of value" in exchange for a referral of business related to a real-
estate-settlement service under agreement between mortgage company’s office lessor to refer
home mortgage loans to mortgage company lessee. Required disgorgement of $27,000.00 in
“origination” fees, and assessed $54,000.00 civil money penalty to be paid by Fidelity Mortgage
Corporation, and its former owner and current president, Mark Figert.40

In late January, the CFPB initiated an administrative proceeding against PHH
Corporation, PHH Mortgage Corporation, PHH Home Loans LLC, Atrium Insurance
Corporation, and Atrium Reinsurance Corporation, alleging that PHH harmed consumers
through a mortgage insurance kickback scheme dating back to 1995. The notice of charges
accuses PHH of having received as much as 40% of premiums paid to mortgage insurers.41 The
Bureau alleges that PHH manipulated its allocation of mortgage insurance business to maximize
kickback reinsurance payments for itself and accuses PHH Corporation and its affiliates of:

- **Kickbacks**: Setting up a system whereby it received as much as 40% of the premiums
  that consumers paid to mortgage insurers;

- **Overcharging Loans**: Charging more for loans to consumers who did not buy mortgage
  insurance from one of its kickback partners and charging these consumers additional
  percentage points on their loans; and

- **Creating Higher-Priced Insurance**: Pressuring mortgage insurers to “purchase” its
  reinsurance with the understanding or agreement that the insurers would then receive
  borrower referrals from PHH; continuing to steer business to its mortgage insurance
  partners even when it knew the prices its partners charged were higher than competitors’
  prices.

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The CFPB is seeking a civil fine, a permanent injunction and victim restitution. The complaint in the PHH Action echoes claims made by the CFPB in its 2013 action against mortgage insurers who paid for captive reinsurance discussed above.

In February 2014, a consent order was entered in the Bureau’s administrative proceeding against Alliance Lending for violating RESPA prohibitions on paying unearned fees in a real estate settlement.\(^{42}\) Alliance provided loss mitigation financing for homeowners in the form of new mortgage loans, receiving a loss mitigation fee at closing of each new mortgage. Alliance financed the new mortgages under warehouse facilities and split the loss mitigation fees with the warehouse lenders. After changing warehouse lenders, it continued to split origination fees with the original lenders even though they no longer provided financing. Alliance self-reported the potential RESPA violation of paying unearned settlement fees prompting a CFPB investigation and order assessing $83,000.00 in civil money penalties and requiring production of numerous non-privileged materials as requested by the CFPB. In announcing the consent order, CFPB director Cordray referred to CFPB Bulletin 2013-06,\(^{43}\) which encouraged self-reporting of violations and extensive cooperation by targeted entities with agencies in investigations. Cordray also stated in the announcement that CFPB would “continue to take into account the self-reporting and cooperation of companies in determining how to resolve such matters.”

Conclusion

The CFPB’s enforcement activity to date has not included the new mortgage rules. It is the author’s opinion that the new servicing rules which went into effect in January, which substantially revise servicer duties concerning communications with borrowers, and in particular, delinquent borrowers, will be a major source of future enforcement activity. Moreover, the enforcement activity pursued to date with respect to the CFPA, RESPA, and other existing consumer protection laws, indicates the Bureau will likely continue to:

- analyze and pay serious attention to consumer complaints in initiating investigations, enforcement actions, and enacting new regulations;
- implement new regulations in response to consumer complaints;
- conduct joint investigations of potential violations with state and federal law enforcement agencies;
- refer ECOA violations to DOJ for criminal prosecution;
- bring joint enforcement actions with attorneys general and DOJ;
- seek disgorgement of funds received in violation of Federal consumer law, injunctive relief, and civil money penalties;
- order remedial measures which include extensive overhaul of institutional compliance management systems and impose rigorous new reporting obligations;
- broadly define UDAAP in the mortgage origination and servicing context;
- closely examine mortgage servicing practices and find that the practices mentioned in the Ocwen order above are in violation of UDAAP;


- closely examine all fees and payments related to, and the structure of mortgage origination arrangements for violations of RESPA anti-kickback provisions;

- closely examine mortgage reinsurance arrangements and the value of such reinsurance in the context of RESPA anti-kickback provisions;

- vigorously pursue Fair Lending complaints and use proxy analysis to analyze disparate impact for purposes of finding ECOA violations;

- reduce or eliminate civil penalties – but not disgorgement or remediation remedies - when entities self-report and cooperate in investigations; and

- vigorously enforce consumer financial protection laws without regard to industry compliance costs.
A CASE STUDY OF THE ENFORCEABILITY OF YIELD MAINTENANCE CLAUSES

By Adam C. Hall

With interest rates at historically low levels following the financial crisis of 2008, many commercial borrowers have challenged the enforceability of yield maintenance prepayment clauses contained in commercial real estate loan documentation. These challenges have given rise to a considerable amount of case law that is instructive as to what might constitute a properly drafted yield maintenance prepayment clause and whether a properly drafted yield maintenance prepayment clause is enforceable. This article provides a brief case study of the enforceability of yield maintenance prepayment clauses that are commonly found in commercial real estate loans.

A Typical Yield Maintenance Prepayment Clause

Yield maintenance prepayment clauses are nothing new and these clauses are often included in commercial real estate loan documentation. The purpose of a yield maintenance prepayment clause is to protect a lender in the event of early prepayment of a loan during times when interest rates are falling. As such, a yield maintenance formula is calculated to cover the lender’s reinvestment loss when the loan to be prepaid bears a superior rate to the current market rate.

An example of a typical yield maintenance prepayment clause is as follows:

(i) one percent (1%) of the then outstanding principal balance of this Note; or

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1 Mr. Hall is a Shareholder with the law firm of Crowe & Dunlevy, A Professional Corporation, in Oklahoma City, Oklahoma, and is a member of the firm’s Banking and Financial Institutions practice group.

2 This memorandum focuses on the enforceability of a yield maintenance prepayment clause in the context of voluntary prepayment; it does not address instances where payment of the yield maintenance premium arises from acceleration or default. However, several bankruptcy courts have recently held that yield maintenance clauses in commercial loans are enforceable in a Chapter 11 bankruptcy. See In re GMX Resources, Inc., et al., No. 13-11456 (filed April 1, 2013); In re School Specialty, Inc., No. 13-10125, 2013 WL 1838513 (Bankr. D. Del. Apr. 22, 2013); In re AMR Corp., 485 B.R. 279 (Bankr. S.D.N.Y. 2013).


4 River East, 498 F.3d at 721.

(ii) at the time of receipt by Payee of the Notice, the difference between (a) the then present value of all unpaid installments of principal and interest due and payable under this Note, calculated from the date of the proposed prepayment to the Maturity Date, discounted at the “Reinvestment Rate” (as hereinafter defined) and (b) the outstanding principal balance under this Note on the date of the proposed prepayment.\(^6\)

The “Reinvestment Rate” referred to in a yield maintenance prepayment clause is typically defined as or tied to the yield to maturity on a United States treasury bond or note.\(^7\) This type of yield maintenance prepayment clause is commonly referred to as a “Treasury-flat” because the remaining interest due under the loan is discounted by the current interest rate on United States Treasuries.\(^8\) Additionally, this type of yield maintenance prepayment provision is described as “Treasury-flat” because parties often negotiate a discount rate that is different from the Treasury yield.\(^9\)

**Significant Cases Upholding Yield Maintenance Prepayment Clauses**

The Seventh and Eighth Circuit appellate courts have held that yield maintenance prepayment clauses such as the example above are enforceable.\(^10\) The case of *River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co.*, 498 F.3d 718, 721 (7th Cir. 2007) involved a loan used to finance a significant commercial real estate development.\(^11\) The borrower sold the property and prepaid the loan balance; however, it later brought suit against the lender arguing that the prepayment clause (or yield maintenance premium) was unenforceable.\(^12\) The trial court awarded judgment in favor of the borrower and the lender appealed.\(^13\) The Seventh Circuit Court of Appeals reversed the trial court’s ruling and held that the yield maintenance premium was fully enforceable under Illinois law.\(^14\)

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\(^6\) See id. Brief of Appellee (River East Plaza, LLC), at p. 7.

\(^7\) Id.

\(^8\) *River East*, 498 F.3d at 721.

\(^9\) Id. at 720.

\(^10\) See generally *River East*, 498 F.3d 718 (7th Cir. 2007); *Great Plains Real Estate Development, L.L.C. v. Union Central Life Ins. Co.*, 536 F.3d 939 (8th Cir. 2008).

\(^11\) *River East*, 498 F.3d at 719.

\(^12\) Id.

\(^13\) Id.

\(^14\) Id.
The “Treasury-flat” language in the above example is a direct quotation from the yield maintenance prepayment clause at issue in the River East case. The Seventh Circuit Court of Appeals described the yield maintenance clause in the River East loan as follows:

[T]he note contained a yield maintenance calculation which the parties describe as ‘Treasury-flat.’ To arrive at the amount of the yield maintenance fee in the event that River East decided to prepay, the parties would need to know the outstanding principal as of the date of prepayment and the scheduled loan payments from that date to maturity. They would also need to determine the prevailing interest rate on United States Treasury bonds or notes maturing closest to the loan’s maturity date... With those three amounts in hand, the clause calculates the difference between the scheduled payments and potential interest if the prepaid principal were invested in Treasuries. That amount is compared to an amount equal to one percent of the outstanding principal. The larger of these two numbers is then compared with the highest rate allowed by law, and the lesser of those numbers is the yield maintenance fee.\(^{15}\)

Applying the terms of the yield maintenance clause meant that if River East elected to prepay the loan, it would be required to pay the lender the difference between what the lender “would have received in interest over the life of the loan” and what the lender “could receive by investing the prepaid principal into Treasuries.”\(^{16}\) In other words, the lender could invest the prepaid principal and prepayment premium into Treasuries and “the expected yield that [the lender] bargained for would be ‘maintained’ by River East supplementing the interest on the reinvested funds with the prepayment fee.”\(^{17}\)

To determine if the yield maintenance clause was fully enforceable under Illinois law, the court first considered whether to analyze the issue under a “liquidated damages” analysis or a “form of alternative performance” analysis.\(^{18}\) The borrower argued that the yield maintenance clause was a penalty disguised as liquidated damages and the lender argued that the yield maintenance clause was a “bargained-for form of alternative performance.”\(^{19}\) The court ultimately analyzed the issue under a liquidated damages analysis to determine whether the yield maintenance clause was an enforceable method of calculating liquidated damages or was an

\(^{15}\) River East, 498 F.3d at 720-21 (emphasis in original).

\(^{16}\) Id. at 721.

\(^{17}\) Id.

\(^{18}\) Id.

\(^{19}\) Id.
unenforceable penalty. In its analysis, the court relied on the general rule that “when the sole purpose of the clause is to secure performance of the contract, the provision is an unenforceable penalty.”

The court held that the yield maintenance provision was an enforceable method of calculating liquidated damages and was not an unenforceable penalty. The court made its determination by reviewing the “relative value of the alternatives” and compared the amount of the yield maintenance premium paid by the borrower to the amount of interest that the borrower would have paid over the life of loan. That court noted that “[b]y electing an option to pay early, River East avoided paying the $13 million in remaining interest payments that would have been due between 2003 and 2020, and instead paid only $3.9 million. Even assuming, due to the time value of money, that the $3.9 million was worth more in 2003 than it would have been worth over the course of the loan, River East seems to have benefitted from this bargain.”

In the case of Great Plains Real Estate Development, L.L.C. v. Union Central Life Ins. Co., 536 F.3d 939 (8th Cir. 2008), the Eighth Circuit Court of Appeals also held that a prepayment premium in a commercial loan was enforceable under Iowa law. The borrower in this case brought suit against the lender to recover the amounts paid under a prepayment premium clause in a promissory note. The trial court granted summary judgment in favor of the lender and the borrower appealed. On appeal, the Eighth Circuit Court of Appeals determined that the issue of enforceability of the prepayment premium should be analyzed as a “form of alternative performance” rather than liquidated damages. The Court determined that the note gave the borrower the choice of paying according to the note’s terms or prepaying the

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20 Id. (Recognizing that “some liquidated damages clauses cross the line and become penalty clauses in disguise, [therefore] the underlying question is whether this clause is punitive in nature.”).

21 Id. at 722.

22 Id.

23 Id.

24 Id. at 722-23.

25 Great Plains, 536 F.3d 939, 945 (8th Cir. 2008).

26 Id. at 942.

27 Id.

28 Id. at 945 (“Under Iowa law, liquidated damages are a remedy for breach of contract. Where a party retains control over the manner of performance, ‘alternatives are not damages provisions but rather performance alternatives.’”). Citing Superfos Inv. Ltd. v. FirstMiss Fertilizer, Inc., 821 F. Supp. 432, 434 (S.D. Miss. 1993).
note in full along with payment of the prepayment premium. 29 “When [the borrower] elected to prepay, [the borrower] was not breaching the contract but was in fact acting in accordance with an express option provided under the contract.” 30

The Eighth Circuit Court of Appeals relied upon the decision of In re A.J. Lane & Co., 113 B.R. 821, 829 (Bankr. Dist. Mass. 1990) and determined that the amount of the prepayment premium was reasonable even if it was viewed as liquidated damages. 31 In Lane, the court suggested that “any prepayment charge should be wholly or largely dependent upon…the difference in the interest yield between the contract rate and the market rate at the time of prepayment, projected over the term of the loan and then discounted to arrive at present value.” 32 The court reasoned that the prepayment clause in Great Plains “was calculated based upon prevailing market rates in an attempt to calculate” the lender’s actual loss of earnings and was therefore “reasonable at the time the agreement was reached.” 33 As such, “[e]ven if the [prepayment premium] were treated as a liquidated damages provision, the [prepayment premium] is enforceable because it constituted a reasonable assessment of the actual or anticipated loss caused by the breach.” 34

Recommendations

As demonstrated by the decisions in the River East and Great Plains cases, a yield maintenance prepayment clause drafted in a “Treasury Flat” manner is generally enforceable whether viewed under a “liquidated damages” or “method of alternative performance” analysis. A properly drafted yield maintenance prepayment clause should not be punitive in nature or result in a penalty to the borrower upon prepayment. Rather, the method of calculating the amount of the prepayment premium should fairly measure the lender’s reinvestment loss when the loan to be prepaid bears a superior rate to the current market rate.

29 Great Plains, 536 F.3d at 945.
30 Id.
31 Id.
32 Id.
33 Id.
34 Id.
Is Mortgage Electronic Registration Systems, Inc. Liable for Assignment of Mortgage Recording Fees?

By Stephen M. Hladik, William E. Miller and Pamela L. Cunningham

In a battle playing out across the country in multiple forums, there is a debate about whether the Mortgage Electronic Registration Systems, Inc. or its parent corporation MERSCORP, Inc. (hereafter, MERS) is liable to the local county recorder of deeds offices for recording fees for assignments of mortgage. This article examines the types and locations of the cases, the status and the legal questions involved. The article also focuses on the matter currently pending in the United States District Court for the Eastern District of Pennsylvania where the Montgomery County Recorder of Deeds, Nancy J. Becker, has recently succeeded in obtaining class certification in her action against MERS.

Background of the MERS System

By way of background, it is first necessary to examine what exactly MERS is, and its role in the mortgage marketplace. MERSCORP is a Delaware corporation that has its principal place of business located at Reston, Virginia. MERS is a subsidiary of MERSCORP. MERS is made up of member organizations that include residential mortgage lenders and servicers. One of the ideas behind the creation of MERS was to maintain a registry of ownership of the loans secured by mortgages. Mortgages could be originated naming MERS as the original mortgagee, and with MERS therefore appearing in the local recorder of deeds office as the mortgagee of record. When a particular loan would be originated, a borrower would execute a promissory note to the lender and a mortgage naming MERS as the mortgagee as nominee for the lender.

After origination, as loans or notes sold or changed hands, the MERS registry would track ownership of the loan, but MERS would still remain on the local county office as mortgagee of record. It is important to note that “MERS does not itself originate, assign, or service mortgages, but instead charges a fee when participating members transfer mortgages on the MERS Registry.”

“[A]mong other benefits to the mortgage industry, MERS proponents claimed that ‘once MERS is established as the mortgagee of record, all subsequent transfers of ownership would be recorded electronically, eliminating the need to physically prepare, deliver, record, and track assignment documents. The estimated cost savings for assignment processing for a single transfer would be an average of $45.50 per loan.’”

The effect of this registry system is that it avoids a great deal of time and cost to lenders each time a loan changes hands, as there is no need to create, execute, and record an assignment of mortgage.

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2 These are sometimes known as “MOM’s” – MERS as Original Mortgagee.
3 County of Ramsay v. MERS Corp., et al., United States District Court for the District of Minnesota, 13-474.
**Background of Litigation**

A movement began across the country focusing on whether, when a loan was transferred or specifically assigned, the recorder of deeds office, in its capacity as the record keeper of mortgages in the local jurisdiction, would be entitled to a recording fee. This section of the article examines a chronological history of opinions throughout the states as to how the issue is playing out.

**The Montgomery County, Pennsylvania, Class Action**

Nancy J. Becker, the Recorder of Deeds of Montgomery County, Pennsylvania, initiated an action against MERS in the United States District Court for the Eastern District of Pennsylvania, challenging that MERS had deprived the county of revenue by failing to record assignments. The Recorder also raised the issue that this “shadow” of hidden assignments also served to harm the public and to deprive the residents of Montgomery County from knowing whom truly owned a particular loan that was on the county records.

As will be discussed in the summary of the growing body of decisions regarding these issues involving MERS, the various counties or governmental bodies that brought actions against MERS and related lending institutions all followed similar theories: claims of unjust enrichment, failure to follow recording laws, claims of civil conspiracy, and requests for injunctive or declaratory relief. Likewise, throughout the country, MERS responded to the lawsuits in similar fashions. Most of the actions were removed from state courts to a federal venue. Almost all cases were either decided on motions to dismiss or summary judgment. The theories advanced in those cases were, generally, that recorders lacked standing to bring such actions, that recording statutes did not grant private rights of action, or that the particular state law did not affirmatively require recording to begin with.

Throughout the cases decided in the last two years, MERS has racked up an impressive record of success – which in ways makes the Montgomery County case stand out. As will be discussed, while Montgomery County is premised in Pennsylvania recording statutes, it is notable as the case has recently received class certification.

By way of background, Montgomery County initiated its class action on November 7, 2011. The defendants thereto moved to dismiss, and the Court denied the motion in almost its entirety on October 19, 2012. The defendants filed an additional motion to dismiss the quiet title claim on December 10, 2012. After disposition of the motions to dismiss, two claims remained: unjust enrichment and quiet title. The Court denied that second motion to dismiss on March 6, 2013, and Plaintiff moved for class certification on April 26, 2013. Via an Opinion on February 12, 2014, the Court issued its decision certifying the class.

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5 Id. at 454.
7 Id. at *13.
Montgomery County contended that Pennsylvania’s recording statute requires that all mortgage assignments be recorded.\(^8\) As such, the County argued that the beneficial owners of mortgages were avoiding recording fees when they transferred these loans.\(^9\) “The Defendants… moved to dismiss, arguing principally that the Pennsylvania recording statute, 21 Pa. Stat. § 351, does not require that mortgage assignments be recorded and that, even if it did, no private right of action exists to enforce the requirement.”\(^10\)

In response, the Court:

conclude[d] that the recording statute does require recordation of all conveyances. We further conclude that we need not reach the question whether the recording statute creates an implied right of action to enforce this requirement because the Legislature intended the quiet title action to permit such relief. And, because we conclude that the Plaintiff has pleaded sufficient facts to state a quiet title claim, we deny the motion to dismiss on these bases. We also conclude that the Plaintiff has pleaded sufficient facts to proceed on her unjust enrichment claim but not on her civil conspiracy claim; the civil conspiracy claim is therefore dismissed.\(^11\)

The Court based its conclusion on the Pennsylvania recording statute which states:

All deeds, conveyances, contracts and other instruments of writing wherein it shall be the intention of the parties executing the same to grant, bargain, sell, and convey any lands, tenements, or hereditaments situate in this Commonwealth, upon being acknowledged by the parties executing the same or proved in a manner provided by the laws of this Commonwealth, shall be recorded in the office for the recording of deeds in the county where such lands, tenements, and hereditaments are situate . . . .\(^12\)

The Court read this section to contain mandatory language for recording: “The statutory command is therefore quite clear: ‘all . . . conveyances . . . shall be recorded in the [relevant] office for the recording of deeds.’”\(^13\) As described below, courts in other jurisdictions, when interpreting somewhat similar statutory language, concluded that this type of mandate did not mandate the actual recording of a document, but rather mandated where the recording must be. The defendants in Montgomery County made that argument, and the Court rejected it. The Court concluded it could not read any words into a statute, especially since doing so in this instance would change the effect or meaning of the language.\(^14\)

Being that the Court concluded that recording was mandatory, the next issue was whether the recorder of deeds had the power to bring an action. The Court reviewed Pennsylvania’s quiet title procedures, and concluded “that Pennsylvania law permits any person in any manner

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\(^9\) Id. at 441.
\(^10\) Id. at 442.
\(^11\) Id. at 443.
\(^12\) Id. at 443-444; 21 Pa. Stat. Ann. § 351 (emphasis added).
\(^14\) Id. at 444.
interested in a conveyance, such as a mortgage assignment, to bring a quiet title action under Pennsylvania Rule of Civil Procedure 1061(b)(3) to compel the person with the appropriate documents in his or her possession to record them.”

Being that the recorder of deeds pleaded facts sufficient to maintain a quiet title claim, the Court likewise then concluded that she could maintain her claims for declaratory and injunctive relief. The Court also permitted the claim of unjust enrichment to proceed, but dismissed the civil conspiracy claim.

After the second motion to dismiss was decided, the defendants eventually answered the complaint. The Montgomery County Recorder of Deeds has now been granted class certification. Presently before the Court are motions for summary judgment. Time will tell whether this Recorder succeeds in recovering recording fees for her county. For now, however, she has clearly prosecuted her claim further than any of the other jurisdictions where these cases have been attempted.

Below is the analysis of state by state decisions in chronological order.

Kentucky, February 21, 2012

In Christian County Clerk v. Mortgage Electronic Registration Systems, Inc., et al., filed in the United States District Court for the Western District of Kentucky, the Court addressed a motion of MERS (and the large banking institutions who had also been named as defendants) to dismiss the complaint pursuant to Federal Rule 12. The County Clerks for Christian County and Washington County initiated the action, naming MERS, its parent company, and fifteen lending institutions. The plaintiffs asserted three claims: “(1) negligent and/or willful violation of KRS § 382.360; (2) unjust enrichment by willful violation of Kentucky statutes; and (3) civil conspiracy to violate KRS § 382.360.” The Court started out its analysis by noting that, “Under Kentucky law, when a mortgage is assigned to another person, the assignee is required to record that assignment in the County Clerk’s Office.” The Court gave a history of the MERS system and how the registry works, and then turned its attention to the defendant’s motion to dismiss, which was premised upon claims:

that (1) the Plaintiffs lacked standing; (2) the statutes in question do not provide a right of action for county clerks; (3) the Plaintiffs lack authority to file a damages lawsuit; (4) Kentucky law imposes no duty to create assignments; (5) Plaintiffs are not entitled to receive any of the relief they seek; and (6) the conspiracy count fails to allege an underlying tort.

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15 Id. at 445.
16 Id. at 451-52.
20 Id., citing KRS § 382.360.
21 Id. at *2.
The first item addressed by the Court’s opinion was whether the plaintiffs lacked Article III standing to initiate the action. The Court concluded that “Plaintiffs have alleged injury to its financial interest caused by the actions or omissions of Defendants and seek redress in this Court. At this stage of the litigation, these allegations are sufficient to establish Article III standing.”

Therefore, the Court turned next to whether there is a private right of action for the plaintiffs. The Court stated “Defendants maintain, and the Court agrees, that Michael Kem and Glen Black, the County Clerks for Christian and Washington counties, do not have statutory standing to assert a claim against the Defendants under KRS § 382.360 and KRS § 382.365.”

The Court cited section 382.360, specifically “[w]hen a mortgage is assigned to another person, the assignee shall file the assignment for recording with the county clerk within thirty (30) days of the assignment….” The Court stated that “[t]here was nothing in the plain language of the statute that indicates that the statute was designed to be enforced by the county clerk.”

The Court looked at the other recording statutes and noted that private rights of action can only be maintained by any owner of real property under the recording statutes. “Thus, the legislature conferred standing upon real property owners or parties acquiring an interesting real property, not upon county clerks, with respect to enforcing the mortgage assignment recording obligations of KRS § 382.360 and KRS § 382.365.”

Alternatively, the plaintiffs argued that a different section of state law provided a remedy for violation of the recording statute. The Court flatly disagreed with that argument. In order to use KRS § 446.070, the plaintiff would have to be a member of a class of persons which was to be protected by the particular regulation. The Court noted that, “the county clerks are not members of the class of persons the General Assembly intended to protect by the recording statutes cited by Plaintiffs. Here, the class of persons intended to be protected by Kentucky's land recording system consists of existing lienholders seeking to give notice of their secured status; prospective purchasers and creditors seeking information about prior liens; and owners of property seeking release of liens once debts are paid off.”

The court stated that “nowhere in KRS § 382.360 and KRS § 382.365 has the General Assembly provided any indication that it passed those statutes to protect county clerks. This conclusion is reinforced by the fact that the General Assembly chose to grant a private remedy for enforcement only to those with an interest in the property.”

The court then concluded by saying, “Furthermore, the lack of intent to protect the County Clerks is further demonstrated by the fact that the recording fees Plaintiffs seek to

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22 Id.
23 Id.
24 Id., quoting KRS § 382.360.
25 Id.
26 Id. at *3.
27 Id. at *4.
28 Id.
recover are not mentioned in the recording statutes, but rather are contained in an entirely different chapter, KRS § 64.012. Since the Plaintiffs do not fall within the class protected by the statutes, summary judgment on this basis is proper.”

Florida, June 27, 2012

The case was also visited in Florida. On or about September 6, 2012, MERS issued a statement on the Florida appeal. In that particular instance the Clerk of the Circuit Court of Wall County Florida voluntarily dismissed his appeal to the 11th Circuit Court of Appeals in the matter of Fuller v. MERS. The press release for MERS noted that MERS expected the appellate court to sustain the holding of the trial court which dismissed the case with prejudice on June 27, 2012. As such, the matter is settled in Florida that the MERS System is permissible.

Iowa, August 21, 2012

Next is the matter of Plymouth County, Iowa v. MERSCORP, in the United States District Court for the Northern District of Iowa. In that particular opinion, the Court was once again faced with the issue of whether MERSCORP, as an “owner and operator of a national registry that tracks ownership interests and servicing rights associated with residential mortgage loans” could be held liable for failure to record assignments of mortgages.

In addition to MERS, the complaint also named various lenders who were referred to as the “member defendants.” The matter was originally filed in state District County Court in Plymouth County, and was removed to the federal court on the basis of diversity. In addition to claims relating to the failure to record assignments of mortgages as required by law, the County, as in the other cases, asserted “claims for unjust enrichment, civil conspiracy, piercing the corporate veil, declaratory judgment and injunctive relief.”

The defendants moved to dismiss the action premising their argument mainly on the fact that the Iowa recording statutes would have no private right of action in favor of the County. Consistent with other cases, the defendants also argued that there was no obligation to record mortgages or assignments under Iowa law, and therefore that the County had no right to bring the action.

The Court summarized the position of the County, quoting directly from the complaint:

106. In order to avoid the payment of recording fees to Plymouth County and the other Class members, MERS Members caused MERS to appear in the public land records of Plymouth County and the Class as mortgagee of record on mortgage loans that MERS Members registered on the MERS System. MERS serves as mortgagee of record with respect to all such mortgage loans solely as

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29 Id.
31 Id. at 1116.
32 Id. at 1116-17.
nominee, in an administrative capacity, for the beneficial owner or owners thereof, and their successors and assigns.

107. By naming MERS as the mortgagee of record, MERS and MERS Members, through the MERS System, intended to and did transfer mortgages among MERS Members without recording such transfers in the public land records of Plymouth County and the Class, and without paying the attendant recording fees.

108. But-for the existence of the MERS System, such transfers would have been recorded and the required recording fees would have been paid by MERS and/or the MERS Members in order to properly transfer mortgages for purposes of mortgage securitization's and otherwise.33

In the motion to dismiss, the defendants asserted that the county’s claims were dependent upon allegations that the holder of assignments of mortgages was required to record those mortgage assignments.

The first argument addressed by the Court in rendering its decision related to the allegations of recording requirements. The Court stated that the County’s “allegations assume that any assignment or transfer that changes the mortgagee of record must be recorded, and that it is only by keeping MERS as the mortgagee of records that such a requirement is avoided.”34

The Court noted that the other counts in the complaint depended upon a violation of a requirement to record the mortgage assignments. The Court stated “the County’s attempt to recharacterize its claims as in no way dependent upon a requirement to record mortgage assignments is disingenuous at best. The claims plainly are based on such an alleged requirement.”35

From there the Court went on to analyze the Iowa recording scheme and whether there is an outright requirement that assignments be recorded. The Court states that there is no such requirement of recording of assignments in that state: “it could be not be plainer that none of the statutes upon which the County relies imposes a requirement on a party assigning a mortgage or receiving such an assignment to record the assignment.”36

The Court goes on to finally indicate that the sections of the Iowa Code impose “no duty or requirement on a mortgagee or assignee to record an assignment.”37 The statute only imposes a duty upon the recorder of deeds to record any assignment that is delivered to the recorder.

As in the other cases, the recorder of deeds filed claims for unjust enrichment. The Court noted that the County’s unjust enrichment cause of action would rely upon “an alleged—but

33 Id. at 1118-19
34 Id. at 1122.
35 Id. at 1122-23.
36 Id. at 1123.
37 Id. at 1124.
nonexistent—legal requirement to record assignments of mortgages, as the basis for the contention that the defendants’ conduct somehow resulted in enrichment that was ‘unjust.’”\footnote{Id. at 1125.} Essentially, with the fact that there is no requirement to record an assignment, there could therefore be no missed assignment recording fees, and, accordingly, no unjust enrichment. For those reasons on May 1, 2012 the District Court dismissed the action.

Arkansas, September 17, 2012

The issue was also visited in the matter of \textit{Mayme Brown v. MERS}, United States District Court for the Western District of Arkansas.\footnote{Docket number 6:11–CV–06070.} Before the Court in this particular opinion was the motion of the defendants to dismiss the action. In this particular case, the Circuit Clerk of Hot Springs County, Arkansas, filed an action against the MERS’ defendants, alleging that the defendants used the MERS System “to deprive Arkansas counties of recording fees.”\footnote{U.S.D.C. AR, Opinion at p. 1.} The Clerk contended that the deprivation of recording fees amounted to a violation of the Arkansas Deceptive Trade Practices Act. In addition, as with the other cases, the County Clerk argued that the deprivation of recording fees served to unjustly enrich the defendants. The Clerk filed the case in a state court, and defendants removed the action to federal court.

The Court stated, “The essential point of Plaintiff’s claims is that Defendants are using MERS to deprive Arkansas counties of recording fees Defendants should be paying but are avoiding through MERS.”\footnote{Id. at 2.} The Clerk contended “that Defendants have a duty to record mortgages and to record them truthfully.”\footnote{Id.}

The Court stated that this claim rested “on two alleged duties: (1) a duty to record every mortgage transfer; and (2) a duty to record every mortgage transfer truthfully.”\footnote{Id. at 3.} Defendants moved to dismiss, saying that Arkansas law imposed no such duty to record a mortgage.

The first area the Court addressed was Plaintiff’s argument that the defendants’ use of the MERS System amounted to an “illegal–exaction claim” under the Arkansas State Constitution. The Arkansas court indicated that such an illegal-exaction claim “is properly brought by a \textit{citizen} to protect \textit{against} the enforcement of any illegal execution.”\footnote{Id. at 4, citing Ark. Const. art. XIII, § 13.} The action is premised upon the Arkansas state constitution, and in this instance, the particular recorder was “not a taxpayer suing because the government made an illegal exaction.”\footnote{Id. at 5.} Rather, the Clerk is a receiver of taxes suing private entities that she claims illegally withheld recording fees. As such, that claim failed to state a claim and was dismissed with prejudice.

The Court next turned its attention to the Deceptive Trade Practices Act and unjust enrichment claims. In order to determine the legal sufficiency of those claims, as in with the
other cases explored herein, the Court was required to examine Arkansas law on recording statutes.

In this particular instance, the Court plainly stated that Arkansas' laws do not require assignments of mortgage to be recorded.46 “In Arkansas, a recorded mortgage provides constructive notice to subsequent purchasers that the subject property is encumbered by the mortgage.”47 However, the Court noted that even an un-recorded mortgage is valid between the parties thereto, and constitutes a lien that could be at enforced against the particular mortgagor.48 Therefore, the mortgage’s legal effectiveness “as to the original parties is not diminished if the mortgage goes unrecorded.”49 In this particular instance, with no requirement under Arkansas law that there be a recorded mortgage, let alone a recorded assignment, there would be no basis for the Plaintiff’s claim.

The Clerk also argued that MERS and the other defendants “have imposed upon themselves by contract a duty to record a mortgage when the underlying loan debt is sold to a non-MERS purchaser—in other words, when a mortgage leaves the MERS member pool.”50 The Court found little validity to that argument stating that “[t]he Court thus finds that Plaintiff is not a third-party beneficiary of Defendants' contracts, and may not enforce any recording duty contained therein.”51 The last argument for the Plaintiff was there was a duty for truthful recording. The defendants argued that if they have no duty to record a mortgage in the first place then there is no duty to record and track truthfully. The Court noted that recording is for their own benefit so, therefore, the Court stated, “the Court thus finds that Defendants have no legal obligation to record truthfully that is enforceable by Plaintiff.”52 For those reasons, on September 17, 2012, the Court dismissed the case, resulting in another victory for MERS.

Missouri, January 14, 2013

The next opinion relating to the MERS issue is *Jackson County, Missouri v. MERSCORP*, in United States District Court for the Western District of Missouri.53 This action was filed by Jackson County, Missouri, naming as defendants MERSCORP as well as other lending institutions. Plaintiff’s allegations therein arose from defendants’ alleged “failure to record deeds of trust assignments and failure to pay the applicable recording fees.”54 The class-action sought to address the economic and public harm caused by the use of the MERS System as a private electronic registry designed to avoid recording and internally track ownership of servicing rights.55

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46 Id.
48 Id.
49 Id.
50 Id. at 6.
51 Id. at 7.
52 Id.
54 Id. at 1067.
55 Id.
Based upon the alleged use of the scheme to avoid recording fees, the plaintiff asserted five causes of action: unjust enrichment, civil conspiracy, *prima facie* tort, declaratory judgment, and injunctive relief. This complaint also sought to pierce the corporate veil of MERS and MERSCORP. The defendants moved to dismiss contending “that the Missouri recording statutes create no private cause of action in favor Jackson County, that Jackson County lacks standing because it cannot recover recording fees for assignments it never recorded, that there is no duty under Missouri law to record deed of trust assignments, and that Jackson County’s allegations fail to state claims upon which relief can be granted.”

The Court first addressed the issue of whether the plaintiff had standing to bring the action. With regard to standing, the Court said, “Plaintiff has alleged an injury to its financial interest in the form of lost recording fees caused by the actions of Defendants and seeks redress in this Court.” The “Plaintiff alleges it has suffered an injury in the form of an inaccurate county land records. These allegations are for sufficient to establish Article III standing.”

Since the plaintiff had standing, the Court next turned to whether a private right of action exists for the purpose of alleged violations of statutes on recording of assignments. The defendants alleged that “the Missouri General Assembly did not create a private right of action to enforce alleged violations of statutes concerning recording assignments of deeds of trust.” Plaintiff responded by saying that it was not seeking to enforce alleged violations, but rather that the County was suing to collect lost funds. The Court sided with the plaintiff that the plaintiff had standing to bring the action.

Being that there was standing to being the action, the Court first focused on count one of the complaint for unjust enrichment. The Court analyzed the elements of unjust enrichment which are rather similar throughout the country. Under Missouri law, the Court cited *Johnson v. Estate of McFarlin ex rel. Lindstrom* for the elements of unjust enrichment, stating, “(1) the plaintiff conferred a benefit on the defendant; (2) the defendant appreciated the benefit; and (3) the defendant accepted or retained the benefit under inequitable or unjust circumstances.”

In the argument for dismissal, the defendants relied on two cases discussed herein: the MERS case out of the Middle District of Florida and the Iowa case. The defendants cited these for the proposition that the unjust enrichment claim could not stand. In order to first analyze whether there was a claim for unjust enrichment under Missouri law, the Court focused on whether there is a duty to record assignments under Missouri law. The Court cited to Missouri Revised Statute § 443.035, which states that “Security instruments may be assigned..., and may be recorded in the office of the recorder of deeds in the county or counties in which the security instrument being assigned was recorded.” The Court cited to *Sando v. Phillips*, stating,

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56 Id. at 1068
57 Id.
58 Id.
59 Id. at 1069.
60 Id., quoting 334 S.W.3d 469, 474 (Mo. Ct. App. 2010).
61 Id. at 1070, quoting Mo. Rev. Stat. § 443.035 (emphasis in opinion).
62 319 S.W.2d 648, 653(Mo. 1959).
“There is no duty on a grantee to record a deed, and the failure to record does not in any way affect the validity of a deed between parties.”

The Court stated that “Plaintiff’s unjust enrichment claim is premised on the notion that Defendants acted improperly by not recording assignments after initial deeds of trust were recorded…” To support its argument, the plaintiff cited to the Montgomery County case. The Court stated, “However, Plaintiff’s reliance on Montgomery County only highlights the flaw in its claim. In that case, the court found the plaintiff’s allegations stated a viable unjust enrichment claim because Pennsylvania’s recording statute requires that all assignments be recorded.” The Court then stated, “Unlike the Pennsylvania statute at issue in Montgomery County, under Missouri law, there is no duty record deeds of trust or other assignments.” As such, the Court dismissed count one for unjust enrichment.

The plaintiff in this case premised the civil conspiracy claim on the basis of its unjust enrichment claim. With the failure of the unjust enrichment claim, the plaintiff’s claim for civil conspiracy also had to fail because it was based on the same scheme that was alleged to be unjust. As such that claim was dismissed.

Next, the Court turned to the claim for prima facie tort. In this case, “Plaintiff’s Amended Complaint merely asserts that Defendants ‘intended that their conduct would injure’ Plaintiffs.” The Court stated that, “[u]nder Missouri law, the mere awareness that one’s conduct would harm the Plaintiff is not enough to establish an actual intent to injure; Plaintiff must prove that Defendant acted with ‘specific, clear-cut, express malicious intent to injure.’” Defendants pointed out, “the Amended Complaint’s factual allegations demonstrate that Defendants intended only to save money and time by not recording assignments.” Therefore, there was no such intent to injure and the prima facie tort claims was dismissed.

The Court addressed the declaratory relief and injunctive relief request together. In order to sustain an injunctive relief case, the plaintiff would have to allege some type of wrongful conduct on the part of a defendant such that an injunction would be appropriate relief. The Court concluded that, “Plaintiff’s injunctive relief remedy is not attached to a viable claim because this Court has dismissed Plaintiff’s common law claims.” Therefore, the counts for declaratory relief and judge injunctive relief were dismissed as well.

63 Jackson County, Missouri, 915 F.Supp.2d at 1070, quoting Sando v. Phillips 319 S.W.2d 648, 653(Mo. 1959).
64 Id. at 1070.
65 Id. at 1070-71.
66 Id. at 1071.
67 Id. at 1072.
68 Id., quoting Tamko Roofing Products, Inc., 450 F.3d at 381.
69 Jackson County, Missouri, 915 F. Supp.2d at 1072.
70 Id. at 1073.
The matter was also visited in the United States District Court for the Southern District of Illinois in *Union County v. MERSCORP, Inc., et al.* \(^{71}\). In this particular case, it had originally been filed in state court and then removed to federal court. The Plaintiff claimed that the defendants’ system and registry tracking ownerships of mortgage loans failed to comply with Illinois applicable recording statutes. “According to Plaintiffs, MERS ‘masquerades’ as the title holder, while shareholder/members actually prepare ‘MERS’’s initial mortgage assignments for record.” \(^{72}\)

As such, the recorder brought the complaint for four claims: (1) declaratory judgment / injunctive relief, (2) restitution and civil penalties for violation of the Illinois Consumer Fraud Act, (3) restitution for unjust enrichment, and (4) damages relating to a civil conspiracy to violate Illinois recording laws. The defendants jointly moved to dismiss, first claiming that the plaintiffs had no standing to bring the action, and, second, that no duty to record an assignment of mortgage exists under applicable Illinois law.

The Court began with a review of the language of Illinois’s recording statute, 765 ILCS 5/28 and the fee statute, 55 ILCS 5/3-5018. Premised upon those two statutes, defendants argued that the plaintiff had no right to bring this private right of action.

The Court stated, that “[u]nderlying the bulk of Defendants’ argument for dismissal (and their most consequential argument) is that there is no duty to record mortgages or assignments in Illinois.” \(^{73}\) Defendants, in further reliance upon the statutory language of the recording statute, noted that the statute only refers to where a recording is to occur. The statute does not state that a recording must occur. Being that there are no legal mandates for recording, the defendants contended that the claims for unfair deceptive active practices, unjust enrichment, civil conspiracy and declaratory judgment had to fail along with the main claim.

The Court in its initial analysis noted all of the decisions relating to this MERS issue, including citations to 13 other cases including the *Montgomery County* case. “The Court has reviewed these cases, but does not borrow any of the rationale – as it is directive of Illinois’s recording statute that is dispositive here.” \(^{74}\)

“The Court finds that the question of whether or not Illinois law requires Defendants to record all mortgages and substantive assignments is dispositive. If there is no duty to record, then the complaint states no claim for relief for violation of ICFA, unjust enrichment, civil conspiracy, or any declaratory or injunctive relief.” \(^{75}\) The Court reviewed various decisions from Illinois law to determine whether or not recording of mortgages is mandatory. “The Illinois

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72 Id. at 925.
73 Id. at 927.
74 Id. at 929 (emphasis in original).
75 Id. (emphasis in original).
Supreme Court mentioned no such duty created by any Illinois statute, and here, Plaintiffs have provided no alternate source of a duty to record.76

The Illinois recording statute reads:

Deeds, mortgages, powers of attorney, and other instruments relating to or affecting the title to real estate in this state, shall be recorded in the county in which such real estate is situated; but if such county is not organized, then in the county to which such unorganized county is attached for judicial purposes. No deed, mortgage, assignment of mortgage, or other instrument relating to or affecting the title to real estate in the State may include a provision prohibiting the recording of that instrument, and any such provision in an instrument signed after the effective date of this amendatory Act shall be void and of no force and effect.77

The defendants argued that there are no provisions within the statute for this type of enforcement or any outright requirement that a document be recorded. Based upon a review of case law from Illinois and that statutory scheme, the Court concluded that there is no fraud in the failure to record a document. The Court went on to state, “the only non-absurd, non-inconvenient way to read the language of the law itself and the language of Illinois appellate courts is to read that the law ‘requires’ a recording only insofar as a mortgagee’s interest in property might otherwise be in jeopardy.”78

The Court concluded, “[t]he statute does not create a general, public cause of action arising when an instrument is not recorded. Therefore, in context and upon consulting Illinois Supreme Court and appellate court decisions, the Court finds that, by the plain meaning of 765 ILCS 5/28, there is no mandatory duty to record here and Plaintiffs’ complaint fails to state any claim upon which relief may be granted.”79 As such the Court dismissed the actions.

Oklahoma, April 24, 2013

In the Board of County Commissioners of the County of Cleveland v. MERSCORP, Inc.,80 the Court addressed MERS’s and Citimortgage’s motions to dismiss. In that particular case, the Board of County Commissioners of the County of Cleveland, filed “a putative class action on behalf of the Cleveland County Clerk and all other similarly situated offices in Oklahoma, seeking to compel Defendants to record mortgage assignments, past and future and to pay the associated fees as required by statute.”81 The recorders asserted that MERS and the lending defendants violated Oklahoma law by failure to record assignments of mortgages. The defendants moved to dismiss the action under two primary bases. First, MERS contended that

76 Id. at 930.
77 765 ILCS 5/28 (Empasis added). This language is similar to the Pennsylvania Recording Statute. In this instance, the Illinois court did not read this to mandate recording, but rather to dictate where it should be recorded.
78 Union County, 920 F. Supp.2d at 931.
79 Id. at 932.
80 District Court of Cleveland County, OK, Docket number CJ-2011-1727.
81 Oklahoma Opinion at para. 1.
46 O.S. § 1, *et seq.*, does not require their mortgages to be recorded. Second, the defendants argued that, even if the Oklahoma recording statutes required recordation of a mortgage, there would be no private right of action to enforce such a requirement.

The Court took notice of lawsuits of this type from all over the country. The Court also noted the most of the cases “have been dismissed based upon the law applicable in that state...”82 The Court actually referenced the *Montgomery County* case. However, the Court noted that each side in this particular matter in Oklahoma was relying upon matters from other jurisdictions as this was a case of first impression in the state.

The Court stated that, “no authority is presented where the recording statutes and other underlying law of the state at issue are congruent with Oklahoma law.”83 The Court found a way to differentiate both the *Jackson County Missouri* case and *Montgomery County* case.

The Court stated that “[i]t is clear from a plane reading of the statutes that recording of mortgages and assignments is mandatory under Oklahoma law.”84 While deciding that recording mortgages is mandatory in Oklahoma, the Court stated that “[t]he next argument is far more difficult—whether the legislature intended to confer a private right of action to enforce the statutes at issue.”85 The plaintiff relied on the *Montgomery County* decision. This Court in Oklahoma stated that none of the arguments in the *Montgomery County* case decided this particular issue. In *Montgomery County*, the cause of action could be recast as a quiet title action under Pennsylvania law while “[t]his remedy is not available under Oklahoma law....”86

The Court indicated that the case must be dismissed because Oklahoma law did not confer any kind of private right of action on the recorder of deeds. The Court stated:

None of the language in the statutes at issue lend to any interpretation other than providing for the rights directly effected by the mortgage or assignment. These statutes clearly have the purpose of providing notice to the world of asserted interest in property and do not convey a cause of action other than to those with a direct interest in the property or mortgage. Based upon the authority presented, this Court finds there is no private right of action to enforce the provisions of 46 O.S. § 1, *et seq.*”87

The Court likewise found that the county’s argument for unjust enrichment failed as well. To finalize the matter, the Court also dismissed any claim for civil conspiracy.

82 Id. at para. 3.
83 Id.
84 Id. at para. 4.
85 Id. at para. 5.
86 Id.
87 Id.
Michigan, May 3, 2013

The issue was brought before the court in the United States District Court for the Western District of Michigan in the matter of Hertel and Hutchins v. Mortgage Electronic Registration Systems, Inc.88 This case is mentioned as it involved MERS and recording issues, though the case is somewhat different, in that it focused on whether realty transfer taxes were due, as opposed to fees for missing assignments.

On or about November 10, 2011, Hertel, who is the Register of Deeds of Ingham County, and Hutchins, Register of Deeds from Branch County, filed a complaint in the state court. Defendants removed the matter to federal court. In that matter, the defendants first raised the issue of whether the plaintiffs had standing to bring the suit.

Plaintiffs contended that MERS and the other defendants violated the Michigan State Real Estate Transfer Act and the County Real Estate Transfer Tax Act (CRETTA), specifically, Michigan law sections 207.502 and 207.523, by improperly claiming exemptions from them. The first argument related to the plaintiffs’ standing to bring the action. “In Michigan, a governmental entity or officer may only exercise those powers which it or he has been expressly granted.”89

The bank defendants and MERS argued that the plaintiffs lacked standing to bring the action because Michigan did not authorize any Registry of Deeds to file a lawsuit. Plaintiffs countered that argument by claiming that they were not suing as register of deeds, but instead as authorized as representatives of their counties.90 The Court agreed with the defendants, and held that the individual Register of Deeds did not have standing to bring the action, even on behalf of the County.

While finding that the plaintiffs lacked standing, the Court indicated that the defect in standing could perhaps be cured by amendment. However, the Court stated that because it believed dismissal was warranted no matter who the plaintiff was, the Court proceeded to analyze the underlying merits of the case. The defendants argued that the case must be dismissed because the real estate transfer tax act did not confer any kind of private right of action on the register of deeds. Plaintiffs conceded that there is no express right of action under the statute. However, they argued that there should still be a private action as it must be inferred because somebody would have to have a right to bring action to ensure collection of unpaid transfer tax.

The Court ultimately stated that, “the lack of clarity over whether the state can enforce the CRETTA, and the fact that dismissal is warranted in the case on the merits, the Court declines to imply a private right of action for the CRETTA.”91

89 Id. at *2, citing Citizens for Protection of Marriage v. Board of State Canvassers, 688 N.W.2d 538, 541 (Mich. Ct. App. 2004).
91 Id. at *5.
The Court noted that even if there were a private right of action under that law, the claims should still be dismissed. The bank defendants all argued that “these instruments are exempt from taxation under the CRETTA and are not required to conform to CRETTA’s drafting requirements.” The Court ruled in favor of MERS on that argument.

**Minnesota, August 26, 2013**

In the matter of **County of Ramsey v. MERSCORP Holdings, et al.**, in the United States District Court for the District of Minnesota, the Court began its opinion on a motion to dismiss by examining Minnesota law on recording: “[e]very conveyance of real estate shall be recorded in the office of the county recorder of the county where such real estate is situated.” In the action, Ramsay County argued that whenever a mortgage was transferred on the MERS Registry, an accompanying assignment of mortgage (and recording fee) should have been lodged with the appropriate recorder office. In its action, Ramsay County made claims for declaratory relief, unjust enrichment and public nuisance.

MERS and the lender defendants moved to dismiss the action pursuant to Federal Rule 12. The first argument by the defendants was that the recorder lacked standing to bring the action. The District Court disposed of that argument in one paragraph, stating that the averment of loss of recording fees was sufficient to establish Article III standing. The Court then turned to the motion to dismiss.

The Court looked at Minnesota statute 507.34. The defendants argued that this particular section was permissive, and did not require recording. The statute itself states that “every such conveyance not so recorded shall be void as against any subsequent purchaser . . . .” Thus, the statute implies that there could be conveyances where such a document was not recorded.

The Court started with an examination of the legislative intent behind section 507.34. The Court noted that it must give effect to all the words of the statute, and just not a partial sentence. In other words, the entire statute section had to be read as a whole. When doing so, the Court agreed with MERS that the statute did not require recording of all instruments that are conveyances of land. The use of the mandatory word “shall” in the section referred to where the particular document must be recorded, not that it must be recorded. Indeed, when read in conjunction with the next phrase, the Court concluded that it was apparent that recording was not required.

To further bolster its argument, the Court pointed out that in other areas governing mortgages and recording of documents, the state legislature was quite specific in its desire of

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92 Id. at *6.
94 Id. at 1085, quoting Minn. Stat. Section 507.34.
96 Minn. Stat. 507.34.
97 County of Ramsey, 962 F. Supp. 2d at 1086, quoting Minn. Stat. 507.34 (emphasis added).
when documents must be recorded. As such, the Court concluded that there was no basis for declaratory relief. As the claim for declaratory relief failed, the other counts for unjust enrichment and public nuisance likewise failed and the entire case was therefore dismissed.

Massachusetts, November 14, 2013

Next is Bristol County v. MERSCORP Inc., out of the Superior Court of the Commonwealth of Massachusetts. This case consists of three consolidated actions: Bristol County, Norfolk County and Plymouth County all challenged the MERS System, contending that the defendants were unjustly enriched under the MERS System, and as such, the counties sought disgorgement of benefits that MERS and the lender defendants received.

In this opinion, the Court first took a look at what documents are executed at the time a lender issues a secured loan. The borrower signs two documents: the promissory note and the mortgage. A lender then takes possession of the promissory note which note can be freely sold. The mortgage is a contract that transfers legal title to the property to the mortgagee. Under Massachusetts law, a mortgage and a note can be held by two different persons.

The court noted that under the way MERS operates, a borrower and a lender contractually agree that MERS will be designated as a mortgagee under the mortgage document. Thus, MERS holds the security interest. When the loan (i.e., the Note) transfers within the “MERS System, the transfer is simply tracked within the system, and MERS remains as the mortgagee, now acting as the nominee of the new holder of the note.”

The Counties contended that the defendants were unjustly enriched. In other words, the County argued that, as members of MERS System, lenders are able to make multiple assignments (or transfers) of mortgages, without having to record any assignments or pay an accompanying recording fee to the County. MERS the other defendants’ primary argument was that there was no unlawful conduct in the action. As the Court noted, “[t]he gravamen of each Complaint is that the defendants wrongfully failed to pay recording fees on mortgage assignments.” However, as noted previously, Massachusetts law does not require recording of a mortgage or an assignment, there is no cause of action.

In addition, the defendants argued whether the plaintiffs had standing to bring the actions. The Court noted that this argument provided an additional basis for allowing a motion to dismiss:

The claim for unjust enrichment alleges that the defendants received two benefits. The first was that they were able to avoid paying a recording fee in connection with an assignment from one MERS member to another. But the Registry of

98 Superior Court of Mass., No. 12-1246-BLS2, consolidated with 12-1247-BLS2 and 12-1251-BLS2.
99 Id. at 2.
101 Id. at 3.
102 Id. at 3-4.
Deeds is entitled to charge such fees only if it performs the public service to which the fee relates.\textsuperscript{103} 

The Court noted that “[h]aving recorded no document which would entitle them to a fee, plaintiffs cannot be said to have suffered any legally cognizable injury.”\textsuperscript{104} The Court further went on to analyze a second alleged benefit unjustly conferred upon the defendants. The Court noted that laws regarding assignments “were passed not to assist counties in raising revenue. Rather, their purpose is [to] give notice of a creditor’s interest in property and to protect potential purchasers and lenders who rely on certain documents.”\textsuperscript{105} For those reasons, the Court on November 14, 2013 entered the order dismissing the proposed class actions.

Texas, March 4, 2014

The next case is \textit{Dallas County, Texas v. MERSCORP, Inc.}, from the United States District Court for the Northern District of Texas.\textsuperscript{106} In that matter, the Court’s ruling on cross-motions for summary judgment filed on November 12, 2013.

In the action, the Plaintiffs requested that a declaratory judgment be entered based upon Texas local Government code § 192.007(a). That section reads:

Records of Releases and Other Actions

(a) To release, transfer, assign, or take other action relating to an instrument that is filed, registered, or recorded in the office of the county clerk, a person must file, register, or record another instrument relating to the action in the same manner as the original instrument was required to be filed, registered or recorded.

(b) An entry, including a marginal entry, may not be made on a previously made record of index to indicate the new action.\textsuperscript{107}

Essentially, Dallas County argued that the MERS System enabled lenders to avoid the filing, registering, recording another instrument relating to the action in the same manner as the original instrument was required to be filed, registered, or recorded.\textsuperscript{108}

Dallas County initiated the action against MERS where:

[t]he gravamen of Dallas County’s complaint is that Defendants conspired to create a private electronic mortgage registration system for tracking ownership interests and servicing rights associated with residential mortgage loan mortgage loans. According to Dallas County, this system usurps the county clerk’s role

\textsuperscript{103} Id. at 5.
\textsuperscript{104} Id.
\textsuperscript{105} Id. at 5-6.
\textsuperscript{107} Tex. Local Gov’t Code §192.007.
\textsuperscript{108} See, generally, \textit{Dallas County, Texas}, 2014 WL 840016, at *1 and Tex. Local Gov’t Code § 192.007.
under the statutorily created recording systems in a manner inconsistent with Texas law, thereby depriving Dallas County of recording fees and corrupting its real property records.\textsuperscript{109}

The counties asserted claims for unjust enrichment, negligent, grossly negligent and fraudulent misrepresentations, as well as other negligence claims, conspiracy and state statutory claims for alleged violations of the Texas Civil Practice and Remedies Code and Texas Local Government Code. The counties also sought monetary damages and declaratory and injunctive relief.

In an earlier opinion of November 4, 2013, the Court granted summary judgment in favor of the defendants as to the Counties’ claims for fraudulent misrepresentation and unjust enrichment, as well as the derivative claims for civil conspiracy and request for declaratory and injunctive relief.

The request for summary judgment by the defendant stated first that the state statutory sections impose no duty to record assignments of previously recorded deeds of trust. Defendants contend that the statutory scheme tells the county clerk how to record a document. In other words, that is not a substantive mandate mandating that anyone must record anything.

Second, the defendants argued that the Court should enter summary judgment because § 192.007 does not require anyone to present or create assignments or other documents. Finally, the defendants argued (as did the other defendants in the other matters) that there was no private right of action permissible by the counties to enforce that section. As such, the counties would be barred from seeking declaratory relief.

First addressing the issue of whether the counties could seek declaratory judgment, the Court noted that “[t]he Declaratory Judgment Act allows a federal court to ‘declare the rights or other legal relations of any interested party seeking such declaration.’\textsuperscript{110} However, the Federal Declaratory Judgment Act does not create a substantive cause of action. In other words, it is not an independent source of a federal jurisdiction.

The Court, citing the United States Supreme Court stated, “‘since its inception, the declaratory judgment actions been understood to confront federal courts unique and substantial discretion in deciding whether to declare the rights of litigants.’\textsuperscript{111} The Court therefore rejected Dallas County’s claim.

\textsuperscript{109} Dallas County, Texas, 2014 WL 840016, at*2.

\textsuperscript{110} Id. at *7, citing 28 U.S.C. § 2201(a).


\textsuperscript{112} Id. at *8.
The Court stated, “[i]n short, the Court determines that the county declaratory judgment claim is barred by the Court’s previous dismissal of the counties’ section 192.007 substantive claim for lack of a private right of action under the statute. As the federal declaratory judgment act is procedural, it is not creating an independent private right of action, defendants are entitled to judgment as a matter of law on the Counties’ declaratory judgment claim.”\(^\text{113}\)

The Court went on to state that, alternatively, even if the county could seek declaratory relief, that the counties have not properly interpreted the statute requiring recordation of intermittent interim instruments, such as assignments of the deeds of trust.

The Court also discussed the motion of the County to reconsider the order dismissing the remaining claims. The Court noted that being that § 192.007 does not impose upon a lender a duty of recording assignments, that there was no basis to reconsider the prior ruling. Thus, judgment was granted in its entirety in favor of defendants and against the plaintiff. That order was entered by the United States District Court on March 4, 2014, and it dismissed the counties’ claims with prejudice.

**Conclusion**

As the Montgomery County Recorder has succeeded in obtaining class certification, it will be interesting to see how this issue ultimately plays out. MERS has won an overwhelming number of the legal battles, but could MERS ultimately lose the war?

\(^{113}\) Id. at *9.